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Venezuela's economy:

Problems Ahead

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It is safe to say that a crisis will follow the current bonanza. It is unclear when it will happen or how intense it will be, but there is no doubt that after the oil respite, difficult times will come.

In an oil-dependent economy, such as the Venezuelan one, these times mean bonanza. The windfall created by soaring oil prices since 2004 has allowed public expenditure to increase steadily, injecting the abundant export revenues into the economy. This increased money supply sharply, making interest rates to fall, and internal demand — particularly private consumption — to steadily increase. As a consequence, internal productive activities expand, allowing the GDP to grow by more than 10 percent on the average in the past two years.

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Nonetheless, this economic expansion has not improved workers conditions. The proliferation of overprotective labor laws, coupled with the lack of private investment in response to hostile socialists policies such as expropriations and invasions of private property, have created a hostile environment for private economic activities affecting the work force. Today's unemployment rate is still above 10 percent and underemployment affects nearly half of the labor force. Additionally, massive public social programs are mainly mitigating adverse living conditions of the poor through widespread subventions, but are not solving their problems on a permanent way.

Although inflation is still above 10 percent, one of the highest in Latin America, it is steadily declining despite of the intense money supply growth. Mainly, this is a consequence of a highly overvalued currency, massive government subsidies, strict price controls and efforts of the central bank (BCV) to reabsorb part of the sweeping liquidity. Abundant dollars coming from oil exports have allowed the government to anchor the exchange rates despite higher local inflation than abroad, which in turn overvalues local currency. Inexpensive and abundant dollars, in defiance of the existing exchange controls, have allowed imports to soar. These foreign purchases, some of which are brought by the public sector as duty free, complement local supply and reduce price pressures on tradable goods. In addition, several products, such as food and other basic consumer goods, are sold with high subsidies through Mercal, a government created nationwide retail network with about 40 percent market share. All these efforts contribute to lower inflation mainly in the tradable sectors, but not in non-tradable activities, such as real estate, where prices are growing at a much higher rate.

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Monetary authorities are making big efforts to reabsorb part of the fast growing money supply in order to avoid additional pressures on prices. In fact, a large proportion of overall liquidity has been subtracted by BCV through the sale of certificates of deposits to banks. Despite these expensive efforts, the central bank's capacity to stabilize prices is very limited as its autonomy is almost inexistent. Thus, a recent legal amendment forced BCV to transfer $10 billion — about a third of the international reserves — to the executive branch for public expenditure financing. Additionally, by imposing the central bank to follow certain accounting policies, artificial foreign exchange profits are recurrently created to finance public spending.

Obviously, high oil prices allow for positive external balances, particularly those of the current account of the balance of payments. In 2005, the trade surplus was $31.5 billion, or 24 percent of GDP, despite a sharp increase in imports. This year that figure is expected to reach $36 billion. The current account also is expected to show again, a large positive balance in 2006 equivalent to 19 percent of GDP. These large surpluses more than compensate the capital account deficit, mainly created by the public sector from its large investments abroad (for example, the purchase of Argentinean bonds), aid to other countries (Cuba, Bolivia and several others), external debt payments, and growing deposits in foreign banks with funds received from PDVSA and BCV (international reserve transfers).

But, how sustainable is the actual situation? Given the open antagonism of the government to private economic activities and to economic integration with the US, or with any regional country that reach free trade agreements with that nation, we could infer that future economic stimulus is not going to come from flourishing private investment or non-oil exports developments. Therefore, the continuation of the bonanza in the coming years will depend on the real public expenditure's possibility to continue to grow. Given that internal tax collection, which has substantially increased in recent years, will have limited growth possibilities, the expansion of public spending will depend on higher oil income. This is why today, more than ever, the economy is reliant on oil revenue, and from previous experiences we know how vulnerable it is to rely on such a volatile source.

Given the rigidity of short term hydrocarbon production capacity, the eventual reduction of oil prices, or even their stabilization, would force the engine that drives the economy to change gears. Under such scenario, public expenditure should be curbed, a difficult task to do, particularly when a large proportion of this spending is concentrated in social programs. This is why less political sensitive disbursements, such as investments, are expected to be the first ones to be cut.

Under an exchange control system such as the actual one, weaker oil prices deteriorate the exchange expectations, driving people to demand more dollars in order to look for protection against a possible devaluation. In response, access to official dollars at preferential rate is normally restricted, forcing people to go into the parallel market where the free rate grows steadily. This causes inflationary pressures as prices are established by expected replenishment costs which are highly influenced by the free exchange rate deterioration.

The larger the difference between the two exchange rates, the higher the pressure for an adjustment of the official rate due to escalating demand of artificially cheap preferential dollars. In addition, higher government revenue needs tempt the government to increase that rate in order to generate more local currency for each available petrodollar. These reasons, combined with the need to correct the high overvaluation, force the official devaluation to take place aggravating the inflationary impact. This causes abrupt contractions of real revenues of the population and confiscatory reductions of private wealth.

As in the past, the central bank could implement tight monetary policies to control inflation and to limit the availability of local currency that could be used to buy dollars. This policy would make interest rates soar. This, combined with contraction of real income and wealth of Venezuelans, would have a very restrictive effect on internal demand and production.

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Given the lack of autonomy of BCV, the government might try to solve an oil revenue deficiency with deficit financing by the central bank. If that is the case, inflationary pressures would be much higher, and would make the crisis to be even worse. The fiscal gap might also be tried to be closed by local or external borrowing, although in critical times lending funds tend to be scarce.

To conclude, it is safe to say that a crisis will follow the current bonanza. We do not know when it will happen or how intense it will be. Most likely it will be a mid term phenomenon, and its intensity will depend on the behavior of oil prices and the implemented public policies. But there is no doubt that after the oil respite, difficult times will come.

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