

Economic and Market Analysis
Country Analysis & Commentary
Venezuela

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A New Government? — A Look Ahead

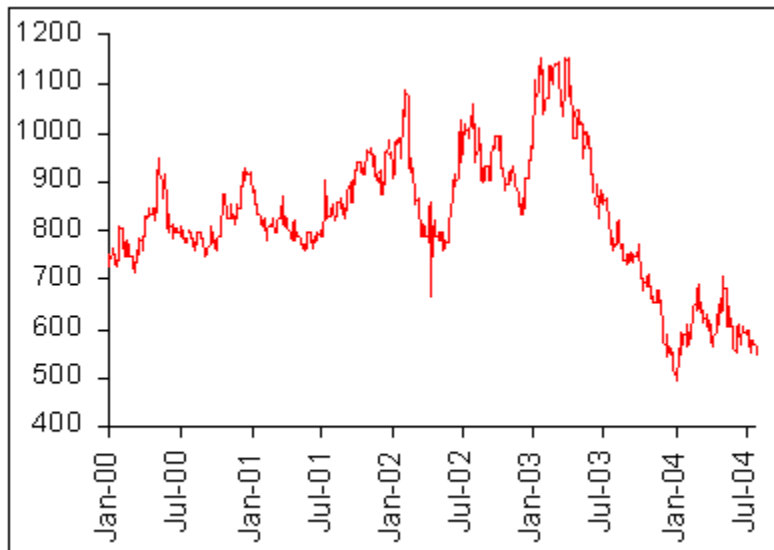
Summary points

- We maintain our overweight recommendation on Venezuelan sovereign debt as the August 15 recall referendum date approaches.
- We think that the recently signed governability agreement is a significant development in that it consolidates unity among the disparate opposition groups.
- In the event that President Chavez is recalled on August 15, the agreement should bolster investor confidence in the coherence of a possible opposition-led government.
- In the event that President Chavez prevails on August 15, our overweight recommendation on Venezuelan sovereign debt would become more contingent on the price of oil.

Staying Overweight on Unity and a Meaningful Message

Venezuela's external debt has rallied strongly in recent months leading to questions of whether or not investors should lighten up positions in view of the uncertainty associated with the upcoming August 15 referendum. (See Figure 1 below.) After analyzing recent developments in Venezuela, we recommend that investors remain overweight Venezuela sovereign debt. Our rationale is, in part, based on our view that the opposition is likely to prevail in the August 15 recall referendum and, in part, on the high price of oil and Venezuela's large stock of international reserves (\$24 billion) relative to its stock of external debt. The referendum is expected to be close, but most of the established Venezuelan polls continue to show that the Venezuelan electorate is likely to revoke the mandate of President Chavez in a tightly contested race.

Figure 1. Spread in Basis Points over UST of Venezuela 2027 Bond (Through July 30)



Source: Citigroup.

What Kind of New Government for Venezuela?

Should Chavez's mandate end on August 15 and should a candidate from the opposition be elected president later this year, a major concern for investors is the question of leadership and unity among the opposition. On Sunday July 25, the opposition (Coordinadora Democratica or CD) signed a governability agreement entitled the National Accord for Social Justice and Democratic Peace. The governability agreement is an impressive document that demonstrates the unity of the opposition, and should go a long way toward giving investors confidence that an opposition-led government would implement coherent economic and social policies. In the event that Chavez is recalled and an opposition led government is elected later this year, we expect that the overall investment climate would improve considerably and that Venezuelan sovereign debt would rally. Here we explain how the governability agreement provides important insight into understanding the goals of the opposition.

The Significance of the Governability Agreement

The governability agreement, signed by all opposition political entities, demonstrates the ability of the opposition to reach consensus decisions and achieve unity on critical issues. The National Accord is a mix of near-term tangible agreements and long run ideals and goals. While some might be inclined to dismiss the agreement as little more than a campaign tool, the opposition has documented its objectives and goals in writing, and therefore enshrined them in history. If President Chavez's loses the referendum, the electorate will surely use these objectives laid out by the CD as a scorecard to judge future governments. For the first time in Venezuela's democracy, politicians have presented a set of written objectives and goals to the electorate for which they can and will be held accountable. The CD leadership understands that a failure to deliver on these objectives would result in a punishing defeat in the December 2006 presidential elections.

What Is the Agreement?

The National Accord is a mix of near-term tangible agreements and long-run ideals and goals. The near term agreement consists of three points:

- The organizations of the opposition agree to present a unity presidential candidate who will be selected through a primary shortly after the recall referendum. Just a short time ago, most analysts were understandably concerned that the opposition would be unable to agree on one candidate.

This agreement, which was signed by all presidential hopefuls in the opposition, resolves the concern.

- All registered voters are eligible to participate in the primary, which would be the first such open primary in the history of Venezuela. This point represents a major change in the way Venezuela's candidates are selected. Previously, presidential candidates were selected through internal party procedures. The mechanism of a primary fully democratizes the candidate selection process, allowing all registered voters to participate in candidate selection, thereby encouraging greater citizen participation.
- If Chavez's mandate is recalled and the opposition candidate is elected president, he or she will not attempt to run in the next scheduled election in December 2006. This arrangement serves one main purpose. The transition president could not use the two-year term in office as a campaign platform for his/her own candidacy in 2006. Consequently, politicians from the CD would not see the transition president as their competition, but instead would have every reason to cooperate with the transition president and make the transition presidency a success. The job of good governance would be the top priority of the transition government and would be in the best interest of all politicians from the CD.

Longer-term Principles Underlying the Accord

Perhaps the most powerful aspect of the governability program is the ideals and goals it establishes for the transition government and all future governments beyond the transition period. While some might argue that these objectives are too general, ideals must be general if they are to remain relevant over time. A case in point is the timeless ideal set forth in the US Declaration of Independence signed in 1776 which states "We hold these truths to be self-evident, that all men are created equal." Over the centuries this simple, general ideal has been the inspiration for many specific policies and laws that have protected minority rights and led to some of the most important and tangible improvements in US society. The aim of the governability agreement is similar—to establish a set of goals, principles, and values to which Venezuelan governments and society must aspire. It will then be up to the next elected government to present specific policies and initiatives to achieve these goals.

There are three ideals which the CD sets forth in the agreement: 1) to achieve national reconciliation and unity among Venezuelan citizens and overcome polarization in society; 2) to establish an inclusive government that takes into consideration the interests of all Venezuelans as opposed to the exclusive approach of past governments; 3) to construct a new democracy that will be responsive above all to Venezuelan citizens. The agreement declares that these are the times of the citizen and that the Venezuelan people will never again return to their homes and leave a paternalistic government to take decisions without giving priority to the rights of the people. The document invokes words from Abraham Lincoln's Gettysburg Address stating the next government will be "a government of the people for the people." In order to achieve these three goals, the agreement establishes several objectives that are essential if the broad goals are to be reached.

- The establishment of autonomous institutions to check presidential power and to ensure justice and the rule of law.
- Greater economic and political openness to the world as a way to improve diplomatic relations and encourage foreign investment.
- Sound economic policy in order to promote local private investment, to create jobs, and to attract back to Venezuela the billions of dollars in flight capital that have occurred in the past five years.
- Extension of social programs in education and poverty reduction to reach those who have been excluded by previous governments.

- Improve security, safety, and policies that demonstrate respect for human life.

Assessment

An obvious question is whether the governability agreement is anything more than high-minded campaign rhetoric. Would a transition government in Venezuela not simply revert to the mismanagement of past governments? While this is possible, in our judgment, the governability agreement is forged out of unique historical experience. It is the end result of a political maturation evident in Venezuelan society generally and among opposition politicians, in particular. This transformation is the result of the multiple governance failures of the past and the turbulence of the last five years in which Venezuelan society has become dangerously polarized. In other words, our analysis is that a meaningful change in Venezuelan society is underway, and new ideas have taken hold in Venezuelan politics. In the event that we are correct that the opposition is likely to prevail on August 15, the governability agreement serves as a clear signal to investors that the investment climate would show a meaningful improvement, giving us confidence in our overweight recommendation.

Disclosure Appendix

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