

Venezuela: Regime Change or More of the Same?

August 15, 2017

Key takeaways

- **Venezuela's dependence on oil revenues in an era of persistently low prices will continue to make governance difficult** for the regime of President Nicolas Maduro or any successor. Dysfunctional economic policies have exacerbated the situation—causing GDP to shrink by an estimated 18% in 2016, spurring hyperinflation and propelling the country's political crisis. Reform won't be easy.
- The democratic opposition is attempting to leverage economic privation to force regime change, but **Venezuelan society has been deeply polarized economically and politically for generations**, and the Maduro government continues to have a committed core of socialist/populist support inside and outside the government.
- **There are two likely political scenarios:** the persistence of grinding economic and political stalemate (with or without Maduro), or a regime change that leads to some form of transition government that tries to stabilize and reform an impoverished, polarized, and armed country. Timing has always been an issue with Venezuela, and the “inevitability” of regime change is an unreliable construct.
- **The US could foment regime change by instituting an oil embargo**, but support in Washington for such a move is limited given domestic and international political risks.

Signposts to watch

- **Sanctions:** A new Constituent Assembly will convene in late August to rewrite the constitution and reconstitute the national legislature to bolster presidential rule. In response, additional sanctions by the US or other countries are likely to be imposed, but their extent, timing, and effect are unclear.
- **The military:** The opposition is attempting to foment a popular uprising to force regime change, but it is not preparing for civil war. The military remains the most potent swing vote in Venezuela and its leadership may be forced to maintain order by moving against the Maduro government, but how the military would rule in the breach is unclear.
- **Credit and energy markets:** Oil prices are unlikely to rise enough to help the government service its debts and meet its fiscal obligations. Venezuelan bonds are widely held, and financial markets have recently marked down the government's creditworthiness. Rolling or complete default would exacerbate economic conditions and possibly trigger political transition. On the other hand, bondholders are likely to be forced to take a haircut in a regime change scenario, given persistently low oil prices and the political risks of imposing an austerity program on an already suffering populace. ▶

Economic context

While Venezuela has a long history of its government mismanaging the economy, former President Hugo Chavez (1999–2013) laid the foundations of the present crisis. In Chavez's view, Venezuela's growth had been sapped by capitalist theft of the country's resources and wealth. His socialist and populist Chavismo campaign sought to build on the Bolivarian revolutionary tradition through massive subsidies and ambitious welfare programs for poor and rural citizens, expropriation of property, nationalization of industries, repression of the political opposition centered in the cities, and a confrontational foreign policy based on staunch anti-Americanism. Since he was elected in April 2013, Maduro, a Chavez loyalist, has doubled down on these policies.

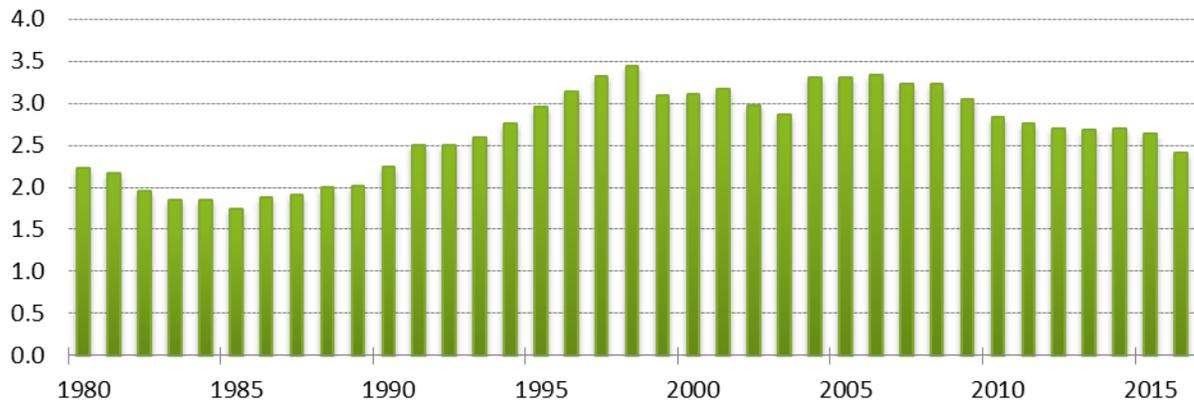
Venezuela has by far the largest proven oil reserves in the world—an estimated 300 billion barrels compared with Saudi Arabia's 266 billion barrels. Hydrocarbons comprise about one quarter of GDP and the preponderance of government revenues. As a result, Venezuela is a prime example of the natural resource curse: Easy oil revenues have supported wasteful spending and corruption and deterred economic diversification. Venezuela sits near the bottom of rankings on corruption, ease of doing business, and government agility (see chart).

Key indicators 2016–2017	Venezuela	Colombia	Mexico	Brazil
Population	32 million	49 million	127 million	203 million
0–14 years of age	28%	24%	28%	23%
Real GDP growth, 2017 forecast	-7.4%	2.3%	1.9%	0.3%
FDI inflows, 2016	\$1.8 billion	\$14 billion	\$27 billion	\$59 billion
Male youth unemployment	12.3%	15.8%	7.1	20.6
Debt/GDP, 2015	28%	48%	48%	69%
Benchmark interest rate	21.56%	5.50%	7.00%	9.25%
Gross national income per capita (PPP)	\$17,770 ₍₂₀₁₃₎	\$13,910	\$17,740	\$14,810
Governance indices (percentiles): 1=best performer, 100=worst performer				
Gender gap	51	27	46	55
Ease of doing business	98	28	25	65
Government agility	89	49	39	52
Corruption perceptions	94	51	70	45
<i>Sources: World Bank; IMF; Transparency International.</i>				

The oil industry was nationalized in 1976, but for two decades the national producer, Petroleos de Venezuela (PDVSA), maintained a reputation as a relatively well-run, technically proficient, and politically autonomous organization. PDVSA suffered gravely under Chavez, as he drove out talent and imposed political and economic strictures on the company's management and operations. As a result, production began declining in 2007; nevertheless, the destructive aspects of Chavez's and Maduro's policies were masked by the supercycle of high oil prices that lasted until mid-2014, when the country tipped into a severe recession (see graphics, next page). ►

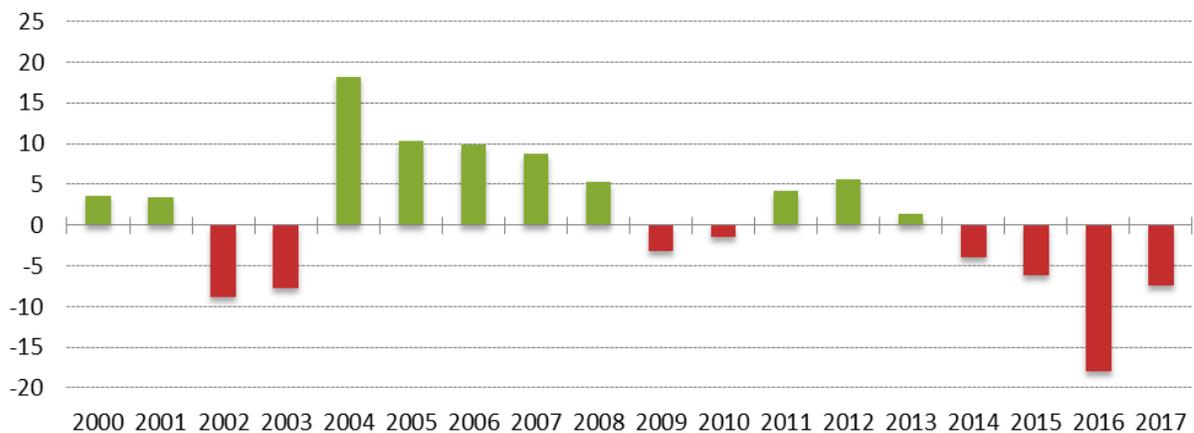


Venezuela crude oil production (million barrels per day, annual)



Source: BP.

Venezuela GDP growth (constant US\$, %)

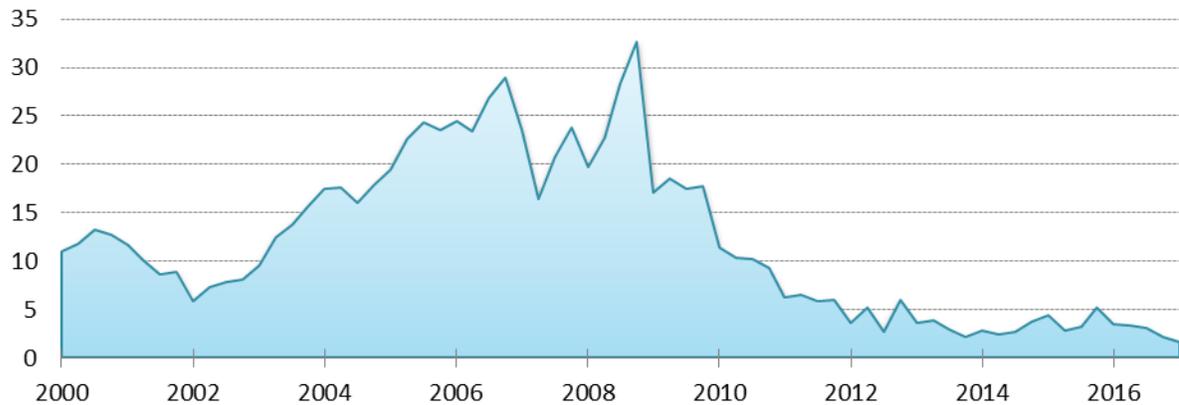


Source: IMF.

Maduro has responded to the fall in production and the oil price collapse in Chavista fashion—by instituting price controls, printing money to finance the budget deficit, limiting access to foreign currency, and restricting imports of intermediate and final goods (creating severe shortages on everything from basic medical supplies to everyday food items). The IMF estimates prices rose 274% in 2016 and will rise 1,133% in 2017. Thanks to all of this, the IMF estimated that GDP shrank by 18% in 2016 and projected that the economy will contract by more than 7% in 2017. (The government has curtailed the publishing of reliable statistics and it severed relations with the IMF and World Bank years ago.) Venezuela’s gross national income per capita in 2013 was similar to Mexico’s (at about US\$17,800), but the IMF has estimated that it has fallen by more than 50% since. As foreign exchange (forex) reserves and the dollar supply have dried up, the value of the bolivar on the black market has collapsed (by 60% in the past month), further compounding businesses’ and citizens’ everyday woes (see graphics, next page). ▶



Venezuela forex reserves (US\$, quarterly)



Source: IMF.

Dollar-bolivar exchange rate (unofficial: grey line, official: green line)



Source: Dolartoday.com.

Political developments

Economic policy has propelled Venezuela's current political crisis, and the country has been stuck in a state of political stalemate for several years.

Chavez assiduously defanged and suborned Venezuela's political institutions by removing checks and balances to presidential power. For example, the judiciary essentially became the legal arm of the state, and it has consistently protected Maduro's government against the democratic opposition. The opposition has sought to leverage the atmosphere of impoverishment and desperation to force regime change, and while opposition forces won a landslide victory and a two-thirds working majority in the December 2015 National Assembly elections, the courts have backed Maduro's efforts to disempower the parliament. ►



As part of this campaign, on July 30, the government held an election for a so-called Constituent Assembly: a new legislative body whose powers would eclipse those of the opposition-controlled National Assembly. (Chavez also convened a Constituent Assembly in 1999.) Thanks to an opposition boycott and very low voter turnout, the ruling Socialist Party won all 545 seats in the new assembly, and the vote has been validated by electoral officials. Among its other powers, the Constituent Assembly will be able to dissolve the National Assembly, rewrite the constitution, and reorganize the government.

Many believe the government's days are numbered, but predicting regime change in Venezuela has proven very unreliable. Public opinion polling is extremely difficult at the moment, but some recent soundings indicate that Maduro's approval ratings are at 20% or below. Two political scenarios seem most likely: regime change leading to a transition government, or a steady grind of current conditions. Neither is very attractive.

Venezuelan society is profoundly divided between rich and poor, internationalists and anti-imperialists, and those who support more democratic and market-oriented economics and those who support the Bolivarian socialist/populist ideal. Even if Maduro were to be forced from office, there are many partisans who would seek to take up the fight. Venezuela lacks a broad base for democratic and market-oriented reforms, while support for the Bolivarian revolutionary tradition remains strong. Moreover, as the regime has bolstered its position, it has enabled the proliferation of paramilitary groups that will likely mobilize and further destabilize the country. A popular uprising, therefore, would likely lead to widespread instability and violence, with potential cross-border impacts in the short term.

The military is the most potent swing vote and remains loyal to the government—in part because it sees itself as defending the country against foreign political intervention. In addition, many high-ranking officers also hold political office, and government largesse flows freely through the armed forces. Should civil unrest spread, the military may step in to ensure order and force Maduro out. It is unclear, however, if the military has the political sophistication to manage a fraught political and economic transition.

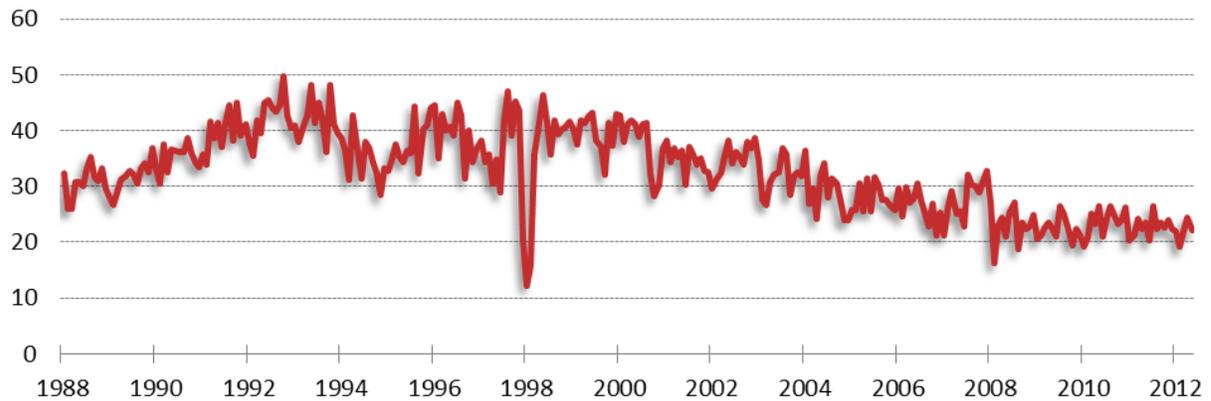
The view from Washington

In response to the July 30 Constituent Assembly vote, the Trump administration slapped sanctions on Maduro, freezing all his assets in the US and prohibiting Americans from any dealings with him. The vote has also raised the prospect of US sanctions directly targeting Venezuela's oil industry.

Despite a falloff in imports, US remains the top destination of Venezuelan crude, in part because many Gulf Coast refiners are set up to process Venezuela's lower-price heavy and sour grades of oil (see graphic, next page). This gives the US significant leverage, as PDVSA can't easily divert its product to other markets. Washington is not yet prepared to take this drastic step, however, as US refiners would need to reengineer their production to process other grades of crude oil and be hard hit economically in the near term while downstream supply chains would be disrupted. (It is estimated the price of gasoline at the pump would increase by more than 25 cents in some markets.)

Other sanctions under consideration include a ban on the sale of lighter US crude that PDVSA mixes with its heavy crude and then sells on to other refiners, and measures to restrict PDVSA's and the Venezuelan government's access to the US banking system. ►

US imports of Venezuelan crude oil (million barrels, monthly)



Source: US Energy Information Administration.

More stringent US sanctions raise a number of geopolitical concerns:

- It's not clear where other countries will land after the latest provocations in Venezuela. The EU, so far, has been largely cautious (Spain has been the most vocal in support of sanctions). Ten Latin American countries met in Lima, Peru on August 8 to discuss the situation: They sharply criticized the Venezuela's authoritarian trend and some imposed financial sanctions against high-ranking Venezuelan officials.
- US oil sector sanctions could hasten the collapse of the Maduro government but would also kindle anti-US sentiment in Venezuela and across Latin America. This could undermine Washington's ability to play a constructive role in any reconstruction effort. Such a scenario would allow for greater influence in "America's backyard" by Cuba, Russia, and China, which have significant financial, ideological, and geopolitical stakes in Venezuela's future.
- If the Venezuelan government collapses, it's not clear to what length US is prepared to go to support political and social reform and economic reconstruction. Washington's failed nation-building exercises in the Middle East suggest that US interest and capacity to execute such a program are limited.
- There is significant concern in Washington that the Trump administration lacks a playbook, the focus, and the personnel to manage a collapse scenario. Even if Washington doesn't foment regime change, there is uncertainty about the administration's crisis response capabilities and how they would play out between the White House, the Treasury Department, and the Department of State.

The view from the markets

Financial markets are signaling rising expectations of dislocation in Venezuela that would likely affect the country's ability to repay its debts. Venezuelan debt is widely held by institutional investors because when central bank interventions were pushing interest rates down globally over the past decade, high yields on Venezuelan debt were extremely attractive to investors seeking returns. Venezuela's debt load is not too onerous and despite falling oil revenues and financial hardships at home, the Maduro government so far has gamely honored repayments. ►



Venezuela 10-year bond (mid yield to maturity, %)



Source: Bloomberg.

But as its forex reserves have dwindled and instability grew this year, bonds began to sell off, particularly around the Constituent Assembly vote, with the expectation that regime change in Venezuela which would likely affect the sovereign’s ability to repay its debts. A full debt restructuring would probably be required under a new or transitional government. In such a scenario, much will depend on the nature of the transition, oil prices, and the new regime’s ability to muster the political will to impose and sustain harsh austerity measures. Venezuela’s relationships with the US and international financial institutions have been deeply damaged and will be rebuilt slowly if the political space to do so exists. ■