EXCHANGE MARKET REPORT

Year 16
November 2020

CONTENT

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Re-examining the money-exchange rate nexus in Venezuela

In our foreign exchange report last September, we pointed out that the relationship between Venezuela's main foreign exchange indicators and the flow of bolivars in circulation seems to be more diffuse with respect to previous years. Both the greater dollarization of local transactions, the cuts in public spending and the limitations to credit resulting from the strict banking legal reserve policy have led to a decrease in the rise of the main monetary aggregates, without this having completely generated a reduction of the upward pressure on prices or the exchange rate.

In this sense, it was argued that other factors such as uncertainty about the future development of the local market, or about the official position and future decisions on fiscal, monetary or FX market matters, seem to have gained relevance in the determination of the current exchange rate.

In other words, it seems that it is no longer enough for regulators to contract spending and thereby minimize the monetary imbalances it produces in order to combat hyperinflation or local exchange rate pressures. As we will see in the next sections, with the current market distortions and the difficulties that households and domestic companies still face in obtaining more foreign currency and protecting their income, these monetary shocks do not seem to have the same effect on prices as before.

COVID-19 as "effective" containment

As in previous weeks, tensions on the exchange rate continue to be mitigated by the hyperinflationary environment itself, whose effect on the real income of Venezuelans has been even greater in the midst of the current pandemic. In this regard, all markers continue to show increases below those seen prior to the arrival of COVID-19 in the country.

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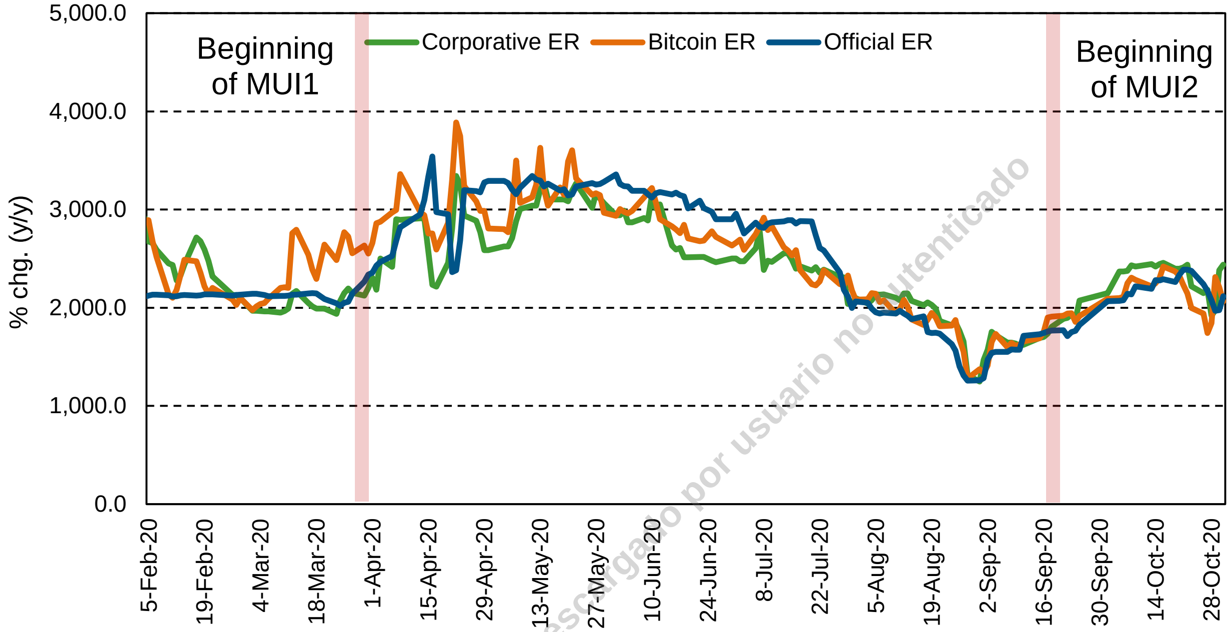
Year-on-year variation of the official and unofficial exchange rate of households and companies



Sources: BCV, Local Bitcoins and Ecoanalítica.

Thus, regardless of whether the flow of bolivars rises, the contractionary demand shocks caused by the pandemic appear to be more effective in controlling inflation and the exchange rate than monetary control itself. In fact, after the BCV ordered a first periodic cut in the legal reserve requirement faced by banks in the country (the so-called Monto Único de Incentivo in Spanish, or MUI1[1]), the adjustments in the price of the currency (with respect to its value in the previous year) were not as drastic as the cut in the exchange rate increase in the middle of the year, when the official quarantine (and the cessation of internal activities) had already reached 125 days in effect.

While the money market itself may be endogenous to this actual contraction (fewer transactions, less money), a marked rise in the exchange rate marker has not always been observed in the weeks when the monetary base has risen since the arrival of the pandemic in the country. That is, decreases/increases in this aggregate have not always led, in the midst of the pandemic, to movements in the same direction (or on same magnitude) in the exchange rate.

[1] More details in our Outlook Note 1: *New guidelines about banking legal reserves: more of the same?* 2020.

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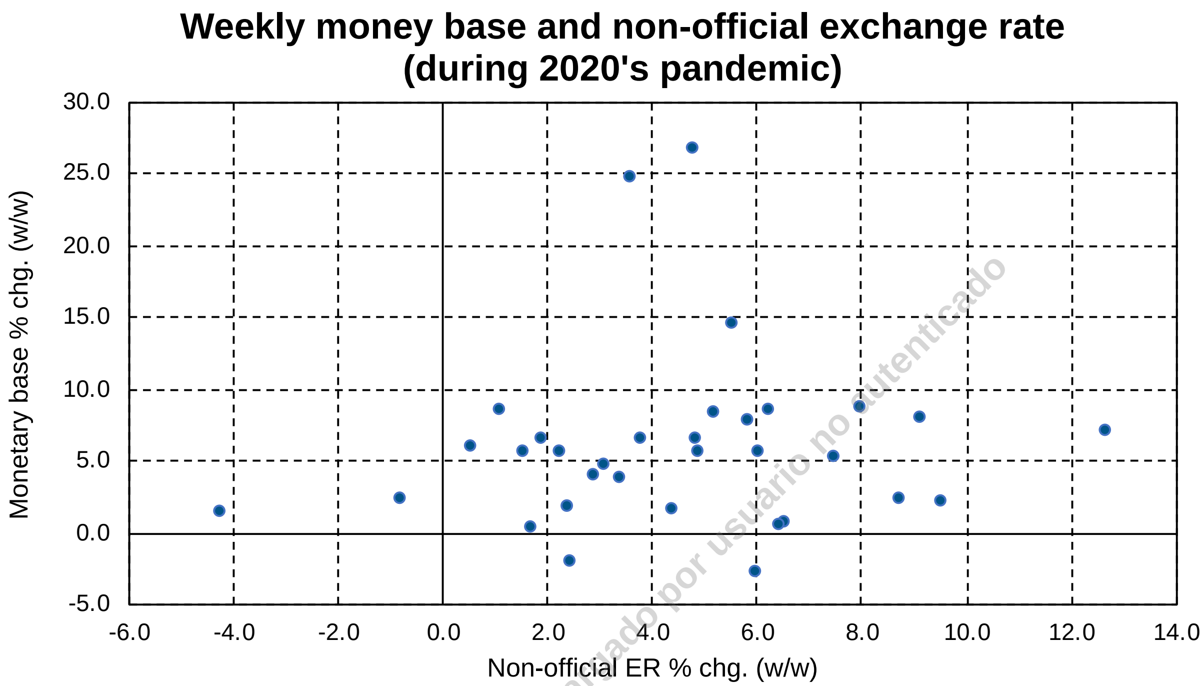

Sources: BCV and Ecoanlítica

Furthermore, in real terms, the amount of money issued by the BCV has remained, on average, unchanged since the beginning of the quarantine, although with a very slight "recovery" in recent weeks[2]. This dynamic is compatible with the collapse of oil revenues and its fiscal consequences since the arrival of the new virus[3].

[2] A remarkable exception to this rule was the observed increase during November's first week, where direct transfers to public entities' employees caused a real weekly growth beyond 20% on this money flow, reaching a new maximum level for 2020. Nevertheless, the non-official ER adjustments begun to show since mid-October when real money base showed lower expansion ratios.
[3] The main channels of transmission of the effects of COVID-19 on the Venezuelan economy can be found in our weekly report number 10: *The bubble in quarantine: How will the COVID-19 impact our economy*? 2020.

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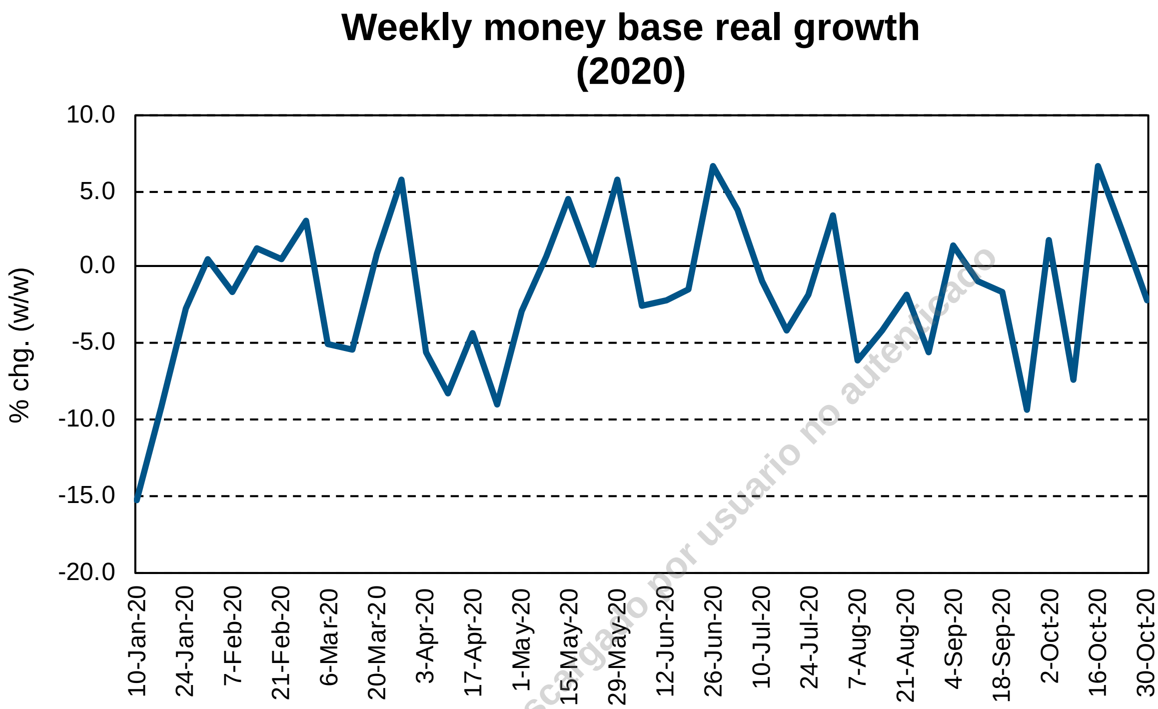

Sources: BCV and Ecoanalítica

However, the relationship between the circulation of bolivars and the exchange rate from the perspective of secondary money seems to be slightly different, at least in the last few weeks. On the one hand, in real terms (and contrary to expectations), up to the last week of October local credit activity showed a rise of up to 12% since the fixing of the MUI2[4] , which is evidenced by the increase in the money multiplier (in the same period) to ranges above pre-pandemic levels. However, this multiplier does not yet exceed the maximum levels observed in 2018, prior to the initial increases in the legal reserve, so that the recovery in local credit activity continues to be little noticeable and insufficient to achieve a recovery in the real sphere.

[4] Details of this can be found in our Outlook Note 3: *New "incentives" to banking credit in Venezuela*, 2020.

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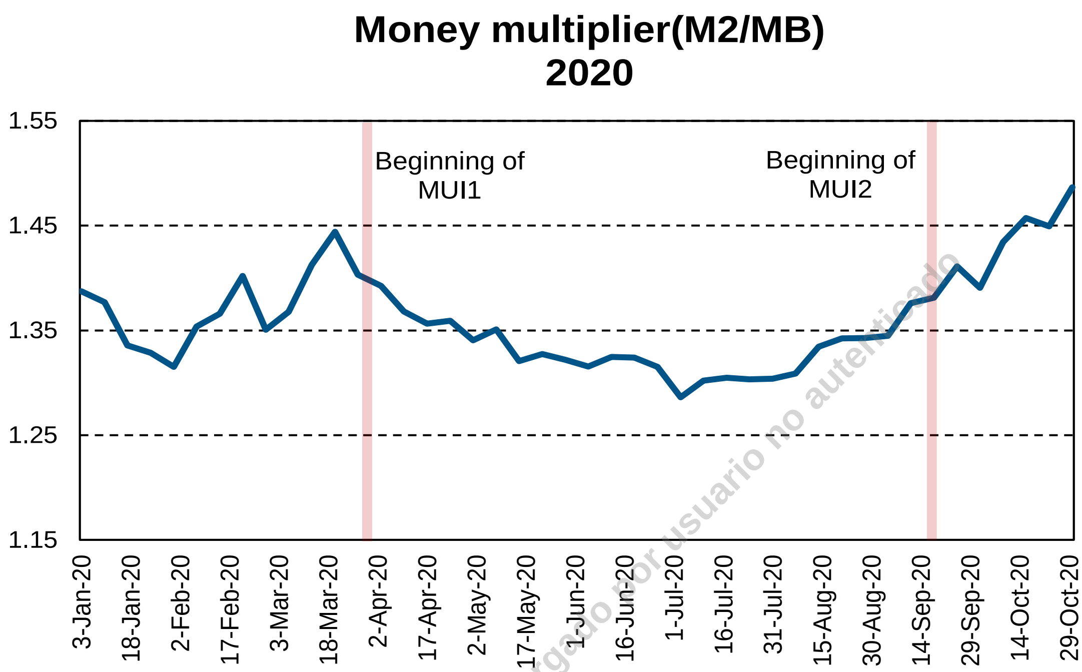

Sources: BCV and Ecoanalítica

Even with this, the above reveals that, despite the slowdown in monetary issuance coming directly from BCV and fiscal shares, the greater credit granted by the banks managed to inject an additional flow of bolivars and drove the real increase of 5.7% in monetary liquidity (M2), which contrasted with the real contraction of 1.1% seen in the same period on the first aggregate (monetary base).

In fact, unlike what was seen after the first weeks of the implementation of the MUI1, the most recent cut in the legal reserve did lead to a faster recovery of credit intermediation, coinciding with the increase (average) of 18.6% in the unofficial exchange rate in October[5]. This suggests that most of this increased financing was directed towards the acquisition of foreign currency, as we identified within the expected effects of the new MUI within the Outlook Note number 03 of this year.

However, a fraction of this balance-sheet's modification would be related to exchange tensions themselves, through the so-called *Investment Index*[6]*,* under which new credits (now expressed on the new Commercial Credit Value Units or UVCC in Spanish), are

[5] In that time, the official and unofficial corporate score (averages) rose 21.6% and 21.2%, in each case.
[6] This kind of indexation is largely explained on our Outlook Note 01: *The UVCC: new restrictions over credit*, 2019.

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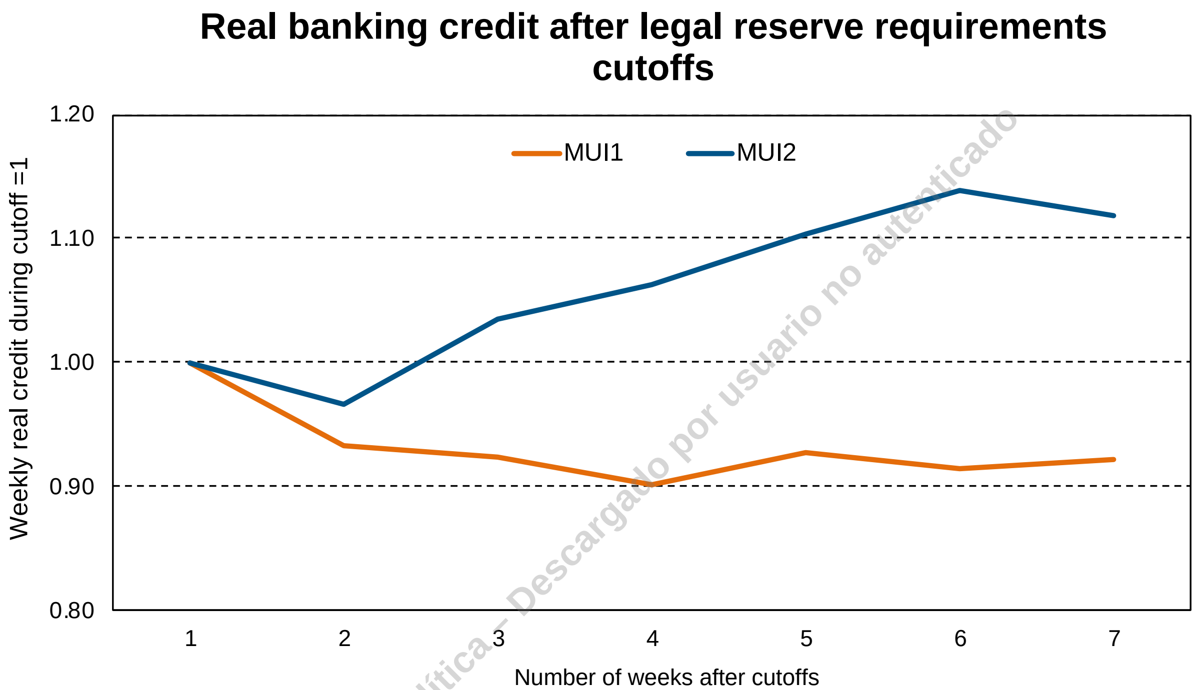
converted to bolivars according to changes on former index every week. In other words, this rise on outstanding local credit would not entirely reveal a larger credit supply, even though new rules only apply for new loans.



Sources: BCV and Ecoanalítica

On the other hand, despite the higher leverage for the acquisition of foreign currency, the adjustment of the exchange rate markers in the last month contrasts with the 28.2% rise in the average exchange rate during September. In this sense, in line with previous arguments, the pandemic and the official countermeasures seem to weigh more in the local exchange dynamics, making the price increase less aggressive in the midst of monetary expansions. On the other hand, as we will see below, credit adjustments have not been without costs in terms of availability of funds to lend, so the longevity of their recovery may be less extended than can be anticipated.

A "short term" reveal

One aspect that seems to support the transitory nature of the recovery in credit (and its exchange rate impact) is the recent dynamics in the short-term money market (interbank or overnight). Thus, both the amount traded between banks (relative to the level of bank reserves in the BCV) and the agreed interbank rates have risen since mid-year (even reaching new historic highs), when the MUI1 was already in force.

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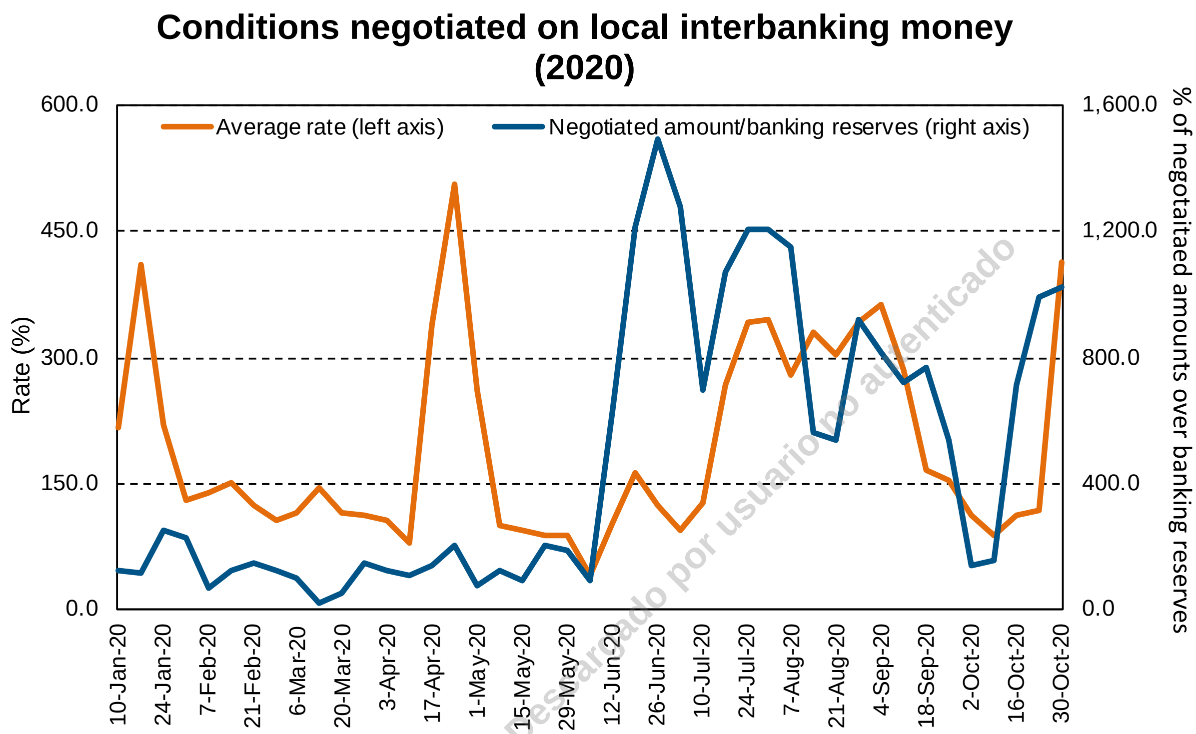

Sources: BCV and Ecoanalítica

After the cutback in the reserve fund implicit in the MU2, both the volume of funds and the yields negotiated gave way to their rise (lower demand), and then increased again significantly near the end of the month.

This context showed a growing scarcity of the resources in local currency required by the banks to face the increase in deposits imposed by the hyperinflation itself, in addition to the high legal reserve, even with the lower activity derived from the pandemic. In this sense, given that the greater credit has emerged amidst such needs for funds, it is expected that the reactivation of this financing will be unsustainable for the next few weeks and, with it, the circulation of bolivars, unless the government betrays itself (and its anti-inflationary policy) by increasing spending.

Tense weeks

All of the above seems to indicate that the exchange rate seems to reflect both the effects of the recent monetary expansion through credit and the effects of the pandemic, both at the real level and in terms of expectations. In that sense, while the above explains the logic of the Executive to control bank financing in Venezuela as a mechanism to prevent

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greater exchange (and price) tensions, it dismisses the use of the contraction of spending through cuts or outdated payments in bonds and salaries of the public payroll as an exclusive mechanism to control hyperinflation, given its lesser impact in relative terms.

However, it must be considered that neither the BCV or the regulators nor the bolivar itself have gained credibility in recent weeks or this year. In other words, the very roots of local hyperinflation have not disappeared despite the pandemic. In view of this, it is not possible to disregard the fact that, in the event that the Government relaxes its stance on its spending, exchange rate tensions will reappear and the link between base money and the exchange rate will be reinforced once again.

Therefore, under the assumption that the government could accelerate its disbursements in the coming weeks (as it has done in previous years), it is likely that we will see further upturns in the (official/non-official) exchange rate in such periods. Already in the first week of November both the bank reserves and the amount traded on the interbank market reached new highs for the year (nominally). This has occurred in the midst of an unusually sharp fall in the agreed rates[7], which indicates that a large part of the liquidity provided in that space seems to come directly from BCV interventions (direct or ordered by the Executive).

In any case, whether it comes from increased public spending or from increased bank financing granted in previous weeks, such a rise in reserves could generate new increases in the exchange rate markers in the coming days. The endless history seems, once again, to repeat itself.

Luis Arturo Bárcenas

[7] About USD 27.1 MM, with an average rate of 27.9%.

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Parallel Exchange Rate projections

Updates Fundamentals:

Given the technical difficulties in doing projections for the nominal exchange rate in a hyperinflationary environment, commented on in previous reports, at **Ecoanalítica** we find we are making adjustments to our prediction model. The results given in this report are due to that process of adjustment and, for that reason, they show relatively significant changes from our previous report.

Projections

Proyecciones del Tipo de Cambio Paralelo

Fecha	Valor efectivo *	Rango					
		Bajo		Moderado		Alto	
2019M01	2,175	849	1,187	1,415	1,881	**2,596**	3,418
2019M02	3,424	809	1,153	1,393	1,899	2,312	**3,604**
2019M03	3,362	553	881	1,120	1,674	2,170	**3,709**
2019M04	6,028	714	1,124	1,454	2,241	2,965	**5,257**
2019M05	6,450	916	1,204	1,589	2,577	3,538	**6,783**
2019M06	7,517	1,081	1,549	2,057	4,912	**7,539**	9,824
2019M07	11,974	2,468	3,448	4,111	5,465	9,078	**9,932**
2019M08	23,158	4,029	5,744	6,938	10,949	12,573	**17,949**
2019M09	19,662	7,198	10,743	15,947	**25,232**	32,784	38,528
2019M10	21,900	8,826	13,172	17,124	**26,827**	40,694	47,240
2019M11	37,191	11,428	17,055	19,574	30,258	**38,666**	61,168
2019M12	55,212	12,835	19,516	23,130	45,580	**54,411**	72,280
2020M01	72,027	12,790	19,447	23,049	45,421	**71,696**	72,027
2020M02	73,251	16,682	25,366	30,063	59,243	**75,158**	93,947
2020M03	89,197	16,212	24,651	29,216	85,451	**91,299**	170,097
2020M04	175,225	21,176	32,198	38,161	92,962	119,253	**237,964**
2020M05	195,647	65,528	107,279	**187,981**	207,635	268,682	342,777
2020M06	205,571	77,180	151,499	**196,612**	225,913	241,724	391,502
2020M07	261,415	84,624	172,993	**233,829**	294,665	351,803	429,260
2020M08	341,279	108,285	223,192	317,513	**365,428**	449,143	522,311
2020M09	432,117	110,036	340,751	374,678	408,605	**449,288**	489,971
2020M10	505,483	115,887	215,215	351,970	488,724	**525,269**	643,814
2020M11		**174,338**	**362,381**	**528,195**	**697,768**	**849,775**	**1,001,782**
2020M12		**251,940**	**380,451**	**484,847**	**863,655**	**1,436,039**	**2,008,423**

Fuentes: BCV, Ecoanalítica y Cálculos propios

*Al cierre de cada mes, a menos que se indique los contrario

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Foreign Exchange Market Indicators

Exchange rates indicators

Exchange Rate Indicators (VES/USD)			
	Oct-20	**m/m (%)**	**y/y (%)**
M2/IR*	43,168.2	29.9	1,402
RER**	879,442.8	18.7	1,985
Money desks ***	506,541.8	16.0	1,975
WER (Consumers)	481,221.0	20.2	2,221

Source: BCV, other Central Banks and Ecoanalítica
* End of month. ** Monthly average (Ecoanalítica). ***Last auction.

Annual exchange rates indicators

Exchange Rates (VES/USD)					
	2017	**2018**	**2019***	**Devaluation**	**Real Depreciation/ Apreciation**
Public Sector ER[1]	**0.001**	**70.8**	**10,584.0**	**99.331**	**-93.0**
Imports ER1	0.03	111.5	10,841.1	**98.972**	-92.8
Real exchange rate[2]	**0.2**	**3,754**	**178,037**	**97.52**	**0.0**
M2/RRII[2]	0.1	91.1	4,328.0	97.9	-97.1

Sources: BCV and Ecoanalítica
[1] Annual average. [2] At the end of the year.
*Data compiled until November. Additionally, the calculations were made using the National Assembly's inflation

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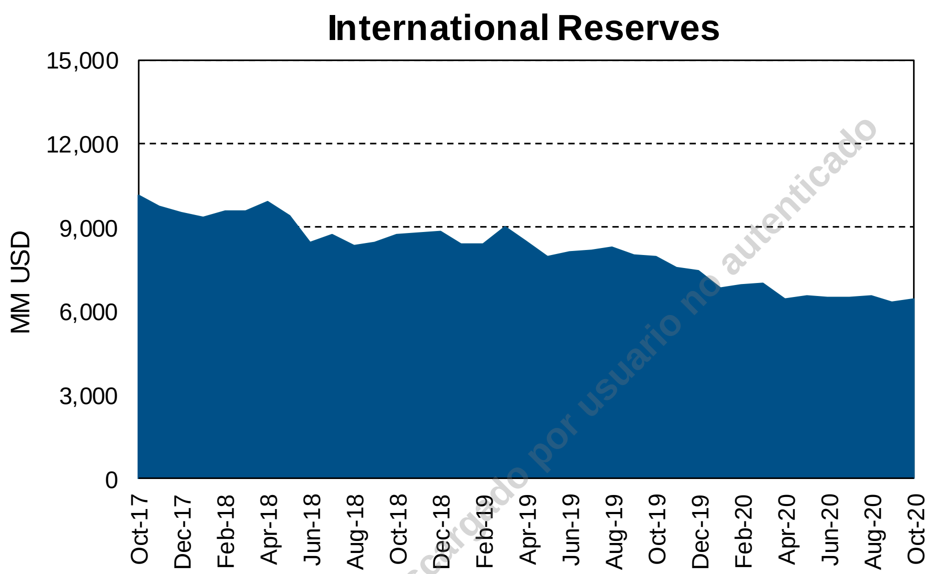
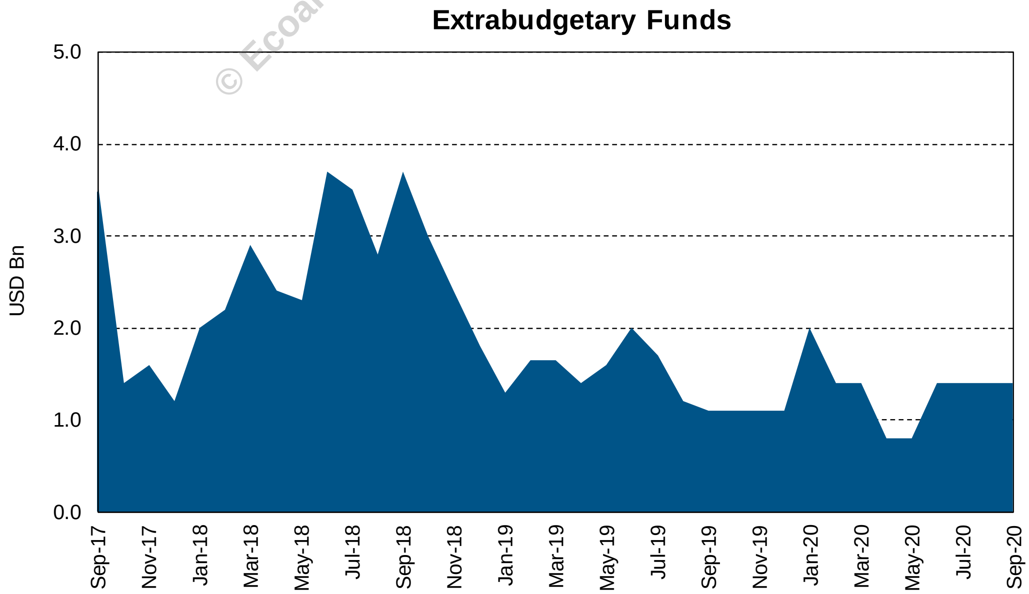
Foreign Currency Availability Indicators

International Reserves



Sources: BCV and Ecoanalítica

Extrabudgetary Funds



Source: Ecoanalítica

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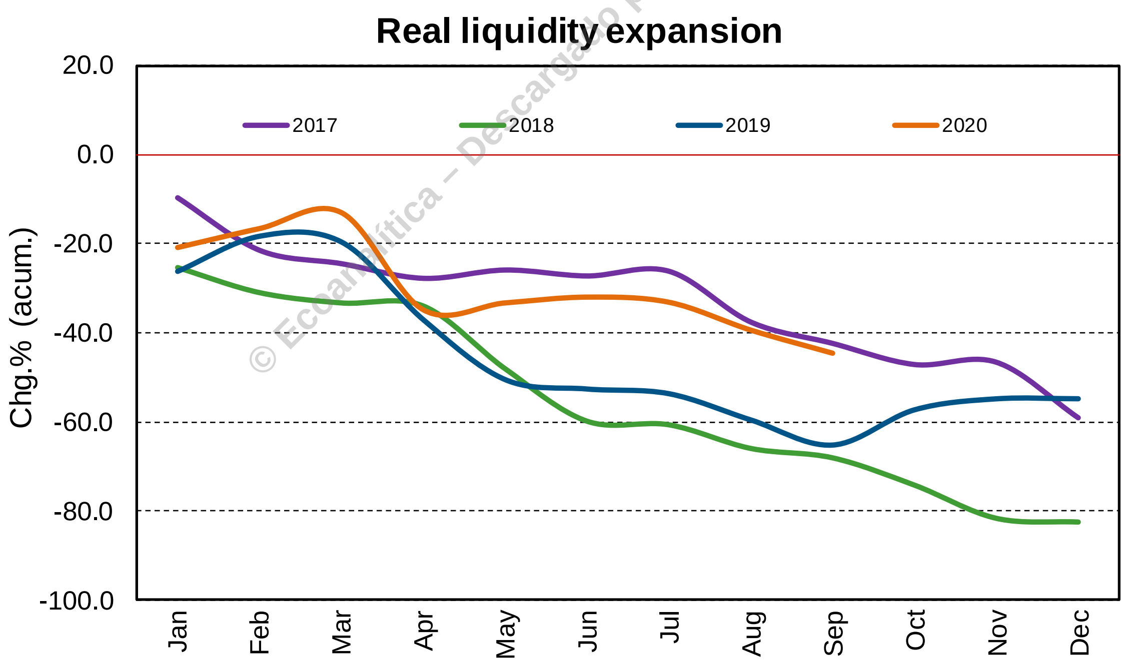
Non-Financial Debt with the Private Sector

Non-Financial Debt with the Private Sector (USD MM)							
	3Q2019	4Q2019	1Q2020	2Q2020	3Q2020	y/y (%)	q/q (%)
CADIVI -Non-settled imports	5.4	5.3	5.3	5.3	5.1	-5.5%	-3.5%
CADIVI -Dividends approved and unpaid	0.2	0.2	0.2	0.2	0.2	-1.0%	-1.0%
CADIVI -Rent and Services*	1.1	1.1	1.1	1.1	1.1	-0.8%	-0.2%
Mixed Companies - PDVSA partners	12.4	9.3	9.0	9.0	9.0	-27.5%	-0.1%
Total	**19.1**	**15.9**	**15.6**	**15.6**	**15.4**	**-19.4%**	**-1.3%**

Source: Ecoanalítica
* Includes debt with airlines.

Monetary Indicators

Liquidity (M2)



Sources: BCV and Ecoanalítica

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You should take into account

- ✓ In most of the states of the country, the month of October passed under a framework of partial confinement measures within the new "7+7 plus" scheme implemented by the authorities, where most of the economic sectors were allowed to operate in time bands staggered over some weeks while other weeks more severe confinement measures were applied in the capital city and the border states.
- ✓ The Venezuelan Central Bank (BCV, in Spanish) published the figures of the National Consumer Price Index for August and September; it shows a monthly inflation of 24.7% and 27.9%, respectively.
- ✓ In September, prices increased 1,813.1% with respect to the same month of the previous year and have increased 844.1% since the beginning of the year.
- ✓ The IMF updated the projections for Venezuela in its World Economic Outlook report. In detail, the IMF worsened the projection of the fall of the GDP to 2020 and placed it at -25%, when in the April report it had been calculated at -20%, while the fall of the GDP in 2021 will be of 10%, although it had been projected at 5% in the previous report.
- ✓ In addition, inflation is projected at 6,500% by the end of 2020, although in the April report it had been calculated at 15,000%. The same is true for the projections for 2021. The balance of payments by the end of the year is estimated to be -4.1% of GDP, while in the previous report it had been calculated at a surplus of 2.4% of GDP.
- ✓ After a US judge on October 16 declared as "*valid and enforceable*" the Venezuelan bonds that were due to expire at the end of this month, they increased their quotation to a range from USD 0.45 to USD 0.50. After the sanctions imposed by the US, their price had been around USD 0.12.
- ✓ The Ministry of Finance issued a statement extending the deadline for creditors to send their response to the "interruption of payments" offer made by the Minister of Economy and Finance, Delcy Rodriguez, which ended on October 13. According to Reuters, the offer has been largely ignored due to sanctions imposed by the US Treasury Department.
- ✓ The BCV ordered "*the immediate cessation of any product or service that the universal banks and microfinance institutions are offering to their clients or users, in order to facilitate the payment in foreign currency of goods and services in the territory of the Bolivarian Republic of Venezuela, by charging the foreign currency accounts held there*".
- ✓ Despite the prohibition, Venezuelans may continue to use cards associated with foreign currency accounts abroad, where merchants must credit payment in bolivars at the BCV exchange rate and the bank that receives the foreign currency must declare it in order to sell it at the exchange tables
- ✓ The appeal in progress since September 22 for the 31 tons of gold of the BCV stored in the Bank of England took a turn of 180 degrees after the Court of Appeal in London granted the appeal filed by authorities of the BCV, supported by Nicolas Maduro.

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- ✓ This concession annuls the ruling issued by the High Court in July, which had considered conclusive the recognition by Great Britain of opposition leader Juan Guaidó as "interim constitutional president of Venezuela. Now it is the turn of the London Commercial Court to clarify the situation.
- ✓ The new monthly report of the Organization of Petroleum Exporting Countries (OPEC) shows that, according to primary sources, Venezuela's crude oil production for September was 397,000 barrels per day (b/d), which represents a slight increase of 0.3% with respect to August. According to secondary sources, September production was 383 kb/d, 14 kb/d below that established by primary sources. This figure also represents a variation of 9.1% with respect to the previous month.
- ✓ Similarly, Venezuela also increased its oil imports in September to 156,000 bpd of condensate, gasoline and diesel, almost three times the volume received in August. Such imports were received in exchange of oil with its clients and commercial partners.
- ✓ According to Bloomberg, Reliance Industries, owner of the world's largest refining complex, signed an agreement to purchase two million barrels of Canadian heavy oil per month over the next six months.
- ✓ According to data gathered by the agency, Venezuela has been Reliance's third largest supplier of crude so far this year. This highlights Reliance's intentions to decrease its trade with Venezuela to avoid repercussions from U.S. sanctions.
- ✓ Venezuelan coal exports to Europe have increased significantly after the US imposed sanctions and shipments of 365,000 tons have been recorded up to June this year, generating USD 37 million, according to Reuters.

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