THE INTERNATIONAL ECONOMY
THE MAGAZINE OF
INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

Venezuela's Oil Trap

Economically speaking, other than oil nothing else is happening.

BY CHRISTOPHER WHALEN

Say what you want about China or India, to global oil mavens Venezuela and Cambodia are the two most intriguing venues in 2007. The latter is the new kid on the block, an emerging oil power that could earn billions of dollars annually via petroleum exports and thereby shift the geopolitical map of Asia (more about this in the next issue of *TIE*), but Venezuela is the wild card, an increasingly unstable factor in the global oil supply equation. This fact comes in large part because of the volatile individual who occupies that nation's presidency.

Hugo Chávez came to power as the result of oil, specifically the sharp decline in oil prices—and thus Venezuela's import revenues. It is fair to say that Venezuela's political consensus was already in tatters following the imprisonment of Carlos Andrés Pérez in 1998 and several coup attempts, including the 1992 coup led by a young army Lieutenant-Colonel named Hugo Chávez, who was later elected President.

Christopher Whalen is global risk editor of TIE *and a Managing Director of Institutional Risk Analytics.*

Crafty Political Opportunist

The leftist rhetoric regarding **Hugo Chávez** paints him in heroic terms, the revolutionary and visionary, the leader of a populist political surge that is sweeping the Americas. But the reality is more modest, namely that Chávez is the latest in a long line of Venezuelan political opportunists who have used oil revenues and inflation to entice support from different elements of the country's population, both the impoverished majority and the influential middle class.

Under-production by PDVSA, coupled with the fact that the Chávez government did not believe that oil prices would ever fall back to $50 per barrel, has created huge financial pressures on Venezuela and the state oil sector. Whether or not Venezuela can stabilize or even increase oil output may be the determining factor as to whether Chávez remains in power.

—C. Whalen

WILSON DIAS/AGENCIA BRASIL

When Chávez took power in January 1999, oil prices had fallen sharply to just $8 per barrel. The steep downturn in international oil prices which began a decade before had a severe impact on the Venezuelan economy. Fiscal cuts spurred by the loss of revenues, high interest rates, and the sharp downturn in export earnings drove Venezuela into recession in 1998.

By 1999, the Venezuelan economy was contracting and one in three of its citizens lived in dire poverty. The chief ingredient behind the country's political rot was oil, and the inflation and corruption that oil seemingly makes a permanent part of Venezuela's political economy. The fact of that social and political rot enabled the rise to power of Hugo Chávez, but it is also the chief and growing threat to his continuance as president of Venezuela.

In 2006, oil represented 91 percent of Venezuela's exports versus 80 percent five years ago.

The leftist rhetoric regarding Chávez paints him in heroic terms, the revolutionary and visionary, the leader of a populist political surge that is sweeping the Americas. But the reality is more modest, namely that Chávez is the latest in a long line of Venezuelan political opportunists who have used oil revenues and inflation to entice support from different elements of the country's population, both the impoverished majority and the influential middle class. As much as Nigeria, Iraq, or Cambodia, oil has come to dominate and distort civil society in Venezuela and is the determining factor in that nation's convoluted political system.

In terms of his political orientation, Chávez is hardly remarkable, being a precise response to the social equation in Venezuela. When oil prices spiked last year to more than $70 per barrel, the political currency of Chávez soared even as the nation's currency, the bolívar, sank to all-time lows against the dollar. Despite the vast increase in Venezuela's export income last year, Chávez managed to alienate foreign investors via several heavy-handed expropriations and accelerated both inflation and the deterioration in living standards among his country's poorest citizens—once his most powerful and reliable base of political support.

Decades of inflation have done enormous damage to the economic psychology of Venezuelans, who instinctively hoard dollars and physical assets such as automobiles and consumer durables. To protect themselves from the ravages of inflation, which is now the highest in Latin America, the new elite that now surrounds Chávez maintain foreign bank accounts and homes, this even while spouting radical *chavista* slogans. The very same cycle of corruption and incompetence that operated under previous regimes exists under Chávez, just with different characters and names.

Early in 2007, Chávez announced that he would chop three zeros off new bolívar currency bills to bolster Venezuelans' perception of a strong currency in a bid to curb inflation, The bolívar, named after Chávez's nineteenth-century hero Simón Bolívar, trades above 4,500 bolívars to the dollar on the parallel market, around double the official fixed exchange rate of 2,150 bolívars.

Oil is now everything in Venezuela, but there is little in the way of new investment, or even new contracts, in the oil sector. As the Chávez government gradually expropriates foreign oil services projects, the government is discouraging new investments and convincing foreign oil companies that the country is not a reliable partner. And this all comes as reliance on oil is growing: In 2006, oil represented 91 percent of Venezuela's exports versus 80 percent five years ago.

A February 15, 2007, article in the *Wall Street Journal* notes that those professionals from the oil industry and other sectors who can leave Venezuela are doing so in growing numbers, driven out by inflation and the radical political course taken by Chávez. Though Venezuela has sharply increased public sector spending in the past several years, the private economy is in dire straits as the Chávez government repeats old mistakes. The country's over-dependence on oil, the decline in energy prices, and the operational problems at PDVSA (the Venezuelan state-owned petroleum company) have put Venezuela in a vise between rising internal inflation and falling external revenues, forcing the Chávez administration to look for alternative economic resources.

The private economy is in dire straits as the Chávez government repeats old mistakes.

Decades of inflation have done enormous damage to the economic psychology of Venezuelans, who instinctively hoard dollars and physical assets such as automobiles and consumer durables.

Patrick Esteruelas, Latin America analyst at the Eurasia Group, tells *TIE* that as the Chávez government moves to increase government intervention in the economy, the importance of oil and the ability of the oil monopoly, PDVSA, to expand or even maintain production grows. Yet this trend also works to make PDVSA "the weakest link in the chain" when it comes to Venezuela's economy, he adds.

Esteruelas notes that PDVSA's contribution to social expenditures in Venezuela grew from 16 percent of revenue in 2005 to 21 percent in 2006, a trend that could limit the company's capital expenditures in future. Indeed, he confirms that Venezuela is unable to meet its 3.1 million barrel per day OPEC quota and currently is producing just 2.4 million barrels per day. Under-production by PDVSA, coupled with the fact that the Chávez government did not believe that oil prices would ever fall back to $50 per barrel, has created huge financial pressures on Venezuela and the state oil sector.

Whether or not Venezuela can stabilize or even increase oil output may be the determining factor as to whether Chávez remains in power. In April 2002, Chávez was almost removed from office by a coup that was supported by a broad segment of the population, particularly the professional managers in the oil industry. Only a few months later, Chávez faced a strike organized by PDVSA management who sought to force him out of office by removing his access to oil revenue.

As a result of the strike, Venezuela ceased exporting its then-daily average of 2.8 million barrels of oil and oil derivatives. Shortages soon erupted throughout Venezuela and gasoline imports were required to keep the country from descending into economic paralysis and chaos. Chávez responded by firing PDVSA's upper management and dismissing 18,000 skilled PDVSA engineers and other employees. Chávez justified this action by alleging their complicity in gross mismanagement and corruption in their handling of oil revenues, while opposition supporters of the fired workers stated that his actions were politically motivated.

Because of the fragile dynamic between Venezuela's government and the large proportion of the population who depend upon government subsidies paid for with oil revenues for their subsistence, foreign investors would do well to consider whether, given a choice between cutbacks in public spending and delaying or even defaulting on foreign debt payments, Venezuela won't choose the latter.

Venezuela's foreign debt only totals about $40 billion, including about $10 billion in short-term debt, but if confronted with a choice between staying in power and defaulting on his country's financial obligations to investors in the United States, Europe, and elsewhere, you should have no doubt that Chávez would immediately choose default—and would do so gladly.

PDVSA is starting to borrow heavily to replace capital funds being confiscated by the Venezuelan government, with $8 billion in new debt issued already this year. This amount includes a $3.5 billion loan facility from Japan, a $1 billion loan by French giant BNP, and a $7 billion Eurobond issue that was wildly oversubscribed by credulous gringo investors. Those investors who are so anxious to own Venezuelan paper do not yet seem to have considered the inevitable financial implications of Chávez's spendthrift populist policies. With reserves in the $35 billion range, Venezuela has sufficient resources to keep the fiscal wolf away from the door for about two years, sources tell *TIE*.

In terms of his political orientation, Chávez is hardly remarkable.

The chief ingredient behind the country's political rot was oil, and the inflation and corruption that oil seemingly makes a permanent part of Venezuela's political economy.

When you add together the cost of rapidly rising public sector expenditures, support for Chávez allies in the region and around the world, weak oil prices, and mounting operational and management problems at PDVSA, the financial outlook for Venezuela seems increasingly problematic. Then consider the action earlier this year of Ecuadorian President Rafael Correa, who seeks a haircut of 60 percent on the country's foreign debt, an action taken with the advice and active encouragement of Hugo Chávez. As Venezuelan oil production slowly edges lower, the financial pressures on Chávez will grow as his spoiled citizens demand new and greater largess from the state.

While it has been almost two decades since Venezuela insisted on a 50 percent debt reduction under U.S. Treasury Secretary Nicholas F. Brady's strategy for reducing third world debt, there should be no doubt that so long as Hugo Chávez remains in power, Venezuela's economic situation will continue to deteriorate. In that event, do not be surprised one day to see Chávez himself—or perhaps his successor—call anew for regional debt reduction to lighten the economic worries of his captive countrymen, especially if oil prices stay away from the triple-digit crude prices about which Chávez himself once dreamed. ◆