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Venezuela: Struggling With Declining Oil Revenues

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An Intelligence Assessment

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ALA 86-10051
December 1986

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An Intelligence Assessment

This paper was prepared by [redacted] Office of African and Latin American Analysis, with contributions from [redacted] Office of Leadership Analysis. It was coordinated with the Directorate of Operations. Comments and queries are welcome and may be directed to the Chief, South America Division. [redacted]

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Venezuela: Struggling With Declining Oil Revenues

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Key Judgments

Information available as of 15 November 1986 was used in this report.

The unexpected depth of the oil market collapse in 1986 has set back President Jaime Lusinchi's efforts to stabilize the Venezuelan economy. In response to the steep decline in oil revenues, Lusinchi has urgently introduced new adjustment measures aimed at checking the economy's slide and bolstering the nation's debt service capacity. The President's efforts, however, are unlikely to provide more than temporary relief to an economy suffering from overdependence on oil revenues and an excess of government intervention. In our view, the Venezuelan economy is likely to remain in recession at least through the 1988 presidential election—a situation that could result in a defeat for President Lusinchi's conservative, pro-US Ortodoxo faction of the ruling Democratic Action party. According to US Embassy and press reporting, Lusinchi is already under attack from his political opponents for his management of the economy. Continued recession is also likely to negatively affect US interests by depressing demand for US products and by limiting Venezuela's capacity to provide economic assistance in the Caribbean Basin. 25X1

We expect Lusinchi to succeed in protecting the nation's capacity to meet its servicing obligations on the external public debt. International bankers are likely to acquiesce in Venezuela's request that most of the principal due through 1990 be rescheduled—providing Venezuela insurance against the risk that oil prices might descend again to $10 per barrel. To conserve foreign exchange, Lusinchi has imposed new restrictions on imports and has devalued the bolivar. These measures, and Venezuela's relatively large foreign exchange reserves, should allow Caracas to meet its external payments obligations over the next three years, even if oil revenues remain depressed. 25X1

We believe, however, that success will continue to elude Lusinchi in his efforts to extricate the economy from a recession that has persisted for more than eight years. The economy's problems extend far beyond a temporary inadequacy of foreign exchange. According to the US Embassy, the principal impediments to growth are deficient institutions and policies that over several decades have resulted in a pervasive presence of the state in the economy—a presence that Lusinchi has not aggressively attacked. His failure to liberalize the economy, his abrupt policy reversals on such issues as the external private debt, and the uncertainty over oil revenues rule out, in our view, a significant revival of private investment in the medium term. Because the oil revenue shortfall also constrains government and consumer

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spending, we see no plausible engine to pull the economy out of its doldrums. A growing danger is the possibility that Lusinchi, out of frustration, will try to spend Venezuela out of recession. We concur in the IMF judgment that such a strategy would provide only a transitory stimulus to the economy—while risking a sharp increase in inflation that would handicap future efforts to generate self-sustained economic growth.

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The moribund economy has become the principal issue in domestic politics and may play a determining role in presidential succession. With campaigning for the 1988 election already under way, COPEI, the Christian democratic opposition, has made modest gains in public opinion polls by stridently assailing Lusinchi's economic management. COPEI's chances to seize the presidency will continue to improve as the economy deteriorates, but we believe COPEI will fall short in the 1988 election—unless Democratic Action, the ruling social democrats, splits over the selection of a candidate. Within Democratic Action, Lusinchi's Ortodoxo faction is being challenged by maverick ex-President Carlos Andres Perez, who also hopes to capitalize on Lusinchi's problems with the economy. Although Perez is fighting an uphill battle against the party machine, his chances are boosted by his immense following among party rank and file and by the Ortodoxos' inability to settle upon a candidate to succeed the popular Lusinchi, who cannot seek a consecutive term in 1988. Perez's bitter relations with the Ortodoxos suggests the possibility that—if his bid falls short—he might refuse to endorse the party's nominee or might even accept a third-party nomination.

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The economic crisis poses no threat to the stability of democratic government over the medium term, in our judgment. Public acceptance of Venezuela's political institutions remains strong and the radical left is almost nonexistent. Labor peace is virtually assured by the intimate relationship between Democratic Action and the Confederation of Venezuelan Workers—the nation's dominant labor organization. Over the longer term, however, the inability of the economy to generate sufficient jobs for the nation's rapidly expanding labor force could become a destabilizing factor.

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US interests will be adversely affected by Venezuela's continuing foreign exchange crisis and economic recession. Over the medium term, US exports to Venezuela will continue to be limited by Venezuelan trade

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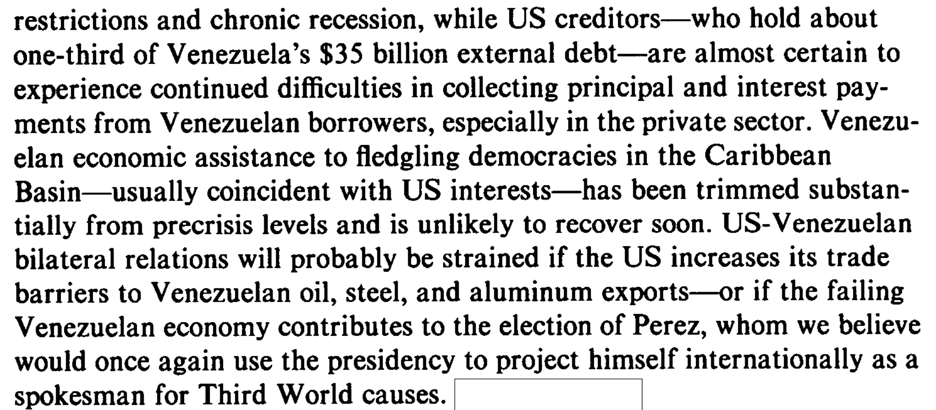
restrictions and chronic recession, while US creditors—who hold about one-third of Venezuela's $35 billion external debt—are almost certain to experience continued difficulties in collecting principal and interest payments from Venezuelan borrowers, especially in the private sector. Venezuelan economic assistance to fledgling democracies in the Caribbean Basin—usually coincident with US interests—has been trimmed substantially from precrisis levels and is unlikely to recover soon. US-Venezuelan bilateral relations will probably be strained if the US increases its trade barriers to Venezuelan oil, steel, and aluminum exports—or if the failing Venezuelan economy contributes to the election of Perez, whom we believe would once again use the presidency to project himself internationally as a spokesman for Third World causes. 25X1

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Figure 1

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Venezuela: Struggling With Declining Oil Revenues

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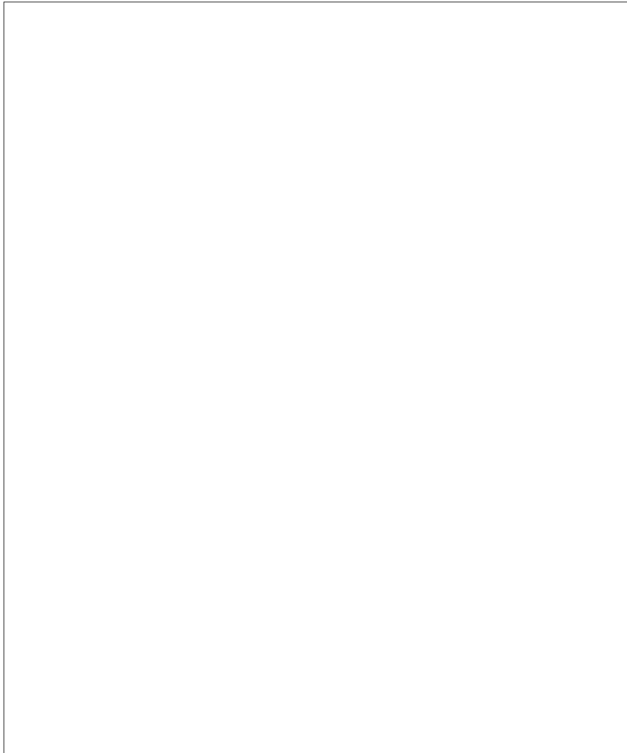

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Introduction

The sudden collapse of oil prices in the first quarter of 1986 has deepened Venezuela's economic crisis—frustrating President Lusinchi's efforts to engineer economic recovery, raising new doubts about the nation's capacity to service its external debt, and jeopardizing the most important US trading relationship in South America. The stalled economy has become the major—almost the only—political issue in Venezuela. COPEI, the Christian democratic opposition party, has used Lusinchi's economic problems to stage a modest comeback in public opinion polls, raising the prospect that it may be able to mount a serious bid for the presidency and for control of Congress in the 1988 election. The main challenge to Lusinchi and his Ortodoxo wing of the ruling Democratic Action (AD) party comes from ex-President Carlos Andres Perez, who heads the party's populist wing. Perez and the populists hope to capitalize on Lusinchi's often fumbling economic management to seize the AD's presidential nomination. If Perez succeeds in winning control of the party and the government, he can be expected to use the presidency to project himself internationally as a spokesman on Third World issues, increasing tensions in Venezuela's traditionally harmonious relations with the United States.

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This paper examines the implications of the oil revenue shortfall for Venezuela's debt service capacity, assesses the economy's growth prospects in light of its foreign exchange constraints and the government's probable policy initiatives, and suggests some implications of these developments for Venezuela's presidential succession and for US interests.

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The Setting

When Lusinchi took office in February 1984, the precarious state of the economy commanded his immediate attention. Over the two previous years, nonoil GDP had declined by 4 percent, the official unemployment rate had almost doubled, the public sector had posted fiscal deficits averaging 10 percent of GDP, net international reserves had plunged $8 billion, and negotiations with international lenders to reschedule $28 billion in external public debt appeared hopelessly stalled. To marshal support for stabilization, the President forged a "social pact" with business and labor in which each agreed to make key concessions in exchange for measures protecting interests vital to their constituents. Business leaders accepted government mandates placing a temporary freeze on layoffs, extending price controls, and requiring firms to provide workers free lunches and commuting allowances. In exchange the government promised the private sector a preferential exchange rate to service foreign debt, and labor leadership pledged to exercise wage restraint. With the "social

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pact" achieved, Lusinchi turned to implement a comprehensive stabilization program—giving priority to correcting the balance of payments and fiscal deficits. He further devalued the bolivar and expanded tough controls on imports and access to foreign exchange. The government also placed stern limits on public-sector expenditures and scheduled certain money-losing entities for dismantling. In addition, debt negotiations with international bankers began in earnest.

Successes. By the end of 1985 the administration could show important results. According to the Central Bank:

- The current account of the balance of payments recorded surpluses in 1984 and 1985 totaling more than $7 billion—allowing a $3 billion net reduction in the external public debt and a $3.7 billion increase in the Central Bank's international reserves.

- Interest arrearages on the external public debt were paid and $21.2 billion in public debt to international bank creditors was rescheduled, the first multiyear rescheduling agreement without an accompanying IMF program.

- Inflation was held to only 16 percent in 1984 and 9 percent in 1985 through the exercise of fiscal restraint, price controls, and a hard line against requests for government-mandated wage increases.

Failures. Success, however, eluded Lusinchi in his efforts to revive the nonoil economy from a recession that started in 1978, four years before Venezuela's oil revenues began their precipitous decline. At yearend 1985, real output in the nonoil economy was far below that of 1982 and only 65 percent of manufacturing capacity was in use. Of even greater concern to the administration, unemployment remained stubbornly high—12.7 percent, according to official estimates, but over 20 percent, according to the Confederation of Venezuelan Workers (CTV), after adjusting for the severely underemployed. Administration spokesmen gave public assurances, however, that the successes achieved during these first two years in stabilizing the balance of payments and the fiscal accounts had set the stage for economic recovery in 1986.

Oil Collapse Provokes New Crisis

The dramatic slide in petroleum prices that began in January 1986 has erased important gains achieved by the Lusinchi administration and accentuated its failures. In 1986 petroleum revenues will fall by at least $5 billion—or 40 percent—from the $13 billion earned in 1985. With oil market analysts forecasting only marginal improvement in market conditions through 1988, Venezuela's oil revenue prospects remain bleak. Consequently, the Planning Ministry's sanguine projection last year that the current account balance would post a cumulative $9 billion surplus through 1988 and that economic growth would average 3 percent per year is no longer plausible. Instead, the Embassy and independent Venezuelan analysts are now projecting that the current account will be barely in surplus and economic growth will be closer to zero percent over the 1986-88 period. The current account's deteriorating prospects have raised fears that Venezuela could experience problems meeting its debt service obligations in the 1987-89 period.

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The oil revenue shortfall also adversely affects the government's budget. At the current exchange rate of 7.50 bolivars/dollar, each $1 billion decline in oil revenues causes the tax payments of Petroleos de Venezuela (PDVSA), the state-owned oil monopoly, to fall by about 5.5 billion bolivars. Consequently, the IMF projects that the $5 billion shortfall in petroleum revenues expected in 1986 will produce a public-sector fiscal deficit equal to about 9 percent of GDP this year, and the oil revenue shortfall expected in 1987 will produce a fiscal deficit almost as large. According to the Embassy, financing these deficits will probably exhaust the public-sector financial reserves accumulated in 1984 and 1985—reserves the administration had hoped to use to finance an economic recovery program over the second half of Lusinchi's term.

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The Political Equation

Lusinchi is under intense political pressure to limit the short-term impact of declining oil revenue and to restore economic growth before the 1988 election. According to the Embassy, COPEI is using the nation's economic difficulties to rail against the administration's policies. Although COPEI has yet to

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Petroleum-Based Economic Development

The Venezuelan experience again demonstrates that abundant foreign exchange earnings alone are insufficient to generate self-sustained economic growth. According to the US Embassy, the institutions and policies necessary for economic development are lacking or deficient in Venezuela. Instead, excessive statism and frequent policymaking flip-flops have discouraged investment, have encouraged the dissipation of oil revenues on consumer goods imports, and have induced the flight of capital to more secure investment havens abroad. [ ]

The surge in oil revenues following the 1973 Arab oil embargo sparked visions among politicians and social planners of transforming Venezuela into a modern industrial democracy. Over the next 10 years, $117 billion in oil receipts—augmented by more than $40 billion in medium- and long-term loans from international lenders—were used to finance a sweeping effort to diversify the industrial base; to expand the government's commitments in housing, education, and other social programs; and to fund an ambitious foreign aid program. Initially, the strategy of government-managed investment of the oil dividend appeared to work. By 1978 the ratio of investment to GDP was among the highest in the developing world, real output in the domestic economy was expanding at an 8 percent annual clip, and per capita consumption was the highest in Latin America. [ ]

Achieving self-sustained growth, however, proved to be an elusive goal. Instead, in 1979 the economy entered a period of long-term stagnation and decline from which it has not recovered. The stagnation phase, 1979-82, was especially disturbing to advocates of state-managed development because even by using the record oil revenues of 1980 and 1981 to fund an ambitious program of public-sector investment projects, economic recovery was not achieved. According to the Embassy, recovery failed to materialize because the fiscal stimulus injected by the government was offset by sharply declining private investment. Private investors, made skittish by irresolute and misguided economic policy making, cut real outlays for plant and equipment by two-thirds over the 1978-82 period. Outright economic decline began in 1983, when declining petroleum prices necessitated retrenchments in public outlays and destroyed remaining private-investor confidence. For the 1978-85 period as a whole, real output in the nonoil economy declined 6 percent, and per capita output fell 24 percent.* [ ] 25X1

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The same factors that discouraged investment were inducements to increased consumption and capital flight. Over the 1973-82 period, the influx of oil dollars and a greatly overvalued currency triggered sharp increases in consumer goods imports. According to official data, most of the 37-percent increase in per capita consumption in this period is attributable to increased imports—not increases in domestically produced consumer goods. Subsequently, in the 1982-85 period, when oil revenues began their downward slide, imports and consumption levels descended in tandem, further underscoring the oil revenue/consumption relationship. [ ] 25X1

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Capital flight absorbed a growing share of Venezuela's foreign exchange earnings through 1983. According to the Embassy and a major money center bank, capital flight took more than $30 billion out of the country by 1985. Embassy analysis shows that capital flight from Venezuela was so strong that, when netted against the external debt, it converts Venezuela into a net creditor nation—that is, Venezuela's foreign-currency-denominated assets currently exceed its liabilities to foreigners. [ ] 25X1

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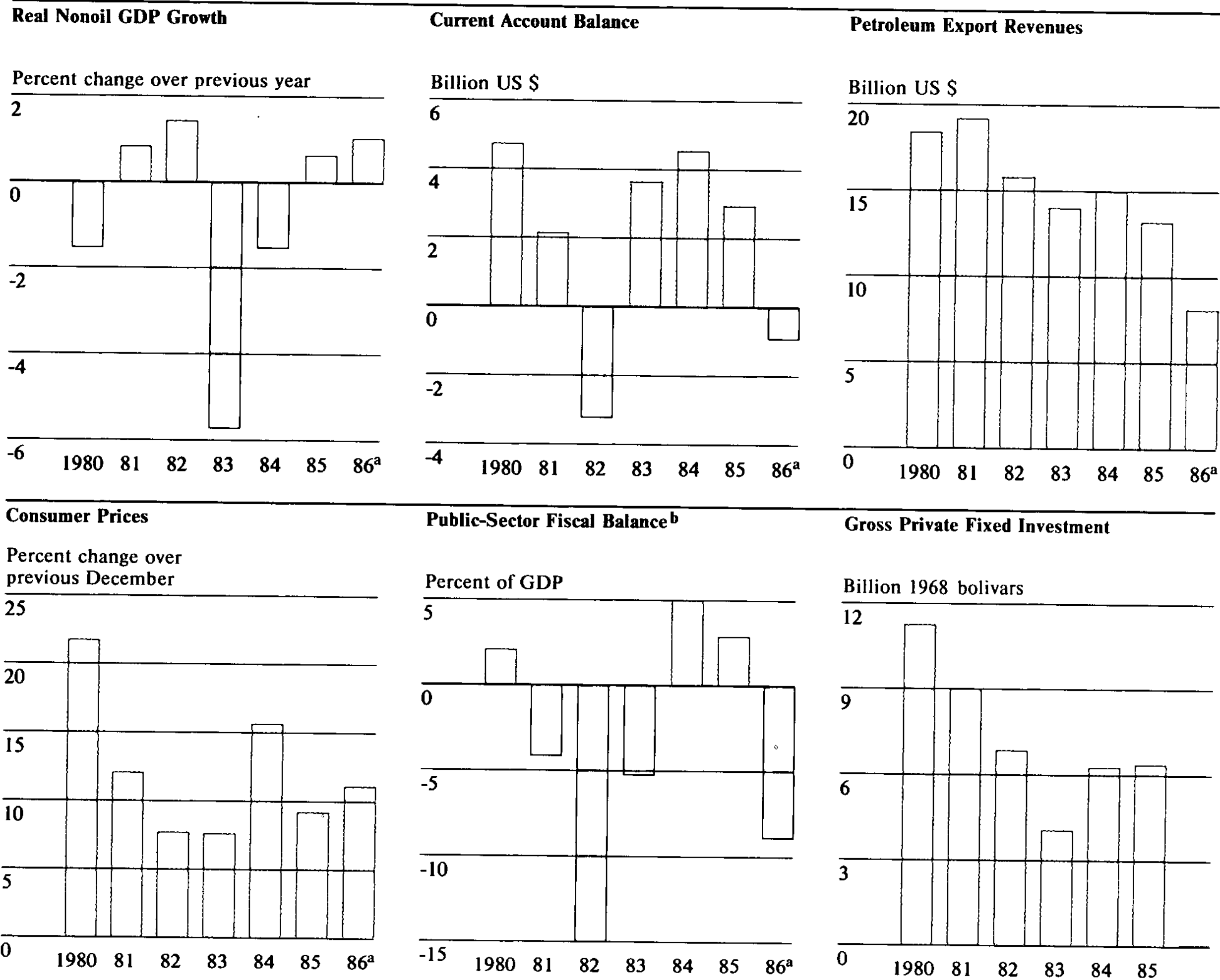
Figure 2
Venezuela: Economic Trends, 1980-86



a Projected.
b Fiscal year equals calendar year.

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formulate its own program for economic recovery—and is unlikely to do so until the party resolves a leadership struggle between party General Secretary Fernandez and party founder Rafael Caldera—its assault on Lusinchi's policies has boosted the party's standing in public opinion polls from the extremely low levels recorded at the close of the failed presidency of Luis Herrera Campins in 1984.

The most serious challenge to Lusinchi, however, comes from within his own party. According to Embassy reporting and press accounts, the populist wing of Democratic Action has strongly criticized the administration for adopting an economic adjustment program that critics believe too closely resembles those the IMF has imposed on other debtor nations. For example, in a widely reported press conference in September 1985, former Planning Minister Luis Matos Azocar—who had earlier resigned in disagreement with administration policy—charged that while business interests were granted key concessions, such as a preferential exchange rate to service their external debt, workers have been saddled with sharp increases in the prices of basics and reduced job opportunities. Matos also advocated linking debt service to export earnings and faulted the administration for running up huge budgetary surpluses, instead of providing fiscal stimulus to the stalled economy. Matos and other critics from AD's left wing have pressed for the removal of Finance Minister Manuel Azpurua and Venezuelan Investment Fund head Hector Hurtado—principal architects of the administration's economic strategy—on the grounds that they are too conservative. The ruling party's leftist and populist backbenchers, many of whom agree with Matos, are reported by the Embassy to support the candidacy of populist ex-President Carlos Andres Perez for the party's 1988 presidential nomination.

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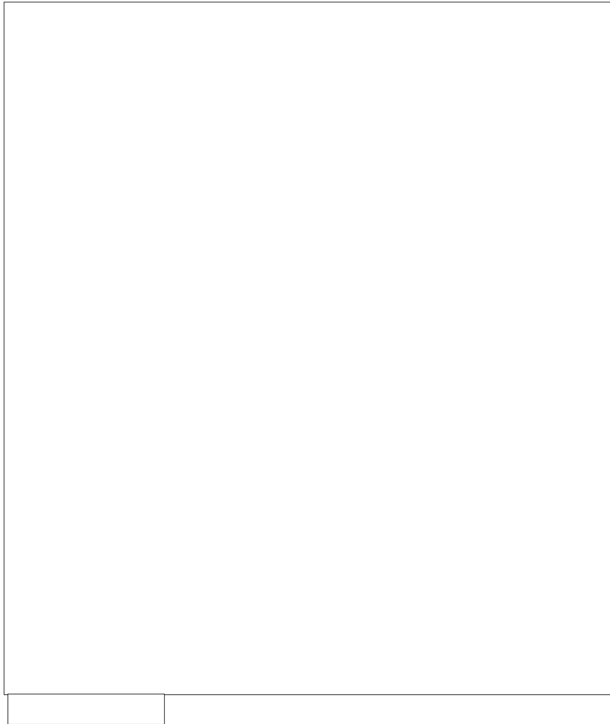

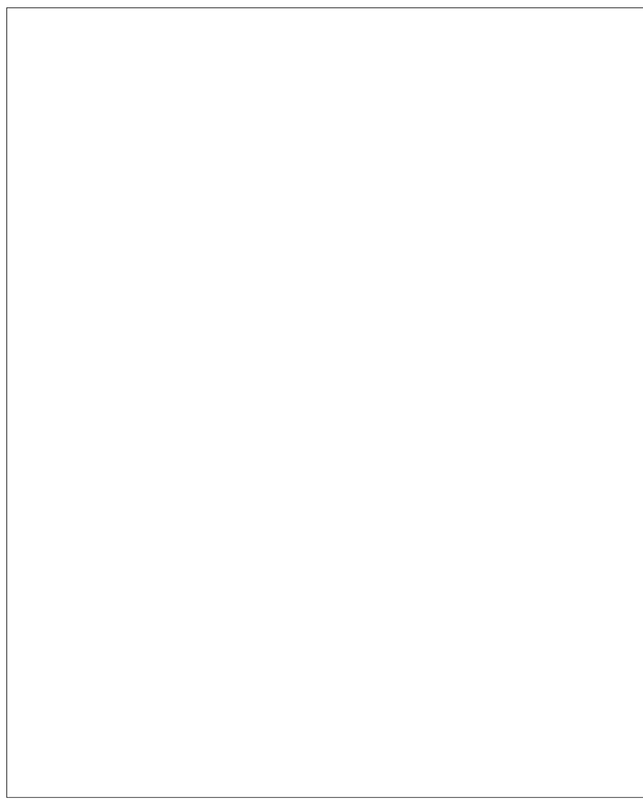

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The charismatic Perez, who presided over the nation in the halcyon days of the nation's oil bonanza, is openly casting himself as a proven manager of the economy and a votegetter. Perez's quest for the presidency is made difficult by the strong control the Ortodoxos and labor leaders exert over the nomination process. According to the Embassy, Perez's problems with the Ortodoxos and labor leadership stem from his highly personalistic style in a party where the exercise of power is traditionally collegial. According to the Embassy, party and labor leaders believe that Perez would again freeze them out of decisionmaking, as he did during his 1974-79 presidency when he often turned, instead, to advisers from outside the party. In addition, Perez's constant sniping from the sidelines has engendered a deep animosity between Perez and the President that, according to the Embassy [25X1] [25X1] has frequently flared into heated exchanges over economic strategy in meetings of the party's executive committee. To gain the party's nomination, Perez must persuade a majority of the 30,000 to 45,000 party stalwarts who will choose the party's candidate that only by turning to him can AD avoid being turned out of power—and government sinecures. According to the Embassy, Perez's prospects for success are improved by the Ortodoxos' inability to find an attractive alternative. After much indecision, the Ortodoxo leadership of the party is now advancing—without enthusiasm—the candidacy of the lackluster former Minister of Interior Octavio Lepage. Despite being anointed by party leadership, Lepage continues to lag far behind Perez in public opinion polls. [25X1]

The resurgent candidacy of Perez and COPEI's gains in recent public opinion polls have added a note of urgency to Lusinchi's efforts to revive the economy and have constrained the administration's policymaking options. The administration has chosen to rely on an economic strategy largely grounded in traditional Venezuelan statism and nationalism, in the Embassy's view, largely because innovative economic adjustment measures would almost certainly provoke intense criticism from entrenched economic and political interests. For example, recommendations by independent

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AD and Labor: An Intimate Relationship

The Confederation of Venezuelan Workers (CTV) is Venezuela's dominant labor organization and plays a key role in setting the nation's agenda. According to US Embassy analysis, the CTV's prominence in national affairs is rooted in its firm command over the labor movement and in its unique ties to Democratic Action (AD), Venezuela's dominant political party. The CTV-AD bond evolved out of a common struggle against dictatorship in the 1940s, and manifests itself today as a comfortable power-sharing arrangement. The mainspring of the arrangement is a network of leadership interlocks between the two organizations. Democratic Action party members hold almost 60 percent of the federation's leadership posts, while labor leaders are represented on AD's National Executive Committee, the Cogollito (the party's informal board of directors), and in AD's congressional delegation. This relationship allows the CTV to define its objectives in broad political, economic, and social terms, rather than in narrow trade unionism. In exchange, the CTV supports AD by mobilizing its grassroots components in support of party candidates and programs. In contrast, COPEI, the Christian democratic opposition, receives little labor support and has negligible influence over the labor movement.

The CTV's influence within the party and the Lusinchi administration has been repeatedly demonstrated. In party affairs, labor was key to the selection of Lusinchi as AD's standard bearer in 1983

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In exchange for labor's support, Lusinchi agreed to name CTV leader Manuel Penalver to the party's secretary generalship. In national affairs, labor lobbied successfully for food and transportation subsidies in 1984 to soften the impact of the President's austerity program on the working class. At the same time, labor pressure was instrumental in administration decisions to freeze prices on a long list of consumer basics and to reject the IMF's recommendation to devalue the currency further. The CTV's influence was also felt in Caracas's negotiations with its creditor banks last year. Labor's strongly voiced objections to the terms of a tentative deal with bankers resulted in a six-month delay, during which the administration placated labor by negotiating minor revisions in the text of the agreement and acquiesced in labor demands for a WPA-type public works program.

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The CTV-AD relationship also helps ensure social peace when AD is in power. The hierarchical CTV controls the process by which the more than 1 million members of CTV-affiliated unions select their leaders and requires that all important decisions of local and state affiliates be approved by the CTV. Because labor leadership is a partner in government, there have been few open manifestations of labor discontent—despite a sharp drop in real wages and a 50-percent increase in the number of the unemployed.

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Venezuelan economists and the IMF calling for a liberalization of the economy have been ignored in favor of a further elaboration of controls over prices, wages, interest rates, imports, exports, and foreign exchange. On the external debt issue, Lusinchi, while recognizing the need to reach a settlement with foreign creditors, has played to public opinion by adopting a dilatory and often confrontational approach with international bankers. As a consequence of Caracas's statist and often stubborn approach to economic management, investors and international lenders have demonstrated a reluctance to make new commitments to Venezuela, according to Embassy

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Stabilization Renewed

According to the IMF, the administration understands that the oil price decline is unlikely to be transitory and that policies should be developed in the expectation of a continued scarcity of foreign exchange. Accordingly, the administration implemented a package of stabilization measures in the third

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quarter of 1986 that seeks to conserve foreign exchange by:

- Rescheduling most of the officially recognized private foreign debt. Foreign creditors will be required to extend the grace period on principal repayment for most of the $6.9 billion in net external private debt, instead of receiving repayment over the 1986-91 period as originally promised.

- Imposing new restrictions on imports of consumer goods and agricultural commodities.

- Mandating that public-sector entities purchase domestic products, if possible.

The stabilization package also includes measures designed to bolster the government's fiscal accounts. To increase revenues, Lusinchi proposed a modernization of the tax system and announced—without specifics—that the "unnecessary assets" of public enterprises will be sold. The central government's revenues received a one-time-only boost by the administration's decision to renege on its earlier promise to provide the private sector with subsidized dollars to service its external debt. This decision allowed the treasury to seize the assets of a special fund in the Central Bank that had been set up to cover the costs to the Central Bank of such subsidies. To cut the central government's expenditures, the President announced new austerity measures for government agencies.

Although the new measures may help somewhat to stabilize the nation's fiscal and external accounts, the administration has avoided some of the more difficult steps recommended by the IMF to restructure the economy along more market-oriented lines and reduce the public-sector fiscal deficit. Such recommendations included progressive elimination of quantative restrictions on imports, ending the practice of export licensing, relaxation of price and interest rate controls, eased regulation of labor markets, increased prices for goods (especially electricity and refined petroleum products) produced by state enterprises, and a sharp devaluation of the bolivar. According to the IMF, a liberalization of the economy and devaluation are essential to a more rational allocation of resources, and to encourage the private investment the economy needs to stimulate economic growth. Embassy reports indicate, however, that ruling party leaders believe adoption of the IMF's recommendations would subject them to charges from their labor allies and their political opponents that they have compromised the nation's sovereignty and have sold out to business interests.

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Tight External Constraints—Two Scenarios

The new measures may prove insufficient to enable Venezuela to meet its debt service obligations and to pay for necessary imports over the 1986-88 period. To assess the external balance problem—and identify corrective measures likely to be taken by the government—we have projected Venezuela's financing gaps under two sets of assumptions regarding future oil prices.[1] In the first case, exports are assumed to average $14 per barrel in 1986, $16 per barrel in 1987, and $18 per barrel in 1988. In the second case, exports are assumed to average $13 per barrel in 1986, but dip to $10 per barrel in 1987 before rebounding to $12 per barrel in 1988. In both cases, petroleum exports are assumed to average 1.50 million barrels per day in 1986 and 1987, increasing to 1.55 million barrels per day in 1988. In addition, the two scenarios assume that the economy does not grow; the interest rate applicable to the external debt is 9 percent; and fiscal, monetary, trade, and exchange rate policy remain unchanged over the period through 1988.

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The Upside. In the first case, Venezuela's financing gaps are probably manageable without additional stabilization measures. The 1986 current account balance posts a deficit of $0.8 billion, which, when added to debt amortization requirements, yields a financing gap of $2.5 billion. This gap can be covered by drawing from the $15.5 billion in international reserves that were held by the Central Bank and the Venezuelan Investment Fund at the beginning of

[1] A financing gap is created when the sum of the current account in the balance of payments and scheduled debt amortization is negative and must be covered by drawing down existing international financial reserves, attracting new capital from abroad, or taking corrective actions such as rescheduling debt or cutting imports.

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Table 1
Venezuela: Estimated 1986-88 Financial Gaps: High-Oil-Revenue Scenario

Billion US $

	1986	1987	1988
Merchandise exports	9.2	10.5	12.1
Oil	7.7	8.8	10.2
Nonoil	1.5	1.7	1.9
Merchandise imports	7.0	7.3	7.7
Nonfactor services (net)	−1.6	−1.5	−1.4
Interest and dividends	−1.3	−1.5	−1.7
Credits	1.4	1.0	0.7
Debits	−2.7	−2.5	−2.4
Transfers (net)	−0.1	−0.1	−0.1
Balance on current account	−0.8	0.1	1.2
Scheduled debt amortization	1.7	1.5	1.8
Public	1.4	1.5	1.8
Private	0.3	0	0
Financial gap	2.5	1.4	0.6

Table 2
Venezuela: Estimated 1986-88 Financial Gaps: Low-Oil-Revenue Scenario

Billions US $

	1986	1987	1988
Merchandise exports	8.6	7.3	8.8
Oil	7.1	5.5	6.8
Nonoil	1.5	1.8	2.0
Merchandise imports	7.0	7.0	7.0
Nonfactor services (net)	−1.6	−1.4	−1.3
Interest and dividends	−1.3	−1.7	−1.8
Credits	1.4	0.8	0.6
Debits	−2.7	−2.5	−2.4
Transfers (net)	−0.1	−0.1	−0.1
Balance on current account	−1.4	−2.9	−1.4
Scheduled debt amortization	1.7	1.5	1.8
Public	1.4	1.5	1.8
Private	0.3	0	0
Financial gap	3.1	4.4	3.2

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1986. Over the next two years, increasing petroleum revenues swing the current account into modest surplus, producing financial gaps of $1.4 billion in 1987 and $0.6 billion in 1988. For the 1986-88 period as a whole, the cumulative financial gap of $4.5 billion could be covered by drawing from international reserves, leaving a cushion of over $11 billion to cover other contingencies, such as increased imports if growth resumes. In our judgment, this scenario requires no additional measures—such as a further rescheduling of the external public debt—to stabilize the external accounts.

The Downside. Under the more pessimistic assumptions of the second case, financing gaps exhaust the nation's liquid foreign exchange reserves by 1989—unless additional stabilization measures are taken. For 1986, the current account registers a deficit of $1.4 billion, creating a financing gap of $3.1 billion after the addition of scheduled debt amortization payments. Although the 1986 gap could be covered by drawing down international reserves, gaps of $4.4 billion in 1987 and $3.2 billion in 1988 would exhaust the nation's liquid reserves.

Bridging Gaps. The low-oil-revenue scenario would require the government to implement tough measures to shore up the nation's external accounts and protect its capacity to service debt. The options open to the government include followup debt reschedulings, devaluation, loans from international creditors, and debt-to-equity conversions. We believe that the potential benefits from these sources—in conjunction with reserve drawdowns—would suffice to cover the financing gaps of the low-oil-revenue scenario. The accompanying reserve drawdowns, however, would probably have to be substantial—perhaps even including partial liquidation of the Central Bank's $3.4 billion in gold holdings—requiring that Caracas learns to live with reserve levels much lower than those with which it has traditionally felt comfortable.

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To protect against the advent of a low-oil-revenue scenario, Caracas appears almost certain to, first, devalue the bolivar sharply and, second, secure a followup rescheduling of most principal due on the

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Table 3
Venezuela: Sources of Additional Foreign Exchange Savings and Inflows, 1987-88

Billion US $

Sources likely to be drawn upon	
Reschedule external public debt to bank creditors	2.3
Reduce interest spread over LIBOR	0.1
Devalue currency	1.5
Total	3.9
Emergency measures	
Reschedule bond debt and debt to official creditors	1.1
IMF facility	About 3.5
Other sources	
Debt-to-equity conversions	NEGL
Nonproject loans from multilateral development banks	NEGL
Nonproject loans from commercial lenders	NEGL

public-sector debt in 1987 and 1988—steps that offer about $4 billion in foreign exchange savings. Caracas has already initiated the rescheduling process. In September, Venezuelan debt negotiator Jorge Marcano gave Venezuela's bank advisory committee the government's proposal for a rescheduling of $21.2 billion in public debt owed to international bank creditors—debt that was initially rescheduled in February 1986. [ ] banks will probably grant Caracas's request to defer most principal repayments due over the next four years, including $2.3 billion in principal payments due in 1987 and 1988. In addition, bankers are likely to grant Caracas some form of interest rate relief, perhaps, as in the case of Mexico, reducing the spread over LIBOR to 0.8125 percentage point from the current 1.125 percentage points. Such a reduction in the spread over LIBOR would save Caracas about $65 million per year in interest payments. [ ]

The administration is also likely to devalue the controlled exchange rate significantly from the current 7.50 bolivars per dollar, according to the Embassy. The dual exchange rate system, with a free-market rate floating above the controlled rate, is likely to be continued, however. Depending on its magnitude, we believe that a devaluation could reasonably be expected to yield $750 million per year in foreign exchange savings—mostly from reduced imports and from the reduced capital outflows that result from such practices as underinvoicing and overinvoicing. [ ]

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Loans from international creditors offer only limited potential for balance-of-payments support. Central Bank president Hernan Anzola has indicated that the administration will continue to seek loans from multilateral development banks to augment the $750 million already secured from the Inter-American Development Bank. But, because such loans are usually granted for projects that would not otherwise be undertaken and because they usually have disbursement schedules linked to progress on the project, they are not likely to provide significant balance-of-payments assistance in the short term. According to the US Treasury, most of the Inter-American Development Bank commitments that Caracas has already secured will be disbursed after 1988. Neither are World Bank loans likely to be forthcoming in the near term. Venezuela has only recently been reinstated to borrower status—after its per capita income declined sufficiently to meet the Bank's criteria for need. Nor is borrowing from foreign commercial banks a likely source of significant financing. [ ] a full-fledged return to world credit markets requires that Caracas first regularize payments on the external private debt. Finally, allowing foreign creditors to convert debt-to-equity holdings in domestic corporations is not likely to become a source of significant savings in the near term. Although such conversions have attracted the interest of Venezuelan officials because of Chile's successful use of such swaps to reduce its debt burden, they are likely to remain minuscule in Venezuela until the government clarifies its recent revisions of the foreign investment code. [ ]

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Other measures, such as borrowing from the IMF, would be undertaken only in the event of an acute emergency. The administration does not want to subject itself to the firestorm of protest from across the political spectrum that government acceptance of IMF performance requirements would almost certainly bring. The administration is also likely to be

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Reform: The Missed Opportunity

Taking charge of an economy in crisis, Lusinchi was presented with an opportunity to restructure Venezuela's economic institutions along more market-oriented lines. Although he has taken important steps to liberalize the foreign investment code and has halted the growth of the state-enterprise sector—actually scaling back or folding up certain money-losing entities—we believe there is no chance that he will abandon the managed-economy approach that presidents of both parties have followed for almost three decades.

The reform issue became the center of a national debate during the first two years of the Lusinchi administration. The National Council of Industry and the Roriama Group—an informal club of wealthy businessmen, most of whom are associated with AD—called for a reduction in the state enterprise sector, an end to price controls, liberalization of the trade regime, and a rational exchange rate policy. In the media, the influential journalists Carlos Rangel and Marcel Granier spearheaded an attack on the philosophy and practice of statism. In the Cabinet, reform was—and continues to be—advocated by Minister of the Presidency Carmelo Lauria, who told the Embassy that a "180-degree turn in economic policy" is necessary for a resumption of economic development. In addition, the IMF has urged—unsuccessfully—that Caracas make structural reforms, arguing that, while the government's measures may succeed in achieving a short-term stabilization of the balance of payments and the fiscal accounts, they do not remove important impediments to long-term development.

According to the Embassy, however, there is little support for sweeping economic reforms within the ruling party or among other power groups. The Cogollito—the ruling party's innermost circle where policy with broad political implications is formulated—is unsympathetic toward the reform movement. Such reforms would threaten important constituencies of the party that have become dependent on the statist practices followed for more than 25 years. For example, labor leaders believe that state ownership of the basic industries, mandated wage levels, and price controls are essential to labor's well-being. In addition, the ruling party's Ortodoxo leadership probably fears that the medium-term dislocations that sweeping structural reforms would produce would give Carlos Andres Perez another opening to launch attacks on the government for dismantling the statist system that Perez himself helped construct and still supports. Neither has COPEI advocated economic reform. With campaigning already in full swing, the Christian democratic opposition would instead be likely to attack any such proposals advanced by the administration. Finally, influential entrepreneurial groups oppose relaxation of important parts of the controls regime, according to the Embassy. Some—such as the Mendoza group from which Finance Minister Azpurua comes—have prospered behind trade barriers and have benefited from the government's indirect subsidization of critical inputs such as credit and energy.

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extremely reluctant to seek a rescheduling of the nonrestructured debt. This debt was not included in the $21.2 billion rescheduling with foreign bank creditors because it largely consists of central government bonds and debt to official creditors. Rescheduling the $1.1 billion due on this debt in 1987 and 1988 would require a Paris Club agreement with official creditors, which in turn would require an IMF agreement.

The Outlook for the Domestic Economy

Although Lusinchi appears to have sufficient maneuvering room to stabilize the external accounts and to pay interest on the external debt, we doubt that he will achieve his most important objective—engineering an economic recovery. The essential problem he faces, in our judgment, is that of continuing weak demand from consumers and private enterprise for domestically produced goods and services.

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Investment Outlays. The outlays of private firms for new plant and equipment have been depressed for seven years and are unlikely to recover before Lusinchi leaves office. According to the Embassy and independent Venezuelan analysts, investor confidence has been sapped by heavyhanded price controls, pervasive concern over the availability of foreign exchange to finance imports, and uncertainty created by sudden changes in economic policy—such as the decision to renege on an earlier promise to provide subsidized dollars to service the external private debt. Moreover, press and Embassy reporting indicate that there is growing friction and distrust between the administration and key business groups—especially with FEDECAMERAS, the umbrella organization that represents the private business sector. For example, on several occasions Lusinchi has bitterly assailed private businessmen for demanding that the government grant them access to subsidized dollars to service the private foreign debt while refusing to repatriate dollars from accounts abroad to finance investment in Venezuela. In response, private-sector spokesmen have publicly charged that the administration itself makes investment unattractive by failing to create an appropriate business climate. FEDECAMERAS has been especially critical of the administration for not consulting with the private sector prior to making decisions on key issues—such as a proposed revision of the tax code. Recent surveys of private investment plans indicate that no near-term revival of outlays on plant and equipment is likely. In our judgment, the Lusinchi administration has missed its opportunity to gain the confidence of private investors and must formulate policy in the knowledge that private investment will remain depressed through 1989.

Foreign direct investment is unlikely to provide a significant stimulus to economic activity, in our judgment. Because of rigid Venezuelan adherence to Andean Pact Decision 24,[2] there has been little foreign investment since 1973. Although the revisions of the foreign investment code announced in September—relaxing restrictions on profit remittances and foreign ownership—may eventually encourage more foreign investment, in the near term, the same factors that discourage domestic investors are likely to offset the positive effects of such revisions.

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Consumer Outlays. Household demand for goods and services is weak and is unlikely to rebound in the medium term. Family incomes have been hard hit by the economic crisis. Real wages fell by 22 percent between 1981 and 1984, according to the IMF, and have probably declined another 4 to 6 percent in the last two years. A resurgence of real wages would require either a significant rebound of oil revenues—unlikely, according to most petroleum market observers—or a significant increase in productivity in the nonoil economy—also unlikely in the medium term, in our judgment.

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Public-Sector Outlays. The government lacks sufficient revenues to fund a significant noninflationary increase in public-sector outlays, in our judgment. In past years, oil revenues funded about two-thirds of the central government's expenditures, including an ambitious investment program in state-owned enterprises and public works. At present, however, the oil revenue shortfall sharply limits the government's ability to apply fiscal stimulus to the economy in the form of increased outlays on investment projects because reduced oil revenues mean reduced tax payments to the central government from PDVSA, the state-owned oil monopoly. Although the 1987 budget bill calls for a 4-percent increase in central government expenditures, inflation-adjusted net domestic expenditures in 1987 will probably fall 4 to 8 percent from 1986 levels.

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Inflation. Embassy and independent analysts are concerned that Lusinchi, out of frustration with the stalled economy, may try to spend his way out of the recession. According to the Embassy, labor and ruling party leaders have told Lusinchi that maintaining expenditures at current levels or higher is essential if the economy is to recover before the 1988 election. But, because the government is experiencing a shortfall of tax revenues, increases in expenditures can only be financed through deficit spending. In a determined effort to meet 1986 budget demands, the government already is drawing down the accumulated reserves of

[2] Under this provision, to foster domestically owned enterprises, the five Andean Pact signatories—Bolivia, Colombia, Ecuador, Peru, and Venezuela—agreed to restrict severely foreign investment.

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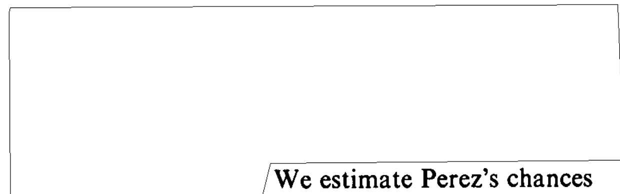
various public-sector entities—PDVSA, the social security system, and the commercial bank insurance fund—to finance a deficit of unexpected magnitude. These funds will be exhausted next year, however, necessitating a search for new revenue sources to cover continuing deficits. According to press and Embassy reports, the administration is considering legislation that would permit direct sales of large amounts of Treasury debt to the Central Bank. If, as independent Venezuelan analysts fear, these deficits require large bond sales to the Central Bank, the monetary base will be sharply augmented, creating the raw material for inflation. According to the IMF, increased inflation would trigger a resurgence of capital flight and further depress the investment climate while giving only a weak and transitory stimulus to the economy.

Implications

Domestic Politics. The deteriorating economy is likely to remain the salient issue in domestic politics through the 1988 election—with COPEI, Carlos Andres Perez, and the radical left opportunistically seizing on the administration's management failures. Despite the economic crisis, however, Democratic Action's hold on the reins of power will be difficult to break. Recent public opinion polls indicate that AD's popular standing has declined only marginally from the high level recorded when Lusinchi took office almost three years ago. This suggests that public discontent over the economy will have to increase significantly to enable COPEI to seize control of the Congress. If, however, COPEI can unify behind a strong candidate, such as the young, dynamic Eduardo Fernandez, and articulate a well-conceived program for economic recovery, the Christian democrats would have a modest chance at winning the presidency. Such a scenario is especially plausible if the nomination of a weak candidate, such as Octavio Lepage, produces a split in Democratic Action—as occurred in 1968. In our judgment, however, the nomination of the charismatic Carlos Andres Perez by AD would almost preclude a COPEI victory.

In his quest for the nomination, Perez will remind voters and party leaders of Venezuela's economic achievements during his stewardship in the mid-1970s, according to the Embassy.



We estimate Perez's chances for obtaining the nomination at less than 50-50, but his prospects are likely to improve, if—as we expect—the economy continues to decline.

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Although the economic crisis will continue to fuel intense politicking, it is not likely to provoke destabilizing political and social unrest. According to the Embassy, the Venezuelan electorate is basically conservative and retains confidence in the nation's democratic institutions. Since the onset of the economic crisis in 1982, there have been few manifestations of social unrest and the number of Venezuelans who identify with the parties of the left has increased only marginally, according to public opinion polls. Labor peace is virtually assured through the end of Lusinchi's term because of labor leadership's traditional conservatism and its strong ties to the ruling party. Labor's rank and file, although battered by the recession, is firmly controlled by the CTV's leadership and is unlikely to engage in more than sporadic, unsanctioned protests. Leftist political parties are small, fragmented, and incapable of mounting large-scale protests. The left, however, is likely to continue to exploit student discontent over such economic issues as the current financial plight of the universities. Student on-campus protests will probably spill into the streets on occasion.

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Regional Assistance. The external payments crisis is causing Venezuela to scale back its commitment to foreign assistance programs in the Caribbean Basin. In the late 1970s and early 1980s Venezuela burnished its image as an exporter of democracy and a promoter of regional stability by making large contributions to regional development banks, by providing oil on concessionary terms to smaller nations of the region through the San Jose Accord with Mexico, and by extending other forms of bilateral aid to more than 10 regional nations. But in 1985, for the first time,

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Caracas trimmed its outstanding net credits for foreign assistance. In 1986, the government cited declining oil revenues as the reason for withdrawing an offer to lend Guatemala $50 million and for drastically reducing its commitment to the Caribbean Development Bank.[3] We believe that depressed oil prices and the continuing economic recession will result in further reductions in foreign assistance, so that the freed resources may be allocated to domestic needs. 25X1

US Interests. The impact of Venezuela's economic decline will continue to be negative for US interests. Once the largest market for US exports in South America, Venezuela has been forced by the reduced availability of foreign exchange to cut imports from the United States by almost 50 percent since 1982. In our judgment, there are no prospects of regaining this lost market in the medium term. Instead, the administration's latest trade restrictions and the gradual phasing out of the preferential foreign exchange rate for consumer goods imports will further limit US export opportunities. 25X1

US banks are also likely to feel Venezuela's foreign exchange pinch. Although we believe that Venezuela will remain current on its public debt interest obligations, further reschedulings of principal repayments are almost assured. On the private debt, US lenders will probably have to accept growing arrearages and writeoffs, because the elimination of the special exchange rate for repaying principal on the foreign private debt will have a sharply negative effect on many firms, producing bankruptcy in some cases, according to independent analysts. A possible benefit to US investors in the long run may result from the growing Venezuelan recognition that foreign direct investment is an important source of risk capital and technology transfer. 25X1

Frictions over trade issues may grow. Concerned over its almost total dependence on oil for foreign exchange earnings, Caracas is seeking to increase its exports of nontraditional products. Within the past year, the government has announced ambitious expansion plans for its state-owned steel and aluminum industries. But Caracas is concerned that the industrial nations, particularly the United States, will close their markets to such products. Still fresh in Caracas's memory is its dispute over steel exports to the United States in 1985—a confrontation that was resolved only after Caracas and the US Department of Commerce negotiated a "voluntary restraint agreement." As the foreign exchange bind tightens, Venezuelans will probably renew complaints that their friendship is taken for granted and that—unlike Mexico—Venezuela is rarely accorded preferential treatment in economic matters. These frustrations are likely to intensify Caracas's efforts to secure non-US outlets for its products. 25X1

If the Ortodoxos fail to retain control of the government, the tone of US-Venezuelan relations is likely to change—especially if the new president is Carlos Andres Perez. Although not an ideologue of the left nor personally anti-US, the opportunistic Perez is, nevertheless, often critical of US actions. For example, his public statements about the Sandinistas are often at variance with US policy objectives—and with what he tells US officials privately. 25X1 we believe that Perez would use the presidency and Venezuela's economic and moral authority in the region to project himself as a Third World leader. 25X1

Notwithstanding the modestly negative implications of Venezuela's economic crisis for medium-term US interests, we believe that US-Venezuelan ties will remain strong over the long run. The strength of Venezuela's democratic institutions, its commitment to regional stability, and the complementarity of the two economies create the basis for a fundamentally congruent relationship. We believe that the Venezuelan president who takes office in 1989 will use the framework of this relationship for solutions to the daunting economic problems he is almost certain to face. He will have opportunities to strengthen the

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[3] Although Caracas did offer Haiti oil deliveries on San Jose Accord terms this year, the current slack oil markets and the recent requirement that 50 percent of San Jose Accord benefits be in the form of nonconvertible bolivars sharply limits the costs to Venezuela of such assistance. 25X1

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economy and US-Venezuelan ties. According to oil market analysts, oil prices are likely to rebound in the early 1990s, bolstering Venezuela's external accounts and US trade opportunities with Venezuela. In our judgment, however, the most important opportunities would be to implement economic reforms. Both Venezuelan and US interests would be served by an aggressive dismantling of the statist economic regime that we believe inhibits Venezuela's return to sustained economic growth.

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