From Private Market to Government Control:

The Exchange Rate Market in Venezuela

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Abstract

This research study analyzes the sudden increase in GDP in Venezuela between 2003 and 2004. After years of struggling economic growth, Venezuela's GDP rate increased from -8% in 2003 to 18% in 2004. During this period, the Venezuelan Ministry of Finance issued a policy in which the government would take over the exchange rate market. Instead of supply and demand factors determining the rate of exchange between the Venezuelan currency, Bolivar (VEF), and the US dollar (USD), the Venezuelan government set a fixed exchange rate from 1,853 VEF to 1,600 VEF per USD. The forced appreciation of the Bolivar eliminated the information that markets provide to consumers, producers, and investors, and it invited actions of corruption. Data on Venezuela's corruption index, according to the Heritage Foundation, shows that during this period of time, corruption increased 11% and it continued increasing ever since. In this research, I used historical data on GDP growth, export growth, import growth, the corruption index and other economic variables in order to determine the cause of this sudden increase in GDP growth. I found that during the time in which a fixed exchange rate was determined in Venezuela, corruption increased and GDP fictitiously increased due to an appreciation of the Bolivar. I show that this increase in GDP is due exclusively to the manipulation of the exchange rate, and not due to higher production of oil or any other source of income.

1. Introduction

Venezuela is an oil-producing country located in the north of South America. The country is well known for its oil, which makes up 95% of its total exports and 52% of its total GDP. According to the CIA, Venezuela is the 10th largest oil-producing country. In 1998, Venezuela chose a president with socialist ideology, different to the typical capitalist ideology which had ruled in Venezuela years prior. President Hugo Chavez came to power in January 1999. He started to spread ideas on how to both solve the problem of inequality in the country and become the most important oil exporter of the world. Hugo Chavez wanted to convince the world that Venezuela was powerful and unstoppable.

One of Hugo Chavez's measures to ensure power was the 2003 elimination of the exchange rate market. On February 5th 2003, the Venezuelan Ministry of Finance enforced a new policy in which the government would take over the exchange rate market. Instead of supply and demand factors determining the rate of exchange between the Bolivar (Venezuelan currency, referred to as "VEF" from this point forward) and the USD, the government set a fixed exchange rate from 1,853 VEF to 1,600 VEF per USD.

In this research, we will analyze why in the period between 2003 and 2004 Venezuela's GDP suffered a sudden increase, even though the prices of oil did not have a major change at that period of time. My general hypothesis lies in the assumption that a corruption indicator serves as compelling evidence to understand a sudden increase in the GDP growth of Venezuela. According to Paolo Mauro (1995), corruption is "the degree to which business transactions involve corruption or questionable payment." My findings indicate that corruption growth increased 3 points according to the "Index of Economic Freedom Scale," while the country's GDP increased from -8% in 2003 to 18% in 2004. Today, Venezuela takes the 179th position out of 180

countries in Heritage Foundation's Ranking of Economic Freedom from least corrupted to most corrupted countries. According to previous findings, which I will later present, corruption usually has a negative relationship with the GDP growth of a country. If Venezuela has high levels of corruption it should then not have a positive growth in the economy. However, the data suggests there was an economic growth, even with high levels of corruption.

2. Literature Review

In this section, we will review the different points of view regarding corruption as a variable in economic growth. Venezuela, a relatively rich country, has an increasing economic growth as well as corruption levels in the past years.

Some authors state that corruption is a positive variable for a country. Mauro (1995), in his research titled *Corruption and Growth,* inquiries about whether or not a malfunctioning institution with high levels of corruption can cause a decrease in the economic growth of a country. Additionally, he questions what characteristics a country should present to suggest a positive relationship between GDP growth and corruption. His study is based on the probability that two random people in the same country belong to the same ethnolinguistic group, which is highly related to corruption. Mauro concludes his research by stating that corruption causes an increase in investments and growth due to bureaucratic efficiency, however, corruption must be used with precautions. In other words, Mauro implies that corruption is a positive variable in economic growth. What Mauro fails to answer is why poor countries turn out to be more corrupted than richer countries.

Some authors have studied that corruption has the opposite effect in the GDP growth. Mo (2000), a professor of economics of the Hong Kong Baptiste University, in his research,

Corruption and Economic Growth, addresses the dilemma economists have dealt with for many years. In his article, Mo focuses on the negative relationship between corruption and GDP growth. Mo developed a new analytical framework that takes into consideration human capital, investments, and political instability. Mo concludes that an increase in corruption levels reduces growth rate. Additionally, he determines that the most important corruption channel to affect economic growth is political instability. This means that corruption is a negative variable, and is directly linked to political instability. This correlation answers Mauro's question about high levels of corruption in poor countries.

3. Market of Exchange Rates Effects on GDP

3.1. Methodology

For this investigation I took data from a set of organizations. This data was later compiled into graphs and charts to identify evidence in the data that supports the hypothesis. The World Bank's "World Development Index" (2017) is the source for which I gathered the data on the GDP growth, the export growth, and import growth from Venezuela and nearby Argentina, Brazil, Colombia, Ecuador, and Peru from 1990-2015. The GDP growth is described as the percentage change of the all goods and services produced within a country in a specific period of time (Mankiw, 2014). The export growth is the sum of all the goods and services produced domestically and sold abroad (Mankiw, 2014). This data allowed me to understand the economic activity of Venezuela compared to other countries in its region.

Other data used for this research were the historical prices of oil; this data was gathered from OPEC (Organization of Petroleum Exporting Countries). The data is composed of the OPEC Reference Basket (2015), a weighted average of the prices of petroleum blends produced by

members of the Organization from 1994 to 2016. This data serves as evidence of no major change in oil prices that would cause the sudden increase in the GDP growth of Venezuela.

Another data set presented is the corruption index which describes the level of corruption within Venezuela. This data was obtained from the "Index of Economic Freedom" (2017) created by the Heritage Foundation. The Heritage Foundation each year gathers more than 7,000 data points acquired from organizations such as World Bank, Economist Intelligence Unit, and Transparency International and set ups the "Index of Economic Freedom," which ranks countries based on their levels of corruption. "The Index of Economic Freedom" is composed of a set of factors: Property Rights, Freedom from Corruption, Fiscal Freedom, Government Size/Spending, Business Freedom, Labor Freedom, Monetary Freedom, Trade Freedom, Investment Freedom, and Financial Freedom. From these factors I gathered the data on corruption from the index, which relays data from the Corruption Perceptions Index 2011; U.S. Department of Commerce, Country Commercial Guide, 2009–2012; Economist Intelligence Unit, Country Commerce, 2009–2012; Office of the U.S. Trade Representative, 2012 National Trade Estimate Report on Foreign Trade Barriers, as well as official government publications from each country. The index is based on a 10-point scale, in which a score of 10 indicates low levels of corruption and a score of 1 corresponds to high levels of corruption. This raw data is multiplied by 10 to make the data easier to understand in a scale of 0 to 100.

And lastly, I provided the exchange rate prices of USD in Venezuela before and after the 2004 policy, which sets the value of the USD in a fixed position in addition to the government serving as an intermediary of an exchange rate purchase. This data was retrieved from the Venezuelan Central Bank database (2003). The Policy was enforced on February 5th 2003. The

data bellow will show the value in Bolivars for each 1 USD sold and bought on the last three days the value changed, the last one being the day the policy was enforced. Also on the chart, I will provide the percentage change from one value to the other.

Figure 1. Exchange Rate Value in Bolivars

Date	17/01/03	21/01/03	4/2/03	5/2/03
Purchase: VEF for 1 USD	1,755.00 VEF	1,849.50 VEF	1,849.50 VEF	1,596.00 VEF
Sale: VEF for 1 USD	1,758.50 VEF	1,853.00 VEF	1,853.00 VEF	1,600.00 VEF
% Change in Purchase Value		5.38%	0.00%	-13.71%
% Change in Sale Value		5.4%	0.00%	-13.7%

3.2. Results

The exchange rate market policy issued in 2003 allowed the Venezuelan government to take control of the demand and supply factors of the exchange market. Figure 1 shows the value of 1 USD in VEF. From the day before the policy was enforced, February 4th 2003, to the next day, the value for each sale of USD decreased 13.65%. The same percentage change is seen on the export growth for 2004. The government never made clear why they believed this policy would help the Venezuelan economy. The policy appreciated the price of the VEF, which is not a common procedure in the region. Commonly in South America, countries devaluate the price of their currency to attract investors into a cheaper economy, and that way gain more profit. Venezuela did the exact opposite, the government appreciated the value of the VEF, which would normally scare away investors. Since the primary resource of Venezuela is oil, and due to its geographic advantage, the Venezuelan government was sure that this policy would not damage their economy as much as it would be damaged if Venezuela was not an oil-producing country.

This policy had effects on the GDP growth as well as the imports and exports. Since the GDP is measured in USD, with the appreciation of the VEF it would seem like the GDP had a sudden increase in the period 2003-2004.

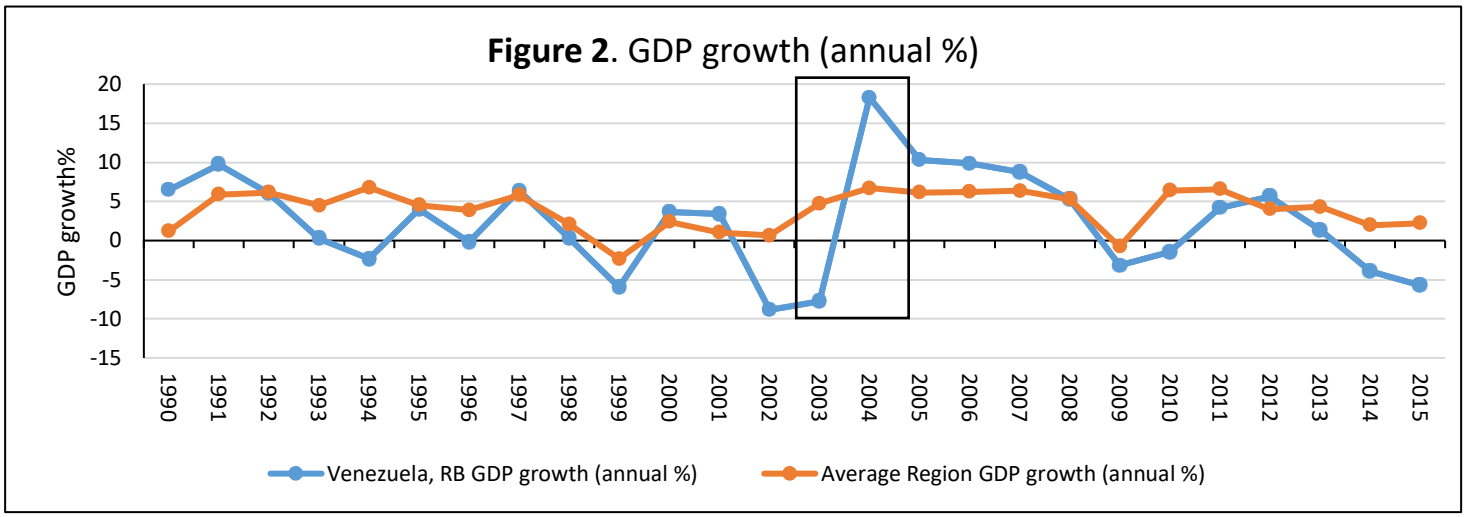


Figure 2 shows the GDP growth rate of Venezuela, and the average of the region from 1990 to 2015. Highlighted is the increase in GDP from 2003 to 2004. In 2003 the growth rate was of -7.8% and in 2004 the growth rate was of +18.29%. The region's GDP growth though, in 2003 was of 4.7% and in 2004 was of 6.7%. The GDP growth in Venezuela compared to the region's growth is significantly greater than, the average of the region. The GDP growth increased because the value of each USD decreased.

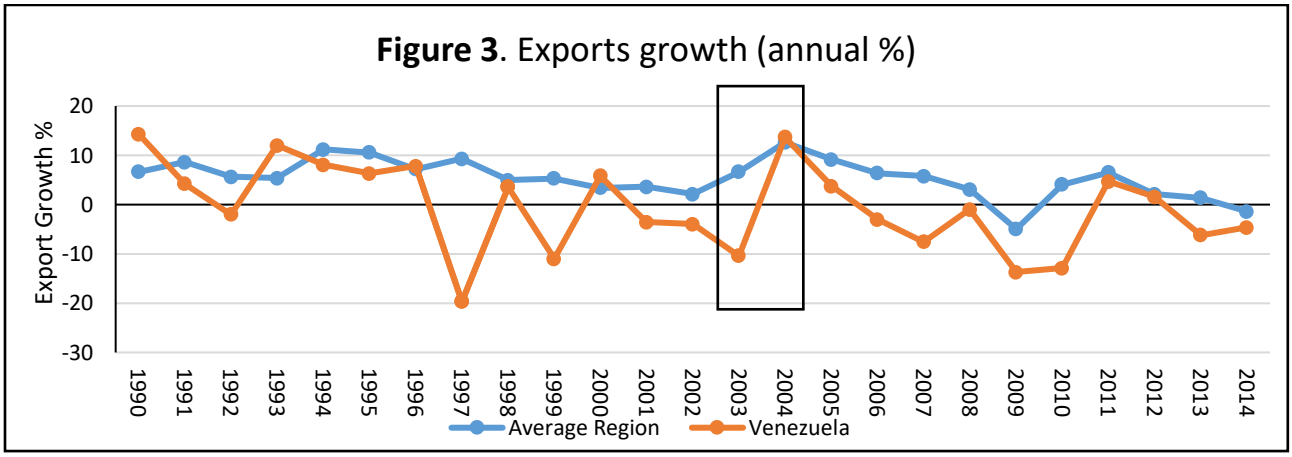


Figure 3 shows the Export growth in Venezuela and the average of the region from 1990 to 2014. The period highlighted, 2003-2004, shows that export growth rate went from -10.4% in 2003 to +13.7% in 2004. In the other side, the region's export growth went from 6.7% in 2003, to 12.6% in 2004. Since the percentage rate is the same as the percentage the VEF was appreciated, this shows that there was no growth in the exports, it was the appreciation.

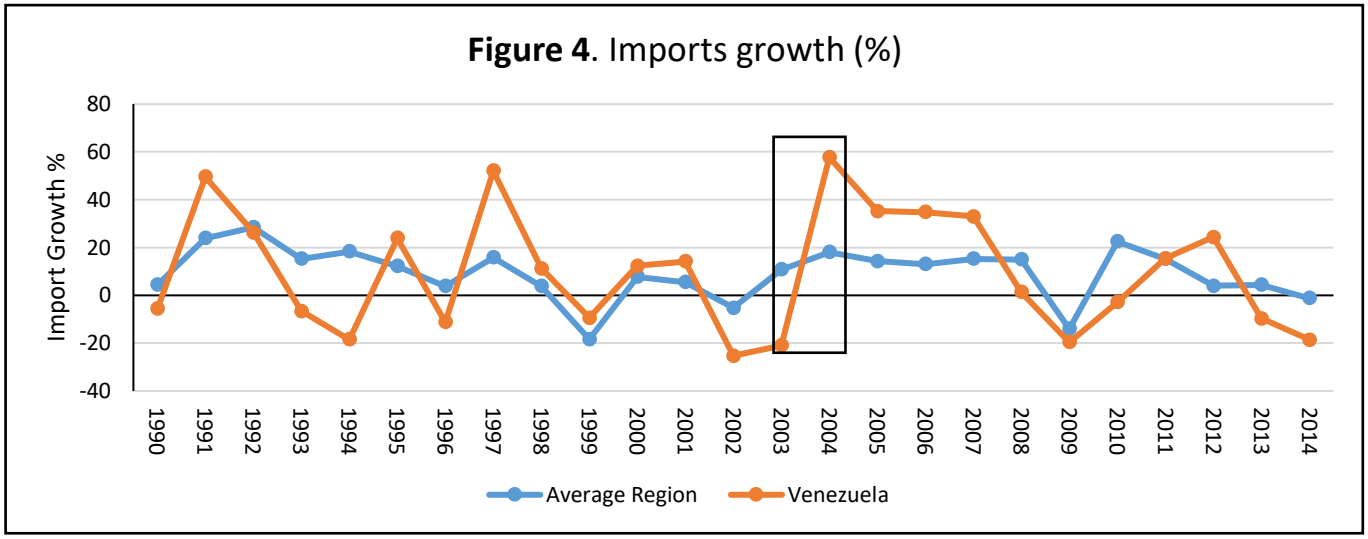
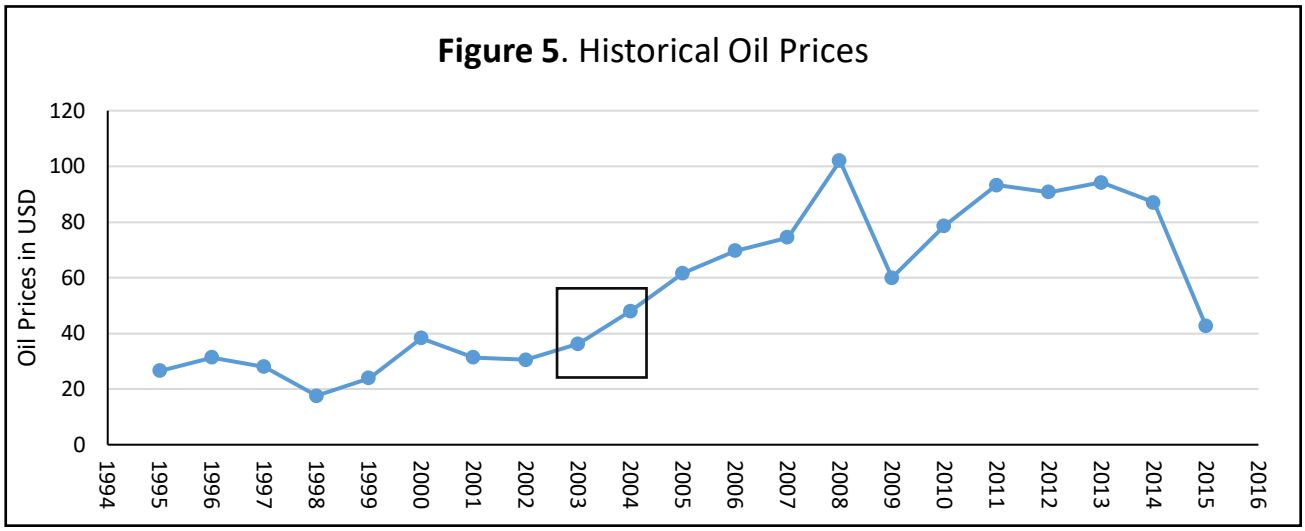


Figure 4 shows the import growth in Venezuela and the region average from 1990-2014. The period highlighted, 2003-2004, shows that export growth rate went from -20.9% in 2003, to 57.7% in 2004. In this period, imports in Venezuela was the GDP component that grew the most. So it can be speculated that the policy was issued to make imports cheaper therefore increase their demand. Since Venezuela is an exclusive oil-exporter, it makes sense that the country had to figure out a policy that would make imports cheaper.

The GDP, export and import growth demonstrate that the policy worked in this first year of enforcement. The problem is that the GDP growth was multiplied by the new exchange rate policy that appreciated the VEF, as well as the exports and the imports. Still, taking away the percentage change between the USD before and after the policy, the import growth was still 58% in 2004. This serves as evidence that the policy was made to make imports cheaper, as well as having control of what enters and leaves the country.



Another fact that serves as evidence that the GDP growth was not due to an increase of production is the changes in prices of oil. Since Venezuela is an oil dependent country, any changes in the market would affect the GDP growth. Figure 5 shows the prices of oil from 1994-2016. In the highlighted, 2003 – 2004, the prices of oil changed from 36.26 USD per barrel to 47.98 USD per barrel.

Figure 5. Index of Economic Freedom: Venezuela 2000-2009

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Level of Corruption Venezuela	23	26	27	28	25	24	23	23	23	20
% Change of Corruption Venezuela	17.8%	13.04%	3.8%	3.7%	-10.7%	-4%	-4.2%	0%	0%	-13.04%
Level of Corruption Region Average	38	40	42	42	40	39	39	40	39	39
%Change of Corruption Region Average	8.7%	5.3%	6.6%	0.5%	-5.2%	-2.9%	0.5%	2.6%	-1.9%	-2%

Figure 5 shows the level of corruption of Venezuela and the Region Average on a scale from 1-100 along with the percentage rate of change from one year to the other. Highlighted is rate of change of corruption in the years 2003 and 2004. In 2003, the corruption index of Venezuela was of 28 and it decreased 11% on 2004 to a corruption index of 25, which indicates higher levels of corruption. On the other hand, the corruption index of the Region is significantly higher, which means there is less corruption in the region. The Region Average's corruption index was of 42 in 2003, and 40 in 2004; there was a 5.2% increase in corruption in the region. Since the policy was the major event of this year, I suggest that obscuring the exchange rate market allowed corruption levels to increase in government institutions.

4. Conclusion

In this research paper we studied that Venezuela is an oil-producing country that in the period of 2003-2004, enforced a policy in which the government took control of the supply and demand factors and set a fixed exchange rate. Through this policy the government appreciated the value of the national currency, making the imports cheaper and the exports less profitable. Since Venezuela is primarily an oil-exporting country and needs to import the majority of the basic goods, this policy actually benefited the country. But this policy solved a problem in the short run. The government seemed unconcerned with the consequences this policy would have on the exports, due to how inelastic oil is in the market.

In this period of time the imports growth increased; which implies that the government took advantage of this policy. The thing is that if they had made the right decision on what to spend their cheap imports in we would have seen evidence in GDP growth on the years presiding the policy. If they had taken advantage of the cheap imports they would have actually been able to increase technology and capital, therefore, increase productivity, which increases GDP. We know that this was not the case because the years following the policy the GDP growth has declined. There are actually some speculations that imply that the imports that where brought into the country where mainly military weaponry, and other non-essential goods.

Corruption is a negative variable for the country's GDP growth. When we whiteness an obscurity in the transaction of a firm, we have corruption. Corruption levels increased after this policy was enforced. What was imported did not benefit the country, the policy did not have any positive outcomes for the economic growth of Venezuela.

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