Barclays Capital Research

Emerging Markets Drivers

Venezuela's Default Story

Emerging Markets Strategy April 10, 2003

Default: Steps, Probability and Ability

"They changed the skies above them, but not their hearts that roam." *– Rudyard Kipling*

In remembrance to those who laid down their lives for Venezuela on April 11, 2002.

Summary

Venezuela's DCBs implied market default probability is 57%, in our view, compared with the 24% implied by current market spreads. We recommend investors to further reduce exposure to Venezuela and to consider a trade that sells Venezuela DCBs and buys '27s.

The key implication of Mr. Chávez's comments regarding the need to restructure external debt this year is that Venezuela's debt default probability is rising rapidly now. Despite a probable further 31% devaluation this year, dollar reserves should decline by a total of USD 3bn in 2003. With dollar reserves falling below USD 12bn this year, default is now a strong possibility in September, when reserves will hit this threshold. Default could happen as early as June if oil prices drop more rapidly. With domestic debt issuance nearing a limit as inflationary pressures from the equivalence of debt and money financing emerge, for the first time external debt default is a serious choice in Venezuela.

Default Probability

We use a "two-state of the world" Finance approach – high and low oil prices to calculate default probabilities under varying scenarios and fair value for Venezuela's DCBs. A "good" state occurs with a probability (p) and a "bad" state happens with (1-p). The "good" state is an improved world with no default, and the "bad" state is characterized by default. In turn, no default is defined by six combinations of high and low oil prices and high, medium, and low political stability. For Venezuela, for example, the best of all worlds means high oil prices and high political stability. Of course, high political stability requires resolving the political crisis.

High oil prices are defined as USD 20 or above for the Venezuelan basket. We then attach default probabilities to each of the six combinations defining the no-default state of the world. For high stability and high oil prices, we consider the default probability to be a low

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25% (Figure 1). However, for low stability and low oil prices, default is almost assured at 95%. High oil prices suggest a 50% default probability for medium or muddle-through stability, as we see now, and a 75% default probability for low stability or a new political crisis. Because oil prices are an even more important driver of Venezuela's ability to pay than the political crisis, we attach a greater probability of default to low oil price scenarios for any level of political noise. Accordingly, the high political stability but low oil price has a 50% probability of default, in line with the intermediate scenario under high oil prices. Low oil prices then mean a 75% default probability for the present muddle-through stability and a 95% probability for a renewed political crisis.

Muddle-through stability and low oil prices have the highest probability of occurrence

We then attach probabilities to each of these states of the world so that they add up to one, meaning that one of them definitely happens. Because muddle-through (medium) political stability appears the most likely scenario in 2003, we attach a greater probability to this event within the high and low oil price category. Also, because the resolution of the Iraqi war and further improvements in the world's oil supply capacity suggest lower, not higher oil prices, we tilt the weight of the low oil price scenario to 60% and thus of the high oil price scenario to 40% (Figure 1).

Within the high and low oil price categories, we skewed the probabilities towards the medium political stability scenario. Accordingly, the medium stability, low oil price has the highest probability of occurrence at 35%, followed by the medium stability, high oil price scenario at 20%. All other scenarios have a 10% weight, except for the low oil price, low stability event at 15%. The event probabilities, of course, add up to one. In this setting, the weighted probability of default is 65.5%, compared with the 62% average (equal weights) probability of default.

Figure 1: Venezuela's Default and Event Probabilities

State of the World	Default Probability	Event Probability	Weighted Probability
Avg, Cumulative and Weighted	62%	100%	65.5%
High Stability, High Oil Price	25%	10%	2.5%
Medium Stability, High Oil Price	50%	20%	10.0%
Low Stability, High Oil Price	75%	10%	7.5%
High Stability, Low Oil Price	50%	10%	5.0%
Medium Stability, Low Oil Price	75%	35%	26.3%
Low Stability, Low Oil Price	95%	15%	14.3%

Note: High oil price corresponds to USD 20 or higher for the Venezuelan basket, while low oil price refers to less than USD 20.

Source: Barclays Capital.

We set Venezuela's default spread level at 2,500bp

We use default and event probabilities for each of the six states of the world to construct Venezuela's DCBs market spreads and implied default probabilities and dollar prices, as follows. First, the bad state is invariably default, which we set at the spread level of a bond with a similar structure that already experienced default, the Argentine FRB. Specifically, on November 5th, 2001, the Argentine FRB traded at a 2,570bp spread for a dollar price of USD 76 before it gapped down to discount an outright default. We, therefore, set Venezuela's default spread level at 2,500bp (Figure 2).

Second, we set spread levels at which Venezuelan DCBs are likely to trade for the no default spread (NDS), which of course is contingent on the state of the world. For example, high stability and oil prices, which would be the best of all worlds for Venezuela, suggest a 900 bp spread for Venezuelan DCBs. High oil prices would mean a 1,250bp spread for mid-stability and a 1,500bp spread for low stability (Figure 2). Low oil prices suggest a lower starting spread of 1,250 even for the high stability scenario, which is the spread that corresponds to the intermediate case under high oil prices. Low oil prices would then suggest a 1,500bp spread for mid-stability and 2,500 for low stability. Of course, low oil prices and low stability effectively imply default, with a 95% probability.

Venezuela's no default spread is 1,515bp and the implied market spread is 2,080bp

Third, we calculate the market trading spread for each of the events based on the default probabilities in Figure 1 using a two-state of the world, as p*2,500/(1-p)*NDS. Then, we estimate the implied market NDS (INDS) and implied market trading spread (IMS) from a weighted average of the event-specific NDS and market trading spreads, respectively, where the weight given to each event is the event probability (Figure 1). Finally, the implied market default probability is obtained from (IMS-INDS)/(2,500-INDS). Our market view of Venezuela's no default spread is 1,515bp and the implied market spread is 2,080bp.

In this setting, we find that the implied market default probability for Venezuela is 57%, as suggested by our model. Because the current market spread on Venezuela's DCBs is 1,755bps, the actual implied market default probability is 24%, as given by (1,755-INDS)/(2,500-INDS). Accordingly, financial markets are currently underestimating the risk of a Venezuelan default by almost one-third of our modeled 57% default probability. DCBs are thus trading rich by over 300bp at a price of USD 72.4, rather than our fair estimate of USD 68.2 (Figure 2).

Sell DCBs and buy '27s to capture a 57% default chance

We recommend investors to further reduce exposure to Venezuela and to consider a trade that sells DCBs and buys '27s. The marked gap-down potential of DCBs should lead to a sharp gain, while the coupon on the '27s should provide an attractive carry while the scenario develops. It could be done at a 2:1 ratio to be default neutral in the two assets, while capturing the sharp drop in DCBs, as a 2,500 bp default spread nears. In addition, should the market recover, the exposure to '27s would offset the losses on DCBs given its greater duration.

Figure 2: Venezuela's DCBs Default Probabilities, Spreads and Dollar Prices

	Default Spread	No Default Spread	Market Spread	Dollar Price	Default Probability
Barclays Model	2,500	1,515	2,080	68.2	57%
Today's Market	2,500	1,515	1,755	72.4	24%
High Stability, High Oil Price	2,500	900	1,300	79.1	25%
Medium Stability, High Oil Price	2,500	1,250	1,875	70.8	50%
Low Stability, High Oil Price	2,500	1,500	2,250	66.1	75%
High Stability, Low Oil Price	2,500	1,250	1,875	70.8	50%
Medium Stability, Low Oil Price	2,500	1,500	2,250	66.2	75%
Low Stability, Low Oil Price	2,500	2,500	2,500	63.4	100%

Note: High oil price corresponds to USD 20 or higher for the Venezuelan basket, while low oil price refers to less than USD 20. Source: Barclays Capital.

A Step from Default

We consider Mr. Chávez's announcement as premature, but the probability of default is growing

Venezuelan bonds plummeted on Mr. Chávez's comments regarding the need to restructure external debt this year. The Ministry of Finance immediately denied that an external debt restructuring or default was in the offing. We consider Mr. Chávez's announcement as premature, but it does indicate that, given Mr. Chávez's sharp political orientation, the time when foreign investors will be made "responsible" for the Venezuelan economic debacle is nearing.

Mr. Chávez's remarks were made during a meeting with Venezuelan businessmen, presenting an opportunity to bring the private sector to the Chávez "revolution." He talked about the importance of businesses in generating growth and the need to create a new business organization and to pay workers. Ministry of Finance officials immediately denied the rumors of external debt restructuring or default.

As unfortunate as the remark was, Mr. Chávez likely tried to anticipate a voluntary debt exchange with a sizable incentive premium that Morgan Stanley appears to be leading for the Republic of Venezuela. While this is not the first time that Mr. Chávez complains about a heavy debt burden and the need to improve the debt profile, it marks the first time that he sets this year as the one in which the restructuring needs to take place.

Mr. Chávez appears to have been trying to pave the way for a debt swap

Because a voluntary transaction would carry very high interest rates and given a traditionally staunch political opposition to expensive debt transactions, Mr. Chávez appears to have been trying to pave the way for a debt swap that would be portrayed as the best option for now, albeit he would address the steep debt cost later. Accordingly, his position on the debt could be to recognize that the swap premium is too high, but that's because "external debt is too heavy a burden", and as such, "it needs to be restructured this year."

With little ability to do any voluntary debt swap until the political crisis is resolved and with an economy plummeting by 19% in the first quarter of the year that should pave the way for the country's worst historical registered recession of at least -12.5%, Mr. Chávez is finally realizing that his government can't survive without growth and that a default could be politically timely. When Mr. Chávez took office in 1999, our view was that his strong self-perception of being the new Bolívar, a self-discovered statesman that was to change the world, suggested that external debt default would be his last political option.

At that time, external debt default would only follow a major economic and political crisis that he could weather only by pushing the political cost of the crisis to foreign investors. No doubt, he considered default as his last option: Being a military man, the last thing he would want is to open the external front and engage in a new "battle" while trying to resolve the domestic front, the country's worst political crisis.

Nevertheless, the default option would only follow if he can convince his Venezuelan followers that a heavy debt burden is Venezuela's real problem and that they need to unite against foreign intrusion. This is especially appealing for Chávez in a "no way out" scenario because it would resemble the Iraqi position in the US and UK-Iraq war. Of course, such a dire outcome could only follow the worst economic debacle in Venezuela's modern history, with all financing options closed. This is indeed the deed that the Chávez regime accomplished in four years. Not surprisingly, he's beginning to wage the default option as a way to gain yet again even more time.

With the same conviction over the value of communist ideas in bringing growth as Mr. Castro in Cuba and indeed underscoring his remarkable failure, Mr. Chávez is now changing his policy focus towards growth. Because it's difficult to get in Venezuela the massive people exodus that Mr. Castro achieved in Cuba to be successful, it appears that Mr. Chávez would have to settle in living Mr. Castro's forty-year dream in just four years. Accordingly, the "boom" –perhaps only from the weapons aimed at innocent Venezuelans on April 11 – and bust of the Castro cycle would be crammed in four years in Venezuela. Being in the bust part of his revolution cycle, he is paving the way to blame the country's troubles on the heavy burden of external debt. This suggests that, as the economic crisis deepens, he is prepared to split the opposition further in an effort to make businesses part of his economic strategy. More importantly, as the going gets tough once he has said that the worst is over, it is difficult to blame locals for the country's continued debacle.

What "Restructuring" Means

The key implication of Chávez's statement about debt restructuring is that Venezuela's debt default probability is rising now rapidly, as it underscores the following:

1. The Chávez regime is now much less willing to lose dollar reserves – perhaps USD 1-2bn at most before default follows. The threshold for default may actually be international reserves of USD 12bn – the old threshold instead of the current USD 14.6bn. In the past, the threshold under Mr. Chávez was estimated at an additional USD 4-5bn loss, or dollar reserves of about USD 10bn or liquid reserves of USD 6bn.

After a USD 3bn decline in dollar reserves, they would fall to USD 11.8bn into Q4

2. We estimate that an average oil price of USD 22 for Venezuela (or USD 27 for WTI) and an average Bolívar of 2,000 in 2003 will result in reserve draw-downs of at least some USD 3bn in 2003. After the USD 1.5bn lost in Q1, an additional USD 1.5bn drop in the remainder of this year would reduce reserves to at least USD 11.8bn or USD 7.4bn liquid. While this would have meant a "muddle through" scenario this year with rising default probabilities but no default, the declining willingness to lose reserves suggests that default could happen this year, as early as June if the situation doesn't improve and more likely in Sept-Oct, when large debt payments would reduce dollar reserves near the old devaluation trigger of USD 12bn. This assumes, of course, that the Bolívar will be "devalued" again in the near term, raising inflation, growth and social pressures. If the pressure is too strong, an unsuccessful voluntary transaction would be followed by a forced restructuring or default. Still, the most likely scenario is that no voluntary transaction takes place and default is announced without any notice in the Ecuador fashion.

For the first time, default is an option for the Chávez regime

3. Given the fiscal strain of 12.5% of GDP or USD 9.1bn in financing needs in 2003, external debt payments of over 7.5% of GDP or USD 5.1bn for the Central Government alone are finally an issue for Mr. Chávez. Including PDVSA, financing needs are well over USD 6.5bn. Because domestic debt will rise by at least USD 2bn more than the authorities envisage, inflationary pressures will likely be much higher than now discounted by financial markets. More importantly, it means that domestic debt issuance is nearing its limit and, as such, external debt restructuring is now a serious option. *For the first time, default is an option for the Chávez regime.*

4. While Venezuela paid the FLIRBS due the last week of March, further payments will hinge on the evolution of dollar reserves and oil prices as well as on an "upcoming" debt exchange that would ease payments this year through an "attractive" premium. Such a debt transaction, however, is unlikely to occur until the political crisis is firmly resolved.

Venezuela's Central Bank has transferred dollars from its reserves position to the Bank for International Settlements (BIS)

5. Venezuela's Central Bank has transferred dollars from its reserves position to the Bank for International Settlements (BIS). It wants to avoid an "Ecuador-style" freezing of dollars by foreign banks in the event of a payments crisis, heightening concerns that Mr. Chávez's willingness to default is rising. The announcement of the Central Bank dollar reserves position, however, would not be affected by these transactions, but what it signals is critical. The amount couldn't be confirmed, but it appears that this has been going on for a few weeks.
6. Critically, the Supreme Court will issue soon the final statement on a ruling that declares FX controls unconstitutional. Once the final ruling is made, the government will have to either remove them or declare an economic emergency. The latter would still require ratification by the Supreme Court and congressional approval with a simple majority. Still, the controls would elapse after four months under an economic emergency and the government would need a three-fifths majority in Congress to keep them indefinitely, a support base that the government lacks. As a result, every effort will be made to protect dollar reserves. A Chávez default could "free" some 5.0% of GDP or USD 3.3bn in amortization payments and another 2.5% of GDP or USD 1.8bn in interest payments.
7. Because a further devaluation would still be needed under any "muddle through" scenario, an average currency of VEB 2,000 per dollar would lead to yet a new inflation spike. With inventories dwindling and exchange controls, scarcity will likely worsen in coming months. Not surprisingly, high and rising unemployment, high and rising inflation, and more devaluation will raise once again social and economic pressures. The Chávez regime could blame the devaluation on the Supreme Court decision and then declare a state of emergency.

Fiscal Ability to Pay

The economic collapse of Venezuela during the Chávez administration has no parallel in the modern history of emerging markets

The economic collapse of Venezuela during the Chávez administration has no parallel in the modern history of emerging markets. With rising inflation of well over 35% (from under 10% a year ago), well over 63% devaluation during the last two years, historically high oil prices (meaning over USD 100 bn in revenues in the last four years), Venezuela's fiscal crisis is remarkable, but not surprising. The depth of the crisis reflects Mr. Chávez's revolution that a country can grow without its private economy, resulting in the collapse of the economy and the fiscal revenue base. A two-year -21.5% recession, 18% and rising unemployment, and uncontrolled fiscal spending explain Venezuela's fiscal debacle.

This year is only different in that it is worse than last year. With the use of foreign exchange controls and Mr. Chávez's efforts to keep dollar reserves, imports are plummeting by well over 30% in the year and the recession is worsening. Because the fiscal gap can't be closed without further devaluation, the Bolívar will plummet further, perhaps to about VEB 2,000, followed by renewed controls. When all is said and done, the only Chávez legacy that would be true to its military upbringing would be the aftermath of Venezuela's worst crisis in its history. The economic devastation, inflation, unemployment and devaluation that the people face today are usually only experienced by countries waging war.

Figure 3: Venezuela's Central Government Fiscal Picture (% of GDP and USD mn)

	2002	2003				
	Estimated	Budget	Official Update		Barclays	
Oil Revenues	**9.8%**	**8.1%**	**6,826**	**7.5%**	**7,677**	**10.6%**
Revenues	9,497	7,273	6,826	6,826	7,677	7,677
Exports	21,311	16,320	15,316	15,316	17,226	17,226
Exports/Production (%)	81%	75%	83%	83%	75%	75%
Oil Price (USD pb)	22.18	23	23	23	22	22
Volume production (avg mbd)	3.3	2.6	2.2	2.2	2.9	2.9
Nonoil Revenues	**9.4%**	**10.8%**	**11,243**	**12.4%**	**8,259**	**11.4%**
Tax Revenues	**9.0%**	**10.5%**	**9,288**	**10.3%**	**7,786**	**10.7%**
Income	1.9%	2.0%	-	-	1,680	2.3%
VAT	3.9%	4.7%	-	-	3,314	4.6%
Customs	1.0%	1.1%	-	-	724	1.0%
IDB	1.3%	1.9%	-	-	1,122	1.5%
Other	0.9%	0.8%	-	-	947	1.3%
Nontax Revenues	**0.4%**	**0.4%**	**-**	**-**	**473**	**0.7%**
Total Revenues	**19.1%**	**19.0%**	**18,069**	**20.0%**	**15,936**	**22.0%**
Current Spending	**17.9%**	**15.4%**	**-**	**-**	**14,532**	20.0%
Wages	3.5%	2.8%	-	-	3,127	4.3%
Goods and Services	1.6%	1.3%	-	-	1,625	2.2%
Net State Transfers	6.6%	6.3%	-	-	5,830	8.0%
Other	1.6%	0.0%	-	-	0	0%
Interest	4.5%	5.0%	3,666	4.1%	3,950	5.4%
External	1.6%	1.9%	1,801	2.0%	1,819	2.5%
Domestic	2.9%	3.1%	1,865	2.1%	2,131	2.9%
Public Investment	**0.8%**	**0.6%**	**-**	**-**	**870**	**1.2%**
Capital Transfers	**3.2%**	**2.6%**	**-**	**-**	**2,303**	**3.2%**
Social Security	**1.2%**	**1.6%**	**-**	**-**	**1,247**	**1.7%**
Other	**0.1%**	**0.1%**	**-**	**-**	**213**	**0.3%**
Total Spending (above the line)	**23.2%**	**20.3%**	**19,354**	**21.4%**	**19,164**	**26.4%**
Nominal Fiscal Position	**-4.1%**	**-1.4%**	**-1,285**	**-1.4%**	**-3,228**	**-4.5%**
Primary Fiscal Position	**0.3%**	**3.6%**	**2,390**	**2.6%**	**722**	**1.0%**
Amortizations	**5.3%**	**6.7%**	**5,006**	**5.5%**	**5,458**	**8.0%**
External	2.7%	4.2%	3,268	3.6%	3,268	5.0%
Domestic	2.6%	2.5%	1,738	1.9%	2,190	3.0%
Borrowing Requirements	**-9.4%**	**-8.0%**	**-6,291**	**-7.0%**	**-9,056**	**-12.5%**

Source: BCV, Ministry of Finance, IESA, Barclays Capital.

Venezuela's external debt default story hinges on oil prices and the degree of devaluation, inflation, and unemployment

In the meantime, Venezuela's external debt default story hinges, as always, on oil prices and the degree of devaluation, inflation, and unemployment that Venezuelans can live with. Figure 3 shows Venezuela's Central Government fiscal picture in 2002 and 2003. In 2003, the budget figures refer to the initial budget assumptions adjusted by recent changes that are not official yet. These assumptions are based on growth of 3.7%, inflation of 20%, an average Bolívar of 1,602, an average daily oil production of 2.6 mbd, and an average oil price of USD 18. We have updated these assumptions to reflect an average oil price of USD 23, nominal GDP of VEB 143,492,000mn (based on the assumed growth and inflation in the budget), and an average exchange rate of VEB 1,602 (the same as in the budget). Financing sources focus on the primary sources that help meet borrowing requirements. Figure 3 also includes a new, official update from a presentation by the Ministry of Finance. These figures are shown both in dollars and as a percentage of GDP.

The fiscal picture is more difficult than the government admits

In our view, the fiscal picture is much more difficult than the budget or the recent official update recognize. We assume a -12.5% recession, 50% inflation, and an average VEB 2,000 exchange rate. To get a clear sense of the depth of Venezuela's fiscal crisis, we assume an oil scenario that relies on high oil prices and high oil production as our starting point. With an average oil price of USD 22 for the Venezuelan basket and average daily oil production of 2.9mbd, reflecting no investment by PDVSA this year, export oil revenues for the government will be about USD 7.7bn, rather than the implicit USD 7.3bn in the budget, or the USD 6.8bn in the official update. The risk of this assumption is on the downside since oil prices will likely fall sharply after the final resolution of the Iraq war in the weeks ahead. Barclays Commodities Group expects an average USD 22 for WTI in June and the risk is that a sluggish US economy in the second half of the year would result in even lower oil prices at a time of rising financing needs in Venezuela. Our assumed average oil price of USD 22 implies an average WTI price of USD 27. We see the balance of risk of an average WTI oil price of USD 27 to the downside, suggesting that USD 23 may prove a more sensible assumption. Similarly, the risk of oil production is to the downside since some 15% of Venezuela's capacity becomes obsolete every year if no investment is made, suggesting that average daily oil production will be at best a maximum 2.9mbd. Our estimates demonstrate that Venezuela could "muddle through" to the end of the year if WTI prices stay at or above USD 27 and oil production averages 2.9 mbd. But this won't be easy.

The official update suggests an unlikely rosy picture

Figure 3 shows that, despite expected lower production versus 2002, the authorities anticipate an improved primary fiscal position on higher oil prices. Some 4-5% of GDP in interest costs will result in a nominal fiscal deficit of about 1.5% of GDP. Accordingly, amortizations would result in borrowing requirements of 7-8% of GDP. Borrowing requirements would be met, as per the budget, through domestic borrowings of about 7.4% of GDP and external, official borrowings of 0.6% of GDP (Figure 4). The official update, however, suggests an unlikely rosy picture. In fact, the authorities assumed that 7% of GDP in borrowing requirements would be met through multilateral debt financing of 2% of GDP or USD 1,720mn, external market or private placements of USD 1,529mn, domestic debt of USD 2,842mn and 200mn from the FIEM.

Under a WTI of USD 27 and 2.9 mbd in oil production, the authorities would have a USD 400mn cushion to deal with lower non-oil revenues. Still, our estimated oil revenues in 2003 would be some USD 1.5bn below last year's oil revenues.

Non-oil revenues appear markedly overstated

Non-oil revenues, however, are a different proposition, as they appear markedly overstated. Because of the severe recession, they could be at least 1.0% of GDP less than the revised, official estimate at 11.4% of GDP. Because the official GDP figure is USD 90bn for 2003, compared to our view of USD 72.5bn, the dollar figure of non-oil revenues differs much more than it first appears. Indeed, non-oil revenues should be some USD 1.9bn less than the updated official estimate at USD 8.3bn. Total revenues would therefore fall to USD 15.9bn compared to USD 18.1bn in the official estimate or USD 18.5bn last year. Reflecting ambitious and unlikely revenue estimates, the recent official update suggests that total revenues would fall by USD 1.4bn from last year's level. In our view, total revenues are likely to be some USD 2.6bn less than last year's USD 18.5bn. Not surprisingly, offsetting a USD 2.6bn revenue shortfall will be a major challenge. In our opinion, non-oil revenues will drop by an average 12.5% from last year's levels, after an estimated 23% drop in the first quarter. Income tax revenues would fall to USD 1.7bn, compared to last year's estimated USD 1.9bn collection, suggesting a 10.5% contraction. Value-added taxes will probably fall by 13.2%, as recession pressures are exacerbated by tax evasion. Revenues would grow as a share of GDP, but only due to the much lower GDP base. By contrast, the official figures envisage a gain of 1% of GDP in VAT collection. Tax revenues have been recently estimated at USD 9.3bn by the authorities, compared to USD 7.8 bn in our estimates (Figure 3).

Current spending in the recent official update overstates the expenditure cuts announced

Current spending in the recent official update overstates the expenditure cuts recently announced, but more cuts will be needed. In fact, the spending cut of VEB 4tn or USD 2.5bn is in line with what the authorities would need to do to offset revenue losses. However, fiscal difficulties don't end in the revenue side. In fact, after the sharp devaluation of the Bolívar and a needed further devaluation to close the fiscal gap, debt service has grown markedly for the sovereign. As a result, part of the spending cuts simply offset the higher debt service costs as opposed to offsetting the revenue losses, suggesting that additional spending cuts would still be required. Specifically, the authorities assume total spending of USD 19.3bn, compared to our estimate of USD 19.2bn. Because total spending was USD 22.5bn last year, the official update of USD 19.4 implicitly suggests a USD 3bn spending cut, rather than the USD 2.5bn announced. As a result, spending would need to be cut by at least another VEB 0.8tn by the official figure or VEB 1.3tn by our own figures.

In light of the sharp recession, a further decline in spending would be politically difficult. Because debt service is rising, public investment and other current spending, notably net state transfers and public sector wages, would have to be impacted. We assume that the wage bill and already reduced transfers to states are cut by 10% in 2003. Because the government would need to cover imports of basic goods and services, we assume that the goods and services category remains roughly unchanged. The spending levels are adjusted by an average exchange rate of VEB 2,000. This means that external debt payments likely will be higher as a share of GDP than currently estimated. Interest payments will likely reach 5.5% of GDP, including external interest payments of 2.5% of GDP. Amortizations would reach 5% of GDP for external debt and 8.0% of GDP for total debt. Because debt service amounts to 13.5% of GDP or two-thirds of total revenues, the authorities are proactively seeking ways to ease the debt burden. With external debt representing over half of debt service at 7.5% of GDP and a deepening recession, Venezuela's external debt burden is growing rapidly.

In this context, the nominal fiscal deficit will rise to 4.5% of GDP, compared to 4.1% of GDP in 2002. In dollars, the nominal deficit would fall from USD 4bn to USD 3.2bn, but again a lower GDP level of USD 72.5bn compared to USD 97bn last year suggests a higher deficit as a fraction of the economy. The updated official estimate keeps the nominal fiscal deficit at 1.4% of GDP. The gap is due to lower non-oil revenues of some USD 2.1bn, despite some USD 200mn in reduced spending vis-à-vis the government assumption. The primary surplus would improve to 1.0% of GDP, compared to last year's 0.3% of GDP due to strong spending cuts of over USD 3bn that would offset lower revenues and somewhat higher debt service. Still, the authorities envisage a 2.6% of GDP primary surplus that we see as unattainable in the present setting. With amortizations of 8.0% of GDP or some USD 5.5bn, public sector borrowing requirements would in fact reach 12.5% of GDP or USD 9.1bn, compared to USD 6.3bn in the official update. As a result, borrowing requirements will likely reach USD 3bn more than envisaged in the recent official update.

The only two leading financing options are domestic bond issuance and drawing down international reserves

Because Venezuela has no access to external markets or to important private placements or to strong multilateral credit, the only two leading financing options are to tap the captive domestic market and to draw down international reserves to cover financing requirements. Because under a situation of no growth and declining savings debt and money finance become equivalent, the issuance of government debt will only take place against credits extended by the Central Bank to the financial system, which therefore acts as a bridge between the Central Bank and the government. The end result, however, is an increase in monetary liquidity that won't be sterilized, especially now that Mr. Chávez has called for fixed, low interest rates. In this setting, issuing more bonds becomes equivalent to issuing money, thus exacerbating recessionary pressures. This means, of course, that the strategy of closing the financing gap with domestic debt issuance will not be sustainable and, hence, won't suffice. Drawing down international reserves would then cap inflationary pressures, as always in the past, but at the cost of raising Venezuela's default probability. The fragile equilibrium of containing inflation and the recession, while limiting dollar reserve drops and default likelihood, is becoming increasingly tenuous.

To close the financing gap, the authorities will have to issue more domestic debt to a captive market as well as to draw down from the FIEM, as in 2002 (Figure 4). The updated official financing, however, suggests that the official financing gap of USD 6.3bn would be closed through USD 1.7bn in multilateral loans, USD 1.5bn in new external debt placements, USD 2.8bn in domestic debt issuance, and USD 200mn from the FIEM. Because capital markets are closed for Venezuela and multilateral financing is limited, the authorities would have to rely more heavily on domestic debt issuance and the FIEM, as well as on the FOGADE fund.

Domestic debt issuance would result in a sharp increase in monetary liquidity, rekindling inflationary pressures

In our view, the financing situation is fairly fragile. In fact, domestic debt issuance would have to grow by a minimum USD 4.7bn, resulting in an ultimate sharp increase in monetary liquidity of over USD 2bn more than the authorities anticipate. This would, of course, rekindle inflationary pressures that the authorities would try to ease by drawing down dollar reserves, but which would raise default probabilities. The tradeoff, of course, would be between the sharply weakened positions of Venezuelans, as inflationary and recessionary pressures grow, and foreign bondholders whose positions would suffer as default probabilities rise.

The FIEM is the next big financing item. Instead of being able to rely on some 3.3% of GDP or USD 3.2bn from the FIEM as last year, the authorities will need to draw down some 3.9% of GDP or USD 2.9bn to meet borrowing requirements. The problem is that the FIEM dropped dramatically from USD 6.2bn in early 2002 to USD 2.9bn at year-end, of which USD 1.5bn were lost during the first two months of the year. Regardless of the ability of the authorities to collect some past uncollected bills, the cash flow problem is such that even with an average WTI of 27 and 2.9mbd in oil production, the FIEM will be depleted this year. As a result, despite a further 31% VEB devaluation this year, dollar reserves likely will fall by USD 3bn to USD 11.8bn. This places Venezuela's dollar reserves at under USD 12bn in

2003. In light of the recent signal of limiting further reserve declines to some USD 1-2bn, a default in 2003 is now a strong possibility. It is especially likely in September-October, when reserves would hit the USD 12bn apparent threshold. However, a default could occur as early as June if oil prices drop more rapidly and dollar reserves fall quickly, as controls are temporarily removed to comply with a court order, thereby allowing the Bolívar to devalue further to close the fiscal gap.

Figure 4: Venezuela's Financing Picture (% of GDP and USD mn)

	2002	2003				
	Estimated	Budget	Official Update		Barclays	
Borrowing Requirements	**-9.4%**	**-8.0%**	**-6,291**	**-7.0%**	**-9,056**	**-12.5%**
Financing	**9.4%**	**8.0%**	**6,291**	**7.0%**	**9,056**	**12.5%**
External	**0.5%**	**0.6%**	**1,720**	**1.9%**	**218**	**0.3%**
IMF	0%	0%	-	-	0	0%
WB	0%	0%	-	-	0	0%
IADB	0.2%	0.2%	-	-	73	0.1%
CAF	0.1%	0.3%	-	-	73	0.1%
Government/Bilateral	0.2%	0.1%	-	-	73	0.1%
External Markets	**0.1%**	**-**	**1,529**	**1.7%**	**0**	**0%**
Domestic	**5.6%**	**7.4%**	**2,842**	**3.1%**	**4,747**	**6.5%**
FIEM/Int'l Reserves Drawdown	**3.3%**	**0%**	**200**	**0.2%**	**2,857**	**3.9%**
FOGADE	**0%**	**0%**	**0**	**0%**	**1,235**	**1.7%**

Source: BCV, Ministry of Finance, IESA, Barclays Capital.

Figure 4 shows that, besides exhausting the FIEM this year and reducing dollar reserves, the authorities will be selling the dollar assets, notably US Treasury bills, owned by the *Fondo de Garantía de Depósitos* (FOGADE). This would give the Central Government some 1.7% of GDP or USD 1.2bn in additional financing in 2003. Without this financing, a default scenario will materialize more rapidly. While these funds were created to protect the banking system, the government will likely withdraw them to fund the daunting fiscal financing gap. This action, however, could begin triggering runs on deposits and the major financial crisis that banks will undergo, as they are stuffed with low-quality government bonds and the depletion of FOGADE ensures an even deeper banking crisis.

The sovereign's overall shortfall is USD 6bn

To summarize, financing needs are likely to be USD 3bn more than anticipated and financing sources are likely to be some USD 3bn less than estimated by the authorities. Thus, our opinion is that there is an overall shortfall of about USD 6bn in the official figures. As a result, the FIEM will likely be depleted, as the authorities draw down some USD 2.7bn more than they expect, the FOGADE fund would be depleted as well by another USD 1.2bn, and about USD 2bn in additional domestic debt would need to be issued to close the USD 6bn effective financing shortfall. Besides this, the authorities would need to let the Bolívar fall to VEB 2,000 to ease the fiscal gap and would need to live with an inflation rate of about 50% and a 12.5% recession in the best of all worlds, one in which oil prices stay high and oil production reaches 2.9mbd. This means, of course, that ***the probability of default is much higher than now discounted by financial markets,*** as there is essentially no room for adverse oil shocks.

BOP Ability to Pay

The current account surplus would fall to USD 5.1bn in 2003

Venezuela's BOP provides further insights into the trend in dollar reserves and default likelihood. Figure 5 shows that the country's sharp trade surplus likely will drop to USD 10.9bn on account of lower oil exports, despite a sharp drop in non-oil imports of almost 30%. Lower services transactions on the back of a sharp recession and an even sharper decline in imports of services would result in a USD 2.4bn deficit. Net income would fall somewhat to USD 2.8bn and current transfers would also decline to USD 575mn from USD 653mn last year. As a result, the current account surplus would fall to USD 5.1bn, from USD 7.6bn in 2002. Typically, countries mired in recession experience a sharp decline in trade volumes due to much lower foreign credit lines. Also, the contraction in income reduces imports markedly. Because of lower volume or transactions, the current account surplus not surprisingly falls as well.

Venezuela's capital account, however, is binding as long as the country avoids default. The critical change between 2002 and 2003 is that large capital outflows have switched from short-term private flows to long-term public flows, underscoring both controls and a growing sovereign debt burden. The USD 8.9bn capital account deficit in 2002 reflected some USD 7.7bn in private capital flight. In 2003, however, controls could limit private capital flight to about USD 1.8bn, largely reflecting the sharp attacks on the Bolívar during the first two months of 2003, when private capital flight was close to USD 1.3bn. Instead, the government's external debt payments suggest a sharp deterioration in the BOP, as total payments grow to USD 5.4bn. Foreign direct investment is assumed at USD 265mn, compared with USD 496mn in 2002.

BOP deficit of USD 3bn

In this setting, the balance of payments deficit should fall to USD 3bn, from USD 3.7bn in 2002. Just as in 2002, the FIEM would be drawn down by USD 2.9bn in 2003 versus USD 3.4bn in 2002. The Central Bank would also lose an additional USD 170mn, leading to dollar reserves of USD 11,790mn by year-end, compared with USD 14.8bn at end-2002.

Figure 5: Venezuela's BOP and International Reserves (Poil=22; 2.9mbd)

	2002 Estimated	2003 Barclays	Difference
Current Account	**7,643**	**5,151**	**-32.6%**
Trade Balance	**13,939**	**10,901**	**-21.8%**
Exports	26,219	20,576	-21.5%
Oil	21,311	17,226	-19.2%
Non-Oil	4,908	3,350	-31.7%
Imports	12,280	9,675	-21.2%
Oil	1,332	1,700	27.6%
Non-Oil	10,948	7,975	-27.2%
Net Services	**-2,652**	**-2,400**	**-9.5%**
Net Income	**-2,991**	**-2,775**	**-7.2%**
Current Transfers	**-653**	**-575**	**-11.9%**
Capital Account	**-8,883**	**-6,928**	**-22%**
FDI	496	265	-46.6%
Long Term Flows	-1,926	-5,437	182.3%
Short Term Flows	-7,453	-1,756	-76.4%
Public Flows	207	0	-100%
Private Flows	-7,660	-1,756	-77.1%
Errors & Omissions	**-2,466**	**-1,250**	**-49.3%**
Balance of Payments	**-3,706**	**-3,027**	**-18.3%**
Change in Int'l Reserves	**-3,706**	**-3,027**	**-18.3%**
Central Bank (USD Change)	-336	-170	-49.4%
FIEM (USD Change)	-3,370	-2,857	-15.2%
International Reserves (Year-end)	**14,817**	**11,790**	**-20.4%**
Central Bank	11,960	11,790	-1.4%
FIEM	2,857	0	-100%

Source: BCV, IESA, Barclays Capital.

International reserves would fall to USD 10.3bn if oil prices average USD 20

However, this is an optimistic scenario. Assuming more realistic oil prices of USD 20 or USD 25 for WTI and oil productions of 2.6mbd, for example, the trade surplus would fall to USD 7.7bn and the current account surplus would be only USD 2.4bn (Figure 6). Accordingly, with private capital flight constrained at USD 1.3bn, the capital account deficit would be USD 6.4bn. Not surprisingly, under this scenario, the balance of payments deficit would rise to USD 4.6bn and international reserves would fall to USD 10.3bn. Because USD 4.3bn is non-liquid assets, USD 6bn is too low a level to avoid default and ensure imports of basic goods and services. This is a more realistic scenario that underscores the notion that Venezuela's balance of payments position is more precarious than now discounted by financial markets.

Figure 6: Venezuela's BOP and International Reserves (Poil=20; 2.6mbd)

	2002 Estimated	2003 Barclays	Difference
Current Account	**7,643**	**2,415**	**-68.4%**
Trade Balance	**13,939**	**7,715**	**-44.7%**
Exports	26,219	17,390	-33.7%
Oil	21,311	14,040	-34.1%
Non-Oil	4,908	3,350	-31.7%
Imports	12,280	9,675	-21.2%
Oil	1,332	1,900	42.6%
Non-Oil	10,948	7,300	-33.3%
Net Services	**-2,652**	**-2,175**	**-18%**
Net Income	**-2,991**	**-2,650**	**-11.4%**
Current Transfers	**-653**	**-475**	**-27.3%**
Capital Account	**-8,883**	**-6,422**	**-27.7%**
FDI	496	265	-46.6%
Long Term Flows	-1,926	-5,437	182.3%
Short Term Flows	-7,453	-1,250	-83.2%
Public Flows	207	0	-100%
Private Flows	-7,660	-1,250	-83.7%
Errors & Omissions	**-2,466**	**-550**	**-77.7%**
Balance of Payments	**-3,706**	**-4,557**	**23%**
Change in Intl Reserves	**-3,706**	**-4,557**	**23%**
Central Bank (USD Change)	-336	-1700	405.9%
FIEM (USD Change)	-3,370	-2,857	-15.2%
International Reserves (Year-end)	**14,817**	**10,260**	**-30.8%**
Central Bank	11,960	10,260	-14.2%
FIEM	2,857	0	-100%

Source: BCV, IESA, Barclays Capital.

Finally, Figure 7 shows various levels of average daily oil production, oil prices, and year-end dollar reserves. The level of dollar reserves is estimated based on the services, net income and private capital flight assumption in Figure 6 for comparison purposes. This explains why for an average oil price of USD 22 and 2.9 mbd oil production, year-end dollar reserves in Figure 7 are somewhat higher than in Figure 6. Figure 7 shows that only a high 27 WTI and thus 22 on the Venezuelan basket and a daily oil production of 2.6mbd or higher could give a muddle-through scenario under which reserves are falling more gradually and default is averted at least through year-end. However, the more likely scenario of an average USD 23 WTI for the year or USD 18 for the Venezuelan basket would lead to dollar reserves of USD 10.3bn or lower by the end of the year. Further, the reduced government willingness to make external debt payments suggests that dollar reserves of

USD 12bn or lower represents the new trigger point for a default scenario that would leave liquid dollar reserves at a "comfortable" USD 7.7bn. This suggests that default is indeed the most likely scenario in 2003 under most outcomes in Figure 7, with a better than 50% probability in June and a 75% probability in the fourth quarter of the year. At USD 10.3bn, liquid dollar reserves would be unbearably low at USD 6bn.

Figure 7: Venezuela's Oil Production Prices and Year-end Dollar Reserves

Production (mbd)	Average Price of Oil (USD)	Year-end Dollar Reserves (USD mn)
2.9	22	13,446
2.9	20	11,880
2.9	18	10,314
2.9	15	7,965
2.6	22	11,664
2.6	20	10,260
2.6	18	8,856
2.6	15	6,750
2.5	22	11,070
2.5	20	9,720
2.5	18	8,370
2.5	15	6,345

Source: Barclays Capital.

Willingness to Pay

Willingness to pay is tied to oil prices and the resolution of the political crisis

Venezuela's willingness to pay will be tied to both the country's sharp financing constraint as well as to Mr. Chávez's ability to resolve the political crisis this year. Willingness to pay has come down markedly after the sharp drop in reserves in the first two months of the year, as the authorities are unlikely to accept more dollar reserves as the year progresses. Accordingly, willingness to pay will of course be tied to oil revenues and therefore oil prices. As Venezuela's ability to pay declines due to rapidly falling oil prices after the resolution of the Iraqi war, the government's desire to pay will also fall, but more than proportionally.

Accordingly, the government will make an effort to pursue a voluntary exchange that reduces principal amortizations markedly in exchange for somewhat higher interest payments. If the transaction is not successful, the likelihood of default will grow. The debt exchange is scheduled to take place in the second quarter of the year, but it's likely to be postponed should oil prices indeed fall markedly and social pressures reemerge. Still, as long as Mr. Chávez believes that he can resolve the political crisis, presumably through an election, Venezuela will continue to make external debt payments, in our view.

Mr. Chávez's ability to settle the political crisis once and for all will determine the government's willingness to continue honoring its external debt. First, in the event that he can get greater support for Venezuelans and indeed a more united Venezuela by attributing the worsening economic crisis to a heavy debt burden, default would be a serious option. Because of the depth of the political crisis, it appears unlikely that calling for a default would generate any meaningful political support. As a result, this venue has a low probability. Second, and more importantly, Mr. Chávez's read of the political opposition to the government is crucial. To the extent that he perceives the opposition to be still in disarray and poorly organized, he would seriously consider bringing an end to the political crisis by negotiating a revocatory referendum that allows him to run in the subsequent presidential election.

Venezuelan opposition could remain uncoordinated and with many candidates

Because the opposition is unlikely to unify behind a single agenda or vision for a new Venezuela, Mr. Chávez will have yet again a great opportunity of "dividing and conquering." Indeed, the Venezuelan opposition will likely run with several candidates, as many as five or so, and in doing so risks splitting the vote enough that Chávez wins a new presidential election with only 25% of the votes. While diverging views and candidates are to be welcomed, the opposition needs to come together to provide a new, broad vision of the kind of alternative country that they have in mind when they criticize Chávez. Further, a sign of political maturity would be to come together and elect, through a primary process, a unified leader that would broadly represent them to end Mr. Chávez's term. Instead, however, the Venezuelan opposition could remain disorganized and uncoordinated, with many diverging candidates that could be overtaken by Mr. Chávez in an election.

In this setting, Mr. Chávez may surprisingly agree to a revocatory referendum that he knows he will lose if he is given the opportunity to run in the presidential election, on which the Supreme Court will rule after the election of the electoral council. An "independent" council would probably lead the Supreme Court to allow Mr. Chávez to run in a presidential election, in our judgment. In turn, Mr. Chávez would agree to hold one as the country's financial situation worsens. An announcement on a revocatory referendum, perhaps late in the second quarter, would cause the opposition to rally, with all the many divergent agendas running freely for a new election. Furthermore, it would lead Venezuelans to see a chance for a new future and inspire them to start rebuilding the country again.

Such actions would benefit Mr. Chávez, as tax collection and public finances would strengthen somewhat. The government would benefit politically, as it could show a "democratic" vocation well beyond doubt, while providing Mr. Chávez with his best chance to solve the political crisis once and for all. He would focus, of course, on the presidential election, while the opposition would concentrate on the referendum.

The opposition would then hope that the Venezuelan electorate can differentiate among the many candidates and pick one. Because the campaign would probably last a couple of months, if not just weeks, the electorate could easily become confused and unable to identify the "likely" opposition winner. Accordingly, a heavily contested election could give Chávez a victory, or as it's said in Venezuela: *A río revuelto, ganancia de pescadores* (unsettled waters, benefit of fishermen).

In a heavily contested election with a short campaign, there is a greater chance that the votes are more closely split among five opposition candidates and Chávez. Because Mr. Chávez would get some 25% of the votes, the other five candidates may not be too far from each other at 15%, suggesting a Chávez victory. The only hope of the opposition then would be that the Venezuelan people can differentiate enough to vote for a single candidate. This would occur by chance, rather than reflecting a well-defined process organized by the political opposition.

As long as Mr. Chávez sees that he has a chance of resolving the political crisis favourably, the government will continue to be willing to honor its external debt service. Accordingly, should the government become willing to call for a revocatory referendum and a presidential election as the crisis deepens, any potential debt exchange would happen after the announcement of the revocatory referendum, signaling the prospect of resolution of the political crisis. This scenario will grow likely as the military resolution of the war with Iraq sometime in April or May leads to a sharp drop in WTI oil prices well under USD 25, or under USD 20 for the Venezuelan basket. WTI prices are now at USD 28.4 or about USD 23.4 for the Venezuelan basket, suggesting that average annual oil prices are likely to be below our USD 22 assumption. At an average oil price of USD 22, daunting financing requirements would mean that the FIEM and the FOGADE funds will be exhausted and that dollar reserves would fall markedly, likely reaching the minimum reserves level during the fourth quarter of the year.

Investor participation in a debt exchange will likely remain limited and debt default willingness will grow

In this setting, investor participation in a debt exchange will likely remain limited, suggesting that debt default willingness will grow, especially into the fourth quarter of the year. Indeed, Venezuela's ability to pay will be greatly hampered during the fourth quarter of 2003, when large external debt payments come due in September, October and December at a time when the FIEM and the FOGADE funds will be exhausted. With or without elections, the chances of a debt default in Venezuela into the fourth quarter of the year appear sizable at about 70%, with an external debt default probability of 40% in June with an agreement on a revocatory referendum and election, or 55% without them. A presidential election would only postpone a default decision, should oil prices average below USD 22, to the last month of the year, especially if Mr. Chávez perceives that he could win such an election. Otherwise, default could ensue early in the fourth quarter, in our view. Given the remarkable inability of the Venezuelan opposition to be more than just "opposition" and thus come together to present a unified candidate, Mr. Chávez has indeed a chance to win and stay in office through 2007. Regardless of the political outcome, the likelihood of default continues to grow in Venezuela, albeit its timing would be underpinned by the government's ability to solve the political crisis.

Divide et Impera ("Divide and Conquer")

As Venezuela's worst modern political crisis continues, the Group of Six Friendly Nations and the Venezuelan opposition to the Chávez regime renew their efforts to find a democratic solution. The business strike successfully raised international awareness regarding the depth of the crisis and forced the introduction of foreign exchange and price controls. Now the dynamics of the country's economic troubles changed rapidly, raising inflationary and recessionary pressures sharply. With inflation now near 35% and heading toward 50% and almost exhausted inventories, scarcity of basic goods and poverty will become a more serious concern. The Supreme Court judge likely will rule that foreign exchange controls are unconstitutional, in an effort to ease the private sector's burden. Not surprisingly, the Chávez regime is now turning its attention toward external debt, thus risking making foreigners the "responsible" actors for the crisis in Chávez's rhetoric.

It has become apparent that the only democratic option available that can resolve the political crisis is to call for the August 19 revocatory referendum, a constitutional right. This is the only option that Mr. Chávez has ever recognized as a solution. Given that it's clear that he doesn't want to leave office regardless of the level of economic devastation in Venezuela, this referendum is the only peaceful solution to the political crisis. The negotiations led by the Organization of American States are now heading in this direction, albeit it is still too early to say whether the end result will be a referendum this year.

Given Chávez's appalling track record in almost every category, it seems remarkable that his regime is still in place. Under his administration, Venezuela suffers from a recession of over 20% in 2002-03, inflation of 30%, 18% and still-rising unemployment, the collapse of the Bolívar, the demise of the country's judicial and legislative institutions, heightened violence from the Bolivarian groups – a kind of militia – on unarmed civilians, his open disregard for and challenge of US policies, the irreversible setbacks on the country's former premier oil industry, and the list goes on. The most common answer is that Mr. Chávez is still in office because there is no one to replace him. This is a rather simplistic answer. The Venezuelan opposition is often criticized for being disorganized and lacking both focus and the necessary leadership to articulate its vision for a better Venezuela. Some of its members appear more concerned with their current and future titles than the work that needs to be done to build a new agenda for Venezuela.

In dealing with his opposition, Chávez has been successful on three important fronts

In dealing with his opposition, Chávez has been successful on three important fronts, albeit at such a high price that it is still difficult to envision that he will be in office this time next year. First, the opposition has responded to Mr. Chávez's tactics of confrontation by exclusively focusing on getting him out, rather than defining a new agenda for Venezuela. This is about to change, as in about one month, the opposition will issue their program guidelines for a new Venezuela, with a strong focus on how to build a new country that addresses the present extreme poverty. Indeed, part of Chávez's success with regards to confrontation has been to lead some people to believe that he is fighting a war against the few and rich on behalf of the many and poor. By dividing the Venezuelans and keeping the struggle at an "us against them" level, he has implemented a destructive strategy that is resulting in the end of private businesses, in favor of a much smaller, easier-to-control society, where the state controls economic activity for much smaller groups of followers. In this context, the business and oil strike played to some extent into Chávez's hands: He advanced his "revolution" by driving out many more businesses, while blaming them for the sharp recession.

Chávez's success at confrontation was on the international front. The global community sharply rejected the opposition's "Chávez out" strategy, when it should have focused on the "new Venezuela" that it wants to build. In fact, trying to end a legitimate government, without making a case on how the government failed to govern for Venezuelans, was not of course well received. Complaints over Chávez's policies and actions with no potential solution offered appeared as mere whining, undeserving of serious consideration. Not surprisingly, as the opposition begins in coming weeks to challenge Mr. Chávez to talk about a vision for a new Venezuela, that is when he will face serious difficulties in answering Venezuelans. His experience is in the battlefield; hence, he is successful at confronting, not building. Perhaps more importantly, it remains crucial to create a political party that serves to bring together the millions of Venezuelans that want a new future under a party called something else than "opposition". This political group needs a name, an identifiable platform, and a campaign strategy.

Second, Mr. Chávez has the uncanny ability to make everyone else responsible other than himself for the country's problems. This is not surprising, as it is common amongst politicians. What is remarkable is the length of time he has been able to get away with it. After more than four years, the opposition has not been able to make Mr. Chávez accountable for the economic and social devastation under his administration. This is partly because Mr. Chávez has destroyed the country's judicial and legislative branches in his effort to install a dictatorial democracy or democratic dictatorship, as we have argued for a long time. However, this doesn't mean that a renewed effort on the part of the opposition can't make him accountable.

Third and most importantly, although 70% of Venezuelans are united and want to end the present regime according to recent polls, their leadership is perceived as split and divided. This is perhaps Chávez's greatest success. The various segments within the opposition each have their own agenda and can't seem to unite in the interest of building a new Venezuela. In practice, the current political crisis would end if a few sharp leaders can articulate a single vision and agenda that allows the thousands of protestors to embrace the opposition's program. Instead, the people are asked to sign requests for 10 different items to get Chávez out, leading to confusion and underscoring the lack of cohesiveness within the opposition. Nonetheless, the Venezuelan electorate has changed markedly over the last four years, with women and the young now playing an important role in the Venezuelan opposition. As such, a democratic, electoral solution will invariably be the best way out of the Venezuelan crisis.

The opposition finally seems to be focusing on advancing a revocatory referendum

Fortunately, after several exercises in futility, the opposition finally seems to be focusing on advancing the negotiations regarding the revocatory referendum, its one viable option, as well as on presenting a program or a vision for a new Venezuela that is inclusive of all Venezuelans. As a result, the focus will shift from Chávez to the country's real economic and social problems, mainly poverty. Nevertheless, it appears clear that, unless the country's economic situation deteriorates markedly in coming months, Chávez is unlikely to call for such a referendum, since it would end his regime. With a probable five million signatures, the outcome would be clear, as only two million are needed to oust him. Thus, the support of the Group of Six Friendly Nations is necessary to push the government to agree to a *date for the revocatory referendum and a date for the presidential election*. Because Mr. Chávez won't be able to run in such an election if his term is revoked, he would continue to buy time by delaying the process. The best window of opportunity for the opposition to secure the date is immediately following the end of the military campaign against Iraq.

If the referendum does not come to fruition and Venezuelans become convinced that there is no democratic process to end Chávez's dictatorship-like regime, the political and social crisis would escalate to new heights. When no democratic option is seen as likely and the people's commitment to restore democracy emerges, the role of the military could become crucial again. The United States, of course, also would play a vital role, as Mr. Chávez has openly demonstrated that he has no interest in pursuing a democratic solution. Despite this future scenario, Mr. Chávez nevertheless will likely try to delay the referendum to August 2004. This would allow his Vice-President, as supported by the Constitution, to take office rather than holding an election.

A less dramatic ending

There could be a less dramatic ending, however. The incompetence of the Chávez era could mean that the economic and social crisis will worsen markedly in coming months, especially after the resolution of the war with Iraq, when oil prices head toward USD 20. Moreover, as long as most Venezuelans stay in the country, which is likely, Mr. Chávez would be unable to implement a Cuba-like regime. He has sought to secure his dream of a new, smaller Venezuela (and of course PDVSA) that would live under his control through economic attrition and migration.

More importantly, in those conflicts requiring military intervention, he has always focused on his personal security and demonstrated an unusual eagerness to give up on his cause.

For example, during the unsuccessful military coup that he led in the early 1990s, he hid in a public library until his safety was formally negotiated and ensured, according to local press. Furthermore, in April 2002, he sought to resign in exchange for his personal safety. When the going gets tough again, he may not stand fast.

Securing a date for the Venezuelan revocatory referendum is the critical trigger point

Securing a date for the Venezuelan revocatory referendum is the critical trigger point for moving into a democratic resolution of the crisis. Once it is set, a new chapter for Venezuela would begin, hinging on the role that Mr. Chávez takes on. However, it is much more likely that Mr. Chávez will attempt to remain in power, no matter the cost. Securing a unified political opposition is the critical trigger point for moving into a permanent resolution of the crisis.

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