Hugo Chávez's Third Devaluation (ARI)

Ronald Balza Guanipa *

Theme: The devaluation is the consequence of accelerated internal public spending funded through oil revenues. Although spending won Hugo Chávez votes, a significant number of voters may now be feeling the negative effects of devaluation.

Summary: This ARI briefly looks at the causes of the loss of value of Venezuela's currency against the US dollar between 1999 and 2010, emphasising the expansion of the monetary base of fiscal origin, the unfavourable outlook generated by the political context and the abandonment of constitutional mandates which prevent monetary financing of spending and require saving at times of increasing revenues. It asserts that the government allowed the bolivar to weaken while it gleaned electoral support through public spending and that it will seek to obtain electoral advantage with the funds obtained from the devaluation. However, since the cycle underlying the inflation and the widening spread between exchange rates could end up harming a large part of the electorate, without promoting new changes that would provide it with more support, the government could try to impose its will through other means.

Analysis: President Chávez informed the country in a night-time address on Friday 8 January 2010 that the official US dollar exchange rate would increase from 2.15 bolivares fuertes to 2.60 for essential goods and services, and to 4.30 for the rest. The announcement was not made through a 'chained' broadcast over the country's radio and television networks, a method that the Venezuelan President has often used to give his views in speeches sometimes lasting several hours. Despite some comments by his ministers on interview shows, no major details of the new exchange framework were released until the following Monday, when the Central Bank of Venezuela (*Banco Central de Venezuela*, BCV) published the 14th Currency Exchange Agreement between the issuing bank and the Finance Ministry.

The President and his supporters denied that the measure was a devaluation. According to the former Finance Minister and member of the National Leadership of the United Socialist Party of Venezuela (PSUV), Rodrigo Cabezas, 'the economic strength of Venezuela at this time makes it impossible to talk about devaluation, but a monetary correction that will prevent the flight of capital and will strengthen national production'; he claimed it was an 'exchange tool' that would offer 'a great opportunity to tackle the industrialisation of imports, as well as the greater competitiveness of Venezuela's exports'. President Chávez threatened to expropriate those who raised prices arguing that 'the articles that are currently being sold were imported at the previous dollar rate', 2.15 bolivares, and he actually said in the National Assembly that his government had in fact revalued the currency: 'There is a terrible campaign, aimed at scaring the people and making them believe that [there has been] a dreadful devaluation of the bolivar; just like that, they repeat that term, a dreadful devaluation. That's a lie! A lie! The dollar exchange

* *Professor of Micro-Economics at the Andrés Bello Catholic University and the Central University of Venezuela.*

rate is falling and prices must trend lower; in other words, what we have done is to revalue the bolivar'. The next day he called the 'currency exchange rate adjustment' an 'act of justice' which would only affect the 'bourgeoisie' accustomed 'to asking for [cheap] dollars to travel, to import luxuries, top-of-the-range vehicles, and so on'.

The quoted comments point to a number of problems. Why did President Chávez devalue the currency and then deny having done so? Does the devaluation of the bolivar fit with president Chávez's project? What are the likely economic and political consequences following the devaluation? Some possible answers are offered below.

The Weak Bolivar

It is worth recalling that in February 1999, when Hugo Chávez took office as President of Venezuela for the first time, the dollar exchange rate was around 575 bolivares, and the price of oil was less than US$10 per barrel. Although the oil price exceeded US$30 in October 2000, in November of the following year it was back below US$17 per barrel. By that time, the government had increased its nominal spending by 90.5% in three years (49.6% in real terms), had admitted to have economic difficulties and was paving the way for spending cuts and tax increases, which were eventually announced in February 2001. Following presidential approval of potentially expropriating decree-laws in December 2001, the already tense relations between supporters and opponents of the government in the state-run Petróleos de Venezuela (PDVSA) and in the country's armed forces (FAN), and the discontent among business and labour organisations and part of the middle class, led to the coup of April 2002. Once the President had been restored to office, he reshuffled the economic cabinet and abandoned the exchange bands system established in 1996 by the previous government. At that time, with the dollar at 793 bolivares, the President decided to allow a dirty float exchange system, which surprised those who knew of his aversion for market mechanisms. The political crisis was taken to the extreme of a strike led by PDVSA between December 2002 and February 2003, calling for the President to resign. Once it had seized political control of the company, the government changed its economic policy in early 2003, establishing price and exchange rate controls from the beginning of the year. With the manifest purpose of protecting international reserves from the impact of the oil strike, on 6 February 2003 the government and the BCV set the dollar exchange rate at 1,600 bolivares. In four years, the exchange rate had soared by 178.3%.

The depreciation of the bolivar was not due solely to the adverse climate generated by the political turmoil. Internal public spending financed with oil revenues expanded the monetary base in Venezuela, heaping pressure on goods and services prices and the exchange rate. This combination of events explained the difficulties which the government encountered in trying to influence the performance of the parallel exchange rate. One year later the official dollar rate was half of the parallel rate, calculated at the time using the relationship between the prices in bolivares and dollars of the ADRs issued by CANTV, the telephone company nationalised in 2007 (each ADR was a share listed in the New Work Stock Exchange, equivalent to seven D class shares listed in the Caracas Stock Exchange). Despite a 59.4% increase in international reserves since the control was established, on 9 February 2004 President Chávez authorised his first devaluation, by increasing the official dollar rate by 20% to 1,920 bolivares. The second devaluation, which added another 12% to the official dollar-bolivar exchange rate, took place on 3 March 2005. Both devaluations took place as the price of oil increased (with some variations) from US$25 per barrel in April 2003 to US$70 in August 2006 and international reserves increased from US$14.06 billion in February 2003 to US$37.44 billion in

December 2006. Although the parallel dollar rate stayed close to 20% higher than the official rate between February and June 2006, the spread between them began to widen until it closed the year at 60%. While the oil price increased from US$46 per barrel in January 2007 to almost US$140 per barrel in July 2008, the spread between the two exchange rates increased to 216% of the official rate in October 2007, and later narrowed and remained at around 60% between April and August 2008. Before the sharp decline in oil prices, dragged down by the global crisis, the exchange rate spread was starting to widen again.

According to President Chávez, when giving his account of his government's achievements in 2009 before the National Assembly, the parallel dollar rate 'reached 7 or 8 bolivares' (*bolivares fuertes*, equivalent to 7,000 and 8,000 bolivares), which would have implied a maximum spread of 272%. Overlooking the fact that close to 60% of imports in the first nine months of 2009 were effected at an official exchange rate of 2.15 *bolivares fuertes* (including those corresponding to a significant proportion of foods, medicines, trade goods and machinery and equipment), the President asserted that bringing the parallel dollar rate to 4.30 *bolivares fuertes* (equivalent to 4,300 bolivares) through the intervention of the BCV would constitute a 'revaluating devaluation'.

How the Government Made the Devaluation Inevitable

What had happened? Why with rising oil prices for almost a decade did the Hugo Chávez government have to devalue the bolivar? Let us start by pointing out that the central government's real spending between 2003 and 2006 increased by 97.2%, and that from 2003 onwards PDVSA began to increase internal spending on social programmes called *Misiones*. In April 2003 the government used up the savings that constitutionally must be held by the Investment Fund for Macroeconomic Stabilisation, later drafting no fewer than seven laws to free itself of the obligation to replenish them. In July 2005, the National Assembly, at the request of President Chávez (on 15 January 2004), reformed the BCV Law to create the National Development Fund (FONDEN), under the administration's control. This Fund was supposed to receive from the central bank (with no consideration in bolivares) US$6 billion in a single instalment, to which PDVSA was supposed to add currency periodically. It is worth highlighting that the creation of FONDEN conflicts with the express prohibition under the 1999 Constitution of financing fiscal spending through the BCV. However, the then-Chairman of the Finance Committee of the National Assembly, Rodrigo Cabezas, asserted that he did not understand 'all the fuss following the announcement by President Hugo Chávez when he proposed to use what he considers to be surplus reserves for economic and social development'.

Accordingly, the potential of internal spending was increased, but not so the supervision. The law explicitly said that the BCV should only transfer US$6 billion in 2005, but this entity has repeated the operation since then, delivering US$4.275 billion in 2006, US$6.77 billion in 2007 and US$1.538 billion in 2008. Of the US$46,131,500,000 received by FONDEN between 2005 and 2008, 40.3% had been delivered by the BCV after printing bolivares for the PDVSA accounts, and 59.7% by PDVSA itself. At the end of 2009 the Chairman of the BCV stated that 'the transfers of international reserves to FONDEN totalled US$12,999,321,946.75' that year, and immediately after the announcement of devaluation of January 2010 he reported that the issuer would transfer another US$7 billion to the Fund.

Although the reform of the BCV Law prohibits internal spending of the FONDEN funds, unless these are classified as 'strategic', the control over their use has been insufficient.

According to its 2008 *Report*, the issuer's evaluation of 'fiscal management is incomplete, since it does not take into account PDVSA's social expenditure and the capital expenditure made by FONDEN'. It also admits that 'the oil boom of 2008 cannot be fully appreciated in the central government's accounts, as it would have been had it not been for the new regulation on the additional contribution which must be transferred directly by PDVSA to the FONDEN', and that the information regarding projects financed by the fund is not delivered to it by official channels, but 'was obtained directly from the FONDEN website'.

Internal spending of oil revenues took a notable toll on the money supply. The BCV recorded a 191.2% increase in the real monetary base and a 154.2% rise in real M2 between 2003 and 2007 (469.2% and 396.9% in nominal terms, respectively). As the issuer says, the government, PDVSA and other public administration bodies and institutions have a positive effect on the expansion of the monetary base. Only currency sales and, to a very small extent, the BCV helped shrink it. This growth stimulated aggregate demand, pushing up the price of goods and the parallel exchange rate. From 2005, when Venezuela posted 14.4% inflation, the inflation rate grew steadily, reaching 31.9% in 2008. It is worth recalling that 2007 was a politically difficult year, since in January the President announced his plans for constitutional reform in order to build a 'socialist' state, which was eventually rejected by a narrow margin in December of that same year. Meanwhile, Chávez's government ordered the nationalisation of major private corporations and tightened controls on mercantile activities, in February implementing a tough law against 'stockpiling, speculation, boycotting and any other conduct affecting the consumption of food or products subject to price control'. He also ordered the December reform of the Law against Foreign Exchange Crime (*Ley Contra Ilícitos Cambiarios*) of September 2005, even setting sizeable fines for 'persons or legal entities offering, advertising, disseminating in written, audiovisual, radio-electronic, computerised or any other form, financial or stock market information or currency rates other than the official value'. The delay in adjusting price controls triggered episodes of shortages of some foods during the year.

Despite the acceleration in inflation, in January 2008 the Monetary Reconversion Law came into force, whereby 1,000 bolivares became 1 *bolivar fuerte*. The US dollar went from costing 2,150 bolivares to costing 2.15 *bolivares fuertes*, although the President himself fuelled fears of a devaluation when he said, among other things, that 'it is not the same, either psychologically-speaking or in terms of concrete reality, to hear that the rate of exchange of one's currency against the dollar is 2,100 bolivares, as to hear that it is, what? One to three, one to five, one to four' (15 February 2007). The rapid rise of the parallel dollar rate from August 2008, compounded by the international financial crisis which restricted the availability of currency for sale through the usual procedures, led the government to intervene in the foreign exchange market by placing PDVSA and FONDEN dollars at the parallel exchange rate. Even though the government and PDVSA had tapped the exchange rate spread to sell dollar-denominated debt paper, the sale of currency through securities brokerage houses was equivalent to establishing a dual exchange system without actually saying so. Confirmation of this suspicion came when the US Drug Enforcement Administration (DEA), following an investigation, froze the bank account of Rosemont Corporation, a Venezuelan foreign exchange operator which, like others related to it, listed the PDVSA among its main clients.

The appreciation of the official exchange rate had its effects on Venezuela's trade with the rest of the world. In an atmosphere that was hostile to private production and with insufficient investment in state-owned companies, the currency's real appreciation helped explain the decline in non-oil exports for three years running, with 2009 the worst year of all (down 44.7%). Furthermore, the appreciation was one of the reasons for the 190.7% rise in imports between 2004 and 2008. Imports did eventually fall by 22% in 2009. The government's political position made it very awkward to announce a third devaluation. But it also made this inevitable.

Devaluation and 21^s-Century Socialism

In August 2006, without declaring himself to be openly 'socialist', Rodrigo Cabezas proposed in the National Assembly that the BCV should implement 'monetary reform' which, although consisting of no more than shifting the decimal point three places, he presented as a 'turning point in the history of the fight against inflation in Venezuela' able to 'reduce annual inflation to a single digit'. Explicitly rejecting 'pro-monetary fund' plans that included the 'liberalisation of the economy which implies privatisations, indiscriminate trade opening, financial opening, tax reforms that always end up pushing taxes higher and making them more regressive, or creating new taxes, liberalising prices and fees, and a central point of this policy is the reduction of public spending', he denied that his was a 'stabilisation or adjustment plan' of the kind that 'began and ended with currency devaluations that undermine our economies and render them poorer'. Based on his statements after the devaluation of January 2010, the difficulty of incorporating the word devaluation into the official discourse is obvious.

However, this third devaluation, as the previous two, could be the price President Chávez was willing to pay to cling to power. The bolivar's weakness is the result of the way the government financed public-spending growth, but spending may also have contributed to maintaining GDP growth between 2003 and 2008, to increasing employment, reducing poverty and inequality in the distribution of revenues and improving the values of the country's Development Index, particularly in its income per capita component. Although these results were obtained on a fragile basis, increasingly dependent on oil revenues, they may have had a decisive influence on crucial electoral triumphs of *Chavismo* in the last few years.

The President admitted at a top level workshop held in November 2004 that the first elections in which he participated (and won), in December 1998, constituted a 'tactical window' open for taking power, which he could not access through armed uprising. Although the so-called 21st-century Socialism did not feature in the President's discourse until January 2005, most of his policies were previewed in written documents of the Bolivarian Revolutionary Movement 200 (*Movimiento Bolivariano Revolucionario*, MBR-200), a civic-military group that engineered the coup in February 1992. One of these documents, the draft manifesto of MBR-200 (*Proyecto de Declaración Programático del MBR-200*), was re-published by the Ministry of Communication and Information in 2007, the year of the proposed constitutional reform. This document states the purpose of maintaining the economy subject to central planning, namely to achieve a 'varied, mixed economy, with three sectors in which the proportion of each one of them or their weighting would be altered in line with the nature, strategic importance and role of each area [using] specific economic policy measures to make it viable'. The State would be in charge of the first sector: the basic industries, including oil, gas and petrochemicals. This is where industrialisation and diversification of exports would focus. There would be a private sector, since in the society to be built 'the subsistence of the bourgeoisie within the social set is assumed'. Monopolies would have been dissolved or controlled from within, by incorporating State and workers' representatives to their executive boards. Foreign capital would be accepted only when it was 'unavoidable'. The third sector would be created by the State: the cooperative sector, 'in which the workers of the area will be a dynamic factor'. The private and cooperative sectors would be in charge of the manufacturing industries that 'would work for the internal market, except for very clearly identified exceptions', and the aim is that 'the State and cooperative sector combined have majority weighting, decisive in the country's industrial economy'.

The creation of an economy such as the one described would imply the destruction of the existing one. This is how the Statement of Motives of the presidential proposal for constitutional reform was put in 2007: 'The proposed 21st-century socialism must be seen as a process both of destruction and construction: a process of destruction of the elements of the old society that still linger (including those on which is based the logic of capital), in order to promote the ideal of establishing new relations of human co-existence based on fairness, social justice and solidarity… The substantive modification of production relations and, in particular, it is worth highlighting the permanent conflict regarding the private appropriation of work, under the premise of control by private capital of the means of production. Accordingly, in the definition of ownership of means of production it is a core element for designing a new productive model'.

Consequently, when the President asserted that the devaluation had 'various objectives: to give renewed momentum to the productive economy […], to slow down imports that are not strictly necessary and also to stimulate export policy' it was clear that he did not plan to favour the owners of the means of production.

Conclusion: The devaluation will enable the government to significantly increase its fiscal revenues, nine-months ahead of parliamentary elections. With them, the government will try to ease the effects on the fiscal accounts of oil price volatility, accentuated by the worldwide financial crisis. Although the government has announced its intention of promoting exports and substituting imports, these objectives appear to be out of reach for various reasons. Keeping controlled exchange rates at pre-devaluation levels (which were insufficient in some cases) and the threat of expropriating businesses, in some cases already carried through, has hampered and discouraged private productive activity in the middle of a recession that began in the second quarter of 2009. Non-oil public companies are being adversely affected by the delays in the necessary public funding. This is the case of electricity generation and the operating problems of base mineral and metal companies in Guyana. Furthermore, the 'socialist' project has been described as one of 'endogenous development', in which communities organised as 'communes' receive government machinery in order to produce for their communities. The scant technology and small scale of the communal companies make it impossible for them to compete with foreign production.

Furthermore, the use of revenues obtained from the devaluation, the currency exchange profits that this generates for the BCV, the PDVSA and FONDEN funds and the possible increases in oil prices will give rise to a new cycle of expansion in spending and the monetary base, inflation, real currency appreciation, widening of the exchange spread and growth of the non-tradable sector at the expense of the tradable, paving the way for later devaluations and for an increase in 2010 inflation initially estimated at 35%-40%, depending on the pace of growth in public spending and monetary liquidity.

In a context such as the current one, liable to corruption and in which all decisions hinge on the President's own interests, the deterioration of the institutions in Venezuela will very likely continue in the quest for a non-viable development model. However, social discontent and the negative outlook on the country's economic situation will no doubt be reflected in national political opinion, giving the Venezuelan opposition the chance to gain political clout following the parliamentary elections of September 2010.

Ronald Balza Guanipa
Professor of Micro-Economics at the Andrés Bello Catholic University and the Central University of Venezuela