Venezuela Addresses Economic Stress

Venezuela, the fourth-largest oil producer in the world, has lately found itself in the midst of rising fiscal deficits, international capital outflows and devaluation. Oil accounts for about one-third of Venezuela's gross domestic product, 50 percent of its tax revenue and 80 percent of its exports. After reascending from 1998 lows, oil prices have weakened significantly from a March 2000 peak in the mid-$30s. Softer oil prices, together with production cutbacks, have slowed Venezuela's economic growth.

In recent months, exchange-rate pressures created by concerns over expansive fiscal policy—together with national strikes and other signs of problems in consensus building—motivated the central bank to tighten monetary policy and increase the targeted depreciation of the nominal exchange rate. When these efforts to stanch the outflow of the central bank's foreign currency reserves were met only with more dollar outflows, Venezuela allowed its currency, the bolivar, to float. The exchange rate moved from 795.50 bolivars per dollar on Feb. 12 to 998.49 the following day.

Countries have historically used devaluation to stem foreign currency reserve outflows and to make fiscal adjustments when they could not otherwise resolve disparities between income and outgo. But Venezuela is perhaps more proactive than many countries in its use of devaluation for fiscal balance.

Exchange-Rate Fluctuations

Increases in oil prices in the late 1990s seem to have energized Venezuela's disposition to spend, but the subsequent oil price declines did not have the opposite effect. Indeed, while Venezuela's central government had targeted a 3 percent deficit in 2001, the actual deficit averaged 4 percent, up from just 1.7 percent in 2000. Even though Venezuela had the third highest GDP growth among Latin America's eight largest economies, it also had the third largest fiscal deficit (*Chart 1*).

The Venezuelan government had been showing signs of difficulty in preserving its exchange-rate regime for some time. In recent years, the bolivar has been allowed to fluctuate within a target band. When the exchange rate moved toward the preestablished barrier on either the weak or the strong side of the band, the government was committed to intervene by selling more dollars at the weak side and buying more on the strong side.

The progress of the bolivar within its band has not always been smooth, and special exchange-rate adjustments have been made from time to time. When the exchange-rate band was established in July 1996, the bolivar was allowed to fluctuate 7.5 percent in either direction from a central parity, which was allowed to move in accordance with an annual inflation target. In January 2001, the band itself was moved to make the central parity rate consistent with the prevailing exchange rate. Because the exchange rate had been pushing persistently on the weak side of the band, the government simply moved the band 7.5 percent so as to position the existing exchange rate in the middle of the band instead of on the edge. The government then targeted the annual depreciation rate at 7 percent.

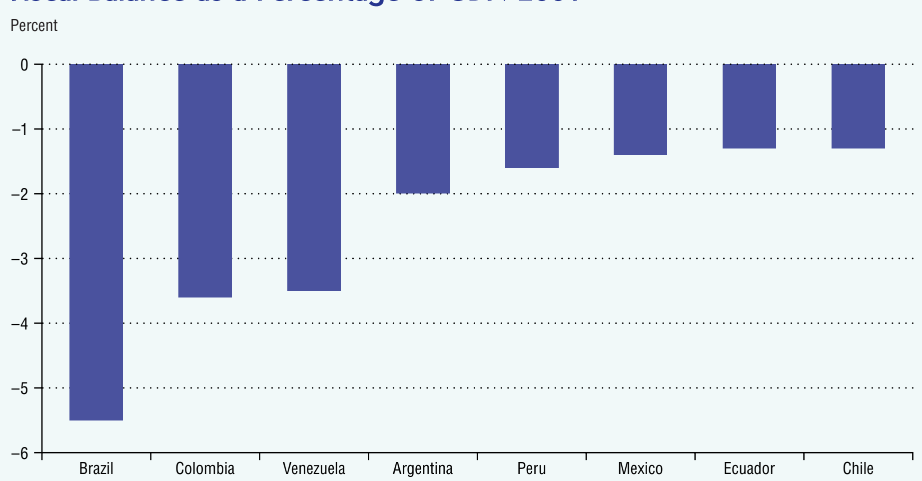
In the face of this weakened commitment, however, more pressures ensued. On Jan. 2, 2002, the government increased the targeted nominal depreciation to 10 percent. When foreign reserves continued to flow out of the country, the government announced on Feb. 12 that the exchange rate would float. The following day, however, this commitment was relaxed. Venezuela began using dollars to purchase bolivars to prevent a serious exchange-rate crash.

Oil for Dollars

The chief source of dollars in Venezuela has historically been the government-owned oil company, Petróleos de Venezuela Sociedad Anónima. This institution is required to turn all its earnings, which are in dollars, over to Venezuela's central bank. In the wake of the devalu-

Chart 1

Fiscal Balance as a Percentage of GDP: 2001



ation, the central bank has allocated a preannounced quantity of dollars to a daily auction.

The combination of capital outflows, failure to achieve political consensus and a relatively tight monetary policy has caused Venezuela to have some of Latin America's highest interest rates. The problem has not simply been exchange-rate risk. Chart 2 shows Emerging Market Bond Index spreads for eight Latin American countries. Because these spreads represent dollar-denominated government indebtedness for each country, they reflect market perceptions of types of risk other than those from losses due to devaluation.

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Investors have perceived some legal changes as increasing the risk of investing in Venezuela. A new hydrocarbons law raises the royalties private firms must pay the government from 16.6 percent to 30 percent. Venezuelan land law now allows the government to evaluate private land use and to seize and reallocate the lands if they are adjudged underutilized.

A striking detail of the Venezuelan devaluation is how much less extreme the financial ratios, which one typically associates with predevaluation stresses, were than in most cases. Current account deficits preceded the great majority of exchange-rate devaluations in the last decade, but Venezuela was running a current account surplus before its Feb. 13 devaluation. Ratios of external debt to exports were greater than 4:1 in the recent Argentine crisis, almost that high in Brazil just before its 1999 exchange-rate crash and greater than 2:1 in Mexico before its December 1994 crash. In Venezuela, however, the ratio of external debt to exports was 1.25:1. The ratio of debt to GDP was also markedly lower in Venezuela than was typical of precrisis countries in the 1990s.

The relatively mild values for these economic stress measures before devaluation suggest that Venezuela's motivations for devaluation differ from those of most countries. In this context, it is interesting to note that in 2001, net internal financing in Venezuela was about three times as high as external financing. This is to say that about three-fourths of Venezuela's 2001 deficit was financed in bolivars rather than in dollars or other foreign currency.

Motivation for Devaluation

Accumulating a debt burden denominated chiefly in the local currency offers motivation for devaluation that would not exist if all debt were denominated in a foreign currency. An important detail about the Venezuelan economy is that oil is priced worldwide in dollars, so a very large portion of Venezuela's total income is denominated in dollars. Devaluation means that the dollar value of such income stays the same, but the dollar value of domestic expenses falls, and so does the dollar value of bolivar-denominated debt.

Some analysts argue that if the bolivar reaches 1,200 per dollar, the Venezuelan budget will be balanced under current circumstances. The bolivar was at less than 800 per dollar before the devaluation but now exceeds 1,000. The country is more than halfway there.

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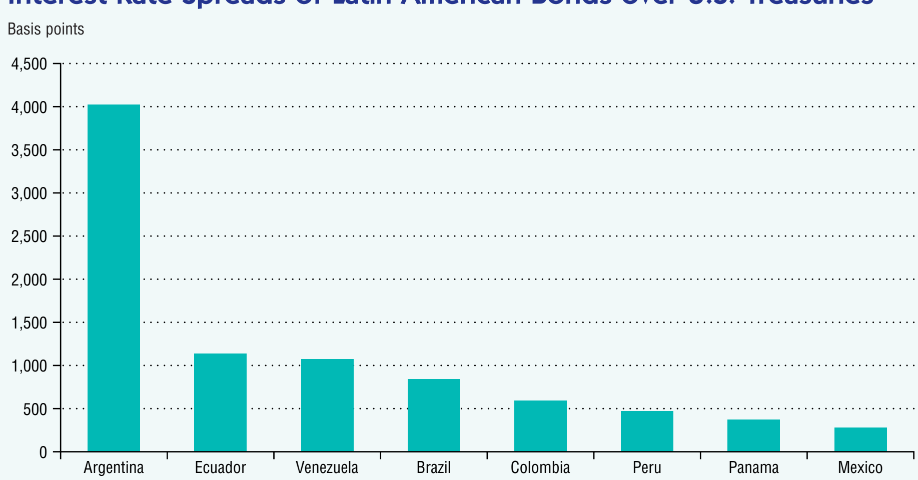
Chart 2

Interest Rate Spreads of Latin American Bonds over U.S. Treasuries



SOURCE: J.P. Morgan, Emerging Markets Bond Index.