Robert Schuman

European Union Center/ Jean Monnet Chair

Venezuela's Economic Meltdown & Road to Recovery

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Vol. 18, No. 2
September 2018

Published with the support of the European Commission

The Jean Monnet/ Robert Schuman Paper Series

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<u>Venezuela's Economic Meltdown & Road to Recovery.</u>

Abstract

Venezuela, once a robust economy in Latin America, has changed since Hugo Chavez was elected president. Chavez was very clear during his tenure about his discontent with open market policies, deciding to implement state-oriented economic ones.

This paper analyzes Venezuela's dilemma of how to grow its infrastructure and industries and contends that it should target two specific fronts. First, Venezuela must reform its economic policies by encouraging Foreign Direct Investments (FDI) via mimicking the structural changes that China implemented decades ago by opening up to FDI while protecting its national interests. One way of doing so is by protecting against massive repatriation funds while giving those investors protections and guarantees. The second front involves the creation of a Sovereign Wealth Fund similar to the one created in Norway. These two fronts can only be successfully addressed by the strengthening the autonomy of Venezuela's institutions.

Introduction

Today Venezuela is at a crossroad. The country's extreme dependency on oil has created a severe financial crisis due to low prices for the commodity. The newly elected congress faces record highs on debt, inflation, trade deficits, public insecurity, food shortages, among other issues. This has created social mobilizations, protests, and many confrontations between citizens and law enforcement. These are pivotal times in Venezuela, but what changes and policies should this administration and future ones enact to change its course? My argument is that it must pull away from a state-oriented and command economy, to a market-oriented and capitalist one; however, this process must be done gradually by adopting protectionist measures for its industries and infrastructures. I suggest that Venezuela should replicate the economic policies implemented in China in 1982 to encourage Foreign Direct Investment (FDI) and help the country develop its depleted and outdated industries. Simultaneously, it would be in its best interest to put in place some protectionist measures similar to the ones imposed by China. As for oil revenues, Venezuela should create a Sovereign Wealth Fund (SWF) similar to the one created by Norway. By doing so, Venezuela could help to alleviate its inflation and cut many social expenditures in its fiscal budget.

Venezuela's Socialist Economy

The beginning of the twentieth century saw the transformation of Venezuela from one of the poorest to one of the richest economies in Latin America. Between 1920 and 1948 the country's GDP per capita grew at 6.8%. By 1970, Venezuela had become the richest country in Latin America and one of the twenty richest countries in the world, with a per capita GDP higher than Spain, Greece, and Israel and only 13% lower than that of the United Kingdom (Hausmann 2013). As of 2005 Venezuela still had the highest per capita GDP in Latin America (adjusted for PPP). Unfortunately, beginning in the 1980s, this prosperity became more disproportionate between the lower and higher classes. Politics were in the hands of an "inner circle of leaders at the head of each party. Venezuelan critics began to call their system a *partidocracia* rather than a *democracia*." (Coppedge 1994). This culminated in two different incidents where Hugo Chavez attempted a coup d'état but failed. Finally, he decided to go the democratic route and won the presidential elections in 1998. Some of his controversial policies started after the first collapse of oil prices in 2006 and continued until his death in 2013, but these policies still continue under new President Nicolas Maduro.

Venezuelans embraced Chavez's rhetoric of drastic change in social and economic inequalities. Unfortunately, those changes came with a steep price tag for the state, which happily carried the burden until oil prices precipitated. Amid the recent low oil prices, the result has been that in the last several years, the people of Venezuela have gone through a severe contraction of their economy, soaring inflation, massive currency devaluation, cuts to social programs, a substantial exodus of companies and jobs, and over 70% of goods are in shortage, happily carried the burden until oil prices precipitated. Amid the recent low oil prices, the result has been that in the last several years, the people of Venezuela have gone through a severe contraction of their economy, soaring inflation, massive currency devaluation, cuts to social programs, a substantial exodus of companies and jobs, and over 70% of goods are in shortage.

Chavez's ideology turned Venezuela from a market-oriented economy to a state-directed type, thus creating a hostile environment towards private enterprise. As the financial crisis became more acute, his successor, Maduro, implemented some fiscal policies by making cuts to social programs and creating the National Superintendence for the Defense of Socio-Economic Rights known as SUNDDE. Nagel explains this internal policy: "Putting aside the fact that its enormous task will require tens of thousands of employees, the very name spells out just how the government views private businesses: as something people need to be 'defended' from. The gist of the law is precisely what it says: Everyone must submit their costs so that the government can set their margins and their prices. Everyone can be audited at any point in time. The maximum margin allowed is 30% of costs. How will the government determine what counts as cost? The law is purposefully vague about this." (Nagel 2014). What is worst about this bill is that it threatens every company with expropriation, with no compensation and with jail time for individuals in case they are found not in compliance.

This type of behavior is what has discouraged private domestic and foreign investors from looking at Venezuela as a viable alternative for their funds. The Venezuelan economy has become state dependent, which, in turn, translates to oil export dependent. The private sector lives in a constant hostile environment, having to watch over lower and higher margins in order to not make excessive profits. As a result, the entire country suffers from shortages of food and other basic necessities.

The Need to Change its Course

The twentieth century was marked by many economic reforms around the world. After stock crashes, the Great Depression, and wars, most of the Western world joined the USA in an attempt to control foreign economies and avoid a future global financial crisis. Shortly after the end of World War II, the Bretton Woods System was created to monitor global economic issues. However, the other side of the world was lured into the Marxian way of economics and adopted state-controlled economies. As the Cold War developed in every region of the world, an economic competition between its two representatives, the U.S.A. and the U.S.S.R., accelerated a desire to prove that their model of economics was the prosperous one. As time passed, communist ideologies lost strength and socialism gained momentum as a viable alternative, the exception being China, which switched from a command economy to a market-oriented one.

Even though Venezuela does not fall under the command economy category, its extreme socialism has a lot of similarities, namely, government overspending in social programs, expropriation of companies to convert them into State Owned Enterprises (SOE), high tariffs and quotas to protect local industries, and price control practices.

It is imperative for Venezuela to make a change from its extremely socialist economic policies to market-oriented ones, but the move must be done with caution and historical knowledge. The clearest examples in history of countries shifting from a command to a market economy are the cases of China and the U.S.S.R. As the Soviet Union collapsed, Russia opened up its economy to a market-oriented one without structure and/or restrictions. The switch created an atmosphere ripe for corruption, which gave open range to a handful of billionaire oligarchs, while the rest of the people suffered the financial and political consequences. The result was an economic catastrophe throughout the 1990s.

The other economic model comes from China, who decided to end the Mao era in 1978 and make an economic shift. Although China still is, politically, a communist country, it has a market-oriented economy. This economic shift came with great resistance from conservative leaders who feared a compromise in national security by foreign investors, among other concerns. Margaret Pearson explains this dilemma:

> "The Chinese government expressed two concerns related to joint venture profits in the early years of the foreign investment policy. The first concern of both conservatives and reformers was that the sole pursuit of profit for profit's own sake (a key element of capitalism) not be a practice that China should adopt. There was also a lingering distance for and suspicion of adopting foreign financial practices wholesale. But reformers broke with conservatives by arguing that some application of profit criteria would foster increases in productivity. A second concern was a Legacy of Chinese views of the country's historical experiences and of anti-imperialist ideology: foreigners should not be allowed to extract "excessive" profits from China. Reformers and conservatives both argued that China should avoid yielding more profits than absolutely necessary for foreign firms. But reformers also viewed foreign firms as the key agent for teaching Chinese firms to be profitable." (Pearson 1991).

Chinese politics look like they have not changed much since the departure of Mao, but Kishore Mahbubani argues, "On paper, the party looks much the same as it once did, but the reality is dramatically different. After more than a century of misrule, China is now run by the best governing class in generations. Gone are the aging commissars clinging to party rule; they have been replaced by leaders committed to moving the country forward, including many young mayors who have been trained at U.S. universities." (Mahbubani 2005). This battle between Chinese conservatives and reformers mirrors similar disputes inside Venezuelan politics today.

There are many parallels between today's Venezuela and Mao's Chinese economy. Ghosh's description of SOE's in the Chinese economy perfectly describes what Venezuela is going through: "Accustomed, as these enterprises had been, for decades, to function on the dictates of the political regime, it would have been a disaster if they were pushed to fend for themselves in a competitive global economy. Institutional deficiencies that had been crippling them were far too deep-rooted across the whole spectrum of the economy. In economic terms they had become virtually bankrupt, borrowing large sums of money from state-owned banks and burdening the banking system with huge non-performing loans." (Ghosh 2005).

The Chinese model of economic reformation has proven to be more successful than the Russian one. One of the reasons is that Chinese economists recognized the need for Foreign Direct Investments (FDI) to not only finance industry development but to mentor companies, helping them to become more efficient and profitable. These reasons made FDI necessary, but unlike Russia, China set up a series of protectionist measurements that would allow the gradual transition without giving up autonomy or creating economic anarchy. Chinese politicians "… must have realized that before they could push through a coordinated reform strategy encompassing state enterprises, the financial system and tax administration, there had to be a safety valve in a large and dynamic non-state sector." (Ghosh 2005). Ghosh further explains how at the time of the reformation process the private sector was "virtually non-existent," much like the one found today in Venezuela.

China created an article in its 1982 constitution that offered protection to foreign investors. In contrast, Venezuela has created the SUNDDE where it shuns and discourages foreign investors. Article 18 of the 1982 constitution "…offered protection … to the legal status of foreign enterprises operating in China. They were permitted to invest in China and enter into various forms of economic cooperation with Chinese enterprises …" (Ghosh 2005). These policies, among others, created stability and enough confidence in foreign investors to look to China for investment opportunities after the 1980s.

The Chinese model is the one Venezuela's economists should study, replicate, and adapt since its political economy is moving from an individualistic and almost isolationistic regime to an open market one. This insistence for change is not coming from the head of the state but from the vote of the Venezuelan people. They demand to leave behind the authoritarian and extreme realist perspective of always putting national security and sovereignty ahead of an open and more liberal economy, or at least one with some protectionist policies. By adopting a liberalization of its economy, even if not fully embraced, Venezuela can find a path towards modernization and infrastructure for its weak industries. Its political leaders must come to the conclusion that just as China was able to develop "… without any obsessive hangover about foreign domination or a nagging fear that their country's national interest or sovereignty is being compromised." (Ghosh 2005), so can Venezuela. Those funds will only come if the state starts providing some guarantees and protections to those investors. The investors should also have an understanding of the risks and idiosyncrasies of the Venezuelan business culture and politics, but more important, Venezuela needs to fortify its institutions in order to offer a credible guarantee for foreign investors.

Institutional Concerns

Ever since Hugo Chavez came to power, Venezuela's institutions have deteriorated; however, under President Maduro, they are completely crippled. Checks and balances have been removed, legitimate democratic processes are almost extinct, the press has been silenced, and civil society continues to be harassed. All of these are examples of eroded institutions that were created to maintain a democracy in the hands of the people, but now they are in the hands of a single person. Current president Maduro has doubled down on his predecessor's political maneuvering, as "The Chavez 'revolution' systematically removed all the checks and balances required for liberal democracy. This was achieved in two stages: eliminating the old actors in a position to check the president, then ensuring the loyalty of the new actors to the president." (Coppedge 2005). Similarly, Maduro has recently called for a new constituent assembly to fill the Supreme Court and mimic Chavez's strategies.

The changes done by both Chavez and Maduro were aimed at controlling two important sectors: the economic one through the nationalization *of Petroleos De Venezuela Sociedad Anonima* (PDVSA) and the political one by weakening democratic institutions. These two go hand in hand in order to ensure total control over the state, which has historically led to authoritarianism and to the eventual failure of the state. "A natural resource-led economy and the pathologies attributed to a country's endowments are jointly determined by weak state capacity and low-quality institutions" (Menaldo 2016).

The Chavismo era was initiated with the loyalty and support of the armed forces, which has allowed this institution to benefit the most while diluting all other democratic institutions. Venezuelan elites are frequently associated with the executive or military power, thus creating an unbalanced democratic system. The contrary could be said for democracies where "even though elites constantly strive to modify the rules of the game to guarantee a more favorable distribution of resources and opportunities, the relative stickiness of institutions across time seriously impinges upon their ability to do so." (Menaldo 2016). Unfortunately, this is not Venezuela's reality today. Its institutions are filled with loyalists to the Maduro regime, and are rampant with cronyism and incompetent bureaucracy, turning an oil-rich country into a dysfunctional curse.
Scholarly literature on political economy is plentiful on the topic of the resource curse, but new literature has expanded or rather contested this notion by adding a new category called the institutional curse. The resource curse label is given to countries with abundant natural resources in high demand, but they lack economic growth and have less democracy. In the case of Venezuela, history has shown that regardless of which democratic system is in place, either *partidocracia* or authoritative, its institutions have been weak when it comes to regulating its natural resources; "however, all agree that Venezuela's regime, democratic or not, is less institutionalized than it used to be" (Coppedge 2005) creating an institutional curse *per se*.

Paradoxically, there are several states that rely heavily on natural resources, yet they continue to foster democratic practices. One of them is the exceptional case of Norway who is one of the world's largest oil producers and exporters, yet what is supposed to be a curse has turned into a blessing for that nation.

Resource Curse to Blessing. The Case for a Sovereign Wealth Fund.

After Norway's discovery of North Sea oil in 1962, the state was lured into a spending spree and inflation rose rapidly, "Symptoms of Dutch Disease appeared, as agriculture declined from 6 to 4 percent of GDP and manufacturing from 20 to 15 percent between 1977 and 1982" (Karl 1997). However, the state was able to maintain a regime despite the political changes. This political stability allowed institutions to be empowered, and unlike other oil exporting countries, it took control of its oil policies. Oil companies realized that the country was not poor, weak, undeveloped, or authoritative. Instead, they found a wealthy, equitable, democratic, and economically diversified country, where civil-service recruitment was solely by merit, and corruption was nonexistent (Karl 1997).This polarizing description reveals the differences between Venezuelan and Norwegian institutions amid their natural resource endowments.

Having such strong institutions has allowed Norway to be more diligent with its rents and use them to create more wealth. “Norway’s Central Bank has taken an extremely hawkish stance against inflation, the country’s Sovereign Wealth Fund (SWF), Government Pension Fund-Global, has fastidiously saved and invested the country's oil rents. It has aimed for a 4 percent rate of return over the long run to effectively husband oil income for future generations." (Menaldo 2016). In comparison, Venezuela has spent every dollar it received during its oil boom and saved nothing for future scarce times. As of September 2017, Norway's SWF is the largest in the world with a net worth of over 1 trillion dollars (Turula 2017), a distressing contrast to the economic havoc Venezuela is living in today.

Venezuela’s historically weak institutions allowed this type of economic behavior before and after the Chavismo era. “During the oil boom years, when growth was extremely rapid and optimism ran high, these groups were content and remained loyal to the democratic regime. But when the oil economy went bust, the middle class shrank, and working-class unions lost membership and clout. The political culture became less moderate and more radical." (Coppedge 2005). These are characteristics of the inability of a weak state that continues to use oil rents as a political stabilizer. The fact that Norway has a different culture, history, and idiosyncrasy, does not mean that Venezuela could not replicate some policies and empower its institutions at an acceptable level. "Strong and competent states such as Norway and Chile, where the rule of law is consolidated, have had great success mitigating these problems through prudent monetary and fiscal policies." (Menaldo 2016). Therefore, Venezuela does not necessarily have to look across the Atlantic to find a suitable economic model. In simply paying attention to its southwestern neighboring country Chile, it would find political and economic stability, along with a SWF model, to mimic.

In order to maintain control overabundant oil revenues, Norway created an SWF in 1990, designed to tackle two fronts. First, to establish a future plan for the use of this resource, since it is not endless, and to leave some of its benefits to future generations. Second, to avoid a dependency on its revenues, leaving the fiscal budgets at the mercy of international price fluctuations. Norway’s rationale was that “the growing burden on the pension system due to the increasing average age of the population, and declining oil production, played key roles in the decision to create the fund.” (Afanas'Ev 2004) This fund counteracts possible negative effects of resource curses by restricting government overspending via savings, and it also controls possible hyperinflation; therefore, “rather than replace non-oil taxation, Norway put much of its recent bonuses into a ‘petroleum fund,’ set up to store wealth for the time next century when its oil starts to run out." (Karl 1997).

The gist of this fund is to set a base price for exported oil below the long-term forecast. Hence, if international oil prices drop at or stay above the set price, the fiscal budget and fund are not destabilized. Any surpluses from this base point are transferred over to the SWF; in the case of shortages, the SWF transfers back to the state budget only a portion of the fiscal deficit. Norway’s SWF model protects its economy against possible resource price fluctuations by putting "its money away into foreign fixed-income assets, as well as stock. These are generally low-risk financial instruments: foreign government securities and bonds from highly rated financial institutions…creating the petroleum fund and maintaining budget balance have helped to reduce fluctuations in aggregate domestic demand, decreased inflation pressure, and restrained the appreciation of the exchange rate." (Afanas'Ev 2004).

In the case of Chile, its government created a Copper Stabilization Fund in 1995 amid the abundance of this natural resource. This SWF was designed within the same parameters as Norway's Government Pension Fund-Global. Chile's government set up a base price for copper and proceeded to transfer earnings to the fund when copper prices were higher, and to withdraw when they were lower than their base set price. "As in Norway, the fund in Chile operates in conditions of mostly tight fiscal policy." (Afanas'Ev 2004).

It is important to mention that Venezuela did, in fact, create an SWF in 1998 by the name of Macroeconomic Stabilization Fund. This fund was set up slightly different from the ones from Norway or Chile since "money from the fund can be spent (with the consent of the Congress) if oil exports prices are less than the base amount, or if the amount of money in it exceeds 80 percent of average annual oil export revenues over five years." (Afanas'Ev 2004). This variation allowed Congress to spend the funds once prices fell below the base amount. This SWF was created the same year that Hugo Chavez won the presidential elections, and as previously stated, Chavez's political maneuvering allowed him to have control over the legislative branch. The variation on Venezuela's SWF allowed Chavez to use its funds as a savings account, withdrawing money when oil prices dropped, instead of making fiscal adjustments on Venezuela's budget. Instead, to make it effective, the fund should only provide "for temporary borrowing of a small part of the fund's money to cover a cash gap in the funding of spending (with mandatory repayment, even if spending has to be sequestered). Strict limitations should be imposed on spending this money for other purposes." (Afanas'Ev 2004).

Conclusions

Venezuela was once the most prosperous nation in Latin America. Its oil endowment allowed this nation to enjoy economic stability despite its lack of strong democratic institutions. Today, those institutions are eroded and filled with party loyalists unwilling to provide the necessary checks and balances to the executive. This has brought unilateral power to the executive branch to enact erroneous economic policies, leading to the economic havoc in which Venezuela lives today. To recover, Venezuela must attack two fronts: first, attract FDI in order to rebuild its outdated infrastructure. This process must be done by mimicking the structural changes China implemented by opening its doors to FDI. One of these changes is economic protections and restrictions on the amounts of repatriation of profits by foreign firms. This policy forced foreign firms to reinvest their profits back into China, creating more jobs for the Chinese market; it also encouraged joint ventures between Chinese and foreign firms where both parties were benefited. Second, Venezuela must emancipate itself from international oil prices. Creating an SWF following the guidelines of Norway or Chile would alleviate its fiscal budget and generate wealth instead of havoc.

In order to diligently confront these two areas, it is imperative that Venezuela restructures its institutions by empowering them with autonomy. In the case of nations rich in natural resources but democratically effective, such as Norway and Chile, "resource blessings were only possible because their institutions immunized them from oil and minerals' pernicious effects." (Menaldo 2016) Thus, instead of dealing with the "devil's excrement", as OPEC's founder called this natural resource (Karl 1997), Venezuela could instead be managing wealth as is the case of Norway. Once institutions are fortified, these two macroeconomic policies should fuel a much-needed economic recovery and place Venezuela back on the road to its former prosperous years.

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