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VENEZUELA'S ECONOMIC CRISIS: ORIGINS AND SUCCESSES IN STABILIZATION

By Robert E. Looney

Venezuela is embroiled in the worst economic crisis it has experienced in more than two decades. The crisis began in 1983 and is marked by heavy foreign debt, a stagnant economy, the highest unemployment on record, a general lack of confidence, uncertain revenues from oil exports, an unstable currency and a government burdened with bloated payrolls and a host of money-losing state enterprises.

Throughout the post-war period until the end of the 1970s Venezuela experienced continuous high economic growth. The pace of growth accelerated during the free-spending years following on the first world oil price shock in 1973-74. However, momentum began to be lost in 1978, and a long period of stagnation commenced the following year as the authorities reined in expenditure to cool-down what was considered an overheated economy. The picture worsened when oil revenues began to fall from the peak value of $19.1 billion attained in 1981.

The crisis finally broke in February of 1983. The bolivar was devalued through the introduction of a complicated multi-tiered exchange rate regime, and an elaborate control system was established to disburse preferential dollars for imports and foreign debt payments. At the same time a moratorium was declared on the amortisation of the 27.5 billion dollar overseas debt of the public sector, and negotiations were started for the restructuring of these obligations.

Venezuela's years of economic boom and easy money are over. Income from petroleum exports — which make up around 95 percent of Venezuela's total exports — are the barometer of the nation's economic activity, and have declined significantly since 1983 with little improvement in sight. The country today faces a combination of economic, financial and social problems greater than any seen since the tumultuous days of the early 1960s. Clearly much of the countries current problems can be traced to wasteful spending. This survey seeks to trace the developments leading up to the current economic crisis. An analysis of the government's response to the crisis is made in an attempt to determine whether the country will soon return to its historical budgetary patterns.

Origins of the 1983-1986 Economic Crisis

From 1974 to 1978, Venezuela's gross domestic product (GDP) rose by around 5 percent a year as the government of President Carlos Andres Perez used abundant petroleum revenues plus proceeds from foreign borrowing to finance an ambitious public investment program and heavy spending in social services. (1) Besides frenzied economic activity, the 1974-1978 period was characterized by unbridled government spending, increased inflation, burgeoning state bureaucracy, shortages of common consumption items, deteriorating public services, corruption and high levels of waste and inefficiency.

The administration of President Luis Herrera Campins, which took office in March of 1979, attempted to cope with the major imbalances which had developed during the previous period: (2)

1. The government pushed ahead with ongoing development projects;
2. The authorities pursued a restrictive monetary policy;
3. Officials allowed many prices to be freed from controls;
4. At least at the outset, the government adopted a generally pro-business attitude.

However, with the new wave of oil price increases in 1978-1979, the Herrera government began to repeat most of its predecessor's errors. (3) The record thus far shows that under the Herrera administration (1979-1984), the country experienced almost no growth in real GDP. Since 1979, the economy has been characterized by:

1. Rising unemployment,
2. Substantial increases in imports,
3. A serious weakening of foreign reserves,
4. High inflation (1978-1981) followed by a significant reduction beginning in 1982,
5. An even larger state bureaucracy, and
6. Continued heavy financial losses by government-owned enterprises.

Complicating these problems further was the government's incompetent planning and management of its foreign debt.

Eventually by 1983, the administration had slid into a full-blown crisis.

Major problems in the international oil market in 1982(4) caused a sharp decrease in income from exports, while general government mismanagement is estimated to have cost some $8 billion.

Early in 1983, continued weakness on the world oil market, plus inability to refinance maturing government external debt, caused capital outflows to gain momentum: the authorities imposed exchange controls in mid-February and instituted a three-tiered exchange rate for the Venezuelan bolivar.

The Herrera administration also began to recognize early in 1983 that it would not be able to repay to foreign banks the more than $18 billion in interest and principal coming due in 1983-1984. This inability to pay was the result both of the government's failure to establish a practical debt service profile (considerable short-term borrowing carried out in 1980-1981 was allowed to accumulate), and the reluctance of many international banks to refinance government debt in Latin America in the wake of the 1982 Falklands War.

At the beginning of 1983, the government began asking banks to grant a moratorium on principal payments for most of its outstanding loans. Talks have been underway to reschedule much of Venezuela's public foreign debt.

In short, the beginning of 1983 was marked by an external payments crisis(5) brought about by a heavy accumulation of external public debt service obligations, a virtual halt of capital flows from international sources of credit, a drop in export earnings and — because of expectations of devaluation — a substantial outflow of foreign exchange through capital flight.

In February 1983, as losses of international reserves mounted and debt service obligations fell behind schedule, the long-standing fixed exchange rate policy under which foreign currencies were freely bought and sold was replaced by a system of temporary exchange controls. These controls operated through a three-tiered exchange market system. At the same time, extensions on the payment of arrears on short-term external public debts to creditor banks continued to be granted. Meanwhile, the new exchange control system and depressed domestic demand led to a sharp drop in imports. The crisis in the external sector and its contradictory effects on income and public spending, together with the measures which the government adopted to deal with the crisis, brought down real personal income, in turn leading to depressed domestic consumption and a drop in investment, particularly in private construction and inventories.

In the external sector, the drop in international oil prices and the OPEC quotas on export volumes led to an 11 percent decrease in export earnings. Nevertheless, the current account balance showed a surplus of $5.017 billion, since the value of imports fell by 61 percent and net expenditures for foreign travel by 69 percent. These declines were due to the domestic recession and the introduction of the new exchange control system.

The non-monetary capital account balance shifted from a large net inflow in 1982 to a deficit of $4.57 billion in 1984. This reversal was caused by a virtual cessation of flows of external financial credit and by outlays for amortization of medium- and long-term external debt. This result, together with exchange controls and discouragement of capital flight, plus a modest inflow of monetary capital ($240 million), produced a virtual equilibrium in the balance of payments, in contrast to the high deficit of the previous year. By the close of fiscal 1983, the Central Bank's international reserves had improved slightly to $11.149 billion. This figure was about one and a half times the value of the external debt service in 1984, assuming that the rescheduling obtained did not include short-term debt amortization in that year.

Treasury expenditures continued to feel the expansionary effects of public interest payments (including some amortization) and the cost of the Central Government's operating expenditures. However, the Treasury did not pay the entire external public debt that had matured since 1983 because of the moratorium that was in effect. In addition, transfers to the rest of the public sector, subsidies for consumer spending and production, and direct and indirect investment by the government all fell substantially. The net result has been a slight rise in total central government spending from 27.8 to 28.2 percent of GDP.

Lower oil earnings, substantially smaller imports, and declining production and domestic trade led to a reduction of almost 17 percent in current Treasury revenue relative to 1982. The changes in the exchange system, along with the fiscal share of the reappraised value of gold reserves, however, gave the government a special source of revenue equivalent to 22 percent of the previous year's total revenue. Counting resources from the smaller sources, the net effect of these developments was an increase in current revenue from 26 percent of GDP in 1982 to 27.4 percent in 1983, and a drop in the fiscal deficit from 1.5 to 0.8 percent of GDP.

At the same time, private domestic investment fell to 25 percent of its 1979 level, unemployment doubled to an official 15 percent, real GDP fell by 4.8 percent and private per capita consumption fell by 6 percent.

The Central Government budget for 1984 called for spending of Bs 74 billion with 56 percent marked for current expenditures, 23 percent for debt service and only 21 percent for investments. The government managed to raise outlays but was restrained by IMF economic pressure.

As a result in 1984, the Central Government spent Bs 85.9 billion as compared by Bs 92.2 billion in 1981 and Bs 68.6 billion in 1980. The overall government deficit for 1983 (including Central Government state-owned enterprises, autonomous institutions, etc.) was Bs 9.5 billion, down from Bs 25 billion in losses in 1982 and Bs 9.9 billion in deficit in 1981.

In short, the government's economic and monetary policy in recent years has earned poor grades. Its goals of achieving economic growth, attracting new investment (foreign and domestic), creating new jobs in the private sector, maintaining monetary stability and foreign reserves, and instilling confidence in the economy had been a dismal failure. Inflation, one of the government's prime targets, was controlled in 1982 through restrictive monetary policies but flared up again in 1983 and 1984 and was expected to continue to rise in 1985.

Efforts to control foreign borrowing by state agencies and repay foreign debt have been totally unsuccessful and the country is now faced with the need to reschedule its public and private sector debt. The government-owned financial institutions (excluding the Central Bank and Venezuelan Investment Fund) have been major money losers; oft-stated official goals in health, education, housing and other social services have logged results ranging from fair to poor.

In summary, Venezuela's crisis has been essentially financial, triggered by a sharp fall in its oil export income (from $19.1 billion in 1981 to $15.81 billion in 1984) and an inability to continue borrowing abroad. An overvalued currency and massive capital flight progressively worsened Venezuela's international financial position and the country and its banks came to realize that it had a massive debt, largely short term, which could not be paid when due. The country is gradually having to readjust to the need to live with sharply reduced oil revenues without new foreign borrowing.

Politically, broad divisions existed between the Social Christian government of Herrera and the opposition Democratic Action Party (AD). As late as 1983, Herrera and his advisors continued to insist upon austerity, a reordering of government finances and assignment of higher priority to social welfare than to infrastructural development. Critics attacked the absence of economic growth, rising inflation and unemployment, and alleged bureaucratic mismanagement. Agreement on the undesirability of inflation, unemployment, a stagnant agricultural sector and the like did not provide accord on measures to improve the economy. (6) In general, the President's policies reflected a commitment to a form of modified Thatcherism: a curbing of wasteful public spending and rationalization of investments in agriculture, power, housing, social programs, etc. The opposition AD promised a new approach to the economy and won the general election in December 1983.

The Lusinchi Austerity Program

The new administration of Jaime Lusinchi set the government's major economic priorities at rebuilding investor confidence and making full use of private sector's productive potential to reactivate the national economy. In addition, the new administration's specific economic goals are to create new jobs, control inflation, gradually unify the bolivar's exchange rate and balance the nation's international accounts. The immediate priority has been to reschedule the public sector's foreign debt and implement a plan for refinancing the public sector's foreign loans. (7)

The Lusinchi administration's economic program, essentially complete by mid-1984, was aimed at making the government more efficient and at cushioning the impact of readjustment on the poorer strata of society. Specific measures included: (8)

1. Exchange Controls: While the multiple rate system has been continued, the bolivar has been further devalued by moving most imports previously on the Bs 4.3 and Bs 6.0 lists to Bs 7.5/dollar. Essential food imports and medicines remain at Bs 4.3/dollars, as do principal repayments on private debt and public enterprise debt;

Travel abroad, profit remittances, personal financial transfers, and certain imports and exports other than Petroleos de Venezuela and Ferrominera (the government-owned iron ore mining and exporting firm) are at the open market exchange rate, currently at about Bs 12/dollar.

2. *Price Controls:* The Law of Cost, Prices and Salaries, passed in early July 1984, replaces the administered price system, which had placed controls on all prices. The new system provides for a special commission to exercise control over prices of all basic necessities. The panel is made up of three cabinet members (insuring a government majority), a member from the principal private sector organization (Fedcamaras) and one from the Venezuelan Labor Federation (CTV). The commission's determination on prices of basic necessities (i.e., mass consumption goods and services) will be binding unless overruled by the government in special cases. Prices on other products and services are apparently not scheduled to be formally controlled, but government offices have warned firms not to increase prices unreasonably.

3. *Controls on Imports:* Widespread import controls remain in effect. In addition, the exchange control system is being used to limit the amount of foreign exchange for import of products (e.g., capital goods, computers) which qualify for preferential foreign exchange. Through such import restrictions, the government hopes to boost domestic import-substituting industries.

4. *Government Austerity:* Public sector receipts and expenditures were virtually in balance in 1984-85, with a surplus achieved in 1985. On the income side, this reflects increased revenues from foreign exchange profits and petroleum price increases. While new social programs will add significantly to government expenditures, the administration is continuing to hold down capital expenditures, and has decided on a 10 percent reduction in regular current outlays.

In addition, the administration has begun to liquidate two major money losers, the Venezuelan Development Corporation (CVF) and the Agricultural Marketing Corporation (CMA), and to reorganize many of the hundreds of other state-owned enterprises and agencies. Salaries of public sector employees earning over Bs 16,000 per month have been cut by 10 percent and those earning over Bs 10,000 per month are not to receive salary increases.

5. Social Welfare: The government has announced various measures to protect labor and other less advantaged groups from the effects of the recession and devaluation. Employers are required to pay workers earning less than Bs 3000 per month a "transportation bonus" of Bs 100 per month. Private enterprises with 10 or more employees are required to increase their employment by 10 percent from January 31 levels. Private firms with 50 or more employees are also obliged to provide subsidized employee cafeteria facilities, or a payment to cover a daily meal. A special employment program (to provide maintenance work on a nationwide scale) uses private contractors for public works maintenance and eventually will employ up to 100,000 workers, 20,000 in the first phase. The Family Food Basket program will provide Bs 300 to Bs 900 per month in food coupons to an estimated 970,000 families with monthly incomes below Bs 2000.

Budget restraint, including restrictions on both capital spending and ordinary current expenditures, has resulted in balanced public sector accounts. While price controls are being used to prevent excessive inflation, some price liberalization is underway. Social measures include a 10 percent increase in private sector employment, a Bs 100 per month transportation bonus and subsidized meals for workers earning less than Bs 3000 per month. Inflation, which was less than 10 percent in 1983, may however be in the 15-20 percent range for 1984-1985.(9)

External Debt

In terms of resolving the country's external debt crisis, foreign banks originally indicated they would not agree to a rescheduling unless the IMF gives its approval to an acceptable economic recovery plan for the Venezuelan government. The Venezuelan government has been generally in agreement with the IMF's recommendations, although they view several of the IMF measures as particularly harsh if implemented over too short a period of time.

In synthesis the IMF recommended that the government:(10)

1. Cut state spending substantially;
2. Institute new taxes, especially a sales or value-added tax;
3. Revoke subsidies on domestic oil prices, bringing them up to international levels;
4. Move to a unified exchange rate as quickly as possible, preferably opting for a single floating rate guided by a target for international reserves;
5. Eliminate domestic price controls and most bans on imported goods;
6. Continue allowing free interest rates.

Venezuela refused to negotiate with the IMF as its creditor banks demanded because, with its large oil export revenues, it had little need for the relatively small amount of funds which the IMF provides or for new money from lender banks.

As noted above, however, Venezuela took many of the steps nations take as part of an IMF-imposed austerity program, including cutting back public sector spending and sharply devaluing its currency to make exports cheaper and imports more expensive. Apparently, these and other measures were sufficient to satisfy the concerns of the international financial community.

Venezuela and its major bank lenders reached an agreement in principal in September 1984 to stretch out repayment of $20.75 billion of the nation's $35 billion in foreign debt over the next 12.5 years at a very favorable rate. In fact, this is the first major accord between a debtor nation and its bankers that has not been made in tandem with an austerity program sanctioned by the IMF. The final debt pact remains conditional on the treatment given to Venezuela's $7 to $8 billion in private debt.(11)

In May 1985 the process of restructuring the country's debt was finally resolved. Negotiations between the banks and the government had bogged down while the government worked to develop mechanisms that would permit private Venezuelan debtors to begin paying their creditors abroad. This is now resolved with the government offering the private sector foreign exchange at a preferential rate of 4.3 Bs/ per dollar over a five year period which began in April 1986.

The greatest stumbling block to a restructuring agreement according to many bankers had been the Lusinchi government's inability to deal effectively with the private sector's debt problems. In the third quarter of 1984, the government moved to provide foreign currency at subsidized rates to aid the private sector in serving its $8 billion in foreign debt. Since the private sector debt was contracted at Bs 4.3/dollar, many firms would be unable to pay it off at the much higher open market rates. Under government decrees, certain categories of that debt were entitled to foreign exchange at preferential rate for interest and, if rescheduled over seven years, for principal. But despite repeated pledges that official attention would be focused on the private foreign debt, the government's debt registration has progressed very slowly, interest payments are not being made and there is little indication that formulas are being developed that would permit Venezuelan debtor companies to absorb foreign exchange losses.

A major impediment to government action in this area stemmed from the fact that many government officials believed that the private sector's debt problems were separate from the public sector. According to one analysis,(13) this conviction, which stemmed partly from traditional anti-business bias on the part of many Venezuelan bureaucrats and politicians, reflected the Lusinchi government's refusal to acknowledge the state's role in the debt crisis.

Conclusions

It is apparent from the analysis above that the new Lusinchi government will have to refine its policies and take action in an environment whose domiant features are:

1. The need to continue rescheduling the debt in arrears and short term maturities;
2. Low volume of exports and low international oil prices;
3. Severe restraints on the amount of resources available to the public sector for executing programs and reviving the non-petroleum economy;
4. A foreign exchange budget with little room for the imports needed to restore domestic economic activity;
5. A growing number of price increase applications not resolved by the administered price system, and
6. High unemployment and depressed real income of large segments of the population.

In general, most of the Venezuelan government's principal goals – economic, industrial and social – had been unfulfilled even before the current crisis. Government mismanagement(13) rather than longer run trends in the world environment may be the major factors responsible for the country's current plight. The new restrictions on government spending have clearly affected all levels of state activity and will set limits on the aspirations of the new administration. Major projects in all areas have been slowed by varying degrees or placed on hold until conditions improve.

FOOTNOTES

(1) A recent account of this period is given in David Eugene Blank, *Venezuela: Politics in a Petroleum Republic* (New York: Praeger, 1984); for an excellent evaluation of the longer-term trends see Loring Allen, *Venezuelan Economic Development: A Politico-Economic Analysis* (Greenwich, Connecticut: JAI Press, 1977).

(2) Cf. John Martz "The Crisis of Venezuelan Democracy" *Current History* (February, 1984) pp. 73-77 for an account of the Herrera Campins presidency.

(3) David Eugene Bank, "Oil and Democracy in Venezuela," *Current History* (February, 1980), pp. 71-75.

(4) An excellent account of the recent oil glut and Venezuela's prospects is given in Bijan Mossauar-Rahmani and Fereidun Fesharak, *OPEC and the World Oil Outlook: Rebound of the Exporters?* (London: The Economist Intelligence Unit, 1983).

(5) Data on the Venezuelan balance of payments and fiscal position is taken from the International Monetary Fund, *International Financial Statistics*, various issues.

(6) John Martz "Venezuela" in Jack W. Hopkins, *Latin America and the Contemporary Record*, Volume I (New York: Holmes and Meier Publishers, 1983), p. 375.

(7) Richard Sweeney "Venezuela Moves to Rebuild Confidence" *Journal of Commerce* (February 3, 1984).

(8) Jose de Cordoba "Venezuela's Recovery Plan Well-Received" *Washington Post* (March 4, 1984).

(9) Cf. Andres Oppenheimer "Clamping Down" *Miami Herald* (April 23, 1984).

(10) John Sweeney "Foreign Banks Reject Venezuelan Debt Plan," *Journal of Commerce* (August 8, 1984).

(11) James Rowe "Venezuela Reaches Debt Agreement Without IMF Plan" *Washington Post* (September 24, 1984).

(12) John Sweeney "Venezuelan Debt Agreement Stalled" *Journal of Commerce* (December 12, 1984).

(13) Roger Lowenstein "Mismanagement Caused Venezuela's Credit Crunch" *Wall Street Journal* (May 18, 1984).