Q&A: Venezuela's downfall

Market Insight

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August 2017

Emerging markets senior sovereign strategist, Graham Stock, discusses the current political and economic climate in Venezuela and the likely path ahead.

Why is the US stepping up sanctions against Venezuela?

Venezuela's Chavista government (so-called because they are followers of the late President Hugo Chavez) has stepped up its twin assaults on democracy and the opposition. In 2016, the government used its control of the supreme court and electoral authorities to bypass the opposition-controlled legislature and stymie opposition attempts to organise a recall referendum that would most likely have removed President Nicolas Maduro from office. This year the government has sought to permanently sideline the legislature and potentially enshrine one-party rule by electing a new, all-powerful constituent assembly on 30 July.

What will the constituent assembly do?

It supposedly has full powers to rewrite the constitution, and is claimed by the government to have absolute authority over all other branches of government in the meantime. The opposition strongly opposes the process, and attracted around 7.2 million voters to an unofficial plebiscite on 16 July to register popular discontent. In contrast, turnout for the government's stage-managed election of pre-screened sympathisers to the constituent assembly itself on 30 July appears to have languished at around half that number. Even the British firm that supplies Venezuela's voting machines stated that the government had clearly manipulated official reports of the turnout, by at least a million votes. Those who did vote appear to have been largely public sector employees, who were threatened with the sack if they stayed away.

Why is the Chavista government now too unpopular to win free and fair elections, as it apparently did between Hugo Chavez's ascent to the presidency in 1998 and Nicolas Maduro's win in 2013 (after Chavez nominated Maduro as his successor before dying of cancer)?

The main explanatory variable is the oil price. Oil accounts for more than 95% of Venezuela's exports and government revenue. The commodity super-cycle that took international oil prices close to US$100/barrel in 2011-14 masked increasing inefficiency in the government's economic policies and allowed for popular redistributive handouts. Now oil is only around US$50/barrel, and Venezuela's heavy crude trades at a further discount of around US$10 to those international prices. As a result, handouts have become less generous but at the same time mismanagement of the economy has resulted in hyperinflation, a collapse in economic activity and widespread shortages of food and medicine. The government has stopped publishing statistics but we estimate that GDP has contracted by around a third since 2013, and inflation is running at around 30% a month.

How has the government retained power in the face of such a dismal economic performance?

As popular support for the regime has waned and progressed to opposition street protests, the government has responded with a playbook of repression and consolidation of power. Opposition marches have been tightly policed and kept away from sensitive locations such as the presidential palace. Official security forces and militia gangs have used lethal force, resulting in over 140 deaths since late March. Meanwhile, President Maduro has increasingly concentrated power in the hands of serving and retired military officers, while continuing to reward loyalty, particularly in the armed forces, with opportunities for personal enrichment through legal and illegal business dealings.

Is the government united in its current stance?

It appears so. There have been isolated incidences of dissent from within the Maduro regime – the chief prosecutor Luisa Ortega has been highly critical and was formally sacked by the newly convened constituent assembly in early August. One of the seven members of the electoral court refused to ratify the official results of the elections for that constituent assembly. But overall, dissenting voices were purged long ago, from all branches of government and from the upper ranks of the armed forces. There may be internal tensions between government officials who served alongside Chavez in the armed forces (and trained with him, or participated in his failed 1992 coup attempt) and those who followed a civilian route (often including Cuban affiliations and ideology). For now, though, they seem equally invested in the survival of the current government.

What will happen next?

This is the key question. There are no signs that a negotiated transition towards free and fair elections is imminent. Instead the government is doubling down on a strategy that concentrates power in a constituent assembly that is wholly aligned with its own preferences. The opposition is struggling to unite behind any one strategy, but is variously engaged in continued street protests, participating in newly announced (and doubtless heavily biased) state-level elections in December, cheerleading for any signs of dissent in the government and armed forces, and hoping that international pressure pays off. In this regard, US sanctions are the most visible concrete steps, and have been directed at individuals in the government deemed responsible for human rights abuses, drugtrafficking, corruption and attacks on democracy. The goal seems to be to drive a wedge between moderates and hardliners in the regime, to encourage the former to break ranks.

Will the US impose sanctions on Venezuela's oil industry?

The US buys about 40% of Venezuela's oil exports, contributing some $10bn a year. Three Venezuelan refineries, under the Citgo brand, exist specifically to process the heavy crude. A ban would, therefore, be very damaging since that oil would need to be sold at an even heavier discount if it were diverted to other international markets. That damage would be felt immediately by ordinary Venezuelans, however, since reduced oil revenues would lead to even more acute shortages of food and medicine, and so the US would be accused, not least by the Maduro administration, of exacerbating the social crisis. Furthermore, sourcing alternative oil supplies would be expensive for US refiners, and lead to higher gasoline prices for US consumers. We consider it unlikely that the US will resort to a ban on Venezuelan exports, although they might ramp up the pressure by limiting the ability of US oil services companies to do business there, or of US producers to supply the diluents that are needed to get Venezuela's heavy crude to flow through pipelines.

How is BlueBay positioned in the face of such uncertainty?

Since the fall in the oil price in 2014, our positioning in Venezuela has reflected our assumptions on the question of whether the public sector (the government and PDVSA combined) would run out of dollars to service external debt before the deteriorating social situation forced a change in economic policy. In broad terms, in 2015 and 2016 we felt that the market was exaggerating the risk of a default, and our bias was to be overweight Venezuela in our benchmarked sovereign portfolios. By 2017, we had become increasingly concerned that buffers such as international reserves and access to new credit from lenders such as China and Russia have been materially eroded. We also perceived a growing risk of further radicalization of the regime resulting in a hard line, Cuba-style repudiation of external liabilities, rather than regime change or a policy U-turn that would strengthen debt service capabilities. We have therefore been underweight so far this year, which has worked well. The Venezuela sub-index of JPMorgan's EMBIG Diversified, our main benchmark, has returned -8.9% (minus 8.9%) year-to-date, compared to a +7.6% return for the overall index.