Bolívar Distorted: The Effects of Exchange Controls on the Venezuelan Economy
Or
"Perhaps Chávez spent too much time reading Machiavelli and not enough time reading Adam Smith."

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Contents

Acknowledgments

This project started in May of 2003 when a self-proclaimed hispanophile economics student found herself immersed in a chaotic city called Caracas, Venezuela. It has been a continual learning process and probably will never end.

I think one expects to change when faced with new places and challenging situations. However, I never thought that a few months could provoke such an extreme turnabout. My three months in Caracas and the subsequent months I spent writing and researching this paper have led me to a refined understanding of monetary economics and the situation in Venezuela, but the process has delved much deeper, and for that, I am forever indebted to so many people.

Thank you to Francisco Toro, my personal search engine and encyclopedia, for bringing me to Venezuela, for your diligent mentorship and daily doses of humor. Ed Tower, you are the best advisor any girl could ask for, thank you for your continuous support. Thank you to Blanca Vera, Robert Bottome, Ligia Perdomo and Elizabeth Ochoa, who taught me to write and endured my daily pop quizzes on Venezuelan economics, history and politics. Thank you to my interviewees, Luisa Alvarado, Fellita de la Cruz, Yulimar Bracho, Isabel Tovar, Carlos Risopatrón, Brian Ellsworth, Francisco Mendoza, and especially Ramón Key of the Venezuelan Embassy in Washington. Additional thanks to José Orozco, Ruth Carlitz, Charlie Becker, Miguel Octavio, Marcela Villaseca, Devon McManus, Juana Sulvarán, and the staff of *VenEconomy*, this would not have been possible without you.

Abstract

This paper attempts to provide an anecdotal analysis of the exchange controls enacted in Venezuela in February of 2003 as well as the political economy driving the process. Using newspaper accounts, interviews and various economic publications, I lay out a framework of the exchange controls and their effects on the Venezuelan economy for approximately one year following their introduction. My analysis shows erosion of incomes, depression of export and import sectors as well as the creation of inefficiencies across a number of internal markets.

Introduction

On February 5, 2003, President Hugo Chávez Frías[1] of the newly reformed Bolivarian Republic of Venezuela enacted exchange controls in order to counteract the effects of a two-month oil strike that crippled the country's export sector and caused staggering declines in foreign reserves. The exchange rate[2] had plummeted to Bs.1,853/US$1, from Bs.772/US$1 only one year earlier, before Chávez suspended all currency trading on January 21, 2003 and international monetary reserves had fallen by US$2 billion.[3] The creation of CADIVI (Comisión de Administración de Divisas or Foreign Exchange Administration Commission), a currency board to monitor all exchanges, came in response to a looming debt coming due in July and ever-accelerating inflation. The board pegged the Venezuelan Bolivar to the U.S. Dollar at Bs.1,600/$1US (to buy and Bs.1,596/$1US to sell)[4] and introduced a rigorous set of requirements and paperwork necessary for the granting of the right to buy dollars.[5]

World bank economists generally believe that exchange controls cause significant distortions in trade, employment and the economy, but when properly managed and coupled with good monetary and fiscal policy, can ameliorate inflation and build confidence in the currency. One such method for curbing inflation is in the mechanism of the implicit or explicit currency auctions created by exchange controls. When governments engage in currency auctions, selling

[1] Hereafter referred to as 'Chávez' or 'the president'.
[2] See Appendix III, Graphs 1 and 2 "Exchange Rate"
[3] Manuel Solano, et.al. "Venezuela imposes strict foreign exchange controls." June 2003.
[4] See Appendix III, Graph 2 "Exchange Rate Recent".
[5] See Appendix II, "Selected CADIVI Regulations."

foreign currency to importers at the highest price, they create an implicit tax on imports and drain money out of the economy. As the money stock falls, so do price levels. In the case of Venezuela, this auction has been relegated to a parallel market where banks instead of the government reap the profits of these auctions.

Since the implementation of the exchange controls, imports have fallen at an alarming rate, unemployment has soared, and the recession has deepened. While oil revenues have rebounded following the end of the two-month strike, causing reserves to rise as well, the economy is still recovering.

Businesses and importers, however, complain that that they have not received dollars in order to import goods, both final and intermediate. As imports comprise the majority of the food supply and most goods sectors (besides petroleum products), shortages have occurred in Caracas and other major cities and businesses have begun to fail due to debt to their providers or a simple inability to conduct business. As importers have had trouble buying dollars through the government, many have turned to the parallel market where the unofficial exchange rate has risen to over Bs.3,000/$1US.

Economists make many claims about the usefulness or not of exchange controls, but their analyses tend to concentrate on the numbers in the aggregate, thereby ignoring individual accounts and non-economic problems such as cronyism. My knowledge of Venezuelan society and history, as well as the contacts I made while in-country, grants me a unique perspective on the situation and a unique opportunity to share the experiences of others and draw conclusions from their accounts. The current set of exchange controls in place in Venezuela is lacking in-depth documentation in English. While finance magazines announced the controls when they were first implemented, the lack of chaos surrounding them, including the continued support of investors in New York has prompted little further academic research on the subject. While more information might arise as the event becomes more removed in time, I believe it is important now to record the effects as they are taking place.

Venezuelans are generally divided on the impetus for the creation of CADIVI, believing that President Chávez created CADIVI for the stated goals of attempting to stabilize inflation and rebuilding foreign reserves or for the political goals of reducing dependence on the private economy by stifling imports in order to implement more state control. The division runs along *chavista*/opposition lines, those who support the current government and those who do not. These divisions will be explained more clearly later on. For the sake of neutrality, I will take these goals as given and not debate their political nature. These are goals that were either stated by President Chávez himself or by his primary opponents. While one of the most common goals of a pegged currency is to halt inflation, the manner in which the controls have been managed has caused inflation to accelerate. Reserves did rise initially, but that their growth was affected by the subsequent decline of the import economy. I also intend to show the erosion of real incomes and its effect on the overall welfare of the country. Conversely, I will examine the ability of the economy to maintain itself despite the pressures of falling imports, a pegged exchange rate and a mounting debt. Additionally, corruption within CADIVI has been denounced by members of the press and is contributing to economic distortion and loss.[6]

Exchange controls present a number of issues pertaining to the micro allocation of resources no matter what country or political system they are under. Among these are rent-seeking costs, sectoral imbalances and corruption, and these inefficiencies often are exacerbated by opaque or insufficient governance. When the numbers are unreliable or nonexistent, econometric analysis is not useful; an anecdotal approach combined with an evaluation of the

[6] Francisco Toro. Interview. July, 2003.

political economy driving the problem can provide an accurate and useful analysis for such a situation.

As political and economic stability in Venezuela hang in a precarious balance, such methodology can be useful. Numerous political and economic disturbances that have disrupted daily life in Venezuela, culminating in the violent demonstrations of late February, present additional hurdles to econometric analysis. Given these events, the proximity in time of the controls, and the extent to which economic indicators are fabricated in Venezuela, numeric analysis would little serve our purpose. By examining similar situations in other countries in tandem with the workings of the exchange control system in Venezuela, the policy implications become apparent. I believe this method of examining primary sources and drawing comparisons with other countries will give us a clearer understanding of the exchange controls themselves amidst the political uncertainty and divisiveness that is shaping the country's politics and economic policy.

The Appendices included in this volume—which include a number of graphs on historical and recent trends in the consumer price index, international reserves and selected macroeconomic variables—provide a valuable graphical representation of many of the phenomena discussed herein. Also included are a number of the regulations pertaining to CADIVI, the currency board.

Literature Review

My greatest conceptual basis for this project comes from the summer I spent working in Venezuela. As an intern at a prominent finance and business magazine, I was privy to the most current analysis and opinions on the volatile political and economic climate. Politics and economics invaded every subject, every conversation, making room for my independent research in oil, trade and poverty to give me a strong, thorough understanding of the political, social and economic debates that reigned in Venezuela. As the information is relatively new, very little academic work has been published in English. For this reason, I will be relying heavily on journalistic sources as well as governmental reports, interviews and unpublished papers for more current information. Newspaper and magazine articles from Venezuela during this presidency and especially the last year have taken on a certain bias. For the first time in Venezuelan history, most major Venezuelan media outlets, including newspapers and television stations such as *El Universal*, *El Nacional* and *Globovision*, have sided with the opposition. Other local publications have sided with the government. Much of the information coming from local news sources can be considered sensationalist or at the very least biased. This will be accounted for in evaluating the information from these sources.

Max Corden's *Inflation, Exchange Rates and the World Economy* has been a primary source of the conventional economic theory concerning exchange rate regimes and the policy tools that can be used to affect changes in consumption and prices using exchange rates and monetary and fiscal policy. Exchange rate pegs and controls in general are thought to cause significant distortions in the economy. The inability of a currency to fluctuate and reflect external and internal demand for the local products can significantly hamper the ability of a country to effect monetary and fiscal adjustments.

Exchange controls are essentially a tax on imports and effectively raise the price of imports, reducing trade.[7] This effect is relevant to the kind of permit system implemented in Venezuela. Controls can also reduce trade through other means such as transaction costs and foreign exchange risk hedging.[8] International credit ratings have a tendency to suffer under long-

[7] Natalia Tamirisa. "Exchange and capital controls as barriers to trade." 1999.
[8] Natalia Tamirisa. "Exchange and capital controls as barriers to trade." 1999.

term exchange controls and a false security created by controls can postpone necessary reforms to the institutions and government.[9] The failure of credit ratings as well as barriers to entry imposed by exchange controls can limit the amount of foreign investment that a country attracts.[10] This is especially important in a country like Venezuela whose primary industry, petroleum, is dependent on continual investment.

While these distortions are real and significant, recent research has shown that some form of exchange rate management, whether a peg or a band system, can effectively hedge wild swings in financial markets of emerging economies. However, they are only viable if the appropriate institutions are in place, i.e. a credible and reliable government with the confidence of its citizens and investors.[11] A peg, when properly adhered to and backed by international reserves, can help to dissuade speculative attacks and foster confidence in the currency.[12] However, no exchange or capital controls can act as a substitute for sound policy and implementation and while controls can alleviate problems in the short run, free-flowing capital is a more sound policy for the long term.[13]

Currency boards and other forms of exchange controls have experienced relative success in some regions, as in the case of Estonia, and relative failure others, as in the case of Argentina. A conglomeration of these examples shows how a similar exchange regime can fail or succeed depending on cultural, temporal, political, and institutional factors. The success of some currency boards and other fixed-rate exchange regimes contradict the formerly prevailing theory that flexible exchange rates were the best model for all countries. Many states have put this theory to the test, with varying results.

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[9] Siddiqi, Moin. "Pros and cons of capital controls." *African Business.* 2000
[10] "CHILE: Capital reforms to boost foreign investment." *OxResearch.* 2001.
[11] "Finance and Economics: Fix or float?; Economic focus." *The Economist.* 2003.
[12] "Finance and Economics: Off the peg?" *The Economist.* 1998.
[13] Siddiqi, Moin. "Pros and cons of capital controls." *African Business.* 2000

Much of the exchange rate literature written before 2001 tends to support currency boards and exchange rate pegs as a feasible and possibly effective way of reducing inflation and creating confidence in a failing currency. The primary example of this is Estonia, a Baltic country that instituted a currency board in the face of hyperinflation and the lack of confidence in a new state's currency following the fall of the Soviet Union. The board created stability and in the new currency where there was formerly only chaos and allowed Estonia to make a smooth transition from Soviet rule to independent capitalism.[14] Under the currency board arrangement, Estonia reigned in hyperinflation over the course of a few years by reducing the money stock, but also suffered from early negative GDP growth and cuts in social spending.[15] Estonia's currency board arrangement, combined with fiscal restraint and strong institutional reform, showed that the type of exchange rate regime is not necessarily critical to the economic system, but rather the institutional arrangement and management that surround it.

However, literature published after 2001 tends to discount more and more the idea of a successful currency board being uniformly successful. It claims that currency boards require a number of other factors in order to be successful, and show that a currency board is not a cure-all for inflation and instability as some economists claim.[16] This change in thought follows the collapse of the Argentinean economy. Under the enormous duress of a mounting external debt and propping up a failing currency, the government was forced to abandon convertibility (the ability to change pesos into dollars at a fixed rate) when there were no longer enough dollars to back the domestic money supply. When the Central Bank ran out of dollars and the currency board collapsed, it propagated a national economic crisis, replete with bank run and general havoc. The literature cautions that while there have been failures in certain currency boards, the

[14] Jakob de Haan, et.al. "How to reduce inflation?" 2001.
[15] Dennis R. Appleyard and Alfred J Field, Jr. *International Economics.* 2001.
[16] Graham Bird. "Cry for Argentina…not for its currency board." *New Economy.* 2002.

failures were a result of institutional and other factors as opposed to the currency board itself. A currency board may work so long as the government guarantees convertibility and commits to backing all currency in circulation with foreign reserves[17]. A currency board may not work in certain regions due to already present instability or poor governance. It is possible that this has been the case in Venezuela. A number of other factors; political instability, strikes, political division, soaring debt, floundering export sector, for example, have significantly contributed to the economic instability that reigns in Venezuela.

A Brief History of Chávez

Hugo Chávez Frías, the current president of Venezuela, came to the forefront of Venezuelan politics in 1992, when he, along with a group of dissident generals, staged a bloody coup on Miraflores, the presidential palace. A low-ranking paratrooper, Chávez quickly gained recognition and fame throughout the country for his remarkable elocution following his failed, illegal attempt at the presidency. Chávez was an active speaker while in prison, presenting himself as a popular leader fighting to overcome the corruption and cronyism that confounded the Venezuelan government. After his pardon and subsequent release from prison, Chávez catapulted onto the political scene and eventually rode his wave of popularity to the presidency in 1999, this time legally. Chávez came to power with the overwhelming support of the nation, over 80% of the population voted for him. His allure and rhetoric bridged class, race, and geography with promises of reforming PDVSA[18], implementing a new constitution (the old one was a holdover from the days of the infamous dictator Pérez Jímenez), and alleviating poverty.

[17] "Finance and Economics: Going by the board." *The Economist*. 1998.

[18] PDVSA is the Spanish acronym for Petróleos de Venezuela, Sudamérica. The Venezuelan Oil company is state-owned and the Venezuelan government earns most of its revenue through the sale of its crude oil, refined gasoline, and petroleum products abroad.

Since his rise to power, President Chávez has implemented some reforms intended to alleviate poverty and improve governance in Venezuela, but many of his reforms have angered opposition-minded politicians and citizens for their lack of constitutional support. The year after his election, a congress was convened to write a new constitution, one which renamed the country the Bolivarian Republic of Venezuela, after the famous liberator and national icon Simón Bolívar[19], but also as a throwback to Chávez's political party, which was initially named Movement of the Bolivarian Republic (MBR)[20] and later became MVR, Movement of the Fifth (V) Republic.[21]

After the new constitution was approved by the electorate, Chávez called new presidential elections to reiterate his mandate under the new law. Approximately 2.4 million people turned out to vote for Chávez in the 2000 election, a very low turnout for Venezuela and significantly down from the almost 80% of the electorate that voted for him the year before. Since the election, Chávez's support base has eroded. While approximately 30% of the electorate still holds him in high esteem, many are looking for an out.[22] His increasingly flippant attitude and alleged disregard for the constitution he enacted and its democratic principles are earning the attention of the international press and have contributed to the failure of a possible recall referendum and demonstrations in the latter part of February and early March 2004, according to opposition analysts.

[19] "Venezuela." www.encarta.com

[20] Venezuelan law mandates that no political party can use the name Simon Bolivar in their title. Bolivar is a popular national hero and the government wished to avoid that one side or another appropriate his image for their gain.

[21] The V Republic represents one manner of dividing Venezuelan political history by its array of dictators and democrats. Chávez calls his government of the V Republic, because he did away with the tyranny of the "IV Republic" led by former president Rafael Caldera. He repeatedly criticizes this group of leaders for stealing oil wealth from the people and neglecting the poor. Prominent opposition leaders have appropriated the term IV Republic dinosaurs to describe Caldera, Carmona and other members of that ruling group and to promote the idea of a new, fresh class of democrats, the VI Republic, who can win against Chávez, a feat that most people do not believe IV Republic leaders are capable of.

[22] Polls conducted by *Datanánalisis.* www.datanalisis.com. February 2004, December 2002, July 2003.

Chávez has been frequently criticized by the opposition for his actions surrounding the state oil company, PDVSA. PDVSA is the primary revenue earner for the Venezuelan government, and up until recently, was lauded as a relatively efficiently run state oil company. Chávez came to power promising to distribute oil profits among the Venezuelan people who had been robbed for so many years of their oil revenues. Plans for the redistribution have never been clear, but social welfare programs enacted over the past few years indicate a desire to increase spending in depressed areas of Venezuela and especially the barrios of Caracas. He exacted some controversial reforms such as recently eliminating the three sectors of PDVSA and uniting them under one director. The subsequent appointments of alleged government cronies and various executives who have more military than petroleum experience has caused many to doubt the president's ability to effectively run the company.[23]

The Problem with the Petrostate

Most economists and development theorists have rejected the idea that the presence of petroleum constitutes a fast, easy road to riches. A Venezuelan and founding member of OPEC, Juan Pablo Pérez Alfonso, called oil "the devil's excrement". He cited the troubles it would bring, notably "waste, corruption, consumption, our public services falling apart…and debt, we shall have debt for years".[24]

One of the most common problems with large oil reserves is that it incites Dutch Disease. The Dutch Disease was named for the crisis that arose following the discovery of natural gas in the 1970s. As mineral reserves were thought to bring prosperity, a favorable balance of trade and a heightened ability to purchase imports, hopes were high for the Dutch. Economists were puzzled by the paradox that followed. A balance of payments surplus led to "declining export of

[23] Erin Fletcher. "Cleaning up the Act." *VenEconomy.* July 2003.
[24] "The Devil's Excrement." *The Economist* May 22, 2003.

manufacturers, lower rates of income growth, and rising unemployment."[25] Other oil booms of the 1970s quickly showed that the Dutch case was not unique, but rather exemplified the problem of single-export economies and the hindrance to development.

The Dutch Disease arises out of primary-export dependence. For many countries, single-export dependence erects a trade barrier through currency appreciation. When a country suddenly strikes oil, for example, it is faced with the opportunity to export a large supply of lucrative goods that can potentially provide much of the country's revenue. The export windfall encourages the sale of the national currency to foreigners who are eager to convert it into the export good, therefore driving up its price via a shift right in the demand curve. The overvalued currency causes an immediate rise in prices of other exports on the world market, thus rendering them uncompetitive. The result is depressive for alternative export industries, whose goods become more expensive on the world market, suppressing production and forcing industries to close or to merely produce locally. Similarly, imports are made cheaper, and the same industries that were forced out of the world market are now competing with cheaper imports as well.[26] The result, one that Venezuela suffers most from, is the lack of available, lucrative industries that are attractive to local investors. This creates the problem of capital flight, which I will discuss below.

State-controlled enterprises, especially those that deal with oil and petroleum projects, have a tendency to breed corruption and inefficiency. These problems are often indicative of more serious problems within the governmental structure. The state-controlled Mexican Petroleum company (PEMEX) has a labor liability of 170,000 people (including pensioners) and an output of around 3.4 million b/d. While PDVSA (Petroleum of Venezuela) has a much

[25] Perkins, et.al. *Economics of Development*
[26] Fletcher, Erin. "Viva Chile." 2003.

smaller labor liability (around 30,000 pre-*paro*[27]), it produces in the same range. Still, PDVSA fired 18,000 workers[28] in early 2003, and has managed to lift production levels to approximately pre-*paro* levels. With higher unemployment, wages must fall in terms of the domestic currency in order to regain full employment, but as wages are extremely rigid in Venezuela, the currency must lose value on the world market.

In Venezuela in particular, there is a profound dependence on oil as the primary export and means of government revenue[29]. Venezuelans do not pay income taxes, and only recently have been required to pay a value-added tax. Petroleum revenues have for years supported the government and all of its programs. There has always been a sense of entitlement among the Venezuelan people; "They think we are rich; that because we have oil, we are rich, and that some fat cat is stealing those riches from the poor."[30] The government forces PDVSA to sell gasoline at very low prices, often below cost, reducing the ability of the company to operate effectively.[31] In 2001, Venezuelans paid only US$ 0.41 per gallon.[32] Not only do artificially low prices encourage excessive use of gasoline[33], but also prompt a sense of entitlement. Gas price hikes in 1988 incited the infamous, bloody Caracazo. Rioters burned buildings, overturned cars and left numerous people dead.[34] The subsidy on gasoline acts as a tax on all other goods in the Venezuelan market, effectively raising prices and causing consumers to substitute gasoline for

[27] *Paro* is the term given to describe the two-month oil strike that ensued in December of 2002 and continued through January of 2003. It literally means 'stoppage,' an adequate representation of the strike that gripped the country's primary industry and means of revenue. I will refer to the strike as the *paro* throughout this paper.
[28] Most of these workers were upper- and middle-level managers and accountants. They were fired for taking part in acts of sabotage and crimes against the state associated with the two-month oil strike that began in December, 2002. There is still much contention over the legality of these firings as the law states that oil workers cannot be fired without reason and are entitled to compensation packages and retirement benefits accrued throughout their tenures. None of these workers has been paid and various unions are working through the courts to be rehired or receive their benefits.
[29] See Appendix I, Graph 4 "Fuel Exports".
[30] Interview Yulimar Bracho Mendez.
[31] Erin Fletcher. "Cleaning up the Act." *VenEconomy.* July, 2004.
[32] OLADE figures. 2001.
[33] Carlos Risopatrón. Interview. June 2003.
[34] "Venezuela." www.encarta.com

other goods. A more effective manner of repatriating oil wealth would be to sell oil on the domestic market at the world price and distribute profits among the citizens. This would eliminate substitution distortions and allow consumers to maximize their individual utilities (and would probably reduce traffic in Caracas).

Additionally, oil is a very investment-intensive industry. Unlike textiles, where a factory can be set up and run for a number of years with moderate upkeep and repairs, oil machinery requires almost continual replacement. Production capacity in oil wells and refineries naturally drops 20 to 25% per year, more in older wells. As the resource itself is depleted, declining pressure in older wells causes an additional decrease in production. Venezuela also suffers from the curse of a very heavy crude oil, meaning that any lapse in production, from malfunction to strike, lets the crude harden in the wells, rendering them ineffective. As a result, new investment is continually needed to maintain production, much more to expand it. The crude also requires specific refinery equipment which is expensive to buy and maintain.[35]

Venezuela's dependency on oil for government revenue also created a political problem in December of 2002. Following the failed coup attempt in April, the opposition decided to call for a general strike or a *paro* led by oil workers. Chaos ensued as the strike dragged on for almost two months and Chávez refused to step down. Without oil revenues bringing in foreign exchange and investors becoming more and more nervous about the political situation, international reserves dropped dramatically as individuals and companies pulled more and more money of out the country, prompting Chávez to enact exchange controls and fire 18,000 PDVSA employees, another political disaster.

International Reserves and the FIEM

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[35] Erin Fletcher. "Cleaning up the Act." 2003.

The primary reason that exchange controls were put in place, according to the Chávez government and most Venezuelans, is that the level of international reserves was falling at an astounding rate. Exchange controls with a fixed exchange rate allow a country to grow its reserves, while a flexible exchange rate with no exchange controls does not. By implementing a system by which the uses of reserves are limited to financing imports, the problem of capital flight can be eliminated and reserves can grow. International reserves play a key role in the economies of countries whose currency is not freely exchangeable in an international market. The Central Bank of Venezuela describes its international reserves as primarily the product of oil revenue, a pool of resources that allows bolivars[36] to circulate and acts to defend the currency.[37]

The FIEM[38] is a very special reserves pool designed by economists to buffer swings in oil prices. Given that the Venezuelan economy is dependent on oil sales and that oil prices are highly volatile, Venezuela historically has experienced huge swings in international reserves and its ability to finance government works.[39] The fund aims to achieve financial stability at all levels of government by saving "extra" oil revenue, that is, revenue from particularly high oil prices.[40] The intention was to avoid having to cut government programs every time oil prices dipped below a certain level. There is some debate as to whether FIEM monies should be counted in measuring international reserves because they are not technically available as convertible funds or to back the local currency.

Capital Flight and Domestic Investment

[36] Bolivar is the Venezuelan currency.
[37] Banco Central de Venezuela. www.bcv.org.
[38] FIEM is the Spanish acronym for Fondo de Inversion para la Estabilización Macroeconómica or Macroeconomic Stabilization Investment Fund. The FIEM is administered by the Central Bank.
[39] See Appendix III, Graphs International Reserves, Historical and Government Spending
[40] "Ley que crea el Fondo para la Estabilización Macroeconómica."

Capital flight has long been one of the greatest challenges to the growth of the Venezuelan economy. US$46 billion dollars leaves Venezuela each year.[41] Prior to nationalization, private interests had the ability to invest heavily in the oil industry. Fuel exports in Venezuela made up 83% of merchandise exports in 2001.[42] While this is down from 95% in 1975, we can still point to a deficit of local industries with viable exports. Capital flight is not only problematic because it prevents enterprise creation in the national economy, but it drives down the price of the national currency. When large sums of Bolivars are sold for dollars or other internationally viable monies, the price of the Bolivar falls. The subsequent inflation drives up the price of imports, which constitute a majority of Venezuelan consumer products, thus raising the cost of living. In countries with substantial national industries, this process would cause consumers to substitute away from imports and buy national products. However, industry constitutes a small portion of GDP due to the heavy concentration on the oil industry and consumers have few choices. Additionally, capital flight can result in a depletion of international reserves. Reserves are used to back the national currency and if they fall dramatically, confidence in the currency can falter, leading to even more pull-out. This phenomenon was one of the primary drivers of the 1997 Asian crisis. Loosening exchange controls and a sudden change in investor sentiment caused a run on the Malaysian and other currencies and stock market collapses. The Venezuelan phenomenon was slower; reserves did not fall as dramatically or as fast, but nonetheless was worrisome.

It is possible that one of the goals of implementing controls was to stimulate a form of Import Substitution Industrialization (ISI).[43] Noting the lack of viable industry within the country and the subsequent dependence on imports from the United States and other countries for textile

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[41] Ramón Key. Interview. February 2, 2004.
[42] World Development Indicators. WDI Online.
[43] Ramón Key, PhD. Interview, February 2, 2004.

and industrial goods, the Venezuelan government decided to enact a plan that had varied success and failure in Latin America in the latter half of the 20th century. The central idea behind ISI is to protect national infant industries from foreign competition, allowing them to develop a niche in the local market and increase productivity. The Chileans, Latin America's new capitalist darlings, "called [ISI] inefficient," notes Dr. Ramón Key, Petroleum Attaché for the Venezuelan Embassy in Washington. While ISI was a popular development theory at the time, economists now view it as a waste of resources and time; a country should not produce something it can get cheaper from someone else. The idea of comparative advantage reigns, and Venezuela's comparative advantage is in oil and petroleum products.

While we are still looking at the short term, as yet there has been no increase in domestic production since the creation of exchange controls. Even petroleum production, according to some experts,[44] has fallen.[45] Stores have suffered shortages of common staples such as corn flour, the informal economy accounts for over 50% of economic activity and dollars are more rapidly obtained on the street than through the government, albeit much more expensively. It seems the only thing the controls have succeeded at creating is a parallel market.

CADIVI and the creation of exchange controls

An amazing aspect of the exchange controls is their influence in everyday life. Normally a topic for only concerned economists and politicians, any Venezuelan in the street can tell you that the exchange controls were implemented "to stop the fall in the level of international reserves," and that the controls complied with their task.[46] Even those whose daily efforts do not

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[44] Oil output is difficult to determine because suppliers do not break down official production numbers. State oil press releases claim that oil production had reached and maintained its pre-paro level (3.4 million b/d) throughout the year, but many experts in the field are skeptical and place the country's oil production at a much lower level (2.7-3.1 million b/d).
[45] Ellsworth, Brian. Interview. July 2003.
[46] Interview. Isabel Tovar. January 23, 2004.

include contact with CADIVI will readily announce that the controls have affected the entire country, if only for the reason that CADIVI is not handing over the dollars.[47]

Near the end of January, 2003, the Venezuelan government and economy found itself still reeling after the end of a two-month oil strike intended to destabilize the government and force the president, Hugo Chávez, to resign. The opposition did not succeed in forcing Chávez to step down, but they did succeed in putting the country on the verge of economic collapse. All oil exploration and production had ceased decisively, leaving Venezuela with no means to support its import-dependent economy. Reserves were falling dramatically[48] and an enormous debt payment was coming due in July 2003.

Currency boards, as present in Venezuela now, are the most rigid form of exchange controls.[49] The local currency is pegged to an international currency, in these cases the United States dollar (US$), and is officially convertible to dollars at any point. In the case of Venezuela, the exchange rate was pegged at Bolivars (Bs.) 1600/US$1. While in Argentina, Argentine pesos were easily exchanged for dollars at banks, exchange houses and even in many stores, the creation of Venezuela's currency board also included the centralization of all official currency exchanges by giving the Central Bank a monopoly over the sale and purchase of dollars and includes a rationing element not present in Argentina.[50]

The implementation of exchange controls meant the complete turnabout of the way foreign exchange was handled in Venezuela, especially in Caracas. Following a two-week suspension of foreign exchange sales, the Central Bank of Venezuela created an Exchange Board

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[47] Interview. Francisco Mendoza. May 25, 2004.
[48] See Appendix III, Graph 3, "International Reserves".
[49] Michael Mussa. *Exchangre Rate Regimes in an Increasingly Integrated World Economy.* 2000.
[50] Hugo Rafael Chávez Frías. Decreto No. 2302. 2003.

(CADIVI)[51] headed by Edgar Hernandez Behrens, the President of the state bank Banfoandes and former military officer.[52] The decree outlining the purpose and scope of CADIVI included a number of regulations.[53] The decree set the exchange rate at Bs. 1,600/US$1 and required all foreign exchange transactions to go through the Central Bank. Additionally, all foreign exchange obtained had to be immediately sold to the Central Bank.[54] This essentially made the Venezuelan Bolivar "inconvertible," or difficult to exchange for foreign currencies[55]. The Central Bank also implemented a permit system by which it would control who could buy dollars. The permit system, and not the exchange controls themselves, has perhaps been the greatest hindrance to growth since the implementation of the currency controls. The ability of individuals and companies to obtain dollars for transactions in their daily lives, from importing goods to buying houses to sending remittances, has been extremely diminished.

CADIVI justifies its own creation citing the faltering economic climate present in Venezuela at the beginning of 2002. A two-month oil strike had crippled the oil industry, with exports dropping to almost zero and riots and demonstrations becoming a common occurrence at PDVSA (Petroleum of Venezuela) outlets around the country. CADIVI's structure is rather unique in that it does not assign distinct currency values to different groups. In many cases, an exchange control will allot currency values for different groups, allowing importers of scarce goods or preferred goods to buy dollars at lower prices than other importers. CADIVI, however, has a uniform exchange rate and identical application process for all businesses and individuals who require dollars for importation of goods, travel, and other activities. This does not

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[51] CADIVI is the Spanish acronym for Comisión de Administración de Divisas or Commission for the Administration of Foreign Exchange.

[52] Edgar Hernandez Behrens has been criticized by the opposition for his role in the 1992 coup attempt on the presidency led by current President Hugo Chávez.

[53] For a partial list of regulations, see Appendix II, "Selected CADIVI Regulations".

[54] Miguel Octavio, et.al. Bbo Weekly Report. February 7, 2003.

[55] This is the IMF's definition of inconvertible and will be used here in this manner.

necessarily imply that the process is wholly free from political and economic interests and bias. Many importers claim that they have been denied the right to buy dollars for political reasons.

The Permit Process and Corruption

The permit system created by CADIVI to monitor the allocation of foreign exchange is one of the most interesting aspects of the exchange controls implemented in February 2003. Following a two-week moratorium on all foreign exchange transactions, the government announced that all transactions would take place through the central bank at a fixed rate and would require an application process for the solicitation of all foreign exchange. Venezuela was importing approximately US$1 billion worth of goods per month before the exchange controls were enacted. Following the implementation of exchange controls, imports fell drastically and businesses complained they could not obtain dollars to conduct business.

During the first five months of exchange controls, the Central Bank had allotted US$5.34 billion of international reserves to CADIVI to dole out among importers and other solicitors. However, only US$1.07 billion had been approved by CADIVI and only US$180 million had actually been liquidated by the Central Bank. Dr. Key noted that the permit process had been useful in weeding out "ghost enterprises," or companies that kept up a façade of importing goods, but in reality produced nothing. CADIVI claimed that the economy was and bad and that other businesses simply were not requesting the funds. [56] CADIVI has provided no explanation to the press or to solicitors for failing to deliver the approved funds.

In order to obtain dollars from CADIVI, a business or individual must fill out a series of forms and submit them to the office. The process is actually relatively simple and can even be done online. Anyone can register. The application is submitted to CADIVI and undergoes an evaluation process by which it is rejected or approved. The criteria for receiving dollars are

[56] Ramón Key. Interview. February 2, 2004.

somewhat unclear and the process of verification is not public, although the board does publish data on requests that have been approved. If approved, the solicitor is then eligible to buy the approved number of dollars. This process is profoundly inefficient and presents infinite opportunities for corruption, as it only mires the process in an extensive, opaque bureaucracy and has no ability to measure the ability or willingness to pay of its solicitors. Many independent analysts and newspapers have accused CADIVI of accepting bribes to speed up the solicitation process. If the permit system is already in existence, it makes more sense to implement an auction as well. Knowing that the Central Bank allots a certain sum of dollars to be approved by CADIVI, solicitors can express their willingness to pay for the dollars. Higher prices for dollars would prevent turnover on the parallel market and increased availability of dollars would lead to a richer variety of products available to Venezuelan consumers.

Venezuela has known its share of corruption and CADIVI is not immune.[57] Like any bureaucracy, CADIVI's permit system presents a prime opportunity for rent-seeking behavior. Businesses provide bribes to the committee members in order to obtain the dollars they require to import goods or pay dividends. Theoretically, an importer would be willing to pay a bribe up to the amount that would be the difference between the official exchange rate and the parallel market exchange rate. (If a person solicited US$100 at the official rate of Bs.1,600/US$1 while the parallel market was at Bs.3,000/US$1, he would pay a bribe of Bs.14,000, and perhaps more if the time spent searching for parallel market dollars was especially costly.) While the bribe is essentially a transfer payment, it is unlikely that those funds are being put to good use by the government, rather that they are going into the pockets of administrators. If an auction were introduced, it would dampen the possibility of bribes.

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[57] *El Universal*

Only recently, with the devaluation and political crisis, are dollars beginning to flow, according to Yulimar Bracho, a resident of Caracas. "And then only for the big companies," she adds.[58] Rumors of the ebb and flow of dollars have circulated over the past year, with little verifiability. CADIVI itself claims that it has received almost 270,000 applications to buy dollars and has approved just over 206,000 such applications.[59] These numbers, however, do not reflect the dollars that have actually been delivered, merely the applications approved. An unofficial *VenEconomy* poll in July, 2003 showed that a number of prominent businesses had received 0-15% of the dollars they had solicited. While the situation has purportedly improved over the last year, there is still evidence of inefficiency and corruption in the application process. At the close of the first quarter of 2004, CADIVI announced that it had authorized the sale of US$4.66 billion. An additional $1.6 billion was authorized in April, but less than half of those dollars have been turned over to their buyers. During the first three quarters of 2003, the Central Bank handed over an average of $13.2million per day. By the fourth quarter, they were giving an average of $37 million per day, a jump of 183%. In 2004, the Central Bank has been even more efficient, handing over an average of $43.14 million per day.[60] Authorizations and sales have accelerated, perhaps indicating a greater efficiency on the part of CADIVI or the businesses that solicit dollars; there is some sentiment that solicitors are receiving their approved funds and the gross national product appears to be bouncing back. Still the Central Bank has yet to hand over more than a third of the dollars approved for sale over the past year.

Exchange Controls as Import Controls

One of the most troubling aspects of CADIVI is its ability to act blithely without explanation and without the possibility of recourse on the part of the solicitor. By selectively

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[58] Yulimar Bracho Mendez. Interview. February 15, 2004
[59] www.cadivi.gov.ve
[60] Miguel Angel Santos and Rafael E. Grooscors. *Evolución y Desempeño de Cadivi.* May 2004.

choosing to allocate foreign exchange to industries based on unclear, unpublished criteria, CADIVI wields astounding influence in the goods that are imported and subsequently consumed by Venezuelans. While this process probably eliminated demand from "ghost enterprises," companies that imported nothing and carried the dollars out of the country, it also has created a sort of command economy, where the government is deciding what is to be consumed, not the market. As Venezuela is very dependent on imports, the responsibility and power wielded by CADIVI is huge and inefficient.

Although speaking to someone at CADIVI is a logistical impossibility, CADIVI does openly publish the approved recipients of foreign exchange on its website. CADIVI figures show that approximately a third of funds liquidated by the Central Bank has gone to finance private external debt or to overseas investment. Overseas investment essentially means that foreign investors who hold shares in Venezuelan companies are being paid their dividends in dollars while there are food and pharmaceutical shortages throughout the country. Most of the recipients of these dollars are banks who give dividends to their parent companies. Kaempfner, Tower and Willett[61] show that governments will often choose trade regimes that will balance their own goals and the goals of groups that have the greatest access to rent-seeking resources, i.e. bribes.

The Venezuelan American Chamber publishes quarterly and yearly analyses of many CADIVI activities. It claims that the exchange controls exacerbated a startling fall in the import sector throughout 2003, pointing to a third quarter 2003 drop in imports of 4% over 2002 and 28% over 2001.[62] Francisco Mendoza, president of Asociación Venezolana de Exportadores[63], echoed that sentiment, citing the depression of both export and import industries due to the

[61] *Trade Protectionism.* June, 2001.
[62] Santos, Miguel Angel and Rafael E. Grooscors. *Informe sobre el Comportamiento del IC de Venezuela.* December 2004.
[63] AVEX or Venezuelan Association of Exporters

controls. Extreme uncertainty surrounding the final handover of dollars has made many foreign companies to be hesitant about doing business with Venezuela. Importers of final goods fail to do business as well as importers of raw materials, which hinders the ability of exporting (non-oil) firms to continue their work.[64]

The Chicken or the Ally?

One of the primary criticisms levied by the opposition is the charge of a desire by the government to push the private sector out of the import market by denying them dollars, replacing their goods with imports solicited by the government from firms that align with the government's politics. When it became clear that the permit process, along with price controls was causing food shortages, the Venezuelan government sought out a way to feed its people and maintain its monopoly on dollars in a manner consistent with the Bolivarian Revolution. That is, a manner that would not support big business, but rather promote the public good. The opposition's claim is that the process is actually part of Chávez's move towards political and economic integration with MERCOSUR[65] and stronger alliances with other Latin American leaders who have expressed ideology closer to his and closer to that of Fidel Castro.

This criticism is especially poignant in Venezuela's trade relations since Chávez rise to power and especially since the implementation of exchange controls. Venezuela is a member of the Community of Andean Nations (CAN)[66], a five-member trading block reminiscent of NAFTA, but much weaker than its southern counterpart, MERCOSUR. There is an explicit and implicit agreement to foster trade among the CAN countries. Recently, however, the Venezuelan

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[64] Mendoza, Francisco. Interview. May 24, 2004.

[65] MERCOSUR is the Spanish acronym for the Mercado Cono Sur (Southern Cone Market in English), a trade alliance whose members include Brazil, Argentina, Uruguay, Paraguay and Bolivia, with Chile as an associate member. It is a relatively strong trading block and has been vocal in putting regional integration before hemispherical integration, as desired by the United States. In Portuguese, the block is referred to as MERCOSUL.

[66] CAN is the Spanish acronym for Comunidad Andina de Naciones and is a regional trading block that includes Venezuela, Colombia, Peru, and Ecuador. Members agree to put trade within the block above other trading partners.

government has been accused of ignoring its Andean neighbors in favor of countries like Brazil, Argentina, and Cuba. Chávez expressed a desire to join MERCOSUR, which would effectively end Venezuela's association with CAN, an offer that many believed has undermined the process of creating a unified South American trading bloc. Such a strong bloc might provide the region with more clout in negotiations with the United States to create a Free Trade Area of the Americas.

In June of 2003, the Venezuelan government announced that it would be importing 3,500 British tons of frozen chickens from Brazil. The deal was reached in a series of negotiations and biddings held in Brazil that were by invitation only. Local businessmen complained that Venezuelan importers were excluded from the bidding and that only companies that fit with the political ideology of the Chávez government were invited. Rafael Alfonso, president of CAVIDEA,[67] told *El Nacional*[68] that Venezuelan firms were being denied permission and dollars to produce and import products that Venezuelans normally consume.[69]

The decision to import from Brazil is not all that strange; Brazil is the world's second largest exporter of chickens, behind only the United States. Formerly, importing chickens was a task left to the private sector; this was a governmental action in a closed bidding process, a process that is rife with inefficiencies. Not only does a closed bidding process preclude the presence of a number of bidders, many of whom could offer a better price, but the process of opening the bidding only to Brazilian companies effectively prohibits the repatriation of funds in an already cash-strapped economy. Quite poignantly, the chicken deal was awarded to Brazilian

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[67] CAVIDEA is the Spanish acronym for Cámara Venezolana de la Industria de Alimentos, or Venezuelan Chamber of the Food Products Industry.
[68] *El Nacional* is the oldest newspaper in Caracas, the capital of Venezuela. It has taken a hard opposition stance against Chávez.
[69] Vladimir Hernández Lavado. "Venezuela recibirá esta semana 3.500 toneladas de pollo brasileño" *El Nacional.* June 16, 2003

company Sadia to import 3,500 tonnes of chicken at a price of $3,150,000 US.[70] Sadia is one of the largest producers of chicken in the Americas, but the fact that raised eyebrows was that until 2002, the president of Sadia was Luíz Fernando Furlan, Lula's current Minister of Development, Industry and Foreign Commerce. Furlan is one of the many heirs of Sadia, and although he no longer serves on the executive board, he maintains his familial and monetary links to the company. As mentioned before, the opposition looked upon this as a Chávez ploy to ingratiate himself with the current Brazilian administration.

The CANTV Dollar and the Parallel Market

With foreign exchange literally impossible to obtain through legal means, many individuals have turned to the parallel market, buying dollars from incoming tourists, from people paid in dollars, or from those who have decided to make a living smuggling dollars. Most of these transactions that take place on the street are small, $200-$300, and do very little to help businesses make a dent in the $1 billion worth of goods per month that was imported before the exchange controls were enacted.

Individuals with large sums of money to convert and businesses needing more substantial amounts have turned to the stock market, a legal loophole in the laws that created CADIVI and enacted the exchange controls. The Venezuelan stock market has traditionally been a small enterprise. A few of the larger Venezuelan corporations, such as CANTV, the telecommunications giant, are traded in New York and can be exchanged for Bolivar- or Dollar-denominated stocks, but the petrostate model has done little to foment local businesses and thus the creation of viable national market.

[70] Vladimir Hernández Lavado. Venezuela recibirá esta semana 3.500 toneladas de pollo brasileño" *El Nacional.* June 16, 2003.

Since the creation of the exchange controls, however, trading on the Venezuelan stock market has increased exponentially. Between June of 2002 and June of 2003, trades of CanTV shares alone increased 334%. Left as a small loophole in the regulations emitted by CADIVI, investors were able to buy shares of Venezuelan stocks like CanTV, which can be exchanged for ADR shares, and sell them in New York for dollars. ADR stocks provide shares of a company on the New York Stock Exchange that are fully exchangeable for shares held in a foreign country. They were created to allow investors to buy shares in large foreign companies without going through the hassle of currency exchange, thereby decreasing transaction costs and the amount of currency traded. Using the price of CanTV, economists have come up with an approximation for the real value of Bolivar on the world market, a number that has also come to approximate the parallel market price of the currency. In June of 2003, one share of CanTV sold for around Bs. 4,800. Seven shares of CanTV on the Venezuelan stock market can be exchanged for one ADR CanTV in New York and sold for US$13.20 in June. With a little math, we see that the approximate price of the dollar in June 2003 was Bs.2,545/US$1. The ADR indicator has been dubbed the CanTV dollar as the majority of ADR shares traded are CanTV shares.[71] The CanTV dollar is a surprisingly accurate measure of the demand for dollars in Venezuela and reflects the value of the dollar on the parallel market in the streets of Caracas.

The Central Bank embarked on an evaluation process of the exchange controls and decided that it would not try to impose any new regulations that would prevent or hinder the workings of the parallel market.[72] The parallel market, and notably the stock market loophole, has been important in allowing importers to obtain dollars and subsequently, keeping stores stocked with goods. The parallel market actually operates more efficiently than the official

[71] Vladimir Hernández Lavado. "Se triplica la venta de acciones de CanTV." *El Nacional.* June 24, 2003.
[72] "El Banco Central respetará el mercado negro de dólares." *El Nacional.* July 9, 2003.

market, even if massive inflation is present, and could yield disastrous results, like extreme shortages, if prevented from operating.

Official Inflation versus Real Inflation

A visit to Venezuela almost certainly takes you through Maiquetía International Airport, located just outside of the valley of Caracas, the capital city. One look around gives the impression that something is amiss; the banks are closed, there are no boards showing the day's exchange rates, the American Express office is boarded up, and tanned men in sunglasses and white *guayaberas*[73] hiss as you pass. "I buy dollars," they whisper in accented English. A quick look around indicates to the traveler that your only way of getting the local currency might be through these hissers. The American Express office has a morbid air around it.. In fact, many travelers sell their dollars at the airport for a price well below the parallel-market rate in Caracas, but then, everything is more expensive at the airport. Taking money out of the ATM is another way to get Bolivars, but that is an official transaction and thus at the official rate.

With the exchange rate pegged at Bs. 1600/$1US and a currency board to back all of the available bolivars, inflation should eventually come under control given appropriate other monetary and fiscal policy. The Bolivar was losing value at an astounding rate before the exchange controls were introduced.[74] Consumer prices have shot up and the parallel market rate is approximately twice the official rate due to the scarcity of dollars and the complications in obtaining them.

The Immigrant Tragedy

The oil boom of the 1970s created a new middle class of oil workers in Venezuela, leaving a void in the service sectors, attracting a significant influx of immigrants to Venezuela,

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[73] Guayaberas are loose-fitting linen shirts commonly found in Caribbean countries.
[74] See Graph Exchange Rate Parity

and especially Caracas. The recession of the 1980's slowed immigration, but people continued to trickle in, especially from the Colombian border. While the majority of Venezuela's immigrant population is made up of Colombians fleeing their own political crisis, immigrants from other parts of the Caribbean have fled their own political and economic problems for the relative stability and fabled wealth of Venezuela.

Fellita de la Cruz[75] came to Venezuela from the Dominican Republic in 1981. She lives high in one of Caracas's famous barrios, high enough that no bus comes to get her. She works six days a week in a restaurant and on her day off cleans houses in a middle-class neighborhood. Each day she hikes down her little mountain and each evening she hikes back up it, complaining that while her money is becoming more worthless, the thieves are becoming more dangerous and more ruthless.

Cruz makes excellent paella. She makes it almost every day in the restaurant where she cooks for the few people in Caracas who still have the financial power to eat meals out. On her off day, she often makes it again for Luisa, the struggling real-estate agent who pays Cruz Bs. 5,000 to clean and cook for her on Saturdays. Cruz says she must work the extra day so that she can send the money home to her son in the Dominican Republic. As with any country with an immigrant population, large sums of money leave Venezuela for poorer countries in the form of remittances. Only recently has Venezuela been the recipient of significant remittances[76]. Under the exchange controls, before devaluation, Cruz's Bs. 5,000 from Luisa was worth about $3.12, but only officially. Banks do not have dollars anymore and even American Express has closed its doors. As she is not traveling and has nothing to import, Cruz has no reason to ask to buy dollars from CADIVI, and thus must sell her Bolivars on the street. The parallel market rate changes

[75] Fellita de la Cruz is affectionately known as Cruz or Cruzita, so I will call her Cruz throughout.
[76] WDI Online. The World Bank does not have figures for remittances received in Venezuela until 1997.

daily, but has recently hovered around Bs. 3,200/ $US, effectively halving Cruz's ability to provide for her child abroad.[77]

In June of 2003, almost five months after its creation, CADIVI finally enacted a provision for remittances under which any person could solicit up to US$300 per month to send to family members abroad.[78] The solicitation process, however, did not get any easier or faster and requires documentation from both the sender and receiver of funds. Many still find it easier and more effective to buy their dollars on the parallel market.

As many Venezuelans are finding they are unable to make a living and thus trying to leave the country, so are many immigrants. Cruz is considering moving to the interior of the country, a less populated region that she thinks is more stable, less chaotic, where she can find better paying work.[79]

Meanwhile, banks and investors are making excellent returns on the pegged Bolivar through currency exchanges, loans and ADR shares. Chávez's revolution to empower the poor has instead brought riches to investors who were smart enough to start early[80] and only exacerbated poverty in already depressed areas.[81]

Price Distortions

Remittances are not the only way that salaries have been eroded since the exchange controls were implemented. While price controls keep basic staples from becoming more expensive, there are often shortages, and the staples are hard to find. Goods that are not considered part of the food basket are experiencing significant price changes. Electronics,

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[77] Fellita de la Cruz. Interview. July 2003.
[78] Francisco Toro. Interview. July, 2003.
[79] Fellita de la Cruz. Interview. February, 2003.
[80] Francisco Toro. Interview. July 2003
[81] Erin Fletcher. "Fighting Poverty the UNDP Way." *VenEconomy.* July, 2003.

appliances and other imported goods and goods that use imported parts are found to be priced closer to parallel market Bolivar rates rather than Official Bolivar rates.

Luisa Alvarado, the woman whose house Cruz cleans, has rented and sold apartments and houses in Caracas ever since she left her hometown in Valdivia, Chile. Luisa is as much a *pinochetista*[82] as she is an *escualida*[83], highlighting the extreme differences in the two leaders' economic policies and their impact on each country. Luisa works six days a week, shuttling all over Caracas showing apartments and homes. She also rents two bedrooms in her own house to traveling students, interns and other short-term residents.

Luisa complains that business is slow. Many apartments for sale are denominated in dollars, and you can hear the incredulity in her clients' voices when she quotes prices. Some hang up, some laugh. Everyone wants to sell in dollars because everyone is leaving, she explains. Bolivars do not hold the same value anymore. But no one can afford to buy in dollars because not everyone can get dollars. She explains that "If they pay in dollars, it has to be at the parallel (parallel market) rate, which is Bs.3,200/US$1. An apartment that used to cost Bs.120,000,000 now costs Bs.200,000,000 because of the dollar. It's the same amount of money, but in bolivars it's a lot more." The parallel market and the scarcity of buyers have created an unbalanced market; there now exist sellers without buyers. Luisa says that rents and sales are down about 50% since before the controls. "Are more Americans coming?" she asks me.[84] She needs them to rent her rooms, and I do not have the heart to tell her that we are discouraged from going to Venezuela.

[82] General Augosto Pinochet led a military coup against the elected government of President Salvador Allende in Chile in 1973. With his rule came a brutal, repressive 17-year dictatorship that is oddly remembered somewhat fondly by a large part of the Chilean population (*Pinochetistas*) who credit Pinochet's privatizations plans and move towards a free market economy as the source of their recovery after the chaos of the early 1970s and their current prosperity.
[83] *Escualido* is a term used by supporters of President Chávez (*chavistas*) to describe his opponents (*anti-chavistas*). *Escualida* is the feminine form.
[84] Luisa Alvarado. Interview. July 2003.

Rents are problematic as well. According to Luisa, no one wants to rent anymore because if "the renter loses his job and decides to stay, which they can end up doing for a long time, the owner obviously loses a lot of money and maybe even risks losing the property, or at least that's the paranoid fear." Another imperfection created is the existence of buyers without sellers. The uncertainty of the job market and of political and economic stability provokes fear among landlords about the ability of their renters to pay, causing them to take their wares (apartments) off the market. The inability of people to move creates rigidity in the housing market and breeds more uncertainty, provoking monetary speculation.

The Central Bank reports that in the first quarter of 2004, the CPI rose 6.4% for consumers in the metropolitan region of Caracas, the capital city[85]. The products that experienced the greatest price hikes were those that are traditionally imported, like cars, home appliances, and airline tickets. These three products have born the brunt of price increases over the past year. Car sales fell significantly immediately following the implementation of controls, down 50 to 80% over 2002,[86] due partially to the failure of wages to rise and the inability of importers to purchase foreign exchange and thus the products. A review of prices of consumer goods by *El Nacional* showed that prices on small home appliances, like blenders, reflected the parallel market price of the Bolivar, not the official rate, indicating either goods smuggling or currency smuggling on the parallel market. Price controls remain in place on many food items, although some have been adjusted to allow for both the devaluation and the inability of many importers to do business with "official" dollars.

The Big Mac Index, developed by *The Economist* magazine, was originally a bored economist's notion of fun, a way to demonstrate purchasing power parity (PPP) differences

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[85] "Indice de precios al consumidor del area metropolitana de Caracas para el mes de marzo, 2004." www.bcv.org.ve
[86] Norberto J. Méndez. "Venta de vehículos cayó 69% en comparación con 2002." *El Nacional*. May 8, 2003.

among countries through one globally available good.[87] Despite its original playfulness, it has proved itself a sophisticated measure of PPP, producing numbers consistent with more complicated methods.[88] Venezuelans have pointed to the simpler burger and the McDonald's global offer of "a hamburger for a dollar" to show price distortions within the country. In early July, 2003, the most basic McDonald's hamburger cost Bs. 2,600, the approximate rate at which the dollar was being sold on the parallel market, while the official pegged rate remained at Bs. 1,600/$1US.[89] Such a price difference reflects a 62% overvaluation of the currency and demonstrates the erosion of real income in Venezuela.

The dramatic rise in prices of consumer goods, and especially the correlation with the rise in price of the dollar in bolivars on the parallel market, indicates that while the exchange controls may claim to be non-discriminatory, they are effectively acting as an import tariff on certain goods.

El Millardito

The "*millardito,*" or little billion[90], has become one of Chávez's most famous requests not only for the uniqueness of the word, but for the outlandish nature of the request. In early February 2004, President Chávez asked the Central Bank to give him "*un millardito*" of dollars from FIEM monies to finance seeding and land projects in the interior of Venezuela. He claimed that one billion dollars worth of reserves was a small price to pay and that all Venezuelans would benefit from the increased agricultural activity.

The move was largely considered silly and the Central Bank wisely denied his request, a decision that was unprecedented for a bank that is widely considered to have lost much of its

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[87] "Big MacCurrencies." *The Economist.* April 12,1997
[88] Dennis R. Appleyard and Alfred J. Field, Jr. *International Economics.*2001.
[89] Vladmir Hernández Lavado. "Tasa McDonalds.: Bs. 2,600." July 9, 2003.
[90] "ito" is a diminutive ending for words in Spanish, so the word literally translates as "little billion."

independence to the Chávez government. Allowing Chávez to access that sum of money would only exacerbate the current inflation problem by expanding the money supply by 15%, assuming that he was granted the funds in bolivars at the official exchange rate.[91] There exist a number of other options to obtain extra revenue for the government's social spending programs. Most of these options require a change in the current monetary and exchange rate regime. The most efficient of these would be an auction, as already discussed. The government receives approximately US$2 billion monthly from oil revenues, which it promptly sells to the Central Bank at the official, pegged rate to obtain bolivars to finance its projects. Instead of selling to the Central Bank, the government could hold an auction whereby it could sell the dollars directly to importers, businesses and individuals who needed dollars. This solution allows the government the bolivars it needs and is actually deflationary. As more bolivars are exchanged for dollars, the bolivars are taken out of circulation, contracting the money supply and driving up the price. So long as the government does not spend all of the bolivars it obtains, there is no inflationary money creation; "money is only passed from private property to government property."[92] Additionally, the sale of US$1 billion would yield more bolivars than a sale to the Central Bank at the official rate. With the parallel market at Bs.3,200/US$1, the government could raise an extra Bs.6 trillion to Bs.16 trillion for its projects. Instead, Chávez chose to stay the course with his exchange controls and devalue in order to gain more funds.

Devaluation

For many, devaluation is one of the first signs of the failure of the exchange controls. Facing mounting inflation, pressure from the parallel market, and sporadic shortages, the Venezuelan government finally devalued on February 9, 2004, bringing the Bolivar to

[91] Carlos Risopatrón. "La politica monetaria y el Proceso Revolucionario." Feb 2003.
[92] Carlos Risopatrón. "La politica monetaria y el Proceso Revolucionario." Feb 2003.

Bs.1,900/US$1. Finance Minister Tobías Nórbrega defended the devaluation citing pressure on the balance of payments, a reason that Venezuelans and Bear Stearns, the company that manages most of Venezuela's oil accounts, found unconvincing.[93]

For others, the 17% devaluation was primarily a political move. After failing to convince the Central Bank to part with Bs. 1 billion[94] to finance agricultural projects, many Chávez critics claim that the purpose of the devaluation was to obtain more Bolivars to finance social programs and maintain the support of the poor. The Venezuelan government receives money from the Central Bank to finance its projects. This money comes from oil sales and royalties paid by PDVSA. By devaluing, the government would receive more Bolivars for every dollar it received, increasing the ability of the government to finance its programs. This process, however does not take into account rising prices. Inflation has eroded the effectiveness of government spending as much as it has eroded wages. Although prices continue to rise in Venezuela, the devaluation will mean that sales of oil yield 17% more bolivars than before. This decision further erodes the value of savings and earnings and reflects a 150% official fall in the bolivar since January 2001. Additionally, the devaluation has not eliminated the need to ration dollars through the permit process. If the government had been utilizing an auction scheme throughout the year, the domestic money supply would have been lower and he would never have been forced to devalue.

Winners and Losers: The Chávez game

While we have shown that there are more efficient methods for reigning in inflation and upping reserves, it must follow that the exchange regime currently in effect breeds winners and losers. Chávez's influence over the Ministry of Finance and the Central Bank is imperfect,

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[93] Mary Anastasia O'Grady. "Money Fun in Venezuela." *The Wall Street Journal.* February 12, 2004.

[94] In an address to the directors of the Central Bank of Venezuela, President Chávez begged the Bank to provide him with a "millardito" or a little billion worth of Bolivars to use on an undefined agricultural assistance program. The Central Bank refused, but many see the act as the ultimate display of Chávez ignorance of economics and the institutions of the country.

shown both in his ability to influence exchange rate regimes and his inability to extract additional funds from international reserves. His control over how government revenues are spent is more refined given his monopoly on the National Assembly and other governing bodies. However, with the exchange set artificially low, Chávez receives fewer bolivars for the dollars earned from oil revenues and reduces his ability to hand out political favors through government spending. Through CADIVI, Chávez can ration foreign exchange to preferred importers, allowing them to buy dollars at a cheap rate; in effect, they are recipients of a quota revenue. This pushes the parallel market rate up as non-preferred importers are excluded from the process. As importers pay higher prices for goods, those losses are passed on to consumers, who pay higher prices for all imported goods and preferred importers reap the benefits. In effect, Chávez distributes quota revenues to preferred importers.

Since inflation began to take off a few years ago, the money stock has been rising at a rate much slower than the rate that prices have been rising[95]. Such a result is typical in a stagnant economy where investors are fleeing an inflating currency. Inflation combined with low interest rates, the result of a prohibition on foreign investing, make the bolivar a poor store of value and reduces the demand for money, pushing up the price level. The implementation of the exchange controls combined with price controls on some products have reversed the comparison, causing prices to rise more slowly than the money stock. Reserves have rebounded under the exchange controls, but prices of many goods, mainly imported goods, are still rising. The exchange controls did meet their purported goal of halting the fall in reserves, but there are better methods available for slowing inflation, ones that do not pose the opportunity for the president to distribute quota revenues to preferred importers and banks. A commitment to keep money growth in line with GDP growth, for example would be more appropriate.

[95] See Appendix IV, Graph 3.

Why not eliminate the controls?

In our examination of exchange controls, we have found that they are actually inflationary, cause significant distortions and imperfections in the market, erode earnings and savings, use up resources through rent-seeking, and generally make people upset. With all of their problems and the wealth of alternative options available, it is odd that the government has maintained its stance on the controls.

Many events have exerted great influence in the Venezuelan economy over the past year of exchange controls that have allowed for relative political stability, the lack of defaults, and the continuing ability to finance which merit the attention of the economist. While certainly not a viable permanent solution and probably not a perfectly-implemented one, it is important to note the effects of the exchange controls and their ability to maintain themselves in spite of political and economic uncertainty.

According to economist Dr. Key, the necessity for eliminating controls has not yet arisen. One of the most baffling aspects of the exchange controls has been the ability to maintain themselves without losing the confidence of investors in New York. As long as Venezuela continues to make payments on its loans and sell its debt, Chávez can defend the controls. They are a "necessary evil" to maintain foreign reserves, according to his supporters.[96] The controls also keep Venezuelan investors from taking their money outside of the country without some difficulty, thus forcing them to invest in Venezuelan government bonds. "Normally," Dr. Key explained, "interest rates for Venezuelan government bonds must be very high, but when there is no other option, the people buy them."[97] Thus the government has additional financing and prevents capital flight.

[96] Isabel Tovar. Interview.
[97] Ramón Key, PhD. Interview. February 2, 2004.

In July 2003, just as a large proportion of its foreign debt was about to come due, the Central Bank of Venezuela (BCV) emitted a bond denominated in Bolivars valued at $1.5 billion ($U.S.). The bond was available for sale in Bolivars or Dollars, but could only be remitted in Bolivars. This effectively closed the market to foreigners, and Venezuelans, with few other investing options, chose to buy the bonds. This action, combined with the exchange controls, helps maintain the local demand for Bolivars at a time when many investors are attempting to unload the Venezuelan currency.

A uniform import and export tariff might be a more efficient manner of gaining revenue for the government. As most consumer goods come from abroad, raising the Value-Added Tax could be a more appropriate method for financing the government's new projects. A tax like this, however, would be imposed on the poor as well as the rich. As Chávez claims to be a pioneer for the poor, this would never do. High oil prices are bringing in more revenue right now, but there is no guarantee that they will stay high, and we have seen historically that gas price hikes in Venezuela have had disastrous consequences.

A more cynical group of economists views investor confidence in New York as a ploy to hedge any criticism of the government from abroad while keeping Venezuelans poor. CADIVI figures show that. Miguel Octavio notes that Venezuelan investors in Venezuela receive their dividends in a worthless currency ever being eroded by inflation; meanwhile foreign investors abroad receive their dividends in dollars at the official rate. Kaempfner, Tower and Willet note that "governments may spend a lot of money trying to save one identifiable individual,"[98] i.e. investors abroad whose monetary support is critical to staying in the good favor of the IMF and the SEC.

Conclusion

[98] Kaempfner, et.al. "Trade Protectionism." June 2001.

Exchange controls themselves are not really the problem in Venezuela, and perhaps not in any country, but rather are a driver of stagnation via bad policies. Following the Asian crisis, many economists decided that the success or failure of a pegged currency or any exchange rate regime hinged more on the politics of the country rather than the regime itself.[99] Dr. Key notes that the "set of policies" driving the country does little to encourage internal investment and that without changing the petrostate policies that define Venezuela's economy, no exchange regime can really work effectively.[100] The exchange controls are indicative of a much larger problem, primarily the energy policy. Oil profits have always gone to finance the government, instead of for any social good. As this process is monopolized by the government, private investors are forced to look to the exterior for investment opportunities, diminishing the ability of local companies to grow or make industrial or consumer goods.

Pegging the Bolivar to the dollar did not doom Venezuela to a depressed economy. While other modes of reigning in inflation and providing more revenue to the government could have been more efficient and useful, the exchange controls did provide one solution, albeit one whose success is hard to measure. The mismanagement of exchange controls, the opaqueness of the government and the inability to define its aim and appropriate monetary policy to accompany the controls created a situation in which the country would be faced with a depressed economy and ever more impoverished citizenry.

We have yet to see the long term consequences of reduced imports, a depressed economy, and high oil prices. OPEC's recent decision to cut production will certainly have an effect on the Venezuelan economy as well as the world economy. A number of other factors unrelated to the controls and permit system themselves, but linked to the nature of Venezuelan politics will

[99] Michael Mussa. *Exchangre Rate Regimes in an Increasingly Integrated World Economy.* 2000.
[100] Ramón Key, PhD. Interview. February 2, 2004.

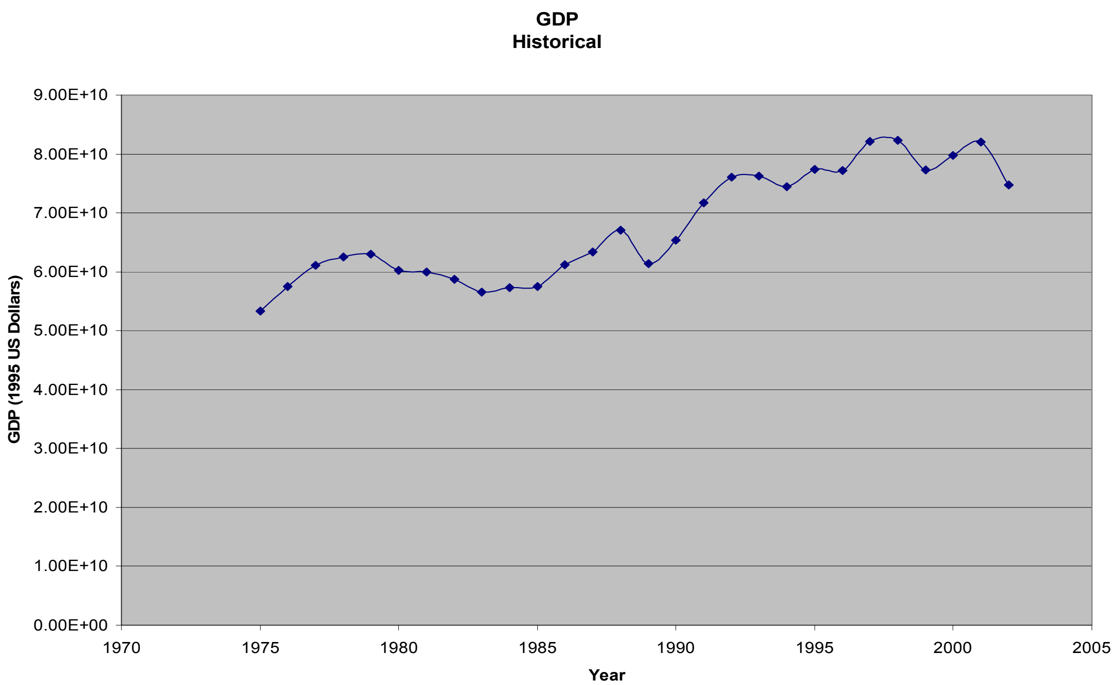
continue to exert influence, making it difficult to separate out the effects of the exchange controls themselves.

Nonetheless, a general consciousness of exchange controls created by the effects of the black market and the multiple instances of exchange controls throughout Venezuelan history have given the country's citizens ample opportunity to evaluate their effects in their own lives. Some Venezuelans do not note many differences. Isabel Tovar claims that little in her life has changed, she has kept her job as a university professor; she has not changed her buying habits although some products seem more expensive. She sees the controls as a necessary instrument to stabilize the economy.[101] For others, such as Luisa and Cruz, their livelihoods have been severely affected by exchange controls, to the point where Luisa refuses to buy fruit and vegetables from markets that she associates with "those shameless *chavista* criminals."[102]

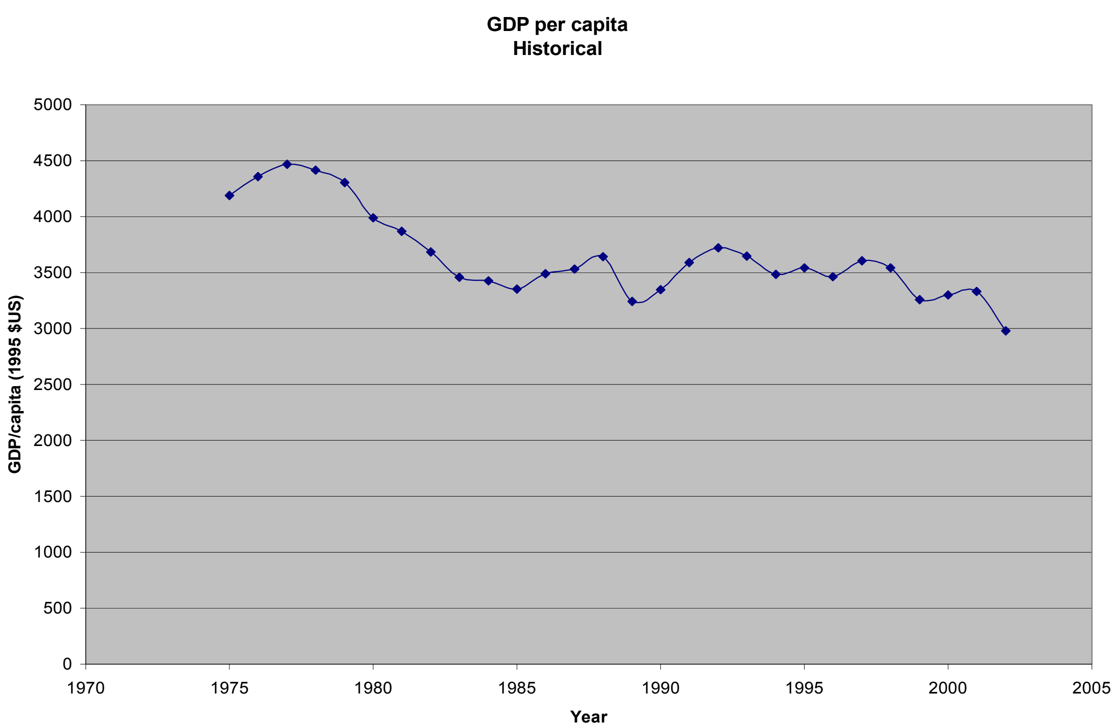
[101] Interview. Isabel Tovar.
[102] Interview. Luisa Alvarado. July, 2003.

Appendix I Macroeconomic Graphs and Tables

1. Annual GDP[103]



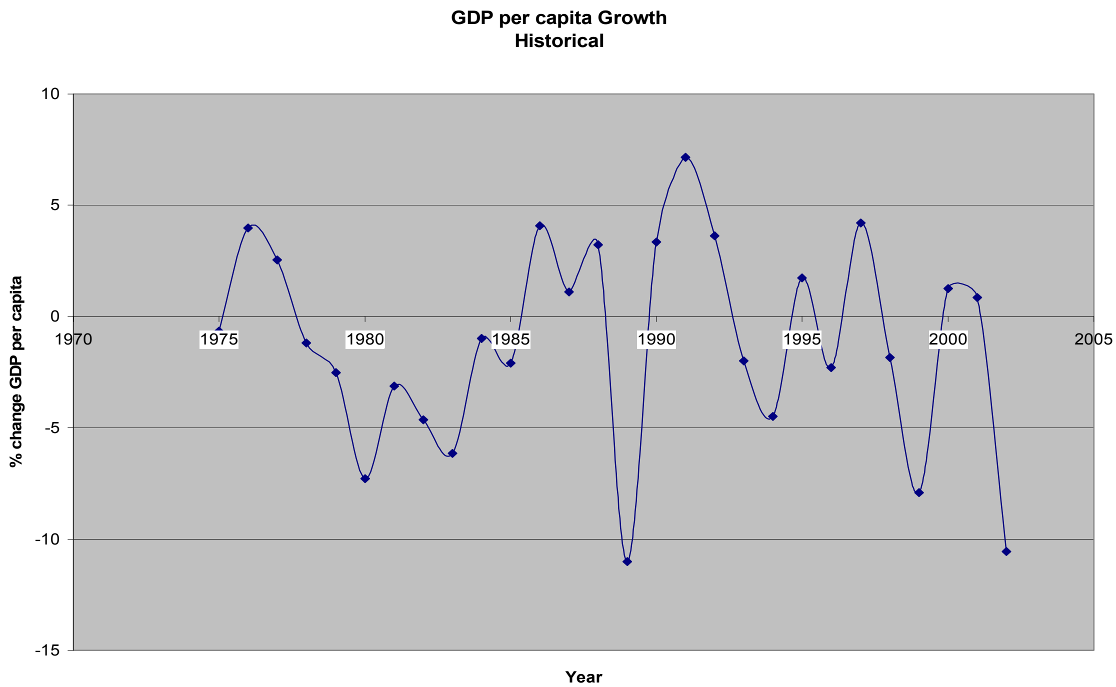
2. Annual GDP per capita[104]



[103] Numbers from World Development Index Online.
[104] Numbers from World Development Index Online.

Appendix I

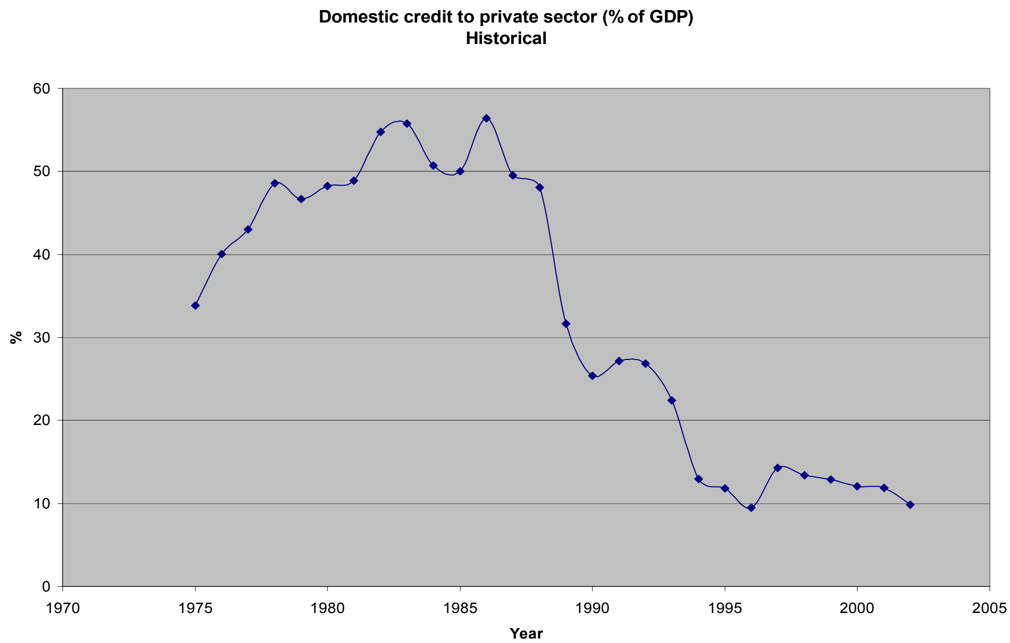
3. Annual rate of GDP per capita growth[105]



4. Annual Fuel Exports[106]

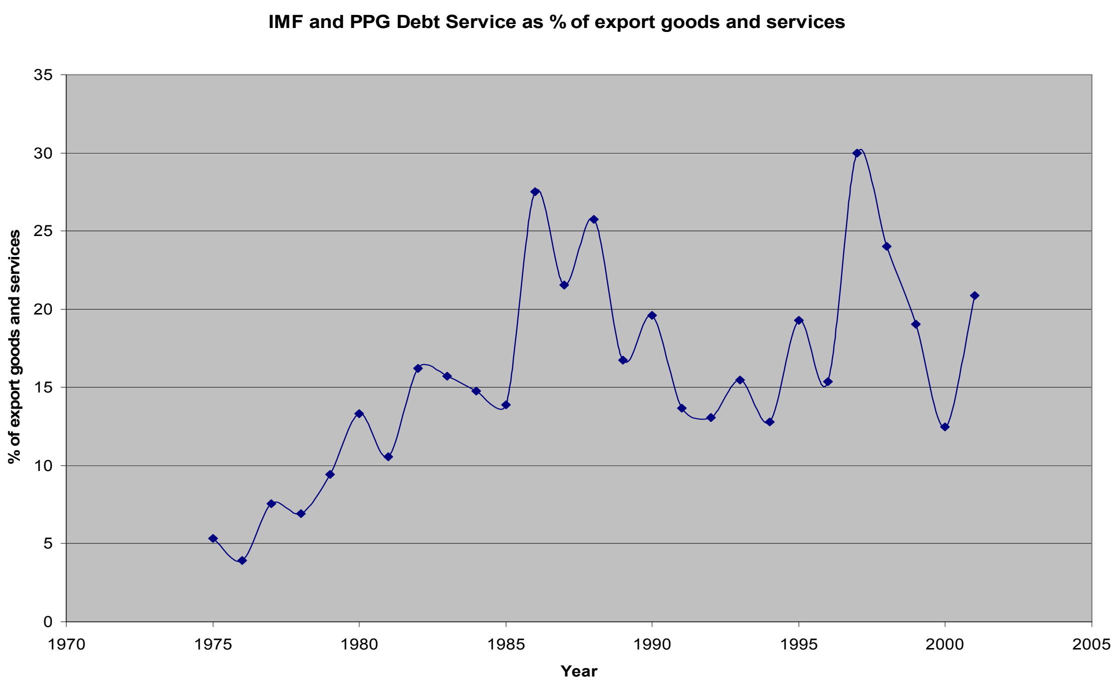
[105] Numbers from World Development Index Online.
[106] Numbers from World Development Index Online.

5. Domestic Credit[107]



-The nationalization of the oil industry and the government's appropriation of much of the tourism sector contributed to falls in domestic credit to the private sector, but is also indicative of the lack of industry for local investors.

6. Debt service[108]



[107] Numbers from World Development Index Online.
[108] Numbers from World Development Index Online.

Appendix II

1. Selected CADIVI Regulations[109]

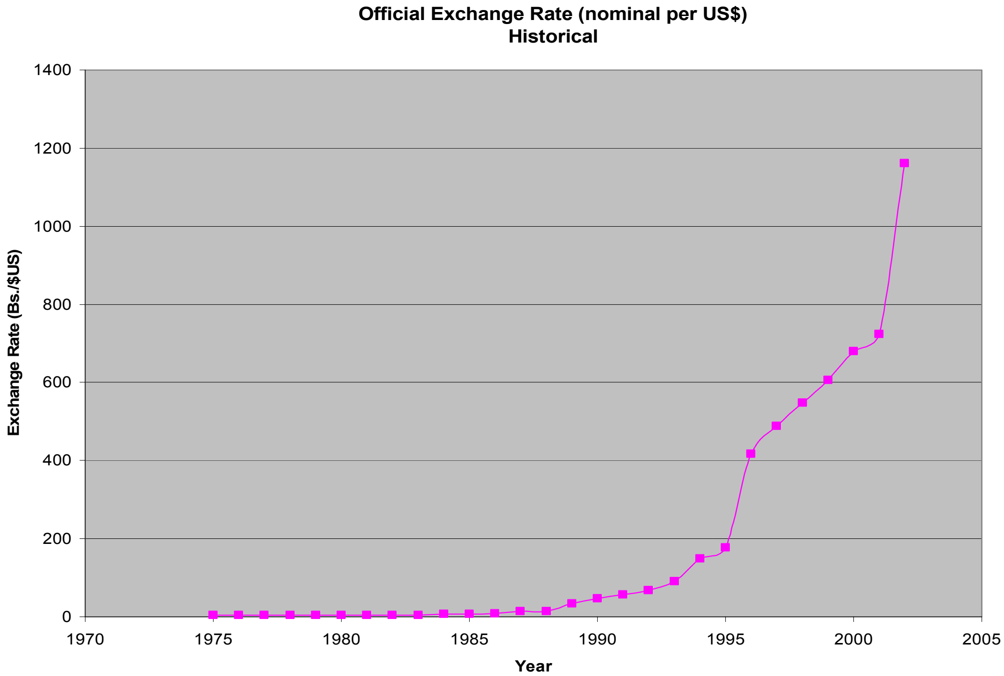
These were among the regulations imposed with the original decree that created CADIVI. These original rules have been modified since to make additional allowances for credit cards, traveling, remittances and other legal activities.

- All foreign exchange transactions will be centralized at the Venezuelan Central Bank
- The administration, control and requirements will be determined by CADIVI
- The Venezuelan Central Bank will establish a budget for the total use of foreign currency during the fiscal year
- The Venezuelan Central Bank will establish an amount above which all important export of monetary instruments in foreign currency will have to be declared.
- All foreign currency obtained from the export of goods, services and technologies will have to be sold to the Venezuelan Central Bank within five days of receiving them. Exports will be calculated at the FOB price, as detailed in the custom declaration
- All foreign currency coming into the country from transport services, travel, wire transfers, leases, dividends and from all other services as well as commercial, industrial, professional and personal activities will have to be sold to the Central Bank
- Companies wishing to pay dividends, capital gains, royalties, intellectual property rights will have to register in order to purchase foreign currency.
- All ADS, ADR, GDS and GDR programs will have to register for payment of dividends, capital gains and interest
- The decree suspends all trading of public debt bonds issued in foreign currency until the Executive branch and the Central Bank establish regulations for such trading.

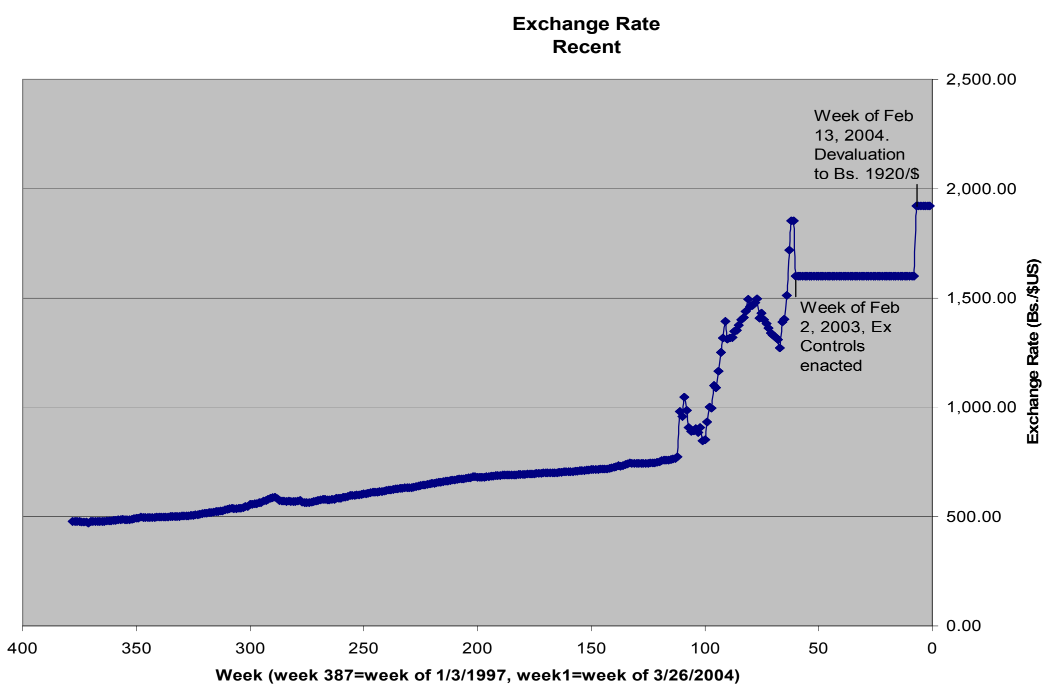
[109] The complete law that created CADIVI and set up the laws surrounding it were published in the *Official Gazette of Venezuela* (*Gaceta Oficial No. 2.302*) on February 5, 2003. These selected regulations were translated and published by Miguel Octavio for *Bbo Weekly Report* on February 7, 2003. Reprinted with permission.

Appendix III. Reserves and Exchange Rate Graphs and Tables

1. Historical Exchange Rate[110]



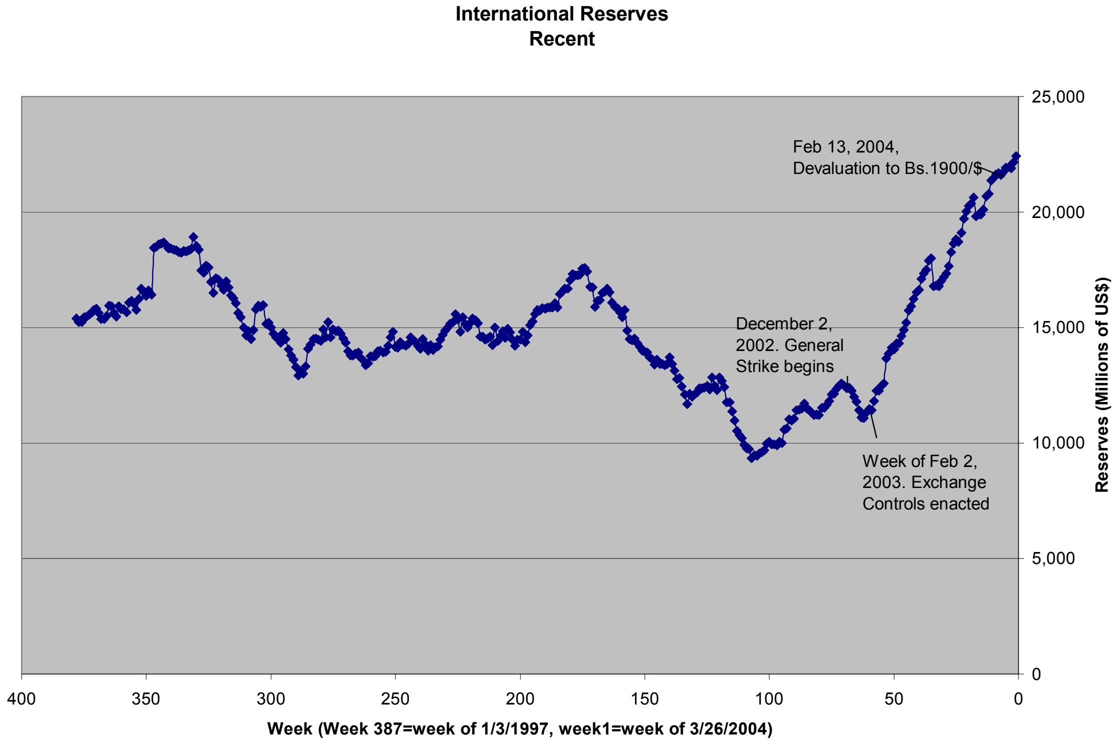
2. Recent Exchange Rate[111]



110 Numbers from World Development Index Online.

111 Numbers from Banco Central de Venezuela Online. www.bcv.org.ve

3. International Reserves (# of weeks ago beginning 3/26/2004)[112]



113

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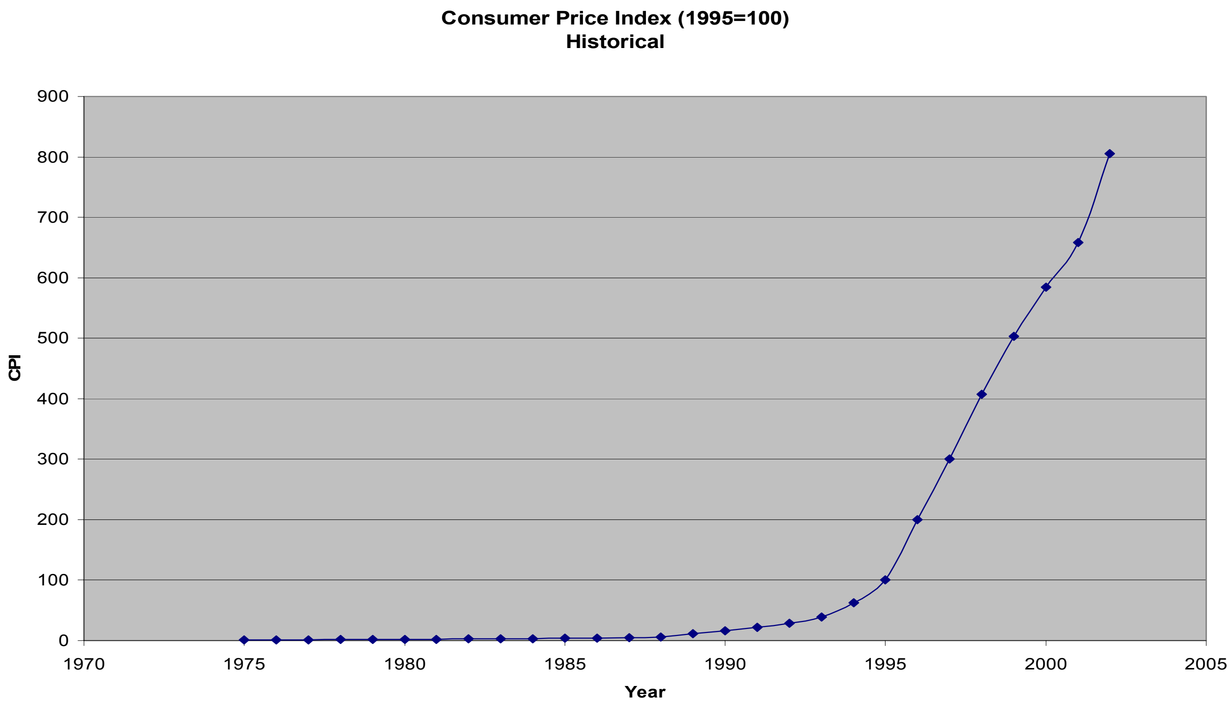
[112] Numbers from Banco Central de Venezuela. www.bcv.org.ve

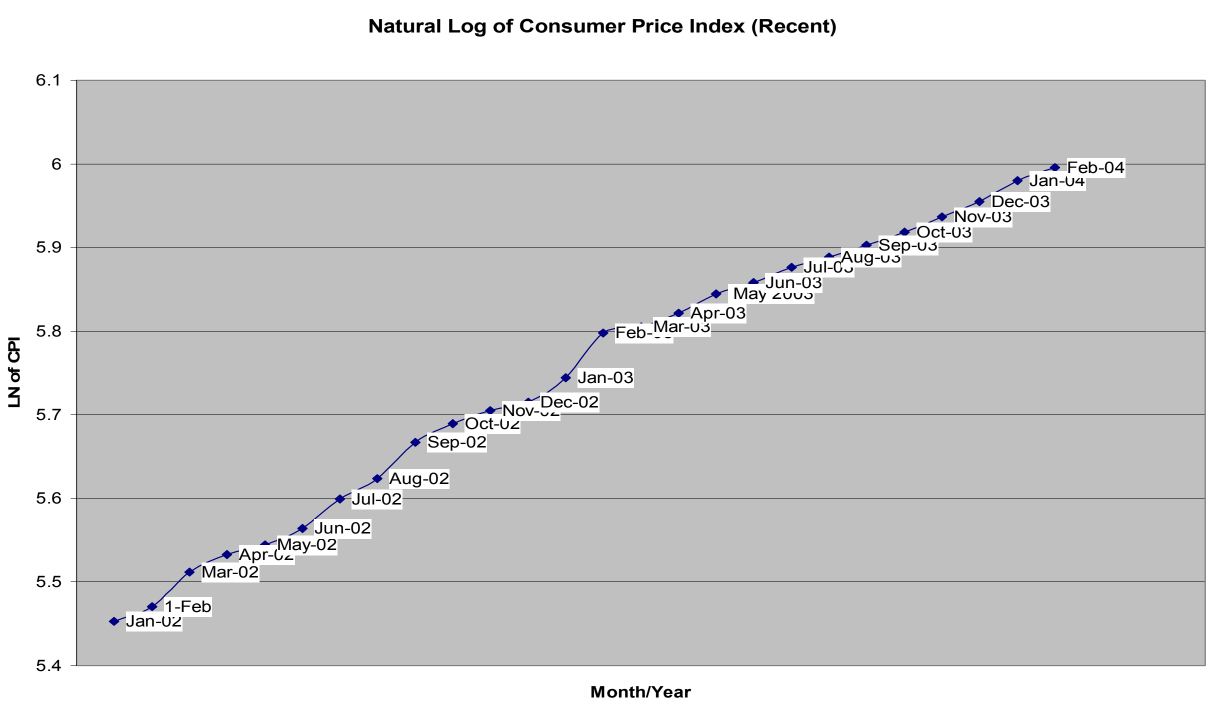
[113] International Reserves do not include FIEM monies.

Appendix IV Consumer Price Data Graphs and Tables

1. Consumer Price Index[114]

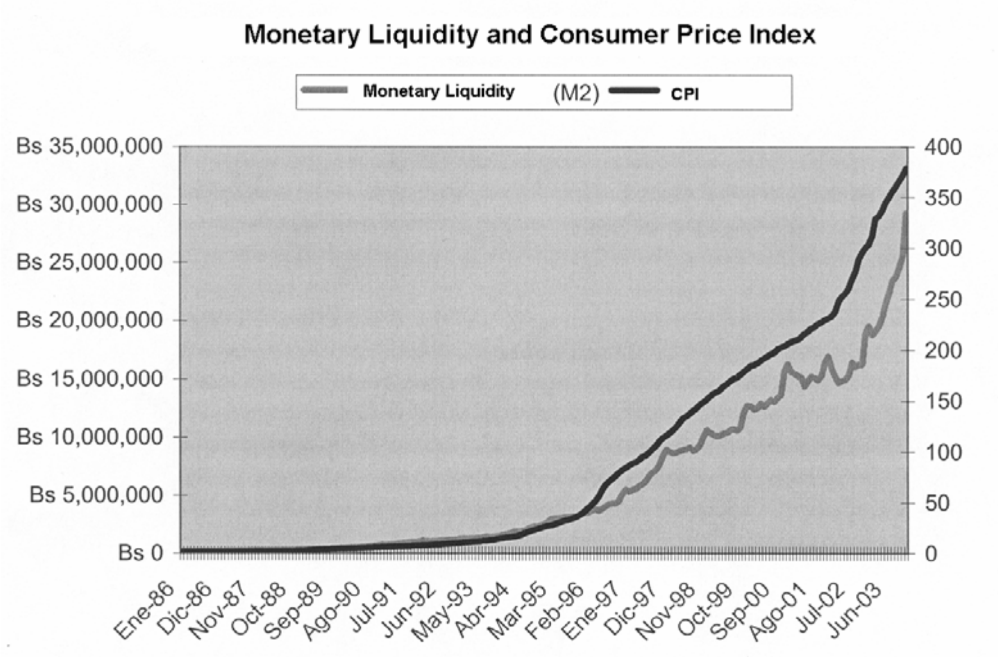


2. Natural Log of Consumer Price Index (Recent)[115]



[114] Numbers from World Development Index Online.
[115] Numbers from Central Bank of Venezuela Online.

3. Monetary Liquidity and Consumer Price Index[116]



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[116] Carlos Risopatrón. "La Política Monetaria y el Proceso Revolucionario." February 2004. Reprinted with permission.

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