

I. THE ECONOMIC ENVIRONMENT(1) Main Features of the Economy

1. Venezuela, with an area of 912,050 square kilometres and a population of 21.3 million, is located in the north of South America, bounded by Colombia in the west, Guyana in the east, Brazil in the south, and the Caribbean in the north. The climate in coastal areas and along the Orinoco is tropical, while mountains are cooler. The capital, Caracas, with a population of some 3.5 million, is close to the coast, at 1,000 metres altitude; the main port for imports is La Guaira, which serves Caracas. Maracaibo is the main port for the oil industry.

2. The population is currently growing at an annual rate of some 2.2 per cent; this rate has fallen steadily from around 3.4 per cent in the early 1970s. The urban population, which has increased much faster, is currently 92.3 per cent of the total. The fertility rate has declined from 5.3 births per woman in 1970 to 3.6 in 1992, and infant mortality has fallen from over 53 per thousand live births in 1970 to 33 in 1992; life expectancy increased from 65 to 70 years between 1970 and 1992 (Table I.1). All children receive primary education, while enrolment in secondary school in 1992, at 34 per cent, has changed little since 1970.

Table I.1
Basic economic and social indicators, 1975-92

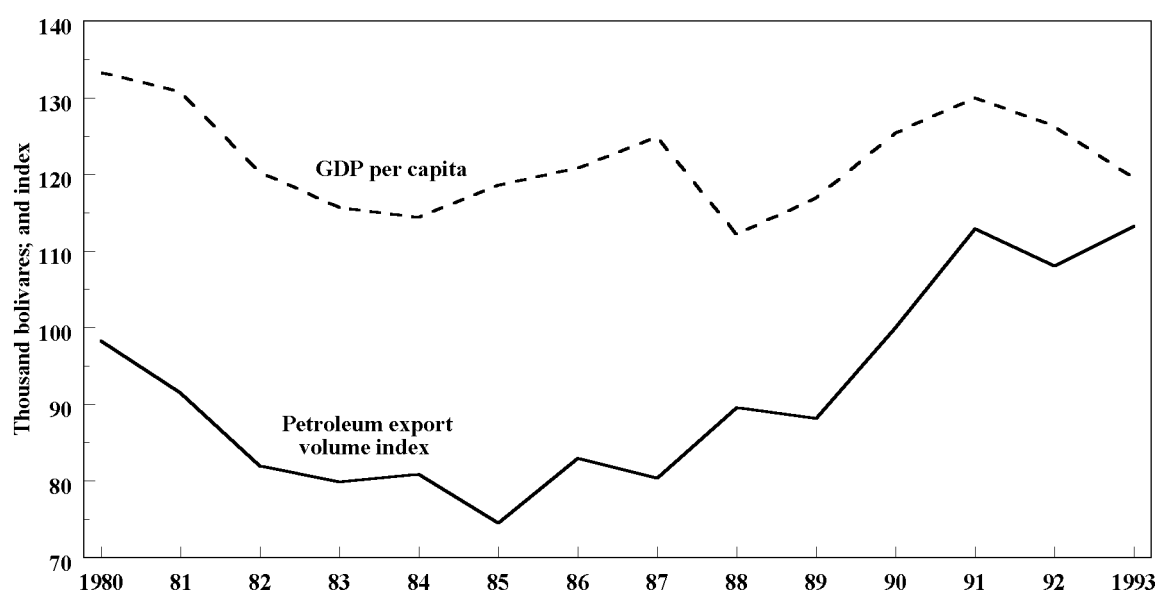
	1970	1980	1990	1991	1992	1993	1994
1. Population							
Population (thousands)	10,604	14,871	19,325	19,787	20,249	20,780	21,378
Urban population (per cent of total)	72.4	83.3	90.5	91.0	91.5	91.9	92.3
Labour force	3,075	5,871	7,064	7,274	7,490	7,713	...
Labor Force, female (per cent)	20.7	25.8	27.6	27.8	27.9	28.0	28.1
Total fertility rate (births per woman)	5.3	...	...	3.7	3.6	...	...
Infant mortality rate (per thous. live births)	53.4	...	...	...	33.0	...	...
Life expectancy at birth (years)	65.2	...	...	70.2	70.3	...	...
2. GDP							
GDP at market prices (US\$ m. 1987 prices)	34,966	45,604	49,475	54,606	57,989	57,431	55,553
Percentage share							
- Agriculture	5.0	5.2	5.8	5.4	5.2	5.1	...
- Industry	51.6	40.2	41.7	42.5	42.5	43.3	...
- Oil	...	...	28.2	22.2	19.0	17.6	...
- Manufactures	12.4	15.7	15.4	15.4	15.3	15.1	...
- Services	43.4	54.6	52.5	52.1	52.3	51.6	...
3. Labour force							
- Agriculture (per cent)	26.0	16.0	...	...	...	...	...
- Industry (per cent)	24.8	28.4	...	...	...	...	...
- Services (per cent)	49.2	55.6	...	...	...	...	...
4. Education							
School enrollment ratios (per cent)							
- Primary School Enrollment Ratio	94	109	97	99	...	...	...
- Secondary School Enrollment Ratio	33	41	34	34	...	...	...

... Not available

Source: World Bank, World Tables 1994/95.

3. GNP per capita was estimated at US\$2,840 in current prices in 1993, but fell to around US\$2,220 in 1994,¹ and seems likely to have fallen further in 1995. Real per capita income, which is correlated to movements in the volume of exports of petroleum, has fluctuated substantially in the last 15 years, falling in the periods 1980-85, 1988-89 and again in 1993-94, and increasing in the periods 1985-88 and 1989-92 (Chart I.1).

Chart I.1
Real per capita income, 1980-94



Source: World Bank.

4. The domestic economy is dominated by the services sector, which accounted for 51.6 per cent of GDP in 1993 (Chart I.2).² The overall distribution of GDP has been relatively stable over the last decade; however, there has been a slight shift from agriculture and services to industry, and the share of the oil sector has also fallen. While data are not available for recent years, figures for 1970 and 1980 show that agriculture is relatively labour intensive and industry relatively capital intensive (Table I.1). Industry includes mining and petroleum, which are highly capital-intensive (Chapter 5). Export trade is overwhelmingly dominated by petroleum and other mining products, although their share in total exports of goods and services has declined from over 93.6 per cent in 1980 to 76 per cent in 1993 (Chart I.6).

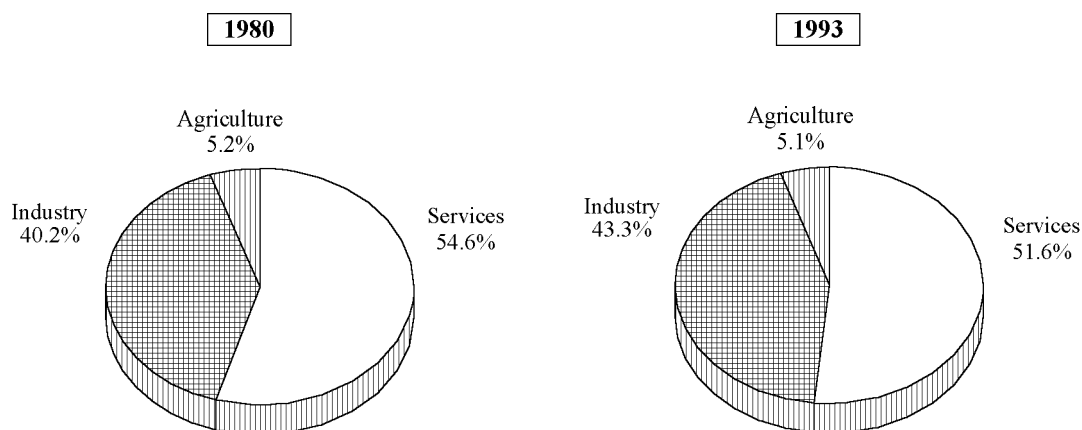
¹GNP per capita of Bs 8,071.5 billion at the official exchange rate of Bs 170: US\$1.00. Population from Table I.1.

²Based on World Tables 1994/95, which include construction and power generation in industry. According to the Venezuelan authorities, services contributed 45.2 per cent to GDP in 1993.

Chart I.2

Sectoral distribution of GDP, 1980 and 1993

Per cent



Source: World Bank, World Tables 1994/95.

5. Oil appears less important in the domestic economy than in exports. For example, the contribution of oil to GDP was measured at 17.6 per cent in 1993, down from 28.2 per cent in 1990 and 24.6 per cent in 1980. However, these overall data understate the heavy dependency of the Venezuelan economy on petroleum (Box I.1). Oil, priced at below production costs for domestic consumption, has provided an abundant source of cheap energy for other sectors of the economy (Chapter V), albeit at substantial opportunity costs. According to the Venezuelan authorities, it also provided about 60 per cent of government revenues in 1993.³ In the past, these oil revenues provided the resources for extensive government involvement throughout the economy. Thus, even in the absence of indirect taxation, there were important advances in education and welfare; the effects of prosperity were widely distributed and, particularly after the oil price increases in the mid-1970s, consumerism was "spectacular" (Europa, 1994).

³World Bank (1995) estimates that the contribution of oil to Government revenues has been over 90 per cent.

Box I.1: Petroleum and Structural Reforms in the Venezuelan Economy

The reduced contribution of petroleum to the Venezuelan economy in recent years does not result simply from the weakening of oil prices compared to the mid-1970s: it is also a result of conscious efforts by the Venezuelan authorities over the years to broaden the economic base of the country. This is most marked in the trade reforms which accompanied the fiscal reform programme in 1989. These reforms involved the elimination of many non-tariff restrictions on trade and the reduction and rationalization of tariffs (Chapter IV).

However, the Government, through the state-owned oil company, PDVSA, also provides substantial input subsidies to industry through low-priced petroleum, priced until recently at US\$0.034 a litre (low-grade petrol). On 7 September it was announced by President Caldera that 95-octane petrol would increase in price by some 140 per cent to US\$0.082 a litre and similar increases were announced for 91-octane petrol. However, 87-octane petrol, used by public buses (*gasolina popular*) decreased to US\$0.03 a litre.⁴

The lack of diversification and the difficulties faced by attempts to expand and diversify exports of the non-oil sector are linked to the upward pressures on the exchange rate because of oil revenues - the so-called "Dutch disease". This problem was also exacerbated by past policies, such as multiple exchange rates which favoured agricultural imports.

A related issue is the fluctuation in the real exchange rate because export earnings are highly dependent on the price of oil. One solution to both problems is the idea of an oil stabilization fund. It has been suggested that this could be used as a buffer to ensure that Government spending is used on changes in permanent income, while surpluses in high price periods are invested, to be drawn on when prices are low.⁵ This would also stabilize the real exchange rate so that other industries could have a clearer picture of their long-term comparative advantage.

6. As oil prices fell in the years following the first oil-price shock in 1974, so also Venezuela's economic performance weakened considerably. However, instead of adjusting to the lower income-stream from oil revenues, expansionist programmes continued, financed by foreign borrowing. In the mid-1980s this led to a sharp deterioration in the external accounts and an acceleration in inflation, leading to a major foreign exchange crisis in 1988. In response to the crisis, the Government launched a macro-economic and trade reform programme in 1989, since when the Venezuelan economy has been undergoing a painful process of adjustment, as discussed below. There was a major problem of capital flight in the wake of a banking crisis in 1994, and exchange controls were introduced on all transactions.

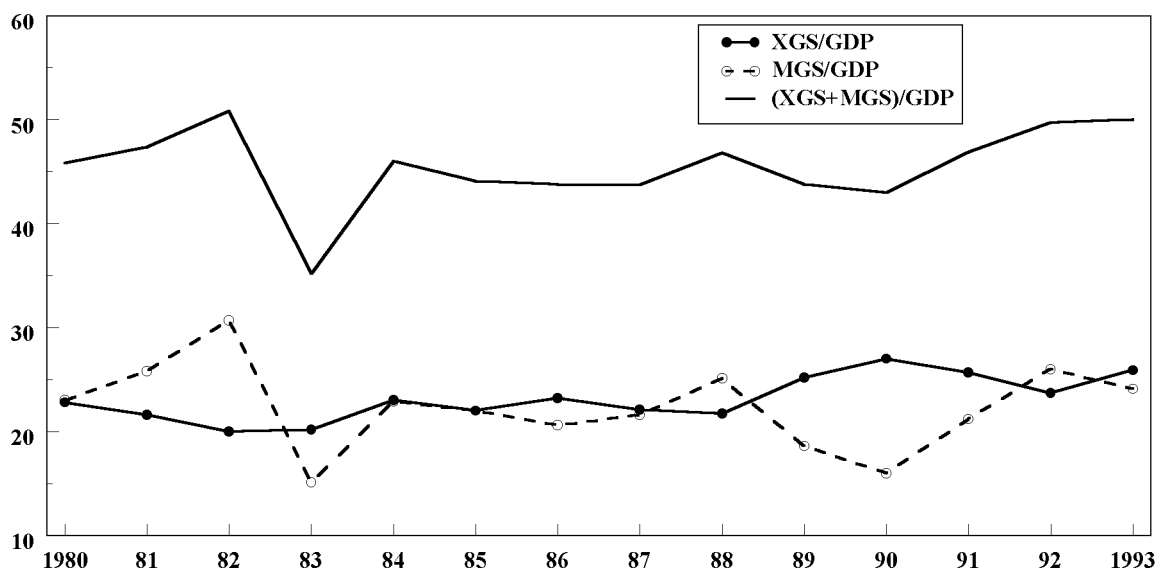
7. As a result of the structural reforms, the share of trade in goods and services in GDP (at constant prices) has grown slightly from around 43 per cent in 1990 to 49.7 per cent in 1993, although this remains less than the 50.8 per cent achieved in 1982 (Chart I.3). The change in the 1990s has occurred mainly as a result of the increase in the imports/GDP ratio, suggesting that the reforms did have a liberalizing effect.

⁴The Economist, 16 September 1995.

⁵World Bank (1993)

Chart I.3
Trade in goods and non-factor services

Per cent of GDP



Source: World Bank, *World Tables*, 1994/95.

(2) Recent Economic Developments

(i) Introduction

8. In response to the foreign exchange crisis of 1988, the new administration of President Perez introduced a macro-economic and trade reform programme in 1989. The key components were fiscal adjustments through increased fuel prices and public service tariffs as well as expenditure reductions. The privatization programme was launched. Monetary policy was also tightened and controls on prices, interest rates and foreign exchange transactions were lifted. The exchange rate was unified and a flexible exchange rate was adopted.

9. The economic reforms brought some visible signs of success in 1990-92 (helped by the recovery in oil prices in 1990). Growth of GDP accelerated in 1990 and 1991 reaching 10.4 per cent in 1991, and slowing to 5.4 per cent in 1992 (Table I.2). In the same period, inflation as measured by the consumer price index fell rapidly from over 84 per cent in 1989 to 41 per cent in 1990 and continued to fall in the next two years to reach 31 per cent in 1992. Government finances turned from a deficit of 7.7 per cent of GDP in 1988 to a surplus of over 4 per cent in 1991.⁶ In late 1990, with the support of the multilateral lending institutions, Venezuela was able to complete a restructuring of its external debt and gained renewed access to commercial borrowing.

⁶Based on World Tables 1994/95. According to the Venezuelan authorities, GDP grew at 9.7 and 6.8 per cent in 1990 and 1991, respectively, while inflation was measured at 36.5 and 31.9 per cent in the corresponding periods. The Central Government surplus was 2.7 per cent of GDP in 1991.

10. The stringent fiscal measures, particularly the increase in public transport fares, were highly unpopular, leading to rioting; there were also two coup attempts in 1992. The pace of adjustment slackened, and the Congress failed to approve the introduction of a value added tax which was to have been an important element in the strategy to reduce the dependency of government finances on oil revenues. Tax exemptions were also increased, marginal tax rates were reduced and the next round of domestic oil price increases was suspended. In consequence, the Government accounts moved from a surplus of over 4 per cent to a deficit of 3.2 per cent of GDP in 1992 (Table I.2).⁷

Table I.2
Economic Performance

	1988	1989	1990	1991	1992	1993	1994
Growth rates (per cent)							
1. GNP & domestic absorption							
GNP at market prices	5.9	-10.3	8.0	11.6	4.5	-0.2	-2.8
Net factor income from abroad	1.9	38.0	-18.3	-27.7	48.3	-6.4	-22.2
GDP at Market prices	5.8	-8.9	6.9	10.4	5.4	-0.4	-3.3
Domestic absorption	10.0	-17.7	1.9	18.4	13.0	-4.4	-13.0
- Total consumption	7.7	-7.0	3.2	8.9	7.1	-0.8	-5.7
--Private consumption	7.2	-7.8	2.9	8.8	7.5	-0.1	-8.2
-- General Government Consumption	11.0	-2.3	5.0	9.5	4.9	-4.6	8.8
- Gross Domestic Investment (GDI)	15.2	-52.6	-7.9	81.5	37.2	-18.4	-44.1
-- Gross Domestic Fixed Investment	8.9	-25.5	-6.0	34.2	28.5	-6.0	-31.8
2. Resource Balance							
Exports of goods & NF Serv.	-1.4	22.9	37.6	-13.5	-7.7	0.9	
Imports of goods & NF Serv.	29.5	-27.8	-2.6	27.7	24.6	-6.5	
3. Competitiveness indicators							
GDP Deflator	21.4	84.1	43.6	21.5	28.2	32.4	57.7
Consumer Price Index	29.5	84.5	40.7	34.2	31.4	38.1	60.8
Real Effective Exchange Rate Index	130.7	111.2	100.0	106.8	111.7	115.4	110.7
4. Money (growth in local currency) & interest rates							
Money plus quasi money (M2)	14.8	46.1	70.3	38.6	17.2	25.4	74.5
Interest: Discount Rate (End of period)	8.0	45.0	43.0	43.0	52.2	71.3	48.0
Share of GDP (per cent)							
5. Government finances							
Balance - Deficit (-) or surplus	-7.7	-1.6	1.1	4.4	-3.2	-2.9	..
Revenues	19.2	20.4	23.5	24.2	18.9	17.5	..
Expenditures	26.9	22.0	22.4	19.8	22.1	20.4	..
Memorandum items							
GDI/GDP %	26.8	13.9	12.0	19.8	25.7	21.1	12.2
GDS/GDP %	20.4	23.6	27.3	23.6	23.4	20.5	20.5

Note: Resource balance from Table I.3.

Source: World Tables 1994/95 and IMF IFS.

⁷World Tables 1994/95. According to the Venezuelan authorities, the Central Government surplus of 2.7 per cent of GDP in 1991 become a deficit of 3.6 per cent in 1992.

Table I.3
Balance of Payments
 (US\$ million)

	1988	1989	1990	1991	1992	1993
1. Current Account	-5,662	1,348	8,562	2,085	-3,400	-1,906
- Balance of trade	-1,998	5,632	10,637	4,837	1,274	2,902
Exports f.o.b.	10,082	12,915	17,444	14,968	13,988	14,019
Imports f.o.b.	-12,080	-7,283	-6,807	-10,131	-12,714	-11,117
- Services	-3,664	-3,284	-2,075	-2,752	-4,674	-4,808
Other goods, services and income (credit)	2,623	2,695	4,032	3,605	3,149	3,274
- Services (credit)	970	1,113	1,374	1,437	1,542	1,585
- Income (credit)	1,653	1,582	2,658	2,168	1,607	1,689
Other goods services and income (debit)	-6,287	-5,979	-6,107	-6,357	-7,823	-8,082
- Private unrequited transfers	-123	-171	-259	-316	-347	-310
- Official unrequited transfers	-24	-16	-24	-33	-6	-7
- Services (debit)	-2,863	-2,029	-2,675	-3,591	-4,466	-4,783
- Income (debit)	-3,424	-3,950	-3,432	-2,766	-3,357	-3,299
2. Capital Account	-1,902	-5,229	-4,556	1,541	2,331	1,208
Direct investment	21	77	96	1,769	429	-55
Portfolio investment	0	-158	13,579	192	61	731
Other long-term capital	-512	-1,237	-16,834	234	2,116	1,704
Other short-term capital	-1,411	-3,911	-1,397	-654	-275	-1,172
3. Errors and omissions						
Net errors and omissions	3,117	1,418	-1,742	-1,516	-295	407
4. Overall Balance						
Overall balance	-4,594	-1,650	1,981	1,761	-1,717	-608
Memorandum items:						
Terms of Trade Index (1987= 100)	81	92	110	97	93	...
Export Price Index, fob	87	100	127	113	111	...
Import Price Index, cif	108	109	116	116	119	...
Reserves as months of merchandise imports	3	7	15	13	9	7

... Not available.

Source: IMF, except terms of trade index and components from World Bank, World Tables 1994/95.

11. The reform process received a further setback in 1993, with real GDP contracting by 0.4 per cent overall. This was linked to a loss of confidence resulting from the deepening political crisis, as well as a reduction in oil export revenues. Following the dismissal of the President by the Congress in June, the interim Government was able to prevent an increase in the fiscal deficit, which it financed by domestic borrowing. Under extraordinary powers, it was, however, able to push through Congress a 10 per cent value-added tax as well as new banking laws, which took effect from January 1994 (Chapter V). Over the year, there was a monetary expansion, an increase in inflation

to 38 per cent as measured by the consumer price index, and there were further reserve losses, amounting to over US\$600 million (Table I.3).⁸

12. Monetary policy was aimed at linking interest rates to returns associated with open market operations. However, market rates rose because of political uncertainties, inflationary expectations associated with the high fiscal deficit, and perceived higher risks. Despite the increase in interest rates, there was a run on the national currency (the bolivar) and the reserves declined, as mentioned above. Reform of the banking sector, including improved supervision and prudential regulation, which had been proposed in 1991 were also delayed by Congress, paving the way for the banking crisis of 1994.

13. The new administration of President Caldera thus took office in February 1994 against a background of a fiscal deficit, rising inflation, reserve losses and further contraction. This was compounded by the banking crisis which emerged early in the year with the collapse of the Banco Latino, the country's second largest bank, and several smaller banks (Chapter V). Delays in announcing a package to address the banking crisis and widening deficit contributed to a lack of confidence in the economy, which was not allayed by the measures which were eventually adopted in March 1994. Over the year, real GDP declined by some 3.3 per cent.

14. Government assistance to ailing banks is reported to have amounted to 12.5 per cent of GDP, financed initially with central bank credit, but in the second half of the year, as the crisis continued to deepen, additional assistance was financed by domestic government bond sales. This increase in liquidity (M2 grew by almost 54.8 per cent) as well as pressures to reduce interest rates (e.g. the discount rate fell from 71.3 per cent in 1993 to 48 per cent in 1994) fuelled inflation, prompting the Government to extend price controls over basic goods and services (Chapter IV). Nevertheless, inflation reached over 70.8 per cent for the year.

15. International reserves fell by some US\$3.8 billion during the first six months of the year and on 27 June the authorities imposed exchange controls and fixed the exchange rate at Bs 170 to the U.S. dollar (since devalued to Bs290 to the U.S. dollar in December 1995). It is understood that reserves made a partial recovery by the end of the year so that the net loss amounted to some US\$1.1 billion (IMF).

16. The situation in 1995 appears to have changed little. According to the authorities, real GDP registered an increase of 1.1 per cent in the first six months of 1995; however, some estimates have suggested that real GDP would decline for the year as a whole.⁹ While non-oil revenues have risen, government revenue is likely to fall short of expenditures. On the positive side, the Government's recent increase in the retail price of petroleum (through higher consumption taxes) should provide a boost to government finances, of the order of 0.7 per cent of GDP. However, the gains from privatization are likely to be lower than estimated. Oil prices have risen, but this has been offset by a fall in crude oil output. On the expenditure side, over one-third of government finance is taken up with debt service payments, investment has already been reduced, and payments for public sector employment and social services remain high. In consequence, the fiscal deficit for the year seems likely to be of the order of 10 per cent of GDP and inflation around 60 per cent.

⁸IMF. According to the Venezuelan authorities, inflation rose to 45.9 per cent in 1994, while reserve losses amounted to US\$345 million.

⁹EIU, 2nd quarter 1995.

(ii) Supply and demand

17. Apart from 1988-89, when services dominated the growth of the economy, the services and industrial sectors have generally combined to lead economic growth in Venezuela in the last decade (Chart I.4). On the demand side, consumption and investment grew substantially in 1991 and 1992, while net exports were negative. However, this situation reversed itself in 1993, with the slump in investment, in particular, driving down demand.

(iii) Savings and investment

18. Investment has been highly erratic in Venezuela in recent years, with the GDI/GDP ratio falling from 26.8 in 1988 to 12 per cent in 1990, rising again to 25.7 per cent again in 1993 before slumping again to 12.2 per cent in 1994 (Chart I.4, Table I.2).¹⁰ While the savings ratio has been on the whole higher than the investment ratio, this too has fallen from the high levels of the early 1980s (over 30 per cent in 1980, 1981, 1984 and 1985) to a more modest 20.5 per cent in 1993 and 1994. The surplus of savings over investment appears to have been used to purchase Government bonds to finance the fiscal deficit.

(iv) Prices

19. During the early 1980s consumer price inflation was held at moderate levels, but increased substantially in 1987 and 1988, peaking at 84.5 per cent in 1989 (Table I.2). Following the reforms of 1989 prices fell progressively 31.4 per cent in 1992, and have since risen sharply.¹¹ In the first four months of 1995 inflation was running at an annual rate of 71.8 per cent.

20. At the beginning of 1994, the interim Government introduced price controls on a range of basic goods and services, and these were extended by the new Government in the second half of 1994 to cover an estimated 10 per cent of the CPI basket (Chapter IV). However, there appear to have been slippages, or, where the controls have held, shortages of some items have developed. The recent increase in petrol prices should have a one-time upwards effect on consumer prices, but they could also feed through to other sectors.

21. In June 1995, the Government agreed on the general lines of a Mexican-style pact with employers and labour to try to reduce inflationary expectations by co-ordinating the plans of the three groups of economic actors; however, no formal agreement has been signed.¹²

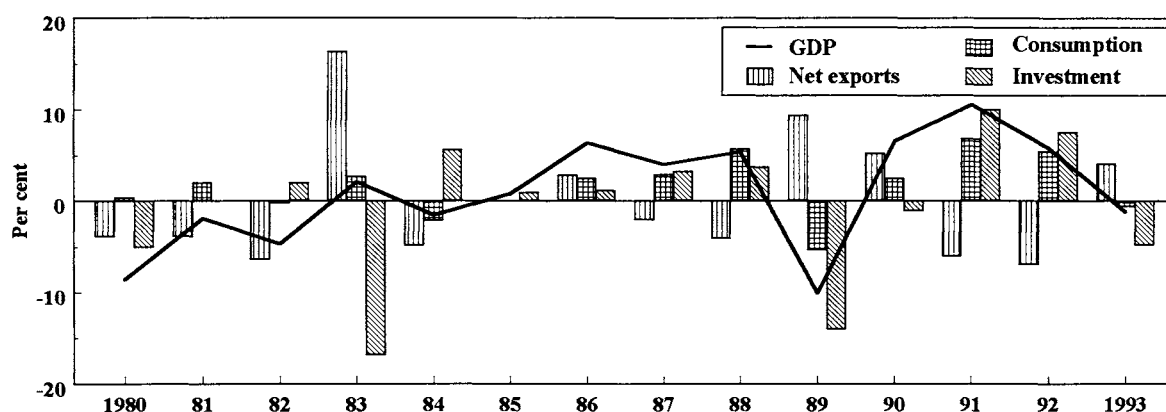
¹⁰World Tables 1994/95. According to the Venezuelan authorities, the GDI/GDP ratio for 1988, 1990, 1993 and 1994 were 27.9, 9.6, 16.9 and 9.9 per cent, respectively. The GDS/GDP ratios for 1993 and 1994 were 15.0 and 18.1 per cent, respectively.

¹¹World Tables 1994/95. According to the Venezuelan authorities, inflation fell to 31.9 per cent in 1992.

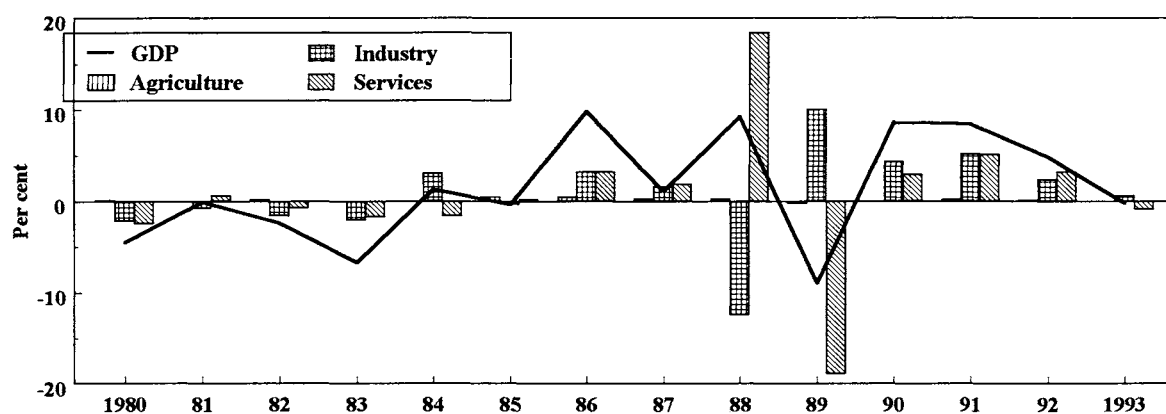
¹²See GATT (1993).

Chart I.4
Selected economic indicators, 1980-93

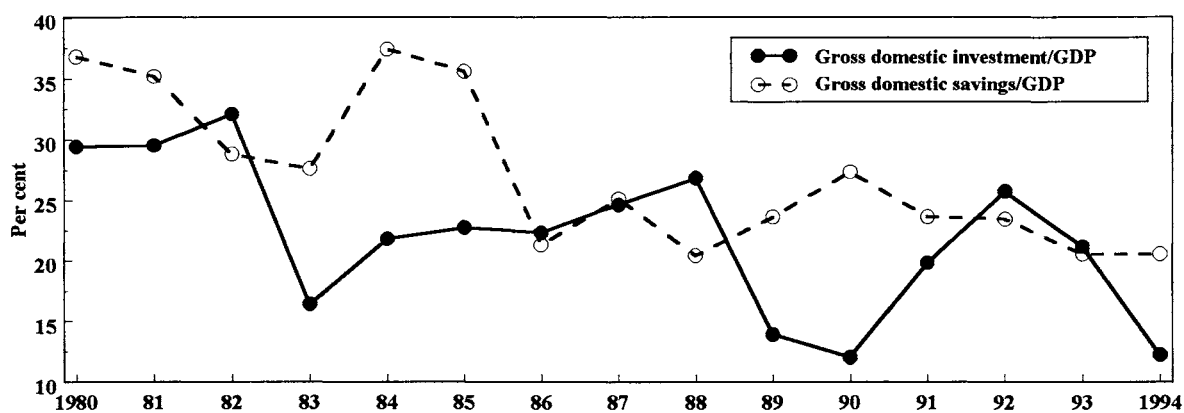
(a) Contribution of demand components



(b) Contribution of supply components to growth



(c) Savings and investment



Source: World Bank, World Tables 1994/95.

(v) Public finances

22. As noted in the introduction, one of the main problems of economic management in Venezuela has been the limited adjustment to lower oil revenues than prevailed in the 1970s. When oil revenues started to fall, particularly in the 1980s, the Government resorted to foreign borrowing to continue to finance social programmes and support the extensive state sector. This has led to increasing foreign debt, with a large portion of government revenues dedicated to debt servicing.

23. Under the reform programme begun in 1989, the privatization programme was intended to reduce expenditure in support of state-owned enterprises (as well as to earn one-time revenues from their sale). However, this programme is limited by constitutional constraints which reserve the exploitation of oil and mineral to the State, which is also heavily involved in their processing. Some modifications are being made in this regard, particularly by means of joint ventures. Nevertheless, the privatization programme is limited by these constraints, and the recent political and banking crises have created some uncertainties among investors, which deepened in the aftermath of the Mexican financial crisis (December 1994).

24. The increase in the deficit in 1994, which has been estimated at 14.4 per cent of GDP, including losses of the Central Bank, was a direct result of the assistance provided to the banking system during the banking crisis, as discussed later. Direct fiscal expenditures (excluding interest on the public debt) were estimated at some Bs 1,000 billion or 15.1 per cent of GDP in 1994. Quasi-fiscal losses of the Central Bank reached 2.1 per cent of GDP, incurred as interest on the "zero-coupon" bonds used to try to sterilize part of the liquidity associated with the financing of the fiscal deficit. However, there can be little doubt that this increase in the fiscal deficit was one of the key factors in driving up inflation in the last two years.

25. The foreign exchange controls introduced by the Government in mid-1994 to tackle the immediate problem of capital flight in the wake of the banking crisis reflected the failure of fiscal and monetary policies, to ensure domestic and external stability. The losses incurred by the Central Bank in bailing out the banking system also seriously weakened its capacity to manage monetary policy, placing an even greater burden on fiscal policy to rectify the current situation.

26. On the revenue side, the gains from the increase in the retail price of petrol should be a significant help, as discussed earlier. While the Government also relies on privatization to generate funds, this may be unrealistic in the short term, particularly in the aftermath of the banking crisis and in view of the constitutional and legal restrictions on extending privatization in the petroleum and mining sectors. On taxation, the Government has been planning an increase in the wholesale and consumption tax (Chapter IV), which replaced the VAT on 1st August 1994, and a new tax on financial transactions, but these have not yet been approved by the Congress (November 1995), (*Impuesto a las Transferencias Bancarias*). The recession is also likely to reduce collections from existing taxes. Although petroleum prices have improved in 1995, output has declined so that it is difficult to see any increase in receipts from this source. The Government is also making an effort to improve the efficiency of tax collection through the operations of the new revenue service, SENIAT.

27. Government expenditure is expected to be cut to a degree this year, mainly because of lower outlays in connection with the banking crisis. In other areas, there are a number of constraints. These include debt service requirements, the fact that investment was already cut in 1994 (the GDI/GDP ratio fell to 12.2 per cent, as noted earlier), and the Government is reluctant to cut social services because of the negative impact on the poor. Consideration is being given to cutting back on redundancy payments to dismissed public sector employees, which would reduce the costs of cutbacks.

28. Overall, it seems likely that the fiscal deficit will rise to 10 per cent of GDP in 1995. Earlier government forecasts of a deficit of some 4 per cent of GDP were predicated on the passing of an increase in the wholesale and consumption taxes from 12.5 to 15 per cent, but this has not taken place. Apart from its hopes for increased privatization funds, consideration is also being given to raising funds through the issue of U.S. dollar denominated bonds on the domestic market as well as the issue on the international market of bonds backed by rights to future oil royalties.

(vi) Money and finance

29. The structure of the financial system in Venezuela is discussed in Chapter V of this report. Until the banking crisis of 1994 it had changed little, with minimal participation by foreign banks, financial weaknesses and inadequate supervision. Reforms, including tightened supervisory regulations and prudential control had been proposed in 1991, but these were held up by the Congress. Eventually, a new Central Bank law was approved in December 1992, following the political and economic crises of that year. Greater autonomy was granted to the Central Bank which was also explicitly forbidden to grant direct credit to the Government. The supervisory and prudential reforms continued to be held up until pushed through under the extraordinary powers of the interim administration in late 1993.

30. Legal restrictions on interest rates had been removed in early 1989, but this move was subsequently ruled unconstitutional by the Supreme Court, and the Central Bank had to re-introduce a legal maximum lending rate and a minimum deposit rate. Since then the Central Bank has tried to influence the level of interest rates by open market operations. It was able to maintain a relatively tight credit policy in 1990-91, but not enough to halt a deterioration in public sector finances, and in 1992 the situation worsened. In the period March-September 1992, the Central Bank, in attempt to dampen price pressures, increased foreign exchange sales, resulting in a loss of some US\$1 billion. This triggered a speculative attack on the currency and paved the way for political unrest.

31. In 1993, in the face of a persistent weak fiscal policy stance and continuing political problems, there was a recurrence of financial and exchange rate instability. As noted earlier, the Central Bank allowed interest rates to rise in line with the returns implied from open market operations, but this did not stem further reserve losses; in the second half of the year the Central Bank allowed interest rates to decline because of concerns about non-performing loans.

32. The first half of 1994 was dominated by the banking crisis. To prevent further closures after the failure of the Banco Latino, the Deposit Insurance Agency, FOGADE, used Central Bank funds to provide financial assistance to other banks and a finance company. However, this was insufficient to stop further runs and the authorities were forced to intervene in several cases. By the end of the year, the authorities had taken over or closed 15 banks out of 47 prior to the crisis. A further four financial institutions were intervened in 1995.

33. The Central Bank, concerned about the effects of higher interest rates on the banks as well as economic activity, only sterilized part of the liquidity increase associated with the issue of zero-coupon bonds. As interest rates declined, reserve losses accumulated and monetary policy was tightened, but this was eased again following the introduction of exchange controls in June 1994. In consequence interest rates fell, becoming negative in real terms.

34. In January 1995 the Central Bank replaced its zero-coupon bonds with the *Títulos de Estabilización Monetaria* (TEMs), with interest rates being set by the Central Bank instead of being determined by the market. Initially these had negative real interest rates and the volume fell short of the maturing zero-coupon bonds, increasing the reserves of the commercial banks held with the

Central Bank. The consequent increase in the money supply is another factor in expectations of increased inflation in the current year.

(vii) Balance of payments

35. The market opening measures undertaken since 1989 have achieved some success in strengthening Venezuela's integration in the world economy, and there has been some expansion of non-traditional exports. Nevertheless, Venezuela's balance of payments continues to be strongly affected by developments in the world oil market and related movements in the terms of trade. Traditionally, the balance of merchandise trade has been strongly positive, and it was shock of the strong negative result of US\$2 billion in the trade account trade in 1988 that led to the serious trade policy reforms initiated in 1989 (Table I.3). The positive trade result for 1991 was largely a result of the increase in oil prices at the time of the Gulf War. Since then the fall in oil prices, from around US\$26 at the end of 1990 a barrel to US\$14 in 1993 for Venezuelan exports, has caused an adverse trend in the terms of trade and continued weaknesses in the balance of payments as a whole.¹³ The improvement in oil prices to some US\$15.05 a barrel in April 1995 should help the situation, except that output has been held back to the OPEC quota level which Venezuela had exceeded in 1994 (Chapter V).¹⁴

36. The overall performance has also been adversely affected by a loss in international competitiveness in the last few years. In the 1980s, the real effective exchange rate depreciated strongly through to 1987, increased sharply in 1988, before bottoming out in 1989 (Table I.2, Chart I.5). However, since 1990 the movement has been upward, except for a slight fall in 1994, indicating a loss in the international competitiveness of Venezuelan exports in the last few years. The expectation is that, following the fixing of the nominal exchange rate in June 1994, there would have been a further appreciation of the real exchange rate.

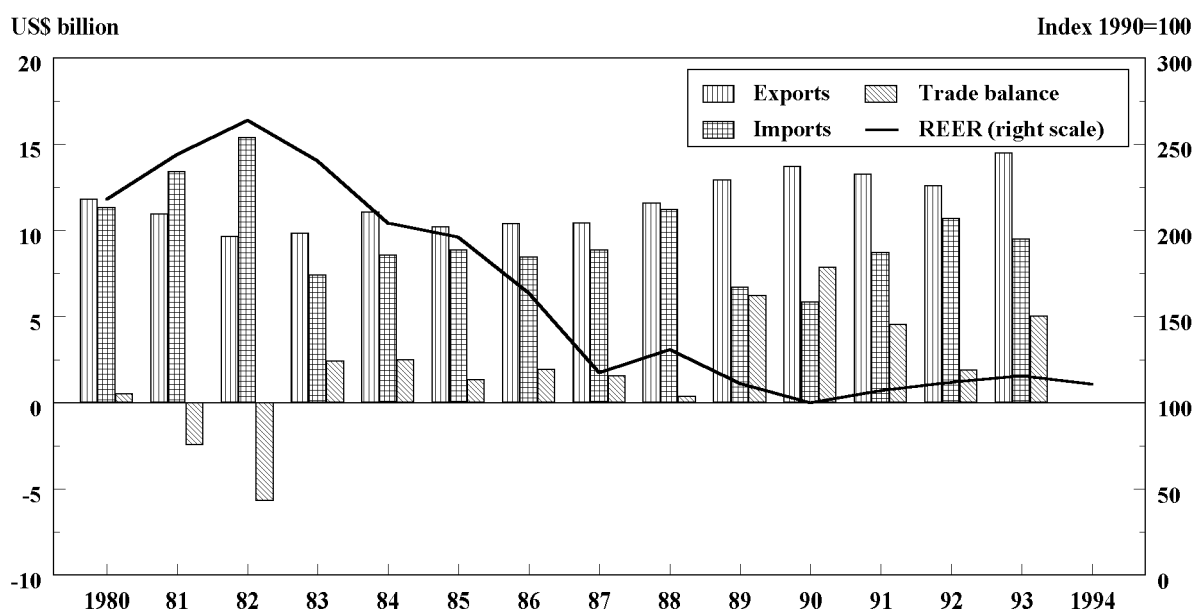
37. Before 1989, there had been a system of exchange controls. In 1989, the authorities allowed the exchange rate to be largely set by market forces, except that the Central Bank played an important role because of the continued surrender requirements for the earnings of the state petroleum company, PDVSA, and its affiliates. In early 1992, during the political unrest, the Central Bank became more actively involved in the management of the exchange rate, selling large amounts of foreign currency to counter pressure on the bolivar. This continued until October 1992 when the Central Bank began to implement a crawling peg exchange rate policy, allowing the bolivar to depreciate at an average daily rate of Bs 0.15 against the U.S. dollar.

¹³The terms of trade moved strongly against Venezuela for much the 1980s, falling almost constantly from 1981 to 1988, with a slight improvement only in 1987 (Table I.3). This movement is composed on the steady increases in import prices and, more importantly, the serious decline in export prices.

¹⁴EIU 2nd Quarter 1995.

38. Despite these changes, foreign exchange losses continued and in April 1994 a system of daily foreign exchange auctions was introduced in which the commercial banks and foreign exchange bureaux bid for the foreign exchange offered by the Central Bank. This system had certain constraints on the resale rate and a parallel market developed. In response the authorities eliminated restrictions on the size of the bids and instituted a Dutch auction system under which foreign exchange could be purchased at the rate bid. While these changes eliminated the parallel market, the bolivar depreciated further to Bs 200 to the U.S. dollar and reserves continued to fall. Finally, foreign exchange controls were re-introduced on 27 June 1994 (Box I.2) and the official rate was fixed at Bs 170 to the U.S. dollar. In June 1995 the Government introduced a degree of flexibility into the foreign exchange market, permitting the trading of Brady bonds on the stock markets. Trade in these bonds had been suspended in March 1995 because of the operation of a parallel currency market, which has developed at around Bs 200-210 to the U.S. dollar and even as much as Bs 235 in Colombia and Bs 265 in Miami (mid-1995).¹⁵

Chart I.5
REER index and merchandise trade (1987 prices), 1970-94



Source: World Bank, World Tables 1994/95; and IMF, International Financial Statistics.

¹⁵Latin American Economy and Business, June 1995.

Box I.2: Foreign Exchange Controls in Venezuela

Foreign exchange transactions are managed by the Exchange Administration Board (*Junta de Administración Cambiaria*) and the Technical Administrative Office (*Oficina Técnica Administrativa de Cambio*). Requests for foreign exchange must originate with a commercial bank and be approved by the Exchange Administration Board in accordance with the quarterly target for international reserves. Two rounds of processing are designed to prevent fraud.

The salient features of the régime introduced in June 1994 are (i) a surrender requirement for foreign exchange receipts, covering goods and services as well as capital movements, (ii) approval of payments for imports of goods and services, (iii) limits on foreign exchange for foreign travel, student and family remittances and on remittances of profits from debt equity conversion schemes, (iv) restrictions on the servicing of private sector foreign debt, including registration and approval procedures, and (v) regulations on the repatriation of foreign capital invested in the stock market. Priorities are established for the allocation of foreign exchange for imports of goods and services; these favour exporters who require more than the 10 per cent that they are normally allowed to retain in order to pay for imported materials or to service their foreign debt. It appears that foreign exchange for the purchase of luxury goods, such as vehicles, alcoholic beverages, etc., is very limited. PDVSA is excluded from the foreign exchange controls. Imports of goods and services under central bank clearing arrangements such as those with the Latin American Integration Association (LAIA) are excluded from the requirement of approval by the Exchange Administration Board.

39. Until the 1980s Venezuela did not have an external debt problem. However, as noted earlier, Government expenditure was not adjusted to the lower oil revenues of the late 1970s and 1980s and the Government financed its current expenditures from foreign borrowing. Since the rescheduling of commercial bank debt in 1990, long-term debt has again risen, reaching US\$37 billion in 1993 (Table I.4). The ratio of total external debt to GNP rose from 10.7 per cent in 1970 to 44.8 per cent in 1980, rising to a peak of 65.3 per cent in 1989 and remaining over 63 per cent since. The ratio of external debt to exports of goods and services, which had been only 50.2 per cent in 1970, rose to reach a peak of over 300 per cent in 1986, a year in which oil prices fell sharply. Similarly, the ratio of reserves to total external debt fell from 44.8 per cent in 1970 to a low of only 8.9 per cent in 1988. The need to service these debts, with long-term interest payments amounting to US\$1.8 billion in 1993 (albeit reduced from a peak of US\$3 billion in 1990), poses severe constraints on the Government in the restructuring of public finances.

Table I.4**External debt**

(US\$ million and per cent)

	1988	1989	1990	1991	1992	1993	1994
Flows							
Long-Term Interest Payments	2,665	2,452	2,993	1,980	1,626	1,761	...
Long-Term Loans, net	-702	523	478	983	1,484	622	...
- Disbursements of L-T Loans	1,727	1,267	2,226	1,774	2,497	2,137	...
- Repayments on L-T Loans	2,429	744	1,747	791	1,013	1,515	...
Debt by categories							
External Debt, total (EDT)	34,738	32,377	33,170	34,122	37,774	37,465	...
- Long-Term External Debt (by debtor)	29,464	30,087	31,170	31,838	32,499	32,782	...
-- Central Bank Ext. Debt, incl. IMF credit	9	1,003	3,014	3,251	2,948	2,681	...
-- Central Government	22,416	21,949	21,986	22,664	23,266	23,899	...
-- Non-financial Pub. Enterprises Ext. Debt	2,755	3,212	2,520	2,272	2,256	2,211	...
-- Priv. Sector Ext. Debt, incl. non-guarant.	4,284	3,924	3,650	3,650	4,029	3,992	...
- Short-Term External Debt	5,274	2,290	2,000	2,284	5,275	4,682	...
Memorandum items:							
EDT/XGS	273.4	207.4	154.5	183.7	220.4	216.6	...
EDT/GNP	54.5	65.3	64.2	63.1	64.3	63.1	...
Reserves/EDT	8.9	12.7	25.1	31.3	25.3	24.6	...

... Not available

Source: World Bank, World Tables 1994/95.

40. As noted in Chapter III, the objective of attracting foreign investment is one of the features of the reforms begun in 1989. However, the results have only been moderately successful. There was a substantial inflow of US\$13.6 billion in foreign direct investment in 1990 (more than offset by outward long-term capital movements) as well as about US\$1.8 in portfolio investment in 1991, but the main inflows in 1992 and 1993 appear to have been long-term borrowing. The political problems in 1992 and 1993 were no doubt the main factors in the lack of interest by foreign borrowers. Moreover, as noted earlier, interest rates have been kept low because of concerns about the level of economic activity.

41. In attempt to woo investors back to the Venezuelan market, conditions for repatriation of investment, dividends capital gains interest, royalties and certain other investment-related transfers were made easier than for other forms of foreign exchange. However, apart from uncertainties about Venezuela, investor interest in Latin American markets in general has cooled in the wake of the Mexican financial crisis of December 1994.

42. Net external reserves, excluding gold, have fluctuated between 3 and 15 months of merchandise imports since 1988 (Table I.3). At the end of 1993, they were estimated at some US\$8.3 billion, equivalent to seven months of merchandise imports.

(3) Composition and Direction of Trade in Goods and Services

(i) Composition of overall trade

43. Chart I.6 and Tables AI.1 and AI.2 shows the changes that have taken place in the composition of Venezuela's trade in goods and services since 1980. The share of manufactures in overall imports grew slightly from 56.8 to 58.6 per cent and that of mining products remained stable at 2.7 per cent, between 1980 and 1993. Agricultural imports have fallen from 12.5 to 9.8 per cent. Transport has increased slightly from 9.7 to 11.5 per cent, while tourism declined marginally from 13.4 to 13.1 per cent. The main items imported are automotive products and non-electrical machinery which represented 13.5 per cent and 13.3 per cent, respectively, of total merchandise imports in 1993.¹⁶

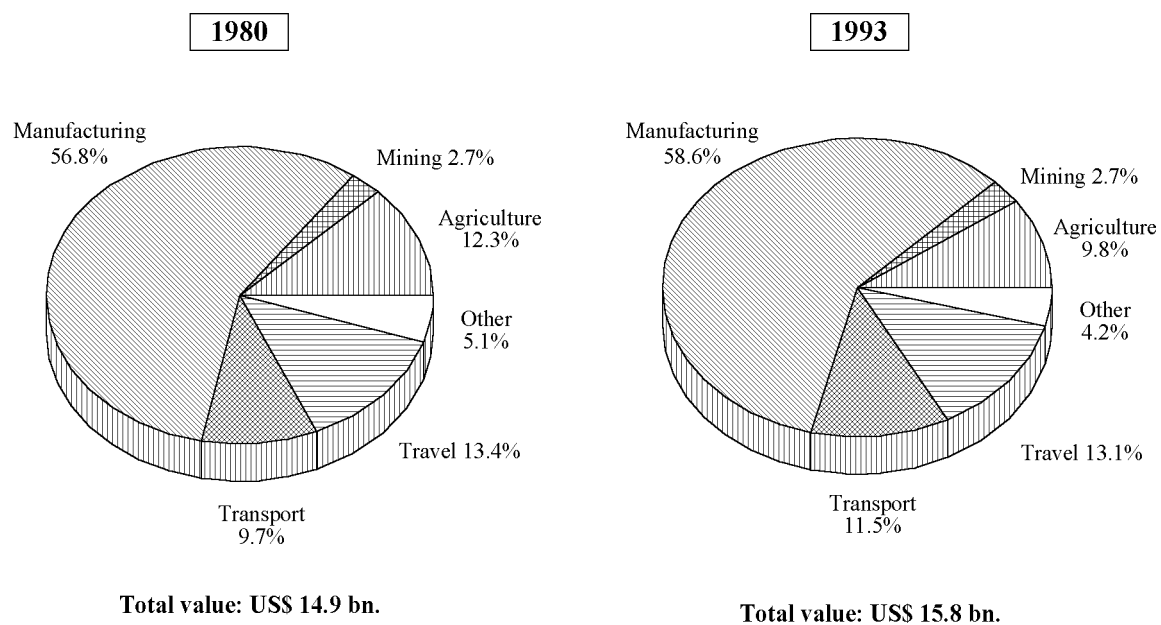
44. Exports are dominated by mining products, including fuels; together these made up 76 per cent of exports of goods and services in 1993, down from 93.6 per cent in 1980 (Chart I.6). The share of manufactures in total exports of goods and services rose from 1.6 per cent in 1980 (not shown on the chart) to 12.3 per cent in 1993. Apart from crude and refined petroleum and petroleum products, significant exports were aluminium (3.7 per cent of merchandise exports in 1993), motor vehicles (3.7 per cent) - mainly exported to other Andean Group countries, iron and steel products, coal and coke, and canned and simply preserved fish.¹⁷

¹⁶UNSTAT Comtrade database.

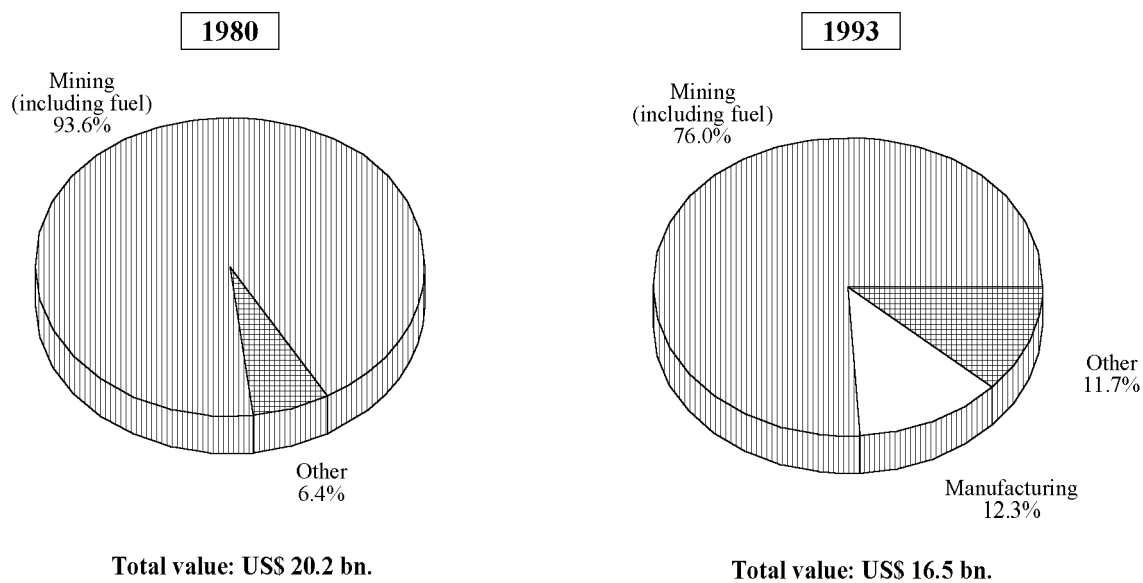
¹⁷UNSTAT Comtrade database.

Chart I.6

(a) Composition of imports of goods and services



(b) Composition of exports of goods and services



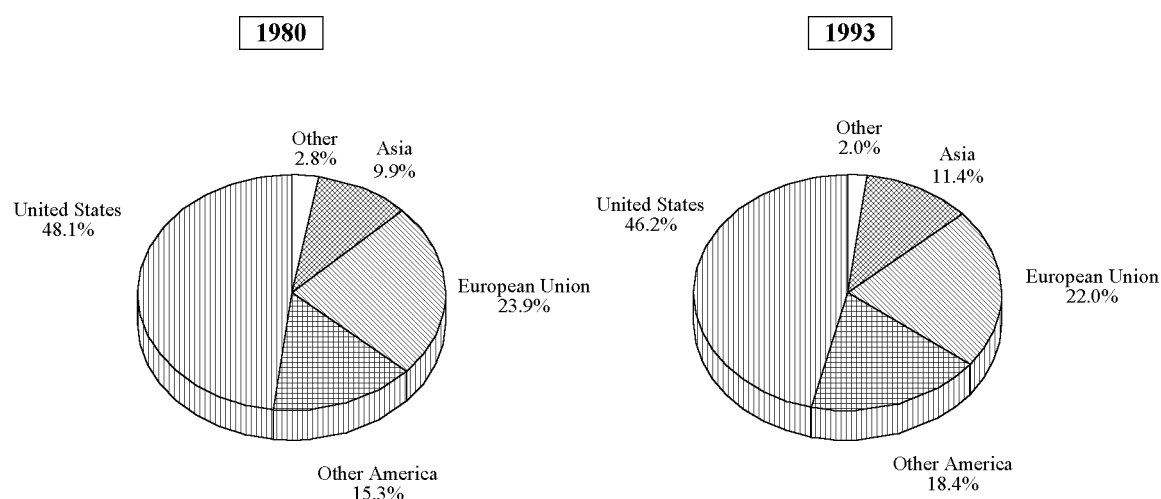
Source: UNSTAT, Comtrade database; and IMF, International Financial Statistics.

(ii) Direction of merchandise trade

45. The United States is Venezuela's most important trade partner (Charts I.7 and I.8, Annex Tables AI.3 and AI.4). While its share of imports is estimated to have decreased slightly from 48.1 per cent in 1980 to 46.2 per cent in 1992, exports increased from 27.3 to 56.4 per cent between 1980 and 1993 (Tables AI.3 and AI.4).¹⁸ The European Union is the second largest source of imports, which also grew rapidly to reach 31.7 per cent in 1993, while exports remained relatively stable (22 per cent in 1993).

Chart I.7
Merchandise imports, by main origins 1980 and 1993

Per cent

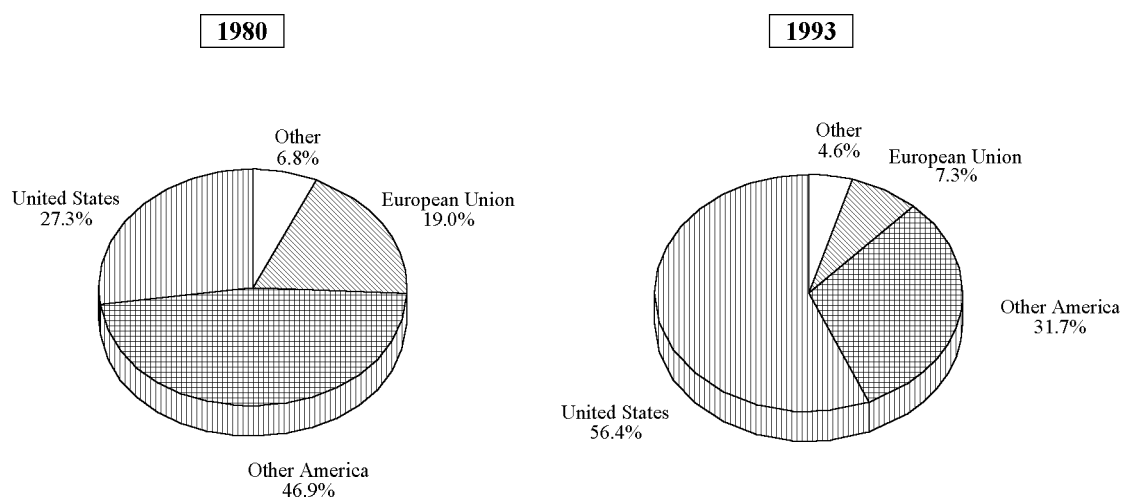


Source: UNSTAT, Comtrade database.

¹⁸UNSTAT data. Figures provided by the authorities show the U.S. share of imports and exports rising from 33 to 45 per cent between 1980 and 1992.

Chart I.8 Merchandise exports, by main destination 1980 and 1993

Per cent



Source: UNSTAT, Comtrade database.

46. Imports from other Latin American countries as a group have also grown in importance, increasing from 15.3 per cent in 1980 to 18.4 per cent in 1993. However, exports to these countries fell from 46.9 per cent to 31.7 per cent in the same period.

47. These overall numbers conceal some important variations within the region (see also Chapter II). For example, within the Andean Group merchandise exports to Colombia have increased their share in the total from 1.5 per cent to 6.1 per cent between 1980 and 1993, while imports from Colombia increased their share in Venezuela's total imports from 1.6 to 4.2 per cent in the same period. Imports from Brazil have also increased their share in the total from 2.1 to 3.5 per cent, but the share of Venezuela's exports to Brazil declined from 3.5 per cent to 2.5 per cent in the same period.

(4) Outlook

48. While some significant progress has been achieved in the restructuring of the Venezuelan economy, the achievements have been at risk since the Government has appeared unable to make much headway in reducing the fiscal deficit, which lies at the root of the problems of economic management. The use of domestic price and foreign exchange controls can only be a short-term solution until the Government addresses the fundamental issue of public finance. The announcement of petrol price increases in September 1995 will be taken as a positive sign that the Government has begun to address

this issue seriously. However, the Government has begun talks with the IMF and the World Bank to obtain financial support for a stabilization and economic reform programme. In the meantime, the economy is in a state of "stagflation" - economic depression, increased unemployment and rising inflation.

49. External conditions are also of some importance. For example, the recent increase in oil prices may help relieve the current economic situation. Negative real interest rates and the continued existence of foreign exchange controls will do little to increase the attractiveness of the Venezuelan capital market. A lifting of foreign exchange controls on current account transactions, which is under consideration, would be a welcome first step towards normalization, avoiding distortions in the allocation of resources associated with prolonged use of such measures. Similarly, there is a need for more transparent exchange rules for the treatment of foreign investment.

50. Membership of the Andean Group, as well as deeper ties with Colombia and Mexico, should lead to a further intensification of regional integration (Chapters IV and V). Such integration could well be deepened by proposals to link the Andean Group with the Southern Common Market (MERCOSUR), but this will only be of real benefit to Venezuela if these agreements are outward-oriented. In this respect, Venezuela might be expected to benefit in the longer from the proposed Free Trade Area for the Americas (FTAA) which should reinforce its autonomous reforms to a greater extent than the more limited regional agreements.

51. The post-Uruguay Round era as well as the FTAA proposal should bring about important changes in the external conditions facing Venezuela, implying a need for greater adaptability in its domestic economy. This can be achieved by continuing the process of liberalization of foreign trade as well as the foreign investment régime, enhancing the results of both through implementation of public sector reforms. Improved management of oil revenues is also critical, not only to the public sector; at present, the combination of cross-sectoral subsidies through low oil prices, fluctuating real exchange rates related to the repatriation of oil price revenues, and exchange and price controls cause mixed signals to other sectors.