A NEW ECONOMIC POLICY IN VENEZUELA

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Venezuela's economic policy has undergone major changes since early 1989. The country has been put through a severe adjustment process intended to correct deep-seated disequilibria, and it is often said that this adjustment is just the first step of a much broader, permanent economic policy to be implemented in the years ahead. It is viewed as a prerequisite for the elimination of severe accumulated distortions, and a necessary condition for the creation of an environment conducive to the successful implementation of a new and more permanent economic policy.

The first part of this paper will provide a brief discussion on the disequilibria that had to be corrected, the main features of the adjustment policy, and the immediate consequences of its implementation. Thereafter, we will offer some comments on the second stage of the process: the local economic policy to be put into effect and the direction it could take, not only in the national arena, but also in the regional one.

1. Introduction

During the last three years of the Lusinchi Administration (1986-1988), the Venezuelan economy fell into a series of economic contradictions. On one hand, economic activity grew at a vigorous rate averaging 4.7 % per year, and unemployment declined to just 7% at the end of 1988. On the other, multiple disequilibria were built up, to the point where the system as a whole was in a state of crisis throughout that year.

Severe and intensifying disequilibria characterized the country's external accounts, its public finance, its monetary and financial markets, and its foreign exchange market. They were accompanied by unprecedented inflation rates in 1987 and 1988, forming the negative side of the economic picture, one than had to be corrected without delay.

2. The Disequilibria of the Venezuelan Economy (1)

We will now proceed to analyze the disequilibria mentioned above in greater detail.

2.1. Disequilibrium in the External Accounts

Venezuela's overall balance of payments was in deficit throughout the 1986-1988 period, provoking a drastic contraction of the country's international reserves: US$ 8.5 billion, approximately 55% of the country's total international reserves, was lost over that period.

This decline largely reflected the severe contraction of oil exports that followed the collapse of world prices in 1986 and their subsequent stabilization at levels far below those of the preceding years. Imports also rose at the time, particularly in 1988, due to the growing need for imported inputs generated by the economy's vigorous growth rate, and the overvaluation of the trade bolivar during the last year of the Lusinchi administration.

The latter was the result of the government's decision to freeze the controlled exchange rate for trade at Bs. 14.50 per US$ for more than two years, in spite of a constant deterioration of relative

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prices. The growing overvaluation of the bolivar, the fixed exchange rate guaranty for imports, and the widespread expectation that a large devaluation would take place as soon as the next administration took office in February 1989, drove importers to make massive purchases abroad, not only to meet their immediate needs for raw materials, intermediate products, and other goods, but also to accumulate substantial inventories.

A third factor contributing to the disequilibrium in the external accounts was the high level of the foreign debt service. More than 40 % of Venezuela's export earnings had to be allocated to debt service payments during the 1987-1988 period.

Venezuela's International Reserves (Million US$)

	1985	1986	1987	1988
Total Reserves	15,494	11,685	11,004	7.081
Central Bank	13,746	9,858	9,376	6,671
Vzla. Investment Fund	1,748	1,827	1,628	410

Source: Central Bank of Venezuela.

A contraction of international reserves on this scale was very dangerous for an economy like Venezuela's, so heavily dependent on oil, whose international prices behave so erratically and unpredictably. The collapse of oil prices in 1986 and the resulting contraction of Venezuela's export earnings sent a clear message that the country needed to keep a high level of international reserves at all times since they are its only defense against extremely adverse oil market situations.

Therefore, the loss of international reserves had to be curbed without delay. Strengthening Venezuela's international reserve position needed to become one of the chief goals of economic policy, if the vulnerability to unpredictable changes in the oil market was to be reduced.

2.2. Disequilibrium in Public Finance

A strongly expansionary fiscal policy generated high GDP growth in the 1986-1988 period. That led to a steadily widening budget deficit, making the restricted consolidated public sector deficit rise from the equivalent of 4.4% of GDP in 1986 to 8.6% in 1988.[2]

In absolute terms, the deficits prior to 1988 were far from critical, but the growing and persistent trend was a cause for serious concern. The risk was that Venezuela could fall into the same error committed by other Latin American countries in the preceding years, where ever larger and cumulative budget deficits were among the chief causes of runaway inflation or even hyperinflation.

2.3. Disequilibrium in the Monetary and Financial Markets

Monetary and financial activity also fell into growing disequilibrium during the last three years of the Lusinchi administration. There was a persistent excess demand for loans, since interest rates were fixed at increasingly negative real levels.[3] That made it more and more attractive to borrow funds with which to acquire dollars or durable goods that would appreciate since the inflation rate was expected to be considerably higher than the cost of financing.

Although effective interest rates for new loans did rise to levels substantially higher than the official controlled rate, they still remained negative in real terms.

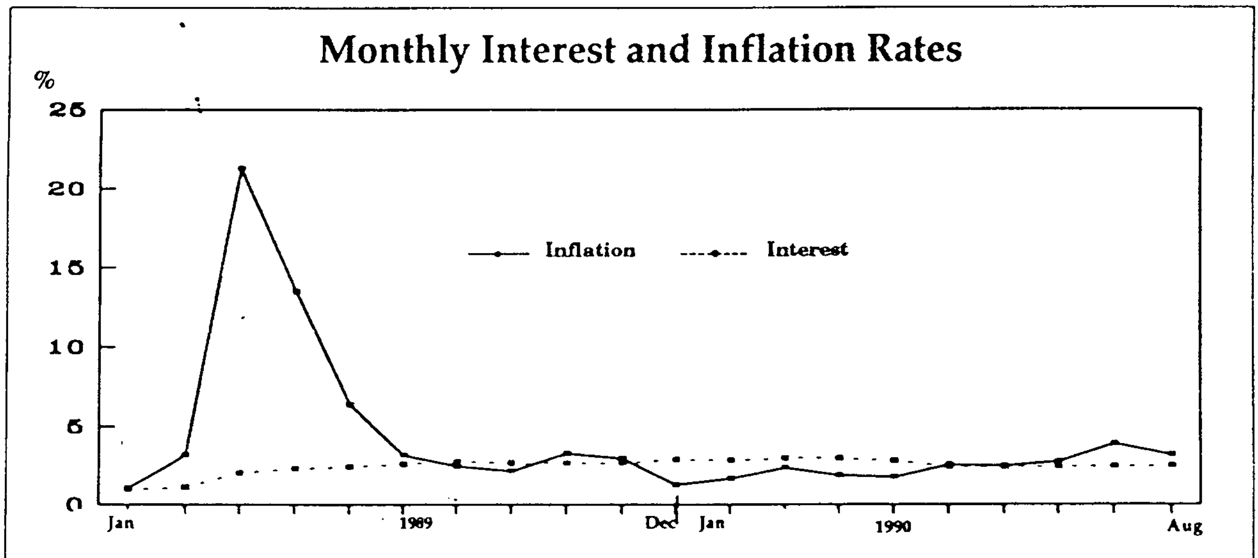
The Central Bank reacted by launching a tight money policy aimed at limiting the bank's lending capacity. Had it not done so, inflation would have been much higher.

The combination of excess loan demand and the banks' declining ability to meet it (due not only to the restrictive monetary policy, but also to the growing difficulty of attracting funds from the public as a result of the negative deposit rates) generated a major disequilibrium in the financial market.

2.4. Disequilibrium in the Foreign Exchange Market

The trade bolivar was drastically devalued in December 1986: the controlled exchange rate for current transactions went from Bs. 7.50 per US$ to Bs. 14.50 per US$, making the bolivar substantially undervalued at the beginning of 1987.

This major devaluation, together with increases in numerous production costs (labor, raw materials, and others), and a substantial growth of local demand, set off a strong outbreak of inflation in 1987.



The acceleration of domestic inflation while the exchange rate for foreign trade remained frozen at Bs. 14.50 per US$, gradually did away with the undervaluation of the bolivar in the course of 1987; by the end of the year, the controlled exchange rate was fairly close to its equilibrium level. Thereafter, the continued immobility of the trade bolivar at a time of intense domestic inflation led to a growing overvaluation of the bolivar throughout 1988, the last year of the Lusinchi administration.

The overvaluation of the bolivar, the fixed exchange rate guaranty for letters of credit, and the expectation that the preferential/trade exchange rate would be corrected by the incoming administration in early 1989, led importers to demand as many dollars as they could buy; this only intensified the disequilibrium in the foreign exchange market.

3. The Adjustment Policy

The combination of the serious disequilibria affecting multiple sectors of the economy and the inflationary outburst of 1987 and 1988 put the Venezuelan economy in an unsustainable condition, which had to be corrected without delay. Had the economic policy then in effect been maintained with the aim of continuing the high economic growth rates of the 1986-1988 period, the economy would have been condemned to an unprecedented crisis within a very short span of time.

In February 1989 an economic adjustment plan was adopted by the incoming Administration, which sought to stabilize the economy and create the conditions for the future implementation of a more rational, coherent, and permanent economic policy.

3.1. Correction of the External Disequilibrium

In simple terms, the correction of the external disequilibrium is achieved by reversing the foreign exchange flows, raising the inflows as much as possible and minimizing the outflows.

A first way to accomplish this goal is by increasing exports. However, Venezuela was not in a position to do so in the short term to the extent needed to make a significant contribution to the correction of the balance of payments disequilibrium.

That is because oil accounts for most of Venezuela's exports, and the prospects for a quick expansion of oil sales were poor in 1989. Venezuela was subject to OPEC production quotas, so any enhancement of earnings would have to come chiefly from rising prices. Fortunately, prices strengthened throughout 1989, and that contributed to an improvement of the country's foreign exchange position.

Exports of other goods cannot rise very substantially in the short term, since any such increase would require conditions conducive to the stimulation and diversification of the country's foreign trade, and that is a long-term process. Venezuela's non-oil exports did go up in relative importance in 1989 and in early 1990, but the increase was rather small in absolute terms, and this is not a potential source for reversing the external disequilibrium in the short term.

Another way to improve the net foreign exchange flow was to reduce imports. Here, Venezuela did have good short-term prospects, since the massive external purchases of 1988 had built up of inventories to the point where the country could dispense with imports to a considerable degree the following year. Other factors, such as the deep devaluation of the trade bolivar and the severe contraction of economic activity in 1989, also helped to reduce imports. As a result, imports dropped by more than 40% in 1989 in comparison to the preceding year's abnormally high level, and are still sluggish in 1990.

As a result, the trade balance recovered from a US$ 2 billion deficit in 1988 to a surplus exceeding US$ 5.8 billion in 1989. The current account also improved dramatically, passing from a deficit of more than US$ 5.8 billion in 1988, to a US$ 2.5 billion surplus in 1989. In spite of these favorable results in the current transactions, the external accounts as a whole were still in serious disequilibrium in 1989, with the balance of payments deficit concentrated in the capital account.

To a large extent, this occurred because payments on 1988 letters of credit greatly exceeded the value of new letters of credit opened in 1989; the decline in the latter year reflected the strong contraction of imports. Adding principal payments on external debts, both public and private, as well as the payment of certain other foreign obligations, the gap in Venezuela's external financial transactions remained very wide indeed in 1989.

This gap was covered with an inflow of flight capital, now attracted to the country by higher interest rates, as well as other sources such as:

1. Loans from multilateral institutions, including the International Monetary Fund, the World Bank, and the Interamerican Development Bank.

2. Loans from official lenders, such as the members of the Paris Club.
3. Private international bank loans.
4. Increasing foreign investment.

Venezuela urgently needed financial assistance and debt relief. This was the motivation for the government's intense efforts to advance the process of restructuring its public foreign debt service payments and obtain international financial assistance.

Venezuela needed and will continue to need substantial financial assistance from abroad, from any available source. Given the reluctance of private international lenders to grant new loans to Venezuela and the other Latin American debtor countries, one of its few options is to seek funds from the international official lenders and certain industrialized countries whose governments have expressed a willingness to assist developing countries, such as Japan, France, West Germany, and others.

However, funds from these sources are only available under IMF conditionality. That is why Venezuela had to reach an agreement with the IMF, in the form of a letter of intent submitted early in 1989. In this document, the government assumed the obligation of carrying out a set of economic policy measures aimed at achieving the following goals.

3.2. Correction of the Fiscal Disequilibrium

Traditionally, reduction of the budget deficit -- a key component of every adjustment plan -- is very difficult to achieve. That is because those plans typically call for devaluations of the national currency in order to stimulate export development and curb imports.

As a result of the devaluation, the State (which in most countries is a net purchaser of foreign exchange generated mainly by private exporters) must lay out a larger amount of national currency to acquire the dollars it needs to service its external debt and make its own imports. This means that the adjustment of the exchange rate provokes higher spending by the State.

Under these conditions, the budget deficit can only be reduced by raising taxes or cutting internal spending drastically, or a combination of both. Such policies plunge the economy into deep recession and generate social and political tensions.

However, Venezuela's situation is just the opposite. Since the State is the chief foreign exchange earner, a devaluation of the bolivar generates additional public sector revenues. Indeed, when the bolivar is devalued, PDVSA (the national oil company) receives a larger amount of national currency for the sale of its dollar earnings to the Central Bank, with which its tax payment rises. Both the industry's retained earnings and the central government revenues increase in direct proportion to the magnitude of the devaluation.[4]

That made the goal of reducing the public sector deficit in 1989 relatively easy to achieve, despite a major increase in public spending. Revenues grew by 110.4%, the following being the main contributors to that growth:

1. The massive devaluation of the trade/official bolivar, due to the unification of the exchange rate in March.

2. Higher tariffs for public services.
3. Higher prices for the goods produced by State-owned enterprises.

Spending rose more slowly than revenues, which drastically reduced the public sector deficit from a level equivalent to about 9% of GDP in 1988 to less than 2% in 1989.

In the first half of 1990, however, the deficit increased again, mainly because of a more limited depreciation of the national currency, shortfalls in local tax collection due to generalized losses and tax evasion, as well as large expenditures for, among other things, external debt service, Nevertheless, the additional oil revenues expected for the second half of the year as a result of the Middle East conflict could help to close the gap.

3.2.1. Structural Changes for the Fiscal Deficit Correction

Exchange rate modifications help to bring down the deficit, but a gradual devaluation of the bolivar similar to that of the recent past (and expected to continue in the foreseeable future) will not in itself solve the problem for good. The achievement of permanent fiscal equilibrium depends on a proper tax structure and on rationalization of spending.

The latter, in turn, requires correction of the financial deficiencies of a multitude of public agencies and enterprises, with a tradition of recurrent and expanding deficits. So it is essential to get the process of restructuring, and in some cases the total or partial privatization, of several public entities under way at once. Not only will the public sector become more efficient as a result, but it can also be reduced in size, which will in itself contribute to the rationalization of spending.

3.3. Correction of the Monetary and Financial Disequilibrium, the Inflationary Surge and Interest Rates

If the cumulative disequilibrium that built up in the country's monetary and financial markets in the 1986-1988 period was chiefly the result of negative real interest rates, the correction of that disequilibrium would obviously have to be based on bringing them into line with inflation. That is why rates had to rise sharply in 1989, as a major element of the economic adjustment package.[5]

Monthly Consumer Inflation

	1989	1990
January	1.1 %	2.4 %
February	3.2 %	1.9 %
March	21.3 %	1.8 %
April	13.5 %	2.6 %
May	6.4 %	2.5 %
June	3.2 %	2.8 %
July	2.5 %	3.9 %
August	2.2 %	3.2 %
September	3.3 %	
October	3.0 %	
November	1.3 %	
December	1.7 %	

Source: Central Bank of Venezuela

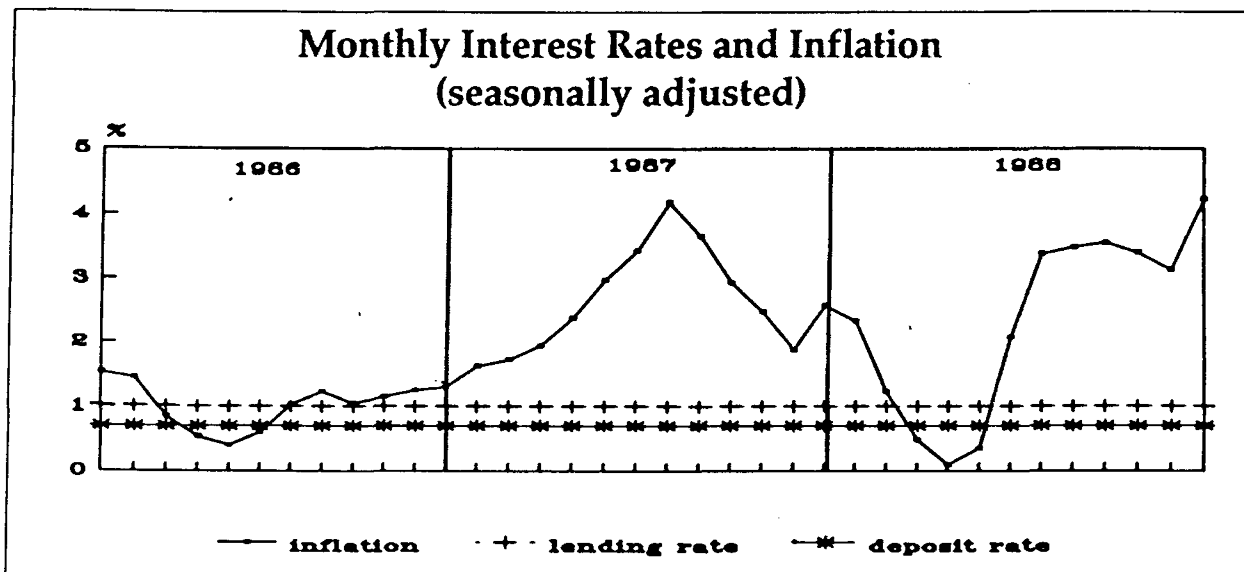
Deregulation of interest rates was, indeed, one of the very first measures taken by the new economic authorities, though some limitations were kept in place, including a preferential rate for agricultural loans. Subsequently, the Supreme Court forced the Central Bank to resume determination of the maximum loan rate and the minimum deposit rate. Throughout 1989 interest rates were in the neighborhood of 40%, although inflation exceeded 80% for the year. However, this should not be interpreted as a continuation of the negative real interest rate situation that prevailed in previous years.

An analysis of price behavior in 1989 shows that most of the inflation was concentrated in a short period of time (March-May). Thus, the March consumer inflation rate was 21.3%; another 13.5%

was added in April, and 6.4% more in May. Thereafter, the inflation rate was relatively stable, at a much lower level, although still high by Venezuelan standards (2.55% per month on the average between June 1989 and August 1990).

The March-May 1989 period was characterized by a true "inflationary tidal wave" reflecting simultaneous and mutually reinforcing increases in multiple costs of production, which were quickly reflected in consumer prices. Those production cost increases were due to:

1. The massive devaluation of the trade bolivar. This not only raised the replacement cost of imported products, but also multiplied the cost of outstanding letters of credit, for which the fixed exchange rate guaranty was only partially honored.
2. The higher rates for public services.
3. The higher prices of the products manufactured by State-owned basic industries.
4. The increase in transportation costs caused by the higher price of gasoline.
5. Across-the-board wage and salary increases.
6. The desire of many businessmen to conserve high profit margins.



During the three months of the "inflationary tidal wave" real interest rates were in fact deeply negative; in effect, they "dove below the wave". However, since the production cost increases that followed were less intense, and there was no inflationary pressure from excess demand (quite the contrary, consumption contracted drastically and stabilized at low levels thereafter), inflation could logically be expected to subside considerably in the succeeding months, permitting real interest rates to become positive.

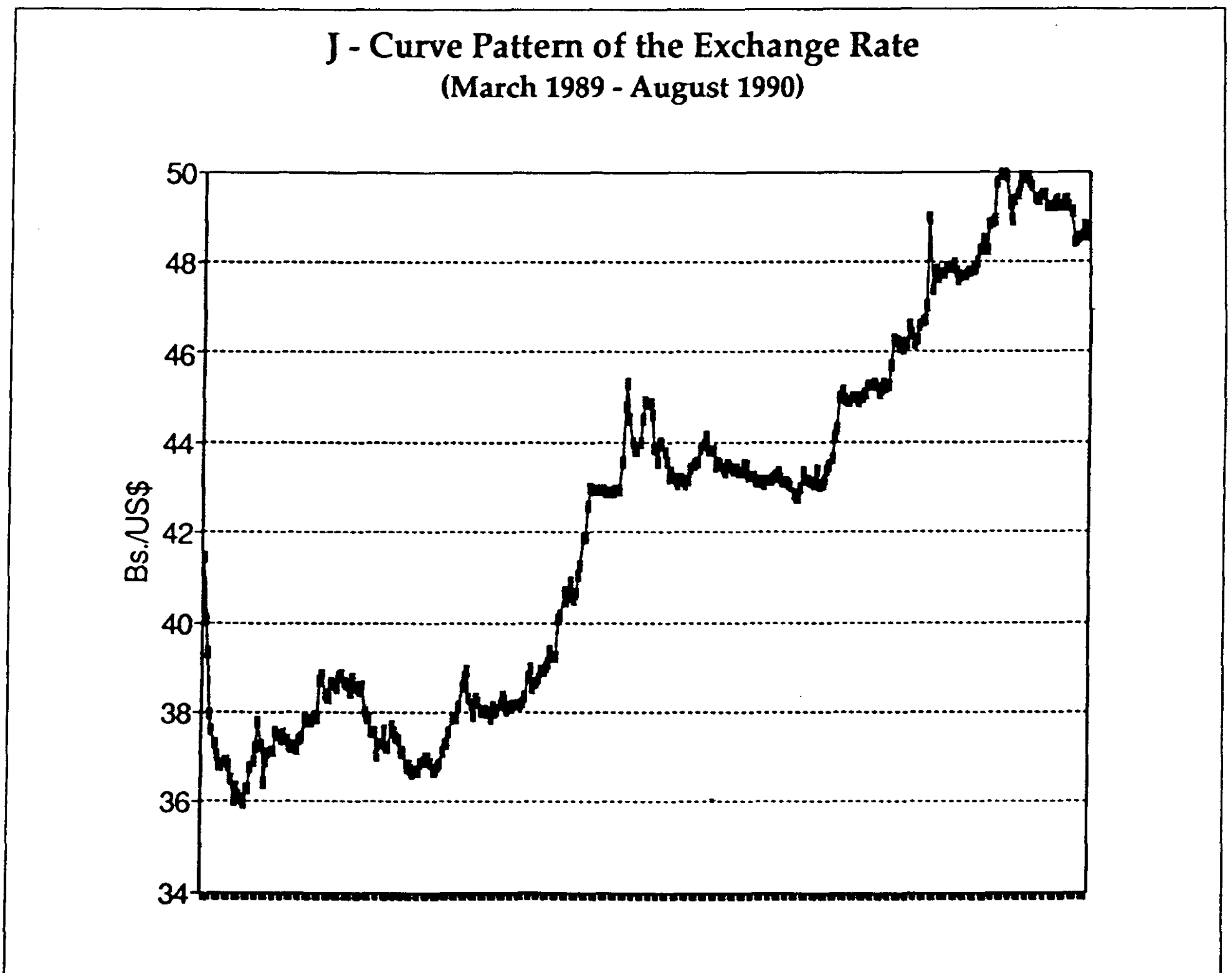
3.4. Correction of the Foreign Exchange Disequilibrium, the Exchange Rate and Monetary Policy

It was quite obvious that the high and increasing overvaluation of the trade bolivar at the outset of 1989 required a major change in the exchange rate to correct the disequilibrium on the foreign exchange market; the bolivar needed to be devalued to put an end to the overvaluation implied by the preferential exchange rate.

The government had alternative strategies at its disposal for achieving that goal. But it opted for immediate unification of the exchange rate, which was decreed and put into practice in March. As was to be expected, the rate for current transactions immediately jumped from the artificial Bs. 14.50 per US$ (and even Bs. 7.50 per US$ for certain essential imports) to the then-prevailing free market rate; this implied a devaluation of the trade bolivar on the order of 170%. As indicated above, this massive devaluation provoked a series of consequences, an intense inflationary pressure among them.

As can be seen in the following graph, since the unification, the exchange rate has behaved as initially predicted, following a J-curve pattern, it dropped in the days immediately following the devaluation, and then stabilized for a relatively long period. In fact, the new floating rate did go down from its initial level of March, and stabilized at Bs. 37-38 per US$ for several months. Then a rising trend got under way in October 1989, which can be viewed as the upward phase of the J-curve. (See Palma-Fontiveros 1989).

The substantial contraction of imports and the inflow of dollars due to flight capital repatriation stimulated by higher local interest rates, during the months that followed the exchange rate unification, were some of the factors that brought about the initial decline and later stabilization of the exchange rate.



However, the drastic deterioration of relative prices due to much higher local inflation made the undervaluation gap created by the March 1989 devaluation vanish in a few months and brought the exchange rate closer to equilibrium. In the months that followed, the persisting inflation differential drove the exchange rate ever higher.

Other circumstances also contributed to the increase in the exchange rate, at times quite abrupt. One of these was the excess liquidity in possession of the banking system, which led banks to demand a larger volume of foreign exchange. Another was the lowering of interest rates by the Central Bank in order to stimulate economic activity.

This point deserves further elaboration. Since March 1989, bank time deposits have shown a solid and steady growth (5.2% per month on the average) in response to higher interest rates and a relatively low expected appreciation of the dollar after the exchange rate unification.[6] As deposits grow, the banks are pressured to find an outlet for the funds; but that has been far from easy, since not only has borrowing been depressed by the high interest rates, but preference for loan exposure has been substantially reduced; the public is now striving to pay off large debts previously obtained at much lower cost.

Under these circumstances, the banks had to look for other investment options for their funds. One logical alternative was to buy foreign exchange, since after the exchange rate had held steady in the neighborhood of Bs. 38 per US$ for several months (until October of 1989), it was clear that it would have to start to rise in the near future. This trend led the exchange rate to start rising.

In order to avoid undesirable pressures on the exchange rate and additional inflationary effects, monetary policy tightened. First the Central Bank's financial assistance to the commercial banks was limited and the minimum reserve requirement was unified at 12% of all banking deposits, and later increased again in May 1990 to 15%.

Second, the Central Bank overnight market interest rate was raised in order to attract the commercial banks' excess funds and keep them from flowing into the foreign exchange market. And third, the Central Bank has resorted to open market operations, selling high-yield short-term zero-coupon bonds.

Late in 1989 the maximum loan rate was raised but the minimum deposit rate was left unchanged. Under these circumstances it would have been better to increase the latter as well, since that would have made it much more attractive to deposit private funds in the financial institutions rather than use them to buy dollars. The intention would have been to channel funds toward commercial banks, which would, in turn, deposit most of them on the Central Bank's overnight market.

Surprisingly, a classic tool of restrictive monetary policy -- an increase in bank reserve requirements which would sterilize a large part of the excess funds held by the banking system (though at a cost to the latter) -- has not been used very intensively. There has been criticism of that reluctance, because the monetary policy tools applied to date impose heavy costs on the Central Bank and generate a parafiscal deficit, while the private banks not only escape any costs but even profit handsomely from the high yields paid on the Central Bank's overnight market facility and zero-coupon bonds.

To date the Central Bank has preferred to rely chiefly on manipulation of the rates paid on its overnight market and of zero-coupon bonds yield to control commercial interest rates. In spite of the persistence of excess liquidity in the banking system since the adjustment plan went into effect, interest rates have remained at levels much higher than would normally have been set by a financial system suffering from a glut of deposits and a dearth of borrowers.

This implies that the Central Bank has played a decisive role in the adjustment process; it has been chiefly responsible for keeping interest rates in balance with existing or expected inflation rates, the desired exchange rate dynamism, and economic growth targets.

3.5. The Need to Keep Inflation Under Control

The intense inflationary surge had a variety of impacts. One of them was a drastic contraction of real personal disposable income, causing private demand -- and particularly consumption -- to contract abruptly in 1989.

Also, it caused interest rates to rise, limiting demand still further, and leading businesses to draw down their inventories throughout 1989 to satisfy a large part of the weak consumer demand. The simultaneous contraction of consumption, the intensive use of inventories, and the disappearance of important neighboring foreign markets due to the elimination of exchange subsidies following the exchange rate unification, caused productive activity to suffer a dramatic contraction in 1989.[7]

The adjustment process highlighted the close linkage between interest, exchange, wage, growth and inflation rates. Thus, it proved that major wage adjustments --obligatory or negotiated -- materialize after important inflationary surges occur. This is exactly what happened in January 1990, and it will probably happen again in the near future.

Furthermore, a stable exchange rate cannot be expected if domestic inflation is much higher than international inflation or if interest rates are set at artificially low levels making them negative in real terms.

All this means that, if Venezuelans aspire to enjoy interest rates low enough to stimulate borrowing and promote consumption growth and investment, while avoiding undue pressures on the exchange rate, one necessary, although not sufficient, condition for the achievement of this goal is to keep inflation low.

That condition, however, is far from easy to achieve in Venezuela, at least in the short term, since current cost-push and structural inflation is very hard to control.

The structural component of Venezuela's inflation was born of a series of distortions built up over a period of decades, as a result of official subsidies and controls which undermined the price structures of many products. The sectors most affected by those controls and subsidies (in many cases infrequently paid) found themselves unable to modernize.

Agriculture is a typical case. Productivity remains low and there are too many small producers, which makes it possible for a limited number of middlemen to buy the output at low prices and then add on very high markups at every stage of the distribution process.

Even the major producers often have low productivity, reflecting the absence of incentives to improve; not only were they traditionally protected by import restraints, but they were also beneficiaries of a government price control system which set prices on the basis of the cost structure of the most inefficient producer.

This experience illustrates the need to adopt an effective agricultural policy as quickly as possible. It should aim, among other things, to stimulate production of those products which Venezuela can produce efficiently, improve the distribution system for bringing agricultural products from the

farmer or stock raiser to the consumer, and make it easier to import foodstuffs to complement domestic production and ensure adequate supply. This is the only way to prevent additional inflationary pressure on food prices.

Among other antiinflationary actions the following are worthy of mention:

A. Reduction of the public budget deficit and continuation of a restrictive monetary policy.

However, keeping the money supply under control through restrictive fiscal and monetary policy will not put an end to cost-push and structural inflation such as Venezuela is now undergoing. It can only prevent additional inflationary pressure born of excess demand. Still, limiting demand in this way may help to prevent the appearance of certain inflationary cost pressures by dissuading businessmen from raising profit margins.

It has also been argued that, far from contributing to control inflation, the increase in interest rates provoked by recent monetary policy has driven inflation even higher, by raising the financial costs of a great many firms which have high levels of indebtedness. This situation, consistent with Taylor's neo-structuralist view (1981), is visible in a variety of productive industries.

B. Maintenance of a flexible but relatively stable exchange rate.

The aim is to avoid both an overvaluation of the currency and massive devaluations which would have a devastating impact on production costs. This is closely related to restrictive fiscal and monetary policy, since those are the tools which bring about the positive real interest rates without which the exchange rate cannot behave rationally.

Experience has shown that the monetary authority must be very careful in manipulating interest rates, in view of potential negative effects. The most recent illustration of this principle came in the second quarter of 1990, when the monetary authorities took advantage of the decline of inflation (to less than 2% per month in the first quarter) to drive interest rates down; they did so by reducing yields on their overnight market and zero-coupon bonds.

This move coincided with a resurgence of inflation starting in April, reflecting new increases in production costs. Interest rates soon turned negative in real terms, and funds returned to the foreign exchange market in search of higher yields. This led to a sustained dollar appreciation throughout the second quarter, setting historic highs in the first few days of July.

Under these circumstances, the Central Bank turned an about face and forced interest rates up again by raising the yields on its zero-coupon bonds. This reversal put an end to the excessive speculation in dollars by the final days of July. Thereafter, favorable expectations generated by the Middle East crisis led to a certain appreciation of the bolivar in August.

C. Adoption of a dynamic trade policy, with more rational import duty levels.

The idea is to eliminate barriers and liberalize imports, allowing foreign goods to compete with domestic products. Progressive reduction and simplification of import duties is also an important part of this new trade policy, which intends not only to prevent speculative pricing in search of excessive profit margins, but also to stimulate national producers to be more productive and competitive.

However, these goals are not always easy to achieve, particularly for small developing economies

such as Venezuela. Their markets are typically monopolistic and oligopolistic in form, affording the major producers near-total control and encouraging low productivity, poor quality of products, and high prices which reflect exaggerated profit margins.

These undesirable structures of production can be attacked by economic policies such as those Venezuela is now pursuing. But at first, the imports that compete with domestic production are likely to be made by the same businesses which have traditionally dominated the local market, undermining the goal.

In that case, a rising volume of imports will not contribute to controlling inflation. Quite the contrary, it might even intensify inflation, since the imported products are likely to be sold at higher prices than the domestic ones, on the pretext of their higher quality and cost. This means that the policy of opening up the local economy to trade only has an anti-inflationary effect if it leads to a diversification of import activity, thereby intensifying competition.

4. Lessons of the Adjustment Process

Throughout this paper, we have mentioned the consequences and effects of the adjustment program applied in Venezuela. Among the most important of these is the correction -- in the short run at least -- of many of the disequilibria which led to its adoption in the first place.

However, the adjustment has imposed heavy economic and social costs, though it has not been as hard as similar programs in other Latin American countries. Venezuela has not suffered the same adjustment crises as Peru, Argentina, and Brazil, or at any rate, not to the same degree; since the distortions in its economy were not nearly so serious as those afflicting the other countries, the correction did not need to be nearly so drastic.

Among the adjustment costs the country has undergone is an inflationary surge far stronger than would have been the case under alternative policies. In this respect, we have been recommending the adoption of a flexible foreign exchange policy for years; such a policy would have brought about the unification of the exchange rate in a relatively short time, but by stages and less painfully. It would have kept inflation down to a considerably lower level and avoided a large part of the hardship caused by the price explosion that actually accompanied the implementation of the adjustment program.[8]

Among the consequences of the recent inflation is the impoverishment of the Venezuelan population due to the erosion of real revenues. The resulting contraction of private consumption initially depressed productive activity and has since kept it from recovering. That in turn has substantially increased unemployment and underemployment.

Evolution of Key Economic Indicators

	1987	1988	1989
Real Personal Disposable Income*	7.4 %	-1.8 %	-14.1 %
Real Non-Oil G.D.P. *	4.2 %	5.7 %	-9.4 %
Unemployment Rate	8.5 %	6.9 %	9.6 %

* Percentage Variation
Note: The high contraction of real personal disposable income suggests that 1989 G.D.P. contraction was greater than officially stated.
Source: Central Bank of Venezuela and MetroEconómica

The simultaneous contraction of real personal disposable income (and particularly of real wages) and rising unemployment and underemployment have obviously depressed living standards for the Venezuelan working and middle classes. The resulting hardship is not effectively compensated by the inadequate welfare programs recently launched by the government, including food grants for lower-income school children and provision of a "market basket" of staple foods at subsidized prices, so social pressure is reaching dangerous levels.

The situation is potentially explosive, and undermines the political viability of the program. Therein lies the need for swift implementation of public spending policies aimed at moderating the social pressure. A Public Investment Program has been drawn up, calling for major outlays to finish public works projects already under way, to increase infrastructure maintenance, and to expand social programs. This would generate an important volume of employment.

We believe the absence or inadequacy of social programs aimed at mitigating the social pressure inevitably resulting from an adjustment policy of this kind is one of the major shortcomings of the current economic policy.

5. Economic Policy for the Future

At this time, there is an intense debate on whether the adjustment policy can or should be continued, and on whether economic policy should become permanently outward oriented once the economy has been stabilized and the adjustment phase completed. Such a policy would be based on the "outward growth" strategy and characterized by smaller State which reduces its economic intervention and regulations of economic activities. Key economic variables such as interest and exchange rates would be realistically determined by market forces, and the private sector -- both local and foreign -- would have a more autonomous and prominent role to play.

Though the government is determined to continue along that road, there is a strong opposition to the new economic policy.

The country's political leadership, including that of the party in power, has repeatedly expressed its discontent, chiefly with the high social cost of the policy. But one of their most important reasons for opposing it is their reluctance to give up the personal power they enjoyed in the past, when abundant oil revenues allowed them to preside over a distorted economy largely managed by clientelistic politics. The political elite then lived on those abundant cash flows captured without economic effort, and historic opportunities for efficient use of the funds were passed up. (see Palma 1989a).

The labor unions, led by political party figures, have also expressed an open opposition to the new economic policy, to the extent where negotiations between them and the government have become increasingly difficult.

This political conflict has given rise to concern as to whether it will be possible to carry on with the current policy after the conclusion of the initial adjustment phase: will it be viable over the medium and long term? In the months and years to come, it will be necessary to create an infrastructure to facilitate the application of the new policy, including an appropriate regulatory and legal framework.

Important steps in that direction have already been taken, including Venezuela's accession to the GATT. This will help Venezuela to build sounder foundations for the development and diversification of non-oil exports. Participation in the GATT negotiations will bring Venezuela more advantageous trade conditions, including a broader and more reliable access to key international markets, and other benefits. But it will also bring commitments.[9] Nevertheless, there is still a great deal to do.

For example, the reduction of the size of the public sector, essential to any improvement of its efficiency and correction of the traditional deficits, will require not only a thoroughgoing tax reform, but also the restructuring and privatization of a great many State-owned entities.

That in turn requires the creation of a legal and regulatory structure to define the rules of the game for the future; without it, privatization cannot be successful. Who will invest funds in an enterprise placed on the auction bloc if the rules of the game are not clearly defined, if they are not favorable, and if investors -- national or foreign -- have no grounds for confidence that those rules will be applied and honored permanently.

However, those necessary preconditions will be very difficult to achieve in a climate of open opposition to the new economic policy direction on the part of the country's political and union leadership, considering that the enactment of the required legal and regulatory structure must pass through their hands.

5.1. The Future of the Economic Policy and the New Oil Reality

Another doubt surrounding the continuity of the new economic policy direction is related to the new conditions of the world oil market created by the Middle East conflict set off by Iraq's invasion of Kuwait in August 1990.

The expected higher oil prices and export volumes would yield Venezuela considerable additional revenues.[10] This has led certain people to think that the country's lower need for financial assistance in the future will eliminate the need to continue submitting to the International Monetary Fund orthodoxy.

Fiscal Budget Expenditures
(Million bolivars)

	1988	1989	1990	1991
Nominal Expenditures	190,585.3	319,476.9	419,338.0	778,100.0
Percentage Variation		67.6 %	31.2 %	85.6 %
Real Expenditures	92,472.2	84,028.6	78,233.8	104,009.7
Percentage Variation		-9.1 %	-6.9%	32.9 %

Note: Used deflator was the C.P.I.

Source: Finance Ministry and MetroEconómica

It has even been suggested that there is no longer any need to continue with the adjustment policy, and that Venezuela should return to its traditional fixed exchange rate policy, raise public spending considerably, and control inflation through massive imports, price controls, and higher subsidies for essential products, public services, and interest rates. In other words, the new increase in oil revenues will allow the Venezuelan economy to go back to the traditional oil rentier scheme of the past.

This proposal is so invalid that we should discard it as a real possibility for the future. However, the rising flow of oil revenues may very well lead to the modification of certain components of the economic policy.

It would not be surprising if public spending were to go up a great deal, as is foreseen in the 1991 budget proposal, in an attempt to ameliorate the social tension and stimulate economic activity.

It is also very likely that the new circumstances of the oil market will lead the authorities to allow the bolivar to overvalue again, in order to dampen structural and cost-push inflationary pressure. In such a case, we believe the monetary authorities would have to compensate with a restrictive policy designed to absorb part of the money injected into the economy by higher public spending. This would avoid or abate the demand-pull inflationary pressure which might otherwise be added to the cost-push and structural pressures already present in the economy.

In a scenario like this, economic growth could recover in 1991, but it would be accompanied by rising imports, a contraction of non-oil exports, and continued high inflation and interest rates.

6. Conclusion

The foregoing analysis discussed the doubts as to the future continuity of the new economic policy. It was found that that policy is likely to be relaxed to some extent in view of the expected oil revenue increase, but that it would be a serious error to return to the anachronistic rentier economy of the past.

The continuity and permanence of the new policy orientation is of the utmost importance to Venezuela, since the desired results cannot be generated without it. Any major relaxation would undermine its credibility and lead to the cancellation of private investment plans (both local and foreign), and in general, discourage private economic activity.

Nevertheless, for Venezuela to be successful in its development process, it is not enough for correct economic policies to be implemented internally. The country must also receive an inflow of resources from abroad with which to finance the needed investments. Given the current scarcity of international financing, due to the limitation of funds and ever increasing demand for them, it is essential to make the best possible use of the additional oil revenues; their allocation will require very careful planning, to maximize their benefits.

Finally, we must observe that, in a world as unstable and changeable as today's, where the great powers are converging toward a common economic direction characterized by market oriented economics, the developing countries have no alternative but to participate actively and try to extract benefits from the contemporary trend.

That is why we must continue with the policy of opening the Venezuelan economy up to the world, and make concerted efforts to pursue regional economic integration. However, those efforts require a different approach than those of the 1960s and 1970s. Now the Latin American countries must unite to decide what products the world is likely to demand in the future that we can produce efficiently, and allocate the capital resources at our disposal to the creation or expansion of the capacity for the production of those goods.

Under such a scheme, the region's capital resources must unite and be invested in the strategic places to achieve optimal large-scale production of those goods. We must likewise invite foreign capital to participate in that effort; that would not only bring us a large volume of needed capital, but also would permit access to high technology, guidance on the kinds and quality of products that will be demanded by the industrialized world, and access to the principal world markets.

The challenge before us is thus vast and complex. Consequently, we cannot afford to stray from the traced path, at either the national or the regional level. If we do, we run the grave risk of becoming isolated from the emerging new world, and would find the development we so earnestly desire further and further from achievement.

Caracas, September 1990

Notes:

(1) For a more detailed analysis, see Central Bank of Venezuela (1990), Palma (1989a), and Palma - Fontiveros (1989)

(2) See Central Bank of Venezuela (1990) and International Monetary Fund (1989)

(3) When the government decided to freeze interest rates at their 1985 levels (13.5% for loans and 10% on time deposits), while expected yearly inflation was in the 35% - 40% range (in 1987-1988), real interest rates became deeply negative.

(4) For a more detailed analysis of the Venezuelan Public Sector deficit, see Velázquez (1990).

(5) For a more detailed analysis of the effects of negative real interest rates on the financial market, and mainly on internal savings, see Rodríguez (1990)

(6) Since the exchange rate unification in March 1989 the appreciation of the dollar has been relatively moderate (less than 19% between March 1989 and August 1990).

(7) In 1989 non-oil real G.D.P. showed a 9.4% contraction.

(8) For an analysis of the alternative foreign exchange system we proposed, and an assessment of its viability and consequences, see Palma (1989b).

(9) See Oficina del Comisionado del Presidente para Asuntos Económicos Internacionales (1990).

(10) At the time this paper was written (September 1990), it was difficult to make predictions for 1991. But we can say that, if Venezuela's daily export volume stays at 2.2 million barrels per day and the average prices for the year is US$ 21 per barrel, the country will receive an additional US$ 7 billion, with total export value standing at US$ 16.7 billion.
However, if Middle East events should force Venezuela to reduce its 1991 exports to the pre-conflict level of 1.75 million barrels per day, and the price holds at US$ 21 per barrel, the additional income would only be US$ 3.5 billion, with total earnings slightly above US$ 13.4 billion.

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