

Case Study on Venezuela's Currency Exchange Rates

by Emma Benoudiz

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Edited by Matthew O'Boyle, Estella Lamarche-Dykeman, & Viktor Biquet

Abstract

The implementation of regulatory measures on a country's currency exchange occurs from experiencing capital flight and inflation. This paper will focus on President Hugo Chavez's attempts to carry out a policy to regulate and distribute the supply of US dollars to Venezuelans who needed it through the CADIVI institution. The government restricted its distribution to certain actors and businesses, by refusing US dollars to the majority of the country. The restricted access to dollars led to the formation and widespread use of a parallel market for currency exchange. Moreover, the corrupt government instilled so much fear within the population, that individuals, desperate to gain dollars, would pay almost any price. This inelasticity of demand resulted in continuously increasing prices, which created the opportunity for specific individuals, in the private and the public sectors, to conduct black-market profiteering via the exchange rates. With the help of shell companies abroad, the process of frauding the government for an increased supply of dollars became a recurring cycle, ultimately sabotaging the country as a whole.

Introduction

Deemed the most problematic country in Latin America, Venezuela's economic turmoil exemplifies a never-ending cycle of deep-rooted corruption. One aspect of this downfall is the emergence of the parallel currency exchange market, leading to a currency crisis. Currency crises involve recurring cycles of speculation on the foreign exchange value leading to a devaluation of the local currency (Drazen, 1999). Indeed, Venezuela experienced a currency crisis after President Chavez implemented exchange control in 2003. During his administration, corrupt behaviours infiltrated the judicial and legislative branches, undermining the government's legitimacy. Through the appointment of inadequate government officials, policies such as the exchange control caused panic within society as the limited supply of dollars meant that the black market for currency exchange prevailed. This widespread use led individuals and businesses to further carry out black market profiteering through the exploitative

use of shell companies abroad. The research is centred on the Venezuelan population and contains interviews with two affected individuals who participated in this phenomenon. This essay will analyze the extent the combination of a corrupted government and the use of shell companies by the private sector impacted the currency crisis in Venezuela.

Literature Review

In order to understand the progression of the currency crisis, Omar F. Saqib has identified phases that may appear during this phenomenon, which will be used to guide the study of the impacts on Venezuela. Phase one of a crisis of this nature is usually due to external shocks such as political events, policy changes, or even financial successes which have a strong impact on the economy, overall. Saqib emphasizes, specifically in this stage, the impact of shocks on opportunities in specific sectors of the economy and the advantage that they may provide in terms of profits and investments for governments and individuals. Phase two includes a boom which expands the money supply due to increased demand for goods, and subsequently increases prices, income, and investment. The money supply will become overtraded due to speculation and overestimation of the benefits that trade will bring. When more people participate in this speculation, the demand for liquidity increases, the price of goods decreases, and firms and banks become insolvent, resorting to illegal activities to survive. The situation becomes chaotic when individuals begin to expect that there is not enough money to allow everyone to make a profit; this chaos quickly breeds panic. The third phase offers a supposed tranquillity if the public turns away from liquid assets, trade declines due to price restrictions, or lenders provide cash flow.

Corrupt behaviour among politicians means that the political sector is a crucial factor in the deterioration of the currency exchange rate—and currency crises as a whole. Cycles of extensive trading due to speculation can be propelled by a country's political objectives. When a country has the appearance of an economic boom—an increase in capital, economic growth, and low unemployment—these factors form a façade that conceals the possibility of negative effects, causing the government to overlook them (Drazen, 1999). Furthermore, there is proof that political booms are linked to a higher likelihood of a country enduring a currency crisis. This is especially the case with governments concerned with popular approval, even though they may be aware of the economy's fundamental flaws, they may be inclined to ignore them if regulation is politically expensive in the short term. Indeed, decisions to, or not, economically intervene are influenced by a lack of political will and the tendency toward a course of action that will boost their support in the short-term (Sever, 2021).

The emergence of Venezuela's currency exchange crisis is directly linked to Chavez's implementation of the 2003 exchange control. As an authoritarian leader, Chavez would proclaim his actions to be for the benefit of the populace, specifically the lower class, as a way to excuse his undermining of the legislative and judicial branches, eroding the democratic system as a whole. Indeed, at the start of his reign, the country benefited from a colossal increase in oil barrel prices, allowing for wealth redistribution. Chavez appointed actors whose political views were aligned with his own, specifically on the *Petróleos de Venezuela S.A.* (PDVSA), meaning he could use the oil profit to give out grants to the poor and certain actors as a trade for loyalty. Later, this exchange expanded to include oil price subsidies to encourage alliance-building among nations that shared political and economic values (Wiseman, 2010). Chavez's selective wealth spreading caused citizens to become increasingly aware of the corruption and lose trust in the government. This mistrust manifested in a two-month oil strike in 2003, in which participants encouraged Chavez's resignation. The strike resulted in a drop in total oil output, increased capital flight, and inflation, to which the government responded by implementing currency controls. Once the populace saw the authoritarian methods Chavez applied, investors lost faith in the future of the economy and began to remove their assets and wealth from the country. Following the policy, the government created CADIVI (*Comisión de Administración de Divisas*) to regulate and redistribute the supply of dollars to Venezuelans. Obtaining dollars became an intricate process that entailed gaining approval on a meticulous set of requirements and paperwork, and fall within the realm of what the government considered useful to grant dollars (Millard et al., 2019).

When analyzing the private sector, it is crucial to understand why individuals and businesses created shell companies as their primary profit method. As Venezuela's reputation as a corrupt state with a volatile economy became an international reality, conducting business with local enterprises was perceived as too risky for foreign investors. Therefore, many Venezuelan enterprises established parallel businesses in nations like the U.S. or Europe to reaffirm their legitimacy and act as a stepping stone to conducting "regular" trade with foreigners. These businesses eventually turned into shell corporations, however, since it was easier to fake it than to manage a real company. Further, the proliferation of shell corporations and hidden bank accounts require flows of money to be laundered through the infrastructure of contemporary offshore banking and then come home with their origins concealed. Most significantly, they are disguised as an imperative by the afflicted economy to forgo its material prosperity, political stability, and social cohesiveness, which exacerbates the crisis, especially since they fall beyond the authority of local officials (Naylor, 2014). The lack of transparency is beneficial to ghost companies who use international wire transfers to move enormous sums by unknown owners (Department of the Treasury, 2006). Lastly, the state's corruption directly impacts the populace, especially through the implementation of regulations and authorization requirements. With these laws, the appointed officials in charge of inspecting operations have a monopoly on authority and full command over the length of the authorization process. A centralized government that

uses corruptive measures incentivizes subsidiary sectors of the government to do the same and extract bribes from the populace (Tanzi, 1998).

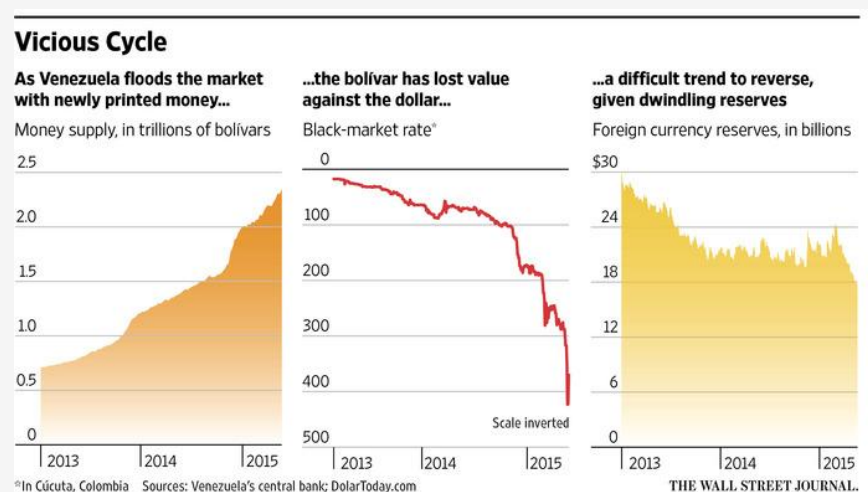
Methods

The research for the public sector is the most complicated as the government tends to withhold its involvement in illegal activities. The historical context will be emphasized as the implications from Hugo Chavez's reign directly correlate with the phenomenon of black market profiteering in currency exchange rates, as he is the reason for the restrictions imposed by the government on this trade.

The research for the private sector was done through a series of interviews with people who have seen the fraud firsthand and participated in buying and selling dollars through shell companies. Anonymity has to be preserved with the individuals interviewed for protection against the criminality of their actions. The interviews will focus on anecdotal events as the individuals are asked to express their methods of gaining dollars outside the official market. The first interviewee is a CEO of a local business in Caracas that imports personal hygiene products. As this person conducted black market profiteering through their creation of a shell company in the US, they will be a great example of the ease of the process and the commonness of the practice. The second interviewee comes from the other side of the process; a CADIVI government official who also committed fraud by creating two shell companies, both local and abroad.

Findings

Figure 1

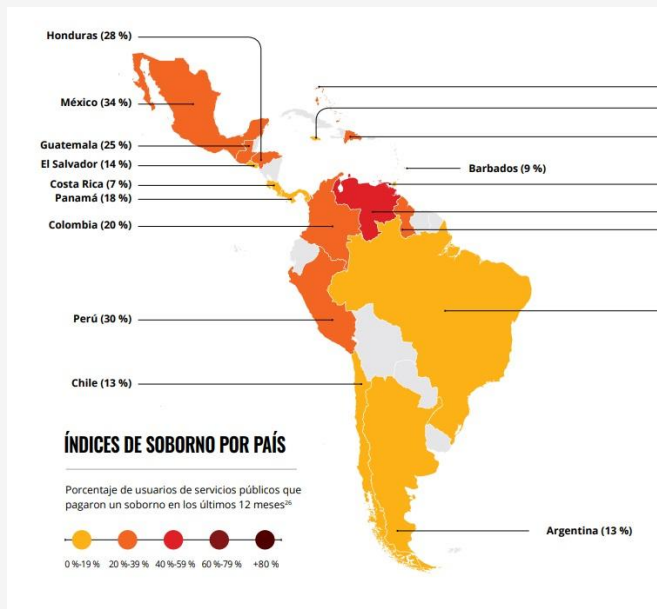


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MJE

The chart above entails the impact of the government's currency control restrictions on the number of dollars allowed to exchange.

Figure 2

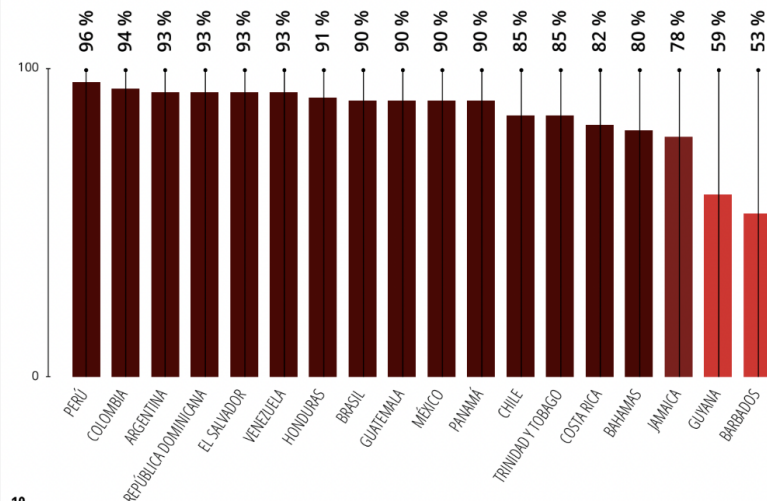


This map shows the percentage per Latin American country of people who participated in bribing government officials.

Figure 3

CORRUPCIÓN EN EL GOBIERNO POR PAÍS

Porcentaje de personas que piensan que la corrupción en el Gobierno es un problema grave¹¹



The bar graph shows an overview of the percentage of people who think their government entails corruptive measures.

Figures 2 and 3 come from Transparency International Opiniones y Experiencias de Los Ciudadanos en Materia de Corrupción Barómetro Global de la Corrupción América Latina y el Caribe 2019.

In the same report as the figures above, it has been found that 61% of the population has engaged in bribing government officials, and 90% of the population does not have trust in the Venezuelan government and its justice system.

Interview 1

This person is the CEO of their company, which focuses on importing personal hygiene products from the US. To respect anonymity, I will call this person Bob for simplicity's sake.

Once the government imposed currency control, Bob, as head of his business, was starting to face issues as there were restrictions on how many dollars individuals and companies could retrieve at a time. The problem arose when the demand for soaps and other hygiene products did not decrease, the rate given by the government became unattainable, and no international business would ship goods or services without paying in advance. As a businessman, since there is demand, there is pressure to get the goods delivered to consumers quickly. Bob resorted to reaching out to other business people about ways to obtain dollars outside the government market, how to import with these restrictions, and general tips to keep his company from collapsing. He found the most favourable and profitable way to avoid this collapse was by creating shell companies abroad. At the start, companies abroad were legitimate; however,

many individuals saw the ease and efficiency in depriving CADIVI, resorting to transforming these companies into illicit ghost companies. Bob fell back to creating shell companies abroad to pay for the suppliers, in this case, in the US. By having shell companies in the US, Bob could construct falsified purchases coming from the company in the US and send the quotas back to CADIVI for approval of dollar exchange. This falsified document also encompasses an overcharge of goods, in this case, shampoos, to gain additional dollars from the Venezuelan government entity, CADIVI. Bob would write in his quote that the shampoo supposedly costs \$10, but in reality, it will only cost him \$3. Once Bob goes to CADIVI with all the necessary documents, they will review and decide if Bob will be granted the said amount of dollars required to carry out the trade. From this, most individuals/businesses have two options: either wait for CADIVI to respond (which could take only 1 week but also runs the risk of never getting a response) or ask for an "accelerated" decision.

Since CADIVI officials also partook in shell companies (which is how they get their wealth), if you wanted an "accelerated" response on your file, you can offer a favourable trade by proposing a specific interest rate to the CADIVI official from your deal and masking it as a different trade of a good or service for the official to pocket. To ensure an understanding between Bob and the official getting said profit, CADIVI approves the file Bob gave in and sends a message to the bank to authorize the trade of Bob's bolivares into USD (for now, the money has yet to be transferred). Bob then goes to the bank to obtain a statement with the official exchange rate, in this case, 1 million dollars was equal to 6.3 million bolivares. Once the banker makes sure the money is in Bob's account, they take the 6.3 million bolivares, go to Banco Central for approval, and send the equated amount in USD to the shell company in the US. With the 1 million USD in Bob's US bank account, he will first pay the said interest to the shell company of the CADIVI official, in this case, 10%, to guarantee allegiance.

With the rest of the money, Bob will pay for the imported shampoos. Since the price was inflated to gain profit, Bob will still buy 100,000 shampoos with the \$900,000, which would cost \$300,000, allowing him to keep \$600,000 from this transaction. Once the shampoo shipment arrives in Venezuela, the shampoos that cost around \$3 (plus shipping and other charges) will be sold for \$10. As this is sold in bolivares, Bob will keep the profits in bolivares for the next round of importing shampoos. Since he still has \$600,000 USD from the first round, he will take \$100,000 USD from that amount and sell it. This amount of money can be taken out by having connections with other businesses that are importing non-essential goods and interested in purchasing dollars. Since they do not have the choice of getting dollars from CADIVI (due to high demand), they resort to buying from the black market. Bob can then take out the \$100,000 USD in multiple transactions (to not get flagged) and sell it through the *permuta* (black market) to these needy individuals. In this case, the \$100,000 = 27 million bolivares (due to the black market current rate at the time). Then Bob took the 27 million bolivares that were traded and rebought dollars through CADIVI, which in this case was 4 million USD. CADIVI will approve this

transaction because Bob had been loyal in giving the 10%, so the official is incentivized to conduct the same trade again, especially if it entails more outstanding sums this time.

In conclusion, for \$100,000 USD, there was a profit of more than 3.8 million USD.

Interview 2:

This person used to work for the Venezuelan government as a CADIVI official. Same as the first interview, to protect the individual, I will name them Mary for clarity.

Mary decided to also partake in this process by creating a shell company abroad and locally. In her case, as seen with Bob, the recurring proposition of people in business to give her partial profits incentivized her to go even further. Creating a shell company, both locally and abroad, allows Mary herself to conduct the same trade people like Bob were engaging in. Like Bob, Mary still needed to create a file because she would require the government to give her dollars. In her case, she falsified that she would purchase some USBs and overpriced them by changing the number of gigabytes they could store. Indeed, a USB of 1GB is not the same price as a USB of 48GB, allowing her to ask for a more significant amount of dollars. Mary would end up conducting the same process as Bob, except that since her company in Venezuela is a ghost one, she does not have a demand to meet from consumers. As seen with Bob, the profits are so large that Mary does not even bother reselling the USBs since they are very cheap proportional to the monetary gains.

Discussion

As Saquib expresses, a currency crisis first emerges due to an external shock, and in Venezuela's case, it can be argued as the coming to power of Hugo Chavez. Chavez's reign encompassed a populist regime where he portrayed himself as representing the people, specifically the poor. For Venezuela, his election to power was revolutionary in the sense that he was a 'Robin Hood', promoting an anti-elite campaign and physically being the darkest-skinned leader ever to rule. His popularity was the reason he won the presidency and kept him in power for a long time, making popular support an important element of Chavez's career to preserve (Corrales, 2016). If we consider Chavez's coming to power as Venezuela's political boom, then Drazen's theory of the link between political booms and a higher likelihood of a country enduring a currency crisis makes sense. Indeed, his inability to address Venezuela's economic situation can be linked to his lack of political experience and will to adapt as well as his overall focus on promoting support. Since Chavez's coalition included poor, former military, and long-marginalized leftist politicians with limited political and economic knowledge, when appointing government officials, his workforce encompassed those who would endorse him but

lacked competency. Additionally, Chavez would ensure the bureaucratic ministers regularly rotate to prevent any coalition building within the government (Corrales, 2006). However, with the oil strikes that were happening previous to the currency control, the economy was shifting toward an economic turmoil that Chavez could not ignore. Since authoritarian governments strive to gain power by increasing society's tolerance for state involvement, the more insecurity citizens feel, the closer they are to live in a brutish state of nature, and the more they will welcome state control. Therefore, the restrictive policies as currency control blinded the populace at the time of the repercussions it would create in the future. Currency control is not the leading cause of the crisis, as these control techniques, when correctly handled and combined with solid monetary and fiscal policies, may reduce inflation and boost currency trust. Indeed, it reinforced the fact that Chavez's corruption was the cause as he did not apply the necessary process for the welfare of the populace.

To understand the findings, one first has to understand how the devastation of the Venezuelan bolivar happened. The prevailing issue was that the official market for dollars was fully administered by the government (CADIVI), which imposes high restrictions and leads many to turn to the black market to get any dollars. Since inflation caused all the prices of goods and services to rise, and the official market rate did not adapt to these changes due to its fixed rate, official dollars became cheaper, leading to higher demand for official dollars given by the government. However, when the number of dollars the government had in its possession decreased, chaos arose from this scarcity. Another issue surfaces through the lack of public confidence that people have in the Bolivar, which impacts the official rate with an increase in inflation, the purchasing power of the Bolivar decreases, and the trust one has in its value coincidingly also decreases. The government's low rate for dollars creates such high demands for the dollar that they resort to trading in the parallel market with a limited amount of dollars. Since the black market is accessible to all, more people traded currencies overall, increasing the dollar value and exceeding exorbitant prices.

The chosen interviewees reinforce this occurrence, as seen through their engagement in criminal and corrupt pathways. As Chavez promoted an anti-elite campaign, the individuals in the private industry experienced the most detrimental effects as any non-essential business would most likely be refused dollars. As expressed in Saqib's phases of a currency crisis, once individuals realized that there was not enough money to allow everyone to sell out at a profit, chaos emerged, and the black market rate, because it does not have a cap, continued to get more expensive while the dollars available through formal pathways depleted. The inability of businesses to conduct regular trade, as seen in Bob's interview, emphasizes that individuals had limited options if they did not participate in the exploitation of the system. It goes even further, as seen in Mary's interview where she, a government official who normally should abide by the law, engaged in the black market profiteering in an even more corrupt way, using two shell companies rather than just one. Coincidentally, as expressed by Tanzi, implementing regulations

enhances corruptive characteristics. The duration of the licensing and inspection process is under the hands of corrupt governments, and she was typically encouraged to demand money from Bob and other persons. In reality, since the central government is corrupt and other officials became corrupted, Mary's case shows a lively example of circumstances encouraging her to engage in corruption despite her position working for the government.

Venezuela's public perception of corruption is also seen through the Barómetro Global de la Corrupción América Latina y el Caribe's Figure 2 and Figure 3. In Figure 2, the participation of Venezuela's population in bribing government officials is shown in comparison to other Latin American countries. From the indices above, one can see that Venezuela has the darkest shade of red, which means it has around 40-59% participation in bribing, confirming it as the highest in all of Latin America. Additionally, it's been found that around 61% of the population admits to having asked officials to accept bribes to facilitate their process. This high participation reinforces the commonality of conducting fraud with the assistance of the government. Figure 3 shows the percentage of people who believe there is corruption within their government and believe that it is a significant issue. Compared to a multitude of Latin American countries, Venezuela still ranks within the top countries. With 90% of the population not trusting the government or the justice system, it brings to perspective the lack of will to follow the law. If the population does not believe the government will work in their favour, protect and provide for them, there is less incentive to keep ethical methods.

Lastly, the effects of the government's currency control measures may be observed in Figure 1, which displays a chronology of the money supply, black market rate, and foreign currency reserves. As stated in the methods section of this paper, governments will not publish the actual numbers of the currency exchange rate; therefore, the data used in the chart above come from the black market rates. Even if the black market encompasses anonymity which should blind the rates people conducted these trades, a website known as DolarToday.com was able to accumulate data from citizens living in nearby Colombian border towns for dollar values. The US-based website has gained lots of popularity among Venezuelans as it shows the parallel market against the official exchange rate, and since the government is incapable of providing dollars, many turn to these websites and see the benefits of trading in the black market. However, as this website published the collapse of the bolivar, the Venezuelan government pushed for the destruction of this website as it undermined the government by publishing 'falsified' information and looking for compensation (Vyas, 2015). This phenomenon only further proves the corruption within the government, as in a democratic, free state, publications should not be restricted. Thus, the combination of lack of government action and corruption will push for the populace to do the same. If governments have a good balance of powers with fair policies applied, then people will tend to choose the righteous path.

Conclusion

As evidenced to be the most corrupt country in Latin America, Venezuela's currency crisis led to an expansion of the underground economy through the emergence of a parallel currency exchange market. With the newly-instated populist president Hugo Chavez coming into power, lacking experience and political will, the economic turmoil that resulted from oil prices quickly destabilized his ruling. Indeed, his inability to sway away from corrupt methods and his appointment of ineffective personnel led to the implementation of regulatory measures for currency exchange to cause destructive effects. Since government officials were corrupt, the system was defective enough for individuals to exploit it and circumvent CADIVI's bureaucratic criteria. As seen through the interviews, black market profiteering was infiltrating both the private and public sectors with extraordinarily high gains. The more prevalent this procedure got, the more appealing the illegal market appeared.

The Venezuelan government attempts to conceal this phenomenon, as seen by limitations on publications, such as the ban on DolarToday.com, which reinforces the general erosion of democratic ideals and instead prioritizes the regime's image and wealth. Thus, this case study reinforces that when a central authority engages in corruptive methods, it incentivizes lesser levels of government and individuals to do the same.

During this research, the challenges that arose were, at first, convincing the interviewees to share their stories. Since they were able to carry out and transcend criminal penalties, they continue to live in terror of being detected after leaving Venezuela. However, their personal experience clearly suggests the complexity and tragedy the country faces as it is still unable to break the cycle. Further research could be done to investigate where these businesses' and individuals' money went and to dig deeper into other currency exchange fraud methods.

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