

Venezuela at the Crossroads

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Nicolas Maduro's rule appears to be approaching its end, but the exact timing and path of the political transition remains uncertain despite the strong momentum behind the anti-government protest. Geopolitical rivalries, foreign influences, military interests, and doubts about the protest movement's staying power suggest that the restoration of democracy in Venezuela will likely be hard to achieve without a strong diplomatic and economic commitment by the U.S. and its allies.

What Happened...

On January 23, 2019, the head of the opposition-led National Assembly, Juan Guaido, declared himself as Venezuela's "acting president." **His declaration reportedly came after pledges of support by U.S. Vice President Pence and followed a carefully developed plan that involved key Venezuelan opposition figures, U.S. officials and lawmakers, and U.S. allies.** In a tightly coordinated response, the U.S., its Latin American allies (i.e. Argentina, Brazil, and Colombia), and Canada quickly recognized Guaido as Venezuela's legitimate leader. President Trump followed the recognition with a promise to use the "full weight" of U.S. economic and diplomatic power to push for the restoration of Venezuelan democracy. Further, with pressure from the U.S., the United Nations Security Council took up the Venezuelan crisis for discussion despite opposition from Russia and China.

Why Now...

The seeds of the current political upheaval were sown in last May's elections when Maduro banned the most important opposition leaders from the presidential campaign and won the presidency in a ballot that was broadly condemned as fraudulent. This in turn also led to the creation of the opposition-led National Assembly, which was internationally recognized as the only representative of the sovereign will of the Venezuelan people.

Following May's elections, the opposition movement failed to make any significant political headway due to disagreements and differences on strategy among opposition leaders, as well as government suppression at the same time that the domestic economic, social and political situation continued to deteriorate further—**hyperinflation (by some estimates as high 2 million percent annually), extreme poverty, violence, corruption, ransacking of public funds, political repression, and large-scale migration set the stage for the current political dynamics. The second inauguration of Maduro as Venezuela's president on January 10, 2019 provided the trigger.**

The external backdrop also favored a different political and diplomatic approach to the Venezuelan crisis. The Trump administration kept the issue of human rights and Venezuela's humanitarian crisis alive in the international diplomatic discourse, imposing sanctions to deprive the Venezuelan leadership of illegal cash, calling on Latin American countries to toughen their stance, and building a tight coalition around the idea of required political change in Venezuela that included senior U.S. officials and allies.

Many right-leaning Latin American governments, most importantly Brazil, Colombia, and Argentina, found a common cause that aligned with the Trump administration. Partially driven by ideological hostility towards the Venezuelan government (and its Cuban backers), as well as concerns over the economic and social stress that migration from Venezuela was imposing on their respective countries, they were ready to throw their support behind the U.S. strategy.

The U.S. meanwhile saw the Venezuelan crisis as an opportunity to resolve a vexing geopolitical concern. Over the years, China and Russia made their influence acutely felt in the U.S.'s "own hemisphere" by propping up the Maduro regime with cash, loans, investments, and military supplies. This support was partially designed as "payback" for the U.S.'s perceived intervention in their own spheres of influence (i.e. in the South China Sea or Ukraine.) China has been a constant source of financing for Venezuela, having lent some \$70 billion, mostly against crude oil, according to Bloomberg. Meanwhile, Russia continues to serve as Venezuela's top military supplier and has made significant investments in Venezuela's energy sector. For example, Rosneft alone has funneled an estimated \$7 billion through loans to Venezuela and enjoys a 49.9% stake in CITGO as collateral for its \$1.5 billion loan to the company. Unconfirmed reports also suggest that the Maduro government has asked Russia to build a naval and military base in the country.

China and Russia have warned the U.S. to stay out of Venezuela, calling recent developments a coup attempt to unseat a legitimate president. Both countries also voted against the U.S. in the recent United Nations Security Council meeting. However, Russia has taken the more aggressive tact, warning in a recent statement that if the U.S. did not stay out of Venezuela, there “would be a catastrophic scenario that would shake the foundations of the development model we see in the Latin American region,” clearly serving as a threat to pro-U.S. governments in the region.

Conditions for a Successful Transition

To bring about a successful political transition, the Venezuelan opposition and its external allies must meet several conditions:

First, keep the intensity of the democratic movement alive and growing. Low-intensity street protests are not likely to lead to Maduro’s demise. He has survived street protests before, and his security and paramilitary units, which are reportedly under the control of Cuban intelligence, have successfully crushed dissent in the past. In acknowledging this risk, John Bolton, the U.S. national security advisor, warned Cuba about its influence over these forces.

Second, incentivize military leadership to switch sides. The military leadership has already declared its “absolute loyalty” to the Maduro regime, making a military coup at this stage unlikely. Incentivizing the military leadership to switch sides presents a challenge given their vested interests (access to illegal money, state funds, etc.) in maintaining the current regime. The opposition’s recent grass-root campaign offering amnesty to the military personnel who abandon the Maduro regime may help crack the military ranks. However, despite their symbolic value, small-scale or low-level defections would have few practical implications for the opposition. An alignment of military leadership and opposition interests could be effective in pressuring the Maduro regime into submission.

Third, deprive the Maduro regime of state oil revenue and other financial lifelines. The U.S. has been proactive and effective on this front—it has already imposed multiple rounds of sanctions on the Venezuelan leadership and their business henchmen, targeting sources of illegal funds and their wealth abroad. The PDVSA sanctions announced on January 28, whereby oil sale proceeds would be put away in “locked accounts,” targeted the oil revenues that served as the Maduro regime’s main funding lifeline. After the announcement, Bolton clarified that the measures would cost Maduro \$11 billion in lost export proceeds over the next two years and block him from accessing \$7 billion in PDVSA’s assets. Meanwhile, Guaido has asked the Bank of England to deny Maduro access to Venezuela’s gold reserves (worth an estimated \$1.2 billion). While the combined effect of these measures is hard to gauge, they will undoubtedly weaken Maduro’s grip on power, thus potentially speeding up the end of his regime.

Finally, continue building international support for the acting president. Undermining Maduro regime’s legitimacy on the international stage should also be a critical part of the strategy to oust him. With the U.S., Canada, and all major Latin American countries (excluding Mexico, Nicaragua, and Bolivia) having already extended official recognition to Guaido, the pressure on other countries to follow suit will increase. In this context, the official, forthcoming recognition from the EU will be particularly important because it may also affect the way Russia and China think about Venezuela going forward. If the international diplomatic tide turns decisively in favor of the new democratic government, the incentive for Russia and China to stick with the receding Maduro regime will eventually fade. After all, both Russia and China have a better chance to protect their interests by working with a new regime that is internationally recognized and reflects the sovereign will of the Venezuelan people.

Market Implications

The surge in Venezuelan bond prices since the beginning of January has coincided with the growing momentum of the anti-Maduro protest movement and its strong backing by the U.S. and its allies. Markets’ positive reaction seems to suggest that a political transition to a new, legitimate government may happen, which in turn could lead to more constructive negotiations on Venezuela’s defaulted debt. **Venezuelan bonds will probably continue to find near-term support given that these dynamics are unlikely to change.**

Over the medium term, the outlook for Venezuelan assets remains cloudy because the eventual transition to a new regime will likely be associated with risks related to the government’s ability to address issues of decades-long economic mismanagement, hyperinflation, unemployment, corruption, insecurity, and basic assistance to an undernourished population. There will also likely be uncertainty about the government’s ability to ramp up oil production, concerns about the legal battles with holders of Venezuelan bonds, the size of haircuts following potential debt restructuring, as well as uncertainty about the sizeable claims on Venezuelan assets by China, Russia, and other actors.

However, over the long term, Venezuela represents a slow, but improving sovereign credit story. Support for this view comes in the form of a strong endorsement and commitment to the new government from the U.S. and its allies, expected strong international

support for an eventual IMF program (injecting much needed cash in the economy), a likely ramp-up of oil production, better control over the state oil revenues, and a less confrontational China and Russia.

In summary, these market scenarios carry significant and ongoing event risks given the context of this confrontation, including where the deterioration of civil institutions and governmental structures can lead to abrupt breakdowns in governance and law and order.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of January 31, 2019

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2019-0638