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External Debt and the Recessive Impact of a Devaluation: The Venezuelan Case

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Since December 1986, the Venezuelan government has been introducing some important changes of economic policy aimed at facing the problems that arose as a result of the sharp fall in oil-export revenues that took place in that year.

The main elements of this new economic policy include:

1. DEVALUATION AND EXCHANGE CONTROLS:

   a. A new exchange rate of Bs. 14.50 per United States dollar was established for all imports and exports of goods and services, with the exception of imports of foodstuffs, medicines, clothing and footwear, agricultural inputs, and raw materials for the manufacture of cardboard and packaging paper; the latter items will continue to be imported with foreign exchange at the rate of Bs. 7.50/$. The Bs. 7.50/$ rate remains unchanged for all imports and exports of the oil and iron-ore industries.

   b. All the foreign exchange earned by the export of goods and services made by State-owned companies other than those of the oil and iron-ore industries, as well as those made by the private sector, must be sold to the Central Bank of Venezuela at the exchange rate of Bs. 14.50/$, and the export bonus is to be maintained and calculated on the basis of that exchange rate.

   c. The free market for foreign exchange continues to exist for transactions between individuals, but the imports which had been made with foreign exchange purchased on that market will now be eligible for dollars at the new preferential rate of Bs. 14.50/$. The latter rate is also applicable to imports made for the Margarita Island Free Port.

   d. RECADI, the exchange control office, is to be eliminated, and its functions will be transferred to an office of the Ministry of Finance, which will hereafter be responsible for the approval and distribution of foreign exchange for imports.

2. EXTERNAL DEBT:

a. With respect to foreign debts, and more specifically, the external obligations of the private sector, access to foreign exchange at a stable price will be guaranteed upon payment of a premium. But neither the Republic nor the Central Bank will assume the exchange and commercial risks inherent in those obligations.

b. In the area of the public foreign debt, there was a change of attitude in the government's position. Accord-ing to the new orientation, the policy will be not to make net principal payments, but rather to obtain financial conditions in accordance with current oil market condition's, in order to protect the country's balance of payments. Announcement was also made of an intensification of efforts to obtain external financing from international financial institutions of both a public and a private character, to cover the required imported components of investment projects for which this kind of financing is justified.

3. FOREIGN INVESTMENT:

Measures to stimulate foreign investment, such as future foreign exchange contracts giving investors clearcut guidelines on the exchange treatment to be accorded to their investments and the remission of dividends abroad, are being taken, as well as measures seeking the re-opening of international lines of credit.

4. TARIFF POLICY:

A new import tariff policy is being carried out, aimed at replacing the exchange-rate mechanism as a means of discouraging non-essential and luxury imports.

5. DOMESTIC INVESTMENT:

A set of measures to stimulate domestic private investment were announced, among which are a provision for the Venezuelan Investment Fund (FIV) to finance such private investment projects through shareholding participation in mixed enterprises, and the opening of overall lines of credit for the financing and development of specific high-priority sectors such as agriculture, industry, and construction of tourist infrastructure.

6. INTEREST RATES:

The intention was expressed of setting interest rates capable of stimulating national savings as a means of sustaining the investment process. In other words, to establish reasonable real interest rates. This decision has been delayed for the moment and the Central Bank is to keep control of interest rates.

7. PRICE CONTROLS:

Existing price control policy is to continue with the aim of preventing speculative outbreaks or monopolistic or oligopolistic practices. Strict controls have been extended to a considerable number of new items.

8. SOCIAL POLICY:

Minimum wage for rural workers was raised from Bs. 1,200 to Bs. 1,500 per month, and that for urban workers was increased from Bs. 1,500 to Bs. 2,000 per month. In addition, the salaries of public employees, particularly those not benefited by Decree 959 of January 1, 1986, will be raised. Salaries of more than Bs. 6,000 will increase by 10%. The armed forces personnel will benefit from this measure as well. New subsidies were introduced for some agricultural products, basically milk and fertilizers.

One of the outcomes of this new policy has been the recent agreement arrived at with the creditor banks to restructure the public sector's external debt. This new accord was achieved on February 26, 1987, and its most relevant aspects made public so far include:

1. The spread over LIBOR was reduced from 1 1/8 to 7/8 of percentage points.

2. The principal payments of 1987-1989 period that added up US$ 3.35 billion according to the old agreement were reduced to US$ 1.35 billion, of which US$ 250 million will be paid in 1987, US$ 400 million in 1988 and US$ 700 million in 1989.

3. The total period to cancel more than US$ 20.3 billion of public debt was increased from 12 years to 14 years.

4. The banks expressed their intention to analize new loan demands presented by Venezuela in order to finance its development plans. The explicit intention of the Venezuelan government is to borrow additional funds for new investment projects and to reduce net amortization payments of its debt, but under no circumstances to

borrow in excess of what is paid to cancel old debt.

This paper synthesizes our ongoing evaluation of the government's economic policy initiatives since last December, their short term effects on the economy, as well as the impacts of the new agreement reached with the creditor banks on the public sector's external debt on February 26th. of 1987.

Our attention is focused on six major areas of interest:

- Foreign trade
- Availability of foreign exchange
- Distribution of income between the public and private sectors
- Effect on the level of economic activity
- Financial repercussions
- Inflation and economic growth

1. Foreign Trade

Foreign trade balance appears poised to achieve a certain degree of recovery in 1987, in comparison with its negative results of last year. Imports are expected to contract while exports should expand quite vigorously.

1.1. Imports at Bs. 7.50 per Dollar

The overall value of the imports still obtained with foreign exchange at this rate (principally food and medicines) will be very similar to that of 1986: between US$ 2 and 2.5 billion. But purchases can be expected to rise in the medium term if this exchange rate is maintained for any considerable length of time, due to the relative cheapening of these imports in bolivar terms, in spite of the strict exchange controls which will be exerted over the use of this exchange subsidy.

In our opinion, the government is most likely to give priority to limiting the increase in prices of food and other essential consumer items during the next two years, motivated by the approach of the December 1988 national election. The conservation of an overvalued exchange rate and resort to large-scale importation of these products will undoubtedly help to keep the internal price relatively low, although this policy is likely to result in shortages due to the restriction of domestic supply.

In addition, the government's financial restrictions will make it very difficult to maintain a policy of minimum prices for the agricultural sector sufficient to compensate farmers for the expected sustained increases in domestic inflation. As a result, the lack of adequate incentives for agricultural production could well lead to weaker growth in this sector. This would naturally stimulate imports to meet demand without giving rise to significant variations in the internal price of these essential products.

1.2. Imports at Bs. 14.50 per Dollar

Imports made with foreign exchange at this new rate are likely to decline, reflecting its higher acquisition cost and the depressive impact on aggregate demand of a 93% increase in the costs of imported components of domestic production and its consequent price increases; imports represent no less than 15% of the total gross domestic product, so a sharp rise in the cost of most of them cannot fail to have a severe impact on the overall purchasing power of national income.

Table 1
Imports of Goods and Services (*)
(Billions of US$)

	1986 (E)	1987 (P)
At Bs. 7.50/$:	8.40	2.15
Oil	1.40	0.90
Non-oil	7.00	1.25
- Public	1.50	0.25
- Private	5.50	1.00
At Bs. 14.50/$:	-----	6.00
Public	-----	1.25
Private	-----	4.75
Free Market:	1.00	0.20
TOTAL	9.40	8.35

(*) Except travellers' expenses
(E) Estimates (MetròEconomica)
(O) Projection (MetroEconomica)

There have been expectations that imports of goods previously made at the free market rate will grow substantially now that those products are eligible for dollars at the official rate of Bs. 14.50/$, since the cost of importation will go down. But the relative revaluation of the bolivar for these transactions will be largely neutralized by a compensating increase in tariff rates, leaving their bolivar prices in the domestic market mostly unchanged.

1.3. Exports

The recent foreign exchange measures will have no effect on the bulk of the country's exports (oil and iron-ore). But the reduction in the exchange rate applicable to all other exports (from the free market rate to the controlled rate of Bs. 14.50/$) could depress the rate of growth of non-oil exports; it is even conceivable that they could decline, since the new exchange rate sharply reduces the profit margin of exporters and so removes a large part of the incentive for exportation. Some export lines might even become uneconomical under these new conditions.

The new exchange rate has virtually eliminated the previously existing differential (under which raw materials and other inputs could be imported at Bs. 7.50/$ and final products exported at the free market rate). Now, inputs must be imported at the same exchange rate applied to those foreign sales. Exporters therefore earn less on their external sales while their costs for imported raw materials rises.

However, firms producing goods which enjoy international competitive advantage can still expect profits attractive enough to make for continued growth in their export volume. Furthermore, exporters earn a tax incentive which can reach as much as 35% of the domestic value added under the recent reform of export incentives.

In any case, there is still a certain degree of exchange advantage for exports, even if much less than previously, since local costs have risen much less than external ones as a result of the sharp devaluation of the controlled exchange rate. In fact, in terms of dollars, domestic costs are now lower than they were at the beginning of 1983.

Under these circumstances, the overall volume of non-oil exports will probably decline to a level more in keeping with the Venezuelan economy's real export capacity. That is, the country will cease to export those products which require a strong exchange subsidy to compete in foreign markets, and will continue to export only those items which benefit from the reduction in internal costs in dollar terms and can therefore take full advantage of the tax incentive.

The larger contraction is likely to come about in the products which have recently been illegally exported due to the vast differential between internal and external prices in dollar terms when the free market rate was used as the factor of conversion. The smaller differential now existing between the controlled exchange rate (Bs. 14.50/$) and the free market rate will limit this type of transactions.

2. Availability of Foreign Exchange

Venezuela's balance of payments will improve in 1987, due to the following factors:

a) Imports of goods and services could contract by an estimated 6%, totalling approximately US$ 8.35 billion.

b) Oil exports are expected to rise by about US$ 1.4 billion as a result of the recovery of prices on the world market.

Table 2

Oil Prospects

	1986	1987	Difference
Exports (Billion $):	7.2	8.6	1.4
Price (US$/B)	12.89	15.85	2.96
Volume (Million B/D)	1.530	1.485	-0.045

Source: PDVSA and MetroEconomica

c) Foreign debt service obligations will also decline in 1987 by more than US$ 1.7 billion. This estimate is based on the new public foreign debt agreement reached with the creditor banks on February 26, 1987. We also assume that this year the public sector will obtain funds for an amount of US$ 900 million, by selling bonds abroad, or by taking new loans from official international organizations, such as the World Bank and the Interamerican Development Bank, or from private banks.

Table 3

Foreign Debt Service
(Billion US$)

	1986	1987	Difference
Public:	3.809	2.629	-1.180
Amortization	1.925	0.880	-1.045
Interest	1.884	1.749	-0.135
Private:	1.916	1.332	-0.584
Amortization	1.409	0.865	-0.544
Interest	0.507	0.467	-0.040
TOTAL	5.725	3.961	-1.764

Source: Venezuelan Finance Ministry and MetroEconomica

The foregoing considerations lead us to expect a net improvement of US$ 3 billion in the flow of foreign exchange this year, as the following summary of the balance of payments illustrates:

Table 4

Summary of Balance of Payments

(Billion US$)

	1986	1987
Trade Balance	1.1	2.9
Current Account Balance	-1.5	0.6
Capital Account	-3.0	-1.3
Others	0.8	0.0
Overall Balance of Payments	-3.7	-0.7

Source: Central Bank of Venezuela and MetroEconomica

This reduction of the foreign deficit could allow the government to normalize the supply of foreign exchange for imports to the private sector, as the year advances, and even to be more flexible in the approval of their requests for increased imports.

Still, private importers may well find themselves in difficulty in the first few months of the year, not because of an insufficiency of foreign exchange available for imports, but due to the inefficient operation of the system for authorizing imports and allocating the corresponding foreign exchange at the preferential rates.

In the context of last December's policy initiative, the government asked the private sector to submit its applications for foreign exchange for its anticipated import needs in the first half of the year, on the basis of a public sector estimate of an annual total of US$ 6 billion. But many importers filed applications for a much higher volume of foreign purchases than they had conducted in 1986; this has created a great deal of congestion in the bureaucratic process for the approval of imports.

The rise in those applications responds to a number of circumstances. The following ones are the most important:

a) The widespread expectation that the Bs. 14.50/$ exchange rate will not last very long.

b) The importers' suspicion that the government will not approve the whole of their demands, in compensation for which, they apply for more funds than they really expect to use.

c) The fear on the part of the private importers that the provision of foreign exchange will be more restricted in the future, and that it is prudent to make their purchases ahead of time and replace or accumulate inventories at a higher than normal rate.

In any case, the government has felt itself obliged to ration dollars on the basis of its own statistical records of imports made in previous years. Since approval of foreign exchange disbursements usually follows the guidelines of the public sector budget, importers are likely to find their demands partially unmet in many cases.

We feel that in making their calculations of import needs, the businessmen tend not to consider the depressive effect on demand that price increases caused by the new exchange rates will have. However, persistent inconstancy and instability in government policy over the last four years fully justifies the expectations prevailing in the private sector. In such a context, it is natural for importers to attempt to assure themselves of an adequate supply of foreign goods in anticipation of future difficulties.

Nevertheless, it is reasonable to expect that, as the foreign exchange rationing problems are gradually solved, and businessmen become more aware of demand contraction for imported merchandise in response to higher prices, the pressure for foreign exchange at the preferential rates will begin to decline and the administrative system will become more efficient.

3. Income Distribution between the Public and Private Sectors

Exchange measures always have public revenue implications in Venezuela, since just as in any other country, a devaluation increases the earnings of exporters and reduces those of importers. The principal exporter by far in Venezuela is the public sector, while the private sector is basically a net importer. This means that a devaluation enriches the public sector and impoverishes the private sector in relative terms.

Our estimates indicate that the recent exchange measures will add approximately Bs. 35 billion to the central government's revenues. These additional funds come from a number of sources: 1) exchange profits, expected to total more than Bs. 30 billion in addition to the level anticipated under the preceding exchange rates; and 2) larger tariff collections, due in part to the increase in the bolivar value of imports on which the tariff is levied, and in part to increased tariff rates on a large number of items (see lines 2 and 3 of Table 5).

However, the public sector as a whole will not benefit to the same extent. The public enterprises, except for those in the oil and iron-ore sectors, will earn less for their exports (line 3 of Table 5), due to the much lower exchange rate applied to these transactions. Consequently, the net increase in overall public sector revenues is expected to be in the neighborhood of Bs. 22.5 billion (see line 1 of Table 5).

Furthermore, public spending will also have to rise as a result of the new exchange rates. The cost of imports by public institutions other than the oil companies will increase by approximately Bs. 8.75 billion (line 7 of Table 5), and outlays for public foreign debt service will be greater because those external obligations covered by the Republic (60% of the total) will now be served at the Bs. 14.50 exchange rate.

According to official announcements, public sector foreign debt principal payments in 1987 will be close to US$ 900 million, of which US$ 250 million correspond to restructured debt with the banking community and the rest to the non-refinanced portion of those liabilities. This will substantially reduce the dollar cost of public foreign debt service, but will not bring about a corresponding decline in its bolivar cost. On the contrary, the new exchange rate at which the Republic is going to serve its foreign obligations will make the total public sector debt payments to be Bs. 3.9 billion higher than originally budgeted (see line 6 of Table 5).

The net result of all these changes in public sector revenues and expenditures will be a gain on the order of Bs. 9.9 billion over the original budget estimates for this year (see line 8 of Table 5).

The private sector faces a very different situation. The new exchange rates will substantially reduce the bolivar earnings from private exports and simultaneously, it will increase the cost of imports and foreign debt service.

Even assuming that private imports will fall by US$ 500 million, compared to what could have been expected had no major change been adopted in the exchange-rate regime, and that most of the goods previously imported at the free market rate can now be purchased with foreign exchange at Bs. 14.50/$, the cost of those imports would still rise by some Bs. 25 billion, as line 12 of Table 5 makes clear.

The cost of private foreign debt service would also increase in bolivar terms if, as expected, most debtors chose to participate in the exchange insurance scheme, under which they would have to lay out as much as Bs. 4.50 more for every dollar of foreign debt service. We calculate that the additional cost of that guarantee would be in the neighborhood of Bs. 3.3 billion (see line 16 of Table 5).

Finally, income from private exports will contract by approximately Bs. 10 billion, even under the optimistic assumption that their dollar value is not undermined as a result of the change from the free market rate for the conversion of the foreign exchange earned to the Bs. 14.50/$ rate. The tax incentive partially compensates exporters for that loss of income, (it is assumed here that Bs. 2.9 billion would be paid to exporters as tax incentives out of a total value of exports of Bs. 13.050 billion), so that the net reduction is expected to be in the neighborhood of Bs. 7 billion (line 10 of Table 5).

This would bring the total loss of income for the private sector to approximately Bs. 35 billion as a direct result of the new exchange rates and rules governing private sector exports adopted last December (see line 19 of Table 5).

Table 5

Impacts of the New Exchange Rates
(Billion bolivars)

	X 1987(A)	Y 1987(B)	Y - X
Public Sector Accounts:			
(1) Income [2+3+4]:	51.150	73.715	22.565
(2) Exchange Profits	11.610	42.000	30.390
(3) Customs Duties	8.940	14.315	5.375
(4) Non-Oil Exports	30.600	17.400	-13.200
(5) Outflows [6+7]:	37.170	49.839	12.669
(6) Foreign Debt	25.920	29.839	3.919
(7) Non-Oil Imports	11.250	20.000	8.750
(8) Public Sector Balance [1-5]			9.896
Private Sector Accounts:			
(9) Income:	22.950	15.950	-7.000
(10) Exports	22.950	15.950	-7.000
(11) Outflows [12+16]:	66.466	94.761	28.295
(12) Imports:	56.475	81.475	25.000
(13) -At preferential rate	45.000	7.500	-37.500
(14) -At Non-preferential rate	0	68.875	68.875
(15) -At free market rate	11.475	5.100	-6.375
(16) Foreign Debt:	9.991	13.286	3.295
(17) -Capital	6.488	9.083	2.595
(18) -Interest	3.503	4.203	700
(19) Private Sector Balance [9-11]			-35.295

(This table continues on the following page)

Table 5 (continuation)
(Billion US$)

Assumptions		1987(A)	1987(B)
(20)	Imports of Goods and Non-Factorial Services:	8.850	8.350
(21)	Imports at Bs. 7.50/$:	8.400	2.150
(22)	Oil Sector	900	900
(23)	Non-Oil Sector:	7.500	1.250
(24)	-Public	1.500	250
(25)	-Private	6.000	1.000
(26)	Imports at Bs. 14.50/$:	0	6.000
(27)	Public	0	1.250
(28)	Private	0	4.750
(29)	Imports at Free Market Rate (Bs. 25.5/$) excluding Travellers	450	200
(30)	Exports of Goods and Non-Factorial Services (excluding Oil):	2.100	2.100
(31)	Public	1.200	1.200
(32)	Private (excluding Travellers)	900	900
(33)	Foreign Debt:	4.788	3.961
(34)	Public:	3.456	2.629
(35)	-Capital	1.677	880
(36)	-Interest	1.779	1.749
(37)	Private:	1.332	1.332
(38)	-Capital	865	865
(39)	-Interest	467	467
	TOTAL EXTERNAL PAYMENTS [20+33]	13.638	12.311

(A) Prospects and official estimates before exchange measures.
(B) Prospects and official estimates after exchange measures.

4. Effects on the Level of Economic Activity

The combination of this year's higher inflation (see Section 7) and the relatively small gains in the average income of the population will bring about yet another contraction in overall purchasing power and, consequently, in real private consumption. This contraction may very well be quite severe, and is likely to undermine the possibility of any significant growth in production.

At the same time, the net withdrawal of resources from the private sector discussed above will bring about a reduction in the disposable income and spending of that sector of the economy.

The exchange profits will be financed mainly by the private sector, and should be viewed as an indirect tax. As a result, private sector demand (both consumption and investment), which contributes 75% of total internal aggregate demand, will contract.

We have already shown how the exchange measures will extract approximately Bs. 35 billion from private sector income. But if the public sector returns only a portion of that amount (we estimate Bs. 9.9 billion), the private sector will undergo a net loss of income on the order of Bs. 25 billion; this cannot fail to exert a strong recessionary effect on the economy as a whole.

The public sector's internal demand, for its part, is also expected to decline in 1987, in spite of an increase of about 25% in nominal public spending in relation to 1986. The cause of this contraction is that only a limited amount of that spending will be made in the local economy, and only a part of that internal spending will have an effectively stimulative effect on economic activity. What is known as stimulative public spending consists of only the portion of internal spending not financed by the extraction of funds from the local economy.

In fact, stimulative public spending (see Table 6) is likely to stagnate and even to contract in 1987. While the private sector will transfer about Bs. 28.3 billion in additional exchange profits and foreign debt insurance premiums to the State (see Table 5), the latter will dispose of only Bs. 9.9 billion to spend in the internal economy; the rest of the additional revenues will have to be allocated to the acquisition of the (more expensive) dollars required to meet public foreign debt service obligations and finance the public sector's import needs, and to compensate for the public sector non-oil exporters' losses.

Table 6 indicates that stimulative internal public spending grew quite rapidly in 1985 and 1986. This factor largely explains the growth in the non-oil economy in the last quarter of 1985 and throughout most of 1986. This type of internal spending is obtained by subtracting public revenues extracted from the internal economy from total internal spending and then adding the monetary financing for that spending (i.e., Central Bank loans, purchases of public bonds by the Venezuelan Petroleum Corporation, etc.). This kind of outlay has a high stimulative capability, since it is a true generator of additional demand aimed at the rest of the economy.

Table 6

Stimulative Internal Spending by the Public Sector

(Billion Bolivars)

		1985	1986 (p)	1987 (e)
(1)	Government Spending	113.3	124.2	158.7
(2)	Net internal spending by Venezuelan Investment Fund (FIV)	0.5	8.0	7.9
(3)	Rest of Public Sector	49.1	60.2	75.1
(4)	Total Spending [1+2+3]	162.9	192.4	241.7
(5)	External Spending (except FIV)	44.6	49.6	60.1
(6)	Internal Spending [4-5]	118.3	142.8	181.6
(7)	Internal Revenues	70.7	98.2	140.8
(8)	Net Internal Spending [6-7]	47.6	44.6	40.8
(9)	Monetary Financing	6.0	23.7	26.7
(10)	Stimulative Internal Spending [8+9]	53.6	68.3	67.5
PERCENTAGE VARIATION		28.6%	27.4%	-1.2%

(p) Provisional figures.
(e) Estimates.

When the expected inflation for this year is taken into account, it becomes apparent that the stagnation of nominal stimulative public spending implies a severe contraction of this variable in real terms; the recessionary impact on the economy is readily visualized.

This leads us to assert once again the urgency of a maximum reduction of the country's net public foreign debt service payments, in order to free a large volume of economic resources to be channeled into the internal economy, instead of leaking them out to abroad.

We estimate that if Venezuela can come to an agreement with its creditors and with the intergovernmental financial institutions for new credits in an amount equivalent to the country's public foreign debt service outlays, an additional Bs. 20 billion or more would become available for stimulative internal public spending.

What Venezuela arranged with the banking community in the latest public debt agreement is not enough. It is crucial for the country to assure additional financial flows in order to reduce even further that debt net service payments. That would not only alleviate the pressure on the country's foreign reserves by improving its balance of payments, but also (and this is much more important and urgent), it would largely neutralize the recessionary factors now afflicting the economy.(*)

5. Financial Impacts

The distributive effects of the exchange measures will strongly increase the demand for credit in this and subsequent years. Domestic inflation, the increase in the cost of imports, and higher foreign debt service costs, will all pressure the private economy to demand a larger volume of loans from the financial system to cover its normal operating requirements.

The public sector will also demand more funds from the internal financial system. The additional revenues generated by the exchange measures have already been committed to existing spending programs, particularly social assistance programs, and little or nothing is left over to cover the budget deficit initially forecast by the authorities at close to Bs. 15 billion for this year; the funds involved in this deficit are allocated mainly to the Three-Year Public Investment Plan.

As stated above, public sector exporters will also suffer a decline in their bolivar income due to the reduction of the applicable exchange rate, thereby diminishing the surpluses on which they have relied in the last few years to wipe-out the deficit of the independent governmental agencies.

That is to say, the public sector will for the first time in a number of years become a net demander of credit from the internal financial system, which will bring it into direct competition for funds with the private sector. The proposed reform of the General Law of Banks and Other Credit Institutions is a clear indicator of the expectations in this respect: the new legislation is aimed at increasing the volume of funds the financial system can place at the disposal of governmental institutions.

The increased financing needs of both the public and private sectors will require the national banking system to develop an enhanced credit capacity, which in return will depend on an expansion of internal savings. That is the reason for the recent announcement by the monetary authorities of the desirability of raising domestic interest rates to stimulate savings and moderate the demand for credit. In any case, the demand for loans may well reach a magnitude requiring the vigorous action by the Central Bank to expand internal liquidity.

(*) For further analysis and information, see Palma, Pedro A., "A New Approach to Managing the Public Sector Foreign Debt", MetroEconómica, Monthly Report, Special Section, Vol.VI, No.1, January 1987, pp. SS 11-12.

It also makes it highly desirable to attract a larger volume of foreign investment, and to return to the international financial markets for new loans care-fully calculated to contribute to compensating for the inadequacy of domestic savings. This is particularly important following the decision of not raising local interest rates in spite of their highly negative levels in real terms, arguing that their increase would create recesive and inflationary pressures in the economy.

6. Inflation and Growth

6.1. Inflation

Inflation this year will mainly be the result of the devaluation of the exchange rate. But other factors will also play their role in forcing prices upward.

The cost of obtaining imported raw materials, inputs and goods of all kinds no longer entitled to the Bs. 7.50/$ preferential exchange rate, will almost double. This will evidently raise production costs, and the affected firms will attempt to pass the cost increases along to the sale prices of their products. Furthermore, the increase in the minimum wage will exert additional, though moderate pressure on production costs. Finally, their increased foreign debt service outlays will lead private companies to seek compensation by way of price increases.

The progressive expansion of the impact of these cost and price rises throughout the economic chain is expected to yield a wholesale price inflation in the neighborhood of 25% for the year. Manufacturing industries have already served notification of price increases fluctuating between 20% and 30% on the average.

Still, these figures do not imply that Venezuela finds itself on the verge of a runaway inflationary spiral. It is more precisely a one-time price adjustment caused by the exchange measures, and to a lesser degree, by labor costs.

The inflationary impact of those factors would be more intense and long-lasting only if internal demand were expanding, or very serious supply shortages were to crop up. But as indicated above, the provision of foreign exchange for imports can be expected to improve as time goes on, thereby avoiding especially serious supply problems, and real internal demand, particularly private consumption, is likely to contract.

That is to say, that after the initial price shock in the early months of the year, the depressed private demand due to the contraction of real personal income and the high sensitivity of the consumers to price changes, on the one hand, and the government's reduced ability to increase the net aggregate demand of the public sector, on the other, can be expected to come into play, moderating the price escalation. These restrictions on the demand side could even contribute to preventing the transfer of rising production costs to prices, as companies fear a sever contraction of their sales volumes.

Furthermore, the government has reacted quite rapidly to prevent the formation of excessive inflationary expectations, through the traditional method of expanding the coverage of price controls and making the approval of applications for price increases more difficult. This response obviously places a great many companies in serious difficulties, but it is a valuable tool for moderating pressure for across-the-board wage and salary increases by the labor unions; this is particularly important in the struggle to stabilize inflationary expectations.

The foregoing does not imply that there will be no demands for general wage and salary increases on the part of the labor leadership, and if they should arise, such demands would probably not encounter determined resistance from the government, concerned with the selection of the governing party's presidential candidate for the upcoming elections.

The powerful influence held by the Union Bureau of the Acción Democrática party in the presidential nominating process is very well known. Under these circumstances, an arrangement in which the government would not strongly oppose wage and salary demands, so as to win the support of the labor leadership for the election campaign, is quite plausible.

6.2. Growth

It will be very difficult this year to achieve the growth rate recorded in 1986. The contraction of real internal demand and non-traditional exports, as well as the restrictions on government spending, could combine to produce a fall in real production on the order of 1% or 2% for 1987.

It should be noted that agriculture, which has achieved one of the highest growth rates in the economy in the last two years, confronts a less encouraging situation in 1987. Recent increases in production were the result of a policy of minimum prices to producers which provided attractive incentives. But as the electoral year approaches, the government tends to become more sensitive to the inflationary impact of its actions, and it can be expected to make every attempt to limit price increases of basic consumer goods, particularly staple foods; the recent tightening of price controls and the conservation of the Bs. 7.50/$ exchange rate for the importation of essential items demonstrate the government's intentions in this regard.

This means that the minimum prices guaranteed by the government to farmers will tend to stagnate or rise relatively little in the coming years, in spite of the increase in production costs as a result of accelerating internal inflation. If this should result in insufficiency of domestic production to meet the demand, the shortfall might well be made up through imports, which would be particularly easy to finance at the Bs. 7.50/$ exchange rate; this would in effect be a subsidy to foreign suppliers. As a result, Venezuelan farmers might find themselves with little incentive to continue to expand production, and the growth rate of food production might decline.

The dynamic forces acting in a positive direction of the level of economic activity are concentrated in the added stimulus for continuing the process of import substitution provided by the new exchange rate. The previous rate of Bs. 7.50/$ was already overvalued, as a result of the differential between domestic inflation and the inflation rates prevailing in the rest of the world during the last three years, plus the deterioration in the country's terms of trade.

The possibility of substituting for imports depends on the difference between the price of domestically produced and imported goods. As imports become more expensive, the ability of domestic industry to offer the public products with a lower relative` price will induce consumers to prefer the cheaper national products, thereby stimulating domestic production.

7. Conclusion

The short-term prospects for the Venezuelan economy are not very bright; they feature higher inflation and more likelihood of a contraction of productive activity, with the resulting growth of unemployment and regression in the distribution of income.

But the recovery of oil prices, the possibility of reducing imports, and the government's intention of diminishing net foreign debt service payments (in part by obtaining new foreign loans), will contribute to improve results in the country's balance of payments and alleviate the pressure on its foreign reserves.

Now more than ever, the measures to stimulate domestic and foreign investment announced last December need to be put into practice, and the necessary economic policy corrections need to be carried out. Those measures must also be complemented by other urgent actions, such as the implementation of a thoroughgoing fiscal reform similar to the one proposed by the Commission on Fiscal Study and Reform several years ago; such a reform would not only improve the collection of public sector revenues, but would also increase the efficiency of public spending and optimize its reorientation, thereby making the management, supervision, and control of the public administration more effective.

Also, a more aggressive and dynamic management of the external debt is desirable in order to reduce the heavy burden created by its service payments. The positive image that Venezuela has recovered in the international markets and the current developments in the financial world should be used to assure new inflows of external resources that help Venezuela to cope with the drastic reduction of its oil revenues and to neutralize the recesive forces that are present in the economy.

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External Debt and the Recessive Impact of a Devaluation: The Venezuelan Case

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