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CIGI Papers No. 147 — October 2017

Venezuela after the Fall

Financing, Debt Relief and Geopolitics

Robert Kahn

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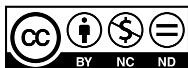

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Table of Contents

vi About the Author

vii About the Global Economy Program

vii Acronyms and Abbreviations

1 Executive Summary

2 Venezuela Today: Hyperinflation and Economic Collapse

3 A Substantial Financing Gap and Dwindling Options

5 What Comes Next?

6 Elements of an IMF Program for Venezuela

7 Passing the Hat: Available Official Financing

9 The IMF's Restructuring/Reprofiling Dilemma

12 Other Issues in the Restructuring/Reprofiling

14 Debt and Geopolitics

15 The New US Administration and the Group of Twenty

15 Conclusion

16 Works Cited

18 About CIGI

18 À propos du CIGI

About the Author

Robert Kahn is an economic consultant and adjunct professor at American University, with an expertise in macroeconomic policy, finance and crisis resolution. Until recently, he was a senior fellow for international economics at the Council on Foreign Relations (CFR), where his work focused on the intersection of foreign policy, economics and markets, including debt crises, sanctions and the future of Europe. Prior to joining CFR, Robert was a senior strategist with Moore Capital Management. He also was a senior adviser in the financial policy department at the World Bank, where he focused on financial sector assessments for developing economies and was the Bank's liaison to the secretariat of the Financial Stability Forum. Robert also held staff positions at the International Monetary Fund (IMF), where he worked on public policy and the resolution of debt crises in emerging markets. He was a member of the IMF team that worked closely with Korean authorities in 1997-1998 to develop a system for comprehensive monitoring and reporting of external debt and reserves, and subsequently was involved in development of the Fund's policy for private sector involvement in crisis resolution. Robert held various senior-level positions at Citigroup and was the managing director and head of the sovereign advisory group, served as the head of the Office of Industrial Nations at the US Treasury, and was a senior economist at the Council of Economic Advisers, as well as the Federal Reserve Board. Robert received his B.A. from the University of Chicago and his Ph.D. from the Massachusetts Institute of Technology.

About the Global Economy Program

Addressing limitations in the ways nations tackle shared economic challenges, the Global Economy Program at CIGI strives to inform and guide policy debates through world-leading research and sustained stakeholder engagement.

With experts from academia, national agencies, international institutions and the private sector, the Global Economy Program supports research in the following areas: management of severe sovereign debt crises; central banking and international financial regulation; China's role in the global economy; governance and policies of the Bretton Woods institutions; the Group of Twenty; global, plurilateral and regional trade agreements; and financing sustainable development. Each year, the Global Economy Program hosts, co-hosts and participates in many events worldwide, working with trusted international partners, which allows the program to disseminate policy recommendations to an international audience of policy makers.

Through its research, collaboration and publications, the Global Economy Program informs decision makers, fosters dialogue and debate on policy-relevant ideas and strengthens multilateral responses to the most pressing international governance issues.

Acronyms and Abbreviations

CACs	collective action clauses
CFIUS	Committee on Foreign Investment in the United States
EFF	Extended Fund Facility
FLAR	Latin American Reserve Fund
GFN	gross financing needs
IADB	Inter-American Development Bank
ICSID	International Centre for Settlement of Investment Disputes
IMF	International Monetary Fund
mbd	million barrels per day
OPEC	Organization of the Petroleum Exporting Countries
PDVSA	Petróleos de Venezuela, S.A.
RFI	Rapid Financing Instrument
SBA	Stand-by Arrangement
TICC	Títulos de Interés y Capital Cubierto (interest and principal-protected)

Executive Summary

Venezuela's economic and political crisis continues to deepen, exacting a growing humanitarian toll and devastating an economy that was once Latin America's most prosperous. With oil revenues falling and foreign exchange reserves exhausted, the government has been forced to slash basic services, ration food and medical supplies, and broker increasingly desperate financing deals to temporarily fend off an international debt default. While the government continues to use force and debase democratic institutions in an attempt to contain dissent and maintain its hold on power, an eventual economic collapse seems inevitable. But what follows?

Despite its rich human and physical resources, restoring the Venezuelan economy will require a comprehensive and expensive rescue package. Such an effort will require speed, ambition and broad international support, including multilateral, regional and private capital. The International Monetary Fund (IMF) is the only institution with the financial resources, influence and technical expertise to pull such a package together, but it cannot do this alone.

A debt reprofiling or restructuring will likely play a central role in the recovery effort. While the situation on the ground will be critical in determining the scope and timing of a restructuring, significant debt relief appears justified to ensure adequate financing of a credible reform package, to restore debt sustainability, and to provide appropriate burden sharing among official and private creditors.

Negotiating such a package will be extraordinarily difficult. Creditors are likely to resist offering generous debt relief to an oil-rich and once prosperous country. Sharply divergent views about the country's longer-term creditworthiness will make negotiations difficult. Further, a complex and legally opaque debt structure, as well as the potential for attaching Venezuelan assets abroad, are likely to encourage litigation and a race for assets beginning at the first evidence of default on external debt. This will complicate efforts to agree on a package that can command broad support. Pressure to move forward quickly with a recovery program will add to the strain on debt negotiators. At the same time, difficult burden-sharing and geopolitical questions are raised by China's role as Venezuela's leading creditor and, more recently, by the growing involvement of Rosneft, a US-sanctioned Russian state-owned oil company, as a de facto lender of last resort to the government.

After a brief overview of the current economic situation in Venezuela, the paper presents the core elements of a comprehensive international rescue effort, and explains why such a program is likely to produce financing needs that outstrip the resources available from the official community. Any program will require an urgent effort to address humanitarian needs as well as long-term financing, and there are important steps that can, and should, be done now to prepare.

Given the scale of the financing required in the medium term, an ambitious adjustment program backed by generous financing and debt relief is needed to get Venezuela back on its feet. It is argued that reform and restructuring need to go hand-in-hand. Any restructuring or debt swapping provides only transitory relief and is unlikely to attract broad political support unless accompanied by a radical reform effort, a program that the current government is unlikely to be willing to consider. But it is not too early to begin planning for the day a new government comes to power that commands strong international support. It is further argued that the success or failure of any restructuring deal will depend on a number of policy and design choices, including the IMF's conditions for lending, and the use of legal innovations and economic incentives to encourage creditor participation in any deal. This effort will be precedential for debt markets, involve extraordinary international cooperation, and potentially be consequential for a new US administration that, in public statements, has signalled a willingness to challenge accepted norms and rules for international policy coordination.

Venezuela Today: Hyperinflation and Economic Collapse

The Venezuelan economy is experiencing a deep and profound crisis — reflected in severe shortages, hyperinflation and a collapse in economic activity. Its citizens are deprived of even the most basic foods and medicines. The government is facing a widening gap between available resources and the basic needs of its citizens, and has imposed highly distortive price and foreign exchange controls to strictly ration imports at half of what they were just two years ago. Venezuelans are travelling to neighbouring countries to access basic goods and seek better living conditions, raising fears of a broader migration crisis. Recent policy measures, including a rise in gasoline prices and changes to the multi-tier foreign exchange regime, have failed to meaningfully address the imbalances. Debt payments have been made with delay, in many cases after agreeing to punitive terms on emergency loans or the fire sale of assets. With substantial debt payments looming later this year and in 2018, a default increasingly appears to be a question not of "if" but "when." Consider the following.

A Collapse in Economic Activity and Hyperinflation

Credible economic data is hard to come by, but the IMF estimates that economic activity declined by around 18 percent last year, and is expected to decline by an additional seven percent this year, with unemployment rising to over 25 percent (IMF 2017b). As these numbers do not reflect the recent turmoil, the actual outcomes this year are likely to be worse. Meanwhile, despite increasingly severe price controls, inflation was around 250 percent in 2016, and is accelerating rapidly this year to over 1,000 percent. Further, as shown in Figure 1, the rapid increase in M2,[1] and related sharp rise in the black market exchange rate, suggests that underlying inflationary pressures are even more severe.

The Multi-tiered Exchange Rate System Increasingly Distorts Activity

New exchange rate rules that were announced on May 19, 2017, demonstrate, and in some respects, intensify, the restrictive and distortive nature of the government's control over foreign exchange. As before, there are three primary exchange rates:

- DIPRO, a fixed, preferential preferred rate of 10 Venezuelan bolívars to the dollar[2] (only available for a small number of state-preferred items);
- DICOM, a secondary market official rate that is currently set at auction for 3,345 bolívars to the dollar (only for approved purposes); and
- a black market rate that has soared in recent weeks to over 29,000 bolívars to the dollar (compared to 1,000 bolívars to the dollar a year ago).

Reserves Are Exhausted

The government reports international reserves at just below $10 billion, but their actions suggest that little, if any, of it is liquid and usable. About 75 percent of this amount is gold and is unlikely to be able to be monetized because it is not of monetary quality, or is already pledged in connection with loans or swaps, or simply because further sales — and the resultant drop in the level of reserves — would signal destabilizing weakness of the government. Also, it is reasonable to assume that some of the remaining reserves are backing, either directly or implicitly, an insolvent Venezuelan financial system that is facing severe financial pressures (some of the reserves are deposited at Venezuelan banks). On the rare occasion where reserves were boosted by one-off deals, the level of reserves has quickly returned to the $10 billion de facto floor, before falling below it in July.

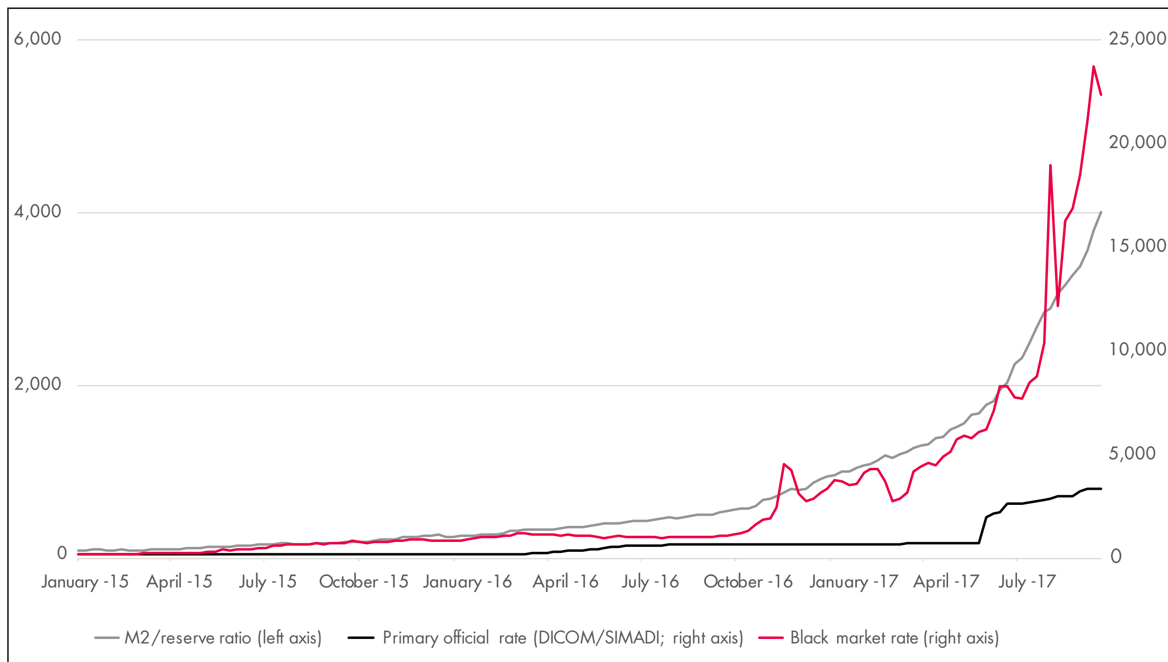
Oil Production Is Falling

Following years of mismanagement and low investment, the state oil company Petroleos de Venezuela, S.A. (PDVSA) has seen a sharp decline in oil revenue. The sharp drop in world oil prices in 2015-2016 was central to the fall off, but there has, in addition, been a steady decline in production due to mismanagement of PDVSA and underinvestment

1 A measure of money that includes cash and chequing deposits (M1), savings deposits and other short-term deposits.

2 All dollar amounts are in US dollars.

Figure 1: Exchange Rates and Money (bolívar/US$)



Data sources: Bloomberg; https://web.venezuelaecon.com/.

in productive capacity. According to the Organization of the Petroleum Exporting Countries (OPEC), oil export volumes have fallen steadily in recent years from 2.4 million barrels per day (mbd) in 2015 to 1.92 mbd in August 2017. The number of operating rigs has fallen in parallel. Further, Venezuelan crude is heavy, expensive to extract and requires the import of distillates to produce an acceptable grade of oil for export. While Venezuela has substantial oil reserves, there would be material hurdles to a significant increase in production.

A Substantial Financing Gap and Dwindling Options

Putting the pieces together, Venezuela has a substantial financing gap (estimated at over $15 billion for 2017) (see Table 1) and little in the way of assets or policy options to close it. At $45 per barrel (around $5 per barrel above current prices for Venezuelan crude), oil exports would be around $29 billion this year, down about three-quarters from 2012. Subtract around $5 billion for oil-related imports of distillates and products, and export revenue woefully is inadequate to meet this year's bonded debt service of $12 billion (rising to near $20 billion with payments to China) (see Table 1).

The increasing challenge of making debt payments has resulted in a number of expensive, ad hoc deals by the government. Last fall, PDVSA offered a debt exchange to push back maturing bond payments to 2020, in which investors received significant compensation in the form of a roughly 20 percent increase in principal and a 51 percent claim on CITGO holdings (Venezuela's oil refinery network in the United States). In December 2016, the government further borrowed around $1.5 billion from Rosneft in a loan that was secured by the remaining 49 percent of the shares of CITGO holdings.[3] More recently, bonds reportedly were sold to a foreign investor at a significant discount to current market prices to raise fresh money for the government (Vyas and

3 This deal — which, despite sweeteners, saw low participation — resulted in litigation by other creditors, including some pursuing compensation for past expropriation, who claim that CITGO holdings secured their claim or that these deals violated negative pledge clauses in other contracts.

Table 1: Venezuela Financing Gap 2017 (in billion US$)

Total Payment	2015	2016E	2017F
Total debt service (PDVSA and sovereign international bonds)	12.3	12.0	12.2
Principal	4.8	4.7	4.2
Interest	7.5	7.3	8.0
Import payments	48.3	28.6	29.5
Goods import	36.9	17.8	18.5
Services import	11.4	10.8	11.0
Subtotal	60.6	40.6	41.7
Financing Sources			
Oil exports	34.9	25.1	28.7
of which cash oil export	29.1	20.9	23.9
Non-oil exports	2.1	2.3	2.4
Subtotal (cashed-in oil export and non-oil export)	31.2	23.2	26.3
Official financing (e.g., reserve drawdown)	29.4	17.4	–
Financing Gap (Baseline)	0	0	-15.4

Data sources: Bloomberg (principal payments), The Institute of International Finance (total debt service figures), Torino Capital (total export and import data), OPEC, US Energy Information Administration.
Note: E=estimate, F= forecast.

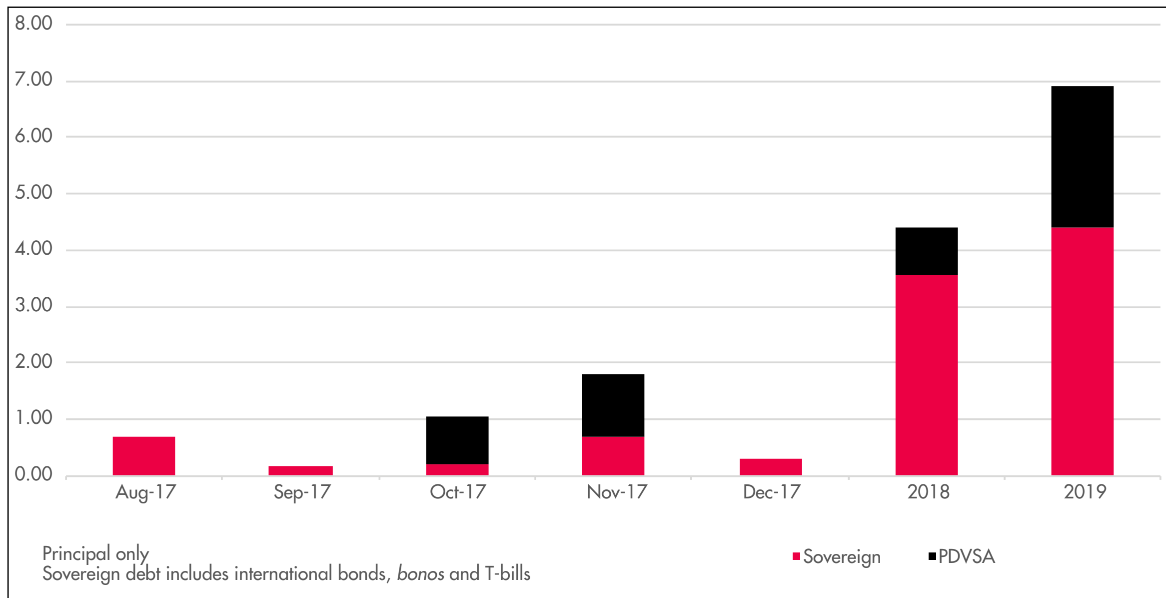
Kurmanaev 2017).[4] Despite these fire-sale deals, payments by PDVSA have been made after the due date but within the grace period, again reportedly with help from Rosneft. Historically, PDVSA had a meticulous payment record, and the use of a grace period appears to reflect trouble raising funds rather than a strategic decision by the company. Looking ahead, the government has significant payments looming in October and November 2017, and again in 2018 (see Figure 2).

The government continues to explore proposals to roll over maturing debt, either through a continuation of the ad hoc deals of recent months or through a more comprehensive swap for longer-term claims, but such deals would do little to alleviate the chronic economic and political problems affecting Venezuela. Further, the current political turmoil makes it hard to imagine that understandings with the current government would enjoy promised protections from a successor government. In any event, given the fundamental downward trajectory of the country, maturity extensions are unlikely to catalyze new private money.

This constellation of challenges will eventually lead to default. But whether through a stubborn unwillingness to accept this reality, fear of litigation and asset seizures, or simply delay in the face of powerful political and economic pressures, the government has shown a strong commitment to pay on debt as long as they can.

4 This was a bond previously issued by the government and not sold into the market, so the purchase by the investors through a broker generated net new resources for the government. More broadly, the sale by the government of "parked" bonds at the central bank and state institutions that are under the control of the government, even if the government is not involved directly, represents a net new emission of debt and adds to reserves. By one estimate, Venezuelan government holdings of its own bonds could total $18 billion. For more see (*El Universal* 2017).

Figure 2: Debt Schedule (in billion US$)



Data source: Bloomberg.

What Comes Next?

The current regime refuses cooperation with Western governments, but it is not too early to begin planning for a time when a future Venezuelan government is willing to take the hard measures that warrant strong and broad international support. The economist Rudi Dornbusch's injunction was never more relevant: "The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought" (Frontline n.d.). That's exactly the Venezuelan story. It will take forever and then it will happen overnight.

Current US policy has put increased pressure on the government to accept new elections, including through the introduction of several rounds of sanctions, and more broadly to promote democratic accountability and governance. More recently, the Trump administration has imposed tough new sanctions against the Venezuelan government for proceeding with plans for a constituent assembly that would strip remaining powers from the opposition-controlled legislature. These latest sanctions, in an innovation in US policy, limit the ability of the Venezuelan government to issue new debt for cash or in exchange for existing debt, cutting the regime off from international markets and making default more likely.[5] But, as pressure on the Maduro government intensifies, so does concern for contagion of the crisis to its neighbours. In recent years, trade and financial links between Venezuela and its neighbours have dropped sharply, and so one could hope that there would be limited spillovers. But the risk of domestic political and social unrest affecting its neighbours is a concern, and, in particular, could cause a regional migration crisis. There is also the broader fear that a crisis in Venezuela would weaken market confidence in other oil-exporting countries, such as Nigeria. That will need to be watched closely.

Developing and financing the economic adjustment program (outlined below) will require the new Venezuelan government and its international partners to move at breakneck speed, and critical basic needs need to be met at the outset. To complement the IMF-led effort described below, a parallel effort by the major multilateral and national aid agencies should focus on rapidly disbursing assistance. This is an atypical case for those agencies, which often focus on countries where poverty is more entrenched, but no less critical here. Getting support quickly to those most in need would bolster the credibility of the new government and make future reform efforts more likely to succeed.

5 See US Department of the Treasury (2017).

Elements of an IMF Program for Venezuela

While there has been a significant evolution in Latin American policy thinking toward the embrace of market-oriented reforms in recent years, the program outlined here challenges a number of taboos, most notably in the necessary central role of the IMF. Such a program would draw on the Fund's extensive experience in post-crisis situations, as well as likely reflect new thinking on how to address energy subsidies in the Fund programs.

There is immense uncertainty about the demands of a rescue effort, and in this regard the IMF will also have a lot of catching up to do: the Fund's last comprehensive review of the Venezuelan economy was in 2004, and its last visit to the country was in 2007. Its assessment, and the financing gap that will need to be filled, will be a moving target at a time when international pressure to get a program going and money flowing will be intense. Still, the economic building blocks of a rescue program (that the international policy makers would back) are not hard to imagine.

They include the following:

- Introduction of a unified, flexible exchange rate regime, likely coupled with an extended period of capital controls to stem flight. This policy proscription reflects the reality that there will not be adequate reserves to allow substantial intervention, as well as recognition of the importance of getting relative prices right (through linking to world markets). Still, floating the exchange rate is not without risks, and in particular a significant, if temporary, exchange rate overshoot is likely. In the scenario below, it is assumed that the exchange rate will depreciate sharply in real and nominal terms relative to the main official rate.[6]

- A multi-step increase in domestic energy prices to world levels, and then allowing prices to be flexible going forward in response to market developments.

- Significant upfront humanitarian assistance, coupled with, over time, a tighter fiscal policy that would be consistent with available resources. Currently, the state uses the resources of PDVSA and other state enterprises as a central element of social policy (and to favour certain elites that support the regime). Thus, a more transparent and fair fiscal policy, coupled with energy price reform, will require creation of a new, targeted safety net, replacing the pervasive and inefficient subsidies now in the system. Public and minimum wage increases would be in line with productivity growth.

- A comprehensive restructuring and strengthening of the banking system, which is likely to be costly given reports of deep-seated corruption.

- Broad measures to address corruption and rule of law. Privatization, market liberalizations and reform measures will no doubt be part of the program, and critical from a longer-term perspective, but unlikely to play a major role in the early stages of the program.

From a Latin American perspective, such a program appears radical and challenges many stigmas associated with working with the Fund. Yet, more broadly, in many respects this is a conventional economic program, similar to the Ukraine 2014-2015 reform effort.[7]

There will be some difficult judgments to be made by the IMF staff in the design of the program. With a fiscal deficit that could currently be in the order of 25 percent of GDP after taking into account net transfers in the energy sector, any program will need to be anchored around a meaningful reduction in the fiscal deficit over time. On the one hand, given that a significant portion of the current deficit may represent inefficiency, corruption and transfers to elites, the argument can be made that a substantial reduction in the deficit can be achieved without severe growth consequences or dislocations to the broader public. On the other hand, a much-publicized lesson from the Fund's involvement in the European crisis of 2010 was the recognition that fiscal consolidation, particularly in the context of weak regional growth, can cause substantial economic drag and undermine efforts to put the economy back on track. Getting the

6 Where the exchange rate settles could have a material effect on the financing gap. A more depreciated exchange rate, by raising the local currency value of oil exports, strengthens budgetary financing but raises inflation and could deepen the recession, while making the burden of servicing dollar debt heavier (measured as a share of domestic output).

7 For the original 2014 IMF arrangement (800 percent of quota over two years), see IMF (2014).

balance right between financing and adjustment will be particularly difficult in this case.

Another challenging issue will be how to factor an unpredictable recovery in energy production into the program. Large oil reserves, while critical to Venezuela's long-run future, are unlikely to be a major support for the economy in the early months of a crisis stabilization effort (especially given the extent to which the current government has undermined the efficiency and professionalism of PDVSA). But oil in the ground would provide the basis for an optimistic future once a root-and-branch reform of the old system has been undertaken.

Another wild card may be the cost of repairing the financial system. The Venezuelan financial system has been repressed by years of controls, and thus may not have the mismatches and leverage that have been seen in some emerging market crises. On the other hand, the government will likely face economic and political pressure to take on large unfunded liabilities and non-performing loans that could materialize. One IMF study found that repairing the damage from large financial crises often cost a country 20 percent of its GDP.[8]

The experiences of other countries in deep crisis and their similar attempts at IMF-backed adjustment efforts demonstrate that the external accounts are likely to improve quite sharply following a large devaluation, the fiscal position, however, is likely to remain under pressure. In addition to the direct fiscal costs of restarting the economy after a crisis, and rebuilding reserves, the stabilization of inflation removes a large and inefficient inflation tax and correspondingly raises the fiscal deficit. Important structural reforms, as valuable as they may be for the long term, could be disruptive in the near term. Returning to growth requires an extended period for economic stabilization and the rule of law to take hold and create conditions for effective new investment. This creates a compelling argument that such a program would have a substantial financing requirement in the first years — on the order of $40–$50 billion over two years.[9] For illustrative purposes, a financing gap of $50 billion is used in the scenarios below.

Passing the Hat: Available Official Financing

IMF

Venezuela's current IMF quota stands at 3.7 billion Special Drawing Rights (or $5.1 billion), which is small relative to the amounts that are likely to be needed in a program. There are three main financing facilities that the IMF could provide: the Rapid Financing Instrument (RFI) is designed for emergency conditions. It can be disbursed quickly and with limited conditionality, but cannot exceed $1.9 billion per year (37.4 percent of quota) and cumulatively $3.8 billion (75 percent of quota) (IMF 2017a). Beyond that, and for the bulk of the IMF's support, the choice is between a Stand-by Arrangement (SBA) or Extended Fund Facility (EFF), both of which provide medium-term financing, subject to conditionality.

Under the current IMF lending policy, a member's borrowing under SBA/EFF arrangements normally is limited to 145 percent of quota annually and 435 percent cumulatively (IMF 2016b). If Venezuela uses RFI first and then a standard program, the country can borrow an additional $7.4 billion for the first year and $22.2 billion over three years, amounts that appear well short — particularly in the first year — of what will be required, even if there is some front-loading of disbursements. Consequently, it appears highly likely that the IMF would need to appeal to its "exceptional access" rules that allow lending, normally in the event of a capital account crisis, in excess of its financial limits, subject to a number of conditions, including a higher level of confidence in Venezuela's debt sustainability than would be the case otherwise.

If, for illustrative purposes, Venezuela received an RFI, followed by a two-year, 500 percent of quota exceptional access program, total IMF support over the two years could reach $27 billion.

8 In their data, Luc Laeven and Fabian Valencia (2008) cover 42 crises in 37 countries between 1970 and 2007. Output losses of systemic banking crises averaged around 20 percent of GDP in the first four years, while the net fiscal cost was 13.3 percent.

9 This is assuming full debt service, imports rebounding to 2010–2012 levels, that reserves are rebuilt gradually to $25 billion and that oil production rebounds slowly.

Under such circumstances, as discussed further below, the IMF would grant exceptional access only if Venezuela also receives financing from other creditors, such as the World Bank and the Inter-American Development Bank (IADB), and the private sector through new money (which is unlikely to be available on reasonable terms in the early days of recovery) or a restructuring.

World Bank

The World Bank does not have any current engagement with Venezuela, after a decision in 2008 by then president Hugo Chavez to pay off all outstanding loans. Consequently, the Bank should not be constrained by its balance sheet from making a material contribution to reconstruction and recovery in Venezuela (Lawder 2017), but it could face significant challenges gearing up its project-lending program. In this context, its efforts could focus on basic needs, including technical assistance in setting up a targeted social safety net, as well as a significant, fast-disbursing sectoral adjustment component in energy or another critical sector that would effectively serve as balance-of-payments support.

Regional Latin American Support

Regional financial institutions are also expected to play a role in any package, in part to lessen the backlash to IMF involvement and show regional support for the new government.

The IADB has indicated a strong interest in being involved and could, in principle, build up a lending pipeline quickly. At the same time, IADB leadership has signalled that they believe that their lending is constrained by overall and country-specific lending constraints, and (as with the World Bank) a request that the IADB "stretch" its balance sheet could become entangled in thorny discussions with the United States over support for a capital increase.

The Latin American Reserve Fund (FLAR) approved a credit line of $500 million for Venezuela in 2016; additional support could be provided to the central bank for balance of payments purposes, as a contingency or to provide liquidity, or in support of a debt restructuring. The balance-of-payments support could be done quickly, is largely conditionality free and could total in excess of $1 billion based on Venezuela's quota.

A regional financing effort, perhaps mobilized through the Organization of American States or a "friends of Venezuela" fund, could be an important and quick source of additional financing.

Other Bilateral Support

Additional assistance from leading powers, including the possibility of loan guarantees from the United States, along with some fresh loans from China, even if small, could play a significant role in catalyzing support elsewhere. There is $3 billion of debt owed to official creditors (other than China) that could be restructured at the Paris Club. While this amount is small and would provide minimal immediate cash-flow relief, its restructuring would establish the principle of burden sharing and could be helpful in raising the needed financing.

Together, official support for Venezuela could be substantial but — if the financing gap is in the upper end of the projected range — will be insufficient to close the financing gap on its own. Consequently, while the next section examines the question of debt sustainability, the timing and scale of a potential debt restructuring may be strongly influenced by the financing needs of the program.

If the IMF were to follow its normal procedures for collecting data and developing a program, it could take three months or more to bring a program to its board for approval. Events on the ground are unlikely to provide such luxury. Indeed, the staff is likely to face enormous pressure to accelerate its timeline.

Putting all these factors together, a fast-track timeline could involve the following:

- → Quick disbursement through the IMF's RFI, which can be done quickly and without substantial conditionality in emergency situations ($1.9 billion).
- → Bridge financing from bilateral and regional sources, including both humanitarian and rapid-disbursing funds. The IADB should be able to disburse some funds rapidly, and regional funding could focus on the most critical humanitarian needs. Together, these efforts could provide $2 to $5 billion in the first three months. While much of this support would be in-kind and not general-purpose financing for the budget, it could be critical for the success of the new regime.
- → The IMF would then need to move quickly to bring forward a program to its board, within

perhaps two months, recognizing that any program produced on an accelerated schedule would likely be subject to substantial revision at the first review. In this case, there would be an argument for delaying a final decision on restructuring until the first review.

- Subsequent sectoral and project lending from the regional development banks, as well as additional regional and bilateral assistance.

An illustrative financing scenario is presented in Table 2.

Table 2: Rescue Package for Venezuela (in billion US$)

Total Obligations	Year 1	Year 2
Total bond debt service (2017-18)	12.2	14.7
Arrears payment and reserve build	5	5
Primary fiscal deficit	10	3
Financing gap	27.2	22.7
Financing Sources		
Multilateral agencies		
IMF	14	13
IADB	1.5	1.5
World Bank	0.5	2.5
FLAR	1	0
Debt relief from official creditors		
China (net of payments due)	2	2
Other	0.5	0.5
Debt relief from private creditors	7.7	3.2
Financing Gap	0	0

Data sources: Bloomberg and the Institute of International Finance (2017).

The IMF's Restructuring/ Reprofiling Dilemma

To paraphrase *Game of Thrones*, when it comes to debt restructuring, the IMF passes sentence and swings the sword. It is too early to be definitive, as the IMF will respond to events when they arrive and can assess conditions on the ground. Whether the debt is current or has already fallen into default will also play a role in their decision making, given the historical resistance of the Fund to force default. Indeed, while the rest of the paper is agnostic as to whether the debt is in default at the time of the program, initial conditions matter a great deal. Most significantly, this will be the first significant test of new IMF lending rules passed in December 2015[10] and January 2016[11] that create a great deal of flexibility around restructuring terms and conditions when in the "grey zone" (IMF jargon for large lending programs where substantial uncertainty exists). Nonetheless, a few things seem clear.

Under the new exceptional access rules,[12] if the Fund is unable to find the debt sustainable with high probability (which would allow it to provide exceptional access without requiring a debt restructuring), it would be left with two choices:

- Debt is sustainable but not with high probability (grey zone). The new policy allows the IMF to grant exceptional access without requiring debt reduction upfront, as long as the member also receives financing from other creditors (official or private) during the program, including through debt reprofiling. This financing should be on a scale and terms that help improve the member's debt sustainability prospects without necessarily bringing debt sustainability at the

10 For official arrears, see IMF (2015a).

11 For private restructuring in large programs, see IMF (2016a).

12 Under this framework, the IMF could only provide large-scale financing in capital account crisis if four criteria were met: a member experiencing exceptionally large balance-of-payments needs; there is a "high probability" that the member country's debt is sustainable; the member has prospects for gaining/regaining access to private capital markets; and the member has the institutional and political capacity and commitment to implement an IMF-supported program. In the "grey zone" where the debt is sustainable but not with a high probability, the new framework gives the IMF appropriate flexibility to make its financing conditional on a broader range of debt operations, including the less disruptive option of a "debt reprofiling."

outset, and provides sufficient safeguards for IMF resources. In cases where a country has lost market access, and the return to market is uncertain, and given that private claims falling due during the program would constitute a significant drain on available resources, a reprofiling of existing claims — that is, a short extension of maturities falling due during the program, with normally no reduction in principal or coupons — would typically be appropriate to ensure adequate financing.

→ Debt is unsustainable. In this case, there would need to be a comprehensive debt restructuring that did result in debt being sustainable with a high probability.

Although a grey-zone reprofiling is a form of debt restructuring, it will likely be less costly to the debtor, the creditors and the system than a definitive debt restructuring. If a reprofiling is chosen, there is significant flexibility under the new rules as to the scope and terms of the reprofiling, "recognizing that it would not be advisable to reprofile a particular category of debt if the costs for the member of doing so — including risks to domestic financial stability — outweighed the potential benefits. For instance, short-term debt instruments (by original maturity), trade credits, and local currency-denominated debt have typically not been included in most past restructurings" (IMF 2016b). Further, under the new policy, financing from official bilateral creditors, where necessary, could be provided either through an extension of maturities on existing claims or in the form of new financing commitments.

The choice between these options will not be easy, and arguably the rules were not meant for a country with the rich resource base and complex debt and politics of Venezuela. In the end, strong political pressures likely will be brought to bear on both sides of the debate. In making the decision, the IMF will need to weigh the following considerations:

Is the Debt Unsustainably High?

Venezuela's total outstanding debt involves guesswork, given the lack of transparency of the government and the increase in arrears and off-balance-sheet fiscal operations in recent years. The majority of the external debt takes the form of international bonds issued by the sovereign ($36.7 billion) or PDVSA ($32.2 billion), bilateral debt owed to China ($18–$20 billion, mainly through an oil-for-loans facility), loans and arrears.[13] There is also a significant amount of domestic currency debt, mainly T-bills and *bonos de Venezuela*, which is overstated in dollar terms because the current official exchange rate (around 10 bolívars per dollar) is extremely overvalued — the dollar values of these two instruments may be much lower than they currently appear. It excludes the cost of a bailout out of the financial system. All this suggests that the total debt of Venezuela following the crisis could be in the $120–$150 billion range, although the extent of arrears remains a significant unknown (see Table 3).

Any analysis of debt sustainability begins with a comparison of debt to GDP, which according to the government is on the order of 20 percent. But these calculations use the highly overvalued official exchange rate, and using an exchange rate close to the parallel rate would reduce GDP to somewhere close to $100 billion, putting debt/GDP as high as 150 percent. For a country coming out of hyperinflation, debt ratios well in excess of 100 percent are far from sustainable, even though it could be argued that, with successful reform, the real exchange rate (and consequently the dollar value of GDP) would rebound materially over time.

Given the uncertainty over the debt ratio, a case can be made for focusing more on cash flows (gross financing needs [GFN]) as a secondary measure of credit worthiness, as has been done in the case of Greece since 2015 (IMF 2016c). In that case, the shift to GFN better captured Greece's true debt burden because the bulk of Greece's debt was provided by European governments on highly concessional terms. Assuming Venezuela had a medium-term debt capacity similar to that of Greece, this suggests that GFN would be below 10 percent of GDP. This is well below current debt service levels. Alternatively, and perhaps appropriate given the uncertainty of GDP, limiting debt service to a reasonable proportion of exports also would not leave room for full payment on debt in the near term (and would be highly sensitive to assumptions about world oil prices and production).

13 The government issues four types of instruments: the international bonds, T-bills, *bonos* (denominated in bolívars) and bonds denominated in dollars but settled in bolívars). For PDVSA, there are bonds, municipal bonds issued by CITGO and loans (lender information undisclosed on Bloomberg). TICC stands for Títulos de Interés y Capital Cubierto (interest and principal-protected)

Table 3: Venezuela Debt Table (in billion US$) — Official Data

	Due in 2017	Total Stock Outstanding
Total Debt (Excludes T-bills, *bonos* and loans)	**6.0**	**120-150**
Principal	2.5	–
Interest	3.4	–
Sovereign		80-110
Venezuela sovereign international bonds		
Principal	0	36.7
Interest	1.9	–
T-bill	**0.4**	**0.4**
Bonos de Venezuela		
Principal	1.7	41.4
Interest	3.2	–
Local dollar bonds (sovereign)		
Principal	0.1	0.9
Interest	0.025	–
Arrears, financial sector recap, other	**n/a**	**30.0**
PDVSA Debt		44.5
Bonds		
Principal	2.1	32.2
Interest	1.5	–
Loans	**0**	**11.9**
CITGO municipal bonds		
Principal	0	0.4
Interest	0	–

Data source: Bloomberg, author's estimates.

On narrow grounds, the extraordinary high levels of debt and debt service projected above would appear to lead to a clear judgement of unsustainability. Creditors will argue otherwise, pressing the case that debt is sustainable based on Venezuela's longer-term capacity to export oil, and the expected rebound in the real exchange rate as the economy recovers. Even if not sustainable with a high probability, the potential for a return to high levels of oil production over time could be seen as justifying a mild and temporary reprofiling of claims. However, a return to historical levels of oil production could take many years, given the decline in institutional, managerial and physical capacity of PDVSA, and IMF staff are likely to be wary about assuming a rebound in production within the program period. More generally, the Fund's experience with countries seeking to monetize assets (for example, privatization) in support of a program is usually disappointing, and a cautious approach would appear warranted. In the end, it is difficult to imagine that the judgment of sustainability, if it can be made at all, would be seen as having a high probability.

What Is the Path Back to Full Market Access?

Prospects for a return to durable market access will be central to the sustainability debate. In this regard, there are likely to be numerous proposals from investors and creditors to exchange oil and other assets for credit. Fund staff will have to assess whether such deals are viable, can be done at a reasonable cost, and contribute to a sound debt structure over time.

IMF Conditions on any Negotiation

The IMF has a principle that it does not directly involve itself in the negotiations, but it will have a strong hand in how negotiations proceed here and ultimately will need to approve what is agreed. Usually this is done by setting conditions on the deal and providing guidance. In the 2015 Ukraine program, for example, the IMF set conditions on the amount of financing that needed to be provided in a debt operation, the debt/GDP ratio after five years and set a cap on gross financing needs.[14] Despite an immediate 20 percent reduction in the value of the debt, the deal that was agreed fell short in several respects from what the IMF was looking for. This was because interest rates remained high and because it provided for reconstitution of the debt if GDP rebounded. Such state-contingent value (optionality) made the deal expensive for Ukraine despite meeting the IMF's conditions.

Similarly, in the case of Venezuela, Fund staff will be rightly concerned that creditors will not receive warrants, step-up clauses or other oil-linked elements that would make the deal unduly expensive and destabilizing in the longer term. Indeed, the experience in other countries has been that warrants linking debt service to future developments have not been a cost-effective tool for restructuring. Nonetheless, some degree of state contingency based on oil exports may well be appropriate to bridge creditor and debtor differences of view on creditworthiness, leaving the Fund with difficult questions as to whether, and in what form, to constrain the negotiations *ex ante*.

14 In Ukraine, the specific conditions were that the deal "(i) generate about US$15 billion in financing during the program period; (ii) bring the public and publicly guaranteed debt/GDP ratio below 71 percent of GDP by 2020; and (iii) keep the budget's gross financing needs at an average of 10 percent of GDP (maximum of 12 percent of GDP annually) in 2019–2025" (IMF 2015b).

Other Issues in the Restructuring/Reprofiling

If a decision is made to restructure or reprofile the debt, there are a number of issues that are likely to arise that will make this one of the most challenging deals in recent years (Gelpern 2017a; 2017b).

Venezuela's Complicated Debt Structure

Any market-based debt restructuring effort will be made more complex by the extreme complexity and variation in the legal contracts governing the debt.[15] There are substantial differences across debt instruments, for example, whether they include collective action clauses (CACs) limiting holdouts (most of the debt of PDVSA, the state oil company, does not contain CACs,[16] most central government bonds do). There is a wide range of *pari passu* clauses, some of which resemble the language that was at the centre of litigation in Argentina. Many of the negative pledge clauses in the bonds are weak, and the non-financial terms vary. In addition, recent ad hoc deals by the government to raise cash, and to turn government arrears into bonds, have created new instruments of debt on which there is little clarity on the legal standing and security. If creditors wish to hold out, there will be a rich array of legal instruments to choose from, and no clear strategy for applying pressure on them to participate in a debt operation.

Asset Stripping and "*The Producers* Effect"

Another factor that is in play here is ambiguity about the assets that Venezuela has that could be brought to bear in support of new bonded debt. As in many commodity-exporting countries, the resource (in this case, oil) belongs to the state and not the energy company, and one strategy for protecting PDVSA from litigation following default would be to more formally strip assets from the company. This may

15 For an excellent comprehensive review of the legal challenges involved in restructuring, and a proposed path forward, see Buchheit and Gulati (2017).

16 The 2020 bond issued late last year to extend near-term maturing payments does include a CAC.

already be taking place, as the government in 2016 created a new energy security company (Camimpeg) that is controlled by the military and has the right to take over energy resources.

Aggressive asset stripping could lead investors to try and "pierce the veil" and argue that the debts of the company are effectively the responsibility of the sovereign. According to legal sources, there is a high hurdle required to prove such a case, although in the case of Turkmenistan, the government aggressively stripped assets, and investors were able to get a ruling in their favour.

More broadly, there are a number of special factors present in Venezuela that could make the race for assets following default particularly intense. Already, a number of arbitration claims are in front of the International Centre for Settlement of Investment Disputes (ICSID), where claimants are seeking assets, including CITGO holdings.[17] Since 2007, ConocoPhillips has been pursuing compensation from Venezuela due to the nationalization of its assets in the country, and the case is still pending at the ICSID.[18] When PDVSA concluded the debt swap in the fall of 2016, ConocoPhillips and Crystallex International Corp sued PDVSA at a court in Delaware over the use of CITGO as a collateral (Ellsworth and Ulmer 2016). In January 2017, the two plaintiffs expanded the suit over the loan transaction between Rosneft and PDVSA (Scurria 2017). The debate over who has call on the assets of PDVSA suggests *The Producers* effect — in which the same assets are promised to multiple investors — could be a significant factor here.

All of this suggests the potential for a damaging race for assets by creditors after default. There are assets in the United States that could be seized (for example, CITGO), efforts could be made to disrupt, or even seize oil tankers and the oil in transit, and there will likely be litigation as to whether the government exercises explicit control over the company. Even for investors that might be inclined to participate in a restructuring, litigation may be seen as necessary to protect their relative standing. This has led to a number of legal scholars searching for innovative and aggressive approaches to provide a new Venezuelan government with breathing space to reform and restructure.

Legal Strategies for Addressing Free Riders

Given this complexity, innovative and perhaps aggressive legal techniques may be required to encourage participation. Recently, a number of legal scholars have raised the possibility that a bankruptcy proceeding in Venezuela could serve as the basis for an orderly restructuring on a portion of Venezuelan debt — that would be issued by PDVSA — and in turn be recognized in US courts.[19] There are a variety of legal issues — both in Venezuela and the United States — that call into question the feasibility of this approach. And this approach would involve a sacrifice of sovereignty, on the part of both countries, that is difficult to imagine being politically acceptable.

A more likely scenario involves the use of "exit consents." Since their introduction in the sovereign context in the 2000 Ecuador debt restructuring, exit consents have played a significant role in discouraging holdouts in a number of sovereign debt restructurings.[20] These consents, in the sovereign context, recognize that while the main financial terms of sovereign bonds issued in the United States often require bondholders' unanimous consent to amend, other terms (sometimes called non-financial terms) often can be amended by simple majority or two-thirds vote. This raises the prospect that those who agree to participate in a bond exchange as part of a restructuring (by agreeing to changes in non-financial terms) can leave the old bonds without many of the protections that they formerly had, making holding out less attractive.

The use of exit consents has always been controversial. Their use has fallen off with the widespread use of CACs in international bonds after 2003, and a number of court decisions in the United Kingdom (and now in the United States) that reined in the use of exit consents as

17 CITGO holdings controls PDVSA's refinery network in the United States.

18 *ConocoPhillips Petrozuata B.V., ConocoPhillips Hamaca B.V. and ConocoPhillips Gulf of Paria B.V. v Bolívarian Republic of Venezuela*, Pending, ICSID Case No ARB/07/30, online: <https://icsid.worldbank.org/en/Pages/cases/casedetail.aspx?CaseNo=ARB/07/30>.

19 In broad terms, the idea is that Venezuelan legislation could create a reorganization bankruptcy process for PDVSA debt that would meet the standard necessary to be recognized by the United States under US corporate bankruptcy law in order to allow, in principle, for a stay of payments that would limit the race for assets; and allow for a binding in of free riders.

20 Notably, this exit consent technique was used by Uruguay in 2003 and the Dominican Republic in 2006.

potentially coercive. Still, given the proliferation of legal terms across Venezuelan bonds in this case, exit consents may return. The complexity of this issue, and the potential to play a pivotal role in a Venezuelan restructuring, is discussed in Lee Buchheit and G. Mitu Gulati (2017) and Mark Weidemaier and Gulati (2017).

Debt and Geopolitics

China's Role

China has been the primary provider of financing to the Venezuelan government in recent years, and while there is little transparency to these deals, it is thought that China has lent the country more than $50 billion since 2007.[21] Net claims are on the order of $20 billion. Many of the contracts require payment in oil, and currently Venezuela sends around one-quarter of its daily crude oil export to China to repay the debt.[22] Even this involves continuing forbearance by China. Full payment of the Chinese claims on original terms could consume 80 percent of the country's daily oil exports, and terms have been modified on several occasions since October 2014. There is little doubt that China will be central to any resolution of the crisis, through a restructuring of Venezuela's debt and the possible provision of new money.

On the surface, China's support does not seem to be waning, even as Venezuela's crisis has been deepening. In addition to forbearance on oil-related debt, in November 2016, China committed $2.2 billion to support new investment in oil production (Shi 2016). Nonetheless, the overall sense is that China is pulling back, wary of the legitimacy of new debt accumulated by the current government. Within Beijing there is increasing frustration about the poor returns from the lending programs[23] and concerns about the longer-term implications of supporting the current government.[24]

Venezuela is not the only country that owes substantial debt to China. Since the early 2000s, China has been lending hundreds of billions of dollars to many resource-rich countries, most of which are in Sub-Saharan Africa and Latin America, and many of which are struggling following the collapse of commodity prices. Similar to the Venezuela loans, these financing packages are secured by commodities such as oil, cocoa and copper. Any agreement with Venezuela consequently could be precedential and affect China's relations globally. As Venezuela's default risk escalates, it is imperative that Chinese lenders become more active in the discussion and potential working of debt restructuring. The role that China plays in resolving the country's debt crisis will be precedential, as there are many other at-risk borrowing countries that may develop crises similar to the one in Venezuela.

China is one of the largest lenders to developing countries, yet its official position on how to deal with sovereign debt crisis is largely muted. Restructuring the Chinese debt owed by Venezuela is best done by China joining the Paris Club of official creditors, and agreeing to restructure on comparable terms to other official creditors. But short of such a decision, China could still participate in a financing package in parallel to other creditors, and in line with new IMF rules on arrears to official creditors introduced in 2016 following Ukraine's default on its Russia Eurobond. Whatever China decides in Venezuela will likely set a precedent for other countries that owe China much debt and have been battered by low commodity prices and slow global growth — countries that will seek restructurings in coming years. The decisions made in this case will be consequential.

Russia's Role

The growing role of Rosneft, Russia's state-owned energy company, presents both legal and geopolitical challenges to any restructuring. As a result of a number of recent financings, Rosneft now holds, as collateral for its loans, 49 percent of

21 The main vehicles of Chinese financing include a joint development fund that was established in November 2007 and a long-term loan facility. For more, see www.thedialogue.org/map_list/.

22 Besides the joint development fund, China and Venezuela established a long-term "oil-for-loan" facility in August 2010. This facility has a duration of 10 years and consists of three components: a $10 billion loan governed by English law, an RMB 70 billion (about $10 billion) loan governed by English law, and an agreement that PDVSA would ship oil to China National Petroleum Corporation.

23 For more, see *Financial Times* (2016).

24 For more, see Hornby and Schipani (2016).

CITGO holdings — Venezuela's oil refinery network in the United States and the most significant PDVSA asset outside of the country. Following bipartisan appeals from US senators, US Treasury Secretary Steve Mnuchin has indicated that he will ask the US government's Committee on Foreign Investment in the United States (CFIUS) to carry out a review. CFIUS has the authority to recommend that the president block covered acquisitions where national security considerations dominate, and while there are unusual conditions at play here that might raise questions as to whether CFIUS remedies apply,[25] there is little doubt that the president has and likely will use the tools to discourage or block Rosneft from controlling the company.

Other recent Rosneft investments appear to be linked to participation in joint-venture oil explorations, which, if they have US partners, would run afoul of US sanctions law, creating another flashpoint. Together, this suggests that, as in Ukraine, Russia has the capacity to disrupt a normalization of financial relations after crisis.

The New US Administration and the Group of Twenty

Venezuela could represent an important early test of the new administration's views on international rescue packages and the role of the IMF in resolving crisis. The president and some members of his team have expressed skepticism about multilateral approaches to international problem solving. In a domestic context, they align themselves with congressional critics of bailouts. Yet there is a compelling case to be made that an orderly resolution of the Venezuelan crisis is in the US national interest, and that an IMF-led international rescue program deserves strong administration support. In this regard, it would not be the first time that a crisis in an emerging market represents an opportunity for a reset of US views on rescue package. In 1982, the Mexican debt crisis, and the emerging market contagion that followed, convinced an initially skeptical Reagan administration that the IMF was a valuable partner and advanced US interests. Similarly, the 2002 Uruguay restructuring led to a strengthened relationship between the IMF and the US government, and served as a catalyst for new rules strengthening the Fund's role in exceptional access cases. Here, the proximity of Venezuela, the importance of oil and the human suffering create conditions where the new administration will want to play a leading and aggressive role in resolving the crisis.

Most of the decisions can only be made after a Venezuelan government has signalled its willingness to work with the West, but there are some steps that can be taken now. They include:

→ early consultations between the IMF, the US government (perhaps working through the Group of Seven/Group of Twenty [G20]) and other stakeholders (most importantly China) to ensure a prompt response when conditions warrant it;

→ understanding that the IMF will need to accelerate its normal timelines for the production of a program, with bridge financing;

→ early discussion of the modalities of debt restructuring; and

→ clearly signal to the Venezuelan people that there would be substantial support for their economic transition, refuting claims by the Maduro government that the West offers only austerity.

Conclusion

The crisis in Venezuela continues to intensify, and default appears to be a question of when, not if. When the day comes that a Venezuelan government is in place that is willing to work with the West, and is capable of generating broad international support, the IMF will need to move quickly to assemble a comprehensive financing package, including short-term financing, exceptional IMF access in return for comprehensive reform and a debt operation.

25 Notably, PDVSA original investment in CITGO took place in 1986, long enough ago that CFIUS may not have jurisdiction over the underlying investment that generated foreign control. In this regard, the acquisition by Rosneft would arise through default rather than an acquisition, and as anticipated in the law.

This paper has argued that the case for a debt restructuring or reprofiling rests on a number of related assumptions: first, such a program will require substantial fiscal financing in the early years, well beyond what the IMF (and the official community more broadly) are likely to be willing to provide, given the substantial economic and political risks in the program. Second, both the stock of debt, and the cost of servicing it on current terms, look to be well beyond the government's capacity to manage during the program period. Third, any debt restructuring will be extraordinarily difficult for legal, economic and geopolitical reasons, and efforts to ensure broad participation could set precedent on a number of grounds. Success would require coordination and cooperation among major powers — the United States, China and Russia, supported by the G20. If managed well, the possibility exists that a successful resolution could contribute to a strengthened relationship between the new US administration, which has expressed skepticism in multilateralism and the IMF. None of this will be easy, but getting it right could be consequential, both for Venezuela and the international community more broadly.

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