Update on the Venezuelan Economy

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Executive Summary

After nearly six years of record economic growth, the Venezuelan economy went into recession in the first quarter of 2009, shrinking by 3.3 percent that year. A number of analysts see this as the end of an "oil boom" and the beginning of a long period of recession and stagnation.

For example, in June, Morgan Stanley drastically cut its forecast for GDP growth in Venezuela to negative 6.2 percent in 2010 and negative 1.2 percent for 2011. And the IMF projects that the Venezuelan economy will contract by 2.6 percent for 2010 and grow by less than 1.4 percent annually over the next five years[1] – i.e. negative per capita GDP growth.

However, the most prominent forecasts for the Venezuelan economy have been wrong in the past, often by enormous margins. This was especially true for Venezuela's most recent economic expansion, where the IMF underestimated Venezuela's growth for the four consecutive years 2004, 2005, 2006, and 2007, by 10.6, 6.8, 5.4, and 4.7 percentage points, respectively.

This update looks at the most recent data on the Venezuelan economy, in an attempt to evaluate its prospects in the foreseeable future.

We find that the Venezuelan economy is most likely already in recovery, and that the 2009 recession has probably ended. This is based on seasonally adjusted quarterly data, which show that the Venezuelan economy grew by an estimated 5.2 percent in the second quarter of 2010, on an annualized basis.

If the Venezuelan economy is indeed recovering, the question remains whether this recovery will accelerate and be sustainable. It appears that this will depend primarily on government policy.

A number of analysts have argued that the Venezuelan economy will remain mired in recession or stagnation, and/or is doomed to long term decline. In this paper, we consider these possibilities and arguments.

One possibility is that the government has created an unfavorable investment climate, and that this will severely limit the country's growth and development. Private capital formation as a percentage of GDP had declined significantly, even before the 2009 recession. The question is whether this necessarily means that the Venezuelan economy, which grew very rapidly in the last expansion from 2003-2008, is likely to face significant constraints on its future growth due to negative investor sentiment.

The answer to this question is, most likely, no. As can be seen in Figure 3, private capital formation rebounded very rapidly as the economic recovery began in 2003, despite intense hostility toward the government on the part of the most powerful business interests This indicates that many domestic investors, when there are profitable opportunities to invest within the country, will take advantage of them.

1 International Monetary Fund 1999 – 2010.

The government can also compensate for the current fall-off in private investment by increasing public investment. This was done successfully in 2008, as can be seen in Figure 3. As the recent electricity crisis has shown, Venezuela has a great need for public investment in infrastructure. The government can also invest in residential construction, transportation, hospitals, and other public needs. All of this can compensate for weak private investment, as necessary. And as can be seen in Table 2, private consumption follows the growth of the economy. Eventually, if it becomes clear that the government is committed to maintaining economic growth, we would expect private investment to increase, as it did from 2003-2006.

The government can increase and maintain economic growth so long as it does not face a foreign exchange crisis. It is important to understand that this is the binding constraint on countries that do not have "hard" currencies (as compared to the U.S., which can pay for its imports in dollars).

Venezuela is not in danger of a foreign exchange crisis. Its official reserves at the Central Bank are currently at US$28 billion. This is a reasonably high level of reserves, however: approximately half of imports for 2008 and over two-thirds for the reduced imports of 2009. (The most widely used benchmark is that international reserves should be sufficient to cover three months of imports.)[2]

Over the past year,[3] Venezuela's current account surplus was US$19.8 billion, or about 6.3 percent of GDP, which is sizeable.

Furthermore, in the case of a collapse of oil prices, the government has considerable borrowing capacity. This was demonstrated in April with a $20 billion credit from China.[4] Venezuela's total central government public debt is just 18.4 percent of GDP; and its foreign public debt is 10.8 percent of GDP.[5] Even if we add in the debt of PDVSA, the state-owned oil company – about 6 percent of GDP – this is a low foreign and domestic public debt burden, which gives the government plenty of room to borrow if there are unforeseen external shocks.

Venezuela's inflation rate is another often mentioned problem, which is generally reported as "the highest in Latin America." Figure 3 shows monthly year-over-year inflation at 30.9 percent. This is high inflation, although there are no signs that it is accelerating: inflation over the last three months is running at an annualized rate of 26 percent, and core inflation has been declining since last September. So long as it does not accelerate, Venezuela's inflation is not by itself necessarily a significant impediment to future economic growth, and can be lowered gradually.[6] It is also worth emphasizing that the predicted surge in inflation following the devaluation did not happen – sources quoted by the media were in the range of 40-60 percent annual inflation for this year.[7] In fact, the 26 percent inflation over the last three months is lower than inflation for the three months prior to the January devaluation.

The main impact of inflation has been an indirect effect, through its influence on the real exchange rate. The nominal exchange rate was fixed at 2.15 from March 2005 until January of 2010. With the exchange rate fixed and inflation averaging about 20 percent annually over the last seven years, the

2 See Wijnholds and Kapteyn (2001) for a review of the literature on the adequacy of reserves.
3 This Q1 2009 to Q1 2010.
4 Molinski and Lyons 2010.
5 Oficinal Nacional de Crédito Público 2010.
6 See Weisbrot, Ray and Sandoval (2009, p. 19) for more on inflation.
7 See for example Forero 2010 and Jaramillo 2010.

bolivar appreciated rapidly in real terms.[8] This has made imports increasingly cheap and non-oil exports increasingly expensive, in real terms. During the expansion, manufacturing basically held its own at about 16 percent of GDP; the fastest growing sectors were non-tradables such as finance and insurance, communications, and construction.[9]

The devaluations have reversed a good part of the real appreciation of the currency over the last 5 years, but not all of it. If Venezuela wants to diversify its economy away from oil – which it has not done over the last decade – it will most likely need a more competitive exchange rate.

Nonetheless, for the narrow question at hand here – whether the Venezuelan economy can resume and sustain strong economic growth – the exchange rate is unlikely to be determinative. It will affect the sectoral mix of economic growth, tilting it toward non-tradables as during the previous expansion. But the pace of economic growth is more likely to be determined by the government's other macroeconomic policies, most importantly public spending.

But because of Venezuela's position as an oil exporter – and one sitting on 500 billion barrels of oil, perhaps the largest reserves in the world – it is very unlikely to run into foreign exchange constraints. Therefore its growth, especially in the near future, will depend overwhelmingly on the government's commitment to maintaining adequate levels of aggregate demand. (In that respect, its immediate situation is similar to that of the United States, the Eurozone economies, and many other economies whose recovery is currently weak and uncertain.)

The prior economic expansion was an important one for Venezuela. Poverty was reduced by 47 percent and extreme poverty by 70 percent. Real social spending per person tripled, and there were greatly expanded public programs in health care and education; unemployment fell by half and there were large gains in employment.[10] According to a recent report by the UN Economic Commission on Latin America, Venezuela had the sharpest reduction in inequality in the Americas during this expansion. The fall in the Gini coefficient from 50.0 to 41.2 from 2002-2008 gave Venezuela the least unequal distribution of income in Latin America.[11]

If the government maintains adequate levels of aggregate demand – including a commitment to strong counter-cyclical policies as necessary – the Venezuelan economy will grow, and the progress in employment, living standards, poverty reduction, and income equality that were seen during the previous expansion will continue. Of course this is not guaranteed – it depends on whether the government is willing to make, and maintain, this commitment to growth. The government will also have to make sure that sufficient foreign exchange is made available for imports that are inputs to production. If these commitments are met, then economic growth, as well as the accompanying social progress, can continue for years, regardless of inefficiencies, development strategies (or lack thereof), or other economic problems. Although there are a number of analysts who are predicting that the Venezuelan economy is on the verge of inevitable (and long-anticipated) ruin, there is nothing in the recent data – or that of the last decade – to indicate that this is true.

8 See Weisbrot, Ray and Sandoval.
9 Ibid.
10 Weisbrot, Ray and Sandoval 2009.
11 United Nations Economic Commission for Latin America and the Caribbean 2010, Chapter 2.

Introduction

After nearly six years of record economic growth, the Venezuelan economy went into recession in the first quarter of 2009, shrinking by 3.3 percent that year. A number of analysts see this as the end of an "oil boom" and the beginning of a long period of recession and stagnation. The IMF projects that the Venezuelan economy will contract by 2.6 percent for 2010 and grow by less than 1.4 percent annually over the next five years[12] – i.e. negative per capita GDP growth. In March, the Economist Intelligence Unit forecast a 5.6 percent contraction for this year,[13] and in May, projected a 10 year average GDP growth rate of just 2.2 percent annually. According to the EIU, the Venezuelan economy "is set to stagnate further in the long term, sliding to become one of the weakest performers among emerging-market economies over the next two decades."[14] There are many press reports with similarly negative prognoses.[15] However, as noted below, most forecasts for the Venezuelan economy have been far off the mark during the last seven years.

This update looks at the most recent data on the Venezuelan economy, in an attempt to evaluate its prospects in the foreseeable future.

Economic Growth, Recession, and Recovery

As can be seen in **Figure 1**, the Venezuelan economy grew very rapidly from the first quarter of 2003, after the oil strike that had caused a severe recession came to an end. This expansion lasted for nearly six years, producing cumulative record economic growth for the country, with GDP expanding by 95 percent from trough (Q1 2003) to peak (Q4 2008). During this expansion, poverty was reduced by 47 percent and extreme poverty by 70 percent (see Table 3). Real social spending per person tripled, and there were greatly expanded public programs in health care and education; unemployment fell by half and there were large gains in employment.[16] It is also worth noting that, according the UN Economic Commission on Latin America, Venezuela had the sharpest reduction in inequality in the Americas during this expansion. The fall in the Gini coefficient from 50.0 to 41.2 from 2002-2008 gave Venezuela the least unequal distribution of income in Latin America.[17]

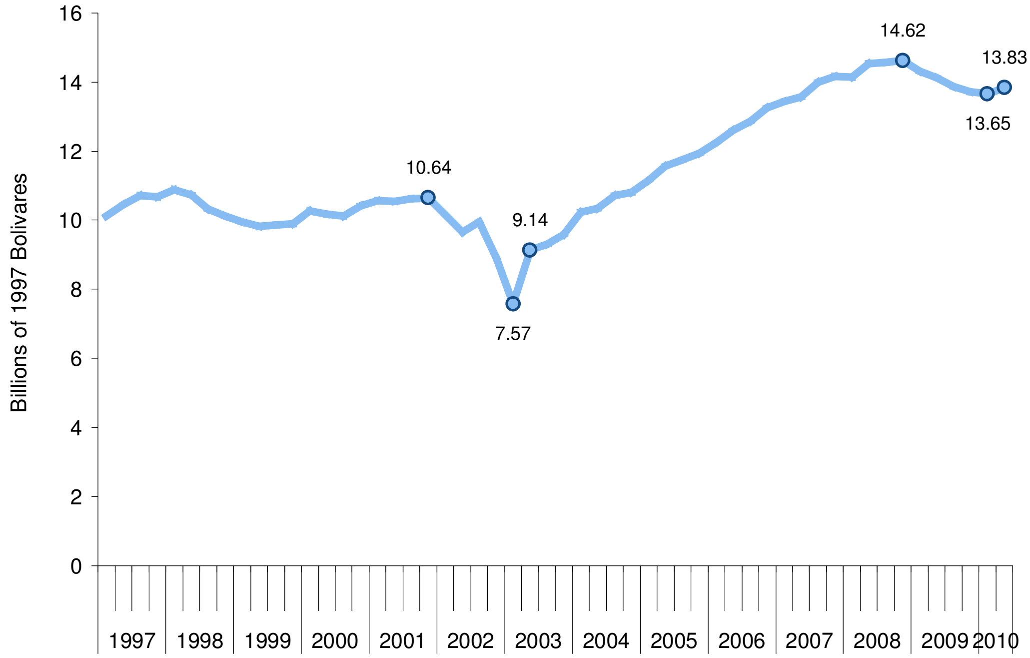
Table 1 shows annual data for the Venezuelan economy since 2002; **Table 2** shows quarterly data (seasonally adjusted) since 2007. In both tables it can be seen that the economy slowed significantly in 2008; and Table 2 shows that growth was negative for each quarter of 2009. For 2010, the first quarter came in at negative 2.0 percent at an annualized rate, and second quarter growth is positive 5.2 percent. Thus the recession appears to be over.

This point is important because it has not yet been recognized that the Venezuelan economy is very likely in recovery. As noted above, the projections and media reports are generally very pessimistic. One technical reason for this could be the use by many sources of year-over-year data, which is not as good an indicator for whether the economy is recovering, as is the change in GDP from one

12 International Monetary Fund 1999 – 2010.
13 Economist Intelligence Unit 2010b.
14 Economist Intelligence Unit 2010c.
15 See for example Cancel 2010, Dobson 2010, and Economist Intelligence Unit 2010a.
16 Weisbrot, Ray and Sandoval 2009.
17 United Nations Economic Commission for Latin America and the Caribbean 2010, Chapter 2.

quarter to the next. Thus, second quarter 2010 GDP, seasonally adjusted, is up 5.2 percent over the first quarter of 2010 at an annualized rate; whereas compared to second quarter of 2009 it is down 1.9 percent. The story is similar for the first quarter of 2010: it is down 2.0 percent of GDP, seasonally adjusted, from the previous quarter, but down 5.2 percent of GDP as compared with the first quarter of 2009.

FIGURE 1
Venezuela: Real GDP (Seasonally-Adjusted)



Source: Banco Central de Venezuela 2010, Table 5.2.4; authors' calculations.
Note: See footnote 19 for seasonal adjustment methodology.

As noted above, the quarterly numbers in this paper are seasonally adjusted. The data from the Central Bank of Venezuela, for the first two quarters of 2010, are not seasonally adjusted; this may have contributed to the slowness of most analysts to recognize the likely economic recovery underway in Venezuela. Without seasonally adjusted data, it is impossible to measure quarter-on-quarter growth, since there is a strong seasonal component to the variation in quarterly GDP data.[18] We therefore performed a seasonal adjustment, using standard methodology,[19] which yielded the data cited above, and shown in Figure 1 and Table 2.

18 For year-over-year quarterly comparisons, seasonal adjustments are not necessary, since the comparison is between the same quarter of different years.

19 Data were seasonally adjusted using the United States Census Bureau's X-12 Arima program. Over the 1997-2009 period, the mean difference between quarterly data seasonally adjusted by Banco Central de Venezuela and data seasonally adjusted through the X-12 Arima program was 0.009%, which is not significantly different from zero, statistically. The various components of GDP shown in Table 2 were adjusted separately and added to get the quarterly GDP data. For more information on the X-12 Arima program, see U.S. Census Bureau 2009.

TABLE 1
Venezuela: Real Sector, 1998-2010 (real annual percent change)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010[a]
Real GDP, total	**0.3%**	**-6.0%**	**3.7%**	**3.4%**	**-8.9%**	**-7.8%**	**18.3%**	**10.3%**	**9.9%**	**8.2%**	**4.8%**	**-3.3%**	**-3.5%**
Public	-2.1	-5.2	3.0	-0.6	-11.1	-1.3	12.5	2.8	2.7	7.4	16.3	0.9	-2.1
Private	1.1	-6.9	4.2	4.9	-5.8	-8.9	17.2	12.9	11.3	7.5	-0.1	-4.5	-3.7
By Economic Activity													
Oil Sector	0.3%	-3.8%	2.3%	-0.9%	-14.2%	-1.9%	13.7%	-1.5%	-2.0%	-4.2%	2.5%	-7.2%	-3.4%
Non-Oil Sector	-0.1%	-6.9%	4.2%	4.0%	-6.0%	-7.4%	16.1%	12.2%	10.9%	9.6%	5.1%	-2.0%	-3.1%
Mining	-7.5	-12.1	15.3	2.8	4.3	-4.4	14.2	3.0	7.2	1.5	-4.2	-11.2	-15.2
Manufacturing	-1.4	-10.1	5.1	3.7	-13.1	-6.8	21.4	11.1	8.3	7.4	1.4	-6.4	-6.4
Electricity and Water Supply	0.5	-2.2	4.7	4.8	2.1	-0.5	8.5	11.2	4.9	-1.5	5.7	4.2	-5.6
Construction	1.4	-17.4	4.0	13.5	-8.4	-39.5	25.1	20.0	30.6	15.5	3.7	0.2	-6.5
Trade and Repair Services	-1.5	-5.4	5.7	4.6	-13.6	-9.6	28.6	21.0	15.7	16.7	4.6	-8.3	-9.0
Transport and Storage	-5.2	-15.3	12.5	-1.3	-10.4	-8.0	24.6	14.7	14.3	13.3	3.8	-8.5	-8.1
Communications	8.2	3.6	2.1	8.1	2.5	-5.0	12.9	22.4	23.5	19.8	18.2	9.8	8.1
Financial and Insurance	0.2	-15.2	-0.7	2.8	-14.5	11.9	37.9	36.4	47.2	16.4	-4.6	-2.4	-8.7
Real Estate	0.7	-4.7	0.8	3.5	-0.7	-6.0	11.1	7.9	8.6	5.8	2.7	-2.0	-2.7
Community and Personal Services and Non-Profit	0.3	-1.7	0.9	2.1	0.1	-0.3	9.4	8.2	16.5	10.9	9.5	3.1	1.1
General Government Services	-0.6	-4.8	2.8	2.5	-0.4	4.9	11.1	8.0	3.0	5.7	5.3	2.4	1.5
Other [b]	3.0	0.5	5.2	1.8	-1.0	-2.9	7.2	12.6	3.7	5.0	5.6	-0.3	-1.2
Expenditure-Based													
Government Final Consumption	-3.1%	-7.5%	4.2%	6.9%	-2.5%	5.7%	14.2%	10.7%	9.6%	6.1%	6.7%	2.3%	1.7%
Private Final Consumption	1.8	-1.7	4.7	6.0	-7.1	-4.3	15.4	15.7	15.5	18.7	7.1	-3.2	-4.0
Gross Fixed Capital Formation	5.5	-15.6	2.6	13.8	-18.3	-37.0	49.7	38.4	29.3	25.3	-3.3	-8.2	-11.9
Exports of Goods and Services	3.5	-11.0	5.8	-3.5	-4.0	-10.4	13.7	3.8	-3.0	-7.9	-2.7	-12.9	-13.5
Imports of Goods and Services	11.3	-9.3	12.4	14.1	-25.2	-20.9	57.7	35.2	34.8	29.9	3.8	-19.6	-21.6

Source: Banco Central de Venezuela 2010, Tables 5.2.1, 5.2.7, 5.2.4.
Notes:
a. 2010 data is for the first half of 2010 compared to the first half of 2009.
b. Includes private agriculture, restaurants and private hotels and various public sector activities.

TABLE 2
Venezuela: Growth, Real Sector (real annualized quarterly growth rates, seasonally adjusted data[a])

	2007				2008				2009				2010	
	1	2	3	4	1	2	3	4	1	2	3	4	1	2
Real GDP, total	**4.7%**	**3.8%**	**15.4%**	**3.8%**	**-0.1%**	**9.1%**	**2.8%**	**1.4%**	**-8.1%**	**-5.4%**	**-6.9%**	**-4.2%**	**-2.0%**	**5.2%**
By Economic Activity														
Oil Sector	-2.2%	-1.9%	-3.6%	7.0%	6.3%	-1.9%	7.1%	-4.8%	-17.9%	1.4%	-15.8%	-8.0%	5.3%	12.5%
Non-Oil Sector	10.2%	3.7%	13.8%	3.8%	0.1%	14.5%	-0.8%	1.2%	-4.9%	-4.8%	-4.7%	-2.4%	-4.8%	4.6%
Mining	-9.3	1.9	8.2	8.6	-21.3	13.3	6.0	-47.9	7.6	7.7	-27.9	-1.6	-11.2	-32.1
Manufacturing	9.1	5.7	11.1	-1.3	-8.2	19.3	-8.0	-1.8	-8.5	-14.7	-11.5	7.1	-13.0	4.2
Electricity and Water Supply	-5.7	-13.2	0.7	-3.3	16.8	18.7	3.1	-10.1	8.0	16.2	1.9	-3.5	-17.7	-14.5
Construction	28.1	-1.9	9.0	17.9	-15.9	30.5	-10.8	8.1	-6.4	9.8	-4.0	-14.5	-7.8	-1.7
Trade and Repair Services	14.7	-1.4	39.4	-6.7	-0.7	7.1	7.3	1.0	-11.3	-20.2	-13.4	-10.3	-2.8	3.4
Transport and Storage	8.2	-2.8	35.6	-9.0	4.10	0.5	5.4	6.1	-6.3	-23.2	-18.2	-16.6	4.0	25.6
Communications	15.7	17.2	13.7	26.6	21.3	41.8	-20.6	18.3	12.6	21.5	-2.2	11.3	10.7	6.1
Financial and Insurance	29.2	0.8	2.3	-21.0	-4.7	-4.3	12.5	-2.9	-6.6	-3.2	-1.6	-7.5	-24.6	5.9
Real Estate	7.7	-0.9	9.6	-3.7	4.9	5.1	4.3	0.2	-7.4	-5.1	-0.1	-2.8	-6.1	6.9
Community and Personal Services and Non-Profit	7.9	4.9	9.2	20.5	1.1	9.4	18.2	-4.3	0.1	4.4	2.8	-2.3	0.0	1.7
General Government Services	7.9	5.4	9.0	6.3	6.9	1.7	3.7	4.1	-0.8	3.8	3.8	2.5	-6.1	9.7
Other [b]	-2.1	22.0	3.1	3.6	3.1	8.3	7.6	2.8	-9.0	3.5	1.0	-6.2	-1.5	3.1
Expenditure-Based														
Government Final Consumption	-4.0%	4.5%	8.8%	14.2%	3.4%	2.6%	3.0%	19.2%	-12.2%	1.6%	3.7%	18.1%	-16.7%	8.5%
Private Final Consumption	22.5	18.6	21.6	6.0	-0.5	8.5	7.7	2.5	-9.0	-9.3	-2.5	-6.5	-3.3	3.7
Gross Fixed Capital Formation	35.8	5.8	25.4	0.0	-42.7	28.1	11.5	26.5	-15.6	-30.0	-25.8	-17.8	1.7	48.0
Exports of Goods and Services	-10.6	0.5	-12.2	-6.8	12.9	-0.4	6.1	-44.6	-20.8	33.2	-13.5	-15.6	-22.4	-26.2
Imports of Goods and Services	8.6	1.6	57.5	-1.3	-6.4	-9.9	3.7	33.6	-9.1	-47.0	-52.2	-42.0	17.7	131.1

Source: Banco Central de Venezuela 2010, Tables 5.2.1, 5.2.7, 5.2.4.
Notes:
a. Data were seasonally adjusted using the U.S. Census Bureau's X-12 Arima program. See footnote 7 for more information on the method used here.
b. Includes private agriculture, restaurants and private hotels and various public sector activities.

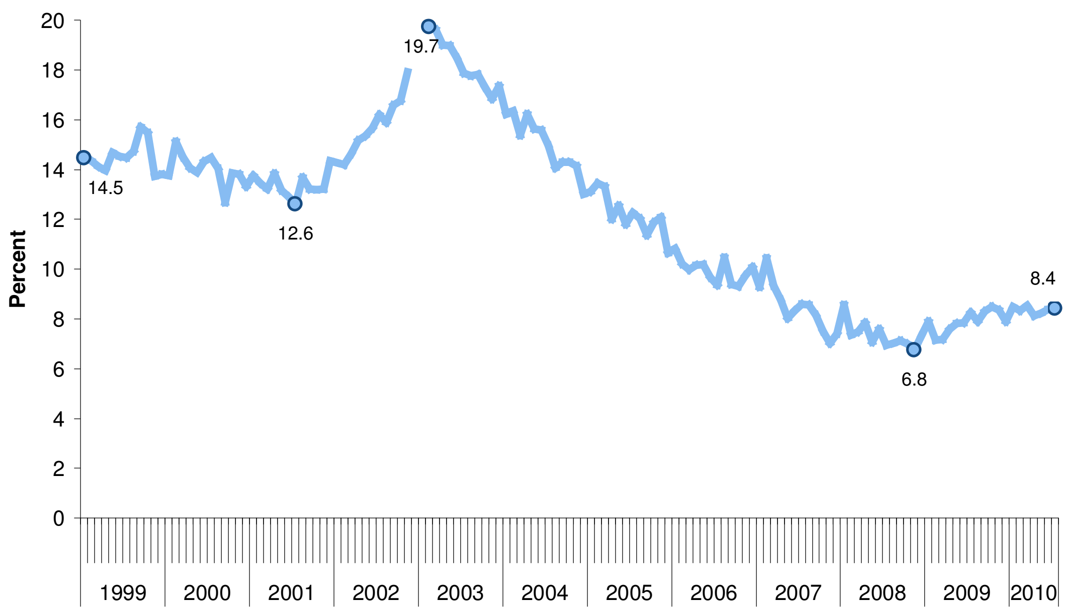
Looking at the most recent data by sector, it can be seen that manufacturing, which has been in decline for seven of the last eight quarters, grew by 4.2 percent. Manufacturing is about 15 percent of the Venezuelan economy, and has been hard hit recently by electricity shortages; water and electricity supply continued their sharp decline in the second quarter, at -14.5 percent. As this crisis has now passed, we would expect that a recovery of electricity supply would contribute to a stronger overall recovery in the quarters ahead.

The change in exchange rate regulation also depressed growth in the second quarter, by causing considerable disruption due to lack of availability of foreign exchange. The new currency market, regulated by the Central Bank, went into effect in June. The increased availability of foreign exchange, relative to the second quarter, is also likely to boost growth in the quarters ahead, so long as it is maintained.

Another positive sign is the recovery of gross fixed capital formation, which had collapsed during 2009. For the first two quarters of 2010, it is up by 1.7 and 48.0 percent, respectively.

To be sure, any conclusion drawn from just one or two quarters of data is necessarily tentative, and especially with so much depending on the second quarter. Moreover, the near future will depend enormously on what the government does. Nonetheless, the data indicate that it is more likely that not than an economic recovery is already under way, and that the recession is probably over.

FIGURE 2
Venezuela: Monthly Unemployment Rate, Seasonally Adjusted



Source: Instituto Nacional de Estadística 2010.

The Downturn

The slowdown in Venezuela began in the first quarter of 2008, about the same time as the U.S. recession. Private sector growth for the year was nearly flat (Table 1). Manufacturing was already declining by the fourth quarter of 2007, as was private capital formation (Figure 3, below). During

2008, it was the 16.3 percent annual growth of the public sector (Table 1) that kept the economy growing, at a 4.8 percent annual rate.

The biggest shock to the economy in 2008 was of course the collapse in world oil prices, which dropped suddenly by 50 percent in the fourth quarter of that year, and by another 21 percent in the first quarter of 2009. Coming on top of a slowdown in private spending that had already begun, this pushed the economy into recession. Added to this was a sharp slowdown in the public sector, which grew by only 0.9 percent in 2009 as compared to 16.3 percent the previous year. We do not have budget figures for 2009, but presumably public spending also decelerated significantly during this time, as indicated by the rapid deceleration of the growth of the public sector and by the sharp fall in public capital formation, as shown in **Figure 3.**

TABLE 3
Venezuela: Poverty and Unemployment Rates, 1997 – 2009

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
2007	1st Half	27.5	7.6	33.1	9.4
	2nd Half	28.5	7.9	33.6	9.6
2008	1st Half	27.7	7.5	33.1	9.2
	2nd Half	27.5	7.6	32.6	9.2
2009	1st Half	26.4	7.0	31.7	8.9
	2nd Half	23.8	5.9	29.0	7.4

Source: Instituto Nacional de Estadística 2010.

On the positive side, the recession did not have a severe effect on social indicators. As shown in Table 3, the poverty and extreme poverty rates continued their six-year decline, from 32.6 and 9.2 percent, respectively, in the second half of 2008 to 29.0 and 7.4 percent, respectively, in the second half of 2009. Unemployment rose during the recession, but not that sharply, from 6.8 percent at bottom in the second half of 2008 to 8.4 percent in July 2010 as shown in Figure 2.[20]

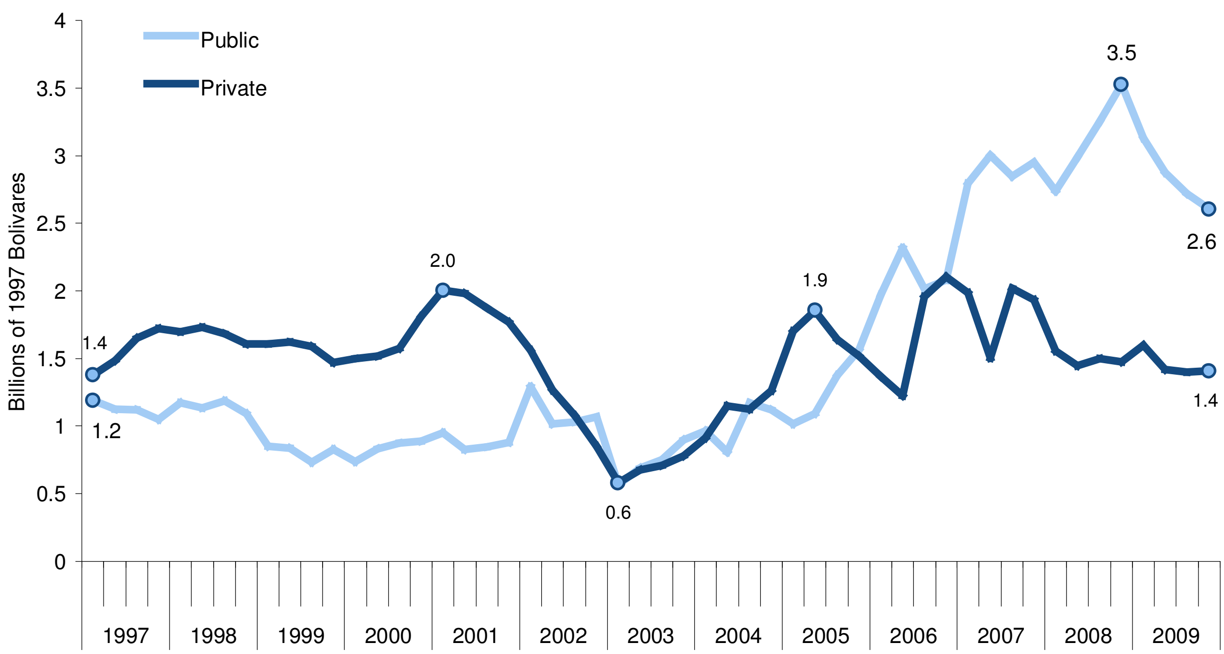
Investment

Figure 3 shows gross fixed capital formation in constant (1997) bolivares fuertes since 1998, public and private. As shown, private capital formation falls sharply (by 71 percent) during the political instability from 2001 to early 2003, when the last oil strike ended. It recovered rapidly to near its pre-recession peak over the next two years. It then becomes more volatile, before going into decline at the end of 2007. However, as a percentage of GDP, it never recovers its pre-recession peak, and by 2009 it is about 10 percent of GDP, as compared to 16 percent in 1999.

Public capital formation follows a similar crash through the oil strike/recession, and recovery; but it continues to grow to about 24 percent of GDP in 2008. It then falls sharply during the recession of 2009. At the end of 2009, combined public and private gross fixed capital formation totaled 28 percent of GDP, as compared to 25 percent in 1999.

It is worth noting that the rate of capital formation in Venezuela is relatively high as compared to other countries in Latin America. In Brazil, for example, it has averaged about 16.6 percent of GDP over the last 16 years, with public investment less than 2 percent of GDP for most of those years.[21]

FIGURE 3
Venezuela: Gross Fixed Capital Formation, 1997 – 2009



Source: Banco Central de Venezuela 2010, Table 7.1.2.

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20 Seasonally adjusted.
21 Instituto de Pesquisa Econômica Aplicada 2010, IMF 1999-2010, and authors' calculations.

Projections for the Venezuelan Economy

Before turning to the future prospects of the Venezuelan economy, it is worth looking briefly at forecasts for the Venezuelan economy over the last decade.

Prior Projections

Table 4 shows the forecast for Venezuela's GDP growth made in the fall of the prior year, in the IMF's World Economic Outlook database.

As can be seen, the first two huge errors occur in the Fall of 2001 and 2002, in the IMF's projections for the years 2002 and 2003, respectively. However, the Fund cannot be blamed for these errors: these huge, unanticipated declines in GDP were a result of an opposition oil strike from December 2002- February 2003. Since the Fall WEO projections for both years were published before the strike, it is understandable that these projections were far off the mark.

However, the strike ended in February of 2003, and there was no sign of a possible repeat by the fall of that year. Nonetheless, the Fund's projections for the next four consecutive years underestimate Venezuela's GDP growth by 10.6, 6.8, 5.4, and 4.7 percentage points, respectively. These are enormous errors by any standard, and especially difficult to explain because they are so large for four consecutive years. Only when growth fell sharply in 2008 did the IMF (Fall 2007 forecast) come anywhere near close to forecasting the actual growth rate for the Venezuelan economy. In 2008, the IMF was over-optimistic for 2009 – as it was in most of the world, not anticipating the depth of the world recession.[22]

Given these enormous forecasting errors, we should not be surprised if the IMF and other projections for the Venezuelan economy turn out to be far off the mark over the next year and well into the future.

TABLE 4
Venezuela's Projected (by the IMF) and Actual GPD Growth

Year	Projected Growth (from Fall WEO, Previous Year)	Actual Growth for the Year	Error in Forecast (Percentage Points)
2000	1.6	3.7	-2.1
2001	3.0	3.4	-0.4
2002	2.8	-8.9	11.7
2003	2.2	-7.8	10.0
2004	7.7	18.3	-10.6
2005	3.5	10.3	-6.8
2006	4.5	9.9	-5.8
2007	3.7	8.2	-4.7
2008	6.0	4.8	1.2
2009	2.0	-3.3	5.3

Source: International Monetary Fund 1999-2010.

22 Across all countries, the IMF's projections for 2009 growth, published in the October 2008 WEO database, were an average of 4.7 percentage points higher than the actual growth rates (or later projections) recorded in the 2010 April WEO database. (IMF 1999-2010).

Future Prospects for the Venezuelan Economy

If the Venezuelan economy is indeed recovering, the question remains whether this recovery will accelerate and be sustainable. It appears that this will depend primarily on government policy.

As noted above, there are many arguments that the Venezuelan economy will remain mired in recession or stagnation, and/or is doomed to long term decline. Here we will consider these possibilities and arguments.

One possibility is that the government has created a unfavorable investment climate, and that this will severely limit the country's growth and development. As noted above, private capital formation as a percentage of GDP has declined significantly, even before the 2009 recession. This is to be expected with the kinds of policy changes that Venezuela has had, since most of the private sector has been against most of the policy changes, and against the government in general. The governments of Bolivia and Ecuador have also faced some of the same hostility from sectors of the business community, as have historically most left or left-of-center governments. The question is whether this necessarily means that the Venezuelan economy, which grew very rapidly in the last expansion from 2003-2008, is likely to face significant constraints on its future growth due to negative investor sentiment.

The answer to this question is most likely no. As can be seen in Figure 3, private capital formation rebounded very rapidly as the economic recovery began in 2003, despite intense hostility on the part of the most powerful business interests – which had just completed two attempts within one year to overthrow the government. This indicates that many domestic investors, when there are profitable opportunities to invest within the country, will take advantage of them. Although most business people in Venezuela are conservative and against the government, they can also be pragmatic. The probability of any investor losing money to expropriation in Venezuela remains very small; it is doubtful that this is a serious practical consideration for most private investment decisions, as compared to the normal risks associated with uncertainty over prices of inputs and output, and demand conditions.

The government can also compensate for the current fall-off in private investment by increasing public investment. This was done successfully in 2008, as can be seen in Figure 3. As the recent electricity crisis has shown, Venezuela has a great need for public investment in infrastructure. The government can also invest in residential construction, transportation, hospitals, and other public needs. All of this can compensate for weak private investment, as necessary. And as can be seen in Table 2, private consumption follows the growth of the economy. Eventually, if it becomes clear that the government is committed to maintaining economic growth, we would expect private investment to increase, as it did from 2003-2006.

The government can increase and maintain economic growth so long as it does not face a foreign exchange crisis. It is important to understand that this is the binding constraint on countries that do not have "hard" currencies (as compared to the U.S., which can pay for its imports in dollars). The fiscal deficit is not a binding constraint, since it can be financed with domestic currency.

Venezuela is not in danger of a foreign exchange crisis. Its official reserves at the Central Bank are currently at US$28 billion. This is a reasonably high level of reserves, however: approximately half of imports for 2008 and over two-thirds for the reduced imports of 2009. (The most widely used benchmark is that international reserves should be sufficient to cover three months of imports.)[23] Furthermore, Venezuela probably does not need as much of a reserve cushion than most countries, because of its currency controls.

It is believed that the government has other reserves in addition to those at the Central Bank, although it is impossible to know exactly how much.[24] Over the past year,[25] Venezuela's current account surplus was US$19.8 billion, or about 6.3 percent of GDP, which is sizeable.

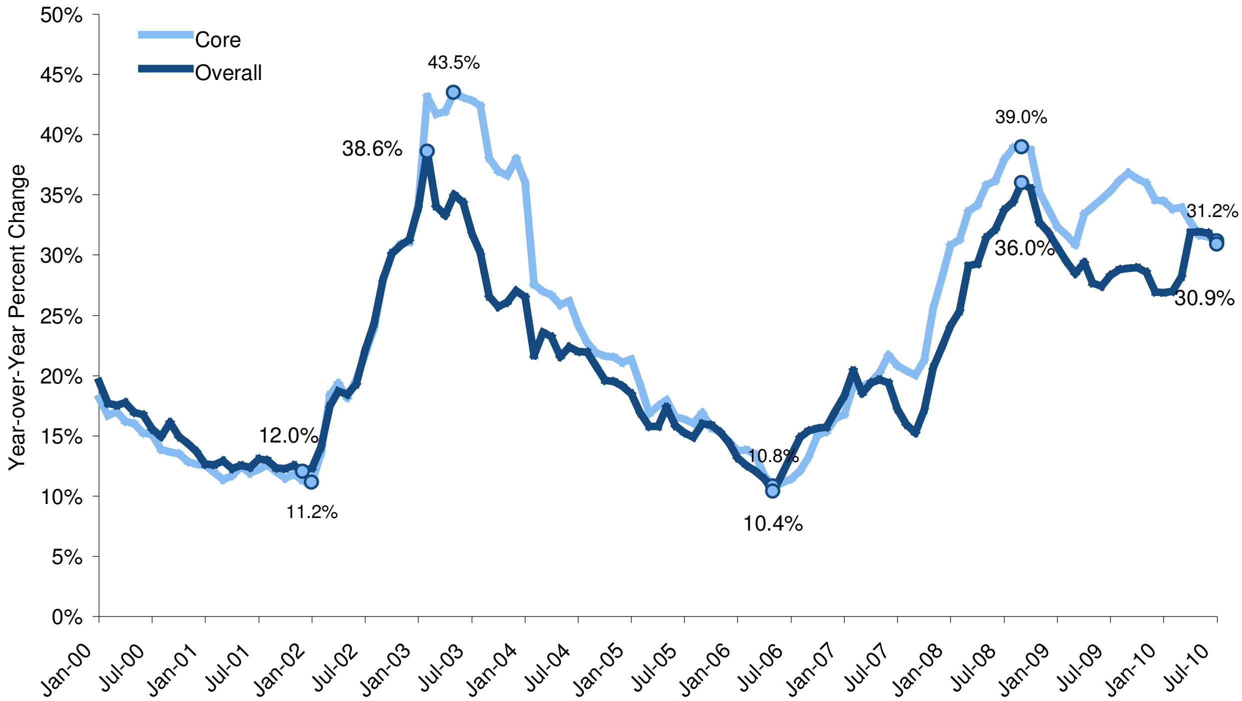
Furthermore, in the case of a collapse of oil prices, the government has considerable borrowing capacity. This was demonstrated in April with a $20 billion credit from China.[26] Venezuela's total central government public debt is just 18.4 percent of GDP; and its foreign public debt is 10.8 percent of GDP.[27] Even if we add in the debt of PDVSA, the state-owned oil company – about 6 percent of GDP – this is a low foreign and domestic public debt burden, which gives the government plenty of room to borrow if there are unforeseen external shocks. It is worth noting that the U.S. Energy Information Administration forecasts oil prices at $85 per barrel over the next 5 years, which is 20% above the current price.[28]

Venezuela's inflation rate is another often mentioned problem, which is generally reported as "the highest in Latin America." Figure 3 shows monthly year-over-year inflation at 30.9 percent. This is high inflation, although there are no signs that it is accelerating: inflation over the last three months is running at an annualized rate of 26 percent, and core inflation has been declining since last September. So long as it does not accelerate, Venezuela's inflation is not by itself necessarily a significant impediment to future economic growth, and can be lowered gradually.[29] It is also worth emphasizing that the predicted surge in inflation following the devaluation did not happen – sources quoted by the media were in the range of 40-60 percent annual inflation for this year.[30] In fact, the 26 percent inflation over the last three months is lower than inflation for the three months prior to the January devaluation.

The main impact of inflation has been an indirect effect, through its influence on the real exchange rate. The nominal exchange rate was fixed at 2.15 from March 2005 until January of 2010. With the exchange rate fixed and inflation averaging about 20 percent annually over the last seven years, the bolivar appreciated rapidly in real terms.[31] This has made imports increasingly cheap and non-oil exports increasingly expensive, in real terms. During the expansion, manufacturing basically held its own at about 16 percent of GDP; the fastest growing sectors were non-tradables such as finance and insurance, communications, and construction.[32]

23 See Wijnholds and Kapteyn (2001) for a review of the literature on the adequacy of reserves.
24 See Weisbrot, Ray, and Sandoval (2009, p 23) for more on these reserves.
25 This Q1 2009 to Q1 2010.
26 Molinski and Lyons 2010.
27 Oficinal Nacional de Crédito Público 2010.
28 United States Energy Information Administration 2010.
29 See Weisbrot, Ray and Sandoval (2009, p. 19) for more on inflation.
30 See for example Forero 2010 and Jaramillo 2010.
31 See Weisbrot, Ray and Sandoval.
32 Ibid.

FIGURE 3
Venezuela: Inflation (Consumer Price Index, Caracas)



Source: Banco Central de Venezuela 2010, Table 4.1.6s.
Note: Core inflation is here defined by the Banco Central de Venezuela. It differs from that presented in Weisbrot, Ray, and Sandoval (2009), which the authors calculated based on the US definition for international comparison.

In January of 2010, the government devalued the bolivar to 4.3 to the dollar for most imports, bringing it much closer to a competitive level. At the same time, a rate of 2.6 per dollar was established for sectors deemed essential, which include food, education, science and technology, health, machinery and equipment, family remittances and transfers to students living abroad. In June 2010 the government implemented a new currency market intended to replace the parallel market, regulated by the Central Bank; the exchange rate for this market has most recently been about 5.3 bolivares fuertes to the dollar.

The devaluations have reversed a good part of the real appreciation of the currency over the last 5 years, but not all of it. If Venezuela wants to diversify its economy away from oil – which it has not done over the last decade – it will most likely need a more competitive exchange rate.

Nonetheless, for the narrow question at hand here – whether the Venezuelan economy can resume and sustain strong economic growth – the exchange rate is unlikely to be determinative. It will affect the sectoral mix of economic growth, tilting it toward non-tradables as during the previous expansion. But the pace of economic growth is more likely to be determined by the government's other macroeconomic policies, most importantly public spending.

Of course it will be better if Venezuela can diversify away from oil sooner rather than later, and minimize the inefficiencies associated with controlling its exchange rate and maintaining currency controls. And as noted above, because Venezuela's inflation is much higher than that of its trading partners, it will continue to cause unwanted real appreciation of the bolivar until inflation is brought to lower levels.

But because of Venezuela's position as an oil exporter – and one sitting on 500 billion barrels of oil, perhaps the largest reserves in the world – it is very unlikely to run into foreign exchange constraints. Therefore its growth, especially in the near future, will depend overwhelmingly on the government's commitment to maintaining adequate levels of aggregate demand. (In that respect, its immediate situation is similar to that of the United States, the Eurozone economies, and many other economies whose recovery is currently weak and uncertain.) In the immediate future, the Venezuelan economy's dependence on oil is not a particular disadvantage, as countries dependent on manufacturing exports, for example, are at least as likely to be hard hit by a global slowdown – if it happens – as are oil exporters.

If the government maintains adequate levels of aggregate demand – including a commitment to strong counter-cyclical policies as necessary – the Venezuelan economy will grow, and the progress in employment, living standards, poverty reduction, and income equality that were seen during the previous expansion will continue. Of course this is not guaranteed – it depends on whether the government is willing to make, and maintain, this commitment to growth. The government will also have to make sure that sufficient foreign exchange is made available for imports that are inputs to production. If these commitments are met, then economic growth, as well as the accompanying social progress, can continue for years, regardless of inefficiencies, development strategies (or lack thereof), or other economic problems. This is very different from the situation of many countries (e.g. the U.S., UK, Spain) in 2007, for example, where asset bubbles had reached the point that a serious collapse in demand was guaranteed, and a severe recession could be predicted – although even in these countries, the recession and subsequent long-term unemployment could have been far more limited if the proper fiscal policies were implemented. Although there are a number of analysts who are predicting that the Venezuelan economy is on the verge of inevitable (and long-anticipated) ruin, there is nothing in the recent data – or that of the last decade – to indicate that this is true.

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