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Venezuela Outlook: Another Year of Double-Digit Contraction

BY JUAN PABLO FUENTES — MAY 31, 2019
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- GDP contracted 22.5% y/y in the third quarter of 2018.
- The annual inflation rate remains well into hyperinflation territory.
- Exports revenues will decline at a faster clip in 2019.
- Recovery is improbable without a resolution to the political crisis.

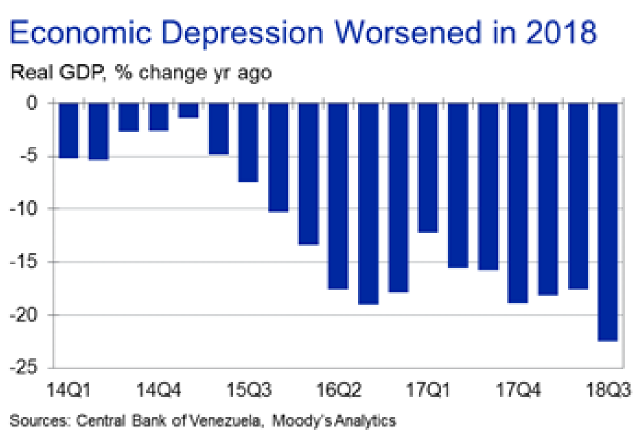
For the first time since 2016, Venezuela's central bank has released basic economic statistics, and they paint a bleak picture. The central bank, the entity officially in charge of economic statistics, released figures for GDP, inflation, and the external sector covering the last three years. The bank did not explain its decision to finally publish economic statistics or say if it will continue to do so.

The decision was likely prompted by the International Monetary Fund's expulsion warning issued last year. To avoid expulsion, which could prove costly for the government, the government must provide accurate and timely updates on core macroeconomic data.

Economic contractions

The economy contracted 17% in 2016, followed by a 15.7% drop in 2017, and a 19.4% contraction in the first nine months of 2018. These figures are generally in line with our estimates, though 2018 readings depict an even larger contraction. Given that deterioration occurred in late 2018 due to the collapse of the oil sector, the economy likely contracted by more than 20% for the year.

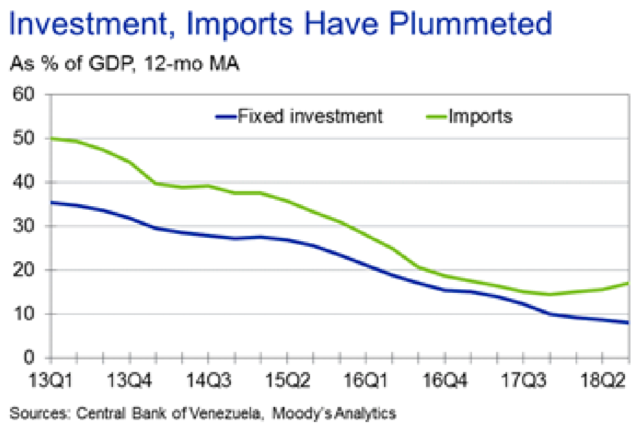
The economy contracted 22.5% y/y in the third quarter of 2018, the largest year-on-year drop since the depression started in 2014. GDP in the third quarter of 2018 was just 48% of the GDP in the third quarter of 2013. The oil economy, which accounts for about 12% of total GDP, contracted 25.8% y/y in the third quarter of 2018. When looking at domestic demand components, private consumption fell 24% y/y in the third quarter of 2018, while fixed investment slumped 47.3%. Imports rose 8.2% y/y, though this mostly reflects a low comparison base. Meanwhile, exports contracted 32.1% y/y amid free-falling oil output.



The economy's rate of contraction likely accelerated in late 2018 and into 2019 amid the imposition of oil sanctions by the U.S. and the collapse of the domestic electricity power system. The deterioration of the political and social climate and the imposition of severe credit restrictions have also hindered economic activity since the third quarter of 2018.

Investment plummets

GDP figures confirmed the sharp contraction in investment and imports during the last few years. Fixed investment represented 35% of GDP by early 2013, before the depression started. By late 2018, fixed investment accounted for just 8% of GDP, a historical low. The collapse of investment spending has hindered output severely, especially in key sectors such as construction, manufacturing and retail. Construction GDP represented only 1.5% of total GDP in 2018, compared with 7.7% in 2013. Manufacturing output accounted for just 8.5% of GDP in 2018, compared with 13.7% in 2013.

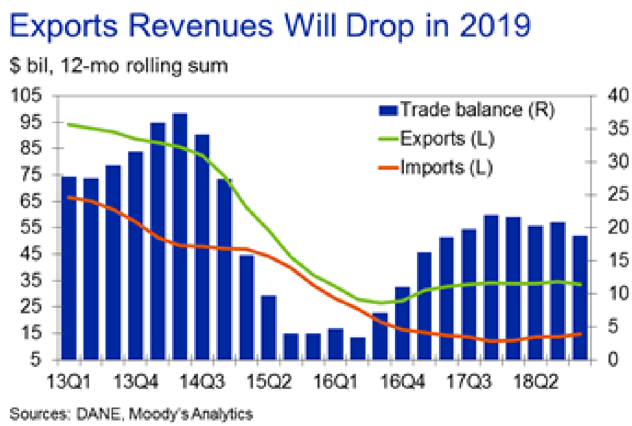


The collapse of investment has been partly the result of a similarly large decline in imports. With no access to foreign financing and with limited foreign currency reserves, the government was forced to cut imports dramatically since 2014. As a result, imports went from representing 50% of GDP in 2013 to just about 16% in 2018. Imports of capital goods all but disappeared as the country faced an increasing foreign currency crunch. Without access to imports, other forms of investment such as infrastructure spending came to a halt. This situation has extended into 2019, as the foreign currency crunch has only deepened following the oil sanctions imposed by the U.S. early in the year.

Trade surplus narrows

The central bank also released balance of payment statistics for 2016, 2017 and 2018. As expected, nominal imports plummeted along with exports. Imports reached US$14.9 billion in 2018, compared with US$65 billion in 2012. Somewhat surprisingly, imports rose 23.6% last year compared with 2017. The increase was because of a 117% jump in oil imports—nonoil imports dropped 25.7% in 2018. Amid declining domestic oil output, the government was forced to increase imports of oil products needed to process Venezuela's heavy crude. However, imports will likely decline in 2019 as oil imports slump amid U.S. sanctions.

Total export revenues reached US$33.7 billion in 2018, down 1% from the previous year. Oil exports declined 5.4% despite a 25% increase in prices, but still accounted for 90% of total exports in 2018. Nonoil exports jumped 52.7% last year thanks mostly to a sharp increase in gold sales. The Venezuelan government has been selling its gold reserves to finance imports and its foreign obligations. Yet gold reserves have been mostly depleted by now, which indicates that nonoil exports will decline in 2019. Total export revenues will decline at a faster clip in 2019 amid plummeting oil output and softer prices.



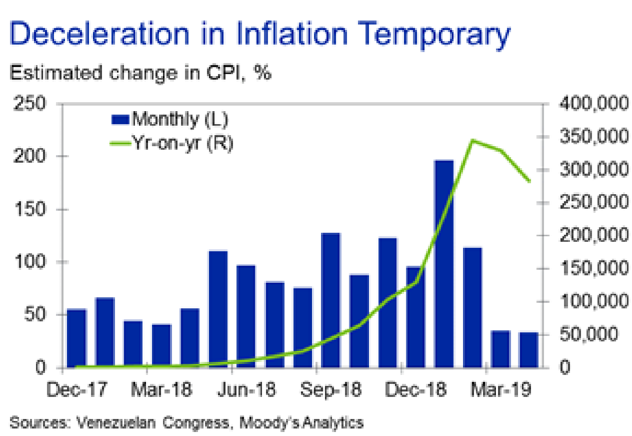
The trade surplus reached US$18.8 billion in 2018, down from US$22 billion in 2017. The overall current account surplus, which includes services and income balances, reached US$6.3 billion, down from US$8.7 billion in 2017. Remittances reached a record US$2 billion in 2018 amid the migration wave. Without remittances, the current account surplus would have been only US$4.3 billion in 2018.

After taking into consideration the capital account deficit, the country's overall balance of payments recorded a small surplus in 2018. This means that foreign currency reserves were mostly unchanged by the end of 2018. That said, foreign currency reserves remain at a historical low, providing little buffer. With oil export revenues declining at faster rate in 2019, the government will have no option but to cut imports again or drop foreign reserves even further.

Inflation slows, temporarily

According to the central bank, the monthly rate of inflation decelerated sharply in March and April. Official figures put the monthly inflation rate at 34.8% for March and 33.8% for April, the lowest reading since October 2017. The monthly inflation rate peaked at 197% in January, according to the recently released figures.

Despite the recent deceleration, the annual inflation rate remains well into hyperinflation territory. The annual inflation rate reached 282,973% in April, down from 329,568% in the previous month. These figures might underestimate real inflation, however. According to the opposition in congress, which began releasing its own inflation estimates in early 2017, the annual inflation rate reached 1,305,000% by April. Both figures are not comparable since they follow different methodologies. The central bank CPI might include the price of many regulated items, which in reality are not available to the typical consumer. Regardless, official inflation figures still depict a bleak picture.



The deceleration in the inflation rate in early 2019 came as the government implemented some policy adjustments. The first was made in mid-2018, when the government began to reduce real wages for public sector employees by delaying nominal adjustments. This reduced, at least temporarily, the pressure on government fiscal accounts.

Second, the government mandated a sharp increase in the amount of bank deposits that must be kept at the central bank. Reserve requirements were set at an unprecedented 57% in late January, while the marginal reserve requirement was set at 100%—any increase in deposits as of late January must be kept at the central bank. This measure has had a massive impact on credit growth and thus on the money supply.

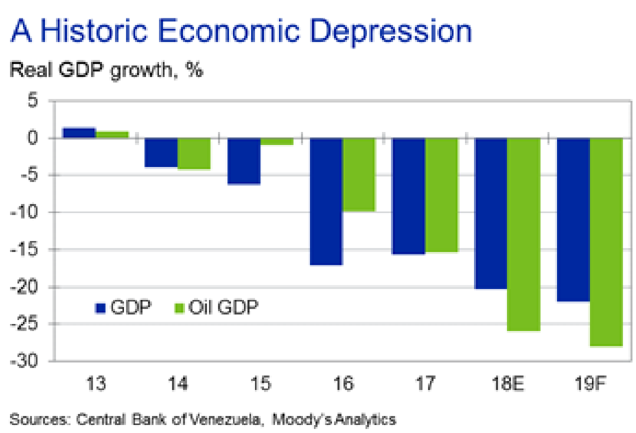
The recent deceleration will be temporary, however. The government has yet to tackle the root of the problem—the monetization of the government's huge fiscal deficit, estimated at around 20% of GDP. With no access to foreign financing, the government has no option but to keep printing money to finance its fiscal gap.

A bleak outlook

The political crisis will prolong the depression. In their effort to force Nicolas Maduro out, the U.S. and other OECD countries have imposed strict sanctions to further isolate his government from international financial markets. More important, in early 2019, the U.S. effectively banned all oil transactions with Venezuela, hurting the government's cash flow. Oil production, which has been falling for years because of underinvestment and mismanagement, will suffer as a result.

On top of the sanctions, the economy has been severely hindered by the emergence of an electricity power crisis. After years of mismanagement and underinvestment, the country's power grid collapsed in March, prompting weeklong blackouts in most of the country and inflicting severe economic damage. Oil production declined by almost half during the blackout, and the private sector suffered large economic losses. Power has been only partially restored with daily rolling blackouts becoming the norm.

The blackouts have pushed the economy deeper into depression. Given the severity of the electricity crisis, we now estimate that the economy will contract by more than 20% in 2019. The economy has been in a depression since 2014 following years of macroeconomic mismanagement and dwindling oil revenues. As a result, Venezuela's GDP contracted by 52% from 2014 and 2018. The economic crisis will have lasting consequences on the economy. The country has lost about 15% of its labor force in last few years due to the exodus of people looking to escape the current crisis. These figures will hurt the country's growth potential for years to come.



The crisis has lasted longer than anybody had predicted. Given the current political gridlock, it is difficult to predict an outcome. The Maduro government has been able to remain in power despite the acute economic crisis by maintaining control of the military and with some help from Russia, Cuba and China. His support system might start to crack in 2019, however, given the government's inability to address the economic crisis and increasing international isolation.

The risk of Maduro facing an internal revolt has increased in 2019 amid the economic collapse. Yet a weakened opposition also seems unfit to take decisive actions and to galvanize popular support for a regime change. This is a complex and an uncertain situation that will continue to hinder the economy in the near term.

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