# SUSTAINABILITY OF ADJUSTMENT PLANS AND ECONOMIC REFORMS: THE VENEZUELAN CASE

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## 1. **INTRODUCTION**

A succession of adjustment packages and isolated measures to that end have been adopted in Venezuela during the last two decades, generally at the time new administrations have taken office. Two of these packages or sets of measures which cannot be characterized as full-fledged adjustment plans - were undertaken by Presidents Luis Herrera-Campíns and Jaime Lusinchi at the start of their respective administrations, in an attempt to correct the fiscal, monetary, financial, and externals disequilibria inherited from the administrations they succeeded. Inflation was not the fundamental problem in either case.'

The adjustment processes launched in 1989 and 1996 were more far-reaching and comprehensive than their predecessors, to the point where they qualify as true adjustment plans and economic reforms. They included inflation control amount their objectives, as well as correction of macroeconomic disequilibria and critical economic reforms; inflation control was particularly central to the 1996 plan. That orientation made them resemble the adjustment plans adopted in other Latin American countries, some of which have been quite successful while others have totally failed or yielded mixed results.

The multiple experiences built up in Latin America are highly instructive, providing the basis for a series of hypotheses on basic conditions required to ensure the sustainability of an adjustment plan aimed not only at correcting macroeconomic disequilibria, but also at implementing structural reforms and at stabilizing prices over a substantial period of time.

Among those conditions are:

1. A leadership which mobilizes support for the plan from the political elite.
2. Support for the stabilization program from the population, in spite of the sacrifices it must make - which can only be partially cushioned by essential social relief measures.

3. The formulation and implementation of an information strategy to clearly explain all members of society of what is to be done or is being done, why it must be done, what consequences it is likely to have, and what results will presumably be achieved. 4. A comprehensive, coherent, realistic, credible, and dynamic economic plan to render the adjustment and reform programs sustainable over time, reflecting a conviction and commitment on the part of those called upon to direct its implementation and enjoying support from the

different sectors of the society. 5. Materialization of a set of requirements and basic conditions which are essential for the different economic participants to play its proper role in the process. We can cite the following among those requirements and conditions:

- efficient stimulus to saving
- clear and permanent rules of the game to investments
- generalized public confidence regarding the leadership's firm commitment to the plan
- repeated and invariable demonstration that the plan is effectively being
- implemented

Below is an analysis of the experiences associated with the last two plans applied in Venezuela, in the light of the foregoing hypotheses. Its purpose is to judge their sustainability and determine what mistakes were made or are presently being made, and what corrective measures are in order. This analysis is preceded, however, by a brief description of the economic conditions prevailing in Venezuela in recent decades, intended to facilitate the reader's understanding of our core analysis.

## II. **THE VENEZUELAN ECONOMY IN RETROSPECT**

Venezuela's recent economic history has been closely tied to oil. Oil production and export volume, international oil prices, the oil industry's tax payments and the ways those resources have been channeled into the rest of the economy through public spending, have given rise to well-defined stages in the evolution of the Venezuelan economy over a period of decades. But apart from the oil industry's critical importance, macroeconomic policy shortcomings and contradictions have also played a decisive role in determining the economy's performance. Among their negative effects is the discouragement of domestic saving and its inadequate use to finance internal investment.

No economy can achieve sustainable development without the investment needed to ensure a solid and permanent expansion of production. Investment requires financing, which must come mainly from the community's own saving since indefinite reliance on externals savings is not feasible.

During the last two decades both the investment and internal saving to GDP ratios have declined significantly. At the same time, however, the national economy has been able to generate important volumes of saving, which could have financed a higher level of investment.[1] The repeated absence of adequate conditions and incentives for internal investment, and multiple reasons for placing surplus funds abroad, have given rise to a massive outflow of capital which might otherwise have been used more efficiently in the internal development process.

Before oil prices rose in the mid -1970s, Venezuela enjoyed a very satisfactory economic growth, based on the generations of high internal saving and investment rates. During the 1960s the ratio of gross domestic saving to GDP averaged 3 1 % and the coefficient of investment was in the neighborhood of 20%, these figures are

comparable to the world's highest and a good deal higher than those prevailing in Latin America. Afterwards, the oil price explosion of the mid 70s and early 80s greatly enhanced both the positive and negative aspects of Venezuela's oil country condition.

The Venezuelan economy received an unprecedented volume of oil export revenues in the 1970's and early 1980's. The series of events which provoked the energy crisis of the mid- 1 970s drove the average export price for Venezuelan oil from about US$ 3 per barrel in 1972 to US$ 11 per barrel in 1974; it then held steady in the vicinity of US$ 13 per barrel until the end of the decade, before surging to over US$ 30 per barrel in 1980. The resulting inflow of oil export earnings totaled US$ 117 billion in the 1973-1982 period, 5 times more than the average amount earned in the 1960s. And since the State is the main beneficiary of the oil business, fiscal revenues expanded at the same rate as hydrocarbon exports at the time.

This revenue explosion laid the basis for an ambitious public investment program, which also stimulated private investment. As a result, aggregate investment grew at an average rate of 28% per year in the 1974-1978 period. It came to represent 36% of domestic demand and was the principal engine of the latter's expansion. The average coefficient of saving to GDP exceeded 36%, reaching a historic peak of 46% in 1974.

Although investment spending rose very substantially in the early years of the period, the coefficient of capital formation to GDP was in the neighborhood of 30% (about the same as in the previous years) from 1974 through 1976, and it was only thereafter - in 1977 and 1978 - that peak investment levels were reached in both absolute and relative terms. The coefficient of investment to GDP carne to 41,5% in 1977 and 42.8% in 1978, the highest figure in history. On the other hand, the coefficient of internal saving to GDP, which achieved a peak at the outset of the oil boom (1 974), began to decline as time went on, forcing Venezuela to resort to externals financing to maintain that massive volume of investment. This plunged the current account into deficit, amounting to US$ 3.179 billion in 1977 and US$ 5.735 billion in 1978, the equivalent of 8% and 13% of GDP, respectively.

Problems multiplied in the following decade, as occurred throughout Latin America. The 19801988 period was characterized by:

- a decline of real GDP growth to only 0.62% per year on the average, which provoked a serious contraction of per capita income and consumption
- a highly unstable oil market
- highly inflationary pressures
- persistent capital flight
- extremely adverse foreign debt conditions

These difficulties seriously undermined investment and internal saving formation. The coefficient of investment to GDP averaged just 22%, and that of saving only 23%, in that period, far below the 33% and 34% averages recorded in the preceding decade.

Outflow of funds reached very high levels in the 1980s, tuning Venezuela into a net exporter of capital. This was a combination of large-scale private capital transfers and heavy foreign debt service payments. Thus during the first half of the 1980s internal saving proceeded on a considerable scale despite the economy's contractions, and it far exceeded investment. These surplus funds, plus those raised by the external borrowing that prevailed up to 1982, provided the basis for the capital flight to the period. The net outflow of short-term private capital peaked in the 1980-1985 period, totaling US$[3] 29.993 billion.

Private capital flight actually began in 1978, when strong devaluation expectations developed as a result of the oil glut then prevailing, the country's enormous current account deficit, and the bolivar's substantial overvaluation. Though the second oil crisis which broke out in 1979 dissipated devaluation expectations, capital flight persists because the controlled domestic interest rates were below the very high international ones. That spread was narrowed, but slowly, and was not completely closed. Although the Central Bank decontrolled interest rates in September 1981, causing important transfers of funds from abroad, that did not offset capital flight caused by devaluation expectations created by the new weakening of the oil market. That situation continued and intensified in the following4 months

With a fixed controlled exchange rate and inflation averaging 11 %, the real exchange rate steadily appreciated and the bolivar became increasingly overvalued. That stimulated a high volume of imports of goods and services, and a rapid deterioration of the current account, which was further intensified by the oil price decline of 1982.

All these factors, combined with the shutoff of external financing after the Mexican crisis broke out, produced a major deterioration of the public's expectations, which in turn led to a massive capital flight throughout 1982 and up to February 1983, when the situation reached crisis proportions. That caused a devaluation of the bolivar and the imposition of a multiple-rate exchange control system.

Adjustment measures were taken in 1984 and part of 1985 to correct a set of fiscal and externals disequilibria; those initiatives were a necessary precondition for restructuring the country's foreign debt. Afterwards, a fiscal expansion policy was implemented, through rising public spending a provision of a wide range of subsidies. This policy led to a buildup of massive economic distortions, which were fully visible by the end of 1988:

a total disarticulation of the foreign exchange market, wherein the free-market exchange rate was 170% above the controlled official rate, and the commercial bolivar was deeply overvalued

a balance of payments deficit amounting to US$ 4.672 billion, and an extremely low volume of foreign reserves

a public sector budget deficit equivalent to 7.8% of GDP a 29.5% inflation rate, in spite of multiple price controls and subsidies, which concealed the presence of a relatively strong repressed inflation

significant financial disintermediation, provoked by deeply negative real interest rates.

So serious was the economy's condition that the incoming administration of President Carlos Andrés Pérez launched a structural adjustment plan in early 1989, along the lines recommended by the IMF and the World Bank. This orthodox plan' was intended to correct the disequilibria mentioned above and reduce inflationary pressure, which though moderate compared to that of other Latin American countries, was high by Venezuela's historic standards. Additionally, some important economic reforms were implemented.

## III. THE 1989-1992 ADJUSTMENT, STABILIZATION AND ECONOMIC REFORM PROGRAM

The first actions taken under this plan were aimed at correcting the profound distortions in the economy, which had in some cases been building up for years. It was decided to:

- adjust the exchange rate to wipe out the accumulated overvaluation, and dismantle the exchange control system
- decontrol interest rate so that they could move up to positive real levels, a basic requirement to correct the financial market disequilibrium
- reach an agreement with the International Monetary Fund to obtain foreign reserve financing
- do away with a number of subsidies which distorted public finance
- progressively rationalize public utility rates and the prices of many goods produced by State owned enterprises, including gasoline;
- remove price controls, with certain few exceptions;
- adopt a number of social relief programs aimed directly at the most disadvantaged sectors of the population, to cushion the adjustment's impact on them;
- impose monetary and fiscal discipline to stabilize the economy

Additionally, announcements about an economic reform were made, identifying as some of its main goals the price stabilization, and the achievement of a sustained growth in a liberalized, free-market economy. Among the most important aspects of the new development policy were:

- an opening up of the economy through import duties rationalization and reduction, encouragement of foreign investment, and the final elimination of the whom-out import substitution policy
- a reform of the public sector through tax reform, privatization, improvement of operating efficiency, and other measures
- a restructuring of the public debt, with a view to reducing the annual debt service burden a significant advance in the economic integration area establishment of clear and permanent rules to govern foreign investment.

The new authorities' intention was to carry out a drastic initial adjustment that would correct the existing disequilibria and wipe out the accumulated distortions, thereby laying the basis for the subsequent adoption, in an effective and efficient manner, of a stabilization and development plan covering a longer time horizon.

As was to be expected, the adjustment phase of the program, covering the first year after its adoption, provoked very strong effects on the economy . Unification of the exchange rate meant a devaluation of the bolivar for trade purposes by more than 150%; that plus the adjustments of prices and rates throughout the economy drove the inflation rate for 1989 up to 85%, the highest level ever experienced in Venezuela, and plunged the economy into an 8.3% GDP contraction. In compensation, the externals accounts and the central government and consolidated public sector budgets carne into balance. The latter achievement stemmed from the major increase in revenue produced by the currency devaluation, which substantially raised the bolivar value of the oil industry's export earnings, and hence, inflated its tax bill.

Following the traumatic initial adjustment phase, a period of stabilization prevailed from 1990 through 1992, during which the economy made dramatic gains. Growth averaged 7.5% per year, the inflation rate averaged 30% and tended to decline, balance of payments surpluses produced a major accumulation of foreign reserves, and Venezuela attracted an inflow of foreign investment averaging US$ 1.5 billion per year.

But these achievements were produced in large measures by an exogenous factor having nothing to do with the local economic policy: the transitory surge of oil earnings provoked by the Persian Gulf conflict that followed Iraq's invasion of Kuwait. This unexpected windfall allowed the government to raise public spending in order to stimulate economic activity while preserving an apparent fiscal balance.

The economic policy makers, who had sent the Congress a set of bills related with the economic reform intended to modernize the tax structure, downsize the public sector, and improve the quality of public administration, felt sure that once oil prices returned to normal, the decline of oil revenues
would be offset by higher internal tax collections and smaller spending requirements. But as we shall see below, the fiscal legislation was not enacted, or was only partially enacted in a very limited fashion. As a result, when the circumstantial and non-recurrent revenues generated by the international crisis disappeared, it proved very difficult to cut spending and a major budget gap opened up.

In addition, in spite of all the progress made, the needed macroeconomic adjustments and structural reform were not completed and that was to provoke serious problems at a later time. The adjustment was incomplete because Venezuelan society was not prepared to bear the impact of this severe economic plan. While the set of measures comprising the plan were coherent and generally well conceived, the social and political circumstances in which they were introduced were inimical to the achievement of satisfactory results.

In the social front, the program was extremely hard on the population, which had to bear the impact of high inflation not offset by major salary adjustments or effective compensatory mechanisms, in the absence of an effective social security system. Though a set of direct subsidies were instituted for the lower-income population in 1989, they were limited and not efficiently implemented, and so could only partially cushion the impact of high inflation. The middle class also suffered a

great deal, since it was equally exposed to inflation but received no compensatory relief measures. As a result, the Venezuelan population's average real income level plunged severely in 1989, on the heels of a steady deterioration since the late 1970s

Not only that, but the adjustment plan took the population by surprise, coming after a brief period of prosperity in the final years of the previous administration. Though that boom was artificial and unsustainable, it had led the public to expect a new period of abundance and easy wealth - especially since the incoming President was associated with the "good old days" that had prevailed during his previous administration. It should therefore not be surprising that rioting of an unprecedented scale broke out only a few days after his inauguration, threatening the stability of Venezuela's system of government.

The country's political elite, for its part, categorically rejected the new economic policy; though the leaders may have understood the need for an adjustment to correct the macroeconomic disequilibria, they were not prepared to accept so radical a change in the way the country was governed. Further, abandonment of the populist style of politics that had prevailed in the preceding decades would run counter to the political parties' own interests, by limiting their accustomed benefits and privileges, so broadly disseminated through the political patronage system.

The new President himself was a highly controversial figure, closely linked to the populism of the past, and therefore lacked the political credibility needed to demand understanding and sacrifice from the population and support from political elite. In fact, party leaders of all stripes, including those from the President's own party, viewed him as hostile to and distant from their organizations, and responded with a radical opposition to the new government policy.

As a result, major components of the program were blocked, since the political support required to create the legal framework on which the new reform policy would have to rely was absent . The fundamental changes needed to sustain the stabilization and reform program, in the following areas, were not carried through:

- the tax structure
- restructuring of the public sector
- reform and liberalization of the financial system, and adequate supervision thereof
- the employee severance benefit rules
- social security
- the judiciary.

These shortcomings made it impossible to achieve several fundamental conditions for the program's success. They deprived the plan of coherence and harmony, and prevented the establishment of clear and permanent rules of the game capable of orienting the economic agents' actions in the desired direction. Even more importantly, a set of basic structural reforms was put off, and their absence contributed to the outbreak of severe problems such as the financial crisis of 1994. It is only now that firm steps are being taken to carry out fundamental reforms which

should have been completed years ago, and the delay is interfering with and holding back the current adjustment plan.

Moreover, the plan launched in 1989 was not accompanied by an efficient public information campaign. The policy makers did not bother to formulate an information strategy to explain to all members of society why it was necessary, on the one hand, to apply a coherent set of actions to overcome the country's economic ¡balances and weaknesses, and on the other, to adopt and unfamiliar development policy in keeping with the demands of a globalized economy. It was necessary to communicate the public of the economic program's benefits and consequences, so that society might understand it, participate in it, and identify with it. The absence of such an explanation was one of the principal shortcomings which contributed to the plan's failure.

The conversion from a paternalistic State to one which promotes a free market economy was even opposed by some members of the business community, who were accustomed to a high level of protection. But other business leaders accepted the challenge, adapted themselves to the new conditions, and profited from the change. One example of that orientation was the firm support given to Venezuela's economic integration with Colombia and other Andean countries, a major part of the reform of opening the national economy to the outside world. Venezuelan companies actively penetrated these market, often through associations or joint ventures with foreign companies which were interested in entering the Venezuelan market.

Workers, for their part, felt they were being forced to make a disproportionate sacrifice while others conserved or even increased their privileges. The burden of the adjustment was thus viewed as being unfairly distributed among the different sectors of the population.

Civil society (and particularly the middle class), which did not fully understand the reasons for this radical change in policy by the State, bore the brunt of the adjustment shock, and watched the political elite’s and power holders maneuvering to evade their fair share of the sacrifice, raised its voice in indignant protest against the "economic package". This climate of opinion led to two failed military coup attempts, which were more an expression of the public's intense discontent than an attack on democratic government per se.

### III.1. **Conclusions drawn from the 1989-1992 Plan**

Important conclusions can be drawn from the experience describes above.

The first such conclusion is that, however well conceived the plan may have been, and however high its internal coherence and integrity in the economic sphere, it did not yield the anticipated results, especially in the medium-term stabilization and reform phase.

The initial measures taken in 1989 were aimed at overcoming the macroeconomic disequilibria then prevailing, and then bringing inflation under

control, generating a climate of confidence among investors who would perceive that the right actions were being taken. As shown above, these measures not only led to the correction of the basic disequilibria but also made it possible for inflation to subside, vigorous economic growth to take place, and the economy's external sector to strengthen.

But the lack of an effective information policy, combined with the absence of broad political and social support, rendered the plan unsustainable.

The basic conditions outlined at the outset of this paper were not met. The population never carne to be convinced of the need for the adjustment, which is a precondition for supporting the program in spite of the sacrifices it entailed. On the contrary, ordinary Venezuelans not only failed to understand why the adjustment was being made, but even expected a totally different policy from President Pérez, who symbolized the economic boom and easy wealth of an earlier time. The absence of an effective information policy to explain the facts contributed significantly to this mistaken perception on the part of the population.

Adding to this the near-unanimous opposition of the political elite, which prevented the enactment of the legislation needed to sustain the economic and structural reform sought by the new development policy, it should be easy to see why the plan could not be maintained, consolidated, or carried through to success.

## IV. THE VENEZUELAN AGENDA, THE ADJUSTMENT PLAN OF 1996

Venezuela was plunged into a period of instability in 1992, which culminated with the impeachment of President Pérez in the middle of the following year and the designation of Ramón J. Velásquez to complete his term (ending in February 1994). During the brief Velásquez administration a number of fundamental laws which had been sent to the Congress by the Pérez administration years before, but had been blocked by the political elite's steady opposition, were finally enacted.

Rafael Caldera was elected President of the 1994-1999 term in December 1993. His image as a total opponent of the Pérez plan and an honest political leader who could root out the traditional corruption pervading the public administration, the judiciary, and the political parties and leadership - which the public intensely wished to eradicate - were major factors in his electoral victory.

### IV.1. Financial Crisis and return to Controls

In January 1994, just a few days before President Caldera's inauguration, the government took over Banco Latino, the country's second-largest bank in terms of deposit volume, which had fallen into insurmountable liquidity and solvency problems. This action set off a financial crisis which carne to affect nearly 55 % of the public's deposits and ended with the nationalization of five financial groups and liquidation of seven commercial banks and 22 other financial institutions, including mortgage banks and financial societies (investment banks)'.

The Deposit Guarantee and Bank Protection Fund (FOGADE) assisted banks in trouble, but since it did not have the funds required given the magnitude of the problem, the Central Bank of Venezuela supplied the resources needed to support the financial system. That implied a direct creation of money by the Central Bank and generated an enormous quasi-fiscal deficit, which has had a strong impact on the system's other variables.

The funds lent to FOGADE by the Central Bank in order to assist failing banks totaled Bs 825 billion (approximately US$ 7 billion) in the first half of 1994, equivalent to 1 0% of the year's GDP and nearly half the M2 liquidity in being at December 31, 1993. This massive injection of funds into the system under conditions of intense uncertainty and negative expectations was converted in large measure into capital flight, provoking a very severe foreign exchange crisis.

The funds distributed to failing banks that were not converted to dollars remained in the internal economy and were largely reabsorbed by the Central Bank through open market operations (placement of Central Bank obligations known as zero-coupon bonds), which were intended to limit foreign exchange demand and capital flight, as well as the inflationary pressure generated by excess liquidity.

By the end of June 1994 foreign reserve losses reached US$ 3.795 billion equivalent to 53% of the volume of financial assistance distributed. The pressure put on the foreign exchange market, the exchange rate, and the foreign reserves was so intense that all currency transactions were halted on June 29 and a new exchange control system was put in place. It was accompanied by price controls over a "basic basket" of staple food products.

In addition to severely restricting all foreign currency transactions by Venezuelan's the exchange controls interfered in practice with repatriation of dividends and capital remittances associated with foreign investment. This, together with the suspension of certain constitutional rights, undermined the economy's openness to the outside world and discouraged foreign investment; it also inhibited the privatization of State-owned enterprises.

This policy soon lost its effectiveness, and with all controls in place, 1995 ended with the economy in extremely poor condition, characterized by:

- a high and rising inflation rate
- a major contraction of foreign reserves
- a severe distortion of the foreign exchange market, with a totally unrealistic official exchange rate and an extremely high free-market rate which reflected the prevailing uncertainty and dissatisfaction
- a massive deficit in the public sector accounts, in spite of progress in tax collection efficiency and changes in the tax structure
- denial of access to external financing stagnation in non-oil economic activity, which grew an insignificant 0.8% in the year after having contracted significantly in the two previous years rising unemployment.

The economy's weakness had a serious impact on the population's well being. Rising inflation, in particular, impoverished Venezuelans more with every passing day, as real income lost ground at an accelerating pace. The out-of-date system of employee severance benefits, which had been adopted at a time of low inflation, became not only ineffective but also turned into one of the chief sources of impoverishment: since severance benefit rights were cumulative and retroactive, calculated on the basis of the last salary earned by a departing worker, companies were extremely careful about adjusting salaries because they would be subjected to an explosive increase of labor liabilities'.

This factor became especially critical in a climate of high inflation, wherein the defense of real income levels requires important salary increases on a par with price variations. Since Venezuela does not have a salary indexing system or other formal mechanisms to compensate workers for inflation, there has been a widening gap between salary adjustments and prices in recent years, and workers have undergone a greater and greater deterioration of purchasing power. This trend has provoked a deep-seated and dangerous collective discontent.

The situation turned critical in the early months of 1996, when monthly inflation rates exceeded 8%, which would yield an annual price variation of over 150%. Under these circumstances, the administration had no choice but to reverse its economic policy direction.

## IV.2. The Venezuelan Agenda: A New Adjustment and Stabilization Plan

The President of the Republic announced the set of economic measures comprising the new economic plan to the country on April 15, 1996; his general remarks were subsequently expanded upon by the cabinet ministers in their respective fields of responsibility. The new economic policy was titled the Venezuelan Agenda. lf reflected the IMF recommendations, which gave the plan its support along with the World Bank and the Inter-American Development Bank.

The new program closely resembles the one launched in 1989, focusing on removal of the controls then operating over the economy:

- a total decontrol of foreign currency transactions and subsequent adoption of a flotation band system
- decontrol of interest rates, which were left to be freely determined by market forces
- removal of most price controls, with a small number of products still under regulation - - only medicines remained under controls at the end of 1996
- price increases for gasoline and other petroleum products
- a sales tax increase from 12.5% to 16.5%
- public utility rate adjustments
- introduction of 14 social relief programs to cushion the adjustment shock on the lower-income population, ranging from food distribution through direct transportation subsidies.

It was announced in July that the IMF had approved a US$ 1.4 billion stand-by loan, contingent on achievement of certain macroeconomic performance targets. Among these are:

1. Reduction of macroeconomic disequilibria:

   4% annual growth starting in the fourth quarter of 1996 reduction of inflation to the 1. 5% to 2% per month range in the second half of 1996 and the 1 % to 1.5% per month range in 1997
   contraction of the central government budget deficit to a level equivalent to 1.5% of GDP in 1996 and a balanced budget in 1997
   - consolidated public sector budget deficit equivalent to 2% of GDP in 1996 and 1 % in 1997
   - net growth of international reserves by US$ 1.5 billion in 1996 and US$ 1.23 billion in 1997.
2. Continuation of the banking system's restructuring and its opening to participation by foreign banks.
3. Strengthening of the social security reform and a change of the employee severance benefit system, to permit higher real monthly compensation to workers and improve, their standard of living.
4. Maintenance and continuation of the progressive rationalization of public utility rates; maintenance of the gasoline price at the equivalent of 85% of the international price at Venezuelan ports.
5. Resumption and acceleration of the privatization of deficit-producing State-owned enterprises.

Unlike the 1989 program, the new plan got under way in a climate of political and social stability. In view of the country's serious deterioration, most of the organizations representing the different sectors of society supported and even pressured the government for measures to overcome the crisis into which Venezuela had fallen. The country was thus united in its hope for an economic policy change, and prepared to make the necessary sacrifices. The labor movement, the business community, and even the political establishment (represented by the opposition parties in the Congress) urged the government to take action and reverse the direction of its economic policy.

There was some skepticism regarding the general public's support for this adjustment and reform program. It was said that, even though inflation had intensified a great deal it was still far below the levels that had been reached in other Latin American countries, where inflation had had to be far higher before the population carne to feel that any sacrifice provoked by an adjustment plan aimed at bringing it under control was worthwhile because it represented a lesser evil. Given that relatively low level of inflation in Venezuela, it was argued that the population had yet to reach the point of resignation needed to generate mass support for an adjustment program.

However, the steadily intensifying deterioration of the Venezuelan population's standard of living for the reasons explained above9, gave rise to a widespread disillusionment that motivated the population to demand action against runaway inflation and for a resumption of sustained growth.

Under these circumstances, the new economic program elicited positive expectations, and unlike the 1989 adjustment, stabilization and reform plan, it rests on a solid foundation of political and social support. It should be pointed out that the President's political leadership, in combination with the implementation of an effective information strategy by the government, made crucial contributions to the materialization of that support power to be fully achieved, it is still necessary to advance toward solution of the remaining distortions; their persistence could undermine the success of the new program

**IV-3 Results**

Below is a summary of the results of the Venezuelan Agenda's application from April 1996 to the present (October 1997).

**IV-3-1 1996**

The results of the adjustment program's application in 1996 were satisfactory in some areas, especially regarding the external accounts, though a great deal remained to be accomplished in the monetary and fiscal areas, in the permanent reduction of inflation, in the privatization process, in and the structural reforms of the national economy needed to provide a permanent foundation for the stabilization program. In addition, many of the year's favorable results would not have been achieved had it not been for a substantial increase in oil export earnings. Below is a detailed description of the most important results in 1996.

**Real Economic Activity**

As was to be expected, the adjustment measures provoked a deep contraction of the principal demand variables (consumption and investment), especially in the private sector. As a result, production outside the oil industry plunged by 3.6%. But the ambitious oil industry investment plan launched the year before as part of the industry's opening to private participation, in combination with a rising physical volume of production, gave the oil sector a very large impact on the economy as a whole. Its 5% growth explains why the overall economy only declined by 1.6%, quite modest in comparison with the recessions that normally occur in the early years of structural adjustment programs of this kind.

**The External Sector**

The major world price increases and the growth of production and export volume led the value of oil exports to surge by nearly 24%. Non-oil exports, on the other hand, declined by 6.2% to US$ 4.2 billion. Imports plummeted 15.6% to reach

US$ 9.105 billion, due to the exchange controls still in force during the first quarter of the year, the recession, and the drastic exchange rate adjustment.

All these factors yielded a highly favorable balance of trade; US$ 13.632 billion in the black; that was the largest surplus ever achieved by the Venezuelan economy. As always, the service account was substantially in the red, offsetting part of the trade surplus. Even so, the current account ended the year with a record US$ 8.266 billion surplus.

The capital account recorded a deficit, but a much smaller one than in 1995, due to a larger inflow of direct foreign investment generated by privatization's and a short-term capital inflow attracted by the high yields paid by Venezuelan financial instruments and the dramatic gains on the local stock exchange, especially during the second half of the year. However, this increased inflow of funds proved insufficient to offset the capital outflow for debt service (public and private), which included not only payments of current maturities but also of arrears from previous years.

The massive current account surplus, in combination with a modest capital account and errors and omissions deficit, resulted in a 56.8% growth of foreign reserves over the course of the year. Reserves reached a very comfortable level, equivalent to 20 months of imports of goods and services.

To sum up, the external sector turned in a highly favorable performance in 1996.

**Inflation**

The 12-month inflation rate (December 1996/December 1995) was 103.2%; the year's average inflation rate was virtually 100% (99.9% to be exact). Among the reasons for that drastic surge of inflation were:

- The December 1995 devaluation and the subsequent decontrol of the foreign exchange market, setting off another devaluation in April 1996.
- Two increases of electricity rates, three hikes of telephone rates, adjustments of water, urban sanitation, and household gas rates, and higher prices for transportation services.
- Higher costs for companies derived from the requirement to mark maximum retail prices on their products.
- The increase in the wholesale sales tax rate from 12.5% to 16.5%.
- Government-ordered wage increases for private sector employees (in March) and public sector employees (in May).
- High liquidity and deeply negative real interest rates. This stimulated consumption among some strata of society, especially consumption of durable goods as a way to protect savings from the ravages of inflation.
- Gasoline and diesel fuel price increases exceeding 400%.

January, May, and June were the months of highest inflation, immediately following the major currency devaluations and the largest adjustments' of other price factors mentioned above. Though the goal of cutting the inflation rate to 1.5% per month in the last quarter of the year was not reached, inflation did come down steadily

in the second half, with December's 3% being the lowest monthly rate for the year. The factors contributing most strongly to the high inflation rate in the final months of the year were the surplus liquidity in the system, negative real interest rates, and retailers' attempts to improve their marketing margins.

**The Exchange Rate**

Venezuela experienced three different exchange rate systems in 1996. Exchange controls remained in force during the first three months of the year and the official exchange rate was frozen at Bs/US$ 290. Free currency convertibility was restored in April, and the exchange rate was allowed to float. Then a flotation band system was adopted on July 1, intended to give investors a range within which future exchange rate movements would be kept, for reference purposes. Under this system the exchange rate could fluctuate within limits 7.5% above and below the central parity rate, which was initially set at Bs/US$ 470. The central parity rate, for its part, would be raised 1.5% per month, which would put it at Bs/US$ 506.32 at the end of the year. But the market rate ended the year adjust Bs/US$ 476.50. This remarkable exchange rate stability was produced by the inflow of foreign investment and speculative short and medium-term capital, as well as by the growth of oil exports earnings in response to a major price increase. All these factors helped add an extraordinary US$ 8 billion to the country's foreign reserve stocks.

At the end of the year the bolivar was effectively overvalued for imports by 5.9%. lf the protective effect of tariffs is ignored, its overvaluation for imports in nominal terms was 16%.

**Public Finance**

Public finance improved dramatically in 1996, when the central government ended the year with a surplus equivalent to 0.9% of GDP. That figure contrasts sharply with the deficit equivalent to 7.4% of GDP that was recorded in 1995.

The improvement carne as a result of higher revenue collections, which surged by 170% and reached the equivalent of 21.5% of GDP. In 1995, by comparison, they had represented only 15.9% of GDP. Total spending expanded by 98% in 1996, almost the same rate as average inflation (100%), reaching the equivalent of 20.6% of GDP, not far from its 1995 level of 20.5%. These figures show that the fiscal correction carne entirely on the revenue side, while heavy public spending continued, and spurred inflation. This illustrates the importance of controlling spending, and that goal can only be achieved by downsizing the State through a drastic restructuring and a major improvement in the efficiency of spending.

lf revenue had not increased as it did, the year would have ended with a massive deficit, equivalent to more than 6% of GDP. The enormous growth of revenue carne from the following sources:

- The devaluation of the bolivar, which pushed the average official exchange rate from Bs/US$ 176.60 in 1995 to Bs/US$ 417 in 1996. This generated a higher volume of oil revenue and a major increase of customs duties as a result of the higher bolivar value of imports.

- An 8.5% increase of crude oil and refined petroleum product export volume.
- An adjustment of internal fuel prices averaging 500%, which generated an additional Bs. 50 billion in revenue from the tax on petroleum products and a Bs. 392 billion royalty payment by PDVSA to the government, equivalent to 1.5% of GDP.
- The wholesale sales tax rate increases from 12.5% to 16.5% on August 1.
- Higher prices and rates for public sector goods and services.
- The SENIAT's efforts to improve tax collection and suppress evasion.
- Application of the Tax Forgiveness Act.

Note that the substantial growth of central government revenue would have sufficed to fund an even higher level of spending. But restrictions were placed on the use of the windfall oil earnings, since their full injection into the economy through public spending could have undermined the achievement of the macroeconomic goals, including inflation.

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Nine months after the Venezuelan Agenda program went into effect a great deal still remained to do in 1997. It was necessary to press forward with the labor and social security reforms, the consolidation of the financial system, the opening of the oil and industries, and the reform of the State and the judicial system. In addition, and in the strictly macroeconomic sphere, the maintenance of monetary and exchange rate stability were viewed as means to reduce inflationary pressure, and the authorities hoped to achieve a sustained growth of economic activity exceeding 4%.

The objectives and measures adopted pointed in the right direction, in most cases at any rate. That, combined with the expectations of large-scale capital inflows from privatizations and oil industry projects in association with private investment, generated a climate of confidence and favorable expectations. This optimism was further reinforced by the authorities' clear wish to extend the standby agreement signed with the IMF in 1996, or to reach agreement with that institution for a shadow program. That was intended not to obtain reserve financing loans -unnecessary in view of the rapid growth of foreign reserves- but rather to gain access to technical cooperation programs in support of structural reforms garner the support of the World Bank and Inter-American Development Bank for social reform programs.

However, many of these goals remain elusive at the time of this report, or have been achieved to a lesser extent than anticipated. That is true of inflation control and fiscal management, both of which have been affected by factors such as the labor reform.

At the beginning of this year, the government called inflation control a clear success for the Venezuelan Agenda program: the monthly inflation rate had been cut from a peak of 12.6% in May 1996 to just 1.6% in March 1997. But inflation has turned upward again in the subsequent months, due to the confluence of several factors, including high surplus liquidity as a result of excessive public spending, public utility rate hikes, a minimum wage increase, payments related to the recent labor reform, and

adjustments in the prices of basic goods and services including gasoline. All these factors have led the public to expect inflation to substantially exceed the government's forecasts this year. But it should be noted that inflation is still far lower than last year.

The government has continued to anchor the exchange rate as a key inflation-control tool. It has been able to do so without difficulty up to the present because of the large-scale inflow of foreign exchange and the sustained high level of foreign reserve stocks. But the situation could turn unsustainable in the medium term, when the bolivar becomes so extremely overvalued as a result of the high internal inflation rate and immobility of the exchange rate that widespread expectations of a future devaluation will appear. That will not only lead the public to take measures to protect the value of savings, which

### IV.4. Corrections remaining to be made

The measures taken to date represented appropriate steps to correct the most serious macroeconomic disequilibria. But for their stabilization and reforming power to be fully achieved, it is still necessary to advance toward solution of the remaining distortions; their persistence could underline to success of the new program.

**Monetary Issues:**

The monetary disequilibrium is a cause for serious concern. The actual excess liquidity, largely originated with the financial assistance of 1994 and more recently reinforced by rising public spending, and also for the labor reform impact in both public and private sectors has made interest rates to fall to artificially low levels, making them deeply negative in real terms. This strongly discourage domestic saving.

The Central Bank has attempted to remove that excess liquidity from the economy with continuous and steadily expanding issues of Monetary Stabilization Titles (TEMs), sold to the country's banks through its open market operations. This massive placement of Central Bank liabilities has put a serious burden on the institution's own financial performance and generated a snowball effect which makes the policy increasingly costly over time, while managing but not solving the underlying problem.

Part of the excess liquidity has been liquidated by the high inflation of 1996, and another portion will be absorbed when economic growth and productive activity pick up steam. But a substantial proportion remains to be permanently sterilized, and that can only be accomplished when the government and FOGADE repay their debts to the Central Bank (or at least a large part thereof) with their earnings from asset sales and privatizations, or capitalize the Central Bank with public debt instruments. The Central Bank will then have appropriate tools with which to carry out its monetary policy. Furthermore, solution of the surplus liquidity problem will allow interest rates to rise to more rational levels, a basic condition to stimulate private saving, and to facilities the development of other financial entities such as pension funds.

**Financial Issues:**

Similarly, a strengthening of the intermediation process and the financial system is urgently required. Just as it is impossible to have a healthy banking system in a such economy, there can be no development with a crippled banking system. In spite of the progress made since the financial debacle of 1994, there are.still causes for concern:

- The low coefficient of financial intermediation which still persists
- Heavy reliance on public securities to generate bank income
- A relatively low coefficient of leveraging, in spite of the vigorous efforts made by many banks to increase their equity
- The high interest rate spread that the country's banks still need in order to operate.

The entry of foreign banks into the Venezuelan financial market has recently begun, with the privatization of two institutions that had been held by FOGADE and foreign purchases of stock in private Venezuelan banks. This trend should strengthen the financial sector, leading to improved service and a narrowing interest rate spread.

**Fiscal Issues**:

Preservation of the fiscal adjustment and the need to give it a permanent foundation in another fundamental requirement. The steps taken to date have been concentrated on the revenue side: a) improvement in tax collection through SENIAT; b) currency devaluation, a kind of indirect taxation in Venezuela (exchange tax) which has transferred an enormous volume of funds from the private to the public sector, c) adjustments of gasoline prices and public utility rates; and d) an increase of the sales tax rate. Additionally, to these factors must be added the revenue surge produced by higher international oil prices in 1996, steaming first from weather conditions in the Northern Hemisphere, and then the confrontation between the United States and Iraq.

However, the necessary changes on the spending side have not been forth coming. Public spending has increased a great deal due to a number of factors, including higher externals and internal public debt service, labor agreements with public employees and teachers, social relief programs, and now for the impact of the recently approved labor reform, etc. It is therefore necessary to sound an alert on the current expansion of spending; if it continues it could neutralize the adjustment which has been achieved on the revenue side and plunge the 1997 and subsequent budgets back into deficit. That in turn would make it impossible to achieve a fundamental goal of any stabilization plan, the fiscal equilibrium which is one of the two chief weapons against inflation, together with monetary discipline.

As occurred during the previous adjustment and stabilization plan, windfall oil revenues are again allowing the government to increase spending while keeping the budget in apparent balance. But given the nonrecurring nature of those revenues, a budget gap may open up once again when oil prices return to normal, since revenue will go down while spending is very difficult to adjust. Therein lies the imperative need to isolate the extra oil revenues in a stabilization fund and avoid their being injected into the economy through public spending. Those funds could be used to pay

foreign debt, thereby reducing the burden of servicing it, or to offset the revenue decline to be expected in the future when oil prices go down again.

**Foreign Exchange Issues:**

It is essential to adopt a clear-cut foreign exchange policy. The illusion produced by the capital inflow resulting from high oil prices, high yields on domestic financial assets, the favorable expectations sparked by the new economic policy, the opening of the oil industry, and the privatization program, is cause for serious concern. All these factors have led to a major buildup of international reserves and a stabilization of the nominal exchange rate, as a result of which the bolivar is appreciating in real terms (See Chart 4).

The capital inflow and international reserve accumulation have induced many people to propose a revaluation of the bolivar, or an anchoring of the nominal exchange rate as a way to control inflation. We believe that neither of those actions is advisable, since they would both produce a substantial overvaluation of the currency, with all the negative consequences such a trend would bring.

An overvaluation created by a deterioration of relative prices and an anchoring of the exchange rate could be managed in the short run, since the resulting imbalances in current transactions could be offset by capital inflow. But a large number of experiences in Venezuela and in many other countries show that it would become unsustainable in the medium term. A high and growing currency overvaluation built up over time inevitably depresses the production of tradable goods and results in a serious disequilibrium in external current transactions. That eventually convinces the public that the currency will soon be devalued. The resulting capital flight reinforces the current account deficit to provoke a rapid depletion of international reserves, to which the authorities must respond with a large devaluation, therefore setting off an economic crisis".

It is being argued that an upward movement of the exchange rate would generate inflation, which is contrary to the stabilization policy's core objective. That is not entirely true, however; inflation has to be brought down through monetary and fiscal discipline and not by an anchoring of the exchange rate, for the reasons expressed above. Inflation control through fiscal and monetary discipline, in conjunction with efforts to improve the competitiveness of the country's tradable goods producers, is the key to ensuring a relative stability of the exchange rate .

**Structural Issues:**

A large number of structural problems need to be resolutely addressed. Many of them are concentrated in the public sector, having originated in the unsustainable paternalistic policies of the past. Under those policies the State had to perform not only its proper actions but many others as well, either free of charge or at prices bearing no relationship to their real costs. That orientation is obviously unsustainable under the economic conditions now prevailing, so it is essential to correct such problems as the State's excessive size, the rapid growth of debt service obligations, enormous labor liabilities owed to public employees, the rigidity and inefficiency of

public spending, and the deterioration of the services rendered by the public administration.

The difficulties plaguing the labor market are no less serious: an anachronistic employee severance benefit system, the absence of a social security system, low productivity, and extreme rigidity. Productive activity, for its part, must reverse the steady decline of the coefficient of investment to GDP, and overcome technological lags and low competitiveness.

Additionally, the legal vacuum must be filled by judicial reform to make way for the construction of a modern legal framework. This is a basic condition for the required high level of investment to materialize, in order to advance decisively in the economic reform.

## IV.5 Conclusions on the Venezuelan Agenda

Based on the foregoing analysis we can conclude that the adjustment and stabilization plan now being implemented in Venezuela has high possibilities to succeed, since it meets a great many of the requirements stipulated at the outset of this paper, though certain major issues remain to be defined, such as foreign exchange policy. The current program enjoys widespread support from the different sectors of Venezuelan society and external economic agents, in contrast to the very limited support garnered by the 1989-1992 plan. That gives it a far sounder foundation.

However, its success is by no means assured. The current plan is now entering its most difficult period, and the government is called upon to provide the leadership needed to take the steps still pending. Society is beginning to express a certain fatigue, union demands are being articulated more forcefully, available resources are now sufficient to return to a paternalistic policy, and the government does not appear to be fully committed to an orthodox economic adjustment. These are the factors which will determine the stabilization plan's success or failure, as well as its sustainability. The key to success is unquestionably political will and collective maturity.

In addition, and beyond the scope of the stabilization plan itself, it still remains to define the development model Venezuela should apply in the future, which must obviously make a place for oil but not be limited to it. It is necessary to make the most of Venezuela's comparative advantages as an oil country, so as to develop the activities in which it has true competitive advantages. The successful completion of the required reforms to lead the country toward a development process, which is sustainable over time, depends on the adoption of such a strategy.

NOTES

In both cases the inflationary pressure present when the adjustments were introduced was relatively low: 7. 1 % in 1978 and 6.3% in 1983. See Palma (1989)

· For more information, see Rodríguez, C. (1990).

· For a more detailed analysis of the capital flight process, see Rodríguez M. (1987). Also see Rodríguez, C.
(1985)

· Paradoxically, in 1981 the Central Bank deliberately stimulated capital flight by setting interest rates at levels substantially lower than external rates. It sought thereby to neutralize the effects of higher liquidity injected into
the economy by rising public spending. This absurd situation was reversed in September of the same year, when interest rates were decontrolled, as mentioned above. See Palma (1 985)

1 For an explanation of the characteristics of an orthodox stabilization plan, as opposed to heterodox plans, see Cardoso & Helwegge (1993), Chapter 7.

' See MetroEconómica (1989) for a more detailed description of this adjustment plan.

7For a more detail on the 1994-1995 financial crisis, see Hemández-Delfino (1 996)

To ¡Illustrate, if a worker has 1 0 years' seniority at the company where he is presently employed, he is by law
entitled to a severance benefit equivalent to 1 0 months' salary, based on the last salary earned. The benefit may be doubled if he is dismissed for reasons not attributable to him.

See the end of Section IV. 1.

lf the current account deficit is financed with short-term capital inflow, the economy becomes far more vulnerable because, once a risk of devaluation is perceived due to the current account deficit, capital flight tends to be massive and highly concentrated. See Buira (1995).

As a consequence, recommendations to implement controls to short term capital inflows in developing countries are common, in order to avoid subsequent crisis produced by massive capital flight. See Eichengreen and Fishlow (1996) as well as Gavin, Hausmann and Leiderman (1995).

11 For a detailed analysis on the consequences of anchoring the exchange rate in order to curve inflation, see Edwards (1995).

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