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Global Political Insights

Adiós Presidente: Venezuela's Political, Economic & Energy Outlook After Chavez

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- **All eyes on the post-Chavez political transition.** Venezuelan president Hugo Chavez's death March 5th followed a long battle with cancer and was expected. What happens next in the country's political transition is less clear; pending a ruling from Venezuela's Supreme Court, our expectation is that Vice-president Nicolas Maduro, a self-declared communist and Chavez's anointed successor, will be acting president until new elections, which could be called as early as April. Current polls suggest the ruling PSUV will go on to win re-election.
- **Who Will Lead Venezuela?** The pre-election period is likely to feature heightened tensions between pro-Chavez supporters and the opposition, with inflammatory rhetoric and the possibility of street clashes, though we think both sides will be inclined toward restraint. Given the PSUV's strong performance in last year's elections plus an expected sympathy factor against a weakened opposition, we anticipate the victory to provide a strong lead for Maduro. However, the mandate will be somewhat vague: the continuation of what the population believes would have been the late President Chavez' policies. While Maduro is expected to be the new President, we do not anticipate that he will enjoy the same level of control over politics as Chavez did. We expect the first line of leadership to be divided between President Maduro, the anointed heir and elected Vice President, National Assembly President Cabello, with strong PSUV and military links, and PDVSA Chairman Ramirez, who ultimately controls the critical oil purse.
- **An Increasingly Complex Economic Outlook:** Independently of who succeeds Chavez, self-inflected wounds to the economy will translate into a year of weak performance, low goods availability and with it inflation acceleration. We currently expect GDP growth of 1.0% for Venezuela this year, which is lower than the 5.6% observed in 2012 according to the central bank. Lower spending and reduction in private production (which still accounts for 70% of GDP generation) will take its toll on economic activity.
- **How Long Can PDVSA Underwrite the Government?** With perhaps the largest oil reserves in the world on paper, Venezuela's crude production has punched well below its weight. Chavez's reign had been characterized by heavy-handed control of the oil sector and declining oil production, and production has languished. Venezuelan oil is relatively heavy and sour, meaning that only more complex refineries can process this crude. But it is not just Venezuela's crude that is getting hit; the country's downstream refining sector is also in bad shape. With domestic consumption now around 850-k b/d, the country has moved from being a net exporter to a net importer of gasoline. With probably falling oil prices and a need to inject capital into the upstream and downstream just to hold steady, petroleum looks strained to keep government revenues even, let alone to let them increase.

Political Outlook for the Post-Chavez Era

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Venezuelan president Hugo Chavez's death March 5th followed a long battle with cancer and was expected. What happens next in the country's political transition is, however, less clear.

As a major energy producer with ties to Iran and Cuba as well as a history of tensions with Washington, political stability in Venezuela has geopolitical implications beyond the country's borders. Venezuelan president Hugo Chavez's death March 5th followed a long battle with cancer and was expected. What happens next in the country's political transition is, however, less clear. Vice-president Nicolas Maduro has temporarily taken over the responsibilities of the Presidency.

There is some debate over the proper interpretation of the constitution - the opposition emphasizing that until new elections are called, the responsibilities should fall on National Assembly President Cabello, while the ruling *Partido Socialista Unido de Venezuela* (PSUV) appears set on its view that Maduro will be both interim President and candidate in forthcoming elections. Venezuela's Supreme Court has yet to express an opinion on the matter, but our interpretation based on their previous ruling, suggests that it will side with the PSUV's interpretation.

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Venezuela's constitution mandates that new presidential elections should be called within 30 days of the President's passing. Given the operational complexities of holding an electoral process, we think the Supreme Court may provide some minor leeway. In any event, it is in the PSUV's interest to hold the elections as soon as possible, implying that they are likely to be held in April or May at the latest. In his last public speech, President Chavez anointed Nicolas Maduro, a left leaning ex-Foreign Minister, as his heir. Given the strength of the President's political will, we anticipate that the PSUV will support Maduro's candidacy.

We expect the ruling PSUV will go on to win re-election in new polls, given their strong performance in last year's elections plus a sympathy factor.

The opposition candidate will mostly likely be Capriles, governor of the State of Miranda and the candidate who faced Chavez in the October 2012 presidential elections. The opposition, however, appears less mobilized and organized than in the previous presidential contest. We expect the ruling PSUV will go on to win re-election in new polls, given their strong performance in last year's elections plus a sympathy factor.

We expect the pre-election period to be a period of high emotion, with the risk that tensions between the opposition and supporters of the ruling party could spillover into disturbances at rallies and public gatherings. While Chavez's passing could be an opportunity for new, less-fraught relations between Caracas and Washington, we expect Washington to refrain from the appearance of interfering in Venezuela's affairs, though calls to openly support the opposition could arise from the neoconservative school of the US foreign policy establishment.

Figure 1. Upcoming Political Signposts in Venezuela

Maduro sworn in as acting president	March 9
PSUV nominates Maduro	March 11
Opposition nominates Capriles	March 11
Presidential election	April 14
Regional elections for mayors	July 14 (now suspended)
2014 budget released	October 1

Source: Citi Research

After managing the initial political transition, likely helped by a sympathetic judiciary, the ability of the PSUV party apparatus to maintain continuity and to manage the country's complex economy becomes more questionable in our view. Chavez's highly personalized leadership style resulted in a small inner circle. Decisions were ultimately taken by Chavez personally. Besides lacking the president's strong public support, internal rivalries between the PSUV and lower oil prices strongly suggest that the previous model will not be sustainable for an extended period.

We believe that power within the PSUV will be divided with three key players: Maduro, a more traditional left-leaning Cuba-ally, as President and with stronger links to the Supreme Court; Cabello, the National Assembly president, with stronger nationalist leanings and with strong connections with the military and political structure of the PSUV; and Ramirez, PDVSA's president, who influences oil policy and is, ultimately, in control of the key oil purse. The "movement-style" nature of Chavismo and lack of a cohesive ideology are likely to test the will of the leadership when faced with politically costly decisions.

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The death of Chavez follows a period of declining appeal of his Bolivarian Socialist model, during which when the Brazilian model of a moderate pro-business left-wing government gained more traction on the continent. In years to come, the declining feasibility of this model could open up space for political alternatives. The risk is that the country deteriorates, and change does not happen in an orderly fashion, but rather sparks confrontation. Furthermore, President's Chavez political style was very influential in several nations in the region. The long-standing autocratic leaders of Ecuador, Bolivia, Argentina and other nations, could draw lessons from Venezuela. If the transition faces complex uphill challenges, those lessons could well be a reduced willingness to relinquish power and changes in succession plans in these and other nations.

The role of the military has always been an enigma in Venezuela but our view is that they will support an institutional way out, independent of the outcome. This is possible thanks to statements made in the previous presidential campaign by former opposition candidate Henrique Capriles, who clearly stated that he will not begin a persecution within the armed forces in case he gets to power. Hence, the military know that their conditions will remain constant independently of who wins the presidential elections.

An Increasingly Complex Economic Outlook

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Initially Chavez's successors will aim to reassure continuity, especially funding for generous social programs. In the near-term, they could move to implement potential near-term populist sweeteners such as a rise in the minimum wage. But such measures will do little to address the country's economic challenges.

Economic pressures on Chavez's expensive "Bolivarian socialist" model are mounting. Initially Chavez's successors will aim to reassure continuity, especially funding for generous social programs. In the near-term, they could move to implement potential near-term populist sweeteners such as a rise in the minimum wage. But such measures will do little to address the country's economic challenges.

Venezuela's economy is in a weak position at this juncture. During 2012, the government pressed hard on spending to lift the economy and to deliver on social

programs that would allow an ailing President Chavez to fight the credible challenge being presented by Capriles. As a result, imbalances grew, inflation was partially contained through price controls, good scarcities mitigated by government imports of foods and medicines and by increased allocation of dollars through an over-valued and dysfunctional FX regime. As a result of the electorally driven policies, the economy grew 5.4% year-on-year in Q4 2012. However, the electoral legacy of deep fiscal and balance-of-payment imbalances, as well as repressed inflation and mounting scarcity, forced the authorities to initiate a process of gradual adjustments. Key amongst those adjustments is a devaluation of the *bolivar*. The initiative attempts to produce both, a balance of payment adjustment and a fiscal adjustment.

However, the lack of elasticity of both exports and imports plus the suppression of the SITME market (and the dollars that were supplied through it) have only resulted in increased FX scarcity and very strict rationing. The result is a sharp move up of the parallel exchange rate, inflationary pressures and a deepening of basic products' shortages. The devaluation shows on the one hand the new authorities attempt at conducting some pragmatic adjustments. Yet it also illustrates the difficulties the government faces to come up with a coherent, comprehensive and sizable enough set of initiatives to address economic imbalances.

The initial phase of the new government is likely to be marked by a tolerant population, still much affected by a strong sympathy effect and the memory of the Chavez' years. However, if economic and political difficulties mount, social demands on the administration are likely to increase. Under those circumstances, more radical action by the leadership to consolidate control, intervention by the country's military or other outcomes with negative implications for political stability cannot be excluded in the years ahead in our view.

Venezuela is both an important player in global oil markets and critically dependent on the income the government derives from oil to finance its Bolivarian Revolution. Venezuela's accounts are murky and it is difficult to determine a precise level of oil prices that allows the country to fund itself. However, with Brent at an average of $108 a barrel in 2012, the country still runs a 5% of GDP consolidated government deficit (including PDVSA). While a more realistic exchange rate could help produce a fiscal adjustment, much of it would emerge from a decline in real wages -- something that the a post-Chavez PSUV may not have much stomach for. Therefore, if oil prices (or production) were to decline, the economic challenges would inevitably mount.

Venezuela's dependence on oil is extraordinary. Almost 95% of the country's exports are linked to oil and a huge fraction of the government revenues emerge from it as well.

Venezuela's dependence on oil is extraordinary. Almost 95% of the country's exports are linked to oil and a huge fraction of the government revenues emerge from it as well. Therefore, the lower bound of oil prices at which the economy's imbalances become truly troublesome is a frequent source of debate. However, estimating a breakeven level is complex as it depends on other factors. For instance a devaluation may increase the fiscal tolerance for lower oil prices. Or, capital outflows may adjust in response to movements of the current account. Notice that a prudent definition of breakevens would take into consideration the fact that the country can partly compensate lower prices through other policies and, importantly, that the government can always use domestic sources of financing (monetary and local debt placement at low interest rates) for fiscal accounts as well as running down some of their external assets.

We estimate that oil prices a lower bound of $85 for the Venezuelan variety below which the balance of payment and fiscal accounts put the country on the threshold of solvency (Venezuela Macro View - The Price is Right? Part I: Fiscal Perspective and Venezuela Macro View - The Price is Right? Part II: Balance of Payments

Perspective). The number, however, has been growing fast over time as Chavismo engages in more aggressive spending at a time when production does not grow. That, plus the outlook for declining Venezuelan variety oil prices (we estimate low 90's for 2013) promise to stress the domestic economy.

A tenet of Chavismo since the 2002 oil strike has been its undisputable willingness to pay its external debt (it is more disputable whether a similar willingness to pay emerges for nationalizations and other business disputes). We think it is highly likely that the new authorities will exhibit the same perspective in the first few months or perhaps years. However, the internal differences and the potentially mounting economic problems could test the resolve of the PSUV new leadership in years to come. Already PDVSA has fallen significantly in arrears with its services payments, both at home and to foreign providers. How the authorities respond will be dependent on a complex set of issues yet, we think, it is fair to say that it is unlikely that the new government will share the same contrition to its debt obligations.

Amid rising inflation, shortages of basic goods, a mounting debt burden and minus the oil price spike that funded Chavez's programs, the response of the government should be carefully scrutinized. It is likely that after a few "pragmatic" attempts at managing the status quo, the authorities are eventually driven to consider more radical reforms.

Amid rising inflation, shortages of basic goods, a mounting debt burden and minus the oil price spike that funded Chavez's programs, the response of the government should be carefully scrutinized. It is likely that after a few "pragmatic" attempts at managing the status quo, the authorities are eventually driven to consider more radical reforms. A likely variant of such reforms is a turn towards increasingly aggressive price controls, nationalizations and other economic interventions.

Despite what has been said by many analysts, the bilateral agreements between China and Venezuela, known locally as the Chinese funds, have provided the country with resources for projects at a cheaper financing cost than standard debt issuance. Another interesting fact is that under the conditions of these agreements, Venezuela has to put money as well, and disbursements are only made after the Chinese Development Bank approves the projects. The first fund was for US$4 billion and currently there are another 2 funds worth US$8 billion and one more for US$20 billion. We do not see additional loans on the horizon and even there has been speculation of China delaying disbursements and complaining about the quality of the oil being exported to China.

Nationalizations have been used by the government as a measure to exert control over the private sector.

Nationalizations have been used by the government as a measure to exert control over the private sector. However, after many years of such privatizations, the share of public and private sectors on the GDP has remained constant at 30% and 70% respectively. Within the government, they know that the private sector is necessary to keep production, but at the same time there is a faction of Chavistas who believe that the role of the state has to be increased even further. This is when the triangle of power between Maduro, Cabello and Ramirez becomes useful as, as long as they stay together, those forces can be contained and we would see a continuation rather than a radicalization of the nationalizations.

It is worth talking about the help that Venezuela gives to other countries through the PetroCaribe and ALBA agreements. We believe that with Maduro this help will continue and only when income runs short they will think about modifying the conditions. Currently, these agreements represent between US$10-12 billion a year (with ~US$4 billion to Cuba) so they are an important liability for the government.

How Long Can PDVSA Underwrite the Government?

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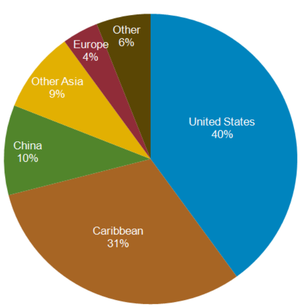
Chavez's reign had been characterized by heavy-handed control of the oil sector and declining oil production, which fell from peak levels of 3.5-m b/d in 1998, the year he was elected, down more than 1-m b/d to 2.35-m b/d in early 2013.

Venezuela has, at least on paper, the largest proven oil reserves in the world, but has struggled to realize its potential. The BP Statistical Review of World Energy 2012 sees Venezuela's reserves at 296.5 billion barrels, above Saudi Arabia's 265.4 billion barrels. Nevertheless, it is the fourth-largest exporter in OPEC.

For further details on the outlook for Venezuela's energy sector, please see "Venezuela after Chavez - A fresh look at Venezuela's oil sector and its potential" by Eric Lee, Ed Morse and the Citi Commodities Team.

Chavez's reign had been characterized by heavy-handed control of the oil sector and declining oil production, which fell from peak levels of 3.5-m b/d in 1998, the year he was elected, down more than 1-m b/d to 2.35-m b/d in early 2013. 1970 saw the peak of Venezuelan production at 3.7-m b/d, but the nationalization of the oil industry and formation of PDVSA in 1976 led to a fall in foreign investment which negatively impacted oil production, which dropped fitfully to the 1985 nadir of 1.68-m b/d. The response to this was the *La Apertura* initiative to open up to foreign investment in the upstream sector after the onset of the first Gulf War in 1990.

Figure 2. Venezuelan Crude Oil Exports by Destination, 2011



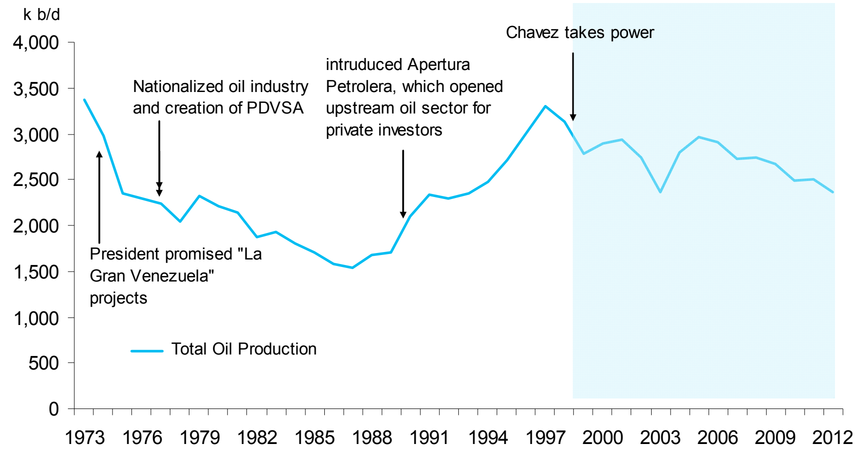
Source: US Energy Information Administration, Citi Research

But as Chavez took power in 1998, oil prices were plummeting. Venezuela played an important role in the OPEC-non-OPEC alliance to cut output and put a floor under prices. Compliance with these quotas meant an easing of production levels. PDVSA would have majority ownership of all oil projects within any joint ventures, or "*empresas mixtas.*" Venezuelan investment in the sector began to recede as oil prices fell on the back of Saudi overproduction at the same time as demand was hit by the Asian financial crisis.

Production since then has languished, exacerbated by the shut-in of production in December 2002 to January 2003 as almost half of all PDVSA workers went on strike calling for the removal of Chavez from office; some 20,000 PDVSA personnel were dismissed following the strike, including experienced engineers and managers, hitting the industry's human capital. Despite the downward descent of the oil sector, in June of last year Chavez continued to call for production to reach more than double to 6-m b/d by 2019.

While production waned, domestic consumption also rose as Chavez implemented wanton government price subsidies which almost doubled oil demand. The country's domestic gasoline prices are among the lowest in the world after subsidies

Figure 3. Historical profile of Venezuela's oil production, 1973-2012



Source: EIG, Citi Research

Several major policies stand out in their impact on exploration and development activities, and the growth trajectory of oil production, including the management of declines of mature fields. Historically, Venezuela's fiscal regime was based on a concession system. The 1967 Hydrocarbon Law saw the first use of Service Contracts, but the oil industry was nationalized before production began at any of the blocks awarded under service contract terms. With La Apertura from 1990, international oil companies returned to Venezuela's upstream sector, under service contracts (Operating Service Agreements, or OSAs). The OSAs saw PDVSA retain title to hydrocarbons production, with operating companies broadly paid on the basis of capital recovery, incentives and operating expenses.

In April 2006, Venezuela moved to take control and majority equity stakes in its OSAs and Strategic Associations. ExxonMobil and ConocoPhillips quit their projects as a result and remain in an arbitration stalemate with Caracas. BP, Chevron, Statoil and Total accepted their new status as minority partners in new "*empresas mixtas*". The services sector was targeted in 2010, and drilling rigs and other assets were partially nationalized.

Venezuelan oil is relatively heavy and sour, meaning that only more complex refineries can process this crude; the US Gulf Coast is particularly well suited to this. But even as Venezuelan production has been struggling, the North American hydrocarbons revolution is reducing the US's need for imports of both light sweet and heavy sour crudes. Venezuelan crudes are already being hit and could continue to suffer, especially as US Gulf of Mexico production of medium sour crudes also begins to pick up, and as Canadian sours increasingly reach the Gulf Coast.

With the US accounting for some 40% of Venezuelan crude exports, this is a major blow, although some trade should remain for term contracts to PDVSA's downstream assets. About half of Venezuela's exports are committed to others, due to the need to service debts, particularly to China.

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Given the continued downward trend in oil production, the country's heavy reliance on PDVSA's oil revenues to finance ballooning social spending, leaving continued underinvestment to bolster these oil revenues going forward, there is a spiral of bloating public debt that means oil policy, government programs and aid to Cuba need to be reassessed. Without the charisma and popularity of Chavez, Venezuela's future leaders may not be let off so lightly on corruption and economic mismanagement of the country by the populous.

So if this unsustainable status quo persists, both Venezuela's crude production and refinery system should struggle. When change comes is hard to say, but if more conducive policy were to conceivably come about, not only would crude oil production (with lower operating costs than Canada's oil sands) put downward pressure on global prices, but also any recovery of the refining system would be doubly bearish on Brent. European refineries would be savaged, and the resulting drop in Northwest Europe crude needs would be bearish for Brent.

Conclusion

Inter-PSUV rivalries and the gradual decline of Chavez-era support compounded by economic constraints could make the country's post-Chavez outlook more complicated and its longer-term prospects more uncertain as a result.

The months ahead will be a crucial time for Venezuela, closely-watched not only by domestic observers but by Washington and others in the region. The capacity of Chavez's successors to manage the transition and the country's complex economy will have implications far beyond its borders, as Venezuela is one of the few remaining significant economies to practice this brand of state-centered socialism. It will not be able to rely upon the dynastic transition enjoyed by the Castro brothers in Cuba.

Inter-PSUV rivalries and the gradual decline of Chavez-era support compounded by economic constraints could make the country's post-Chavez outlook more complicated and its longer-term prospects more uncertain as a result.

Appendix A-1

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