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Global Economics

Latin America

VENEZUELA: FROM STABILIZATION TO GROWTH

DARRYL MCLEOD AND JOHN H. WELCH
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- Venezuela's April stabilization program successfully reversed capital flight, weakened the exchange rate, improved fiscal accounts, and reduced inflation after an initial surge. The subsequent economic stability and higher oil prices have led to a substantial increase in dollar inflows.

- The recent increase in oil prices has turned a strong flow of dollars into a flood. During a prior stabilization program in 1989, a similar oil price surge led Venezuela to withdraw from its IMF program.

- Because its reform program still lacks the credibility needed to reignite robust private investment, we think that Venezuela will stick to the core of its current IMF program, specifically privatization, severance pay and pension reform, and restructuring the banking system.

- If the government follows through on its reform program, the prospects for Venezuela sustaining high growth rates become formidable.

Venezuela's stabilization program is progressing well. Aided by high oil prices, the government has already achieved many of the program's key macroeconomic targets. International reserves are up over 20% and the bolivar has stabilized. Falling inflation and higher oil prices create a positive outlook for economic growth in 1997. Opening the oil sector to foreign investment capital should combine with higher investment in other mineral sectors to raise GDP growth to between 2% and 3% next year. If the Venezuelan government can sustain momentum for reform and privatization, private investment and capital inflows could fuel a much stronger and broader recovery. Since we think that the Venezuelan government will follow through on its most important reforms, we expect economic growth to exceed 5% in 1997.

How quickly and broadly the economy moves from stabilization to growth depends largely on the government's adhering to its privatization and reform agenda in the face of the sudden abundance of dollars. After the last IMF stabilization attempt in 1989, recovery and oil revenue abundance led the government to abandon the IMF program.[1] This time, the government may jettison some reforms and projects, but we expect a substantial core of initiatives to survive and even benefit from the oil windfall. Initiatives likely to continue include privatization of several state enterprises and banks, severance pay and pension reform legislation, and some administrative reforms necessary to stabilize the economy during an oil boom.

The basic rationale for economic reform has shifted from the need to stem the outflow of dollars to the need to encourage private investment. The experience of the last 15 years shows that high oil prices alone cannot fuel Venezuelan growth. On the contrary, the macroeconomic instability generated by fluctuating oil prices often discourages private investment. The problem is not low domestic savings. Domestic saving has consistently exceeded investment over the past 20 years, making Venezuela the only net creditor nation in Latin America. Encouraging investment in domestic nonoil sectors that account for 75% of the country's GDP remains the main challenge for the government. And the only way achieve that is through continued reform.

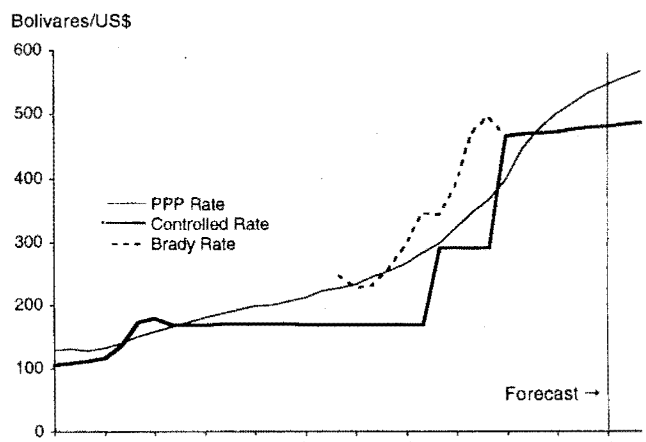
A number of the government's policies to improve macroeconomic stability and encourage investment in nonoil sectors have already borne fruit. The nonoil sector of the economy has made substantial progress over the last seven years. The export share for the nonoil sector has risen from 5% in the early 1980s to 30% of total export earnings. Expanding nonoil growth depends upon a transparent exchange rate policy and a more flexible labor market. The recent opening of the oil sector to private investment expands initiatives dating back to 1992. These measures will significantly increase demand for locally produced goods, especially construction services, over the next five years.

The first step toward reviving private investment—stabilization of the exchange rate and inflation—is well underway. The next step is to push forward with privatization and labor market reforms. Finally, the government has undertaken some administrative innovations such as the recently established oil windfall debt account and the new crawling band exchange rate system. But the government must fine-tune and institutionalize these actions to head off another boom and bust cycle.

SUCCESSFUL STABILIZATION AND HIGH OIL PRICES BRING NEW PROBLEMS

After the government ended its 22-month experiment with exchange rate and price controls on April 22, 1996, it restored free convertibility to the bolivar and allowed markets to determine interest rates. Although many expected the bolivar to weaken, it quickly appreciated as the controlled and free parallel rates converged (Figure 1). In early July, the government announced a new currency band with a moving central parity. Initially, the central parity depreciated at a 1.5% rate

Figure 1. **Exchange Rates: The Bolivar Stabilizes**



[1] For a comparison of the current situation with 1989, see Darryl McLeod and Sylvia Maxfield, "Venezuela's Congress and the IMF: Not 1989 All Over Again," *Lehman Brothers Global Economics Emerging Markets-Latin America*, March 7, 1996.

per month. The subsequent large inflow of dollars and higher oil prices have led the central bank to roll back the crawl to about 0.5% monthly. By allowing the bolivar to strengthen, the government is expecting that a slower crawl will help to bring down inflation.

Inflation has moderated from a high of 12.6% in May just after the government raised gasoline prices and devalued the bolivar to 3.6% in September (Figure 2). With annualized inflation still over 50%, it is too early to declare victory. But with a stable exchange rate and tighter monetary policy (Figure 3), inflation should fall toward 2% by year-end. Another round of increases in gasoline and other public sector prices will push inflation up a bit in the first quarter of next year, but the rate should still average just about 2% monthly or 28% annually in 1997.

Figure 2. **Monthly Inflation Abates**

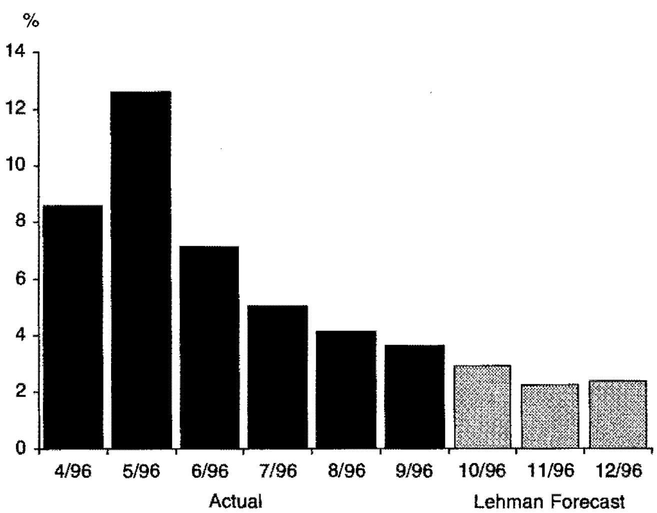
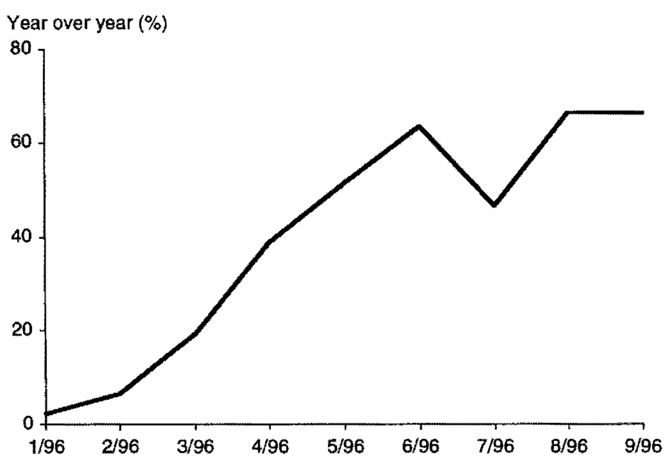


Figure 3. **Monetary Base Growth**



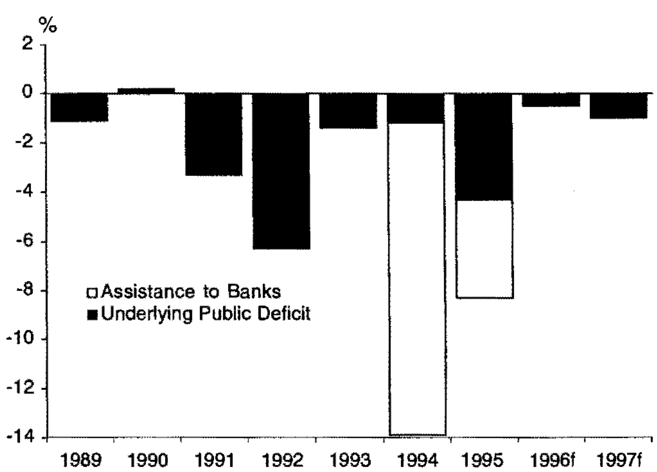
Source: Central Bank of Venezuela.

Falling inflation depends on sustained fiscal balance and a transparent and flexible exchange rate regime. Higher oil prices and a major fiscal adjustment package could eliminate the overall government deficit following an 8% budget deficit in 1995 (Figure 4). But as occurred in 1991, budget deficits will return unless the government implements new budgetary procedures. Similarly, the bolivar could appreciate substantially—both in nominal and inflation adjusted terms—unless the central bank continues to force the bolivar weaker with the crawling band system and rationalizes the execution of monetary policy.

SUSTAINING REFORM WITH AN ABUNDANCE OF FOREIGN EXCHANGE

Venezuela's external payments outlook has changed dramatically in the past six months. When international reserves fell under $9 billion in late 1995, many feared the government would not meet its debt service obligations and were greatly relieved when it negotiated a $4 billion multilateral loan package. The government has about $5 billion in external debt amortization through the end of 1998, including its newly restructured Paris Club debt. Today, Venezuela has abundant foreign exchange. Cumulative current account surpluses over the next two years are likely to exceed $8 billion. The government also has at least $5 billion in public assets it could sell. Already committed foreign direct investment in mineral and beverage industries will also bring about $6 billion into the country by the end of 1998, not to mention portfolio capital inflows into equity and bond markets.

Figure 4. **Venezuela Overall Public Sector Deficit**



f=forecast.

Prospects for selling public assets have clearly improved. Because dollars have become so abundant, however, the government may not pursue a multiyear extended facility agreement with the IMF. Moreover, the authorities may come to resent IMF intervention in domestic policy formulation. But Venezuela still needs the improvement in policy credibility that accompanies IMF monitoring of macroeconomic performance to get private investment going again. And because related Inter-American Development Bank and World Bank programs that involve technical assistance go a long way to fostering this investment, we expect the government to stick with the IMF program.

Under current law, the government will earmark privatization revenues to reduce foreign debt. And we expect congress will soon approve the government's new oil windfall debt buyback fund. Eliminating a loophole in the current law allowing current interest payments would improve the effectiveness of this fund, however. This year's budget surplus also provides a good opportunity to fund some $4 billion severance pay obligations. Moreover, the government can use surplus funds to restructure treasury and FOGADE (Fondo de Garantía de Depósitos y Proteccíon Bancaria, the deposit insurance agency) obligations to the central bank.

As in 1989, the current oil boom may induce the government to stick to only selected elements of the reform agenda summarized in Figure 5. Though the need for fiscal revenue has diminished, the improved economic outlook raises the expected selling price of these assets. FOGADE, the deposit insurance agency, remains strapped for revenue and has a strong incentive to sell some of its banks and real estate assets. Consequently, we think government will stick to its privatization program. Privatization will also help demonstrate the government's commitment to reform, thereby encouraging private investment.

We also expect severance pay and pension reform to go forward. The government made considerable progress earlier this year through ongoing negotiations among labor, business, and government at the highest levels. The government can use excess fiscal revenue to fund severance pay and pension liabilities, or for current severance payments to workers made redundant by restructuring of the fiscal sector.

The central bank may finally win its long campaign to restructure its balance sheet. The government can productively use some of the oil windfall and sterilize the dollar inflow by repaying treasury and FOGADE debts to the central bank. In order to dampen the inflationary impact of dollar inflows, the central bank would otherwise need to conduct open market operations. And the consequent tighter monetary policy would help reduce inflation, which is so essential in sustaining Venezuela's recovery.

TURNING OIL WEALTH INTO ECONOMIC GROWTH

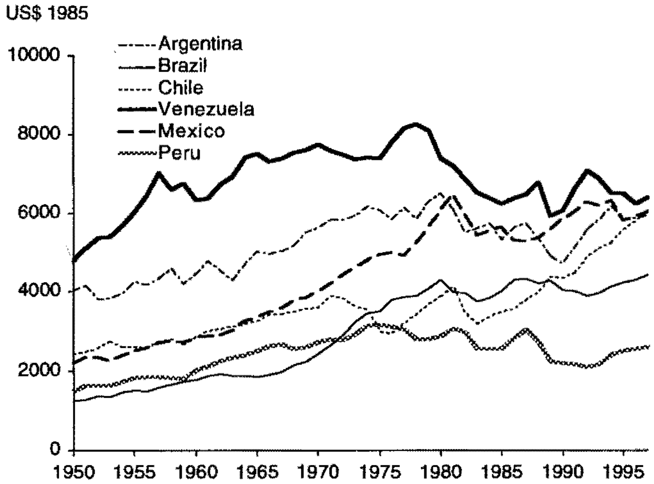
During the past 20 years, Venezuela's economy has sometimes performed poorly when oil prices were high, and well when oil prices were low. Overall, the country's 20 million residents have not enjoyed as much prosperity as the tremendous oil and mineral wealth should provide. Though average income per person is still the highest in Latin America, it has fallen steadily since 1979 (Figure 6). The decline in oil prices after 1986 is only part of the reason. Even as oil prices peaked in the early 1980s, growth slowed as Venezuela became mired in the debt crisis and GDP actually declined (Figure 7).

High oil prices do not have a uniformly positive impact on Venezuela's economy. High oil-related tax revenues weaken the political resolve of policy makers and congress to push

Figure 5. **Venezuela Reform Timetable**

April 22, 1996	✓ Lifting of exchange and most price controls.
July 1996	✓ Introduction of exchange rate band with a moving central parity
August 1996	✓ Raising the wholesale tax from 12% to 16.5%
October 1996	✓ Adjust electricity rates and propose a regulatory framework rate adjustment. • Approve spending provisions for the government oil windfall debt fund. • Reach an accord with business and labor on severance pay and pension reform.
November 1996	• Approve restructuring of central bank's treasury and FOGADE liabilities.
December 1996	• Introduce legislation for severance and pension reform. • Restructure key government agencies.
January 1997	• Readjust gasoline prices.
March 1997	• Pass severance pay and pension reform bill.

Figure 6. **Per Capita PPP Income**



Sources: Penn World Tables v. 5.5 and Lehman Brothers estimates.

Figure 7. **Real Oil Prices and Economic Growth**

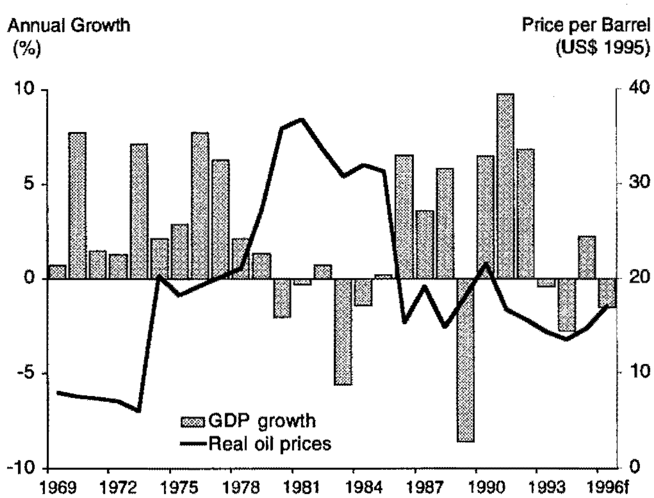


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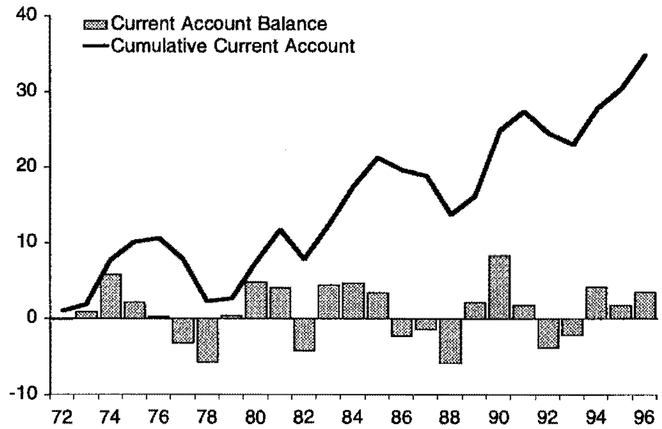
Figure 8. **Venezuela Cumulative Current Account Surplus,** US$ billion



Assumes 3% average return on assets.
Source: IMF, *International Financial Statistics.*

through much needed public sector reforms. Large oil export revenues also strengthen the bolivar reducing the competitive position of nonoil export and import competing industry. Public spending increases only to retrench a year or two later when oil prices return to trend levels. Anticipating this boom and bust cycle, the private sector is reluctant to commit itself to new long-term investment, especially in nonoil export industries.

Though private domestic investment has lagged, low savings rates are not the problem. As shown in Figure 8, Venezuela has cumulative current account surpluses amounting to over $35 billion because domestic savings has exceeded domestic investment on average. Since the country also has a net debt of about $30 billion, total assets held abroad may exceed $50 billion. At most, $5 billion of these assets represent PDVSA foreign asset holdings, leaving a large stock of private capital abroad.

The impact of these foreign assets on growth is evident in Figure 9. When high inflation presages devaluation and capital flight, growth falls. Most OECD countries show the exact opposite reaction. Political pressure on the central bank to increase money printing when oil revenues fall provides the link between oil prices and inflation. And this instability translates into instability of the inflation-adjusted bolivar exchange rate. As shown in Figure 10, the inflation-adjusted bolivar exchange rate fluctuates dramatically over these boom and bust cycles. Our own research[2] and that of Hausmann and Gavin (1995)[3] show that real exchange rate instability reduces growth and investment, especially in sectors that do not export or compete against imports such as construction and services. Still, the bolivar has weakened considerably over the last 15 years, encouraging nonoil exports. The problem is again instability rather than the overall level of the bolivar exchange rate.

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[2] Darryl McLeod and John H. Welch, "Exchange Rate Uncertainty and Economic Growth in Latin America," Federal Reserve Bank of Dallas, Research Paper No. 9338, September 1993.

[3] Ricardo Hausmann and Michael Gavin, 1995, "Hacia Una Economía Menos Volátil," Banco Interamericano de Desarrollo, *Progreso Econômico y Social en America Latina: Informe 1995,* pp. 195-266.

The authorities have established some new institutional mechanisms to reduce the variability of inflation and the inflation-adjusted exchange rate. The new exchange rate band, for example, can manage the exchange rate while reducing inflation in an environment of fluctuating dollar inflows. But once massive flows of dollars enter a country, no exchange rate mechanism can stop a substantial appreciation of the currency. Efforts to sterilize all capital inflows as Mexico did in 1993 can create a large stock of internal debt even when the government has balanced fiscal accounts. The government can take advantage of the dollar inflows to reduce debt service, restructure debt, and preserve sufficient flexibility in monetary and exchange rate policy to weaken the currency later.

Both the Venezuelan Investment Fund's (FIV) debt reduction fund and the government's new oil windfall fund can create a counteracting dollar outflow by buying back external debt. By tempering the inflation-adjusted bolívar's appreciation and keeping public spending tight, these policy innovations could create a stable environment for private investment and help to avoid the boom and bust. The Venezuelan government, however, has not yet completely implemented either mechanism and their effectiveness depends on the willingness of policymakers to utilize them fully.

A number of previous government reforms have taken root and are now bringing dividends. Tax initiatives including introduction of a wholesale sales tax and better tax collection have steadily reduced the importance of oil revenue (Figure 11). In 1994, central government tax revenue from nonoil sources actually exceeded petroleum related tax revenues. Devaluation, trade liberalization, and efforts to develop regional trade during both administrations has led to a steady rise in the share of nonoil exports shown in Figure 12.

OPENING THE OIL SECTOR

The significance of Venezuela's decision to open its oil industry to private investment has gone relatively unnoticed outside the oil industry. Venezuela's state-run oil company PDVSA has already received commitments of $12 billion

Figure 9. **Venezuela Growth and Inflation**

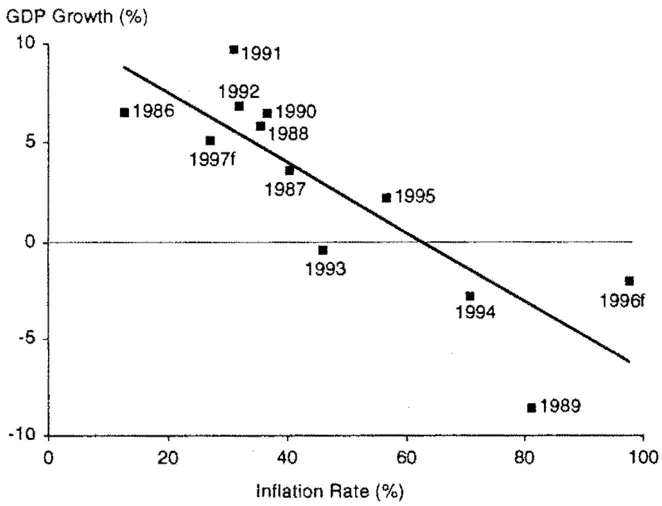
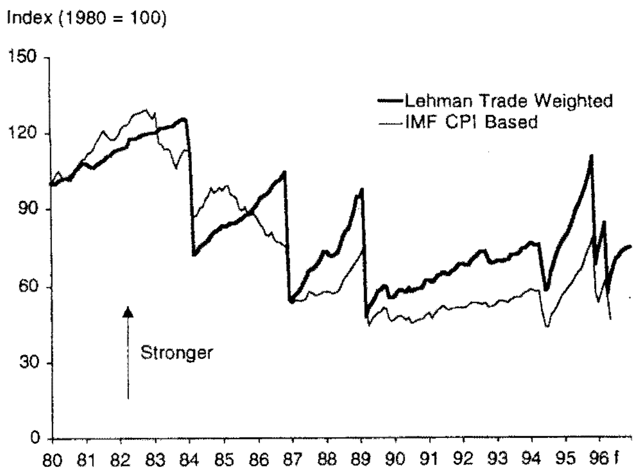


Figure 10. **Venezuela Inflation-adjusted Exchange Rates,** January 1980-December 1996



f=forecast.
Sources: IMF, IFS, and Lehman Brothers.

Figure 11. **Oil Revenues as a Share of Central Government Revenues Declines from 77% to 50%**

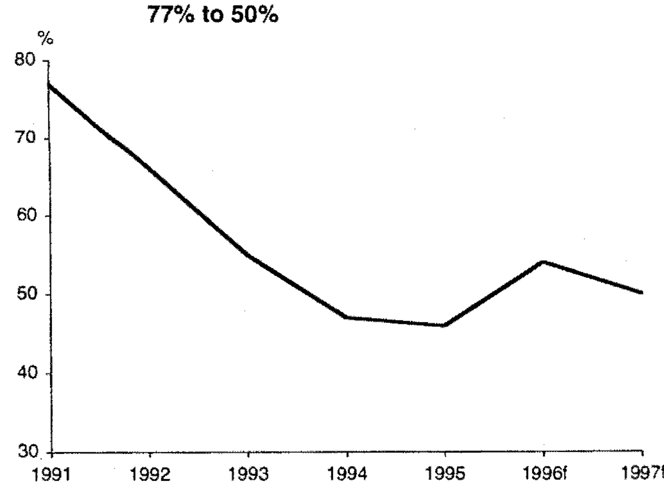


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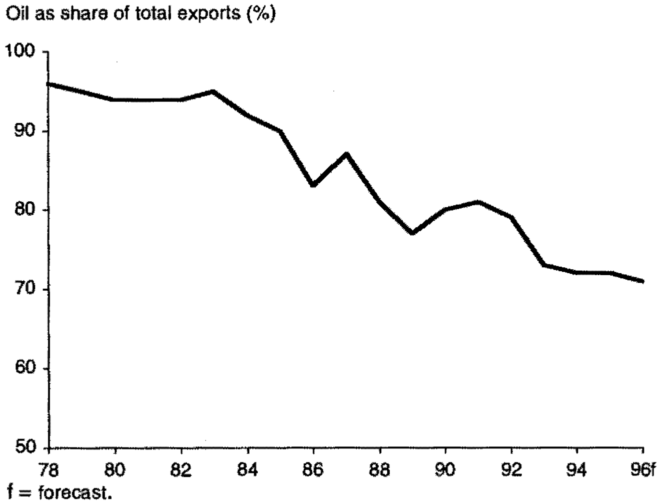
Figure 12. **Dependence on Oil Exports Declines**



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for new oil exploration under profit-sharing arrangements with Mobil, Conoco, Enron, British Petroleum, Nippon, and other international oil companies. It has also signed joint processing and services contracts with Shell, Pennzoil, Occidental, Chevron, Teikoku, Norcen, Amoco, Total, and a number of other petroleum processors. Together these partnerships are expected to generate over $33 billion in new investment over the next eight years, at total PDVSA will match with its own investment. As shown in Figure 13, this new investment in exploration and processing along with other new mineral development projects will add at least 4% of GDP to investment demand over the next three years. Since 50% to 60% of these investment outlays go to domestic suppliers—mainly in the construction sector—these projects alone will add about 2% to GDP growth over the next several years.

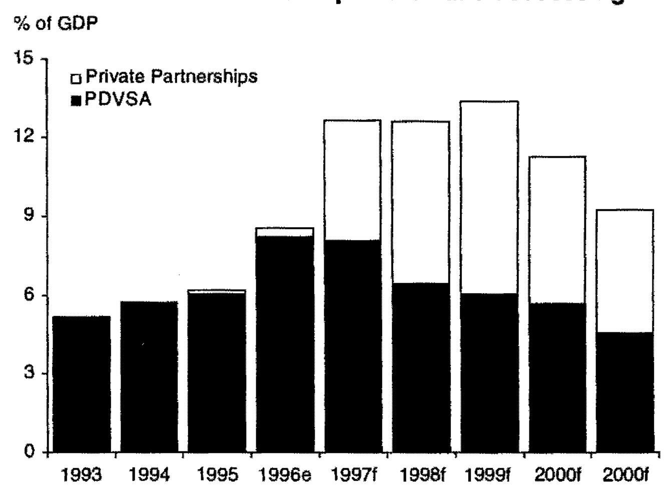
After a period of low investment in the 1980s, the Venezuelan government decided to raise PDVSA's investment budget from 1989 onwards. This higher level of investment paid off quickly as export volume increased from 1.6 million barrels per day (mbd)—about Mexico's rate—to almost 2.9 mbd in 1995. During the same period PDVSA's total sales doubled to $26 billion. Opening PDVSA to foreign investment will reduce demands on public expenditures but continue raising oil production to about 4 mbd by 2005. Rising export volumes will allow PDVSA to generate high oil revenues even at lower oil prices of $13 to $14 per barrel. As shown in Figure 14, even in inflation-adjusted terms, total revenues will reach levels attained during the 1970s oil boom but with higher volumes rather than higher prices.

While Venezuela's oil sector is strong, its banking sector needs major restructuring and reform. The abundance of oil and investment revenue may weaken the government's resolve to restructure the financial system. But turning the current oil boom into sustained economic growth depends upon the government's completing planned reforms of the banks.

DEEPENING FINANCIAL MARKETS: FOGADE AND THE BANKING SYSTEM RESTRUCTURING

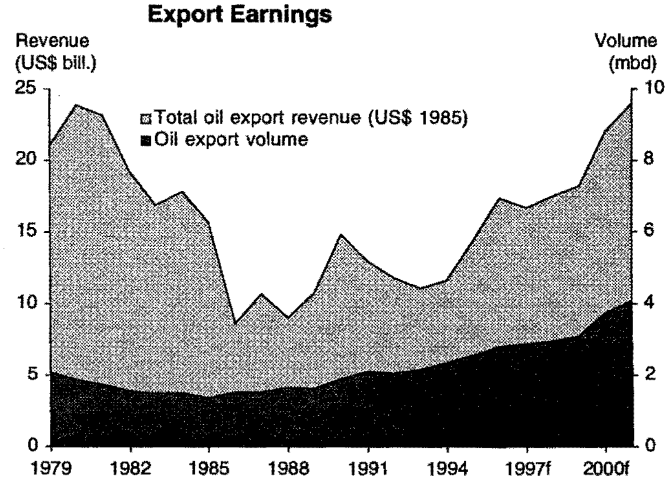
Other Latin American countries have dealt with chronic capital flight problems by developing more efficient local

Figure 13. **Opening the Oil Sector Will Double Investment in Exploration and Processing**



f=forecast, assumes 5% average GDP growth.
Sources: PDVSA and Lehman Brothers.

Figure 14. **The Oil Opening Will Increase Export Earnings**



f=forecast.
Source: PDVSA.

financial markets to keep capital in their own banking systems. Unfortunately, as in the U.S. savings and loan crisis, oil booms can also end with a banking crisis. Similarly, the macroeconomic instability of 1993 and 1994 left Venezuela with the largest bank crisis as a percentage of GDP in the Americas. The deposit insurance fund FOGADE transferred the equivalent of 12% of GDP to problem banks in 1994 and another 4% in 1995 (Figure 15). Assistance to banks has totaled Bs. 2.5 trillion or $5.3 billion (Figure 16). To finance the intervention, the central bank extended to FOGADE low interest loans. Over the subsequent two-year period, central bank lending to FOGADE totaled Bs. 1.3 trillion or around $2.8 billion.[4] FOGADE estimates the total cost of the bailout at around Bs. 2.5 trillion or $5.33 billion. Now that the crisis has subsided, FOGADE must try to recover assets that it now holds through increased collection and reprivatization of the banks. FOGADE President Esther de Margulis expects to recover only 24.5% of the costs or Bs. 623.41 (US$1.3 billion).[5] FOGADE must also seek a rational funding of the costs of the bank assistance program. A good portion of the funding came from the central bank, compromising its ability to conduct monetary policy.

A multitude of events detonated Venezuela's banking crisis in early 1994. But its origin lay in a progression of events that look strikingly similar to prior banking crises such as those in Chile, Argentina, Texas, and Uruguay[6] in the early 1980s and the recent Mexican banking crisis. After the 1989-1990 adjustment program, Venezuela proceeded to remove barriers to entry and exit to its financial system. Lower inflation and exchange rate stability fueled a spending boom and capital inflows. The corresponding expansion of bank credit outpaced the ability of regulators to monitor the situation. The fragility of the banking system's portfolio grew to a point where the system could not weather the political turbulence, and a growing fiscal deficit in 1993 led to capital flight and a run on the banks in 1994. Starting with the high profile intervention in Banco Latino, FOGADE went on to take over the assets of nine banks including Banco Consolidado and Banco de Venezuela, representing one-third of all bank deposits.

[4]The successive devaluations in November 1995 and April 1996 dramatically reduced the U.S. dollar value of the bank assistance given by FOGADE. Before the November 1995 devaluation, the assistance represented $8.1 billion at an exchange rate of Bs. 160/US$, and before the April 1996 devaluation it represented $4.5 billion at Bs. 290/US$.

[5]As reported in "Venezuela Fogade: To Take in 623B Bolivars From Asset Sale," *The Wall Street Journal*, October 1, 1996, and "Cálculos de Fogade: El Estado recuperará 24.5% del costo de la crisis financiera," *El Nacional*, October 2, 1996.

[6]For a general discussion of these crises in the context of international capital flows, see John H. Welch, 1996, "Capital Flows and Economic Growth: Thoughts on Latin America in the 1990s," *Lehman Brothers Global Economics Emerging Markets—Latin America*, July 9, 1996.

FOGADE now faces the task of recovering as many assets as possible and reprivatizing the banks. But its ability to sell these assets has benefited from the repatriation of capital since April 1996 and the profitable performance of remaining private banks. Moreover, Venezuela's high inflation rates of the last three years have decreased the banking system's liabilities in inflation-adjusted terms. FOGADE has already started the privatization agenda that appears in Figure 16.

Figure 15. **Venezuela: FOGADE Operations**
(Bs. billion and % of GDP in parenthesis)

	1993	1994	1995
Total Revenue	27	354	192
	(0.5)	(4.1)	(1.4)
Current revenue	27	61	85
	(0,5)	(0.7)	(0.6)
Deposit insurance premia	10	43	52
	(0.2)	(0.5)	(0.4)
Interest income	17	18	33
	(0.3)	(0.2)	(0.3)
Capital Revenue		293	107
		(3.4)	(0.8)
Transfer from Central Government		293	107
		(3.4)	(0.8)
Sale of Assets			
Total Expenditure	-1	1105	649
		(12.8)	(4.9)
Current Expenditure	0	4	121
			(0.9)
Operational Expenditure		4	2
Interest			119
			(0.9)
Capital Expenditure and Net Lending	-1	1101	528
		(12.7)	(4.0)
Financial Assistance to Banks and Payments to Depositors	-1	1101	528
		(12.7)	(4.0)
Current Balance	27	57	-36
	(0.5)	(0.7)	(-0.3)
Underlying Balance *	27	350	71
	(0.5)	(4.0)	(0.5)
Overall Balance	28	-751	-457
	(0.5)	(-8.7)	(-3.4)

* Overall balance excluding sale of assets and assistance to banks.
Sources: FOGADE and BCV.

Figure 16. **Venezuela: Bank Assistance and Privatization**

	(Bs. billion)	(US$ million at Bs.470/US$)
Total Cost	2,537	5,397.9
Privatizations		
Banco Consolidado	76.3	162.3
Banco de Venezuela	168.6	358.7
Banco Latino	20.0	42.5
Banco Republica	7.1	15.1
Banco Andino	3.0	6.4
Recovered to date	153.7	32.7
Expected recovery	623.4	1,326.4

Source: FOGADE.

In March 1996, FOGADE sold its stake in Banco Provincial and CA La Electricidad de Caracas. In the fourth quarter, FOGADE intends to sell Banco Consolidado and Banco de Venezuela for Bs. 76.3 billion ($162.3 million) and Bs. 168 billion ($358.7 million). Additionally, Banco Latino (Bs. 20 billion or $42.5 million), Banco Republica (Bs. 7.1 billion or $15.1 million), and Banco Andino (Bs. 3 billion or $6.4 million) come up for sale in 1997.

Unfortunately, FOGADE's reprivatization faces a number of legal risks peculiar to Venezuelan banking law that showed up when it tried to privatize Banco de Venezuela. Apparently, FOGADE can sell a bank before giving a full disclosure of assets and liabilities in the courts but must ultimately divulge this information. Until FOGADE completes this process, the courts can impose injunctions to stop the divestiture of a bank. The courts had imposed an injunction on Banco de Venezuela's sale that was subsequently overturned. But FOGADE chose to cancel the auction because the main bidder feared further such actions initiated by either the former owner or those opposed to selling to a foreign bank. In any case, FOGADE moved Banco de Venezuela's sale to November along with the sale of Banco Consolidado. We think that the authorities' will to sell these assets remains strong and that the cancellation reflects complexities of Venezuelan banking law and idiosyncracies of Banco de Venezuela.

The proceeds of the privatization should allow FOGADE to pay down some of its liabilities. But the remaining Bs. 1.9 trillion or $4 billion in liabilities needs restructuring. The 20-year $1.3 trillion loan extended by the central bank at highly subsidized nominal interest rates not only complicates the conduct of monetary policy but also represents the transferral of a fiscal cost directly to the monetary authorities. Venezuela's new policy agenda necessarily includes refinancing these loans to remove them from the central bank's balance sheet.

THE CENTRAL BANK'S BALANCE SHEET AND MONETARY POLICY

The Central Bank of Venezuela's (BCV) balance sheet (Figure 17) contains two asset items that complicate the conduct of monetary policy. The first represents 20-year loans to FOGADE of Bs. 1.3 trillion at subsidized nominal interest rates of 3% for the first 5 years and 5% for the remaining 15 years. With inflation running at 70.8% in 1994 and 57% in 1995, the subsidy to FOGADE and to the receiving banks was substantial. At our projected 102% inflation rate for 1996, the subsidies on these loans become extraordinary. Second, the central bank extended loans to the treasury to finance acquisition of the U.S. Treasury bond collateral for

Figure 17. **Balance Sheet of the Central Bank of Venezuela**
May 31,1996

Assets	(Bs billion)	(US$ billion)	Liabilities	(Bs billion)	(US$ billion)
1-Gold and SDRs	1,839,053	3.91	1-Currency in circulation	468,999	1.00
2-Foreign Currency	657,748	1.40	2-Local Currency deposits and obligations	1,495,136	3.18
3-Foreign Currency Investments	2,195,108	4.67	3-National Treasury	201,578	0.43
4-Foreign Institutions	1,425,415	3.03	4-Venezuela Investment Fund	80,172	0.17
5-Local Currency Loans	149,143	0.32	5-International Agencies	2,214,194	4.71
6-Local Currency Investment (Includes FOGADE)	1,389,714	2.96	6-DEG	214,683	0.46
7-Federal Government	1,341,843	2.85	7-Foreign Currency Deposits and Obligations	1,278,549	2.72
8-Banks and Credit Institutions	4,075	0.01	8-Other Liabilities	204,860	0.44
9-Bank Deposits guarantees	26,213	0.06	9-Deferred Credits	3,160,236	6.72
10-Private agencies	0				
11-Real estate and Physical Plant	46,992	0.10	Total Liabilities	9,318,412	19.83
12-Other Assets	489,452	1.04			
			11-Initial Capital	10	0.00002
Total Assets	9,415,764	20.03	12-Capital Reserves	97,341	0.21
			Total Net Worth	97,351	0.21
			Total Liabilities and Net Worth	9,415,764	20.03
Memorandum Accounts	11,297,015	24.04	Memorandum Accounts	11,297,015	24.04

Source: BCV.

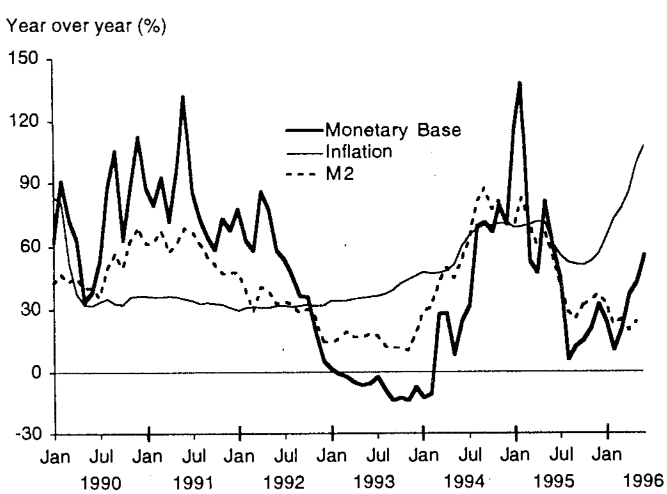
Venezuela's Brady bonds. Both FOGADE and the treasury have gone into arrears on these loans to the central bank.

A central bank accounts for losses on loans through declines in its net worth. Such operations can have two expansionary effects on the money supply. When the central bank concedes loans to FOGADE to finance deposit withdrawals, the money supply increases unless the central bank can issue enough debt to soak up this money. The secondary effect comes from central bank decapitalization—if the central bank incurs losses, it may end up printing money to cover them.[7] Whether a central bank can avoid such secondary money creation or not, investors and households may doubt the asset quality of the central bank and move out of bolivar-denominated securities into dollars and goods. The BCV's having these loans on the books has reduced its credibility in the implementation of monetary policy to lower inflation.

The effects of the banking crisis of 1994 on money growth and inflation appear in Figure 18. Both monetary base and M2 growth went from low rates of expansion to rates close to 100% by the end of 1994. Inflation followed this money growth upward in the second half of 1994 and again in the second half of 1995. Moreover, inflation continued to accelerate despite more moderate money growth rates starting in late 1995. The central bank began reducing money growth by issuing increasing amounts of stabilization bonds (TEMS). But investors and households did not expect these low rates of money growth to continue in the face of high fiscal deficits, a weak banking system, and a central bank whose assets continued to deteriorate. Consequently, investors bought dollars and households bought goods with their bolivares, leading to accelerating capital flight and inflation.

[7]See Paul Beckerman, 1996, "Central Bank Decapitalization," The World Bank, mimeo.

Figure 18. **Monetary Aggregates and Inflation**



Source: IMF, *International Financial Statistics.*

For the recent stabilization efforts of the government to translate into dependably stable prices, persistent capital repatriation, and increasing investment, the central bank must remove these loans from its balance sheet. To do this, FOGADE will have to use the proceeds and new bolivar issues from privatization to retire this debt. The large capital inflow resulting from the initial success of the recent stabilization should allow FOGADE to issue new bonds into the Venezuelan financial system without great difficulty. Moreover, the treasury should use part of its oil windfall in addition to new bolivar bond issues to square arrearages with the central bank.

New bolivar bond issues by FOGADE and the treasury will not only solve problems with the central bank balance sheet. The bond issues will also neutralize the expansionary effects on the money supply of the large capital inflows that the stabilization plan has generated. Issuing bonds to pay back loans from the central bank destroys money and will counteract any money increase from central bank purchases of foreign exchange. Therefore, for the central bank to regain the ability to fight inflation depends upon refinancing these credits off its balance sheet.

WILL VENEZUELA SUSTAIN RECOVERY?

Venezuela has made substantial progress in laying the groundwork for a sustained economic recovery. The current program represents a continuation of a long-term movement away from funding government and private consumption through dependence on oil revenues. The Venezuelan government now has the opportunity to move a step closer to sustained growth by continuing to restructure the public sector through tax reform, pension and severance reform, privatization, and restructuring the banking system.

A weakening of political resolve to continue Venezuela's new agenda due to the initial success of the plan and recent large oil windfall represents the largest risk to long-term recovery. Although the Venezuelan government may pass on some of the reforms, we think it will continue with the most important parts of the program. These include first and foremost privatization, restructuring the banking system, and reforming the public pension and severance pay systems. The stagnation that Venezuela suffered over the past three years persuaded a large majority of the population to support the current adjustment plan and, hopefully, to stick to it.

Darryl McLeod (212) 526-3677/528-5870
John H. Welch (212) 526-1223/528-5866