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Venezuela: A Nation In Need of Reform

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March 2003

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Venezuela: A Nation In Need of Reform

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ABSTRACT

The Venezuelan economy is currently undergoing tremendous economic and political upheaval. However, of the Latin American countries, it was one of the least damaged by the events in 2001 and also made a steady recovery from the Asian crisis of 1997. Using a combination of economic indicators, it is shown that Venezuela's difficulties occurred not through contagion from other countries' problems but through (a) its reliance on the oil sector and (b) poorly constructed and ill-sequenced policy. Given this, the paper then explores the country's policy options and asks what can be done to make it an emerging market success.

Keywords: Currency Crises, Emerging Market Economies, Natural Resources.

Introduction

In recent years, the Latin American countries making the headlines have primarily been Argentina, Mexico and Brazil, each enduring their own economic crisis. Only relatively recently has attention been diverted to Venezuela. It too is a country experiencing economic and political upheaval yet it is distinctly different from its Latin American counterparts. This is a story of missed opportunities by a country which could have benefited from investor sentiment in the post Asian crisis period. Instead, the evidence suggests that its current difficulties are largely of its own making.

Venezuela is rich in terms of its natural resources particularly oil deposits. It is the fifth largest oil exporter in the world and hence oil is pivotal in the economy giving it tremendous economic power. However, these rich endowments have been both a blessing and a curse. In times of recovery, oil resources have quickened the move out of recession and into boom. Conversely, growth has slowed in periods of oil price decline and the country has been drawn into recession. It follows that oil prices have underpinned the relative performance of the economy and determined its fortunes over the years.

By contrast, while the Venezuelan economy has been greatly influenced by oil prices, it was one of the least damaged by recent events in neighbouring countries and so this provokes debate as to what caused Venezuela’s recent problems. This article considers Venezuela’s financial vulnerability in the post-1997 era and discusses the extent to which it was subject to “contagion” from other countries’ ills. It emerged from the Asian crisis and more recently, Argentina’s debt default, in a favourable position yet poor policy making and subsequent strikes have been at the root cause of the country’s recent ills.

The article is organised as follows. First, there is an outline of the Venezuelan economy detailing its political and economic history and describing the important policy measures of the last two decades. This provides a background to the next section which considers the issue of financial vulnerability. Without providing a detailed technical analysis, it considers the degree of vulnerability of Venezuela since the Asian crisis of the late 1990s. Also included in this section are some statistics relating to other countries in the region to give an idea of how Venezuela lay in relation to the other Latin American countries. In the light of this, the article then concludes by considering the way forward for Venezuela. It discusses some of the options facing the government particularly in terms of capital controls and choice of exchange rate regimes.

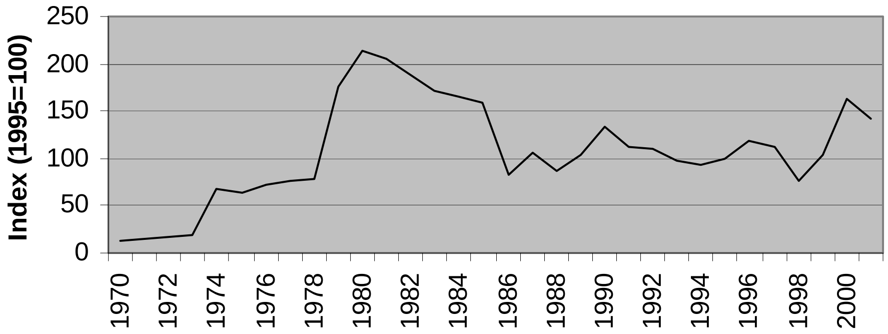
Background

There are two recurring themes in a discussion of Venezuela in the last three decades. The first concerns its rich endowments of natural resources. Venezuela is renowned for its large deposits of oil as well as coal, iron ore, bauxite and gold. In the early 1900s it was the world’s largest exporter of oil. Currently, it ranks as the fifth largest and is an OPEC member. This however has led to an over-dependency on its oil industry making Venezuela vulnerable to oil price shocks over the years.[1]

The second main feature concerns policy making. Disappointing economic performance throughout the period has been attributed to a poor choice of policies. Coupled with this is a very uneven distribution of the country's wealth with an estimated 85% of the population living in poverty. The end result has led to civil unrest and national strikes in recent months, the impact of which is yet to be fully realised.

In the last thirty years, the economy has been characterised by periods of boom and bust led primarily by oil prices (See Figure 1). The oil price boom in 1973-4 led to demand-driven growth in the economy and strengthened the currency against the US dollar producing an all-time high in the level of the exchange rate. There was also a second round of oil price increases in 1979-80. However, by the mid 1980s, the economy was falling into recession following a dramatic fall in world oil prices. As a consequence, Venezuela experienced negative growth in the 1979-85 period (as seen in the steady decline of the GDP index in Figure 2). In addition, prices were rising. Not surprisingly, this was followed by a period of unrest and by late 1980s the country was experiencing deep depression and was the recipient of an IMF loan.

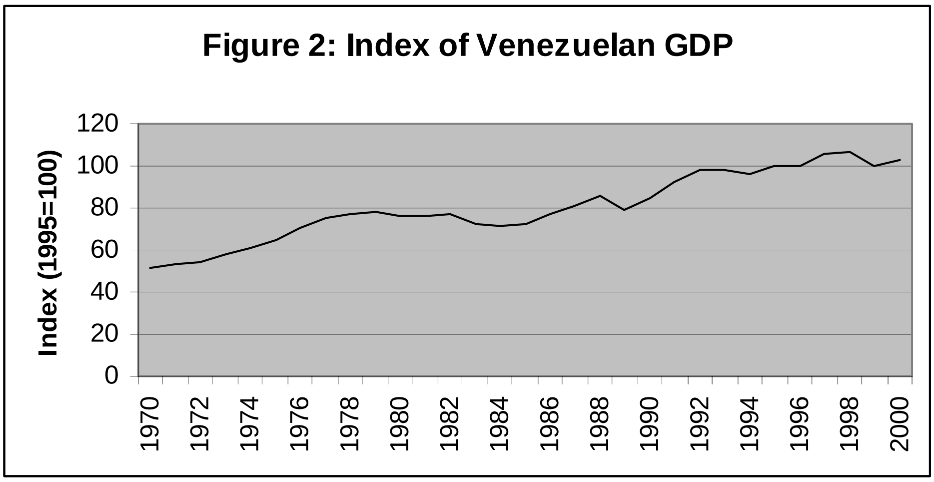
Figure 1: Index of World Average Crude Petroleum Prices



Source: IMF International Financial Statistics.

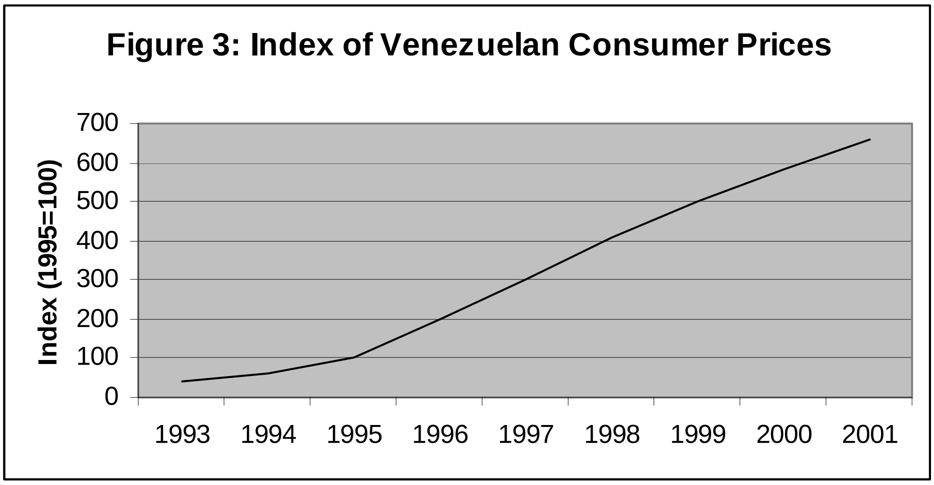
As a consequence the government carried out an expansionary policy between 1986 and 1988. This caused a temporary rise in growth but the effect was short-lived and soon inflation was once more on the rise with nationwide shortages developing. The exchange rate was pegged at the time and hence this also implied a fall in international reserves.

[1] Cuevas (2002) shows a strong statistical association between Venezuela's real GDP and the real price of oil. He also more disturbingly points out that while this association is still strong, it is not as major as it was in the early 1980s and hence Venezuela must not rely on it for its future growth. Policy should then be directed at export diversification.



Source: IMF International Financial Statistics.

Political unrest continued throughout the 1990s with two attempted coups in 1992 led by the future leader, Colonel Hugo Chavez. In 1993, Ramon Jose Velasquez became interim president since former president, Carlos Andres Perez, was ousted on charges of corruption. Political instability also coincided with falling export prices and a major domestic banking crisis which led to deteriorating economic conditions during 1993 and 1994. Non-oil GDP plummeted, inflation accelerated and once more there was a decline in international reserves. The government responded in early 1996 with a program of exchange rate measures (later to be replaced by a system of exchange rate bands), liberalised interest rates, the abolition of most price controls and an adjustment in domestic fuel prices.



Source: IMF International Financial Statistics.

The ensuing recovery in growth was at the expense of high inflation and unemployment. This meant that the economy was poorly placed when recession hit in 1998. Again, this was led by falling oil prices and exacerbated by a high domestic real interest rate. Chavez came to power in that year and inherited a country in disarray. Real wages had fallen by approximately 23% over the 1990s affecting all sectors of the economy including the oil sector and unemployment was on the increase.

The problem of oil dependence is all apparent when looking at its impact over the decade (World Bank Country Brief September 2000). The share of oil GDP in total GDP rose from 21% in the early 1990s to 26% in the latter half of the decade. Conversely, the share of agriculture in total GDP dropped from 6% in 1990 to 4% in 1999 while the share of manufacturing fell from 13% to 10%. Furthermore, the share of non-oil exports remained below 25% for the period in question thus illustrating a lack of export diversification from the oil sector.

On gaining power Chavez implemented an array of economic policies. First, he limited public sector wage increases to an average of 17.5% in order to reduce the rate of public expenditure. Second, he made cuts in government investment. He also increased public sector revenues by lowering the sales threshold of firms subject to Value Added Tax. He reduced oil production in order to increase oil prices in international markets in an attempt to boost growth. Finally he pledged to maintain the exchange rate within a band system.

As a consequence the outlook in 2000 was cautiously optimistic. Oil prices rose throughout the period thus giving the government the opportunity to fuel an economic recovery. GDP grew throughout the year in contrast to 1999 which saw a fall of 7.2%. While Venezuela still faced ongoing problems with inflation, it was considered well placed to face the new millennium. However, at this point, poor policy making choices were made and the economy was plummeted not just into recession but into civil unrest.

The slowdown of 2001 varied across Latin countries. Venezuela faired best of its counterparts with growth of 3%. By contrast, Brazil managed between 1 and 2%, Mexico saw little or no change and Argentinian output declined for the third year running (Krueger, 2002). However, in November 2001 in the midst of the Argentinian economic crisis, Chavez put into place sweeping reform laws particularly concerning land and the oil industry. The intention was to restructure investment within Venezuela. However, essentially it gave the government more control and the right to expropriate land deemed unproductive. This led to widespread protests demanding among other things the sacking of the state oil monopoly leaders.

Furthermore, in early 2002, at a time when both Argentina and Brazil were experiencing exchange rate crises, Chavez floated the currency and disbanded the exchange rate controls used to defend the Bolivar. The currency immediately dropped 25% against the US dollar further exacerbating political tension. The discount rate was then raised to defend the currency and reached a high of 50% during January and February. The rest of 2002 saw continued upheaval with a general strike and the resignation of Chavez. He was subsequently reinstated to office two days after his resignation but the unrest continued.

December 2002 saw the start of a prolonged nation wide strike aimed at forcing Chavez from office. Its impact was severe. Oil production was estimated by Standard and Poor’s to be 3 million barrels per day prior to the strike; 75% of which was exported. By mid-January 2003, it was thought to be approximately 500 000 per day. This represents a considerable loss given that oil accounts for about half of total government revenues and a third of gross domestic product (Hale, 2002).

Furthermore, almost all of the country's foreign investment is aimed at the energy industry hence losses were incurred in multiple areas.

The strike continued throughout January 2003 bringing the economy to a standstill. Currency trading on the Bolivar was suspended since the central bank was spending $70 million per day in an attempt to support the failing Bolivar. In addition OPEC agreed on an increase of 1.5m barrels of oil per day to avoid any sharp changes in the price of oil as a consequence. On the domestic front, intense discussion then followed regarding the next course of action.

Venezuela's Financial Vulnerability

There is already a vast literature discussing the causes of currency crises. For an excellent summary of this extensive literature see Pesenti and Tille (2000). However, with the onset of the Asian crisis and also the ongoing problems experienced by Latin America, the focus is now on financial vulnerability and finding those key indicators which identify whether a country is heading towards crisis. A country is classed as financially vulnerable (Perry and Lederman, 1998) if there is a high probability of a successful speculative attack against the currency. Without providing a detailed technical analysis, this section assesses the degree of vulnerability of Venezuela in the post Asian crisis period based on a combination of economic indicators.

In the case of the Asian crisis, financial vulnerability produced symptoms of real exchange rate appreciation, export slow-down, rising current account deficits, high short term obligations relative to reserves, unhedged currency mismatches and credit booms with asset price bubbles. The end results for the Asian countries were insolvent financial institutions and a liquidity crisis.

For this reason, the indicators used need to capture both movements in the current and capital accounts plus more general measures of the country's overall health. The indicators used to establish the state of the current account are exports, imports and the real exchange rate. A fall in exports, increase in imports and real appreciation of the domestic currency are indicative of potential problems in the current account.

The indicators used to establish the health of the capital account are (a) the proportion of foreign exchange reserves to money stock, M2 and (b) foreign currency exposure as a proportion of M2. A drop in reserves is a sign of potential future difficulties in the capital account as is a small net foreign asset position. Measures of output, interest rate and share prices are also given since a fall in output and the stock market index is also indicative of an impending crisis whereas a rising interest rate can be a sign of exchange rate difficulties. A final indicator which is perhaps the most revealing is based on the Emerging Market Bond Index (EMBI). This provides a measure of investor sentiment. A large spread is indicative of adverse investor sentiment and a possible forthcoming crisis.

Current Account Indicators

As seen in Table 1, Venezuela's real exchange rate appreciated throughout the 1997-2001 period indicating a country with potential current account difficulties.[2] However, the degree of appreciation slowed between 1999 and 2001 suggesting that the real exchange was at least stable. A further investigation of the current account reveals export revenues which gained strength rather than fell in the post Asian crisis period. Why? To answer this, an extra column has been added to the table showing petrol export revenues for Venezuela. Throughout, the period, this has dominated the country's total exports. Furthermore, Figure 1 shows that in the 1998-2000 period, world prices rose. Hence it follows that export revenues would follow suit. Import revenues remained stable between 1997 and 2000 with a small increase in 2001 but nothing of great concern. In short, for Venezuela the gap between its export and import revenue increased between the Asian crisis and 2001. In these terms then there was not overwhelming evidence of financial vulnerability, just an over-reliance on its oil industry for exports.

The opposite may be said of Argentina and Mexico where import revenues outstripped exports for the entire period. For Brazil export revenues exceeded imports but only by a small margin. However, their real exchange rates tell a very different story. For both Argentina and Brazil there is a real depreciation in the exchange rate throughout the period. Since both these countries hit economic crisis during this time, this warrants further attention. Brazil had considerable success in its policy of inflation targeting between 1994 and 1998. Hence while we see evidence of inflationary build-ups later in the period, this may explain the trend in the real exchange rate. Table 1 also provides figures for CPI. Notably, Argentina experienced deflation during this period hence the depreciation in the real exchange rate. Mexico, like Venezuela, experienced real exchange rate appreciation thus calling into question its financial vulnerability.

Capital Account Indicators

Indicators for the capital account place Venezuela favourably in comparison with its counterparts. Consider the proportion of reserves relative to money stock. For Venezuela there is a steady decline between the crisis of 1997 and 2001. However, as can be seen, the ratio is considerably higher than for the other three countries. One might therefore say that this decline is indicative of some uncertainty but nothing in comparison with its neighbours.

A further indicator is the degree of foreign currency exposure as seen in net foreign assets as a proportion of M2. For Venezuela this actually increased in the late 1990s, reaching a peak in 1999 but dropping in the following years. It has, however remained positive throughout. This cannot be said of Argentina or Brazil both having experienced negative net foreign assets. Mexico's position is strongest here but notably, the change in net foreign assets exhibits volatility.

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[2] The nominal exchange rate is expressed as the domestic price of foreign currency. This means that a rise in the index indicates a depreciation of the *real* exchange rate while a fall is an appreciation.

General Indicators

Table 1: A Comparison of Economic Indicators for the Latin American Countries

Venezuela					
Year	***Export Revenue (Millions US$)***	***Petrol Export Revenue (Millions US$)***	***Import Revenue (Millions US$)***	***Total Reserves-Gold/M2***	***Net Foreign Assets/M2***
97	21624	18186	13159	0.865	0.035
98	17193	12021	14250	0.696	0.043
99	20190	16295	12670	0.682	0.060
00	31802	26772	14606	0.637	0.042
01	27409	22112	16236	0.425	0.026
	GDP Index (1995=100)	***CPI (1995=100)***	***Share Prices (1995 = 100)***	***Real Exchange Rate (1995=100)***	***Discount Rate (% p.a.)***
97	106.16	299.89	162.99	61.08	45
98	106.34	407.2	173.02	51.14	60
99	99.87	503.18	85.59	48.56	38
00	103.1	584.72	82.89	46.63	38
01	-	658.01	133.91	46.46	37
02	-	-	84.77	-	-

Argentina					
Year	***Export Revenue (Millions US$)***	***Import Revenue (Millions US$)***	***Total Reserves-Gold/M2***	***Net Foreign Assets/M2***	
97	26370	28553.3	0.288	-0.043	
98	26441	29557.8	0.289	-0.053	
99	23333	24129	0.294	-0.088	
00	26409	22052	0.278	-0.069	
01	26655	19148	0.200	-0.125	
	GDP Index (1995=100)	***CPI (1995=100)***	***Share Prices (1995 = 100)***	***Real Exchange Rate (1995=100)***	***Discount Rate (% p.a.)***
97	114.09	100.68	145.93	104.63	6.63
98	118.48	101.61	144.17	105.28	6.81
99	114.47	100.43	104.78	108.84	6.99
00	113.57	99.48	155.95	113.59	8.15
01	108.51	98.42	144.16	118.07	24.9
02	-	-	57.79	-	-

Source: IMF International Financial Statistics. The share price index is based on the S&P/IFCG Index taken from Datastream. A dash (-) indicates that the data is not available at the time of writing.

Table 1 (continued): A Comparison of Economic Indicators for the Latin American Countries

Brazil					
Year	***Export Revenue (Millions US$)***	***Import Revenue (Millions US$)***	***Total Reserves-Gold/M2***	***Net Foreign Assets/M2***	
97	52994.3	59744.4	0.223	-0.066	
98	51139.9	57743.9	0.184	-0.038	
99	48011	49214	0.207	-0.066	
00	55085.5	55744.7	0.202	-0.079	
01	58222.6	55578.1	0.236	-0.068	
	GDP Index (1995=100)	***CPI (1995=100)***	***Share Prices (1995 = 100)***	***Real Exchange Rate (1995=100)***	***Discount Rate (% p.a.)***
97	106.02	123.78	122.06	98.26	45.09
98	106.25	127.74	123.01	104.46	39.41
99	107.09	133.95	53.00	150.59	21.37
00	107.94	143.37	119.67	158.45	18.52
01	-	153.2	128.59	181.41	21.43
02	-	-	83.75	-	-
Mexico					
Year	***Export Revenue (Millions US$)***	***Import Revenue (Millions US$)***	***Total Reserves-Gold/M2***	***Net Foreign Assets/M2***	
97	110431	109808	0.259	0.018	
98	117460	125373	0.298	0.040	
99	136391	141975	0.252	0.041	
00	166367	174500	0.300	0.037	
01	158547	168276	0.317	0.081	
	GDP Index (1995=100)	***CPI (1995=100)***	***Share Prices (1995 = 100)***	***Real Exchange rate (1995=100)***	***Discount Rate (% p.a.)***
97	112.27	162.1	134.72	68.73	21.91
98	117.76	187.91	155.60	73.54	26.89
99	122.16	219.08	110.94	62.11	24.1
00	130.27	239.88	185.28	59.01	16.96
01	129.91	255.14	181.23	54.49	12.89
02	-	-	196.33	-	-

Source: IMF International Financial Statistics. The share price index is based on the S&P/IFCG Index taken from Datastream. A dash (-) indicates that the data is not available at the time of writing.

The share price indices show the same basic pattern for each country, namely a rise just prior to the Asian crisis and then a dramatic tumble in 1999. After a further fall in

2000, Venezuela then made a recovery in 2001 climbing 61.5% on the previous year's level. The Mexican index having recovered in 2000 fell in the 2000-2001 period as did that of Argentina. The Brazilian share price index meanwhile climbed by a modest 7.5%. At this stage then, Venezuela could have consolidated its gain by prudent policy choices and hence seen further increases in its shares in subsequent years. However, as the figures show, share prices tumbled in 2002 as a consequence of poor policy making and civil unrest. Likewise, Argentina's market collapsed in 2002 as did that of Brazil. Mexico was the only country of this group to experience an increase in that year.

This should be viewed alongside the other indicators of interest rate and prices. Venezuela experienced an ongoing struggle with inflation as reflected in the consumer price index. This managed a steady increase throughout the period matched by an equally high discount rate. One may argue that while this is unsatisfactory, it is at least stable. Argentina, by comparison maintained a steady price level throughout the period matched by a moderate discount rate until 2001. At the time of its currency crisis, the interest rate shot up to 24.9%. Brazil and Mexico also experienced moderate inflation levels but discount rates which have been both high and volatile. In this sense, Venezuela compares poorly with the other three countries.

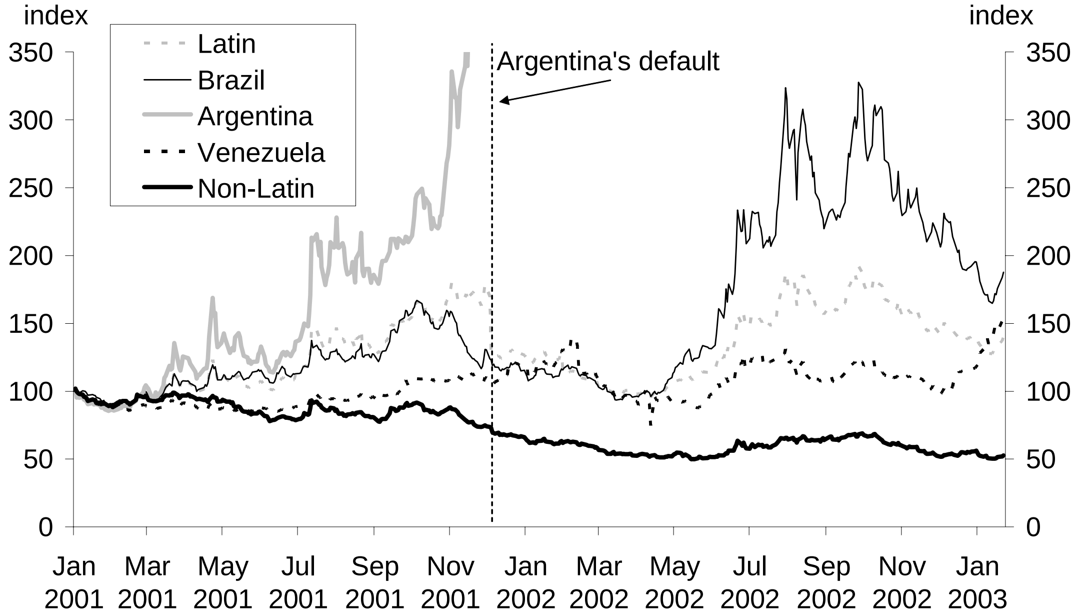
Disappointingly, GDP figures from the IMF for Venezuela are only available up to 2000. However, they still show a drop in 1999 but a subsequent recovery in 2000. Figures for 2002 and 2003 will also reflect the impact of the nationwide strike and are expected to reduce GDP considerably. Argentina's figures meanwhile show a peak in 1998 but steady decline throughout the rest of the period. Brazil also shows only a very marginal gain with Mexico the only country of the four to have a steady climb post 1997.

The evidence thus far suggests that Venezuela felt the impact of the Asian crisis but then started to recover thereafter. It also reveals a specific set of problems facing the country i.e. its high and persistent level of inflation coupled with an appreciating real exchange rate. However, the current conditions in terms of EMBI spreads tell a very interesting story and highlight the fact that Venezuela missed an opportunity for development in the post Asian crisis period. Figure 4 shows an index of interest rate spreads (Emerging Market Bond Indices) on bonds in the emerging markets of Latin America for the years 2001-2003. They are recalibrated so that the base year is January 2001 thus allowing a comparison to be made across the countries in the region. An increase in this index implies that the bond spread is getting larger and hence that investor-sentiment in the country is deteriorating. Therefore a rise in the index implies an adverse change in sentiment for the bonds of that particular country.

Clearly, at the time of the Argentinian debt default in 2001, the spreads for Venezuela and Brazil were not increasing at an excessive rate thus suggesting that they were in no immediate danger from speculative attacks. However, by late 2002 indices for all of the Latin American countries were on the increase with Venezuela in particular demonstrating a sustained fall in investor sentiment.

This tells us two things. First, it confirms the view that investors are learning to distinguish between countries in a region in a time of crisis (Vogel, 2001). Second, the rise in Venezuelan spreads coincides not with other events in the region but with its own domestic difficulties. Thus the unrest and nationwide strikes have precipitated an adverse response from investors. In short, its problems have been country specific.

Figure 4: A Comparison of Latin American Emerging Market Bond Spreads



Source: JP Morgan

Policy: Which Way Forward?

Current policy in Venezuela is based on emergency measures. The Bolivar's rate has depreciated rapidly and hence it has been fixed with a trade ban extended in order to try and boost foreign exchange reserves. These have depleted considerably. By January 2003, international reserves had dropped to a level of $13.6 billion. Since Chavez came to power in 1999 approx $35 billion have left the country with the government recently spending up to $70 million per day supporting the currency. This has raised concerns of an impending debt default (Venezuela currently has $22.4 billion of foreign debt) and hence the need to stem this outflow of capital. As a consequence, Chavez now plans to put in place controls on financial transactions based on the Tobin tax. Clearly, this is an economy in need of some long term policy reforms.

A lot has already been written on the potential policy measures for emerging market economies in general. However, very little has focused on the specific case of Venezuela. Instead of regurgitating the current literature, I focus on how it relates to the case of Venezuela. There are two main issues currently up for debate; (a) the choice of exchange regime for the country and (b) the use of capital controls. Each of these issues has been tackled by Eichengreen (1998, 2002) and the salient points will be raised here.

Exchange Rate Policy

Venezuela faces three basic options. First, it could fix its currency either by a currency board or, in the case of Ecuador, dollarising. Second, it can go for complete flexibility in the exchange rate (as in the case of Brazil). Alternatively it can opt for something in the middle ground. The crucial point noted by Bird (2002) is that the choice of exchange rate should reflect the particular country's characteristics. Furthermore, the appropriate exchange rate will differ across time according to the circumstances facing that country. This suggests a need to distinguish between emerging market economies and not put them all into one category. In doing so, there are a number of key features of the Venezuelan economy which may help in identifying an appropriate exchange rate.

First, as with many emerging market economies, it is subject to higher exchange rate pass through. This means that a change in the exchange rate will impact quickly on import prices and hence on to domestic prices and the inflation rate. In terms of Venezuela this poses a serious problem since the country is already prone to a high and persistent inflation rate implying that it is more sensitive to expected changes in prices. The recent depreciation of the Bolivar has been testament to this since it has exacerbated an already large inflation rate. This is also an argument against the use of a flexible exchange rate in Venezuela at present. Flexible rates are renowned for being erratic and fluctuating considerably thus leaving prices vulnerable to volatile exchange rate movements.

Second, Venezuela, like others, is commodity price sensitive. Fluctuations in the world price of oil have dramatic impacts on domestic prices as has been discussed in an earlier section. An upward movement in the oil price level has led to increased GDP and the chance for growth. However, the country has also been exposed to sharp drops in price plunging it into recession. Clearly, this makes inflation targeting difficult and exposes the economy to both inflationary and GDP volatility.

A third feature is that of liability dollarisation. Countries with dollar denominated debt but assets in domestic currency suffer severe balance sheet effects as a consequence of exchange rate depreciation. This is yet another argument against the use of a flexible exchange rate at present in Venezuela. While its exposure is not as great as that of Brazil or Argentina (see Table 1), it still poses a considerable problem for the country.

Fourth, and perhaps the most vital characteristic at present is the lack of policy credibility. It is well documented (Eichengreen, 2002, among others) that countries lacking central bank independence and thus credibility are historically those that struggle to attain an independent monetary policy. If it is apparent to the markets that the government is not committed to fighting inflation (or indeed other pre-announced proposals) any shock hitting the country will cast doubt as to the government's willingness to stick to its plans. Firms will thus not react by appropriate price changing measures and the desired impact on inflation will not be attained. The implication here is that shocks to the system impacting on interest rates, exchange rates or international capital flows will have knock-on effects on other financial variables thus generating destabilising effects on output.

This therefore raises the question of what can be done to achieve credibility. There are a number of different avenues which Venezuela needs to explore. First, as mentioned above is central bank independence. The task is to overhaul the financial system so as to attain a central bank whose decision making is absent of political suasion. In principle this should be easy. It is, after all, a matter of passing a law establishing central bank independence and then appointing appropriate governors to long term positions in office. However, in practise this is fraught with difficulty for a country in which institutions have been run according to political ideals.

Related to this is the need to demonstrate transparency in policy making in order to enhance credibility throughout markets. One possible way forward is to produce an Inflation Report as in the case of Mexico and Brazil in order to convince investors that the central bank is committed to its policy. However, alongside these measures it is also important to reform fiscal policy making. A typical feature of emerging markets has been the tendency for free riding whereby federal governments bail out debt ridden regions thus undermining their credibility. One of the main problems for Venezuela has been the amount of state controlled industry. Indeed, the strikes of April 2002 concerned the running of the state owned oil firm, PDVSA. The implication here is that any changes in monetary regime should also be accompanied by significant fiscal policy changes reining in fiscal spending.

Each of the above features suggests that a flexible exchange rate regime would be disastrous for Venezuela at present (as demonstrated by the floating of the Bolivar in 2002). However this is contradictory to the evidence of the advanced industrial countries which predominantly have flexible or near-flexible regimes and apply a policy of inflation-targeting. Indeed, the conventional arguments put forward in favour of flexible exchange rate regimes suggest that they allow for considerable policy flexibility which could be valuable to a country wanting to make systematic changes through monetary policy. So why should Venezuela not float?

In short it is an open economy and exposed in terms of its dependence on the oil industry to changes in world oil prices. Second, its net foreign exposures, while not the worst in the region indicate that it has a lot to lose from currency depreciation. Third, its institutions lack credibility. These issues need to be addressed before Venezuela can contemplate adopting the exchange rate regime of a high income country. In the meantime, there are gains to be made in adopting a hard peg at least in the short term.

Countries in crisis are typically ones in which policy credibility has reached an all time low. Venezuela would certainly fit into this category. Therefore, the main aim is to try and rebuild credibility. A hard peg has a number of advantages; its simplicity, transparency and its credibility. With a stable exchange rate, the policy makers could set to work solving some of the underlying institutional problems i.e. overhauling the monetary and fiscal institutions. This then leaves the discussion of whether to apply capital controls.

Capital Controls

In terms of their popularity, capital controls are back in favour. This has primarily been with the success of Malaysia in its use of strict controls following the Asian crisis (Jomo, 2002). However, closer to home capital controls in Chile were also deemed a success (Reinhart and Smith, 1997). Their imposition reduced the volume of capital inflows and lengthened their maturity.

However, again this contradicts the policies pursued elsewhere. Indeed, the other major industrial economies have open capital accounts and their currencies are convertible for capital account transactions. So why not follow the trend and maintain an open capital account in Venezuela?

A completely open capital account is the final step in the long process of developing a deep and efficient domestic financial system. Venezuela is nowhere near achieving this goal and hence for the moment, one can make a strong argument in favour of some form of capital controls. It is generally regarded that capital controls or Tobin taxes (as is being proposed in Venezuela) should not be pursued in the long term. However there is a role for such controls as a short term interim measure while the country builds a deep financial system, upgrades supervision of its institutions and reforms monetary and fiscal policies. Their advantages are obvious. However, the main disadvantage of such a policy is that it is very costly to implement and cumbersome in terms of bureaucracy. Of course, the counter argument for a country like Venezuela is that it is accustomed to bureaucracy and hence this should not be an awkward transition.

There are however a few words of warning here. The imposition of a Tobin tax or other capital control may act as an incentive to deter the all-important policy reforms which are badly needed in Venezuela. The key is not to let a capital control hinder the process but complement it.

Second is the issue of sequencing. Venezuela clearly has to undergo a dramatic change not just in terms of monetary and fiscal policy but also in the setup and governance of its institutions. It is therefore crucial that these policies are pursued in the correct order. Sadly, it has already paid the price for poor sequencing in its actions in 2002. Floating the exchange rate and abandoning controls prior to institutional reform proved disastrous particularly as it coincided with crisis in neighbouring countries. To quote Eichengreen, “After Mexico in 1994 and Asia in 1997, do we really need a third reminder of the dangers of premature and precipitous financial liberalisation?” Venezuela has already given us that third example.

Conclusion

Venezuela is a country in difficulty. Aside from ongoing troubles with inflation and an over-dependency on its oil industry, it now faces the aftermath of a nationwide strike, the effects from which are yet to be fully realised. The changes needed are not merely a matter of movements in fiscal or monetary policy stance but instead require an overhauling of the whole financial system. This is not something which can be achieved overnight. The key to its recovery lies in a long term commitment on the part of the authorities and a willingness to embrace change. Given the current political climate of Venezuela this may be easier said than done.

However, the news is not all bad. The evidence has shown that while Venezuela was affected by the Asian crisis of 1997, it had a propensity to recover. Similarly, when Argentina fell into crisis, investor sentiment did not immediately class it as financially vulnerable. The implication here is that Venezuela could be a success if only it would make the overdue institutional reforms. This outcome is unlikely given the current political climate. However, it is certainly food for thought.

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