CHAPTER TEN

# The Syndrome of Economic Decline and the Quest for Change

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The Venezuelan economy spun out of control sometime in the 1970s after many years of stability and high growth. Successive governments applied different approaches to solving the deep problems that spread from the economic system into the very heart of the society. Their failures contributed to a malaise that undermined confidence and generated competing theories of what had gone wrong. For a quarter of a century, the country had enjoyed a stream of income from oil which should have made it possible to put Venezuela on a path to development, but by the turn of the millennium, most citizens thought that all their riches had been turned to naught. How did this come about? Would the Chávez "revolution" find a way out of the maze?

The answers to these questions require an understanding of the interplay between the economic events that marked the democratic period since 1958 and the ideas about the economy which guided policymakers. This chapter shows that, despite trends taking root in many developed and developing nations, Venezuela resisted more than most countries the idea that market processes would produce prosperity and equality. Experiments with the market, especially the short-lived effort to liberalize the economy between 1989 and

1993, generated deep and even violent conflict, thus reinforcing the traditional bias toward seeking growth and income redistribution through government action. Although most of the market reforms of that period remained intact and some were even furthered, successive governments continued to fail to achieve the stability that sustained growth would require.

The "antineoliberal" campaign and eventual political triumph of Hugo Chávez Frías in 1998 seemed once again to reveal the deep preference of most Venezuelans for letting the state take the lead and their distrust of leaving development to the forces of the unguided market. The peculiar mix of policies of the Chávez government, some profoundly interventionist and others surprisingly liberal, defied the simple conclusion that Venezuela would slide back to a reliance on government controls. The country was looking for a new formula that would permit a better balance between policies that would reduce income disparities and at the same time stimulate investment and growth. The Chávez mix promised growth with equity and, based on the record, seemed to seek growth through a continuation of the macroeconomic policies of his predecessors while ensuring equity through changes in microeconomic policies and transformation of the political system.

There was no guarantee that the country had found its way. Wishing for an innovative route to prosperity is not the same as finding it, especially in an environment of radical political and social changes that inevitably provoke resistance and uncertainty. Even in the absence of such turbulence, underlying realities of dependence on oil, volatility in basic economic variables, public impatience with unemployment and poverty, and the persistence of government inefficiency and corruption would continue to dog efforts to put the system on an even keel. In particular, popular expectations for a quick turnaround pressured the government to look for "easy" solutions and promises that would be hard to keep without endangering the solvency of the state.

Venezuela's quest for change after years of decline confronted the dilemma of reformers everywhere. Stagnation and crisis reflect deep-seated institutional problems that demand radical transformation; at the same time, radical change is inherently destabilizing and generates resistance and uncertainty in such a way as to undermine the very objectives the government seeks to achieve. The challenge for the future will be to break the syndrome of failure and to restore citizens' confidence in the ability of their governments to provide prosperity while reducing poverty and widening the possibilities of the whole population.

## Long-Term Features of Economic Policy in Venezuela

Economic policy reflects the institutional and social context in which countries make decisions. Venezuelans themselves were conscious of the factors that conspired against solid and consistent economic policy: the capture of the state by powerful interests, party hegemony that blocked change, popular pressures for short-term economic results, and presidential government insensitive to the weakening of its own legitimacy.

The very stability of the Venezuelan political system created in 1958 and the progressive dominance of two main competing parties, Acción Democrática (AD; Democratic Action) and Comité de Organización Política Electoral Independiente: Partido Social Cristiano (COPEI; Committee of Independent Electoral Political Organization: Social Christian Party), forged a consensus view of economic and social policy which tended to suppress alternative models and to create a strong alliance between government and elite groups like the peak business associations organization, Federación de Cámaras y Asociaciones de Comercio y Producción de Venezuela (FEDECAMARAS; Federation of Chambers of Commerce and Production of Venezuela),and the powerful unions, particularly the Confederación de Trabajadores de Venezuela (CTV; Confederation of Venezuelan Workers). This consensus favored the protection of both industry and workers through trade protectionism, state-owned industries, subsidies, controls, and a comprehensive labor law. In effect, Venezuela closely resembled the kind of polity described by Mancur Olson in *The Rise and Decline of Nations* (1982), in which long periods of stability give rise to entrenched coalitions of groups in society which institute policies that favor their interests but which gradually undermine the forces of renewal and change necessary for a country to adapt and compete in a dynamic world.

### *The Influence of the Oil Economy*

The case of Venezuela might well reveal how a democracy enters into decline and fails to deliver the very economic results that voters want. But an additional factor specific to the country contributed to the phenomenon: oil. Production of oil in Venezuela was important since almost the beginning of the twentieth century but became even more so as a result of the spectacular rise in oil prices which began around 1973.

Perhaps it was not inevitable that Venezuela should have failed to convert its oil wealth into sustained development, but such was not to be the case. In

Venezuela, the dominant obsession since at least the 1930s had been centered on how to avoid turning over to foreigners the bulk of the substantial profits the industry produced. Until the nationalization of the industry in 1976, most oil was produced by large multinational companies, and Venezuelans were universally aware that they did not control the exploitation of their most precious asset. The idea voiced by the young intellectual Arturo Uslar Pietri in the thirties that Venezuela should "sow the oil" became the common aim of the whole country, in the sense that oil should be the seed of development and investment in the future. This idea informed a positive developmentalist ideology that would push the country first to increase taxes on the foreign companies, then to make common cause with other petroleum producers in the founding of the Organization of Petroleum Exporting Countries (OPEC) in 1960, then to form a state-owned oil company as the eventual base for local knowledge of operations and technology, and, finally, to mandate the state takeover of the entire industry.

Venezuela's long, and even heroic, struggle for control was based fundamentally on a view of the world which corresponded to that of the dependency theorists of the 1960s and 1970s: development required gaining autonomy from the economic currents of the developed world; injustice and inequality resulted not from the national failure to give equal opportunities to the whole population but from asymmetries of power; the market should be firmly regulated by the state so that oligopolistic power should not be used against the interests of citizens. Around this set of beliefs a strong consensus developed in Venezuela. As could be expected, some voices of dissent could be heard, particularly from business interests that felt squeezed by the growth of state-owned enterprises in much of the economic system, but the paternalistic state made room for just about everyone, guaranteeing protected markets for the private sector.

## *The Statist Consensus*

By the time of the nationalization of the Venezuelan oil industry in 1976, the wave of optimism in the country reached an unprecedented level. Economic growth was high and unemployment low; investment in industry presaged a new future for diversification of the economy, and little doubt existed that the nation was now on the route to closing the gap with the most developed countries. Students were sent abroad in huge numbers to absorb the knowledge that such development would require. Everything indicated that the con-

sensus reached on how to achieve success was correct. In fact, within only two or three years, evidence accumulated that all was not well. Growth began to falter, the balance of payments weakened, and prices started rising. Occasional booms in the oil market convinced Venezuelans that such problems were temporary, but the truth was that the country began a long decline at the end of the 1970s which was marked by repeated crises and failed attempts to deal with them. As Fernando Coronil said (1997: 368), "The myth of Venezuela as a wealthy democratic nation steadily advancing toward modernity continued to hold into the 1990s despite problems that had become evident by 1978."

Yet the consensus about economic policy and the role of the petroleum state in ensuring the welfare of every citizen failed to break down, despite the record of poor economic performance. Two brief periods of liberalization, during the government of Carlos Andrés Pérez (1989–93) and during the last part of the government of Rafael Caldera (1996–99), although promising in terms of economic recovery, ended with popular rejection and calls for reining in the market. Hugo Chávez's presidential campaign in 1998 repeated the traditional rhetoric of distrust of the market—"savage capitalism" in the candidate's repeated words—and called for a restoration of state leadership and of the reinforcement of government control over the oil industry. As demonstrated later in this chapter, the Chávez government did not always apply its own rhetoric, yet its need to insist on the old formulas hostile to the market and liberalization reveals the force of popular conceptions of the optimum balance between the state and the market.

A key factor that the new government did not take into account was its administrative capacity to take over the state and redirect its energies. Good intentions might not be enough if inexperience, corruption, and incompetence were to get in the way. What would impede the repetition of the same patterns in the Chávez period? In Venezuela, the yearning for change had become irresistible, but it was unlikely that the syndrome of decline could be reversed without real changes in economic policy, especially in maintaining fiscal balance and stability.

## The Record of Economic Performance until 1998

Four key variables sum up the evolution of the Venezuelan economy in the democratic period leading up to the political changes that were to mark the start of the Chávez era. In the first place, income per capita gradually eroded

between 1978 and 1998. Another variable, inflation, started to rise in the 1970s and accelerated thereafter. The exchange rate, stable for many years, also began a long depreciation that steadily reduced the value of the currency after the crisis of 1983. Finally, oil prices imposed a stop-go pattern of boom and bust which imposed great uncertainty on policy makers and contributed to capital flight and low investment. Efforts to stabilize these variables and restore growth met with popular and political resistance that seemed always to return economic policy to traditional solutions based on state controls.

### *The Fall in Income per Capita*

The best measure for understanding the drama of the Venezuelan economy in the democratic period is real income per capita. As figure 10.1 shows, income per capita rose steadily for many years until about 1978, when it began its progressive decline. Venezuelans in 1999 had slipped back to commanding a per capita gross domestic product (GDP) that was about the same as it was in 1962, and the purchasing power of their average salary was only 33 percent of that in 1978.

### *The Surge in Inflation*

A second variable, inflation, tracks the failure of economic policy with equal force. Venezuela, long a haven of price stability in Latin America—where other countries often suffered hyperinflation—also faced disturbing peaks in inflation which took citizens by surprise, eroding the purchasing power of their salaries and causing grave uncertainty (see fig. 10.2). Under the circumstances, people tried to protect the value of their assets by investing abroad, thus contributing to capital outflows.

Figure 10.2 shows how inflation had remained modest during the 1960s; with the oil boom of the 1970s, however, prices began to rise slightly. The response at the time was simply to declare price controls on basic goods and services, particularly those affecting consumers, such as food and rents and, of course, public services such as telephones, electricity, and the like. Even producers were favored in that the prices of inputs produced by state-owned companies—steel, energy, cement, and fertilizers—were kept low. Low prices also meant low returns, however, and the private sector naturally pressed for protection from cheaper imports, access to low-cost credit, and diverse subsidies. The government generally obliged, often absorbing losses through public enterprises that constantly needed injections of capital from the state and

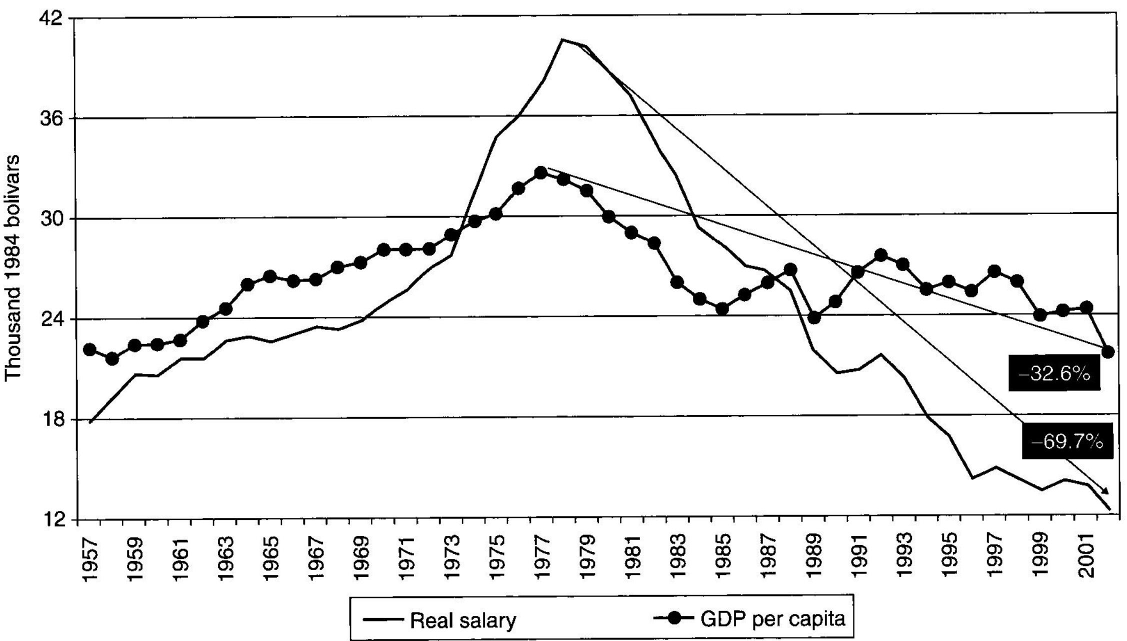


*Fig. 10.1.* GDP per capita and average real salary. *Sources:* Central Bank of Venezuela, Central Office of Statistics and Information, and MetroEconómica.

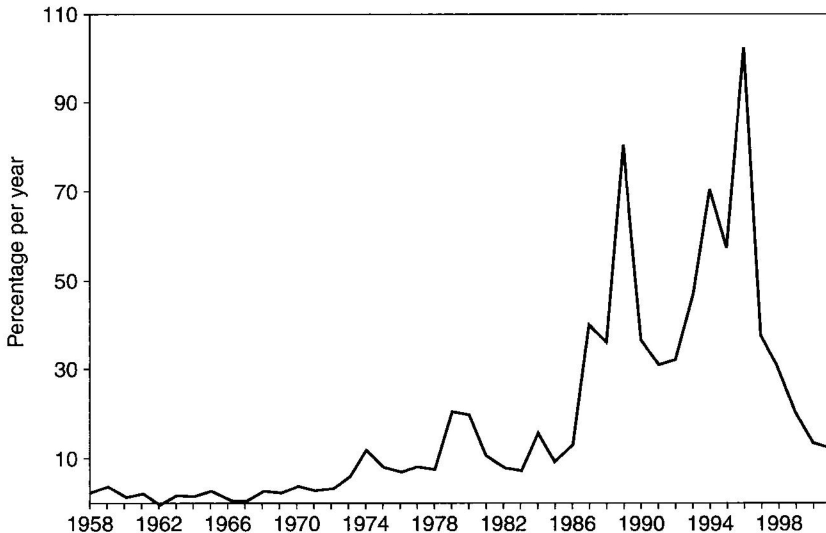


*Fig. 10.2.* Inflation, 1958–2001. *Source:* Central Bank of Venezuela.

often sacrificed good management in the face of financial pressure. The government, in turn, took advantage of the availability of foreign credit to pay for its increasingly unsustainable pattern of spending.

### *The Loss of Control over the Exchange Rate*

No country can maintain a fixed exchange rate in the long run if its rate of inflation differs significantly from that of its trading partners because that disparity overvalues the currency, making imported goods cheaper and deteriorating the trade balance. This in turn leads to devaluation expectations and capital outflows as people try to protect the value of their assets. If, in addition, the country accumulates debt abroad, uncertainty about its ability to service those obligations compounds the problem. In the end, devaluation becomes inevitable, although governments often try to put off the moment of truth by implementing restrictive monetary policies and by sacrificing their international reserves. This cycle began in Venezuela with the inflation of the late 1970s and continued to repeat itself throughout the 1980s and 1990s. Venezuela maintained a fixed exchange rate for most of the period until 1983, when the bolivar was devalued and exchange controls were put into effect until early 1989. Despite efforts to return to stability, the inflation-devaluation cycle

*Table 10.1. The Exchange Rate, 1982–2001 (bolivars per dollar, end-year)*

| Year | Bs/$ | Rate of Depreciation (%) |
|---|---|---|
| 1982 | 4.30 | |
| 1983 | 10.87 | 152.8 |
| 1984 | 12.10 | 11.3 |
| 1985 | 13.80 | 14.0 |
| 1986 | 22.20 | 60.9 |
| 1987 | 28.20 | 27.0 |
| 1988 | 34.02 | 20.6 |
| 1989 | 43.79 | 28.7 |
| 1990 | 50.79 | 16.0 |
| 1991 | 61.63 | 21.3 |
| 1992 | 79.60 | 29.2 |
| 1993 | 106.00 | 33.2 |
| 1994 | 215.33 | 103.1 |
| 1995 | 334.12 | 55.2 |
| 1996 | 476.75 | 42.7 |
| 1997 | 504.25 | 5.8 |
| 1998 | 564.50 | 11.9 |
| 1999 | 648.25 | 14.8 |
| 2000 | 699.75 | 7.9 |
| 2001 | 763.00 | 9.0 |

*Sources:* Central Bank of Venezuela and MetroEconómica.
*Note:* The exchange rates indicated refer to the estimates of the end-of-period value in the free market, including periods of exchange control.

proved difficult to break, especially when the world oil market entered a downturn.

The constant depreciation of the bolivar constituted external evidence of the economic failures of the democratic regime in Venezuela.

### *The Volatility of Oil Income*

Making economic policy is never easy; many factors conspire to thwart the most careful plans, and, as we have seen, politicians are often tempted to sacrifice the long-term health of the economy in favor of short-term benefits. In Venezuela, the problem of economic policy is complicated by the powerful impact of oil prices on the rest of the economy. Venezuelan governments have always given in to the temptation to spend excessively during periods of high oil prices, without saving for the inevitable reversal of the positive trend.[1] The

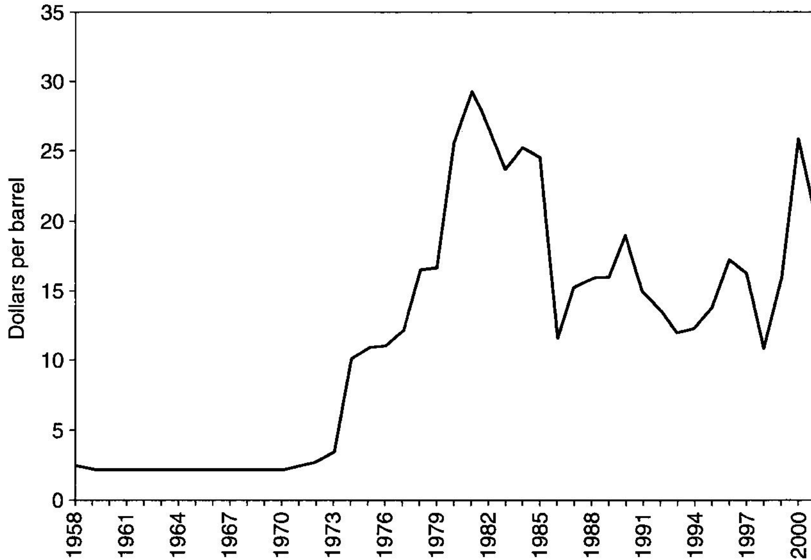


*Fig. 10.3.* The price of Venezuelan oil, 1958–2000. *Source:* Venezuela, Ministry of Energy and Mines.

costs of volatility are considerable. According to a study carried out by the Inter-American Development Bank (IDB) (1995), the more volatile an economy, the lower will be its growth over time, especially because of negative effects on certainty which scare off investment and make long-term decisions highly risky. According to the theory of the economic management of uncertainty, government policy should be designed to smooth out irregularities (Newbery and Stiglitz, 1981).

As figure 10.3 shows, the price of Venezuelan oil underwent a long cycle of extreme instability after 1973. War in the Middle East, revolution in Iran, and invasion in Kuwait produced high peaks in the oil price in 1973, 1979–80, and 1991. Likewise, economic declines in the industrialized countries brought down prices as demand fell off; the Asian crisis also contributed to the steep decline of the oil market in 1998. Venezuela suffered serious ups and downs with each change in the market.

Under the liberal regime of Carlos Andrés Pérez in the early 1990s, the need to establish a well-functioning stabilization fund appeared on the public agenda, but political pressures impeded its approval. The idea was still alive, however, so that the government of Rafael Caldera, chastened by its own

experience with falling oil prices during 1998, decided to create the Fondo de Estabilización Macroeconómica (FEM; Macroeconomic Stabilization Fund), whose only purpose was to ensure a regularization of public spending and avoid the tendency of governments to spend more in times of plenty and then find themselves without resources in times of hardship. This fund was not created in time to leave a cushion of savings for the next fall in the price of oil, however, leaving the incoming Chávez regime with little margin when it faced the historically low prices at the beginning of 1999. Thereafter, and with the recovery of world oil prices, savings accumulated in the fund, thus providing a cushion in the downturn of 2001–2.

## The Decline of the Punto Fijo Regime

### *The First Crises, 1983–1988*

The combination of a weakened oil market, high level of imports due to the overvaluation of the bolivar, massive capital outflows, the outbreak of the debt crisis, and the lack of a sound economic policy led to a crisis in February 1983 which the government could not control.[2] Its response was to institute a system of exchange and price controls which would be maintained by the succeeding government of Jaime Lusinchi until 1989. This marked the end of the fixed exchange rate system that prevailed for several decades. Those controls, which led to unprecedented levels of corruption, permitted the government to satisfy major groups of consumers and producers, since they constituted an implicit subsidy for all, at least until the money ran out.

Even though the exchange rate volatility that followed sounded a warning that the pattern of debt, protection, and subsidies was unsustainable, it was not until 1989 that the country had to face the truth. Oil income simply could not cover the cost of maintaining an artificial economy, and international reserves were insufficient to pay the accumulated public debt of some $27 billion. Even so, in the 1988 presidential campaign, voters chose Carlos Andrés Pérez as president for the second time without any suspicion that crisis was once again about to break out.

### *The Short Liberalization Experiment of Carlos Andrés Pérez*

Pérez assumed the presidency for the second time in February 1989 after a comfortable victory, but his popularity would not last for long. Elsewhere in

this book, the story is told of the violent riots that shook the country shortly after his inauguration. As important as the announcement of price increases to come were the severe shortages in basic foodstuffs which had been growing in the preceding months.[3]

Pérez had little choice but to accept the conditions of the International Monetary Fund for a major stabilization program that mandated a sharp reversal of the interventionist policies that had been applied in former years. His team of technocrats led the way, convinced that the country had to break its pattern of subsidization and dependence on oil income. Prices had to be freed up, the exchange rate needed to be adjusted regularly to avoid overvaluation of the currency, trade protectionism needed to be reduced and the rules of international commerce set by the General Agreement on Tariffs and Trade (GATT; later the World Trade Organization) accepted, and unprofitable public enterprises needed to be privatized.

The Pérez reform program was an instant disaster that quickly turned into what looked like a success. The disaster was so great, however, that the incipient signs of success were insufficient to undo the political harm. In 1989, real incomes fell precipitously, and inflation surged above 80 percent in the wake of a massive devaluation and the liberalization of prices. When growth returned —the economy grew by 4.4 percent in 1990, 9.7 percent in 1991, and 6.7 percent in 1992—little credit was accrued by a government that had carried out such a violent adjustment in 1989.

In addition, the reduction in protective tariffs created resentment in a group of businesses threatened by foreign competition. Opposition groups delayed or blocked approval of some key parts of the reform program, such as the institution of a value-added tax that would balance government accounts, and a financial reform aimed at increasing competition in the banking system and granting more autonomy to the Central Bank. Likewise, the labor law reform that was to be a step toward reducing distortions in salaries was sabotaged in the Congress and left essentially as it was. The government made no progress toward modernizing the system of social insurance, which was underfinanced and of poor quality, both in pensions and in health care.

It is impossible to say what might have happened in Venezuela had there not been two unsuccessful coup attempts in February and November 1992. However, what is undeniable is that the political unrest of 1992 contributed to a weakening of Venezuela's economy. The government continued to fight for its reforms, but with less capacity, as political pressures forced the president to

incorporate into his cabinet politicians opposed to his neoliberal policies. He also bent and restored subsidies that had eased living conditions for the urban poor. In addition, he rescinded the increase in gasoline prices. Privatization also caused discord, especially the sale of CANTV, the telephone company, which was turned over to a consortium led by GTE (now Verizon). This privatization would be recognized as highly successful only long after Pérez was gone.

### *The Path to Another Crisis: Caldera and the Collapse of the Banking System*

Despite the excellent record of economic growth from 1990 to 1992, serious problems still plagued the Venezuelan economy. In particular, inflation was by no means under control. In 1992, prices rose by almost 32 percent and in 1993 by 46 percent. One policy of the Pérez government, continued by his interim successor, President Ramón Velázquez, seemed to feed the inflationary process: the strategy of continuous devaluation under the so-called crawling peg. Encouraged by the International Monetary Fund, Pérez's chief economist and planning minister, Miguel Rodríguez, defended the policy as the correct way to allow the economy to escape its dependence on oil, permitting exporters a competitive environment to develop alternative industries and limiting excessive imports. If prices in Venezuela were rising, therefore, the currency should be devalued by at least an equivalent amount. From 1989 to 1993, the currency went from 43 bolivars per dollar to 106 bolivars per dollar (see table 10.1).

The problem with devaluation is that it has a direct impact on inflation, especially in Venezuela, where imports and their cost are a vital part of the economic system. Thus, a devaluation immediately raises the price of imports and, to the extent that such imports have no easy substitute produced at home, increases the prices within Venezuela. Of course, when imported goods rise in price, there is a tendency for all prices to rise over time, since even barbers want to raise the price of a haircut so that they can pay for their imported bread or their imported televisions. Devaluation in many countries stimulates the foreign demand for exports, but in Venezuela, this effect is minor, since the price of oil is set in dollars in international markets and is unaffected. What is more, oil income in dollars is translated into more bolivars after a devaluation, so that the government may actually be able to spend much more after a devaluation because of its increase in fiscal revenues from oil exports. For these reasons, devaluation in Venezuela tends to have an especially inflationary ef-

fect. This suggests the importance of keeping inflation low through monetary and fiscal discipline in order to minimize the need for depreciating the currency.

Political uncertainty coupled with a lower price of oil in 1993 compounded economic problems. Interim president Velázquez achieved approval for a modest value-added tax in that year, which might have signaled that Venezuela was finally getting serious about raising taxes and putting government finances on a more solid base. But the tax stimulated popular opposition, and presidential candidate Caldera took advantage of the resistance by promising to do away with it. Rather than signaling responsible policy, therefore, Caldera inadvertently sent the message that Venezuela's problems were not over and that bigger deficits might lie ahead.

Confidence disintegrated, and huge capital outflows followed in the wake of Caldera's victory. This forced the Central Bank to implement a tight monetary policy.[4] Interest rate on loans at commercial banks jumped to more than 80 percent, which implied real rates of 40 or 50 percent. Since no business can generate enough profits to pay that kind of interest rate, banks found themselves hard pressed to offer depositors a sufficient rate to persuade them to leave their money in Venezuela. The banking crisis was about to start, just at the moment when a new government was coming into power, unprepared to deal with the threat of a general banking collapse.

Once again, poor economic policy and political uncertainty plunged the country into a downward spiral. Instead of containing the banking crisis that started with the collapse of one of the largest institutions, the Banco Latino, in early 1994, the government closed the bank and set off a chain of further bankruptcies that continued throughout the year. The president of the Central Bank resigned in frustration. Bailouts failed to staunch the failures, and huge amounts of liquidity were injected into the monetary system, stimulating capital flight even further. Exchange controls were put into effect once again, lasting for two years. Other negative economic developments between 1994 and 1996 included yearly devaluations of more than 70 percent and annualized inflation reaching 150 percent.

### *The Caldera Correction and the Second Liberal Experiment, 1996–1999*

President Caldera's policies of returning to state-centered economic growth failed miserably. By the end of 1995, with his popularity at a historical low (57%

of the population expressed little or no confidence in his ability to manage the country; Datos, 1995), Caldera faced a dilemma similar to that of President Pérez in 1989. He could accept the only alternative available, implementation of a severe adjustment program, or continue with a failing strategy. President Caldera's statement "We are in bad shape, but getting better" served to win public patience with a reversal of policy which was hardly understood by voters who had placed their confidence in a leader whom they thought would give them something different.

Caldera's second round of policies included an even more daring aspect than had been undertaken by Carlos Andrés Pérez. Convinced by Luis Giusti, the charismatic president of Petróleos de Venezuela Sociedad Anónima (PDVSA; Venezuelan Oil Company, Incorporated), the state-owned oil firm, Caldera approved the move toward opening up the oil industry to limited private investment, for the first time since the nationalization of the industry in the 1970s. He also downplayed Venezuela's loyalty to OPEC by launching a frank expansion of oil production and ambitious plans for investment in new capacity for the future. PDVSA designed a ten-year plan that would have doubled oil production by 2006.

Following a massive devaluation of the bolivar, the exchange controls were eliminated and replaced by a band system in early July 1996, according to which the exchange rate would fluctuate within a band defined by upper and lower limits. The administration had come to the conclusion that devaluations were not part of the solution but rather part of the problem. The government decided to try to limit the rate of devaluation, keeping it well below the inflation rate so as to act as a brake on prices. Inflation did start to recede but stayed well above that of Venezuela's trade partners, causing the overvaluation of the commercial bolivar to exceed 35 percent by the end of 1998.

## Rise of the Fifth Republic

Hugo Chávez's presidential campaign in 1998 left many observers in the dark with respect to the kind of economic policy he preferred. Indeed, he was often vague about his specific intentions, which only contributed to uncertainty. Expectations around his presidency were largely limited to speculation about the orientations of his closest collaborators, many of whom came from the Venezuelan Left.

## *Economic Thinking*

The most important group advising Hugo Chávez on economic matters reflected the thinking of Professor Jorge Giordani of the Universidad Central de Venezuela (UCV; Central University of Venezuela). Giordani sat at the center of a circle called the "Garibaldi group," which included future ministers José Rojas (Finance), J. J. Montilla (Production and Commerce), and Héctor Navarro (Education). Giordani himself became minister of planning, a post from which he would exert considerable influence over the president and the cabinet. The Garibaldi group, inexperienced in practical policy, shared the president's hostility to the liberalizing policies implemented by both Carlos Andrés Pérez and Rafael Caldera. This team prided itself on offering an alternative route to development, one that would contrast with the liberal, or "neoliberal," approaches advocated by the International Monetary Fund, the World Bank, and, by extension, the United States. The Garibaldi group was socialist, with little time for reformist experiments with market forces. Its ascendancy awakened doubts in the business community about what was to come.

Chávez also enjoyed the support of the military sector, where economic nationalism tends to thrive as a component of national security doctrine, although differences certainly exist among officials. Significantly, Francisco Arias Cárdenas, a former comrade in arms who became a rival to Chávez and ran against him in the presidential campaign of 2000, presented a platform that placed him in the liberal camp, with the natural support of important business interests. Yet the Movimiento Bolivariano Revolucionario 200 (MBR-200; Bolivarian Revolutionary Movement 200), the original group that encompassed all the coup plotters of February 1992, was later revealed to have had long-standing contact with the remnants of the old guerrilla leadership of the 1960s through the intermediation of Adán Chávez, the future president's brother (Garrido, 1999).

Much of the history of the circle close to Chávez was unknown during the campaign, and Chávez himself defied easy definition. One of the best sources of his thinking, a series of long interviews carried out by Agustin Blanco Muñoz published in 1998, revealed Chávez as a person who borrowed from whatever sources caught his attention. He tried to present himself as a person who wanted to construct an original Venezuelan position, based on traditional

historical figures like Simón Bolívar, Ezequiel Zamora (a populist of the nineteenth century), and Simón Rodríguez, who was Bolívar's teacher. Since Bolívar was an aristocrat and Zamora a rebel who promised land to the peasants, it was unclear what Chávez was about at all.

Chávez rarely expanded on his plans beyond this level of generality. His interests were concentrated on political change more than economic programs. His words sounded vaguely threatening to the business community and to many who thought that Venezuela needed less direct state intervention in the economy and more modern and efficient regulation. Optimists thought that he would soon learn the impracticality of his ideas and that the best strategy was to seek contact with the candidate so as to educate him about the realities of running an economy.

## The Fifth Republic Defines Itself

### *The First Semester: Economic Caution*

What would economic policy look like under Chávez? Two problems confronted the government and constrained its freedom to institute significant policy initiatives. In the first place, the oil price had reached its lowest level in years by the end of the Caldera government. Second, the noise surrounding the presidential campaign and reports of the candidate's incendiary rhetoric against "savage capitalism" and neoliberal policies, together with his references to the problem of the foreign debt—which became increasingly watered down over time—led to pessimistic projections by the national and international financial communities. Chávez first showed his pragmatic side by confirming President Caldera's minister of finance, the Christian Democrat Maritza Izaguirre, as his own minister. This was an undeniable sign that Chávez was willing to do whatever was necessary to calm the markets and signal that he was no danger. The FEM was confirmed as government policy. Izaguirre's presence also guaranteed the continuation of the Caldera exchange rate policy, which permitted flexibility but also tried to minimize the depreciation of the currency, in order to bring down inflationary pressures.

The problem of the oil market was critical. In early 1998, oil production (excluding gas) had reached 3.3 million barrels per day, a level that had risen gradually since its average of about 2 million barrels per day at the start of the 1990s. PDVSA's plan had envisioned doubling oil production to 5.7 million

barrels per day by 2005, with foreign investors accounting for about 28 percent of production under the new arrangements for joint ventures between PDVSA and private companies. It was a bold policy to capture a greater world market share, but 1998 was a year of low demand and, it seems, low tolerance for such a policy on the part of Saudi Arabia, the most powerful member of OPEC, which was willing to let the price fall to punish Venezuela (Morse and Richard, 2002). OPEC's cooperative reaction came too late to avoid a total crash in the oil market.

Economists predicted that if the oil price remained below $10 per barrel in 1999, the fiscal deficit could be enormous, opening once again the possibility of a major loss of control. Chávez had blamed the fall in the world oil price on Venezuela's own policy of expanding oil exploration and production under the ambitious plans developed by Giusti and his predecessors. Even though the Caldera government had already recognized the problem by cutting oil production by more than a half a million barrels and delaying the expansion plan, 1998 saw on average the lowest real prices for Venezuelan oil exports since the early 1970s (see fig. 10.3), combined with the highest production reached during the same period.[5]

Giusti resigned days before Chávez was sworn in. Roberto Mandini, an experienced oil executive who had been at odds with Giusti over issues other than the company's market strategy, was appointed PDVSA's new president. Chávez also named a prominent critic of Giusti, Alí Rodríguez, as minister of energy and mines, with the mission of bringing PDVSA firmly under government's control. Negotiations continued within OPEC to order further reductions by agreement of all members. The expansion plan was frozen, and Venezuela played a stronger leadership role in achieving unity among OPEC members, which had often produced above the agreed-upon quotas (including Venezuela).

Higher oil demand in response to the Asian countries' recovery, combined with lower oil supply, made the world petroleum price recover from its slump within a relatively short time. From a low price of $ 8.43 per barrel for Venezuelan oil in February 1999, when Chávez assumed the presidency, the price rose steadily to $22.77 in December. OPEC mandated another production cut in March 2000, bringing the Venezuelan quota down to 2.7 million barrels and reducing total OPEC country production to 23 million barrels per day. From then on, the market strengthened, and OPEC once again increased production, at least until the end of 2000, when Venezuela could produce 3 million

barrels per day. By January 2001, concern reappeared that a possible recession in the United States could slow world demand, and prices were already sliding. OPEC reduced production again on January 17 and March 17, with Venezuela's quota reduced to 2.8 million barrels per day.

Of course, in the first months of the Chávez government, no one was sure that the price would recover as it did, and dire action was needed to avoid an unsustainable deficit in the budget. This was the critical moment for an untested government. Perhaps in a more established administration, it might have been possible to cover the deficit with foreign borrowing, on the grounds that the problem was unlikely to last for a long time. For Chávez, however, such an option was hardly open. The distrust he had generated in international markets made borrowing there highly unattractive. His economic team, perhaps with the exception of Finance Minister Izaguirre, failed to impress observers, especially since it included many newcomers without experience in managing economic crises. What is more, a question mark hung over the country as the result of the president's announcement that he would call a constituent assembly to overhaul the political and economic system—with results that might prove negative for the economy if the worst predictions about Chávez's ideological orientation were to come true.

It was at this point that Chávez revealed some surprises. To prove that he was no irresponsible demagogue, the president announced a series of actions designed to gain confidence. In the first half of 1999, the Congress approved an enabling law that gave the president wide decree powers to manage the emergency. The following actions were swiftly taken:

- The value-added tax was officially established at 15.5 percent, lowering the rate by 1 percent in comparison with the old wholesale tax it replaced.
- A temporary emergency tax was placed on financial transactions, at a 0.5 percent rate.
- The budget was cut across the board by more than 7 percent.
- FEM, created by the previous government, was converted in May into the Fondo de Inversión para la Estabilización Macroeconómica (FIEM; Investment Fund for Macroeconomic Stabilization), basing the saving rule on a very conservative oil price base of $9 per barrel.

With unemployment on the rise and a weakening economy, the government accompanied these measures with actions designed to alleviate the worsening social situation. Additionally, President Chávez decided to support fur-

ther emergency actions by the armed forces within a project called Plan Bolívar 2000, whereby military personnel would provide direct services in poor areas and relieve unemployment with short-term hiring of civilians in some of the operations.

Thus, the Chávez government consciously made an attempt to combine harsh macroeconomic policies with direct programs for the poor. He complemented his strategy with his constant presence in the media and his appeals to the people to be patient. He was sufficiently convincing to maintain his popularity despite the poor economic conditions. Indeed, he argued repeatedly that the problem was the result of the "forty years" of corrupt party rule, poor oil policy, and inhuman neoliberal ideology. This rhetoric, plus the promise of social action oriented toward the poor, was enough to assuage potential resistance to the cutbacks.

Although President Chávez surprised many with his decisive action, it was not enough to gain approval abroad, where his antimarket rhetoric continued to raise doubts. To send a further positive message in the United States, the president gave the green light to final approval of a bilateral tax treaty with that country, despite the doubts of some of his more radical followers. However, the government did not go so far as to finish negotiations on the stalled Bilateral Investment Treaty with the United States, although it did approve a new law for the protection of foreign investment in general which went a long way toward establishing a commitment to providing security under Venezuelan law. Chávez would visit New York and Houston in June 1999, meeting with financial and petroleum industry leaders, with the clear intention of communicating assurances that he was willing to do business.

Another aspect of continuity was the exchange rate policy, which was similar to that implemented by Caldera since mid-1996. This policy was controversial—many businesses complained that they were being forced into bankruptcy because of high imports stimulated by the bolivar's overvaluation—but the Chávez government decided that controlling inflation was a high priority. From a level of 30 percent in 1998, inflation fell to 20 percent in 1999, still high by world standards but a measurable improvement from the point of view of the Venezuelan consumer. Critics claimed that inflation was receding only because of the recession and that the country would pay later for its increasing overvaluation of the bolivar, but the government undoubtedly reaped political benefits from this policy, which would continue to reduce price increases to more bearable levels over the next two years.

## *The Second Semester: The Constituent Assembly and Chávez Economics*

President Chávez promised a new constitution in his electoral campaign and swore on his inauguration in February to go ahead with a constituent assembly. As the organization of the constituent assembly proceeded in 1999, fears rose that the newly elected representatives might write a constitution that would finally confirm the radical economic ideas of Chávez and his followers. Some information seemed to point in this direction as proposals emerged from some of his more radical followers (Kelly, 2000). The Movimiento Quinta República (MVR; Fifth Republic Movement), which won an overwhelming majority in the constituent assembly, clearly included representatives who would vote for a constitution that would reduce the market and increase the role of the state. As the constituent assembly began its task, President Chávez, assisted by a commission he had appointed, presented a draft of the concepts that he would suggest to the assembly on August 5.[6] Although the document contained some controversial articles that prompted quick responses from business sectors, it also tended to calm many doubts because its economic clauses were little different from traditional statist approaches to the economy. In any case, the final version of the constitution hardly confirmed the claim that the Chávez government planned to socialize the economy or diverge greatly from traditional economic strategies.[7]

The debate leading up to the popular referendum approving the constitution was short, since the government was insistent on ending the somewhat chaotic process as soon as possible. For this reason, the referendum was set for December 15, 1999, less than a month after the draft was completed. The main opposition to the document came from the business organization FEDECAMARAS. Given that the constitution was likely to be approved easily in an electorate that still supported the government by an overwhelming majority, some thought that outright business opposition would be foolhardy and might prejudice future business-government relations. Indeed, President Chávez began to see the business elites as enemies, and, with some exceptions, they returned the favor. This conflict would continue unabated until the violent events of April 2002, by which time a formidable alliance had been built linking FEDECAMARAS with unions, oil workers, human rights defenders, and a large number of common citizens.

In contrast to the FEDECAMARAS opposition, other economic interests

were more circumspect in expressing their doubts. The binational Venezuelan-American Chamber of Commerce and Industry (VenAmCham) issued a businesslike report on the constitution which avoided political judgments, and American ambassador John Maisto privately expressed the view that the constitution meant no particular danger for international investors.[8]

## The Year 2000: Normalcy or Something New?

The close of the debate over the constitution provided a measure of political stability, and early in 2000 the government turned to the task of economic recovery. The budget, severely restrained in that year, could be expanded, and indeed the government proposed an increase of 13 percent in real terms for 2001. As oil prices rose, spending plans grew as well. President Chávez solicited extra spending authority that would have permitted an even larger increase in spending, although, at year's end, it became clear that the executive had not been able to carry out a significant portion of total authorized spending (Bs. 23.6 trillion). Instead, the government spent 20.7 trillion, or 21.4 percent of GDP, with a deficit of 1.8 percent of GDP.

The economy grew in 2000 at a rate of 3.2 percent in real terms, an improvement over the rate of 6.1 percent in 1999. Inflation continued to decline, leveling off at 13.4 percent at year's end. What most concerned the analysts, despite the visible improvement in most indicators, was the dependence of the government's economic strategy on the assumption of a strong world market for oil.

The ambiguous character of the Chávez economic strategy left room for important initiatives that pointed toward modern approaches to the economy. For instance, investors praised innovative policies in high technology. The Comisión Nacional de Telecomunicaciones (CONATEL; Telecommunications Commission) pressed for competition and opened up new services to bidding. This sector showed the highest growth rate in 2000, the last year in which the privatized telephone company would enjoy its monopoly in basic services.

Doubts about government plans for the oil industry surfaced when President Chávez named the controversial Héctor Ciavaldini as president of PDVSA in mid-1999. A period of conflict ensued, with the resignations of many experienced oil executives, leading to accusations that the industry was being politicized. But in 2000, after a botched negotiation of a labor dispute, Ciavaldini was himself replaced by Guaicaipuro Lameda, a respected general who rein-

stated a modified plan for expanded production and investment which initially reassured private investors. This policy would eventually lead to Lameda's dismissal in 2002, which in turn led to the strike by oil executives in April which challenged the very legitimacy of the Chávez government. Plans for opening the gas industry to private investment also went ahead despite a long debate on what price commitments would be necessary to stimulate interest in investment projects. A new electricity law adopted forward-looking concepts designed to permit competition in generation and distribution, although its implementation was put off and the industry would soon face the effects of insufficient investment.

The Chávez government used diverse means to provide credit to small enterprises—through a "People's Bank" (Banco del Pueblo Soberano) and, later, a National Development Bank (a transformation of the Venezuelan Investment Fund) and a Women's Bank. The People's Bank quickly ran into difficulties as a result of administrative failures and an unclear objective; a new law would be approved in 2001 to provide easier rules for these socially oriented banks—rules that might end up ensuring their dependence on government subsidies. Given a very high unemployment and an informal sector of workers that exceeded 50 percent of the labor force, however, it is not surprising that the government sought to provide direct assistance to poorer groups. In these projects supporting "microenterprise," Chávez was seeking to solve the problem of poverty by giving help to people who wanted to work.

## The Unraveling of 2001–2002

Considerable optimism accompanied the Chávez government at the start of 2001. Most macroeconomic indicators supported the official economic strategy, and the projections provided by the minister of planning pointed to further gains on inflation, better economic growth, and strong international reserves. Storm clouds were forming at home and abroad, however, and excessive confidence led to plans for government spending based on oil price expectations that were not to materialize. Indeed, the political radicalization of the government during 2001 owed much to unfounded arrogance based on what would be only fleeting economic success.

The U.S. economy was entering recession, which would weaken the world economy in general and the oil price in particular. Already by the first quarter of 2001, Venezuela's average oil price had fallen by 22 percent over the average

price of the previous year. And after the terrorist attacks of September 11 on the United States, the price fell almost by an additional 20 percent, far below the budget forecast.

By the final quarter of 2001, there seemed to be no alternative to admitting that a new economic policy would be necessary, although the end-of-year figures still showed positive, if weakening, growth of 2.7 percent overall. But the drop in the public oil sector would soon spill over into the rest of the economy, repeating the cycle that Venezuelans had suffered for several decades.

How did the Chávez government react to the classic problem of the Venezuelan economy? Certainly, his revolutionary regime no longer enjoyed the huge popularity that had once supported it. Convinced that the traditional business, labor, and ecclesiastical elites were responsible for the long decline of the country, the president attacked. Empowered by an enabling law, he issued a series of controversial decree-laws: a hydrocarbons statute that disappointed those who hoped for a return to the expansive oil policies of the 1990s, a land law that raised doubts about the protection of private property, a civil service act that turned public employees against him, and other sectoral laws that brought new groups into the opposition. The national strike of December 10, 2001, revealed the depth of the opposition. The political climate turned nasty, worsening the economic situation and stimulating unsustainable capital outflows that led to a fall ofmore than $3 billion of international reserves in the first eleven weeks of 2002.

Once again, the government faced a situation similar to the crisis of 1999. One factor that alleviated the impact of falling oil prices was the existence of the FIEM, in which more than $7 billion had been accumulated since 1999. The government changed the formula for drawing from the fund in October 2001 and in so doing reinforced doubts about its willingness to adhere to fiscal discipline. The budget shortfall was so great that only a vigorous recovery of the oil market could prevent the crisis from deepening. Local governments increased their borrowing, which drove the public debt to more than 14 trillion bolivars at the end of 2002, an amount five times larger than that of 1999. The national debt rose from 4 percent of GDP in 1999 to 12 percent in 2002.

Faced with an untenable situation and a looming fiscal deficit, President Chávez announced a major change of policy in February 2002. The Central Bank would abandon its defense of the exchange rate, letting the bolivar float to a new level, in effect devaluing the currency. Spending would be cut and

taxes increased, in particular through the reimposition of the same emergency financial transaction tax that had been used in 1999. To assuage his disappointed supporters, especially among the poor and lower middle classes, the president promised to maintain spending on health, education, and welfare and to expand small business loan programs.

An unexpected oil respite materialized in March, when OPEC production cuts and the U.S. military campaign in Afghanistan drove up oil prices. Higher petroleum revenues, combined with higher excise tax rates, heavy local borrowing, and intensive use of the FIEM resources, allowed the government to continue its expansionary fiscal policy throughout 2002 despite lower tax receipts (due to the economic slowdown). Nevertheless, it was a year of devaluation, recession, high unemployment and underemployment, inflation, and impoverishment. Political turmoil, combined with social tensions and uncertainty, led to additional capital flight, channeling abroad resources that had been injected into the economy through public spending. That forced the Central Bank to implement a restrictive monetary policy, which drove interest rates up to very high levels.

The banking sector also felt pressure. Nonperforming assets increased substantially. Borrowing declined as a consequence of the deep recession, limiting the possibilities of using monetary policy to manage the crisis. Since devaluation expectations made dollar purchases very attractive to the banks, the Central Bank imposed limitations on the amount of foreign exchange they could hold; nevertheless, exchange profits from the dollar's appreciation were plentiful during 2002. In addition, the Central Bank restricted its financial assistance, leaving the banks with few options on how to use the funds they received as deposits. That situation, in conjunction with the considerable fiscal gap the government was facing, explains why the banks bought massive amounts of public bonds during this period, causing the ratio of investments to total assets to grow steadily.

Inflation and recession were two major problems during 2002. The bolivar's devaluation, higher excise taxes and salaries, and high financial costs were among the reasons for the inflation rate's jumping to 31 percent, causing real salaries to decline. The level of economic activity also fell as a result of reductions in oil production, in response to cuts ordered by OPEC in 2001, and a severe contraction in nonoil sectors. Devaluation, higher interest rates, lower consumption, and plummeting investment due to uncertainty and negative expectations explain the severe GDP contraction of 6.4 percent during the first

three quarters of that year. The situation worsened during the fourth quarter because of the national strike of December, which paralyzed the oil industry and severely restricted other economic activities. This caused total GDP to decline 8.9 percent for the year as a whole, a historical record.

## The Devastation of 2003

Radicalization and confrontation are only two of the features that characterized 2003. The continuation of the general strike into February 2003 had devastating effects on the whole economy. The firing of more than eighteen thousand PDVSA employees, mainly top and middle managers and highly skilled workers, had and would continue to have such far-reaching consequences as declining production capacity, environmental degradation, and severe deterioration of some oil fields and industrial infrastructure.

A dramatic contraction of real wages during the first half of the year, combined with massive layoffs due to downsizing or simply the bankruptcy of several firms, worsened the already adverse situation of the labor force, causing reported unemployment to surpass 18 percent and underemployment to approach 55 percent. As a consequence, poverty increased substantially, affecting more than 70 percent of all Venezuelan households.

The extremely adverse political and economic conditions prevailing in January 2003 induced capital flight to surge out of control, causing the bolivar to depreciate by 47 percent in just one month and the international reserves to decline deeply. On January 22 all Central Bank foreign exchange transactions were suspended, and two weeks later severe exchange controls were imposed. That move was followed by strict controls on prices, setting several prices at levels below cost; this condemned many producers to work with very narrow margins or simply to lose money, forcing them to shutdown.

During the first four months of the exchange controls, the system was totally inoperative. The Comisión de Administración de Divisas (CADIVI; Exchange Control Agency) authorized the delivery of only $30 million for private imports, a figure totally divorced from the country's foreign currency needs. In addition, the government made massive duty-free imports of basic food products, mainly from Cuba and Brazil, imposing unfair competition on the private producers. This reflected the official objective of taking revenge on political opponents such as entrepreneurs who had supported the strike.

Although some improvements in the approval of official dollars for imports

and debt service took place in the third quarter, the situation was still far from normal as of early November 2003. Economic activity remained depressed. In fact, after a devastating 27 percent GDP contraction during the first quarter of the year, the second quarter continued showing a deep recession, with sales contractions on the order of 20 to 40 percent in some sectors. That has constrained inflation at the consumer level, though at the wholesale and producer levels price adjustments due to the bolivar's depreciation were very intense. Shrinking purchasing power among the population prevented those higher wholesale prices from being passed along to the consumers, leading to a repressed inflation.

Ongoing economic decline led to demands for ending the Chávez presidency through the constitutionally delineated process of the revocatory referendum. In response, the government ordered a substantial fiscal expansion during the third quarter of 2003. Coming in the face of declining oil prices and lower tax receipts, this action increased the deficit. President Chávez ordered the Central Bank to finance the deficit by artificially creating profits through the manipulation of exchange rate differentials. His action had the intended effect of inducing local financial institutions to purchase public bonds in large amounts. All of this provoked multiple concerns: about the future viability of public finance, the inflationary impacts of the Central Bank financing, and the effects on the banks with high exposure to public sector obligations, particularly several small and weak banks with low levels of equity.

Fiscal expansion in the second half of 2003 did not lead to revitalization of the public infrastructure. Hospitals, schools, public transportation, and highways were in a serious state of disrepair because of low capital formation and deferred maintenance. They continued to deteriorate throughout 2003 as public disbursements were concentrated in salaries and other current expenditures.

## Conclusions

After four years of the Chávez revolution, many Venezuelans were still at a loss to define the economic policy of the regime they had elected at the end of 1998. Once again, policies that failed to establish fiscal responsibility and stability had ushered in a severe economic and political crisis. After his near ouster in April 2002, the president replaced his economic team. The new ministers of finance, planning, and production held orthodox credentials but

questionable political clout. They attempted to restore credibility with local and international business interests by proposing a traditional package with higher taxes and cuts in government spending. But political resistance to the regime was so intense that even those who had been calling for such policies refused to support any initiative by the government. Chávez found himself trapped between his dazed supporters, who had not banked on further impoverishment, and his opponents, who would settle for nothing less than the installation of a new government.

In many ways, the Chávez formula meant the implementation of reforms that had been promoted previously, especially in the area of regulation of public services and the financial sector. Rather than reversing plans for the expansion of the petroleum industry and the development of downstream and related activities in gas and petrochemicals, the government liberalized some areas in the energy sector but maintained the traditional insistence on restricting oil production within the OPEC framework, even risking destabilizing its own industry when conflict broke out over oil strategy.

Equally, the effort to control inflation with exchange rate stability represented the continuation of the policy initiated by the Caldera government, although this turned out to be just as fragile as previous policies when the rest of the economy weakened. Practically no important changes were made in trade policy; the government resisted returning to the protectionism of the 1980s but also refused to consider any deepening of commercial liberalization, either with Latin American neighbors or within the proposed Free Trade Area of the Americas.

Perhaps the greatest doubts with respect to the economic future of Venezuela rested precisely on the lack of change that Chávez was to bring about. The economy showed no signs of freeing itself from its dependence on oil, which continued to mean the dominance of the state in the economy. Social commitments, particularly in health and pensions, could once again put Venezuela back into the dilemma of its Punto Fijo predecessors: excessive promises for government subsidies that would surpass the country's ability to pay for them. It was yet to be seen if progress could be made toward an effective tax system, which the government promised to achieve but failed to implement effectively.

The most serious problems of the Venezuelan economy, however, might have little to do with economic policy as such. Thus, President Chávez's foreign policy, resistant to the perceived dominance of the United States in the world, and in Latin America in particular, sent signals of alert to investors

unsure about the stability of a country at odds with plans for a free trade area in the Americas, doubtful about globalization, and openly critical of markets. In addition, the arrival of a government weak in administrative experience and careless with the formalities of bureaucratic controls opened the possibility of new sources of corruption and inefficiency which could defy the best intentions. Reports of chaotic implementation of social programs like the Plan Bolívar 2000 and the Unified Social Fund, among others, fueled the doubts and contributed to a sense of disorder. Politically, the president's continuous attacks on traditional leadership groups and the press created a level of social tension which would undermine the best of economic policies, not to speak of those that repeated the mistakes of the past.

Venezuela, then, seemed to cling to economic strategies followed for decades which had failed to produce the kind of results necessary to raise the income and quality of life of the population. The Fifth Republic promised that, somehow, political changes would be sufficient to make the economy work. Yet in the face of another failure, as evidenced by the political and economic crises of 2002 and 2003, Venezuelans would have to think again about how to achieve prosperity, this time with real changes in economic policies that would go beyond wishful thinking and grandiose rhetoric.