
[Backgrounders](#)

Venezuela's Economic Fractures

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Introduction

Hugo Chavez's transformative presidency left behind an economic model that has sown deep, heated divisions within Venezuelan society. The country's oil reserves—among the world's biggest—largely sustain the state-controlled economy, in which social development and affordability for the poorest sectors of society are prioritized. But stringent currency and price controls and a thriving black market for U.S. dollars have contributed to inflation, stagnant production, and frequent goods shortages, catalyzing vocal discontent with the government's economic management. Crashing oil prices in late 2014, paired with reduced output, threaten to diminish the country's main source of income.

The oil squeeze and fears that it could trigger a default come months after mass protests rocked Caracas. A year after Chavez's death in March 2013, demonstrators railed against his hand-picked successor, Nicolas Maduro, voicing frustration over the flailing economy, soaring crime rates, and the government's crackdown on the opposition. The demonstrations—Venezuela's most intense in more than a decade—resulted in more than thirty deaths. The Maduro administration has scrambled to make economic adjustments, but analysts say these moves alone are not enough to stabilize the economy. Meanwhile, Venezuela's volatility threatens its regional relationships with oil beneficiaries and trade partners.

An Oil-Based Economy

Venezuela's powerful oil industry, helmed by the state-run petroleum company Petroleos de Venezuela, S.A. (PDVSA), underpins the economy. The industry, which sits atop the world's largest oil reserves (it surpassed Saudi Arabia in 2012), accounts for about 50 percent of government revenue, 25 percent of Venezuela's GDP, and 95 percent of its exports.

Chavez used this oil wealth to cement international relationships, selling petroleum at steep discounts to states belonging to the eighteen-member Petrocaribe alliance, including the Dominican Republic, Nicaragua, and Haiti, as well as [longtime ally Cuba](#). Under barter agreements, many of these countries export agricultural products to Venezuela, whose food production has declined since the 1990s. Venezuelan oil exports also sustain the eight-member Bolivarian Alliance of the Americas (ALBA), founded by Chavez and Cuba's Fidel Castro in 2004.

Venezuela uses its oil to repay its external debts, as it does with China, which has [loaned it nearly \\$50 billion since 2007](#). Domestically, oil subsidies provide Venezuela's thirty million citizens the world's cheapest gasoline, at about 6 cents a gallon.

Oil has been central to the trajectory of Venezuela's political economy and underpinned Chavez's political power. In their 2011 book [Dragon in the Tropics](#), analysts Javier Corrales and Michael Penfold write that "institutional changes, both prior to Chavez and in the first years of the Chavez administration, allowed Chavez to seize control over the political system and the oil industry. The subsequent oil windfall allowed him to save his government and consolidate his control."

The current cost of oil is half of what Caracas needs it to be to cover budgeted expenses. This shortfall has stoked fears of a default.

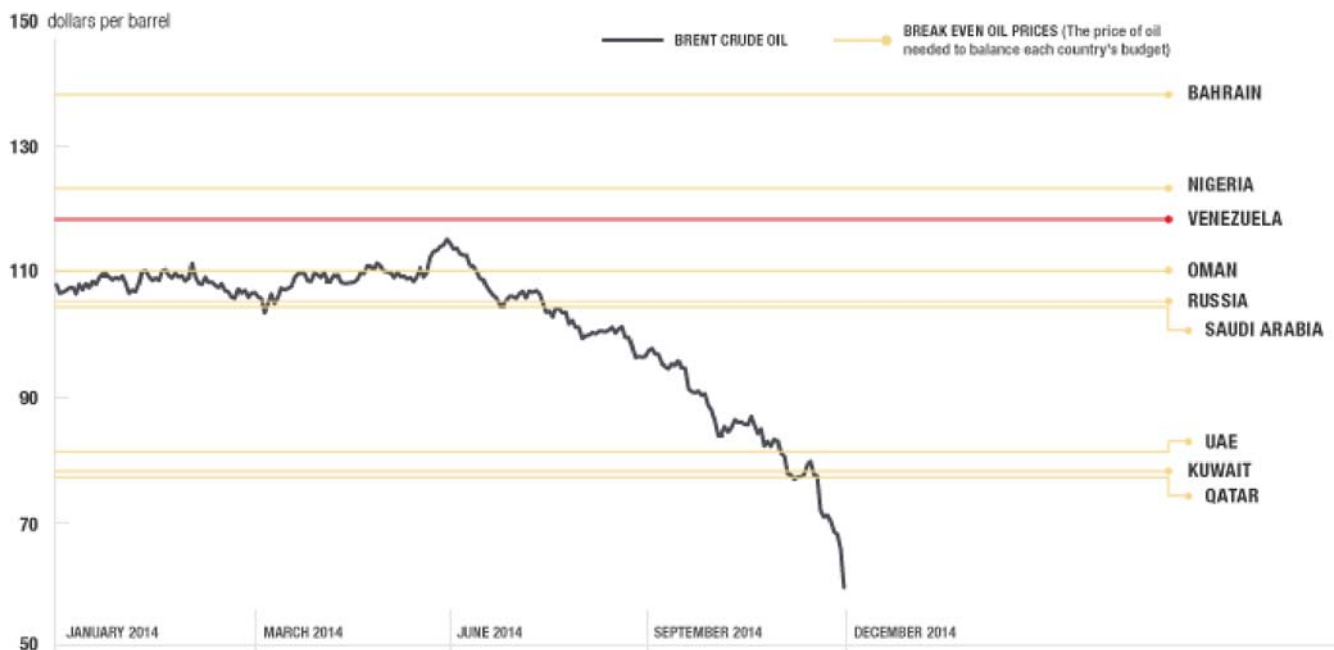
PDVSA controls all oil exploration, extraction, processing, and exports in Venezuela, making it one of the largest oil companies in the world. But as Chavez expanded his control over the oil giant, it [became a politicized body](#). The company [bankrolls](#) food and housing subsidies, medical services, and educational programs for the poor. Critics say PDVSA is grossly mismanaged, citing diminished production, a string of refinery accidents, and the addition of a hundred thousand employees to the company's bloated payroll during Chavez's fourteen-year presidency. Nationalizing multi-billion-dollar oil projects disrupted the economy and delayed payments by PDVSA to contractors have driven away workers. Some argue that diverting oil revenue into social programs rather than reinvesting it in oil operations has weakened the industry. Others say Venezuela's oil discounts and barter arrangements block cash flow to PDVSA.

Another result of the Venezuelan economy's reliance on oil has been the erosion of other productive sectors of the economy. "[The Venezuelans] make [nothing besides oil today](#)," CFR's [Shannon K. O'Neil](#) told Bloomberg TV. "What you've seen in the last ten years under Chavez and now Maduro is a hollowing out of the rest of the economy through regulations, bureaucracy, price controls, and sheer amount of expropriations of businesses. You've seen the agricultural sector decline and manufacturing decline." O'Neil said that in the 1990s 25 to 30 percent of Venezuelan exports were non-oil products; today, she said, that figure was around 4 percent.

Because the oil industry is so central to Venezuela's access to foreign currency, particularly U.S. dollars, oil prices and production greatly affect the production capacity of the country's other industries—a problem that is exacerbated by high inflation.

In December 2014, oil prices fell below \$60 per barrel, a five-year low, threatening to further derail Venezuela's economy. The drop in oil prices was largely the result of increased supply, particularly due to an influx of shale gas from North America. [Venezuela and Iran](#) appealed to fellow Organization of the Petroleum Exporting Countries (OPEC) members in November to reduce supply to drive oil prices back up, but OPEC, led by Gulf states like Saudi Arabia, demurred, keeping supply steady—and prices low—to undercut new suppliers.

FALLING OIL PRICES



Source: Deutsche Bank, EIA

Credits: Danielle Renwick, Julia Ro

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This drop in prices is felt acutely in Venezuela, where analysts say a one-dollar-per-barrel drop in world oil prices translates to [\\$700 million in lost annual revenues](#). A [Deutsche Bank report estimates \(PDF\)](#) that the current cost of oil is half of what Caracas needs it to be to cover budgeted expenses. This shortfall, paired with waning foreign reserves (at \$22 billion in December 2014, they have fallen by more than a quarter in three years), have stoked fears of a default.

A Two-Tiered Currency System

High oil prices, in addition to expansionary fiscal and monetary policies, led to average annual GDP growth of about 5 percent from 2005 to 2012. But growth slowed in 2013 to about 1 percent, reflecting increasingly binding exchange controls and supply constraints. The [IMF projected](#) Venezuela's economy would contract 3 percent in 2014 and forecasts continued negative growth in 2015.

Many barriers to increased production and investment can be traced back to strict currency-exchange controls, which keep U.S. dollars heavily restricted to the general public. The scarcity of U.S. dollars has contributed to a thriving black market for the currency, where they trade for nearly twenty times as many bolivars as the official rate offers. (The official exchange rate is 6.3 bolivars to the dollar; the black-market rate in December 2014 was 180 to the dollar.) These economic distortions have made it difficult for businesses to calculate costs and profits, and consumers face stark differences in purchasing power depending on the type of currency they hold.

Arbitrage schemes, known as *raspao*, or "big scrape," are lucrative opportunities for those with access to dollars. Erstwhile Economy Minister Rafael Ramírez said in February 2014 that [one in three dollars](#) circulating in Venezuela was misused or stolen.

Scarcity and Shortages

Price controls compound the distortions. Many consumer goods, including food and appliances, have government-mandated prices that are artificially low to make them more affordable for the poor. Maduro has expanded the list of price-controlled items and imposed a [30 percent cap](#) on all businesses' profit margins to prevent price gouging.

Low consumer prices, minimized profits, and the difficulties involved with accessing U.S. dollars and importing goods have caused businesses to halt or cut back on production and supply, resulting in shortages across industries. Several newspapers have struggled with paper shortages, leading to an [emergency loan of paper](#) from Colombia to three Venezuelan dailies in April 2014. Car manufacturer Toyota announced it was [stopping assembly operations in Venezuela](#) in early 2014 because of difficulties in importing materials. Shortages of items like milk, cornmeal, and toilet paper are frequent, and shipments of staples in short supply have resulted in notoriously long lines at supermarkets.

In many cases, it is far more profitable for importers to take government-issued U.S. dollars and trade them on the black market, or [smuggle imported goods out](#) of the country to fetch higher prices. Shortages of staples have given consumers [incentives to hoard them](#), exacerbating scarcity.

Venezuela's scarcity index, which measures the amount of basic goods that are out of stock at a given time, reached a record 28 percent in January 2014. (Since then, the Venezuelan Central Bank has stopped publishing scarcity index figures.) These shortages have also pushed up inflation, which reached an annualized [63.4 percent in September 2014](#).

Support for the Poor

Despite the economic disruptions to daily life, the Venezuelan economy has reduced poverty and inequality. A hallmark of Chavez's presidency was the implementation of social missions, which stressed human development in poor communities and provided free doctors, teachers, and social workers. With Latin America's lowest rate of inequality, Venezuela has carried strong support for the government among the

working class and poor. Between 1998 and 2012, [poverty rates fell](#) from 50 to 25 percent.

Regional Tremors

Economic instability in Venezuela poses concerns for its regional and international trade partners. Venezuela is a member of regional trade bloc Mercosur, which includes Brazil, Uruguay, Argentina, and Paraguay, and its economic woes may foster further divisions within the already fractious group. The United States also remains one of Venezuela's most important trade partners. Venezuela's [exports to the United States](#) have slowed in recent years, from \$43 billion in 2011 to \$26 billion in the first ten months of 2014.

Uncertainty over whether Venezuela will be able to continue to supply its friends with cheap oil may have been a factor in the United States-Cuba détente.

Falling oil production has put Venezuela's oil commitments to the Petrocaribe states on shaky ground, leading to delayed shipments and readjustments of exchange rates. Some analysts have speculated that [uncertainty over whether Venezuela](#) will be able to continue to supply its friends with cheap oil (Venezuela currently ships one hundred thousand barrels of subsidized oil to Cuba a day) may have been a factor in the United States-Cuba détente, announced in late December 2014.

Piecemeal Reform

Falling oil prices and speculation that it would lead to default have lowered Maduro's already-low approval ratings to [24.5 percent](#), according to a November 2014 poll by polling firm Datanalisis. Venezuelan bonds were at a five-year low, and in September Standard & Poors downgraded the country's credit rating to CCC+, Venezuela's lowest investment grade since 2002. Maduro announced in December 2014 that he planned to cut spending by 20 percent, and the government also [cut back on subsidized exports](#) to Petrocaribe countries. Experts say Maduro will likely have to devalue the bolivar and sell CITGO Petroleum Corporation, a subsidiary of PVDSA the government values at \$10 billion, to avoid default.

The late-2014 drop in oil prices has exacerbated the sluggish growth, high inflation, scarcity, skewed currency markets, and stagnant production that spurred protests earlier in the year. But critics of the government's approach say its crackdown on political opponents has complicated reforms and that it has to move beyond exchange-rate fixes. Analysts say the liberalization of exchange controls must be accompanied by tighter macroeconomic policies, meaning higher interest rates and lower government spending. These moves may entail politically risky decisions, such as [raising gasoline prices](#). But the longer the government waits to act, analysts warn, the more severe the economic pain down the road.

Additional Resources

Caracas-based journalist Girish Gupta writes about [falling oil prices and its political reverberations](#) in Venezuela for the *New Yorker*.

CFR's Shannon K. O'Neil analyzes the [oil price drop](#) on Bloomberg TV.

Javier Corrales and Michael Penfold's 2011 book [Dragon in the Tropics](#) dissects the trajectory of Venezuela's political economy during Hugo Chavez's presidency.

The Americas Society/Council of the Americas provides a [timeline of the 2014 protests](#) and rounds up expert analysis on the crisis.

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Interviewee: Jennifer McCoy, Director of the Americas Program, Carter Center

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Author:

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, Nelson and David Rockefeller Senior Fellow for Latin America Studies and Director for Latin America Studies

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, International Affairs Fellow in Residence, 2010-2011

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