The Venezuelan Economy in the Chávez Years

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July 2007

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Acknowledgements

The authors would like to thank Dean Baker, Rebecca Ray, and Dan Beeton for their comments, and Kunda Chinku for editorial and research assistance.

Executive Summary

Venezuela has experienced very rapid growth since the bottom of the recession in 2003, and grew by 10.3 percent last year. The most commonly held view of the current economic expansion is that it is an "oil boom" driven by high oil prices, as in the past, and is headed for a "bust." The coming collapse is seen either as a result of oil prices eventually declining, or as a result of the government's mismanagement of economic policy.

There is much evidence to contradict this conventional wisdom. Venezuela suffered a severe economic growth collapse in the 1980s and 1990s, with its real GDP peaking in 1977. In this regard it is similar to the region as a whole, which since 1980 has suffered its worst long-term growth performance in more than a century. Hugo Chávez Frias was elected in 1998 and took office in 1999, and the first four years of his administration were plagued by political instability that had a large adverse impact on the economy. (See Figure 2). This culminated in a military coup that temporarily toppled the constitutional government in April 2002, followed by a devastating oil strike from December 2002-February 2003. The oil strike sent the economy into a severe recession, during which Venezuela lost 24 percent of GDP.

But in the second quarter of 2003, the political situation began to stabilize, and it has continued to stabilize throughout the current economic expansion. The economy has had continuous rapid growth since the onset of political stability. Real (inflation-adjusted) GDP has grown by 76 percent since the bottom of the recession in 2003. It is likely that the government's expansionary fiscal and monetary policies, as well as exchange controls, have contributed to the current economic upswing. Central government spending has increased from 21.4 percent of GDP in 1998 to 30 percent in 2006. Real short-term interest rates have been negative throughout all or most of the recovery (depending on the measure—see Figure 4).

The government's revenue increased even faster than spending during this period, from 17.4 to 30 percent of GDP over the same period, leaving the central government with a balanced budget for 2006. The government has planned conservatively with respect to oil prices: for example, for 2007, the budget plans for oil at $29 per barrel, 52 percent under the average $60.20 dollars per barrel that Venezuelan crude sold for last year. The government has typically exceeded planned spending as oil prices come in higher than the budgeted price, so it is possible that spending would be reduced if oil prices decline.

However, Venezuela has a large cushion of reserves to draw upon before an oil price decline would begin to squeeze its finances. A decline in oil prices of 20 percent or more could be absorbed from official international reserves, which at $25.2 billion are enough to pay off almost all of Venezuela's foreign debt. This does not include other government offshore accounts, which are estimated to be in the range of an additional $14-$19 billion. With its low foreign debt (14.6 percent of GDP), the government could also tap international credit markets in the event of an oil price decline. Furthermore, a collapse of oil prices does not appear to be likely in the foreseeable future. The July 10 short-term outlook of the US Energy Information Agency projects oil prices at $65.56 per barrel for 2007 and $66.92 for 2008. The risks of unanticipated supply shocks – especially in the volatile Middle East – seem to be mostly on the downside, which would increase prices.

The Chávez government has greatly increased social spending, including spending on health care, subsidized food, and education. The most pronounced difference has been in the area of health care. For example, in 1998 there were 1,628 primary care physicians for a population of 23.4

million. Today, there are 19,571 for a population of 27 million. The Venezuelan government has also provided widespread access to subsidized food. By 2006, there were 15,726 stores throughout the country that offered mainly food items at subsidized prices (with average savings of 27% and 39% compared to market prices in 2005 and 2006, respectively).

The central government's social spending has increased massively, from 8.2 percent of GDP in 1998 to 13.6 percent for 2006. See Table 2. In real (inflation-adjusted) terms, social spending per person has increased by 170 percent over the period 1998-2006. But this does not include social spending by PDVSA (Petróleos de Venezuela, the state oil company), which was 7.3 percent of GDP in 2006. With this included, social spending reached 20.9 percent of GDP in 2006, at least 314 percent more than in 1998 (in terms of real social spending per person).

The poverty rate has decreased rapidly from its peak of 55.1 percent in 2003 to 30.4 percent at end of 2006, as would be expected in the face of the very rapid economic growth during these last three years. (See Table 3). If we compare the pre-Chávez poverty rate (43.9 percent) with the end of 2006 (30.4 percent) this is a 31 percent drop in the rate of poverty. However this poverty rate does not take into account the increased access to health care or education that poor people have experienced. The situation of the poor has therefore improved significantly beyond even the substantial poverty reduction that is visible in the official poverty rate, which measures only cash income. Measured unemployment has also dropped substantially to 8.3 percent for June 2007, its lowest level in more than a decade; as compared to 15 percent in June 1999 and 18.4 percent in June 2003 (coming out of the recession). Formal employment has also increased significantly since 1998, from 44.5 to 49.4 percent of the labor force.

The main challenges facing the economy are in the areas of the exchange rate and inflation. The Venezuelan currency is substantially overvalued. The government is reluctant to devalue because this would raise inflation, which is currently running at 19.3 percent and exceeds their target. Since there are exchange controls and the government is running a large current account surplus (8 percent of GDP), there is nothing that would force a devaluation in the near future (as for example, the currency collapses in Argentina, Russia, and Brazil in the late 1990s). But this poses an intermediate-run problem, since even if inflation is stabilized and begins to be reduced, current rates of inflation will continue to appreciate Venezuela's real exchange rate. This makes imports artificially cheap and non-oil exports too expensive on world markets, hurting the tradable goods sector and eventually becoming unsustainable. It also makes it extremely difficult for the economy to diversify away from its dependence on oil.

Inflation itself is a problem, now running at 19.4 percent. But it should be emphasized that double-digit inflation rates in a developing country such as Venezuela are not comparable to the same phenomenon occurring in the United States or Europe. Inflation in Venezuela was much higher in the pre-Chávez years, running at 36 percent in 1998 and 100 percent in 1996. It has fallen through most of the current recovery, from a 40 percent annual rate (monthly, year-over-year) at the peak of the oil strike in February 2003 to 10.4 percent a year ago, before climbing again to its present rate (see Figure 3). Over the last three months it appears to have stabilized at 19.4 percent.

Because of its large current account surplus, large reserves, and low foreign debt, the government has a number of tools available to stabilize and reduce inflation – as well as eventually bring the currency into alignment – without sacrificing the growth of the economy. It appears the government is committed to maintaining a high rate of growth, in addition to its other goals. Therefore, at present it does not appear that the current economic expansion is about to end any time in the near future.

Introduction

Like almost everything surrounding Venezuela, discussion of Venezuela's economy is almost always polarized, with emphasis generally on the negative. For example, for almost two years, major U.S. media outlets, as well as more specialized publications[1] stated that poverty had increased under the administration of President Hugo Chávez. This was false, but the media did not correct its reporting until the Center for Economic and Policy Research published a paper on the subject.[2]

This brief overview takes a look at Venezuela's economic performance over the last eight years, examining the major economic indicators, fiscal and monetary policy, the foreign sector, social spending and programs, poverty, and other policy issues. The authors hope that it will contribute to clarifying some of the important issues surrounding this controversial subject.

Economic Growth

Many accounts of the Venezuelan economy today dismiss the country's current rapid economic expansion as an "oil boom" that will end in a disastrous bust, similar to what happened in the 1970s and early 1980s.[3] It is therefore worth looking at Venezuela's growth in both current and historical perspective to see if there is any basis for this commonly held view.

Latin America as a region has suffered a sharp slowdown in economic growth in 1980, from which it has yet to recover. For the 26 years from 1980-2006, per capita GDP has grown only about 15 percent, as compared to 82 percent during just the 20 years from 1960-1980. This is the worst long-term growth performance for more than a hundred years, although the last three years have shown a significant improvement.

Venezuela was no exception to this trend, although its decline from peak GDP in 1977 was sharper than most of the region, and lasted longer. As can be seen in **Figure 1**, real GDP per capita declined by 26 percent from 1978 to 1986. It hit bottom in 2003, 38 percent below its 1978 peak.

Since the first quarter of 2003, the economy has grown by a remarkable 76 percent.[4] There are several issues that arise when looking at this growth in both current and historical perspective.

First, it must be noted that there are serious measurement problems with the data prior to 1984.[5] Without going into all of the measurement problems, there is a general problem that in an oil

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[1] See, for example, Javier Corrales, "Hugo Boss," *Foreign Policy*, January/February 2006; Jorge G. Castañeda, "Latin America's Left Turn," *Foreign Affairs*, May/June 2006; and Michael Shifter, "In Search of Hugo Chávez," *Foreign Affairs*, May/June 2006.

[2] Mark Weisbrot, Luis Sandoval and David Rosnick, "Poverty Rates in Venezuela: Getting the Numbers Right," Center for Economic and Policy Research (CEPR), May 2006: [http://www.cepr.net/documents/venezuelan_poverty_rates_2006_05.pdf].

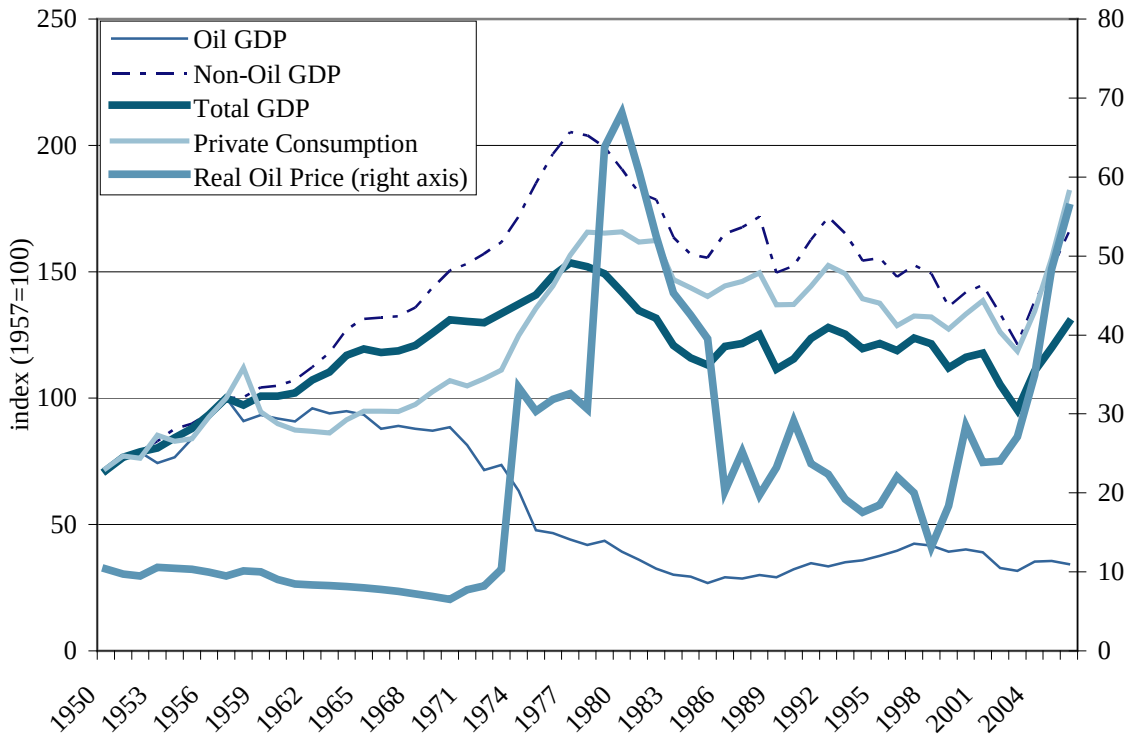
[3] See, for example, Economist Intelligence Unit, "Venezuela risk: Risk overview," Risk Briefing Select, April 27, 2007; Chris Kraul, "Chávez's grand, risky dream," *Los Angeles Times*, June 23, 2007; and Jose de Cordoba, "Land Grab: Farmers Are Latest Target in Venezuelan Upheaval," *The Wall Street Journal*, May 17, 2007.

[4] See (*Banco Central de Venezuela*, BCV) quarterly GDP series in 1997 constant prices (not seasonally adjusted) available at: http://www.bcv.org.ve/c2/indicadores.asp (under 'Agregados Macroeconomicos'). Since this is from the first quarter of 2003 to the first quarter of 2007, seasonal adjustment is not necessary.

[5] See Rodriguez (2006) for a discussion of these measurement problems. Since Rodriguez' paper was written, the Penn World Tables data was revised (version 6.2) and so the major data sets at least tell the same basic story: Rodriguez,

economy, consumption and therefore living standards can rise with the price of oil even as oil GDP declines in real terms. This is because the rising price of oil can allow the producing country to buy more internationally, even while the volume of oil produced (which is what real GDP measures) is constant or declining. In fact, during the 1970s it was precisely the decline in output from Venezuela and other OPEC nations that caused oil prices to rise. These relationships can be seen in Figure 1. From 1970 to 1985, real oil output fell by 70 percent, while consumption and non-oil GDP rose. Oil prices spiraled enormously during this period, increasing by 948 percent from 1970 to 1980.

FIGURE 1
Venezuela: Real Per Capita GDP and Consumption and Oil Prices



Sources: Banco Central de Venezuela (BCV); BP Statistical Review (2007); Federal Reserve Bank of St. Louis, Federal Reserve Economic Data (FRED); and authors' calculations.

Oil prices collapsed beginning in 1981, and the Venezuelan economy went down with them.[6] Is this sort of unraveling ahead in Venezuela, as many analysts predict? Of course, the future of oil prices is difficult to project. The July 10 short-term outlook of the US Energy Information Agency projects oil prices at $65.56 per barrel for 2007 and $66.92 for 2008.[7] The risks of unanticipated supply shocks seem to be mostly on the downside, which would increase prices. Most importantly, there is the potential for adverse supply shocks from the Middle East, where the Bush Administration has threatened to bomb Iran if the standoff over that country's nuclear program cannot be resolved; and

Francisco, "The Anarchy of Numbers: Understanding the Evidence on Venezuelan Economic Growth," Canadian Journal of Development Studies, Vol. 27, No. 4 (2006) [Available through the author's website at: http://frrodriguez.web.wesleyan.edu/docs/working_papers/Anarchy.pdf].

[6] GDP peaked in 1977, but most of this downturn came after oil prices collapsed.

[7] Energy Information Administration (EIA), "Short-Term Energy Outlook," July 10th, 2007. Available online at: [http://www.eia.doe.gov/emeu/steo/pub/contents.html].

the general risk of widening war, terrorism, or rebellion there carries an unknown risk for other major world suppliers in the region. However, there is always the risk of an unexpected downturn in oil prices. If such an unanticipated reduction in oil prices is temporary, Venezuela would seem well-prepared to withstand it. The government has about $25 billion, or about 14 percent of GDP, in international reserves. This is much more than is needed maintain a safe level of reserves for imports or other needs. As discussed below, the country also has relatively low levels of public and foreign public debt, and if necessary could borrow rather than cut government spending or public investment enough to seriously slow the domestic economy. The government also budgets conservatively for oil prices that are far below current prices: for 2006, the government budgeted for oil at $26 per barrel, whereas the average price of Venezuelan crude oil was $60.20 (see below). The probability of an economic collapse brought on by falling oil prices therefore appears to be very small.

It is also worth noting that the current economic expansion is far greater than the 1973-1977 upturn, when oil prices were also rapidly rising. As noted above, since the first quarter of 2003, Venezuela's real (inflation-adjusted) GDP has grown by 76 percent; during the 1973-1977 expansion it grew by 31 percent. This is despite the fact that oil prices actually rose even more, and to a higher level in real terms, from 1973-1980 than in their present climb from 1998. Although some of the recent expansion is clearly a rebound from the 2002-2003 oil strike/recession, there was also a significant downturn prior to the 1973-1977 expansion (see Figure 1). Thus the current economic expansion has seen rapid growth even for an "oil boom," and even given its recovery from the oil strike and recession. It seems likely that the government's expansionary fiscal and monetary policies, and perhaps other policies (e.g. exchange controls since February 2003 which have kept more capital within the country) may have contributed to the rapid growth of the present expansion.

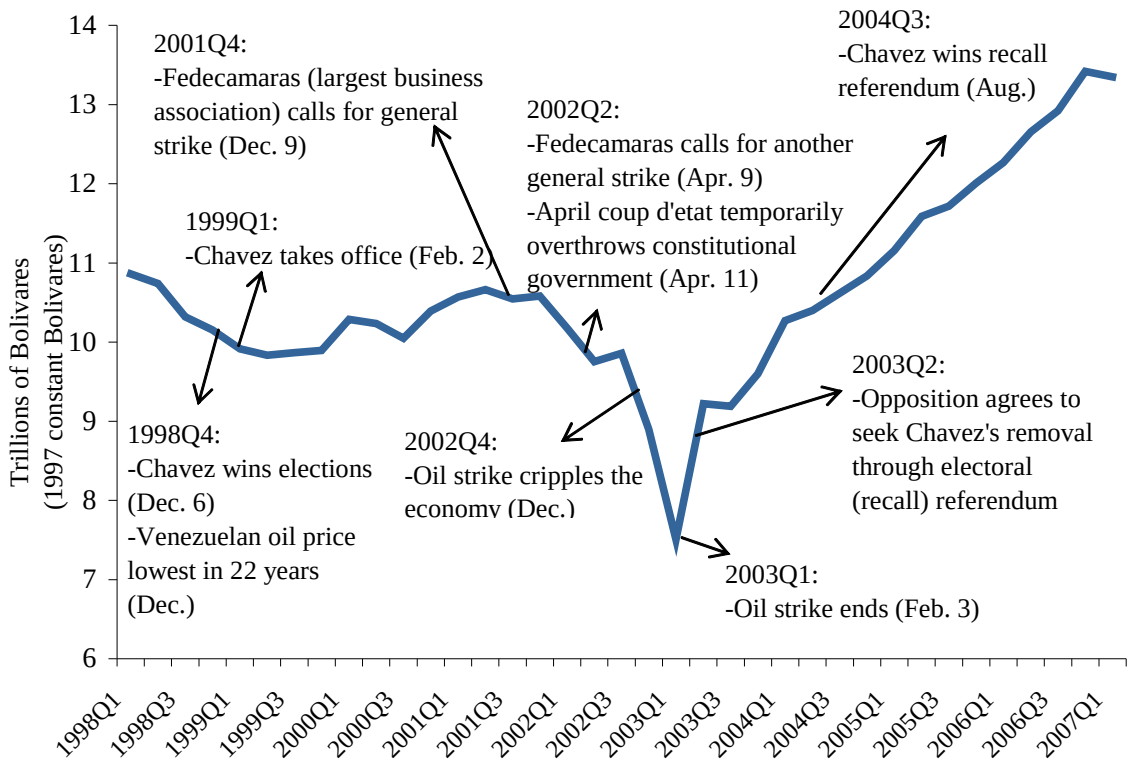
Figure 2 shows Venezuela's real quarterly GDP from 1998-2007 (first quarter)[8]. As can be seen from the graph, the trajectory of the economy appears to be very heavily influenced by external shocks, especially political instability and strikes. Chávez's first year (1999), which began with the price of Venezuelan oil at its lowest point in 22 years, was marked by negative growth. But the economy began to grow in the first quarter of 2000 and continued through the third quarter of 2001. The next few months were a period of the most extreme political instability: in December of 2001 the Venezuelan Chamber of Commerce (FEDECAMARAS) organized a general business strike against the government. This political instability, with much capital flight, continued through April 2002, when the elected government was overthrown in a military coup. The constitutional government was restored within 48 hours, but stability did not return, as the opposition continued to seek to topple the government by extra-legal means. Growth remained negative through the summer and fall of 2002, and then the economy was hit with the opposition-led oil strike of December 2002-February 2003. This plunged the economy into a severe recession during which Venezuela lost 24 percent of its GDP. The economy began to recover in the second quarter of 2003 and has grown very rapidly since then.

While some macro-economic policies may have contributed to the economy's poor performance for brief periods – for example the government's temporary pro-cyclical fiscal policy at the beginning of 2002 – it is clear that not only the price of oil but political instability played a very large role in Venezuela's business cycles over the past eight years. After the failure of the oil strike in February 2003, the opposition – especially after an agreement reached with the government in May 2003 – began to focus primarily on electoral means of dislodging the government. This culminated in a

[8] Seasonally adjusted.

presidential recall referendum in August of 2004. Thus, the political situation stabilized considerably in mid-2003 and has continued to stabilize throughout the current economic expansion.

FIGURE 2
Venezuela: Real Per Capita GDP (seasonally-adjusted)



Source: Banco Central de Venezuela (BCV) and authors' analysis.

The big upswing from the first to second quarter of 2003 was driven by the recovery of oil production that was cut off during the strike. But the economy's double digit growth continued up to the present, with the result that annual growth was 18.3 percent in 2004, 10.3 percent in 2005, and 10.3 percent in 2006. This growth has been concentrated in the non-oil sector of the economy, with the oil sector barely growing at all for 2005-2006 (see **Table 1**).

As can be seen in **Table 1**, the private sector has grown faster than the public sector over the last 8 years, and therefore the private sector is a bigger share of the economy in 2007 than it was before President Chávez took office.[9]

Table 1 also shows the sectoral growth of Venezuela's economy over the last 8 years, through the first quarter of 2007. The growth has all been during the current economic expansion – the four years from Q1 2003 to Q1 2007. The fastest growing sector during this period has been finance and insurance, which grew 240 percent during this period. Other fast-growing sectors included construction (144 percent), trade and repair services (127.5 percent), communications (99.5 percent) and transport and storage (87 percent). Manufacturing has done better than the overall economy,

[9] In 2006, the private sector's total value added was 63 per cent of total GDP, up from 59 per cent in 1999. Calculations based on constant price GDP series from the Venezuelan Central Bank (Banco Central de Venezuela, www.bcv.org.ve (last accessed on 06/18/07).

with 91 percent growth, but this is not enough growth in this sector to contribute to a process of serious diversification away from its dependence on oil.

TABLE 1
Venezuela: Real Sector (1998-2007) (real percent change)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007Q1 /a
Real GDP, total	0.3	-6.0	3.7	3.4	-8.9	-7.8	18.3	10.3	10.3	8.8
Public	-2.1	-5.2	3.0	-0.6	-11.1	-1.3	12.5	4.1	2.9	1.7
Private	1.1	-6.9	4.2	4.9	-5.8	-8.9	17.2	12.2	12.3	10.3
By Economic Activity										
Oil Sector	0.3	-3.8	2.3	-0.9	-14.2	-1.9	13.7	2.6	-1.9	-5.6
Non-Oil Sector	-0.1	-6.9	4.2	4.0	-6.0	-7.4	16.1	11.1	11.7	10.6
Mining	-7.5	-12.1	15.3	2.8	4.3	-4.4	14.2	-1.7	3.9	-4.9
Manufacturing	-1.4	-10.1	5.1	3.7	-13.1	-6.8	21.4	9.5	10.4	7.8
Electricity and Water Supply	0.5	-2.2	4.7	4.8	2.1	-0.5	8.5	8.6	6.2	4.6
Construction	1.4	-17.4	4.0	13.5	-8.4	-39.5	25.1	23.1	32.1	26.5
Trade and Repair Services	-1.5	-5.4	5.7	4.6	-13.6	-9.6	28.6	21.6	19.9	20.8
Transport and Storage	-5.2	-15.3	12.5	-1.3	-10.4	-8.0	24.6	13.6	12.3	16.4
Communications	8.2	3.6	2.1	8.1	2.5	-5.0	12.9	20.0	23.2	18.3
Financial and Insurance	0.2	-15.2	-0.7	2.8	-14.5	11.9	37.9	34.6	39.2	26.2
Real Estate	0.7	-4.7	0.8	3.5	-0.7	-6.0	11.1	7.7	8.2	6.7
Community and Personal Services and Non-Profit	0.3	-1.7	0.9	2.1	0.1	-0.3	9.4	10.0	16.3	14.8
General Government Services	-0.6	-4.8	2.8	2.5	-0.4	4.9	11.1	7.2	3.8	3.5
Other /b	3.0	0.5	5.2	1.8	-1.0	-2.9	7.2	8.0	5.1	2.9
Expenditure-Based										
Government Final Consumption	-3.1	-7.5	4.2	6.9	-2.5	5.7	14.2	9.4	7.4	4.5
Private Final Consumption	1.8	-1.7	4.7	6.0	-7.1	-4.3	15.4	17.7	18.8	19.0
Gross Capital Formation	4.4	-10.6	6.7	13.6	-34.0	-35.5	91.3	27.4	29.9	37.0
Exports of Goods and Services	3.5	-11.0	5.8	-3.5	-4.0	-10.4	13.7	4.1	-4.2	-4.1
Imports of Goods and Services	11.3	-9.3	12.4	14.1	-25.2	-20.9	57.7	36.3	31.4	42.3

Source: Banco Central de Venezuela (BCV)
Notes:
a/ Growth in first quarter of 2007 compared to the same quarter in 2006.
b/ Includes private agriculture, restaurants and private hotels and various public sector activities.

In subsequent sections, we will look at the trajectory of Venezuela's foreign and domestic debt, balance of payments, foreign exchange reserves, inflation, investment, government budget, and other indicators to assess whether there are any serious economic imbalances that would justify the prevailing view that the current expansion is headed for some sort of collapse. From what we seen so far, however, there is at least a *prima facie* case that this is not true. Rather it appears that the Venezuelan economy was hit hard by political instability prior to 2003, but has grown steadily and quite rapidly since political stability began improving in that year.

Social Spending, Poverty, and Employment

The Chávez government has greatly increased social spending, including spending on health care, subsidized food, and education. The state oil company alone was responsible for $13.3 billion (7.3 percent of GDP) of social spending last year[10].

The most pronounced difference has been in the area of health care. In 1998 there were 1,628 primary care physicians for a population of 23.4 million. Today, there are 19,571 for a population of 27 million. In 1998 there were 417 emergency rooms, 74 rehab centers and 1,628 primary care centers compared to 721 emergency rooms, 445 rehab centers and 8,621 primary care centers (including the 6,500 'check-up points,' usually in poor neighborhoods, and that are in the process of being expanded to more comprehensive primary care centers) today. Since 2004, 399,662 people have had eye operations that restored their vision.[11] In 1999, there were 335 HIV patients receiving antiretroviral treatment from the government, compared to 18,538 in 2006.[12]

The Venezuelan government has also provided widespread access to subsidized food. By 2006, there were 15,726 stores throughout the country that offered mainly food items at subsidized prices (with average savings of 27% and 39% compared to market prices in 2005 and 2006, respectively).[13] These plus expanded special programs for the extremely poor (e.g., soup kitchens and food distribution) benefited an average of 67 percent and 43 percent of the population in 2005 and 2006 respectively.[14] These do not include the 1.8 million children that were beneficiaries of a school food program in 2006, compared with 252,000 children in 1999.[15]

Access to education has also increased substantially. For example, the number of students in 'Bolivarian schools' (primary education) increased from 271,593 for the 1999/2000 school year to 1,098,489 for the 2005/2006 school year.[16] Over one million people also participated in adult literacy programs.[17]

The government has also increased its collection of non-oil taxes on businesses,[18] which had been avoiding their taxes, as is common in most of Latin America.[19]

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[10] From PDVSA's 2006 summary of financial operations. Available online at: http://www.pdvsa.com/interface.sp/database/fichero/publicacion/1792/76.PDF.

[11] For these data and more information on the impact of the 'misiones' go to: http://www.misionesbolivarianas.gob.ve.

[12] Logros, febrero 2007, SISOV, Ministerio de Planificacion y Desarrollo, available online at http://www.sisov.mpd.gob.ve/estudios/.

[13] Ministerio de Alimentacion, Memoria y Cuenta 2006 (Annual report of the Ministry of Food/Nutrition to the National Assembly).

[14] Logros, febrero 2007, SISOV, Ministerio de Planificacion y Desarrollo, available online at http://www.sisov.mpd.gob.ve/estudios/

[15] Ibid.

[16] Ibid.

[17] Update on Misión Robinson (February 16, 2007), Ministerio del Poder Popular para la Comunicación y la Información: [http://www.misionesbolivarianas.gob.ve/component/option,com_docman/Itemid,0/task,doc_download/gid,223/].

[18] Non-oil tax revenue went from 10 percent of GDP in 1999 to 12 percent in 2006 mostly due to an increase in the collection of income taxes (on individuals and companies) from 2 percent of GDP in 1999 to 3.2 percent in 2006. Data from Venezuela's Ministry of Finance (www.mf.gov.ve, last accessed on 06/18/07).

Table 2 shows the central government's social spending from 1998 to 2006. There has been a massive increase, from 8.2 percent of GDP in 1998 to 13.6 percent for 2006. In real (inflation-adjusted) terms, social spending per person[20] has increased by 170 percent over the period 1998-2006. But this does not include PDVSA's social spending, which was 7.3 percent of GDP in 2006. With this included, social spending reached 20.9 percent of GDP in 2006, at least 314 percent more than in 1998 (in real social spending per capita).

TABLE 2
Venezuela: Central Government Social Spending (1998-2006)/a

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total Public Spending	23.7	24.5	29.6	31.6	29.4	31.0	28.4	28.5	31.0
Total Social Spending	**8.2**	**9.4**	**11.0**	**12.1**	**11.2**	**12.1**	**11.8**	**11.6**	**13.6**
Education	3.4	4.1	4.5	4.8	4.8	4.6	4.8	4.1	5.1
Health	1.4	1.5	1.4	1.5	1.7	1.5	1.6	1.6	1.8
Housing	1.0	0.8	1.7	1.0	0.8	1.1	0.6	1.3	1.6
Social Security	1.4	2.0	2.2	3.4	2.8	3.4	3.1	3.0	3.6
Social Development and Participation	0.8	0.9	0.8	0.9	0.8	1.1	1.2	0.9	1.0
Culture and Social Communication	0.2	0.1	0.2	0.2	0.1	0.3	0.3	0.3	0.3
Science and Technology	0.1	0.1	0.2	0.3	0.1	0.1	0.3	0.3	0.2
Social Spending (% of Public Spending)	34.7	38.5	37.3	38.4	38.2	39.0	41.4	40.6	44.0

Source: Sistema de Indicadores Sociales de Venezuela (SISOV) and Banco Central de Venezuela (BCV)
Notes:
/a Does not include social spending by PDVSA, the state oil company, which in 2006 contributed $13.3 billion (or 7.3 percent of GDP) to social projects

The poverty rate has decreased rapidly from its peak of 55.1 percent in 2003 to 30.4 percent at end of 2006, as would be expected in the face of the very rapid economic growth during these last three years. Table 3 shows the poverty rate since 1997, by household and population. If we compare the pre-Chávez poverty rate (43.9 percent) with end of 2006 (30.4 percent) this is a 31 percent drop in the rate of poverty, which is substantial.[21] However this poverty rate measures only cash income – it does not take into account the increased access to health care or education that poor people have experienced. As we have shown previously, taking the most conservative estimate of just the value of the health care benefits – what the poor would have spent on health care in the absence of these new programs – would lower the measured poverty rate by about 2 percentage points. [22] Of course, this is a very conservative estimate of the value of just the increased health care benefits to the poor, since in the absence of these benefits, most poor people would simply have gone without health care, and therefore suffer from worse health, lower income, and lower life expectancy. So the value of these health care services is much greater than the amount that they would have spent out-of-

[19] See John Schmitt (2003), "Is it Time to Export the US Tax Model to Latin America?", Center for Economic and Policy Research. Available online at: http://www.cepr.net/index.php?option=com_content&task=view&id=391&Itemid=8.

[20] Per capita social spending is a better measure than social spending *per se* because it takes population growth into account.

[21] It is worth noting that the economy has grown for more than half a year since the last survey, so poverty would probably be somewhat lower today.

[22] Weisbrot, Sandoval and Rosnick (2006). "Poverty Rates in Venezuela: Getting the Numbers Right," Center for Economic and Policy Research (CEPR), Washington, DC: [http://www.cepr.net/documents/venezuelan_poverty_rates_2006_05.pdf]: see Table 2 and text.

pocket in the absence of the government programs. [23] The situation of the poor has therefore improved significantly beyond even the substantial poverty reduction that is visible in the official poverty rate, which measures only cash income.

In evaluating government policy with respect to poverty, it is also worth noting that sharp spike in the poverty rate at the end of 2001 (39 percent) to its peak of 55.1 percent in the second half of 2003 is overwhelmingly attributable to the opposition oil strike of 2002-2003. There is little doubt that poverty would be even lower today if not for the enormous economic damage caused by this strike.

TABLE 3
Venezuela: Poverty Rates (1997-2006)

Year /	Time Period	Households (% of total declared)		Population (% of total declared)	
		Poor	Extremely Poor	Poor	Extremely Poor
1997	1st Half	55.6	25.5	60.9	29.5
	2nd Half	48.1	19.3	54.5	23.4
1998	1st Half	49.0	21.0	55.4	24.7
	2nd Half	43.9	17.1	50.4	20.3
1999	1st Half	42.8	16.6	50.0	19.9
	2nd Half	42.0	16.9	48.7	20.1
2000	1st Half	41.6	16.7	48.3	19.5
	2nd Half	40.4	14.9	46.3	18.0
2001	1st Half	39.1	14.2	45.5	17.4
	2nd Half	39.0	14.0	45.4	16.9
2002	1st Half	41.5	16.6	48.1	20.1
	2nd Half	48.6	21.0	55.4	25.0
2003	1st Half	54.0	25.1	61.0	30.2
	2nd Half	55.1	25.0	62.1	29.8
2004	1st Half	53.1	23.5	60.2	28.1
	2nd Half	47.0	18.6	53.9	22.5
2005	1st Half	42.4	17.0	48.8	20.3
	2nd Half	37.9	15.3	43.7	17.8
2006	1st Half	33.9	10.6	39.7	12.9
	2nd Half	30.6	9.1	36.3	11.1

Source: Instituto Nacional de Estadística (INE), República Bolivariana de Venezuela.

Unemployment has also dropped sharply during the current economic recovery. As can be seen in Table 4, the unemployment rate has fallen from 18.4 percent in June 2003 to 8.3 percent in June 2007,[24] its lowest level in more than a decade. If we compare to the beginning of the Chávez administration, unemployment stood at 15 percent in June 1999. By any comparison, the official unemployment rate has dropped sharply. Of course, an unemployment rate of 8.3 percent in

[23] The alternative would be to estimate the market value of health care services received, but this would exaggerate the impact of health care on the actual situation of the poor; we have therefore used the conservative estimate described above as a lower bound of the impact of this health care spending on the poor. (see Weisbrot, Sandoval and Rosnick, 2006).

[24] The data are not seasonally adjusted, so we are comparing unemployment rates for the same month across years.

Venezuela, as in developing economies generally, is not comparable to the same rate in the United States or Europe. Many of the people counted as employed are very much underemployed. But the measure is consistent over time, and therefore shows a considerable improvement in the labor market. This can be seen in other labor market indicators. For example, employment in the formal sector has increased to 6.06 million (2006), from 4.41 million in 1998 and 4.72 million in 2003. As a percentage of the labor force, formal employment has increased significantly since 1998, from 44.5 to 49.4 percent.

As can be seen in Table 4, there has been an increase of about 1.9 million jobs in the private sector and 478 thousand jobs in the public sector since 1998. Employment as a percentage of the labor force has increased by 1.5 percentage points since 1998. Private employment was a slightly larger percentage of the labor force (75.2 percent) in 2006 as compared to 1998 (74.9 percent). However, both of these indicators probably understate the improvement in the labor market since the number of people who were out of the labor force for education – as access to education was increasing -- rose by 3.4 percentage points, relative to the labor force, during this period.

TABLE 4
Venezuela: Labor Force Indicators (1998-2007)[/a]

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
					(in thousands)					
Labor Force	9,907.3	10,225.0	10,326.6	11,104.8	11,673.9	12,008.7	12,105.3	12,108.3	12,269.6	…
Total Employed	8,816.2	8,741.6	8,960.9	9,685.6	9,786.2	9,993.8	10,417.6	10,734.0	11,104.6	…
Public Sector	1,395.3	1,319.8	1,323.6	1,416.8	1,369.2	1,402.5	1,631.7	1,715.2	1,873.5	…
Private Sector	7,420.9	7,421.8	7,637.3	8,268.8	8,417.0	8,591.3	8,785.9	9,018.8	9,231.2	…
Formal Sector	4,409.0	4,160.6	4,212.4	4,850.0	4,755.5	4,724.3	5,324.3	5,719.0	6,056.4	…
Informal Sector	4,370.4	4,578.1	4,747.8	4,832.0	5,023.0	5,262.0	5,086.3	5,014.6	5,041.6	…

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
					(% of total labor force)					
Labor Force	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	…
Total Employed	89.0	85.5	86.8	87.2	83.8	83.2	86.1	88.6	90.5	…
Public Sector	14.1	12.9	12.8	12.8	11.7	11.7	13.5	14.2	15.3	…
Private Sector	74.9	72.6	74.0	74.5	72.1	71.5	72.6	74.5	75.2	…
Formal Sector	44.5	40.7	40.8	43.7	40.7	39.3	44.0	47.2	49.4	…
Informal Sector	44.1	44.8	46.0	43.5	43.0	43.8	42.0	41.4	41.1	…
Unemployment Rate[/b]	…	15.0	14.8	13.3	16.2	18.4	15.5	11.8	9.7	8.3

Source: Instituto Nacional de Estadística (INE), República Bolivariana de Venezuela
Notes:
a/ Data correspond to the second half of every year (from the INE's biannual Household Survey)
/b Corresponds to the unemployment rate (in %) in June of every year.

Fiscal and Monetary Policy, Exchange Rates, Balance of Payments, and the Sustainability of the Current Economic Expansion

As noted previously, one of the most persistent themes in reporting on, and discussion of, Venezuela's current economic expansion is that it is an oil boom headed for collapse. Although some of these statements rely on a drop in oil prices as the trigger for Venezuela's economic collapse, many such prognostications offer little in the way of concrete explanation as to what will bring the current expansion to a halt.[25] This is quite different from predicting, for example in the United States at the peak of the 1990's stock market bubble, that stock prices would fall sharply and that this loss of wealth would cause a recession (as did actually happen). Or that the housing bubble, which appears to have peaked last year, would have to burst and that this deflation (through the wealth effect and credit impacts of falling home prices, a shrinking construction sector, etc.) will cause a recession. In these cases one can estimate the overvaluation of asset prices, the size of the expected correction, and the expected impact of such a correction on the economy.[26] But given the vagueness of this popular conception of Venezuela's expected economic troubles, it is not possible to address the argument with this kind of specificity; however, it is possible to look at the Venezuelan economy and see if there are any serious economic imbalances that threaten to cut short the current economic expansion.

Venezuela has budgeted conservatively with respect to the price of oil, and the prospect of a collapse in oil prices in the foreseeable future seems unlikely – as described above. Critics also point to the run-up in government spending as an unsustainable trend. Table 5 shows the government's finances since 1998. As can be seen, there has indeed been a very large increase in central government spending, from 21.4 percent of GDP in 1998 to 30 percent in 2006. However, revenues increased even more, from 17.4 to 30 percent of GDP over the same period, leaving the central government with a balanced budget for 2006. For 2007, the government has once again budgeted very conservatively for oil at $29 per barrel, 52 percent under the average $60.20 dollars per barrel that Venezuelan crude sold for last year. However, what the government generally does as oil revenue far exceeds the budgeted price, is to spend beyond budgeted expenditures. Thus, while a fall in oil prices will not cause a budgetary crisis, it could lead to reduced government spending from current levels. This could slow the economy from its present very rapid pace, but it is unlikely to cause a downturn, because Venezuela has a considerable cushion to deal with a decline in oil prices.

As can be seen in Table 5, Venezuela has taken advantage of the current expansion and increased oil revenues to reduce its public debt, and especially foreign public debt. Total public debt increased

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[25] For example, Domingo Maza Zavala, then director of the Central Bank, warned the *New York Times* in October 2005 of a recession as soon as 2007, without offering an explanation of how this might happen (October 30, 2005), "Chávez Restyles Venezuela With '21st-Century Socialism," *The New York Times*). Also, the IMF has projected a drastic growth slowdown for three consecutive years, which has not materialized. See Table 2 in David Rosnick and Mark Weisbrot (2007), "Political Forecasting? The IMF's Flawed Growth Projections for Argentina and Venezuela," Center for Economic and Policy Research. Available online at: http://www.cepr.net/index.php?option=com_content&task=view&id=1107].

[26] See, for example, Dean Baker (2000), "Double Bubble: The Implications of the Over-Valuation of the Stock Market and the Dollar," Center for Economic and Policy Research. [Available online: http://www.cepr.net/documents/publications/double_bubble.pdf] and; Dean Baker and David Rosnick (2005) "Will a Bursting Bubble Trouble Bernanke?: The Evidence for a Housing Bubble," Center for Economic and Policy Research. [Available online: http://www.cepr.net/documents/publications/housing_bubble_2005_11.pdf]

quite substantially through the crisis of 2002-2003, reaching a peak of 47.7 percent of GDP in 2003. But by 2006 it was down to a modest 23.8 percent of GDP. The government also transitioned away from foreign financing, leaving the external component of the foreign debt at just 14.7 percent of GDP. Goldman-Sachs projects a further decline of total debt to 20 percent of GDP, despite their projection of a growth slowdown (from 10.3 to 7 percent of GDP).[27] Total interest payments on the public debt, foreign and domestic, summed to a relatively small 2.1 percent of GDP in 2006.

TABLE 5
Venezuela: Central Government Finances (1998-2006) (in percentage of GDP)/1

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue	**17.4**	**18.0**	**20.2**	**20.8**	**22.2**	**23.4**	**24.0**	**27.7**	**30.0**
Current Revenue	**17.4**	**18.0**	**20.2**	**20.8**	**22.2**	**23.4**	**24.0**	**27.7**	**30.0**
Tax Revenue	12.2	13.0	12.9	11.4	10.6	11.3	12.7	15.3	15.8
Oil	1.3	2.2	4.2	2.5	0.9	1.5	1.8	3.7	3.9
Non-Oil	10.9	10.8	8.6	8.9	9.7	9.8	10.9	11.6	12.0
Non-Tax Revenue	5.2	5.0	7.3	9.4	11.5	12.1	11.3	12.3	14.2
Oil	4.5	4.4	5.8	6.9	9.6	10.1	9.4	9.8	12.0
Non-Oil	0.8	0.6	1.5	2.5	2.0	2.0	1.9	2.6	2.2
Total Expenditure and Net Lending	**21.4**	**19.8**	**21.8**	**25.1**	**26.1**	**27.8**	**25.9**	**26.0**	**30.0**
Current Expenditure	**16.7**	**16.4**	**17.5**	**19.3**	**19.1**	**20.8**	**19.6**	**19.1**	**22.2**
Capital Expenditure	**4.0**	**3.0**	**3.3**	**4.4**	**5.1**	**5.5**	**5.0**	**5.8**	**6.7**
Off-Budget Expenditure and Net Lending	**0.7**	**0.4**	**1.0**	**1.5**	**2.0**	**1.5**	**1.3**	**1.1**	**1.1**
Primary Balance	**-1.4**	**1.0**	**0.9**	**-1.5**	**0.6**	**0.3**	**1.8**	**4.6**	**2.1**
Overall Balance	**-4.0**	**-1.7**	**-1.7**	**-4.4**	**-4.0**	**-4.4**	**-1.9**	**1.6**	**0.0**
Financing	**4.0**	**1.7**	**1.7**	**4.4**	**4.0**	**4.4**	**1.9**	**-1.6**	**0.0**
Domestic	2.8	2.8	4.0	4.0	3.1	3.3	-0.7	-2.5	-1.3
Foreign	1.2	-1.1	-2.3	0.3	0.9	1.1	2.6	0.9	1.3

Source: Ministerio del Poder Popular para las Finanzas (MF), República Bolivariana de Venezuela.
Notes: /1 Latest data available. Subject to revision.

Thus there is plenty of room to borrow, if necessary, if Venezuela were to face an unexpected decline in oil revenues. But before having to borrow, the government could dip into its international reserves. As can be seen in Table 6 (below), the government's foreign exchange reserves, as of June 30 were $25.2 billion, or about 14 percent of GDP. This has dropped sharply from its peak of $37.4 billion last year, but it is still much larger than the country's needs, enough to pay off almost its entire foreign public debt. The recent depletion of reserves was the result of a $6.77 billion transfer to the National Development Fund (FONDEN), the creation of an offshore account by the National Treasury for PDVSA's tax payments in order to manage monetary liquidity (i.e. this is central government tax revenue held in dollars and not being spent), a significant increase in the

[27] Goldman Sachs, Latin America Economic Analyst, Issue No 07/10, May 18, 2007.

volume of currency transactions to finance imports approved by CADIVI[28], and the recent purchase of dollars from the Central Bank by PDVSA as a result of placing $7.5 billion in international bonds (i.e. money raised in bolivares and sold to the Central Bank in order to absorb liquidity). Therefore, these actions do not represent any economic trend that would be expected to further deplete reserves. Also, if we add the offshore accounts of the FONDEN and the National Treasury to the current level of international reserves, the total is in excess of $40 billion[29]– with some estimates of these total effective international reserves as high as $45 billion.[30] The government's revenue from oil last year was $28.9 billion. In the face of an unanticipated decline in oil prices, the government could therefore draw on reserves and borrowing from financial markets for some time before any serious budget cuts would be necessary. For example, if oil revenue were to decline by as much as 20 percent, this could be absorbed from reserves, which would otherwise be expected to grow over the next year.

Another common feature of the "oil boom to be followed by bust" analysis of Venezuela's economy is that government spending is fueling rapidly rising inflation, which will spin out of control. According to this theory, which also is not well specified, either the inflation itself would cause a crisis – e.g. become hyperinflation – or the government would be forced to put the economy into a sharp contraction in order to avoid or reduce dangerous levels of inflation.

Figure 3 shows Venezuela's monthly year-over-year inflation rate since 1991. As can be seen in the graph, inflation declined steadily from May 1998 to January 2002, from a 40 percent to a 12 percent annual rate. It then rose rapidly during Venezuela's worst political instability, from February 2002 to February 2003. This period included the military coup of April 2002 and most importantly, the oil strike of December 2002 to February 2003, which generated major supply shortages and pushed inflation back up to a 40 percent annual rate. After the strike ended, inflation declined steadily again for the next three and a half years, despite the rapid growth during recovery that began in the fourth quarter of 2003. But since June 2006 there has been another upswing, pushing the year-over-year inflation rate from 10.4 percent to 19.4 percent (June 2007).

The current uptick in inflation is fueled by a combination of shortages and the accumulated effects of three and a half years of very rapid growth. How serious of a problem is this increased inflation, and could it lead to an economic crisis and/or the end of the current economic expansion? First, it should be kept in mind that there is no consensus in the macroeconomic research on inflation as to how high it can go without a negative impact on growth, with some studies finding a threshold of 20 percent or more – a threshold that Venezuela is just now approaching.[31] Second, it should be

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[28] CADIVI (*Comisión de Administración de Divisas*) is the government's Currency Administration Commission, which processes applications to obtain foreign currency in Venezuela.

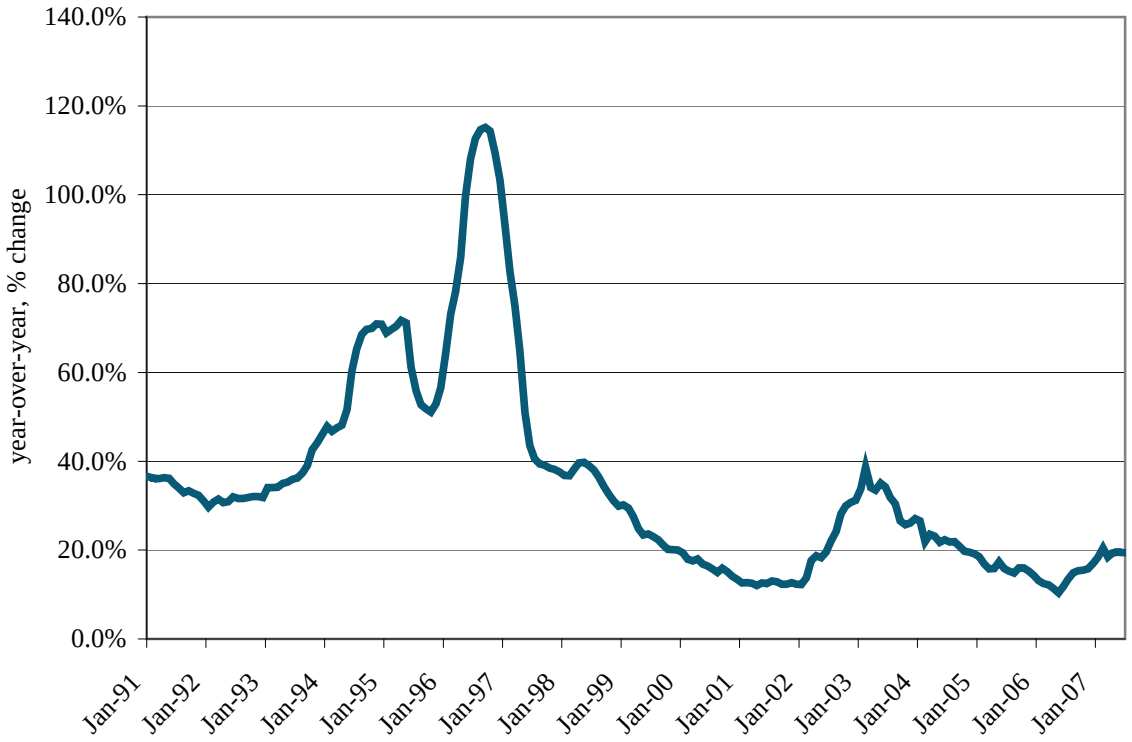
[29] This calculation is based on the sum of (a) $6.77 billion in transfer of BCV international reserves to Fonden (assuming it was all kept in foreign currency); (b) $8.86 billion ($8.85 billion and EUR 4.5 million that the Fonden had in foreign currency as of Dec. 22, 2006 [http://www.fonden.gob.ve/descargas//32/Sintesis%20Ejecutiva%20Memoria%20FONDEN%202006.pdf]; and (c) at least $5 billion in National Treasury's foreign currency denominated account for PDVSA's fiscal contribution [see, Bancaribe Monthly Reports (September 2006: http://www.bancaribe.com.ve/uploads/MENSUAL_Septiembre.pdf; February 2007: http://www.bancaribe.com.ve/uploads/MENSUAL_Febrero.pdf].

[30] Goldman Sachs, Latin America Economic Analyst, Issue No 07/14, July 13, 2007

[31] See, for example, Michael Bruno (1995), "Does Inflation Really Lower Growth?" *Finance and Development*, September; Michael Bruno and William Easterly (1998), "Inflation Crises and Long-Run Growth," *Journal of Monetary Economics*, 41, pp. 3-26; and Robert Pollin and Andong Zhu (2005), "Inflation and Economic Growth: A Cross-Country Non-linear Analysis," Political Economy Research Institute, Working Paper Series No. 109: University of Massachusetts, Amherst

emphasized that double-digit inflation rates in a developing country such as Venezuela are not comparable to the same phenomenon occurring in the United States or Europe. Inflation in Venezuela was much higher in the pre-Chávez years, running at 36 percent in 1998 and 100 percent in 1996. Although much of the public does not understand this, it is real (after-inflation) growth in incomes— and employment – that affects people's living standards, not the rate of inflation *per se*. This is true so long as inflation does not spiral to the point where it actually reduces real growth. So far, it does not appear that inflation in Venezuela is getting out of control. In the last 3 months it has stabilized at about 19.4 percent. Beginning in February of this year, the government reduced the value added tax, in an effort that probably contributed to stabilizing the inflation rate. It is also worth noting that inflation has fallen sharply through most of the current economic recovery, and has only risen over the last year. In the last year it has risen to about half of its peak in February 2003, which was driven by the oil strike of that year.

FIGURE 3
Venezuela: Monthly Inflation Rate, Consumer Prices (January 1991 - June 2007)



Source: Banco Central de Venezuela (BCV)

Furthermore, since the country is running such a large current account surplus, and the government is taking in more revenue that it can spend, it has a number of tools to fight inflation without necessarily sacrificing economic growth. One has been sterilization, whereby the government takes excess domestic currency out of circulation by issuing bonds. The recent sale of $7.5 billion worth of bonds by PDVSA in April, which were snapped up by a large number of investors,[32] are an example of the government using bond sales for this purpose. Venezuela's current account surplus

[Available online: http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_101-150/WP109.pdf].

[32] Benedict Mander, "PdVSA Issue Proves a Pioneer in the 'Democratisation' of Capital," *Financial Times*, April 12, 2007.

also gives it the leeway to defuse inflation through imports. This is what happened through most of the current economic recovery, when inflation was falling despite very rapid growth – excess domestic currency was converted into dollars and spent on imports. As can be seen in Table 6, imports tripled from their depressed level of $10.5 billion in 2003 to $32.2 billion, or 17.8 percent of GDP in 2006. But exports, fueled by rising oil prices and the recovery of oil production from the strike, grew much faster, from $27.2 billion in 2003 to $65.2 billion, or 36 percent of GDP. As a result, the country is running a huge current account surplus: it was 15 percent of GDP for 2006. In the last 2 quarters this surplus has shrunk considerably, but is still about 8 percent of GDP.

In sum, inflation has been rising over most of the last year but it is not an imminent threat to the current expansion. This is likely to remain the case so long as Venezuela maintains a large current account surplus. Nonetheless, the government will need to make sure that inflation does not begin another upward climb of the sort that has happened over the last year. Fortunately, given the government's favorable current account, international reserves and borrowing capacity, it has the ability to bring down inflation without a sharp slowdown in economic growth.

In recent months there have been reports of shortages of foods such as beef, sugar, corn oil, milk, chicken and eggs. In most cases these foods can be purchased in various black markets when they are unavailable in supermarkets and the Mercal centers. These shortages are generally believed to be at least partly a result of price controls, the rapid growth of the economy and consumption, as well as hoarding of some items. While this may become a political problem if it persists or worsens, it is something that the government can easily mitigate. Even more so than in the case of inflation, the government has the ability to ease any shortages through imports, and presumably would do so if there were a serious threat of economic or political damage.

The most serious economic imbalance is the exchange rate. The bolivar is pegged at 2,150 to the dollar; it was fixed at 1,600 in February 2003 when the government implemented foreign exchange controls. If we assume that the currency was neither overvalued nor undervalued when the exchange controls were implemented – more likely it was already overvalued – we would expect a depreciation to about 2,790 as a result of Venezuela's inflation.[33] Thus the Venezuelan currency is at least 30 percent overvalued relative to the dollar. It is worth noting that this is not necessarily overvalued to the extent indicated by the parallel market rate, where the currency has depreciated rapidly over the last year, to more than 4,000 bolivares per dollar. It is also worth noting that the parallel exchange market is relatively small as measured, for example, by the difference between total imports (goods and services) and the amount of CADIVI[34]-approved currency transactions. For 2007 Q1, total imports of goods and services amounted to $9.7 billion while CADIVI approved transactions for the same period totaled $9.1 billion, which suggests that only $583.3 million, or 6 percent of total imports (at the official exchange rate) were covered by the parallel exchange market in that period. Nonetheless the currency is still significantly overvalued. This is something that will have to be remedied if Venezuela is going to pursue a long-term development strategy that diversifies the economy away from oil. An overvalued currency discourages the development of non-oil sectors, especially manufacturing. It makes imports artificially cheap and the country's exports more expensive on world markets, thus putting the country's tradable goods at a serious disadvantage in

[33] This is based on the ratio of Venezuela's cumulative consumer price inflation since Feburary 2003, which is 98.3 percent, to U.S. inflation of 13.6 percent.

[34] The government's Commission for the Administration of Foreign Exchange.

both international and domestic markets.[35] This is a serious long-term development problem. There are also distortions and inefficiencies associated with the system of exchange controls and the parallel market.

The overvalued fixed exchange rate, combined with present levels of inflation, also presents a significant intermediate-term problem. Even if inflation is stabilized and begins to be reduced, so long as it remains at or near current levels and the nominal exchange rate remains fixed, Venezuela's currency will become increasingly overvalued. This will increasingly squeeze domestic production outside of oil and non-tradables, and would eventually become unsustainable.

Nonetheless, Venezuela's overvalued exchange rate does not present the kind of immediate threat that e.g., overvalued exchange rates in Argentina, Mexico, Brazil, or Russia presented in the 1990's, where a sudden and forced devaluation was imminent. The cost of adjustment in such situations can be quite significant, as it was in Argentina and Mexico. But the Venezuelan government has a number of options for bringing the currency to a more competitive level over time, given its large current account surplus. The government is understandably reluctant to devalue at present, when it is trying to stabilize an inflation rate that has risen sharply over the last year. But it is a problem that must be dealt with sooner or later.

Real interest rates have been negative throughout the recovery as measured by the 90-day deposit rate or most of the recovery, as measured by the lending rate.[36] This is shown in **Figure 4**. These low interest rates, combined with the government's expansionary fiscal policy, have no doubt contributed to the economy's rapid growth since the fourth quarter of 2003. It is worth noting that the government's currency controls, originally enacted in February 2003 as a means of limiting capital flight from the country, have enabled it to pursue expansionary fiscal and monetary policies while maintaining a fixed exchange rate. Thus the overall combination of macroeconomic policy has been successful at promoting rapid growth, although with an increasingly overvalued real exchange rate.

Finally, another recurring theme is that Venezuela's economic growth will be cut short from a lack of investment, as investors – both foreign and domestic – perceive the economy to be an unfavorable investment climate. Table 6 also shows gross capital formation and gross fixed capital formation since 1998. As can be seen from the totals, gross fixed capital formation stagnated from 1998-2001 and collapsed by 57 percent during the worst instability and oil strike of 2002-2003. However, it has grown enormously during the current economic expansion. It rebounded sharply in 2004, growing by 49.7 percent year-over-year in real terms. It has continued its rapid growth through the present, increasing by 37.9 percent in 2005, and 33.5 percent in 2006. For the first quarter of 2007, gross capital formation is up 27 percent year-over-year.

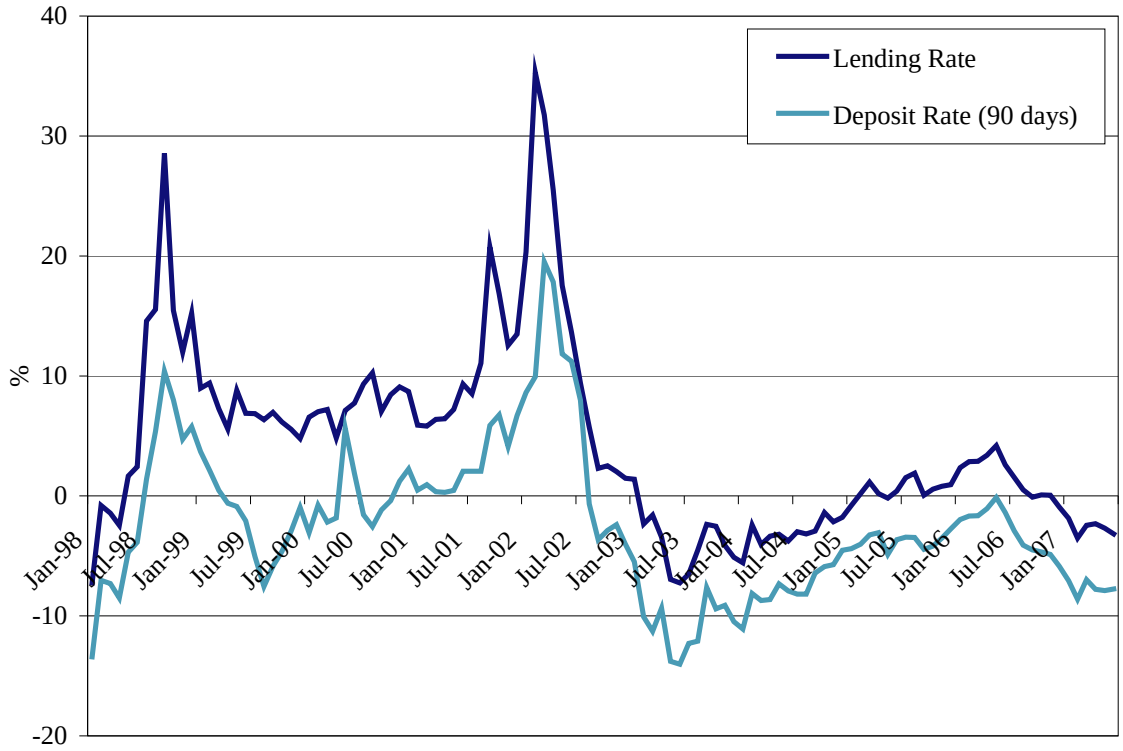
These figures do not separate public and private investment. Data for gross capital formation which does make this separation is available through 2004. In that year, gross private capital formation grew by 138.9 percent, while gross public capital formation grew by 48.7 percent. It is possible however, that private investment has not kept pace with the growth of public investment after 2004. We do know from Central Bank balance of payments data that foreign direct investment in

[35] The phenomenon of resource-exporting countries having overvalued currencies and the harmful results of such overvaluation are sometimes called "Dutch disease," from the experience of the Netherlands after the discovery of natural gas there in the 1960s.

[36] The lending rate is a weighted average of the rates charged on promissory notes and loans made by commercial banks and universal banks.

Venezuela was negative for the year 2006, for the first time in eight years of the Chávez government. This is a significant change, although not that large, as foreign direct investment in Venezuela was about 1.8 percent of GDP in 2005. But we do not know yet how much of the growth in total or fixed capital formation of the last two years has been private versus public.

FIGURE 4
Venezuela: Real Monthly Interest Rates (Annualized)



Source: Banco Central de Venezuela (BCV) and authors' calculations

But even if private investment is lagging, public sector investment has been badly neglected for decades and there is much potential there to improve the productivity of the economy – as was most famously demonstrated by collapse, and then recent repair of the Viaduct 1 bridge that was a vital part of the route from the La Guaira airport to Caracas. The government has not built a new public hospital since the 1970s. If private investment does not keep up with the economy's rapid growth, it is not clear that this will necessarily slow Venezuela's growth and development.

In the last six months, the government has accelerated its drive towards its announced goal of "21st century socialism," nationalizing the telecommunications giant CANTV and some of the country's electricity generation (which was already more than 80 percent in the hands of the government). It has also taken a majority stake in its joint ventures with foreign oil companies in the Orinoco basin. These moves have generally been portrayed as very negative not only for Venezuela's investment climate and for its economic future.

TABLE 6
Venezuela: Selected Economic Indicators (1998-2007)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
					(in US$ millions)					
Current Account	-4,432	2,112	11,853	1,983	7,599	11,796	15,519	25,534	27,167	3,662[/a]
Trade balance in goods	952	6,471	16,664	7,456	13,421	16,747	22,647	31,780	32,984	4,571[/a]
Exports, fob	17,707	20,963	33,529	26,667	26,781	27,230	39,668	55,473	65,210	13,679[/a]
Oil	12,178	16,735	27,874	21,745	21,532	22,029	32,871	48,069	58,438	12,057[/a]
Non-Oil	5,529	4,228	5,655	4,922	5,249	5,201	6,797	7,404	6,772	1,622[/a]
Imports, fob	-16,755	-14,492	-16,865	-19,211	-13,360	-10,483	-17,021	-23,693	-32,226	-9,108[/a]
Oil	-1,494	-1,446	-1,709	-1,781	-1,291	-1,342	-1,774	-1,943	-2,762	-745[/a]
Non-Oil	-15,261	-13,046	-15,156	-17,430	-12,069	-9,141	-15,247	-21,750	-29,464	-8,363[/a]
Trade balance in services	-2,649	-2,839	-3,253	-3,305	-2,909	-2,634	-3,383	-3,866	-4,259	-1,115[/a]
					(in US$ millions)					
Gross Public Debt										
Total	27,914	28,875	32,308	37,643	36,110	39,618	43,213	47,166	44,104	42,465[/b]
Foreign	23,313	22,590	21,732	22,505	22,516	24,785	27,470	31,200	27,253	26,532[/b]
Domestic	4,601	6,285	10,576	15,138	13,594	14,834	15,743	15,966	16,851	15,933[/b]
					(in % of GDP)					
Gross Capital Formation										
Total	30.7	26.5	24.2	27.5	21.2	15.2	21.8	22.6	24.7	…
Public	12.2	8.0	6.1	6.5	9.3	8.3	9.1	…	…	…
Private	18.5	18.5	18.0	21.0	11.9	6.9	12.7	…	…	…
Gross Fixed Capital Formation	28.6	23.7	21.0	24.1	21.9	15.5	18.3	20.2	22.5	…
Change in Inventories	2.1	2.8	3.2	3.5	-0.8	-0.3	3.5	2.4	2.2	…
					(real % change)					
Total	4.4	-10.6	6.7	13.6	-34.0	-35.5	91.3	27.4	29.9	37.0[/c]
Public	7.7	-19.5	-2.1	9.9	-15.4	-24.3	48.7	…	…	…
Private	1.9	-3.7	12.5	15.7	-44.0	-44.7	138.9	…	…	…
Gross Fixed Capital Formation	5.5	-15.6	2.6	13.8	-18.4	-37.0	49.7	37.9	33.5	27.0[/c]
Other										
Nominal GDP (US$ millions)	90,946	97,476	116,758	122,448	90,554	82,801	112,333	143,319	181,608	…
Average exchange rate (VEB per USD)	550	609	682	726	1,191	1,621	1,893	2,112	2,150	2,150[/d]
Average inflation rate, consumer prices (%)	35.8	23.6	16.2	12.5	22.4	31.1	21.7	16.0	13.7	19.3[/e]
Gross International Reserves (US$ millions)	14,849	15,379	20,471	18,523	14,860	21,366	24,208	30,368	37,440	25,213[/f]

Sources: Banco Central de Venezuela (BCV); Ministerio del Poder Popular para las Finanzas (MF), República Bolivariana de Venezuela.

Notes:

a/ First quarter of 2007. Not on an annual basis.

b/ Balance as of March 31, 2007.

c/ First quarter of 2007 in 1997 constant prices, compared to the same period in the previous year.

d/ As of June 30, 2007.

e/ Average for the first half of 2007, compared to the same period in the previous year.

f/ As of June 30, 2007

However, it is important to keep some perspective on these changes. The telecommunications sector was nationally owned and then privatized in the 1990s. The recently nationalized companies were compensated fully for their assets as part of the recent privatization: "I think this deal is a fair one," AES chief executive Paul Hanrahan said at a news conference in Caracas, adding that negotiations had "respected the rights of investors."[37] CANTV has a near-monopoly on land phones and internet service, and has been slow to expand access – Venezuela's internet access remains below average for the region, with 125 users per 1000 people, as compared to 156 for Latin America.[38] (This is particularly bad because Venezuela is far above average in per capita income for the region).

In the oil sector, the first round of negotiations were settled for 31 of 33 contracts, with only Total and ENI choosing to leave. Last month, most of the remaining joint ventures were also renegotiated, but Exxon-Mobil and ConocoPhillips announced that they had rejected the government's offer and are planning to pull out. Venezuela is one of the only major oil-producing states in the developing world that allows foreign investment in oil production – even US allies such as Mexico and Saudi Arabia, for example, do not. Venezuela's reserves of heavy crude in the Orinoco region are now estimated to be among the largest in the world, so foreign companies have strong incentives to stay involved. They also face increasing competition from state-run companies from countries such as China, Brazil, India, Russia, and elsewhere.

In sum, the Venezuelan government's moves toward increased state involvement in the economy have not involved any large-scale nationalizations or state planning, and have been careful not to take on administrative functions that are beyond its present capacity. As noted above, the government has not even increased the public sector's share of the economy. The central government's spending, at 30 percent of GDP, is far below such European capitalist countries as France (49 percent) or Sweden (52 percent). There is still plenty of room for both private and public investment.

[37] Steven Mufson, "AES to Sell Utility Stake To Venezuela; Chávez's State-Control Plan Nets Electric Firm," *The Washington Post*, February 9, 2007.

[38] Source: World Bank, World Development Indicators Online, last accessed on 06/06/2007.

Conclusion

In sum, the performance of the Venezuelan economy during the Chávez years does not fit the mold of an "oil boom headed for a bust." Rather it appears that the economy was hit hard for the first few years by political instability, and has grown rapidly since the political situation stabilized in the first quarter of 2003. High oil prices have certainly contributed to this growth, as has the government's expansionary fiscal and monetary policy. Containing and reducing inflation, as well as realigning the domestic currency, appear to be the most important challenges in the intermediate run; in the long run, diversifying the economy away from its dependence on oil is also a major challenge.

However, the declining public debt (as a percentage of GDP), the large current account surplus, and the accumulation of reserves have given the government considerable insurance against a decline in oil prices. This favorable macroeconomic situation has also left the government with much flexibility in dealing with inflation and the related imbalance in the exchange rate. Since the government is committed to maintaining solid growth, it does not seem likely that it would sharply curtail economic growth in order to bring down inflation, as is often done. This is especially true since it has not exhausted other alternatives. Therefore, at present it does not appear that the current economic expansion is about to end any time in the near future. The gains in poverty reduction, employment, education and health care that have occurred in the last few years are likely to continue along with the expansion.