The political economy of Maduro's economic policies

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1 October 2020

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So far, we have told a story of policy failure. Maduro inherited an economy that was overextended fiscally and had saved very little of the oil boom enjoyed by Chávez. It was thus very poorly prepared to handle a large negative terms of trade shock like the one it faced starting in late 2014. But when the shock hit, Maduro did the opposite of what was needed. Rather than devaluing the exchange rate to create incentives for import substitution and export production, Maduro let the real exchange rate appreciate significantly while relying on state-led rationing to allocate the increasingly scarce foreign exchange. Rather than adjust the prices of goods and services provided by the public sector to the public - such as gasoline - he monetized rising budget deficits, driving the economy into a hyperinflation. Rather than improve conditions for foreign partners in the oil sector to fund the investment that PDVSA no longer had the money to pay for, he maintained tight controls on the sector, forcing joint venture partners to sell their dollars into the local market at the overvalued official rate, effectively imposing a large additional tax on their operations.

What we have not yet done is to explain why Maduro did all of this. Had his administration reacted with a different set of policies, it would have been able to navigate the downturn in oil prices with a much smaller economic contraction and decline in living standards. It seems evident that improved economic performance would have benefited Maduro, not only by improving his re-election chances but also in forestalling the international outcry that ensued as a result of the country's humanitarian crisis.

While corruption and incompetence certainly contributed to the policy failure, we are skeptical that these can by themselves account for the mistakes. There are many ways to transfer resources to cronies without destroying a country's economy, and mounting evidence that macroeconomic policies were compounding the problem was too glaring to be ignored.

In this chapter, we sketch out an alternative explanation for this apparent paradox. We argue that the country's political system embodied in its 1999 Constitution dramatically increased the stakes of power, raising both the benefits of being in power and the costs of leaving office. But it also significantly increased the frequency with which elections were held, exposing the government to a near-permanent state of electoral exposure. The combination of high stakes of power and high electoral exposure raised the incentives for policymakers to focus on the short-term effects of policies and disregard their long-term consequences. This mix proved toxic when the economy was

hit with a large negative shock that required it to implement adjustments with significant near-term costs.

Alternative explanations: incompetence, corruption, and conspiracy

The first explanation that comes to mind when trying to understand the logic behind Maduro's policy actions is that of incompetence. Perhaps the government caused a hyperinflation because it didn't know better. The government's rejection of "neo-liberal" economists as well as its contempt for specialists with academic training led it to rely on policymakers with little if any formal background in economics. In contrast to the norm in other countries of the region, no economist occupied the main economics position in the cabinet; neither was the Central Bank president an economist during most of Maduro's term in office.[2] In fact, at times there was not even a single economist among the 7 members of the Central Bank board.

Maduro increasingly relied on a group of economic policy advisors of questionable academic credentials and whose ideas were on the fringe of academic thinking. Even some of the heterodox economists close to the administration, such as Rodrigo Cabezas and Jesús Faría – two academic economists with policy experience – were sidelined in favor of a group led by Spanish economist Alfredo Serrano. Serrano argued that class struggle rather than monetary policy was the main driver of inflation, and that scarcity was due to intentional coordinated hoarding by business groups (Del Valle, 2016). In 2016, the *Wall Street Journal* investigated Serrano's academic credential and found that three universities where he claimed to teach denied ever having had him on their staff (Kurmanaev, 2016).

Nevertheless, the idea that sheer ignorance drives policy failure is problematic in several dimensions. The most evident one is that a government that has managed to stay in power for more than two decades isn't exactly the best candidate for a charge of stupidity. Opposition negotiators involved in talks with the government, for example, regularly point to the ways in which the government ended up outmaneuvering them, leading them to take decisions – such as the suspension of protest in November of 2016 while initiating talks - which ended up playing in the government's favor (Romero-Castillo, 2017). And the government has not shied away from seeking top talent in other areas – such as the design of its electoral campaign strategy.

Perhaps most importantly, it is one thing to have believed that money creation did not cause inflation in 2013, when inflation was in the same double-digit range in which it had spent the previous three decades, and another one to deny it in 2018, when inflation had risen to seven digits.

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[2] So far during Maduro's terms, BCV has had 6 presidents. Out of these, 3 have not been economists: Edmee Betancourt (Industrial Engineer with postgraduate degrees in math and linear programming), Nelson Merentes (Mathematician) and Calixto Ortega (Industrial Engineer, with an MBA and a Master's Degree in economic policy).

The presence of non-conventional economists with fringe ideas in the teams of governments that cause hyperinflations is common, but it is also true that after hyperinflation ensues, governments tend to replace these with more mainstream teams that proceed to implement stabilization strategies.[3]

An alternative explanation is that the policy distortions that exacerbated the country's economic crisis were also the mechanisms through which Maduro was able to allocate rents to the military and other key power brokers without whose support he could not have stayed in power. Francisco Toro (2016) coined the term "Arbitrageur Kleptolobby" to refer to politically connected elites that made huge gains on the arbitrage from foreign currency allocations, and which he argues were instrumental in blocking the policy reforms proposed by Rafael Ramírez in 2014 (Toro, 2017).

Yet while the corruption hypothesis appears intuitive, it is problematic at several levels. The first one is that while there are many corrupt governments in the world, very few of them produce the type of macroeconomic crisis generated by Maduro's government. Malaysia's Prime Minister Najib Razak managed to siphon $700 mn to his bank accounts through state-owned 1MDB corporation but inflation was less than 2 percent and the economy was growing at 6 percent when he left office (Bloomberg, 2018).

The second one is that there is nothing about policy distortions that makes them an efficient mechanism for distributing corruption rents. Governments typically use payments to contractors as a way to siphon off resources to their cronies, and when - as in Venezuela - there are no effective accountability institutions, this is remarkably easy to do. The amount of resources that a government can transfer to connected firms through overpriced contracts is limited only by the size of the budget. There is no need to create massive policy distortions that shrink the size of the whole economy and thus of the government's resources in order to steal money.

In fact, if there is something striking about Venezuela's currency and price controls is the size of the rents created by the system that were going to ordinary people. Any Venezuelan that bought dollars through CADIVI at a preferential rate in order to travel abroad was receiving a piece of the rents created by the system, as did anyone who bought essentials at controlled prices. By 2014, Venezuela had accumulated a bill of $3.8bn with airlines arising from the sale of international tickets sold under the currency control scheme (Cardenas, 2017). The beneficiaries of these tickets were not corrupt regime oligarchs; they were ordinary Venezuelans who purchased their tickets in local currency and took advantage of the opportunity to travel cheaply.

This is not to argue that outright corruption was small in the system, but rather that the need to share rents with ordinary Venezuelans impedes rent-seeking groups from capturing the totality of the rents and makes the system particularly inefficient as a way to pay for corruption. Perhaps even more importantly, any argument that Maduro's economic policies were done to benefit the

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[3] See *Carbonetto et al. (1987).*

arbitrageur kleptolobby has to explain why this lobby allowed these distortions to increase to a level where they caused a macroeconomic crisis large enough to seriously threaten their hold on power.

A third, more complex hypothesis, is that Maduro's policies were part of a systematic plan to destroy the Venezuelan economy. In this thesis, the rationale for the policies was political and not economic. Advocates point to the case of Cuba, where a stagnant economy has facilitated the regime maintaining itself in power for over sixty years. A weak private sector and emigration of the educated middle and upper classes may harm the economy, but also makes the country easier to control politically.

Applied to Maduro's policy decisions, this argument suggests that he faced a choice in 2016: to free up the economy, which would have strengthened civil society, or to double down on controls and to strengthen the state. As one defender of this thesis writes: "Yes, the catastrophe would weaken the regime; but society would weaken even faster, assuring the regime continued control." (Hausmann, 2018).

In my view, there is definitely an element of truth to this thesis. Certainly, many in the government were relieved to see the young activists of the 2017 protests leave the country during the following year's mass emigration wave. As prisons minister Iris Valera said in a TV program in early 2018 "the majority of those who are leaving are those frustrated by the *guarimbas* [slang term for street blockings]. Those who were here burning people. For my part, I hope they never return." (El Nacional, 2018).

Nevertheless, the idea that re-empowering society was the only way to solve the country's macroeconomic crisis from 2013 on seems stretched. In order to impede the economy from entering into the macroeconomic tailspin that it ended up in, Maduro needed to do a few basic things: close the budget deficit by raising revenues and restraining spending, and reduce excess demand of imported goods by devaluing the currency. There is nothing particularly re-empowering about devaluation or tax hikes. And while lower spending may have decreased some of the government's political clout, the collapse in real spending levels caused by hyperinflation was much more harmful for the government's capacity to purchase loyalties.

What many of these hypotheses are missing in our view is an understanding that Maduro's key policy decision between 2013 and 2018 was to pay for high levels of government spending using a particularly distortionary form of taxation, which is inflation. High spending levels certainly make the government more powerful. But there are many ways to fund a larger state: for starters, you can raise taxes and you can confiscate assets. In order to make its state all-powerful, Cuba installed a centrally planned economy, as did many other communist regimes. It never ran a hyperinflation.

Put differently, there is a good reason why authoritarian governments with the power to quash political dissent don't usually run hyperinflations. Hyperinflations tend to end up eroding the government's capacity to sustain high spending levels. Continued deficit monetization is not a sensible choice from an intertemporal standpoint for a government that plans to stay in power for a

long time. It may buy you a greater chance to stay in power today, yet at the cost of a significantly lesser chance to be in power tomorrow.

In order to understand the reason why a government appeals to printing money, it is important to take account of the fact that one of the things that makes inflation different from other taxes is the time lag associated with its effects. There are in fact two important time lags associated with inflationary financing. One is the lag between the moment at which money is printed and the moment when prices go up. This gives the government the capacity to finance spending without making its cost of it immediately apparent to the public (Carlson, 1980).

The other relevant lag is the time it takes the economy to reach rates of inflation at which the capacity of the inflation tax to fund real spending wanes. As we explained in chapter 4, a decision to print money over and above what is necessary to keep up with rising money demand initially enables the government to fund increasing levels of spending. But as this process evolves and inflation continues to increase, money demand falls so fast that real resources mobilized by the inflation tax begin to decline. Furthermore, real taxes collapse due to the lag between the moment at which they are generated and the moment at which they are collected. Once an economy is on the downward-sloping side of the inflation Laffer curve, more money printing is self-defeating as it leads to lower real levels of expenditure. In fact, deficit monetization ultimately leaves the government less, not more, capable of financing spending than it was at the outset.

The crux of our argument is that in order to understand this policy choice, we have to ask what is it that makes the government prioritize the near term above the future, so much so as to systematically appeal to a mechanism to fund its spending that yields short-term benefits but has significant long-run costs. In other words, what makes the government behave as if it had a very high discount rate? In a nutshell, our answer is that the combination of high stakes of power and frequent elections incline the government towards prioritizing near-term results, and that this scale of priorities can causes greater economic harm in the presence of large negative terms-of-trade shocks. The rest of this chapter lays out our argument in greater detail.

Elections, polarization and policies: A review of the literature

We now argue that key changes in constitutional rules, and particularly those that raised the frequency of elections and the stakes of power, dramatically affected the quality of economic policymaking in Venezuela, raising the incentive of decisionmakers to defer needed economic adjustments. These adjustments were strongly needed after the 2014 oil price shock hit, and the economy's inability to enact them was the-primary cause of the country's economic implosion.

Our hypothesis thus relies on three key arguments: that elections distort the incentives for policymaking, causing policymakers to pursue more short-run oriented policies; that increased stakes of power raise the incentives for policymakers to stay in office and thus increases the likelihood that they will pursue distortionary policies ahead of an election; and that the cost of pursuing short-run

oriented policies is higher in the presence of a terms of trade shock. All three ideas have a basis in the established literature.

Elections, policies and competence

The idea that elections can distort the incentives for policymaking is at the base of an extensive literature on political business cycles (PBC). An initial set of contributions in this literature argued that the government would have an incentive to pursue expansionary policies ahead of an election by exploiting a short-run Philips curve to generate economic expansions ahead of elections (Nordhaus, 1975). A second generation of models, consistent with rational expectations, relied on the idea that governments have asymmetric information on their "competence" and used inflationary financing near election time to fool voters into believing that they were more competent than they actually were.

In a seminal formulation provided by Rogoff and Sibert (1988), competence is modelled as the ability of a government to provide a given level of public goods at a lower cost to taxpayers. In election times, governments will resort to inflationary financing in order to try to fool voters into believing that its policymakers are competent. Rogoff and Sibert lay out an equilibrium in which most policymakers cheat (i.e., generate inflation surprises) in election time, and those with intermediate ability cheat the most.

One important implication of this contribution is that policymakers resort to inflationary financing only during election years (Rogoff and Sibert, 1988, p.5). The reason is that it only makes sense to fool voters if doing so improves your chances of having them re-elect you. If you use inflationary financing in an off-election year, by the time of the election voters will have figured out that you were not as competent as you appeared to be. The crucial assumption here is that voters only observe the level of inflationary financing after the election, an assumption that is consistent with the literature documenting the lagged effect of monetary policy on prices.

These results do not necessarily mean that elections are necessarily bad for the quality of policy. This is because there are two separate effects of elections on economic performance: on the one hand, they allow voters to pick more competent politicians, and on the other hand, they introduce incentives for governments to carry out more distortionary policies at election time.

A sizable empirical literature has documented evidence for the existence of a political business cycle. Shi and Svennsson (2006) use a panel of 85 countries over a 25-year period and find evidence that on average, government fiscal deficits increase by around one percentage point of GDP in election years. They argue that the cycle is more pronounced in developing than developed countries. Brender and Drazen (2005) argue that this effect is driven by recently established democracies and that it is stronger in weaker democracies. Chauvet and Collier (2009) attempt to empirically distinguish a cyclical from a structural effect of elections on policies: the structural effect captures how elections may improve the quality of policies via increased accountability, while the cyclical

effect captures the idea that policies will be of lower quality near election time. Using a panel of 82 countries, they find that the quality of policy is indeed highest in the middle of the electoral term. There is also a much broader literature on the effects of democracy on economic performance, as well as a longstanding debate on whether democracy is good or bad for growth.[4]

The stakes of power and the foundations of limited government

Another established literature argues that limiting the stakes of power improves governance and economic performance. In a now classic study of transitions to democracy, Adam Przeworski (1991) argued that constitutions that provided insurance to the losing side and reduced the stakes of competition were more likely to induce the losers to participate, resulting in rules that would be stable across a wide range of historical conditions. Weingast (1997) extended this observation to argue that democracy would emerge when leaders accepted constraints on their power; when leaders are unconstrained, they will in the final instance use their power to remain in power.

North, Summerhill and Weingast (1999) contend that high stakes of power lead leaders to sabotage constitutional and democratic rules and lead those out of power to use extra-constitutional means to try to attain power. They also argue that in the absence of well-defined and widely accepted rights, higher stakes generate increased rent-seeking and lower aggregate wealth. They use these observations to trace the different development paths observed in the British North American colonies in contrast to the Spanish colonies of Latin America in the post-independence period. A key driver of the difference in growth patterns can be explained, according to their argument, as a result of the ability of the North American colonies to create a system of constitutional rules that limited state authority and lowered the stakes of power as a result.[5]

High stakes of power can reinforce existing processes of political polarization. Increased stakes of power often come about as a result of "power grabs" – attempts by those in power to further increase the power under their control. Power grabs increase the sense of precariousness of opposition forces and can lead groups that had previously viewed themselves as holding irreconcilable views to join forces in order to resolve their collective action problems. Differences between opposition groups are blurred as stopping the power grab becomes the overriding political priority; a similar process occurs among pro-government forces. Increasingly, political positions end up being defined by support for the government instead of by substantive policy preferences.[6]

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[4] See Barro (1996), Tavares and Wacziarg (2001), and Knutsen (2012).

[5] A related literature deals with the economic effects of constitutions, although to the best of our knowledge no attempt exists to codify differences in constitutional rules in order to operationalize the concept of the stakes of power and measure its impact on economic performance or other dependent variables.

[6] For an analysis of the relationship between polarization and the stakes of power in the Venezuelan case, see O'Donnell and Schmitter (1986).

The politics of economic adjustment

There is of course a voluminous literature in economics on macroeconomic adjustment. Countries facing a current account imbalance that cannot be financed typically have to engage in a combination of expenditure reduction, which lowers domestic absorption in order to bring it in line with disposable income, and expenditure switching, which requires moving domestic demand away from tradable goods and towards non-tradable ones (Corden, 1989). Expenditure reduction is often achieved by a mixture of contractionary fiscal and monetary policies, whereas expenditure switching occurs through changes in relative prices. Thus, the typical adjustment program will include fiscal expenditure cuts, tax increases, and a devaluation of the nominal exchange rate, as well as accompanying monetary policies to ensure that the nominal devaluation transfers to the real exchange rate. The magnitude of the needed adjustments will be higher after a negative terms of trade shock.

In the absence of adjustment policies, countries will sooner or later go through a balance of payments crisis. Before that, governments attempting to maintain an overvalued exchange rate will see international reserves drop. Once reserves are low enough, it will make sense for investors to stage a speculative attack against the currency, given the knowledge that the exchange rate level is ultimately unsustainable. Once the government runs out of reserves, it has no option but to let the exchange rate drop to its equilibrium level.[7]

It is relatively straightforward to account for adjustment policies in the context of the political business cycle model of Rogoff and Sibert (1988). Delaying adjustment policies is one way in which policymakers can try to fool voters into believing that they are more competent then they actually are. Recall that a government's competence in that model is defined as the ability to generate public goods with a given level of tax revenues. Voters can read the tax increases or expenditure cuts implemented in a structural adjustment program as a signal that the government is inefficient at converting taxes into public goods, and thus decide to vote against the government as a consequence of these decisions.

The issue is compounded in the case in which the state is also the owner of the export sector because then the exchange rate acts as a tax. By increasing the relative price of tradables, a devaluation increases the purchasing power of the state's oil revenues, and decreases the purchasing power of the private sector, which is a net importer. Therefore, both the policies that you need for expenditure reduction (tax increases and expenditure cuts) and those that you need for expenditure switching (devaluation) act as taxes on voters and can thus be read as signs of government incompetence.

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[7] See Krugman (1979) for the classic presentation of this mechanism.

There is evidence that governments try to hide the existence of serious balance of payments imbalances ahead of elections. This is not surprising, as balance of payments crises tend to be electorally costly. Broz, Duru and Frieden (2016), for example, find that governments are much more likely to resort to capital controls and international reserve depletion ahead of elections, leaving major exchange rate adjustments and changes in trade policy until after the elections.

The above reasoning can explain why governments would resort to inflationary financing ahead of election, allowing them to fund higher spending levels and/or lower taxes than they would otherwise. It does not explain why the government would decide to use rationing instead of price increases as an allocation mechanism. One electoral advantage of rationing is that it gives the government direct control over the identity of the recipients, and thus enables the government to target these benefits to pivotal constituencies. This ability to target benefits can become much more important in times of electoral competition.
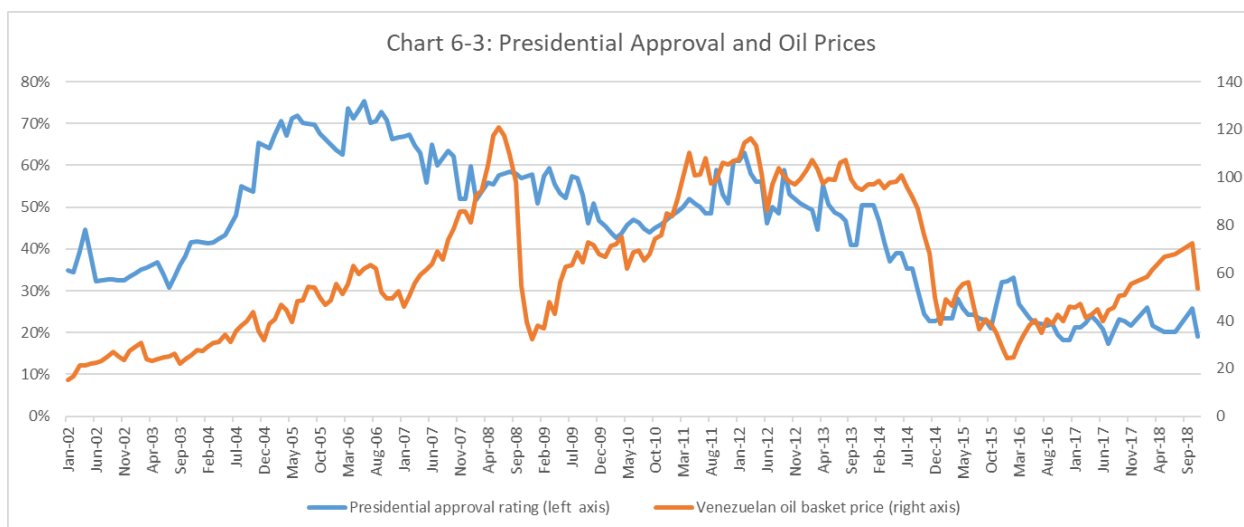
An arguably sensible assumption in modeling Venezuelan politics is that voters do not have direct information on oil price shocks of the magnitude of oil revenues. If this is the case, then policymakers will have an incentive to raise spending and lower taxes when oil prices go up, rather than to save the windfall, because this will allow voters to believe that these governments are more efficient in delivering public goods with lower taxes. But this also means than when negative terms of trade shocks occur and governments are forced to lower spending or raise taxes, voters are likely to take this as a sign that they are less competent and therefore punish them electorally.[8]

It may seem odd to argue that oil prices are not directly observable by voters in a country where news on oil market developments are typically at the top of the local press headlines. Yet it is nevertheless reasonable to think that the majority of voters do not have an incentive to invest in attempting to comprehend this information, which has very limited private returns to them. Whatever the validity of the argument, it is certainly the case that approval ratings are positively related to oil prices. This was not only true for the Chávez-Maduro years, as illustrated in Chart 6-3, but also helps explain much of electoral performance in the pre-Chávez period. Carlos Andrés Pérez, who held office during the first oil boom, became one of the country's most popular politicians and was easily re-elected to office as soon as he was legally eligible to do so. In contrast, Luis Herrera Campins and Jaime Lusinchi, who ruled during periods of declining oil prices, became deeply unpopular and were never considered as nominees by their parties when they became eligible to run again.[9]

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[8] There is an underlying assumption that governments are credit constrained, so the positive shock allows them to raise spending. In practice, positive shocks also tend to improve access to capital markets, allowing the government to raise spending by more than the magnitude of the shock, while negative shocks tend to be associated with the closing-off of market access and thus deeper spending contractions.

[9] The 1961 Constitution had a two-term ban on immediate reelection, making Pérez eligible for re-election in 1988 (when he won), Herrera Campins in 1993 and Jaime Lusinchi in 1988.

Chart 6-3: Presidential Approval and Oil Prices

Presidential approval rating (left axis) — Venezuelan oil basket price (right axis)

Raising the stakes: the 1999 Constitution

Towards the turn of the century, Venezuela's political system was radically re-shaped from one premised on and requiring cooperation by diverse political actors to one in which there was an outsized concentration of power in the hands of the national executive and cooperation played next to no role. These changes resulted for the most part from the institutional sea-change brought about as a result of Chávez's successful bid to reform the country's Constitution.

Venezuela's political system between 1958 and 1998 has been aptly labeled one of "pacted democracy" by political scholars (Karl, 1987). The system emerged from a set of agreements between the nation's key political parties to limit inter-party competition and ensure cooperation among key political players. The initial explicit documents, subscribed by the country's main political parties (with the exception of the Communists) just after the overthrow of the Pérez Jimenez dictatorship in 1958 and before that year's presidential elections, provided amnesty to the military, committed all parties to support a common economic program and guaranteed a "prolonged political truce," ensuring consultation among parties and depersonalizing political debates. Each party was guaranteed access to state jobs and contracts, a partitioning of ministries, and participation in a complex spoils system.

These arrangements were later enshrined in the 1961 Constitution. The Constitution lowered the power of the executive branch by limiting presidential re-election (presidents could only aspire after ten years had elapsed since the end of their first mandate) and it lowered the scope for inter-party competition by apportioning seats in Parliament through the principle of proportional

representation with closed lists. It also limited the president's legislative prerogative: Venezuela had the lowest index of executive power in an index of legislative powers constructed by Carey and Shugart (1995).

The 1999 Constitution would change all this. The presidential term was raised to six years, with one immediate re-election (in 2009, the two-term limit was eliminated). The president obtained direct control over promotions within the armed forces, scrapping the previous requirement of Congressional approval for promotions for senior officer positions (Trinkunas, 2002). The president's legislative powers were raised, and he also obtained powers to activate any kind of referendum, thus effectively gaining the ability to circumvent most powers of the legislature. The share of seats allocated through majority voting rose to 60 percent, significantly lowering the power of political parties.

Some of these reforms rode a wave of public discontent with the power of political parties. The 1990s had been rife with criticism of the outsized power and lack of accountability of existing political parties. The country's political system came to be derisively known as the *partidocracia* ["party-ocracy"]. The shift away from proportional representation towards a mixed system began with reforms first instituted in 1989, which set the share of seats to be allocated by majority voting to 50%, with this share rising to 60% by 2000 and to 69% by 2015.[10] The climate of discontent with parties also made it easy for the 1999 reforms to abolish public financing of political parties.[11]

Increasing the powers of the presidency while lowering those of political parties dramatically raised the stakes of power, making it costly not only to be part of the opposition but also to form part of dissenting factions within the government. When Chávez faced an internal rebellion from a moderate faction led by Luis Miquilena in 2001, it was easy for the government to marginalize them; when Chávez ordered the governing *Movimiento Quinta República* (Fifth Republic Movement, MVR) party in 2007 to dissolve itself in order to create a new *Partido Socialista Unido de Venezuela* (United Socialist Party of Venezuela, PSUV), he found no opposition from party leaders.

One key change in the 1999 Constitution effectively subordinated all institutions to the presidency: the ability to call elections for a National Constitutional Convention with the power to restructure existing branches of government. Recall from our discussion in Chapter 1 that in 1999 the Supreme Court allowed the recently elected Constitutional Convention to take over legislative powers from the existing Congress, effectively abolishing the old legislature. The new Constitution would enshrine these powers, allowing a future Constitutional Convention to replace the heads of any existing branch of government. Furthermore, the president could define not only the timing of the

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[10] This share is set by law so it has varied over time independently of Constitutional changes. See Molina (2009).
[11] For a description of the Constitutional reforms of 1999 in contrast to the institutions of pacted democracy, see Monaldi and Penfold, 1999.

elections for the Constitutional Convention, but also propose its electoral rules, allowing him to increase the likelihood of being able to control the elected body.[12]

Even without appealing to this "nuclear option", however, the President could still impose his will over other branches of government. For example, after the Supreme Court refused to try military officers for their participation in the 2002 coup attempt, Chávez supporters in Congress decided to reform the Supreme Court Law, raising the number of magistrates from 20 to 32, and taking advantage of the fact that the Constitution allowed them to appoint the new magistrates through a simple majority vote. This allowed them to secure a comfortable pro-Chávez majority in the court.

In other words, the new rules made it extremely easy for a popular president – and even to a certain extent for unpopular ones – to replace the heads of other branches of government, erasing one of the key restrictions necessary for effective separation of powers to prevail. They also made political parties weaker and eliminated any sharing of government positions with opposition forces. The combination of a powerful presidency, a judiciary that was subordinated to the executive, and weak political parties, significantly raised the benefits of being in power as well as the costs of being out of it.

As expected, higher stakes of political competition led to deeper polarization. This was seen not only in the attempts by the government to concentrate even more power in its hands and to abuse the structure of the state in order to maximize its chances of winning elections, but was also reflected in the opposition's willingness to appeal to increasingly extreme means in order to drive the government from power. As argued by Monaldi and Penfold (2013),

> *"Constitutional changes have radically increased the stakes of power and therefore have promoted a less stable democracy. (…) As a result, a significant part of the opposition has incentives to exclude itself from the regular democratic political process, and instead to invest resources in trying to overturn the regime by nondemocratic means (as observed in the April 2002 coup and the 2002-3 oil strike). This has led to a process of radical political polarization as well as a politicization of the armed forces." (pp. 307-8)*

In this sense, higher political polarization and increased stakes of power became mutually reinforcing processes. The higher the stakes, the more that either side was willing to resort to extreme measures to preserve or attempt to gain power, and the deeper that the divide between *chavistas* and *opositores* became.

One way in which political polarization can increase the stakes of power is by raising the exit costs for the incumbent. If current government leaders feel that they face a real prospect of going to prison once they leave office, then they will try very hard to stay in office. Indeed, as political

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[12] In 1999, the president proposed a set of electoral rules together with the proposal for holding a Constitutional Convention to voters, who approved both in an initial referendum. In a controversial interpretation used by Maduro to elect the 2017 Convention, the National Electoral Council set the electoral rules based on a proposal submitted by the president. See Chapter xx for a more detailed discussion.

polarization rose, many in the opposition began demanding not just that *chavismo* leave office, but that many of their key leaders be jailed. That this was a credible threat became evident during the April 2002 coup, during which Chávez as well as several of his ministers were imprisoned without charges. It is not surprising that after Chávez returned, the position of radical leaders within his administration who rejected any compromise with the opposition became stronger.

Electoral competition and the rise of electoral exposure

Another of the most important institutional changes that took place in the past three decades in Venezuela was the increase in the frequency with which elections were held. This, in fact, is still a statistic often cited by government advocates: rather than a dictatorship, they claim, Venezuela has held 25 elections since Chávez rose to power, in most of which voters had reaffirmed their support for the government (Wilpert, 2018).

However, the start of the increase in the frequency of elections predates Chávez and has much to do with a movement to increase accountability of Venezuela's governments by increasing the number of positions filled through electoral means. In a hallmark 1986 report, a commission appointed by President Jaime Lusinchi (AD) with the objective of studying possible reforms to Venezuela's state and political institutions recommended that state governors, who had previously been appointed by the president, should be elected directly by voters. While the proposal was rejected by the sitting government, it found strong support in public opinion, particularly among civil society organizations that were critical of the existing party system, and was ultimately embraced by incoming president Carlos Andrés Pérez (AD).

One timid reform had been carried out in 1979, when municipal council elections were separated from the national elections. The 1989 reforms went much deeper, introducing the direct election of state governors as well as of mayors, a newly created figure (Penfold, 2003, pp. 197-225) (Lucena, 2003). Other electoral reforms allowed the election of councilmembers through open lists as well as the election of the majority of state and national legislators through nominal voting (Crisp & Rey, 2001).

One of the effects of these reforms was to increase the frequency with which governments had to deal with a nationwide election. Between 1958 and 1979, governments faced just one major election near the end of the presidential term. Between 1979 and 1989, governments would face an additional election near the start of their term, but in practice that new election (for municipal councils) was so close to the presidential election that governments could still expect to spend most of their terms in office without facing an election.

The 1989 reforms changed this: the government would now have to contend with regional elections once every three years, in addition to the presidential and legislative election every five years. A

consequence of this was that the administration that introduced the reforms that year ended up facing elections during three of its five years in office (1989, 1992 and 1993).

The idea of having even more staggered elections gained force with Chávez's 1999 constitution. The constitution established periods of four years for governors and mayors as well as state legislators, five years for members of Congress and six years for the President.[13] In practice, this meant that Chávez would not have to deal with elections during the first three years of his first presidential term under the new constitution, but then the frequency of election years would begin to vary over time, depending on when each of the terms came to an end.

In addition, the 1999 Constitution introduced a new institution: the recall referendum, which allowed voters to recall the mandate of any elected officials through a popular vote after the first half of the official's mandate had elapsed. What this meant is that governments were exposed to facing a nation-wide election not only whenever the terms for president, legislators, or regional governments ended, but also during the last three years of the presidential term.[14] Any government could be subject to a nationwide election or recall referendum for at least half of its years in office, and a government that was unlucky enough could face elections on five of its six years in office.

At this stage, we introduce two concepts that will prove analytically useful. We define electoral exposure as the risk that a government will have to face a nationwide election at any time during its term in office. Our measure of election exposure is the number of years of a government's term in office during which a nationwide election is held or can be called through actions initiated by the opposition (this refers to the recall referendum). We also introduce an alternative measure capturing what we call election insulation, defined as the longest period of time that elapses in a presidential term during which no elections are held or (again in the case of the recall referendum) can be called.

Both of these concepts capture how constrained governments are by the holding of elections during their term in office. A government that has to face an election only towards the end of its term effectively enjoys low electoral exposure and high election insulation, while a government that has to face elections every year will have high election exposure and low election insulation. But while the concepts are related, they are not necessarily identical. It is possible for a government to have high electoral exposure but, if all of the elections are bunched up in time, it can also have a relatively high period of electoral insulation. This was true for example of Chávez's second term (the first under

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[13] The Constitution did not specify the length of the period of municipal council members, but the Law of the Municipal Public Power states that it is also of four years.

[14] We do not count in this assessment the years in which officials others than the president could be subject to recall. In practice, these recalls were hart to invoke and infrequently carried out. Our focus is on nation-wide elections that have the potential for significantly changing the national political balance and threaten the government's hold on power.

the 1999 constitution), which faced a sequence of consecutive election years in the second half of his term but had a 4-year period at the outset of his term during which it faced no elections.[15]

The concept of electoral insulation is particularly interesting for understanding the way in which electoral institutions can affect the formation of macroeconomic policies. Electoral insulation can be understood as a measure of the length of the "window of opportunity" that a government has to implement policies and present the results of these policies to voters. A government with a five-year insulation period can reasonably implement adjustment policies that impose significant economic costs towards the start of its term and wait for these policies to deliver economic growth by the time it faces elections. A government with a one or two-year insulation period has a much shorter time span to implement policies and deliver their results without facing a backlash at the polls.

Under the rules laid out in the 1999 Constitution, a government's election exposure would be at least 50% - that is, a government would be at risk of facing a nationwide election for at least half of its years in office - given that a recall referendum could be called during the last half of the term. But for a government that was unlucky enough, election exposure could rise to 83% or even – after electoral authorities decided to separate the election date for municipal and state elections in 2005 - to 100%. Similarly, while some governments could enjoy a 4-year election insulation period, others could end up having election insulation as low as 1 year.[16]

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[15] From July 30, 2000, when he was elected to August 15, 2004, when the recall referendum was held. We take the date in which the referendum was held as the relevant date to measure electoral insulation in the following two presidential terms, on the assumption that if the opposition had successfully called a referendum in these terms, it would have faced delays similar to those seen in 2004 between the beginning of the midterm, when the president effectively becomes eligible to face the referendum, and the date at which such a referendum would have been held.

[16] From 1958 to 1973, all five nationwide elections (for the president as well as national, state and municipal level legislative bodies) were held on the same date. Starting in 1979, elections for municipal councils were held roughly six months after the presidential election, lowering the electoral insulation period from 5 to 4.5.

Chart 6-1: Election exposure across presidential terms, 1958-18
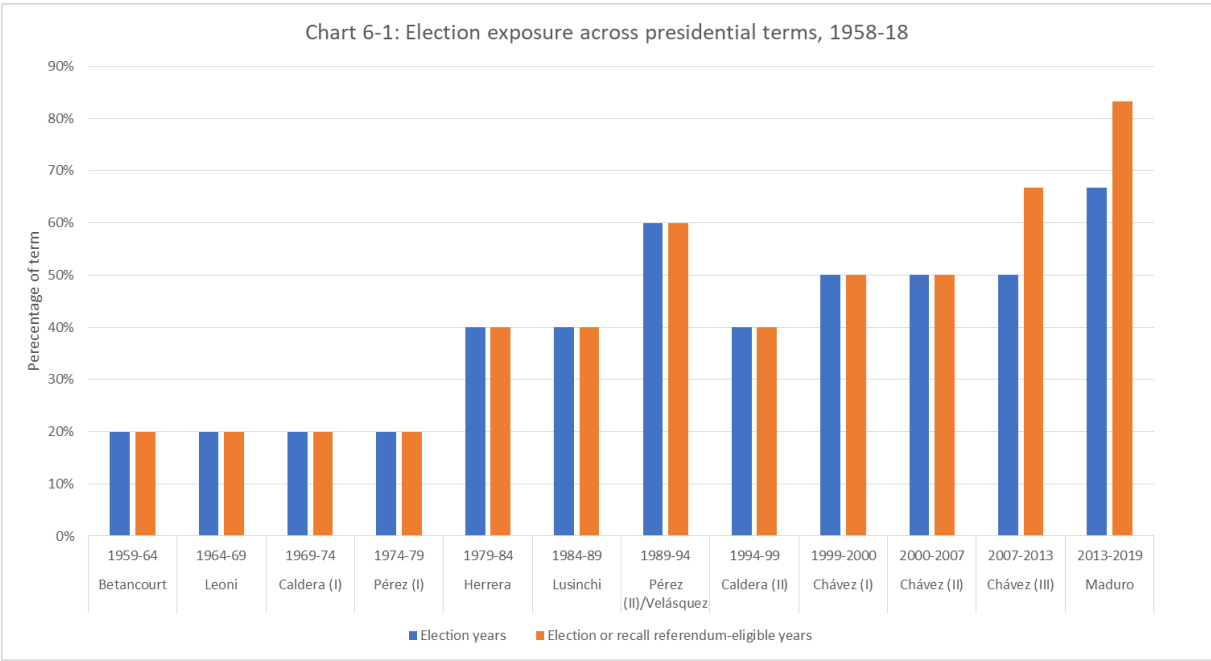
Charts 6-1 and 6-2 show the evolution of measures of electoral exposure and insulation throughout Venezuela's democratic history.[17] Between 1958 and 1979, governments faced one election every five years and thus had electoral exposure of 20%. When municipal elections were separated from other elections in 1979, the exposure ratio rose to 40%, and increased again to 60% right after direct elections for mayors and governors began to be held. Once we include the years in which a recall referendum could be called into our measure of election exposure we find that the two most recent presidential terms have had the largest levels of election exposure observed so far in Venezuela.

Our measure of electoral insulation tells a similar story. Chart 6-2 displays the length of the maximum electoral insulation period measured both in absolute number of years as well as relative to the total length of the presidential term. Up until 1989, governments had very long stretches of time without facing elections. This declined markedly after 1989 and then fell further with the 1999 Constitution. With the exception of Chávez's shortened first presidential term, which only lasted

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[17] For purposes of our measure, we take into account only elections that are scheduled by constitutional rules. We do not count referenda or elections for Constitutional Conventions, such as those held in 1999 and 2017, as these are initiated by the government and can thus be understood as an "electoral option" that the government can decide to invoke. The fact that the government can decide whether to call these contests implies that it can choose not to do so if these are an obstacle for the implementation of its policy agenda. However, once the Constitution was passed in 1999, then new elections were scheduled to "relegitimize" all branches of government in 2000. We count the 2000 elections in our measure as these are set in observance of constitutional rules.

two years, the last two presidential terms have shown some of the lowest levels of electoral insulation in the period.

According to both measures, Nicolás Maduro's presidential term was marked by very high levels of electoral exposure and very low electoral insulation. Because of Chávez's death, snap presidential elections were held on April of 2013, during the first year of the term. But electoral authorities also ended up delaying municipal elections twice – the second time because of the scheduling of the snap presidential election – with the consequence that these were held in December of 2013, one year later than originally planned.[18] The government thus faced nation-wide elections during four of its six years in office (2013, 2015, 2017 and 2018) and was subject to a recall referendum drive starting in 2016. Its longest stretch of election-insulated time was thus the 24-month period between the December 2013 municipal elections and the December 2015 legislative elections. In other words, Maduro faced the highest level of election exposure and the lowest level of relative electoral insulation seen by any president in Venezuela's democratic history.

Chart 6-2: Electoral insulation across presidential terms, 1958-2018

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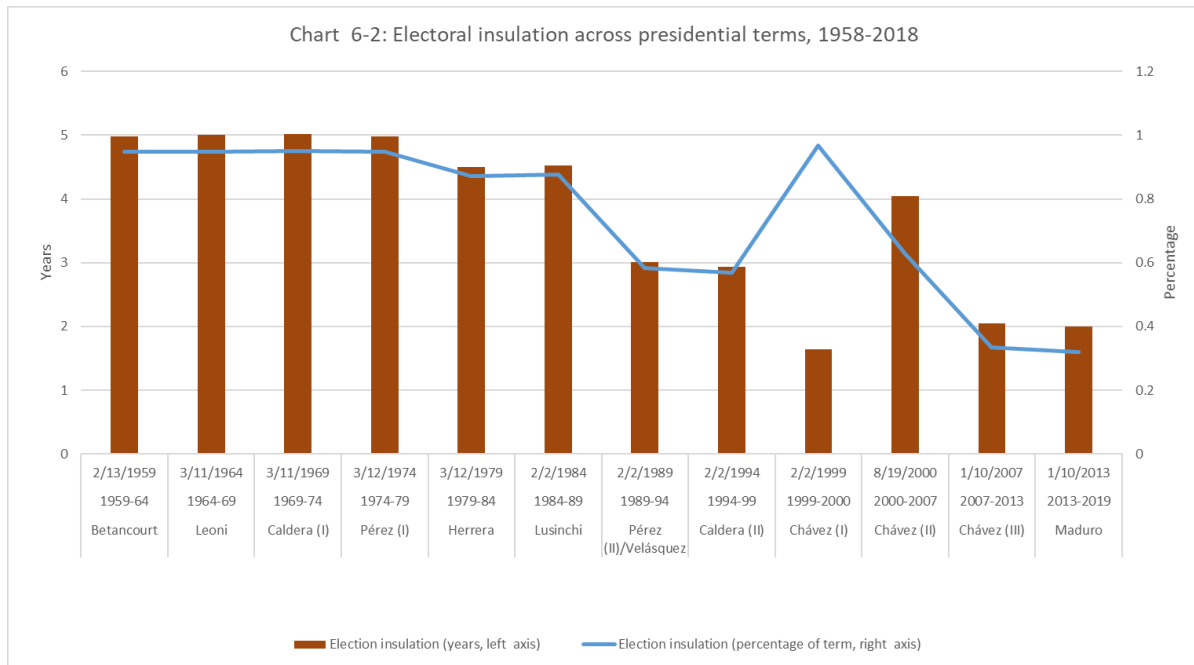
[18] The possibility of manipulating the timing of elections implies that the timing of elections is not necessarily exogenous. Authorities can in principle use this power to lengthen the windows of opportunity to enact unpopular policies. However, as we argue in chapter 7, the political costs associated with manipulating the timing of elections are far from trivial and there are instances in which the politically optimal move may be to bring forward elections (as in May 2018), thus reducing electoral insulation.

Short-term political costs and benefits of reform

The economic costs of avoiding devaluation are proportionate to the size of the gap between the economy's exchange rate and its equilibrium exchange rate. The larger this gap, the greater the drain in international reserves if the government is defending the parity, and the greater the black-market premium if the government is imposing exchange controls (as was the case in Venezuela). A large black-market premium will generate increased incentives for rent-seeking, whereby individuals and firms devote resources to appropriating the valuable asset (i.e., cheap foreign exchange) and reselling it in the black market. By forcing large swathes of the economy to function at misaligned prices, a large black-market premium combined with price controls impedes resources to reallocating to the economic activities where they are most needed, thus reducing output.

However, a higher black-market premium also entails a higher political cost of resolving the distortion by devaluing ahead of an election. Maintaining an overvalued currency is one of the mechanisms that a government has for fooling people about the economy's ability to sustain high living standards ahead of an election. Voters can interpret an overvalued exchange rate – and the associated low price of imported goods compared to local incomes – as a sign that the government is competent in generating the economic conditions that allow them to enjoy greater living standards. Conversely, a large devaluation will be interpreted by voters as a sign of the government's incompetence. The larger the devaluation, the greater the "incompetence surprise" and the greater the cots that the government will pay when people go to the polls.

Nevertheless, if the government is imposing exchange controls and rationing access to goods in order to sustain the overvalued exchange rate, it will become evident to voters that the goods are not easy to find and that the government is thus not all that competent at providing cheap imported goods for everyone. Yet the government may still be able to target key constituencies through the allocation of goods, and these constituencies may come to believe that the government is capable of sustainably delivering cheap imported goods to them. Being able to provide access to cheap goods to just a fraction of the population can also appear consistent with the political message of a movement that has promised to reverse historical inequalities and empower previously disadvantaged groups.[19]

As we chronicled in chapter 4, Venezuela suffered a massive decline in oil revenues between 2014 and 2016 due first to the decline in oil prices and later to the collapse of oil production. One of the consequences of this decline was to increase the magnitude of the adjustment that the country needed to carry out in order to resolve the misalignment of the exchange rate and restore external sustainability.

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[19] Of course, FX controls can do just the opposite, by allowing politically connected groups to build large fortunes on the basis of arbitrage. But this is much less visible and thus harder for voters to take into account at election time.

In order to get a sense of the size of these effects, we estimate the level of the exchange rate that would have been needed to correct the overvaluation of the currency. My estimates are based on an econometric model in which the equilibrium real exchange rate has a long-run stable relationship with the level of per capita real oil revenues, after controlling for the periods of presence of exchange controls.[20] Chart 6-5 shows the results of our estimates, alongside the evolution of the country's oil export revenues.

The real exchange rate can be understood as a measure of external prices relative to domestic prices. An increase in the real exchange rate indicates that imported goods are becoming more expensive in terms of domestic goods: this is called a real depreciation.[21] The index is measured in relation to a baseline level of 100 in December of 2007. At the start of 2014 the index was at 70, or, in other words, 30% stronger than in 2007, reflecting the effects of the oil boom. By the close of the year it had risen to 116, and at the start of 2016, when oil prices tanked, it reached 295. By the end of 2018, with the collapse in oil production and the additional pushback in oil prices, it had risen even further, to 331. In other words, in order to correct the exchange rate's misalignment, the government would have had to devalue the exchange rate to make dollars 4.2 times more expensive in terms of local goods in 2016 than it would have needed to in 2014 (4.7 times more expensive by 2018).

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[20] Describe model, references.
[21] We follow a convention widely used among Latin American economists – but not so in other regions – of representing the real exchange rate as the relative price of imported to domestic goods. Therefore, a higher value of the exchange rate corresponds to a weaker or more depreciated exchange rate.

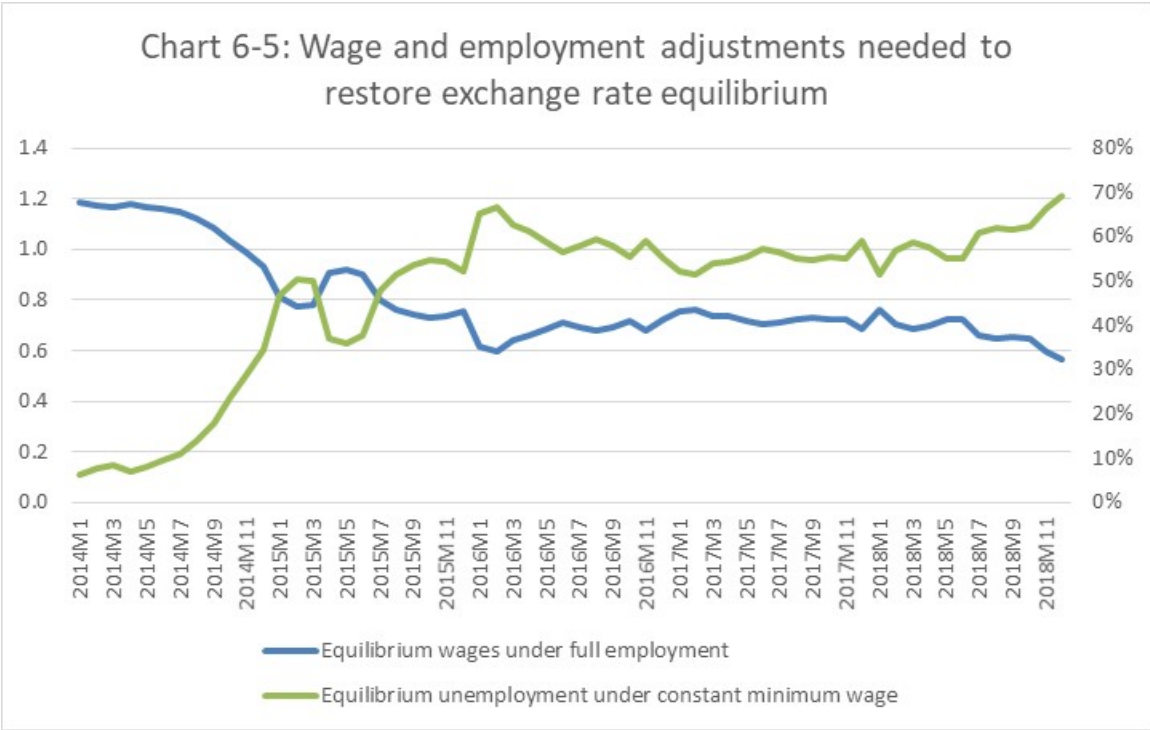Chart 6-4: Oil exports and equilibrium real exchange rate
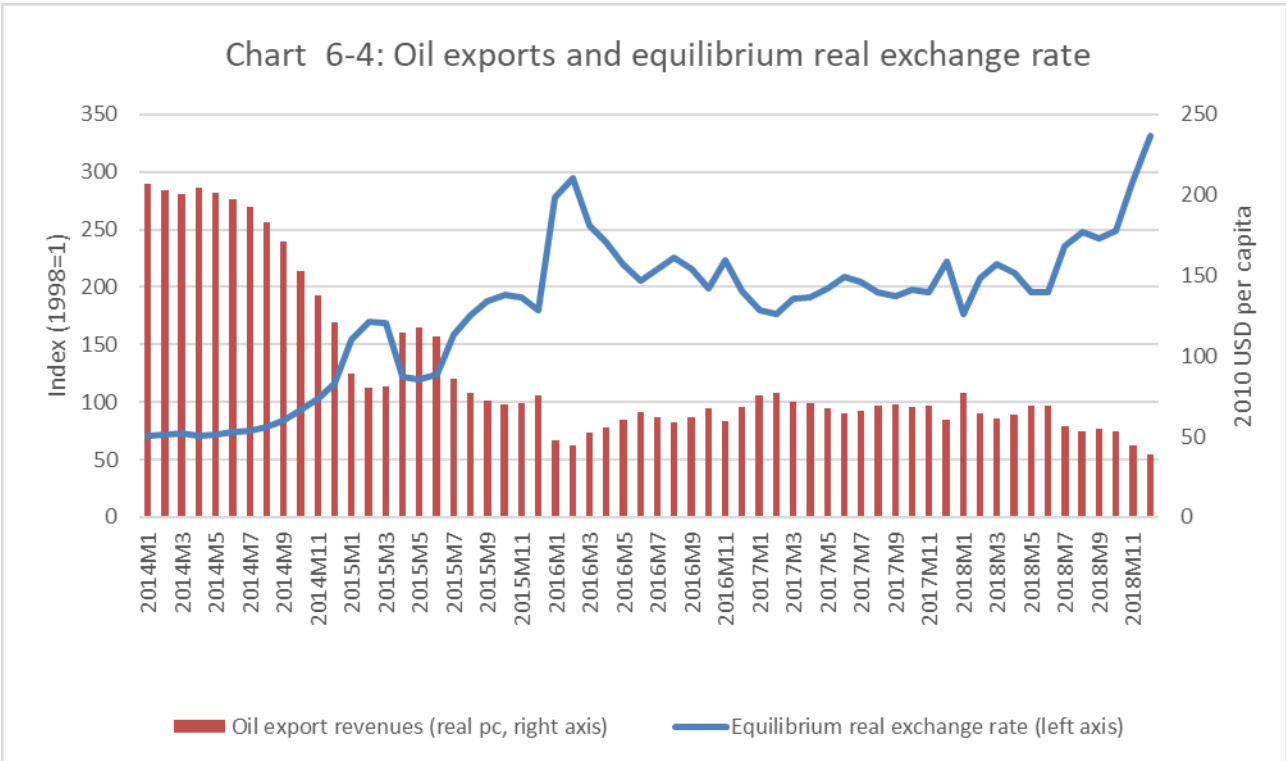
A four-fold depreciation of the real exchange implies an increase of four times in the prices of imported goods in terms of domestic goods. Since nominal wages are proportional to the prices of domestic goods, then it also would imply cutting the purchasing power of wages in terms of imported goods by four-fifths.[22]

The net effect on real wages will depend on how large the weight of imported goods is in the consumption basket of workers. A reasonable proxy for this is the share of tradable goods in the consumption basket used by the Central Bank to calculate the nation's Consumer Price Index, which is 48%.[23] Using this number, we can estimate the real wage that would result if the real exchange rate were allowed to reach its equilibrium, absent changes in other determinants such as productivity. The resulting series, represented in Chart 6-5, shows that Venezuelans would have had to see real wages fall by 51% by 2016 – and 56% by 2018 – as a result of the depreciation of the exchange rate that would have been needed to eliminate the distortions in the exchange market.

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[22] The proportionality of nominal wages to non-tradable prices is a feature of models in which the economy is fully specialized in natural resources and thus does not produce alternative tradable goods. See Sachs (1999) for a stylized description of this case.

[23] Although we have distinguished between imported and domestic goods in the text for the purposes of exposition, analytically the correct distinction is between tradable and non-tradable goods, as the prices of tradable goods, regardless of whether they are produced domestically or not, are determined internationally.

Chart 6-5: Wage and employment adjustments needed to restore exchange rate equilibrium

Equilibrium wages under full employment

Equilibrium unemployment under constant minimum wage

Note that the wage represented in Chart 6-5 represents the real wage under the assumption that labor markets are fully clearing and competitive. One way to generate this decline in real wages is through inflation, and in fact this is what happened in Venezuela. In fact, the decline was much greater, with the real minimum wage falling by 99.4% between January of 2012 and December of 2018, although a precise estimate is hard to pin down given uncertainties about price data after the Central Bank stopped publishing inflation series in 2015. In other words, the government was not able to stop the slide in the exchange rate (which occurred through the parallel market) or in real wages (which occurred through inflation). What it could try to do, and in fact consistently did, was to pretend before voters at election time that there was no need for this adjustment.

What would have happened if the government had neither printed money nor devalued the currency? Since equilibrium real wages would have dropped anyway as a result of the shock in external revenues, the government would have had to either cut the minimum wage or accept very high levels of unemployment. Chart 6-5 also shows the unemployment rate that would have resulted if the government had been able to hold the real minimum wage constant at 2012 levels. The model predicts that if the government had maintained a constant real minimum wage, unemployment would have had to rise to more than 50 percent by mid-2016.

The two series represented in Chart 6-5 can be seen as two extreme scenarios in terms of the policy response to a negative terms of trade shock. Either authorities let the shock transmit fully to wages and

experience a massive decline in them, or they chose to maintain the level of real wages and thus see a massive rise in unemployment. Most governments (except those bound by dollarization or a currency board, who can't lower real wages through inflation) adopt a mixture of the two approaches, letting real wages drop and unemployment rise at the same time.

Venezuela opted for lower real wages. But it did so in a roundabout and distortionary way. By refusing to devalue its currency while experiencing high inflation, the government let its official exchange rate appreciate at the time at which it was experiencing a negative terms of trade shock which required a real depreciation. It thus raised the gap between the official and black market rate, with all the associated distortions. Chart 6-6 shows two measures of the exchange rate in the economy: the official exchange rate, and the weighted average exchange rate over all transactions (including parallel-market transactions). Note that the government has direct control over the former but not the latter, since the black market rate is set by market forces. Nevertheless, the series shows that the effect of the appreciated official exchange rate was so significant so as to maintain the average exchange rate of foreign exchange purchases by Venezuelans well below (less depreciated) than the equilibrium rate.

Chart 6-6: Real exchange rates
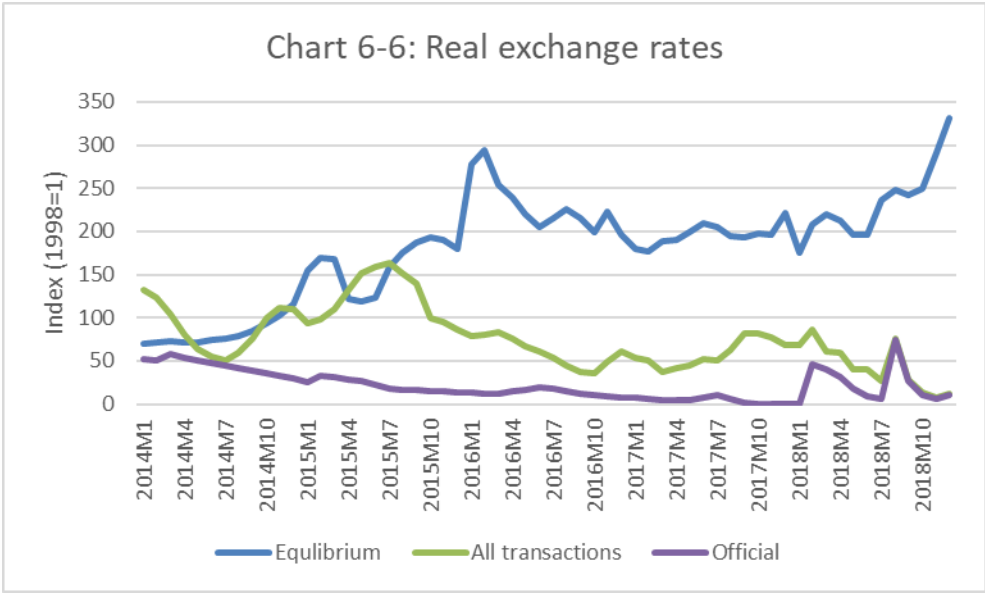
In sum, our estimates show that if Maduro had undertaken the policies necessary to restore external balance and eliminate the exchange rate's overvaluation, he would have had to accept the need for real wages to drop by more than 50 percent, or for unemployment to rise to the high double digits. Very few governments manage to win elections after carrying out this type of adjustments. It is thus not surprising that Maduro opted for policies that would hide the need for these adjustments ahead of every election.

Ironically, the magnitude of the decline in real wages ended up being even greater than what we estimate would have been necessary to deal with the external shock, precisely as a result of Maduro's highly distortionary economic policies. There are many reasons for the decline in real wages, but one of

them is the government's decision to systematically rely on inflationary financing. Real wages in fact tend to decline strongly under hyperinflations, as a result precisely of the erosion of the government's capacity to finance real expenditures.[24] This is the essence of populist policy responses: by delaying adjustments, they allow voters to perceive short-term benefits at the expense of deeper long-term costs.

Economic decision-making when the political clock is ticking

In this chapter, we have argued that Venezuelan political institutions, some of which were significantly transformed in the late 90s and early 00s, fundamentally altered the incentives of policymakers to take certain type of economic policy decisions. By increasing the frequency of elections and raising the stakes of power, they raised the incentive for politicians to attempt to avoid electoral defeats at any cost while raising the frequency with which they had to make a choice between addressing economic imbalances and maintaining their hold on power. These contradictions came to a head during the Maduro administration, when an increase in electoral exposure and growing polarization coincided with a huge decline in the country's external revenues.

This analytical framework can help us shed new light on the evolution of macroeconomic policies during the Maduro administration discussed in detail in chapters 2-4. Maduro came to office with a very weak mandate, first taking over after Chávez became too ill to govern and then winning a presidential election in April of 2013 by a slim margin. Despite this, he undertook first steps towards adjustment by devaluing the currency two months before the election and severely curtailing imports.

However, Maduro had to contend with several political realities that complicated his time in office from the start. First, there was a very highly mobilized opposition, some of which was openly questioning the validity of the results leading to his election. Second, there was widespread skepticism about his ability to lead *chavismo* to electoral success, given that his only electoral victory came riding on a widespread sympathy effect after Chávez's death in March. Third, the opposition began mobilizing around the idea of making the December 2013 municipal elections a referendum on Maduro's rule.

The risks to the government became evident as polls showed the government lagging opposition candidates by large margins ahead of the municipal elections. This led the government to shelve any discussion about economic adjustments until after these elections. Furthermore, the government chose to raise economic distortions ahead of the elections by forcing prices down during the *Dakazo*. The essence of the *Dakazo*, in fact, was convincing voters that the government was able to

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[24] Braumann (2000) studied 23 cases of high inflation in 17 countries and estimated an elasticity of -2.5 of real wage growth to the log of inflation, with real wages 21% below their initial value on the year after the onset of high inflation.

ensure the supply of cheap imported goods, even if the result could only be sustained for a short period of time ahead of the elections.

The fact that the government proceeded to announce policy adjustments including increases in the price of gasoline on the day after the municipal elections is strong evidence that the delay of adjustments had been driven by political and electoral considerations rather than by ideology or rent-seeking. The fact that the government's only serious attempt at presenting a coherent macroeconomic stabilization plan under Rafael Ramírez as economics vice-president came in the only year of its term in which the government did not have to face an election or recall referendum (2014) is consistent with our view that elections are a deterrent to economic adjustments, and that frequent elections will increase the likelihood of governments letting macroeconomic imbalances pile up.

However, it is impossible to understand the government's policy decisions in 2014 without taking account of *La Salida*. By calling on people to go to the streets to try to generate a change in government, the promoters of *La Salida* were effectively turning 2014 into something very similar to an election year. As we discussed in Chapter 3, government leaders began to see stopping the protests from extending to poorer neighborhoods as their overriding objective.

Protests died down in the second half of 2014, and there again we see the government seriously begin to push the Ramírez plan. But then the Ramírez plan is shelved precisely at the time at which oil prices are collapsing. During the last six months of 2014, the amount by which the government would have has to let real wages fall as a result of the devaluation needed to restore external equilibrium dropped by 30 percent. The magnitude of the needed price adjustment, in other words, turned from large to daunting, throwing the government into a deeper policy paralysis.

By when they had had time to think it over – and realize that oil prices were not going to recover[25] - it was election year again. And 2015 was not any election year: the National Assembly, where a supermajority of two-thirds had the constitutional power to impeach the President, was up for grabs. The opposition in fact won that two-thirds majority, leading the government to suspend the election of several legislators. In 2016, electoral authorities scuttled a drive to call a recall referendum that Maduro seemed certain to lose, at a significant political cost for the government.

The following chapters take a closer look at the evolution of the country's economic and political dynamics in 2017 and 2018. Both were years in which competition for popular support – both at the voting booth and in the streets – was intense, and during which the stakes of power and the costs of exit rose dramatically. It is thus possible to account for the continued adjustment delays in those years as a result of the priority given by the government to shoring up popular support in the

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[25] Recall from chapter 3 our discussion of OPEC's decision not to curtail output in November 27 of 2014. In the runup to that decision, Venezuela lobbied strongly for an output cut. Therefore, it only became clear that oil prices were going into free fall after the supporters of maintaining production levels carried the day in the November OPEC meeting.

face to real and immediate threats to their hold on power. In other words, the conditions which induce a bias towards prioritizing short-run considerations in policy decisions, were, if anything, more prevalent in the last two years of Maduro's first term in office.

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