After the Oil Boom

BY MATTHEW BLOMERTH

Last February 15th, President Hugo Chávez looked upon an adoring crowd from the balcony of Miraflores Palace in Caracas. His supporters, dressed in the red of Chávez’s socialist revolution, came to celebrate their leader’s victory in a referendum that abolished presidential term limits in Venezuela, allowing Chávez to run for office indefinitely. However, the public spending that has sustained President Chávez’s political power for the past decade may soon dry up as the global financial crisis negatively impacts the Venezuelan economy.

Mr. Chávez’s South American petrocracy is particularly vulnerable because his socialist revolution has gravely undermined the fundamentals of the oil industry, by far the country’s most important economic sector. Without large surpluses from petroleum exports, the president will no longer be able to fund the myriad social programs that maintain the support of his political base. At the same time, Chávez has overseen the spending of vast sums of money meant to serve as the nation’s cushion for precisely this sort of economic downturn. As a consequence, Chávez’s ‘Bolivarian Socialist Revolution’ may, literally, be running out of gas.

Back to the Future

In order to understand Hugo Chávez and the political movement he created, it is necessary to go back to the moment Mr. Chávez leapt onto the political stage. On another February day, a different president gazed out of the widows of Miraflores Palace at the people gathered beneath him. However, on that morning in 1992, President Carlos Andrés Pérez was not in a celebratory mood, for the throng massing outside the palace was a company of rebellious soldiers.

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attempts to storm the palace and overthrow his democratically elected administration. Commanding the rebels was a young lieutenant colonel named Hugo Chávez.

Chávez had been plotting a coup for years with a cadre of disaffected army officers and leftist intellectuals. In 1992, Venezuela was suffering from severe economic problems due to a prolonged period of low oil prices. The poorest Venezuelans were especially hurt by major decreases in public funding decreed by President Pérez in order to close the budget gap. Corruption within the government also undermined the credibility of Pérez’s reformist administration. The time seemed ripe for one sudden blow to bring down the tottering constitutional framework and replace it with a military-led socialist state.

Unfortunately for Mr. Chávez, President Pérez managed a spectacular escape, and the plotters were rounded up by loyal troops. Chávez was arrested and spent time in detention before eventually being pardoned by Pérez’s successor. By 1998, the Venezuelan economy was even deeper in shambles, the government and both major political parties were disgraced due to scandal, and Hugo Chávez was once again poised to seize control of the reigns of state, this time by the ballot rather than the bullet, in a stunning electoral coup.

A New Revolution

Upon taking office, President Chávez began a radical restructuring of the Venezuelan economic and political system. One of the first changes implemented by President Chávez was the fundamental reordering of the Venezuelan state. Under the old system, a liberal democratic government ruled via a checks-and-balances arrangement that heavily borrowed from the United States Constitution. Chávez eliminated this framework by drastically increasing the power of the chief executive, eliminating the Senate, and making it easier to pack the Supreme Court. This new Bolivarian (in honor of Simon Bolívar) Republic supplanted liberalism with populist democracy, with the vast majority of political power concentrated in the presidency.

At the core of Bolivarian philosophy is state control over the economy and centralized control of the branches of government based on the philosophical inspiration of Karl Marx, who Chávez called “one of the greatest revolutionary thinkers that the world has given birth to.” Among world leaders, Chávez sees Fidel Castro as his ideological role model, a leader responsible for turning Cuba into “a sea of happiness.” Following in Castro’s footsteps, Chávez has encouraged the creation of a personality cult around himself, which portrays him...
as the sole leader of the Venezuelan revolution. This combination of political ideology and personality cult led one political commentator to brand Chávez’s Bolivarian philosophy as “Narcissism-Leninism.”

Economic Consequences

Oil accounts for eighty percent of Venezuela’s total exports and thirty-three percent of the nation’s GDP. Chávez’s election in 1998 could not have come at a better time for the leader of an oil-rich nation. That year, average crude oil prices reached their lowest level (adjusted for inflation) since the Second World War, about eight dollars per barrel. Then, from 1998 until 2008, oil prices climbed to over 140 dollars per barrel, a price higher than during the peak of the second oil shock in the late 1970s, before finally retreating last fall. The litany of foreign and domestic policy initiatives the Chávez government has undertaken since coming to power were made possible by this sustained, unprecedented surge in the price of petroleum.

However, now that oil prices have fallen drastically, all oil exporting nations are beginning to feel the economic squeeze. Unfortunately for Venezuelans, their country is likely to experience a more painful economic contraction than other petro-states.

Declining Oil Production

First, oil production at Petróleos de Venezuela (PDVSA), the national oil company, has fallen drastically since Chávez took office. In 1998 PDVSA was producing approximately 3.3 million barrels of oil per day. Each year’s production figures were independently authenticated by foreign observers and the United States Securities and Exchange Commission (SEC). After President Chávez came to power in 1999, oil production began to decline. Faced with several consecutive years of embarrassing decreases, in 2004 President Chávez ordered the cessation of all external verification of oil production figures, including the official certification by the SEC. Since then it has grown increasingly difficult to obtain accurate figures, as PDVSA releases internal production figures with growing infrequency. The reports it does release are viewed with skepticism by most outside observers.

Today two sets of production figures exist, the official PDVSA figures released by the Venezuelan government and the unofficial estimates by the International Energy Agency (IEA) and other independent foreign observers. According to PDVSA’s official 2007 report, oil production has increased steadily since 2002, with crude oil production reaching over 3.5 million barrels per day (counting an addition two hundred thousand barrels of various byproducts) by the end of 2007. Thus the government’s official position is that oil production has re-
covered to pre-Chávez levels over the last decade. However, the IEA estimates that PDVSA’s production has experienced a steep decline, most notably since 2002, leading to the loss of approximately one million barrels per day in production. IEA figures estimate oil production to have been approximately 2.4 million barrels per day in 2007.10

A major reason for this decline in productivity has been a tremendous loss of human capital. Experienced workers began leaving the company in large numbers shortly after Mr. Chávez was elected because he threatened to politicize the company by replacing skilled experts with inexperienced political appointees. The departure of human capital continued until, in April 2002, matters came to a head when most staff walked off the job to protest the government’s sacking of several top executives.11 Chávez responded by firing several other officials live, on national television, a few days later.

This action precipitated a nationwide work stoppage by oil company workers with the support of the major business and trade associations, which created such instability that a group of disaffected army officers launched a coup that briefly removed the president before his supporters within the military rallied to his rescue. After his reinstatement, Chávez fired over ninety percent of the white-collar staff of PDVSA because he believed they had endorsed the coup.12

As replacements, the new PDVSA, now led by the president’s political ally Rafael Ramirez, brought on tens of thousands of new workers, using political reliability rather than industry expertise as the main qualification for employment. In a speech to a gathering of PDVSA workers, Ramirez announced that the company would henceforth be primarily a political organ of the Bolivarian Revolution. Although his speech was delivered to a closed audience, a secret video recording was made by one employee that shows Ramirez stating, “We have to say clearly... that the new PDVSA is red, ultra red!” Ramirez went on to contend, “It is a crime, a counterrevolutionary act, if a manager here does anything to slow down the political activity of the workers here who are in support of President Chávez.”13

In tandem with this catastrophic loss of human capital, once Chávez seized political control of the oil company, he began diverting much of the money slated for upkeep, exploration, and drilling toward financing his ambitious social spending programs. As a result, PDVSA’s infrastructure is decaying faster than it can be repaired, further reducing production.

Infrastructure reinvestment is not simply a matter of repairing leaking pipes or fixing pump motors. Proper care of subterranean oil deposits is also crucial to sustain production and is extremely expensive. Internal PDVSA statistics claim that the government spent eleven billion dollars on reinvestment (including
further exploration) in 2007. PDVSA claims that it spent approximately sixteen billion dollars in 2008. In reality the government authorized the company to spend a slightly lower fifteen billion dollars in 2008, with an additional fifteen billion dollars per year over the next seven years.

A closer look at the official reinvestment budget indicates that a substantial portion of money earmarked for infrastructure maintenance was diverted toward social and non-oil related projects. PDVSA admits to having spent close to four billion dollars last year under the vague budget line item ‘Support and Management’. The budget shows that this line item includes funding for non-energy related areas including an ‘Agrícola’ program designed to promote “agricultural and social growth in rural areas.”

Lack of third party verification and the vagueness of the government’s financial reports make it unlikely that anyone will ever know exactly how all of PDVSA’s money has been spent.

In 2007, the state announced the nationalization of the telecommunications and electricity industries. The government does not simply seize these industries. It offers owners what it considers to be fair prices for their purchase. The billions of dollars needed to pay for these takeovers must come from somewhere, and PDVSA, as the largest single contributor to the government’s coffers, is the most obvious source.

Diego Gonzalez, an engineer of over forty years experience at PDVSA and in the private sector, estimates that at a bare minimum the oil company ought to reinvest twenty billion dollars per year to hold steady its oil production and maintain a moderate rate of exploration. In comparison, Exxon-Mobil allocated a capital budget of 19.9 billion dollars in 2006 and pumped approximately 2.6 million barrels of oil per day, a level roughly equivalent to PDVSA’s current production.

PDVSA’s inability to approach the minimum reinvestment threshold becomes more serious each day because the longer infrastructure decline persists the harder it becomes to fix. While the costs of fully repairing transmission lines,
motors, drilling units and other machinery grow as more and more equipment breaks down, mechanical infrastructure can be fixed relatively quickly. With enough money, new equipment can be purchased and installed in short order and bottlenecks to production eliminated. However, the lack of maintenance of the underground petroleum reservoirs presents a much more serious problem and a much longer recovery time.

It is a common misconception that a nation’s, or company’s, oil reserves include all of the petroleum beneath the sea and land surface for which they have a legal right to extract fossil fuels. In fact, usually no more than thirty percent of a given oil reservoir’s petroleum is actually extractable. Money is needed not only to purchase the most advanced technology, but also to ensure that the environmental conditions within the oil reservoirs remain favorable for extraction. An area’s oil reserves can fluctuate markedly depending on the level of investment and conditions of the underground reservoirs, even as the physical amount of oil located under the earth stays the same.

Most of Venezuela’s operational oil fields are older, ‘secondary reserves’ that require a regular infusion of gas and fluid to keep reservoir pressure artificially high. Expensive injections of high pressure heated water or acid to break loose petroleum pockets trapped within rock or sand, are also commonly used. If regular efforts are not made to maintain secondary reserves then production quickly begins to fall off as the percent of the oil located in the reservoir that is extractable (the oil reserve) shrinks.

Experts estimate that reduced attention to reservoir care alone has led to a decline of between twenty to twenty-five percent in oil production, and a corresponding reduction in oil reserves, in Venezuela over the last several years. With each passing year it becomes increasingly expensive to erase the damage caused by neglect. By now enough time may have elapsed to make a substantial amount of previously extractable oil essentially irrecoverable because it would cost more money to retrieve than it would bring in the market. The long-term consequence is a decline in Venezuela’s overall oil reserves.

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**Missing Dollars**

In addition to a decrease in future revenues based on falling production and diminished prices, Venezuelans should be concerned that a large portion of the
money saved for the purpose of helping the country ride out an economic downturn has already been spent. In 2005, the Chávez-controlled National Assembly passed the ‘Revision of the Central Bank of Venezuela Act’, which stipulated that PDVSA would only be required to sell to the Central Bank enough dollars to cover the government’s budgetary obligations in the Venezuelan currency, the Bolívar.23

This change represented a marked departure from previous accounting practices. PDVSA was previously required to sell the dollars it received in payment immediately after each sale of oil to the Central Bank, which then exchanged the dollars for Bolívares at the market rate. Since all funds had to go through the bank, PDVSA’s income was subject to multiple audits, was published in the budget, and was therefore harder to misappropriate.

Another way the government has reduced accountability is through the elimination of the independence of PDVSA. Before Chávez successfully imposed his personal control over PDVSA following the 2002-2003 strikes, PDVSA was run independently. It was harder for both PDVSA and government officials to make off with funds because each entity played an important role in transfer and accounting. This has changed. PDVSA management knows that there is no room for negotiation between PDVSA and the government now.24 The president and his officials exercise control over the company’s operations and budget with practically no checks within PDVSA, the Central Bank, or the Treasury.

The amount of money that still goes through the Central Bank, appears on the official budget, and is subject to auditing is a smaller, shrinking piece of the total fiscal picture for revenues and expenditures each year. This is because each year the Treasury makes a very conservative estimate for what the price of oil will be for each coming year and uses this estimate to write-up the annual budget. In 2007, the national budget was designed for oil revenues of twenty-nine dollars per barrel, less than half the year’s average of just over sixty dollars per barrel.25

The 2005 Revision Law stipulates that most of the rest of the excess earnings that PDVSA is not required to render to the Central Bank be transferred to the National Growth Fund, or FONDEN as it is called by its Spanish acronym. FONDEN, which was also created in 2005, is an off-the-books account for the purpose of “supporting social investment projects.”26 The money that enters FONDEN essentially disappears from the balance sheet. FONDEN’s barebones website provides extremely little information, with only a few vague financial details and no line-item accounting for transactions.27 Chávez treats this money, which in 2007 amounted to over half of PDVSA’s profits, as discretionary money. According to PDVSA, over fifteen billion dollars was transferred to FONDEN between 2005 and 2007.28
From here, it becomes almost impossible to follow the money. While some of the money probably does go to legitimate social projects, evidence suggests that vast sums are diverted by the president for use wherever he sees fit. Many observers suspect he pays large sums to key supporters within the government and to members of the military to buy their loyalty. If the number of new mansions in the posh Valle Arriba and Country Club neighborhoods of Caracas is any indicator, quite a few individuals are reaping enormous gains from oil profits. Despite the secretive nature of Venezuela’s new accounting structure, evidence does surface occasionally, offering a brief glimpse inside Venezuela’s fiscal black box.

The most publicized example of the redirection of state funds for dubious purposes was the FARC computer scandal of 2008. Colombian army troops raided a FARC terrorist camp across the Ecuadorian border, discovering a laptop containing emails from senior Venezuelan officials to the terrorists offering 300 million dollars and millions of dollars worth of free oil to help fund their efforts to overthrow the Colombian government.29 The contents of the laptop were later certified as authentic by Interpol.

Additionally, in March 2007, a Venezuelan businessman was arrested at the Buenos Aires airport with 800,000 dollars in cash in his luggage. Subsequent investigation showed that he was illicitly transferring PDVSA money at President Chávez’s behest to the presidential campaign of leftist Cristina Fernández de Kirchner. The businessman returned to his second home in Florida, where he was subsequently approached by operatives of the Venezuelan government who threatened him and his family unless he refused to divulge the source of the money. The businessman and one of the operatives were recently convicted in U.S. federal court on charges of operating as unregistered foreign agents inside the United States.30

During my fieldwork in Venezuela, I was made aware of what is perhaps the most revealing insight into how government funds are being diverted for Chávez’s personal causes. On June 1, 2006, Marta Lomas Morales, Cuba’s Minister of Foreign Investment and Economic Collaboration, sent a letter to the president of PDVSA. The letter requested that Venezuela pay Cuba 212 million dollars for medical and other services that were provided to the Venezuelan government during the first half of 2006. For several years Venezuela has been exchanging approximately 90,000 barrels of oil per day to Cuba for the use of Cuban doctors and other services. Outside analysts concur that the oil-for-services deal heavily favors Cuba and speculate that this lopsided exchange is a way for Chávez to transfer funds to bolster allies and build foreign support for his government. Thus the appearance of a letter from the Cuban government claiming arrears by Venezuela seems highly suspicious. Nevertheless, President Chávez signed a decree authorizing PDVSA to pay the full amount requested by the Cuban
government. Then, in October 2006 the Cuban government again requested back-payment from Venezuela, claiming 127 million dollars in arrears for the final trimester of 2006. Again, Chávez authorized PDVSA to pay the full amount.  

For the July transaction, Venezuela transferred the money to Cuba via offshore holding accounts in Spanish, French, and German banks. Here the scarcity of records demonstrates the secretive nature of Venezuela’s oil finances. The entire payment process, including the request letters from the Cuban government, authorization from Venezuela, and wiring instructions amounted to only sixteen pages. Indeed, the only record indicating the overall structure of the transfer was a one page, handwritten note written, presumably by Rafael Ramirez, on a steno pad sheet. This secrecy is understandable given the fact that this transfer was illegal under Venezuelan law, which requires the approval of the National Assembly for any foreign conventions of this nature.

This case suggests that not only is money being spent from FONDEN to fund questionable causes, but also that large sums of money directly from PDVSA are being misappropriated for political causes. This calls into question the reliability of all of PDVSA’s official budgetary figures. It suggests that the oil company, at the government’s behest, is padding its cost figures in order to hide the illicit expenditure of hundreds of millions, if not billions, of dollars. The fact that Venezuela has resorted to giving cash to Cuba instead of oil also suggests that PDVSA’s oil production is indeed down markedly and that PDVSA may be unable to produce enough oil to meet all of its obligations.

These three glimpses into the inner-workings of the Venezuelan state’s financial black box suggest that vast sums of money are being secretly spent each year to advance the political causes of Chávez by supporting foreign allies and terrorist movements. For every example that sees the light of day, there is no way to know how many take place that are never exposed. Thus outside observers can do no more than speculate that at least hundreds of millions of dollars are being diverted from PDVSA’s operating budget and from government social spending programs toward promoting many of the Bolivarian Revolution’s less savory foreign policy aims.

**Conclusion**

The steep fall in the price of oil since last summer, combined with a massive decline in productivity at PDVSA and irresponsible spending of national savings, have set the stage for economic catastrophe in Venezuela. Chávez seems
to have finally recognized the looming fiscal crisis and recently moved to trim the federal budget in response. However, the Venezuelan president is caught in a trap of his own making.

Chávez came to power and has remained popular by redistributing oil income to the poor at heavy cost to the nation’s savings and infrastructure. He cannot now alienate his political base by withdrawing government handouts during a period of widespread economic hardship. The president already learned this lesson when, in December 2007, the Venezuelan government’s failure to provide social services in the poorer urban neighborhoods of Venezuela cost Mr. Chávez his first electoral defeat over a referendum to alter the national constitution.

Even more worrisome for Chávez, prolonged periods of low oil prices have historically led to political instability in Venezuela. Chávez himself attempted to capitalize on public discontent when he launched his failed military coup in 1992. He should now be rightly worried that his political enemies may plan a similar move as the full consequences of Venezuela’s economic misfortunes take effect.

Chávez cannot afford to stay in Venezuela unless he is in power. If Chávez were to leave office he would undoubtedly be called to account for the vast corruption and misappropriation of state funds that have gone on during his presidency. Previously, Chávez used his enormous popularity among the poor to inoculate him from his opponents, but if he loses the support of his base he may have no choice but to further restrict democracy in Venezuela and use heavier handed tactics to stay in office. In the end, whether Chávez stays in power or is forced out of office, the big losers for Venezuela will be the democratic process and the legitimacy of Chávez’s ‘popular’ movement.

-Shreya Basu served as lead editor for this article.

NOTES

13 Rafael Ramirez, “Rojo Rojito Speech”, Rojo Rojito Video Recording, Compact Disk.
14 PDVSA Información Financiera y Operacional, p. 35. 15 Based on personal interviews and information provided to the author by senior PDVSA officials during fieldwork conducted in Venezuela.
16 PDVSA Información Financiera y Operacional, p. 35-36.
17 Dr. Diego Gonzalez, Personal Interview with Matthew Blomerth, Caracas, June 10, 2008.
21 Compare an estimate of a 20% decline in production made by Diego Gonzalez versus a 25% decline estimated by Martin Essenfeld.
22 Dr. Martin Essenfeld, Personal Interview with Matthew Blomerth, Caracas, June 11, 2008.
23 PDVSA Información Financiera y Operacional, p. 173.
24 Based on personal interviews and information provided to the author by senior PDVSA officials during fieldwork conducted in Venezuela.
26 Sandoval and Weisbrot, p. 1.
27 FONDEN Government Website, Online: http://www.fonden.gob.ve/descargas/.
28 PDVSA Información Financiera y Operacional, p. 88.
31 Based on personal interviews, information and documents provided to the author by senior PDVSA officials and other oil industry professionals during fieldwork conducted in Venezuela.
32 Ibid.