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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/130

10:00 a.m., August 31, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	H. G. Schneider
	X. Blandin
A. Donoso	
	M. K. Bush
	D. C. Templeman, Temporary
	T. Alhaimus
H. Fujino	T. Yamashita
G. Grosche	
J. E. Ismael	Jaafar A.
	L. Leonard
	G. W. K. Pickering, Temporary
A. Kafka	C. Robalino
	N. Coumbis
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	
	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
M. A. Senior	
	A. K. Juusela, Temporary
	T. A. Clark
Zhang Z.	

L. Van Houtven, Secretary
R. S. Laurent, Assistant

Also Present

European Department: H. Vittas. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Kanesa-Thasan, P. J. Quirk. External Relations Department: C. S. Gardner, Deputy Director. Fiscal Affairs Department: P. Shome. Legal Department: S. A. Silard. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, A. Cheasty, L. E. Escobar, J. Fajgenbaum, M. E. Hardy. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, E. A. Ajayi, H. A. Arias, S. E. Conrado, S. El-Khouri, G. E. L. Nguyen, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, I. Angeloni, R. L. Bernardo, J. Bulloch, M. B. Chatah, Chen J., L. E. J. M. Coene, G. Ercel, G. Gomel, V. Govindarajan, D. Hammann, L. Ionescu, H. Kobayashi, A. Koné, E. Portas, D. J. Robinson, J. E. Rodríguez, A. A. Scholten, Shao Z., S. Sornyanyontr, M. A. Weitz.

1. VENEZUELA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Venezuela (SM/84/192, 8/7/84; and Cor. 1, 8/17/84). They also had before them a report on recent economic developments in Venezuela (SM/84/201, 8/17/84).

Mr. Senior made the following statement:

> The current economic situation and prospects of Venezuela look very much improved since the previous Executive Board discussion of the Venezuelan economy in July 1983 (EBM/83/97). This improvement is clearly the result of the strong adjustment effort that the authorities have been implementing, and underscores their commitment to completing successful redressment in the near future. Just as important, such an effort has been built upon a program basically conceived and structured by the Venezuelan authorities, and which corresponds to the social and political realities of the country. The Fund's assessment of this program and its further advice have been helpful in reinforcing the program's adequacy and consistency. The continuing dialogue between the Fund and Venezuela underscores the authorities' high regard for the Fund's advice, as well as their commitment to bringing about the needed redressment without taxing this institution's already extended resources. This position is quite congruent with Venezuela's traditional stance as regards the Fund, of always contributing quite strongly to strengthening the Fund's resources rather than subtracting from its capacity to financially support other members perhaps in greater need.
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> As indicated in my statement of July 1, 1983 on the occasion of the previous Article IV consultation on Venezuela, the authorities were clearly aware of the need for redressment, and thus were already adopting important measures to restore internal and external equilibrium. The staff report gives a detailed account of the significant improvements in the public finances and balance of payments positions in 1983 that were produced by the measures adopted in February of that year; thus, I shall not dwell at length on such performance. I should mention, however, that the public sector deficit declined from 11.3 percent of GDP in 1982 to 4.7 percent of GDP in 1983, a reduction equivalent to more than 6 1/2 percentage points of GDP in one year; this is by no means an insignificant or even minor adjustment in such a short period. The current account of the balance of payments shifted markedly from a deficit of $3.2 billion in 1982 to a surplus of $3.3 billion in 1983, an improvement of $6.5 billion or 6 percent of GDP in one year, also quite an impressive performance by any standard. While such an outcome admittedly did not signify the complete restoration of external and internal equilibrium in Venezuela by the end of 1983, such a restoration was not the purpose of the measures adopted at that time. The adjustment effort

put into effect in 1983 was meant to be an initial, albeit significant, step to set the basis for further adjustment in the future. The new authorities who came into office at the beginning of 1984 were faced by a still-unsustainable situation, which explains their prompt adoption of new and stronger measures.

Since coming into office, the new authorities have built upon the initial adjustment effort of 1983, strengthening it considerably and even tackling some of the more protracted structural problems of the economy. Thus, they have concentrated their efforts on the most pressing problems of external imbalance, recurrent budget deficits, and the structure and level of the external debt. In this regard, they have considered that an appropriate general framework for the elaboration of economic policy has to be based on the premises that the country must adjust to a lower level of external revenues, and that this adjustment must be achieved in a relatively adverse external environment of high interest rates and reduced Latin American access to the international capital markets. All of this, of course, has occurred in the context of an extended period of stagnation faced by the Venezuelan economy in the past few years, which has resulted in negative or nearly zero growth rates and in a doubling of the unemployment rate to about 13 percent.

To deal with the problem of adjustment in a socially tolerable, and thus sustainable way, the authorities have framed their overall policies and their medium-term economic strategy in the context of a social pact, guaranteeing in this fashion broad acceptance by the different sectors and their support for the stabilization effort. The broad short-term objectives of the Venezuelan economic program may be summarized as follows: elimination of the overvaluation of the currency; elimination of the public sector deficit; price flexibility at a socially acceptable rate; rescheduling of the external public debt; maintenance of an appropriate level of international reserves; achievement of a balance of payments current account surplus; rationalization of domestic prices and consumption of petroleum products; limitation of the financial pressures of devaluation on the productive sectors; and selective stimulation of the economy.

Based on these objectives, the authorities have already adopted a series of significant adjustment measures that should bring about a further reduction in the public sector deficit to zero or even a surplus of about 1 percent of GDP, and a balance of payments current account surplus of between $1.5 billion-2 billion, while keeping inflation at an average of about 15 percent and unemployment at no more than 13 percent. The most significant of the newly adopted measures include a 40 percent devaluation of the bolivar while maintaining, temporarily, a preferential exchange rate for a small portion of basic imports;

an average doubling of domestic prices for petroleum products; a public sector austerity program designed to reduce by at least 10 percent the nominal current expenditure budgeted for 1984; a freeze on wages for most public sector employees; and a commitment by private firms to increase employment by 10 percent and by unions not to seek wage adjustments that would offset the price increases stemming from devaluation. In general, these measures and policies are geared to restructuring relative prices in a context of price stability, through the complementary use of tight fiscal and monetary policies.

The outcome entailed in the above-mentioned policies would signify a substantial adjustment effort in the past two years. As mentioned in the staff report, the nominal effective exchange rate of the bolívar has been depreciated by about 70 percent; thus, the real effective exchange rate has fallen to approximately the level that existed prior to the second oil price hike of 1979-80. This flexible exchange rate policy will continue in the future, as more imports are gradually transferred to the Bs 7.50 rate, and as unification of all controlled exchange rates is achieved by December 1985. Furthermore, taking into account the effect of the adjustment policies adopted, the expected trend in the external accounts, and the implementation of a complementary tight monetary policy, the authorities intend to unify all exchange rates after 1986. Underscoring this commitment, and perhaps moving even faster than originally envisaged, on August 3, 1984 the authorities transferred an additional 136 foodstuff items and 258 pharmaceutical items from the preferential rate to the Bs 7.50 rate. This new transfer represents a reduction of about 60 percent of all items included in the preferential rate, as well as a 20 percent reduction in their value. It is expected that a new transfer will be effected in September, and there is already agreement on about 50 percent of the items that the authorities are to include in such a transfer.

The gradual approach taken by the authorities in the exchange area, through a multitiered exchange system, is a temporary and realistic one. It reflects the peculiarities of production and exports in Venezuela, as well as the conditions needed for broad acceptance of the adjustment effort as a whole, thus guaranteeing its permanence and success. As I indicated in my statement at the previous Article IV consultation, a general devaluation--while normally acceptable--in the Venezuelan case would have been inappropriate, just as a too-fast unification of all current exchange rates would also be inappropriate at present. Oil constitutes practically 95 percent of Venezuela's exports, is government controlled, and does not suffer from profitability problems. A general devaluation is not essentially required for production increases in the oil sector, especially if account is taken of other factors affecting such production. Non-oil exports, on the other hand, are cleared at the free rate, thus creating the appropriate incentive needed for production. The preferential rate basically covers old private sector external debt and some basic imports. This system thus allows the authorities to be selective, shielding some sectors from the most negative immediate effects of a devaluation and helping to reduce pressures for increased subsidies and wages. While such a system can be appropriate at a given time in the adjustment effort, however, the authorities recognize that it might not be a permanent solution; thus it is their intention to unify all controlled rates as previously indicated. This is a subject on which the Executive Board itself has not reached a conclusion, as evidenced by the discussion some time ago on what would be the most appropriate exchange rate policy for oil exporting countries.

In public finances, the elimination of the deficit in 1984 would signify an adjustment of more than 11 percentage points of GDP in two years, and of some 5 percentage points of GDP in the current year. By any standards, this is a significant achievement and underscores the authorities' determination and perseverance. For the years ahead, the authorities intend to keep the consolidated accounts of the public sector in balance, thus returning to their traditional conservative stance in this respect. During 1984 the public finances will benefit from the new exchange situation--as oil revenues will be 40 percent higher than in 1983--even though 40 percent of all exchange profits by law are being retained in the Central Bank of Venezuela. Moreover, steps are being taken to improve tax collection and to introduce reforms in the tax system. Altogether, this will produce a surplus for the Central Government, thus providing the funds needed for debt amortization payments without exerting new pressures that would precipitate further reserve losses. In this regard it is important to mention that the financing needs of the Central Government will remain low, and the authorities will cover them mainly by internal financing while allowing enough resources to meet the financing needs of the private sector. In other words, even in the context of a prudent monetary policy stance--in which M-2 will be growing by less than 12 percent in 1984--the financing needs of the private and public sector will be accommodated without undue pressures on the growth of domestic assets and targeted international reserve holdings.

In another area, the earnings of government enterprises will be increased under a rationalization program that includes improvements in their administrative management and collection procedures, as well as rate adjustments. The current expenditures of these enterprises will be reduced in 1984 and 1985 under the austerity program and through their comprehensive reorganization, as ordered by the Central Government.

Monetary policy will play a complementary role, maintaining a cautious policy stance geared mainly to attaining and safeguarding external equilibrium and of reducing inflationary pressures without impairing economic recovery. In this regard, interest rates will be adjusted in accordance with these objectives, taking into account trends in international financial markets and the need to encourage domestic savings. As mentioned before, the reduced financing needs of the public sector will allow real increases in credit to the private sector, at rates compatible with the growth and inflation targets, as well as those of the balance of payments.

Venezuela has traditionally been highly--perhaps excessively--dependent on imports. To aid in adjusting the economy to a lower level of imports, besides the implementation of prudent demand management policies, the authorities intend to maintain import controls during 1984 and 1985, so that the adjustment effort can be fully guaranteed without speculative or wasteful use of resources. Nevertheless, this control is being handled flexibly and has not given rise to bottlenecks or excessive restrictions. These controls are regarded by the authorities as a temporary mechanism, and as demand management policies take hold there will be less effective need and use for such controls. The authorities expect that by 1986, when exchange rate unification has been accomplished and the industrial sector has had sufficient time to adapt to the new external situation, import restrictions will have been relaxed greatly and more reliance placed on tariff mechanisms.

One of the key areas in which the authorities have concentrated their efforts is that of external debt. Although the problem of external debt is mostly one of liquidity or maturity concentration in a short period--rather than one of solvency or an exaggerated level of debt--it cannot be denied that in current circumstances this problem is a restriction that must be overcome if any adjustment effort is to succeed in the near future. Fortunately, negotiations in this respect have proceeded satisfactorily, and it is now expected that a settlement is near at hand. This has in great part been made possible by the reasonable position adopted by Venezuela, by the progress achieved in adjustment, and by the authorities' firm commitment to continue with that effort. Their determination and perseverance has been amply demonstrated by economic performance, as well as by the comprehensive set of measures and policies put in place. This experience should help them to achieve a successful agreement with the banks on the basis solely of Venezuela's own commitment and their demonstrated capacity to carry out adjustment policies successfully.

The medium-term development strategy of Venezuela has set out the following main objectives: stable and sustained growth of employment and production, centered on private sector activity; balanced external accounts and maintenance of an adequate level of international reserves; promotion of nontraditional exports and import substitution; a noninflationary public sector expenditure policy consistent with the overall objectives; a unified rate of exchange, managed in a flexible way so as to guarantee an appropriate real parity of the bolívar; and a level of external debt consistent with the size of the country's economy.

The above-mentioned objective has been specifically translated into a reduction of the absolute level of Venezuela's external debt. This reduction is to be achieved through the generation of surpluses in the current account of the balance of payments and a small reduction in current international reserves. At the same time, however, an effort will be made to improve the country's access to commercial credit and multilateral and bilateral financing. In this regard, it is important to indicate that Venezuela has presented to the banks a rescheduling proposal that would entail a viable once-for-all solution that would not foresee further rescheduling needs in the future, except of course if exceptionally adverse developments occur in the oil and/or financial markets.

The Venezuelan economy has undergone significant adjustment over the past 18 months, as underscored by the staff report and related figures. The Venezuelan authorities have faced the crisis courageously, undertaking strong measures to overcome it, framing their own adjustment program, and increasingly mastering a difficult economic situation. To date, results have been positive. However, the authorities are conscious that a full restoration of Venezuela's traditional financial stability and economic growth rates requires perseverance and sustained efforts. Thus, they are committed to adopting additional measures if and when needed. Similarly, restrictions will be phased out as appropriate.

In order to carry out this commitment, by Decree No. 247 of August 20, a monitoring system was set up with the establishment of a high-level committee that will report quarterly to the President of the Republic on the country's economic performance. For this purpose, the committee will establish quantitative criteria or reference benchmarks to measure the advances made and to signal the need for corrective actions. For at least the next two years, this firm monitoring of the adjustment process is considered indispensable by the authorities. It is expected that the main structural imbalances that contributed to the crisis will be corrected during that time. This course of action underscores the basic approach of the Venezuelan Government toward adjustment, as a process of continued effort that should not be interrupted until growth rates are re-established in a context of price and exchange stability and sound financial policies.

Mr. Robalino recalled that, during the 1983 Article IV consultation with Venezuela, his chair had been one of the few that had not shared the pessimistic view expressed in the staff appraisal. He was thus pleased that the country had undergone a remarkable adjustment in 1983, with the trend continuing in the current year. He had been particularly impressed by the authorities' plan to maintain strict control over spending: the public sector deficit was projected to decline by 10.5 percentage points of GDP in just two years without any major increase in taxation and with stable or declining oil prices. The Venezuelan authorities were to be commended for the substantial adjustment in fiscal policy in such a short time. Indeed, the budget was expected to be in balance in 1984. A key element in fiscal policy was that wage settlements had been kept free of any official interference. Another factor promoting adjustment had been that Venezuela's price controls had not worked as well as usual and that no major price distortions existed in the economy. He welcomed the flexible interest rate policy and agreed with the staff that a cautious monetary policy was crucial to containing inflation.

In the estimates of the overall public sector balance for 1984, a difference amounting to 2 percent of GDP existed between the staff and the authorities, Mr. Robalino noted. As the explanations presented on page 13 of the staff report seemed unconvincing, could the staff elaborate on the reasons for the divergence?

The staff and the authorities did hold roughly the same view on Venezuela's medium-term prospects, Mr. Robalino stated. Although he was glad to see balance of payments estimates from both the authorities and the staff--such estimates had not appeared in the staff report for the 1983 Article IV consultation--he would be happier if the authorities' projections could be spelled out more precisely than they were in the staff report. He was inclined to agree less with the staff than with the authorities because of their record of being on the cautious side: on the 1983 current account, they had been expecting a deficit of $1 billion, and the final data had shown a surplus of $3 billion. Fortunately, the medium-term balance of payments projections made by the staff indicated that the current rate of imports was consistent with sustained growth. The expected pattern for the debt service ratio was also satisfactory, particularly in view of the large proven petroleum reserves.

He agreed with the authorities that a unification of the exchange rate system was needed, Mr. Robalino continued. The present system was too complex and inhibited confidence in the bolívar, which he hoped would return to its former position as a strong international currency. However, the authorities should move cautiously, taking into account that unification would have adverse effects on the rate of inflation and also that the benefits to Venezuela's exports, if any, were going to be small.

The Venezuelan authorities' should be commended for continuing to provide official aid to countries in Central America and the Caribbean, particularly in the present difficult period, Mr. Robalino remarked. Not having seen the dollar amount of Venezuelan aid listed in the staff report, he would be grateful if the staff could furnish the figure.

The views expressed in the present staff report were more balanced and analytical than those in the 1983 staff report, Mr. Robalino considered. The present restrictions were clearly temporary, and he hoped that the authorities could remove them as soon as possible. Finally, could the staff or Mr. Senior review the progress made in the discussions between the authorities and the commercial banks on rescheduling Venezuela's external debt?

Mr. Clark endorsed the staff appraisal. He welcomed the substantial reduction in Venezuela's consolidated public sector deficit, as well as the turnaround in the current account during 1983. The authorities had taken several steps to deal with the structural problems of the economy, such as reorganizing the parastatals and reducing or eliminating a number of subsidies. They had made considerable efforts to put the economy back on track following the sharp fall in oil exports and in per capita GDP since 1982.

It was encouraging that the authorities had been able to reach agreement on continued wage restraint, despite the sharp fall in real wages during the previous two years, Mr. Clark continued. The agreement also represented a tribute to the commendable realism of labor unions. Given the sharp rise in unemployment during 1983, he could understand the pressures to link wage restraint with a commitment by the private sector to increase employment by 10 percent, but, like the staff, he was concerned about the longer-term effects of such an undertaking, particularly if the rule were to apply to enterprises individually as well as collectively. In order to reduce possible adverse effects on productivity and competitiveness, the authorities ought to allow enterprises to interpret the commitment flexibly.

Although he welcomed the adoption of a more flexible interest rate policy, both borrowing and lending rates would probably become negative in real terms during 1984, because the inflation rate was projected to reach 16 percent, Mr. Clark said. Nominal interest rates did remain higher than those prevailing abroad, but the authorities would have to keep a close eye on the effect of negative real interest rates on domestic savings. In addition, he agreed with the staff that the provision of an interest rate subsidy in the agricultural sector appeared undesirable, especially because pressure on that sector would decrease as food imports were shifted by a more depreciated exchange rate. He would encourage the authorities to eliminate the subsidy as soon as possible.

The continuing increase in the complexity of Venezuela's exchange rate system was disturbing: including the intervention rate, transactions could take place at five different rates, Mr. Clark noted. Despite the authorities' intention to unify most of the fixed rates by the end of 1985--and he welcomed Mr. Senior's statement that they had made some progress in the current month--in the absence of a firm, specific timetable for general liberalization, he agreed with the staff that it would be inappropriate at present for the Fund to approve Venezuela's four-tier exchange system.

The continuing buildup of external arrears, mainly on private sector debt, had contributed to the delays in rescheduling negotiations, Mr. Clark observed. He appreciated the authorities' wish to maintain substantial reserves and to avoid allocating foreign exchange at preferential rates to debtors with substantial foreign assets. Indeed, deposits of Venezuelan nonbanks abroad had been not much less than Venezuela's net international reserves at the end of 1983. Nonetheless, the authorities' concern had resulted in a slow pace of debt authorization and a further buildup of arrears in 1984. Could the staff bring Executive Directors up to date on where authorizations stood at present and also on the prospects that rescheduling negotiations might be completed by the end of September?

In sum, the Venezuelan authorities had taken several important steps to put the economy on a sustainable course and to resolve external debt difficulties, Mr. Clark said. He would encourage the authorities to consider the further measures outlined by the staff.

Mr. Fujino commented that, since early 1983, the Venezuelan authorities had taken some significant steps to adjust the economy following the crisis in external finances in 1982 and early 1983 precipitated by the downturn in the world oil market. Encouragingly, the new Government that had entered office in February 1984 had adopted a set of measures designed to adjust the cost-price structure further and to restrain domestic demand. Among the measures taken had been a 25 percent average devaluation of the bolívar, a tightening of fiscal policy, and an incomes policy based on a wage freeze for most public sector employees. Notwithstanding those impressive efforts, policies in the past 18 months had been largely dependent on transitional mechanisms. He was in general agreement with the staff's assessment.

The authorities' strategy on wage settlements constituted a social pact, whereby wage restraint by unions was linked to an undertaking by private enterprises to pay a transportation bonus and to increase employment by 10 percent over the January 1983 figure, Mr. Fujino noted. The pact appeared to be reasonably well thought out and intended to solve immediate employment problems. At the same time, he agreed with the staff that the Venezuelan authorities should permit some flexibility to enterprises in fulfilling their commitment to increasing employment, so as to avoid distortions in the labor market. On another point, it was understandable that the system of universal price controls should be viewed as part of the social pact and as a counterpart to wage stability. However, as noted by the staff, simplification and reduction in the scope of price controls would be desirable, for the current system might give rise to distortions.

On fiscal policy, the measures being taken by the authorities to increase domestic fuel prices, to restrain public spending, to freeze salary increases, and also to merge, divest, and liquidate certain public sector agencies all seemed to be in the right direction, Mr. Fujino continued. Owing to such measures, as well as to higher petroleum prices and a further reduction in investment in real terms, the overall deficit of the public sector was expected to decline to less than 1 percent of GDP in 1984. As the staff pointed out, however, some additional fiscal measures might become necessary in order to finance the remaining public sector deficit without crowding out the private sector or creating inflationary pressures. He hoped that the authorities could achieve their goal of eliminating the public sector deficit, as mentioned by Mr. Senior. At any rate, he endorsed the staff's recommendation that the authorities should implement a tax reform program along the lines recommended by the 1983 tax reform commission and should also draw up quantitative financial targets for all branches of the public sector.

On monetary policy, Mr. Fujino went on, he agreed with the staff that a cautious fiscal stance would need to be buttressed by tight credit policies and flexible interest rates. As the accumulation of payments arrears on private external debt and reductions in inventories had led to a buildup of excess reserve holdings by commercial banks, the suggestion made by the staff to raise the effective bank reserve requirement further seemed appropriate. He also agreed with the staff and the authorities that subsidized interest rates to agriculture could be eliminated progressively with an increase in profitability for the agricultural sector.

The Venezuelan authorities planned to unify the existing four-tier exchange rate system by the end of 1985, Mr. Fujino noted. He joined the staff in urging adoption of a timetable for shifts toward a unified system, as the present system was causing significant distortions, especially the large subsidy element. The most recent move toward a unified system, as cited by Mr. Senior, was certainly welcome. He would also agree with the staff that quantitative import restrictions represented an inefficient substitute for approaches relying on the price mechanism, and that protection of domestic economic activity could be made more efficient through a reformulation and simplification of the tariff structure. In that respect, the setting up of a commission to propose a restructuring of the tariff system was a step forward. Finally, he agreed with the staff assessment that Venezuela's outstanding arrears were extremely damaging to the country's creditworthiness and that speedier approval of applications for foreign exchange to service debts abroad would expedite the flow of other credits.

Mr. Nimatallah expressed general agreement with the staff's analysis and conclusions. During the previous year and a half, Venezuela's adjustment to lower oil earnings had been substantial. The new authorities were to be commended on their good management in continuing and accelerating the adjustment efforts begun in 1983. As expected, the improvement in the country's financial position had been accompanied by a reduction in imports and also in economic activity. Imports had been halved in 1983 compared with 1982, and they would remain substantially below the 1982 level in 1984, even though they were projected to increase. In 1983, real non-oil GDP had declined by about 5 percent, and it was expected to remain constant in 1984. Furthermore, Venezuela's external indebtedness was high, and debt service would constitute a drain on the country's resources for a number of years. The primary task of economic policy facing the authorities was therefore to achieve sustained economic growth over the medium term while maintaining financial stability. The authorities' medium-term strategy, as outlined by Mr. Senior, showed that they were fully aware of the need for continued adjustment over a number of years.

He welcomed the authorities' intention to achieve small overall surpluses in public finance over the medium term, Mr. Nimatallah remarked. Such surpluses should help to prevent any crowding out of the private sector, thus allowing private sector activity to grow in a noninflationary environment. He also welcomed the authorities' intention to keep current budgetary outlays constant in real terms, while allowing capital outlays for development to increase at an annual rate of about 4 percent in real terms for the rest of the 1980s. The increases should help to enhance capital formation and expand productive capacity, so that growth might proceed.

The emphasis placed on wage restraint since 1982 had been commendable, Mr. Nimatallah considered. Indeed, real wages had declined by 10 percent during the previous two years and were expected to decline again in 1984. The principal reason for the success of the policy of wage restraint lay in the social pact that had developed among business, labor, and the Government. An innovative approach to reducing unemployment, the pact had been designed to hold down wage increases while allowing employment to increase. It could stand as a practical example for other countries searching for ways to tackle unemployment. Although there was a risk that the jobs created might not really be needed, the authorities should maintain the pact while making efforts to avoid creating wasteful jobs.

Since early 1983, the bolívar had been devalued substantially, and the real effective exchange rate had reached about the same level prevailing before the 1979-80 increases in oil prices, Mr. Nimatallah noted. However, the present exchange system was highly complex; simplification would increase economic efficiency and improve resource allocation. He welcomed the authorities' intention to unify the four-tier exchange system by the end of 1985; the recent move of additional food and medical items from the preferential rate to the rate of 7.5 bolívares to the dollar indicated that the authorities were pursuing with determination their efforts at unification. He hoped that they would continue in that direction. In addition, for reasons of efficiency, the authorities would do well to eliminate the quantitative import restrictions gradually.

A speedy and successful conclusion of the negotiations between the authorities and the banks on rescheduling Venezuela's public debt would be important in order to facilitate the task of economic management and to re-establish confidence, Mr. Nimatallah went on. He had been encouraged by Mr. Senior's statement that a settlement of the problem was at hand. He was also encouraged that progress had been made most recently in registering private sector debt and authorizing debt service payments.

As Mr. Senior had indicated, Venezuela highly valued the advice of the Fund but had preferred to undertake adjustment efforts without the use of Fund resources so that they could be available for countries in greater need, Mr. Nimatallah observed. Such an attitude was commendable.

The authorities had recently set up a high-level committee to monitor the performance of the economy and to report quarterly to the President, Mr. Nimatallah noted. He had been pleased to learn that the committee was to establish quantitative yardsticks to measure the progress achieved and to transit signals for corrective actions should the need arise--actions not dissimilar to the financial programming that underpinned countries' arrangements with the Fund. He was confident that the Fund would stand ready to offer any technical advice to the Venezuelan authorities should they request it.

Mr. Schneider commented that, despite the policy measures undertaken in 1983 and 1984, Venezuela's economic situation would remain difficult for some years to come. The dependence of the economy on oil had adversely affected its smooth adjustment. Negotiations with the commercial banks over the consolidation of short-term debt had been continuing since 1981. Uncertainties about external debt policy were another major factor in the present difficult setting. Despite commendable progress in narrowing the deficits of the public sector and the balance of payments, there remained areas of concern--such as the decline in output, a rise in inflationary pressures and in unemployment, capital flight, and unsettled private sector external debt--that had led the authorities to impose a number of internal and external restrictions and controls, which in turn had produced distortions in the economy.

One of the major improvements had been the reduction of the public sector deficit by about 10 percentage points of GDP during the previous two years, Mr. Schneider continued. As the staff had pointed out, however, continuation of such progress during the next few years would have to be based on further fiscal measures, including a tax reform and higher and selective cuts in the planned program of public investment; after all, the decrease in the overall public sector deficit, expected to be less than 1 percentage point in 1984, had been achieved by higher petroleum revenues and lower investment. Furthermore, the imminent need to meet the cost of the exchange rate guarantees on private external debt and the repayment of public debt would both exert strong pressures on budgetary expenditure. Those developments meant that the authorities would need to concentrate on further measures to enhance revenue. Therefore, he welcomed their intention to prepare the legal documentation for the fiscal reforms to be submitted to the Venezuelan Congress.

In monetary policy, the critical areas were the sterilization of commercial banks' excess liquidity, as well as supervision of the banking sector and interest rates, Mr. Schneider pointed out. A recent significant decline in the actual excess reserve holding in the banking sector had been a welcome development, but it should be monitored closely. The financial difficulties of several banks during 1983, attributable mainly to weak loan portfolios, which had required intervention by the banking authorities, demonstrated the need for effective supervision of the banking system. The flexibly managed interest rate system, formalized in June with the aim of encouraging domestic savings and reflecting changes in external interest rates, had been an appropriate measure.

The staff had stressed that subsidized interest rates for agricultural loans were not an efficient way of stimulating the sector, Mr. Schneider remarked. Nonetheless, in 1983 agriculture had contributed almost 7 percent of GDP and generated about 15 percent of employment, figures suggesting that the agricultural sector was suitable for integration into a future balanced economic structure. Could the staff comment on which policies could be used by the authorities, other than the interest rate policy, to stimulate the agricultural sector?

On the external side, Mr. Schneider concluded, he agreed with the staff that the present multiple exchange rate system was complex and was giving rise to severe distortions within the economy. Therefore, unification of the various exchange rates was urgent. He also agreed with the staff that, in the absence of any timetable for liberalizing the exchange system, the Fund should not approve Venezuela's present system.

Mr. Pickering observed that, since 1983, Venezuela had made progress in adjusting its economy to a low inflow of foreign earnings. In particular, speculative capital outflows--as measured by the errors and omissions item in the balance of payments--had reached $5 billion in the three years ended 1983 but were projected to decline to zero in 1984, a good indication of the improving credibility in Venezuela's economic policy. However, it had not yet been fully established, in part because a number of the economic policies implemented had been transitional mechanisms such as multiple exchange rates, exchange and import restrictions, and price controls. He strongly urged the authorities to place greater emphasis on correcting structural imbalances within the economy. As the staff had said, they needed to formulate and clarify their policies by drawing up a quantified financial program and a timetable for eliminating transitional mechanisms, thus providing the necessary coordination of policies and re-establishing confidence in the economy. As Mr. Senior had indicated, the authorities might well act without receiving any financial support from the Fund.

In the fiscal area, the program of restraint underpinning the adjustment effort was a wide-ranging one, covering revenue-raising, expenditure-cutting, and incomes policy measures, as well as reorganization of public enterprises, Mr. Pickering observed. In view of the limited scope for noninflationary domestic borrowing, even after large gains toward restoring budgetary balance, the authorities would have to continue their efforts to increase net revenue. Unfortunately, the long-delayed increase in domestic fuel prices, from $5 to $12 per barrel, still left the new oil price at less than half the price prevailing on international markets. Subsidization of domestic oil consumption to such an extent not only meant forgone public sector revenue, but also inhibited the long-run competitiveness of non-oil sectors. On the expenditure side, the staff's advice to hold the line on public investment during the next few years and to favor export industries along with small-scale infrastructure seemed to offer a desirable balance between promoting fiscal restraint and avoiding adverse effects on gross unemployment. In addition, reform of the tax system, when implemented, could contribute to strengthening public finance.

The authorities should restrain both monetary and credit policies in order to contain inflationary pressures and protect the balance of payments position, Mr. Pickering recommended. Out of concern about the current excess liquidity of banks, he agreed with the staff that the authorities should refrain from injecting resources into the banking system in order to support financial institutions in difficulty, unless they carried out offsetting actions such as increasing reserve requirements.

One positive development in Venezuela had been the adjustment in real wage rates since 1982, Mr. Pickering considered. However, while welcoming restraint in wage demands, he felt uncomfortable with the understanding that private companies should increase employment by 10 percent; the authorities should allow flexibility to companies in fulfilling that commitment.

Considerable adjustment had occurred in the real effective exchange rate for the bolívar since early 1983, Mr. Pickering noted. However, the existing four-tier exchange rate system did appear to be causing significant economic distortions. He urged the authorities to unify the exchange rate system at an appropriate level, at an earlier date than the current target. As to trade, the staff made a strong case for replacing quantitative import restrictions with a new tariff structure. He supported the staff's recommendation to make Fund approval of Venezuela's exchange measures under Article VIII conditional upon development of a firm timetable for liberalizing the exchange system.

With regard to external debt, he agreed with the staff that rescheduling was needed to facilitate economic management and to re-establish confidence in the country's policies, Mr. Pickering went on. Outstanding arrears had had a significant negative impact on the country's creditworthiness, and he urged the authorities to move ahead quickly on registering private sector debts and authorizing debt servicing. An increased effort at adjustment could well lay the basis for a multiyear rescheduling of private debt outside a Fund program. Furthermore, the authorities would have to ensure that interest on public sector debt was kept current.

In conclusion, Mr. Pickering said, a major policy challenge lay in phasing out the mechanisms intended to control prices, exchange rates, and trade that had been set up to deal with Venezuela's pressing external financing problems. Those measures should be replaced by a system more responsive to market forces. It was equally important for the authorities to restructure external debt and eliminate outstanding arrears, thus promoting a restoration of confidence in the economy. Despite a sharp decline in economic activity and the attendant rise in unemployment that had emerged in 1983, the authorities would have to persevere and to intensify their efforts at adjustment.

Mr. Templeman recalled that, one year previously, in commenting on Venezuela's initial adjustment measures--consisting largely of strict controls on prices, foreign exchange, and imports, together with the creation of a four-tier exchange system--his chair had criticized those measures as insufficient and inappropriate. Fortunately, a more positive assessment had become possible. There had occurred a substantial correction of the exchange rate, a sharp drop in the ratio of the budget deficit to GDP, a shift of the current account into surplus, and a slowdown of inflation. Should that progress be maintained and consolidated, and should relations with external creditors be normalized, Venezuela had a good chance of ending a prolonged period of economic stagnation.

Venezuela had chosen to undertake its adjustment program outside the framework of a stand-by arrangement with the Fund, Mr. Templeman noted. In a number of respects, the country's financial problems were limited: it had relatively large reserves and did not need to use Fund resources. Nonetheless, a restructuring of external debt was called for. The staff's generally positive assessment of the Venezuelan adjustment program to date provided a reasonable base for the negotiations under way on a multiyear rescheduling of public sector external debt to commercial banks. However, during the period covered by the rescheduling arrangements, Venezuela ought to continue working closely with the Fund on its adjustment policies. As the staff had said, the authorities should draw up a quantified financial program and a timetable for eliminating transitional mechanisms introduced to protect the balance of payments. Moreover, he hoped that the Government would put into place a program of further structural reforms supporting the macroeconomic stabilization efforts. The overall program could then be reviewed by the Executive Board, perhaps twice a year, so that the targets, policies, and performance could be evaluated and revised as necessary in a consistent manner.

One aspect of Venezuela's financial situation remained disturbing: large-scale private payments arrears were persisting, Mr. Templeman observed. Whatever the complexities involved in the system for registering private sector debt, continued arrears were difficult for external creditors to understand, given Venezuela's large reserves and improved external balances. The result was to undermine unnecessarily Venezuela's creditworthiness, a perception that would only hamper the authorities' efforts to diversify and reactivate the economy. Despite the successes of the adjustment effort, improved relations with external creditors and the normalization of financial flows would occur only when arrears were eliminated.

Venezuela ought to diversify both its overall economy and its exports, Mr. Templeman considered. Development of petroleum resources would no doubt continue to provide an essential economic foundation, but the experience of the past few years demonstrated the vulnerability of single-product economies, even those of petroleum producers. Close cooperation among business, labor, and the Government would be important both in restoring economic growth and also in preserving Venezuela's record of moderate inflation. The unions' decision to subordinate wage demands to employment goals, along with their record of wage restraint in the public sector during the past two years, were promising signs. Nonetheless, was the projected increase in the consumer price index of 16 percent in 1984--compared with some 6.5 percent in 1983--mainly the result of adjustments in the exchange rate and in administered prices? He was glad that price controls would be implemented flexibly, as indicated by staff contacts with the business community. Even though price controls were linked to wage restraint under the social pact, he would urge maximum simplification of procedures and limits on coverage. Moreover, he endorsed the staff's recommendation that the commitment to greater employment made by businesses should be implemented in a realistic fashion.

The authorities were to be congratulated for the large fall--from over 11 percent in 1982 to an expected 1 percent in 1984--in the ratio of the public sector deficit to GDP, Mr. Templeman continued. Although most of that improvement was accounted for by higher revenue, it reflected the correction of some major distortions such as the move to a more realistic exchange rate, with a favorable effect on revenues from the petroleum sector, and also a partial adjustment of domestic prices for petroleum products. Moreover, large cuts had been made in capital expenditure from the unsustainable point reached in 1982, when the authorities had attempted to stimulate the economy through that means. However, he supported the staff's recommendation that the authorities should take sufficient additional fiscal measures to avoid the danger that financing the 1984 public sector deficit and the large amortization payments on foreign debt might crowd out the private sector or cause a resurgence of inflation. For example, the authorities might further increase prices of domestic petroleum products, still equivalent to $12 per barrel or less than half the current world price. Apparently, the most recent fiscal measures did go some way toward reaching the staff's recommended goal of a reduction in the deficit amounting to about Bs 4 billion. Could the staff explain what remained to be done to reach that target?

In the monetary area, he remained puzzled by recent interest rate and exchange rate policies, Mr. Templeman acknowledged. The need to revive domestic investment and avoid large-scale capital outflows made such policies crucial to economic recovery. He was glad that the authorities intended to follow a flexible interest rate policy in order to stimulate domestic savings and avoid capital outflows. As deposit and lending rates should be heavily influenced by market developments, he wondered whether they had become positive in real terms; the authorities should in any event keep administered interest rates under continual review. As to preferential interest rates for agriculture, the authorities had at present a rare opportunity to move toward market rates, as prices for food and agricultural products were moved toward the more depreciated exchange rate. In addition, the authorities' target for M-2 to grow by 12 percent in 1984 represented a substantial slowing of monetary growth from earlier years and should help them to meet their targets for inflation, the balance of payments, and real economic activity.

The significant devaluation in the effective exchange rate for the bolívar had been an important measure, Mr. Templeman remarked, but, as the authorities recognized, it was crucial to maintain that improved international competitiveness through supporting monetary, fiscal, and wage policies. Although a significant devaluation had occurred, problems with the exchange system continued to exist owing to the maintenance of multiple exchange rates. He agreed with the staff that the existing four-tier system was causing significant distortions; the authorities ought to move as quickly as possible to unify the fixed exchange rates and ought to view the end-1985 date not as a goal for unification, but as a final deadline. He would also support a reunification of the fixed and free rates, but the authorities' reference to eventual unification for 1986 seemed vague and uncertain.

As the staff had said, simplification and liberalization of Venezuela's comprehensive trade and payments restrictions would help to improve future growth prospects and help in resisting protectionist pressures, Mr. Templeman commented. Thus, the authorities' clear intent to continue import controls through 1984 and 1985 was particularly disappointing. He agreed with the staff that the Board should not approve Venezuela's exchange measures under Article VIII.

The new Government had taken some positive steps recently, Mr. Templeman remarked. Problems like large-scale capital flight, high fiscal deficits, an uncharacteristic deficit on the current account, and rapid inflation had all been rectified to some extent. The task before the authorities was to take advantage of their successful effort to strengthen and broaden the stabilization effort and to begin to effect structural reforms that would renew growth and diminish Venezuela's future economic vulnerability. He hoped that the Government would move boldly in pursuit of those goals.

Mr. Alhaimus recalled that, during the previous two years, Venezuela had been experiencing increasing economic difficulties that had culminated in a serious crisis in 1983. Since 1980, the growth of output had been stagnant, and it had declined in 1983 following the imposition of severe adjustment measures. The external balance had also weakened in recent years, mainly owing to a large fall in export earnings that had amounted to as much as 10 percent of GDP in 1982 and 1983, when the external debt situation had been aggravated and unusually high fiscal deficits had been incurred. The major factors having contributed to the severe difficulties in Venezuela could be traced to the sharp fall in oil revenues and the uncertainties in the capital markets, although the authorities had readily acknowledged inadequate policy responses in a number of areas. They had made considerable progress in the past year by carrying out strong, realistic measures relying on their own resources.

The measures adopted in February 1983 had eventually resulted in a sharp improvement in public finances, although at the expense of a steep cut in output of nearly 5 percent and a sharp escalation of unemployment, Mr. Alhaimus pointed out. The authorities had brought down the public sector deficit from 11.3 percent of GDP in 1982 to about 4.7 percent in 1983 and expected a further tightening of fiscal policy to yield a small fiscal surplus in 1984. However, if the staff's projection of a deficit of 1 percent of GDP proved accurate, the crowding out of the private sector could prove harmful for the authorities' efforts to activate the economy. Therefore, it was encouraging that the authorities seemed to be contemplating additional fiscal measures, including some urged by the staff, to strengthen public finance and help to ensure that their target of a fiscal surplus for 1984 would be attained.

Considerable adjustment had occurred in the external sector since the strong measures taken in early 1983, including import limitations and a depreciation of the bolívar, Mr. Alhaimus remarked. As a result, the current account had improved by 6 percent of GDP in 1983, moving into surplus by $3.3 billion. In 1984, the surplus was expected to remain large, despite a substantial increase in imports. In addition, the authorities had indicated that transitional mechanisms--including multiple exchange rates, exchange and import restrictions, and price controls--had been used since 1983 for only limited periods, and they had in fact already set specific dates for phasing out such mechanisms.

The exchange rate for the bolívar had already been brought down to below the 1979 level in both real terms and nominal terms, Mr. Alhaimus observed. There was a need to maintain a balanced view of the role of the exchange rate in a country where petroleum constituted 95 percent of exports. As to the related issue of exchange rate unification, he was uncertain why the staff should have gone so far as to assert that fiscal and monetary policies should be geared to achieving unification of this rate. The statement seemed to place undue emphasis on the subject, which the authorities were addressing in a gradual way.

Despite a projected increase in 1984, the rate of inflation remained moderate in Venezuela, in part owing to a responsible incomes policy pursued by the authorities and the labor unions, Mr. Alhaimus said. In response to the difficulties, real wages had declined by 10 percent in 1982 and 1983 and were expected to decline further in 1984. Under the "social pact," wage restraint had been linked to a 10 percent increase in employment by private enterprises. The staff had expressed reservations about such a link on the grounds that a more lasting improvement in employment could be achieved by keeping costs to a minimum. That might be the ideal approach in normal circumstances, but in Venezuela the question was whether a social pact could indeed be concluded without a commitment to increasing employment, especially when the unemployment rate had risen from 6.9 percent in 1982 to 13.5 percent two years later. In a major debtor country undergoing painful adjustment and seeking to win the confidence of capital markets, social harmony could be a crucial factor, as was being made increasingly evident by recent experience. The staff should take that experience into account when judging delicate trade-offs between wage restraint and higher employment.

Mr. Grosche observed that, since the beginning of 1983, Venezuela had implemented a number of measures that had turned around the balance of payments and reduced budget deficits in the public sector. However, the authorities had achieved that progress mainly by restrictions and regulations. Unless changed in due course, the policy would further aggravate the distortions within the economy that had already been a cause for concern during the 1983 Article IV consultation with Venezuela. Such measures did not inspire confidence, nor would they facilitate the debt rescheduling negotiations. They imposed a heavy burden on the country's future prospects for growth and would not contribute to a viable balance of payments position in the medium or long term. He was glad to note that the authorities were willing to regard those measures as transitory and foresaw a gradual reduction in them during the next 18 months. He encouraged the authorities to speed up the reduction, if possible.

As the staff had said, additional measures should be implemented to reduce the overall public sector budget deficit further, Mr. Grosche continued. Perhaps Mr. Senior could give Executive Directors some indication of his authorities' reaction to the suggestions made by the staff, including cuts in public investments, reductions in subsidies, and adjustments in prices for electricity and domestic petroleum products. In addition, the reform of the income tax should be expedited. According to the staff, the reform would be comprehensive, broadening and stabilizing the tax base, and increasing economic incentives as well. So far, variations in capital expenditure had been the principal instrument used by the authorities in adjusting overall government spending, as it would be again in 1984, when the servicing of external debt would increase current expenditure quite considerably. However, might some room for maneuver be created within the current account of the public sector? He would also like to encourage the authorities to go ahead with the system for monitoring public expenditure, which should include public enterprises.

As the authorities had said, monetary policy should be designed to support the adjustment effort and limit inflationary pressures, Mr. Grosche remarked. Would the lowering of interest rates earlier in 1984 serve those aims? Another cause for concern was the high degree of government intervention in the banking sector. Preferential loans for agriculture at rates far below the inflation rate would lead to distortions and might hamper overall adjustment. It might also be advisable for the Central Bank to reconsider its role as lender of last resort; the injection of resources into the system in order to provide relief for ailing banks might jeopardize the overall orientation of monetary policy. In general, he would favor a much more global approach to monetary policy than the one currently pursued in Venezuela. After all, monetary and interest rate policies were not best suited for sectoral purposes.

As to external policies, although Venezuela's international reserves were still comfortable, a decline of more than 40 percent during the previous two years nonetheless presented serious cause for concern, Mr. Grosche remarked. He strongly urged the authorities to unify the four-tier exchange rate system, which was causing significant distortions. The authorities' determination to unify rates by the end of 1985 would be illustrated if they were to adopt a specific timetable for making shifts toward unification at regular intervals, as proposed by the Fund staff. A flexible unified exchange rate would also facilitate the removal of the rigid exchange and trade regulations, which were difficult to administer and cumbersome. Indeed, the disadvantages of a four-tiered exchange rate system, even in the short run, far outweighed any eventual advantages that the system might have.

On wage policy, Mr. Grosche said, he was pleased that the trade unions were willing to reduce their wage claims in order to alleviate the problem of unemployment. In the future, wage restraint would be essential for dampening inflation further, limiting aggregate domestic demand, and making greater resources available for investment.

As the staff and other Directors had noted, Mr. Grosche concluded, without more room for an efficient working of the price mechanism, the future prospects for Venezuela's economy did not look promising. If prices could not respond to market forces or reflect relative scarcities, Venezuela, despite recent improvements, would continue to encounter serious balance of payments difficulties that could negatively influence present and forthcoming negotiations to restructure the country's foreign debt.

Mr. Coumbis expressed broad agreement with the staff appraisal and conclusions. Emergency measures introduced by the authorities in 1982 and 1983 to deal with the balance of payments crisis had been more or less successful: imports in 1983 had been reduced by 50 percent compared with 1982, and the current account in 1983 had recorded a $3.3 billion surplus after a deficit of nearly the same size the previous year. At the same time, the public sector deficit in 1983 declined to 4.7 percent of GDP, compared with 11.3 percent in 1982; the rate of price increase in 1983 fell to 6.4 percent, compared with 10 percent in 1982.

Emergency measures such as controls on prices, imports, and the exchange rate, as well as the four-tier exchange rate system, might be efficient in the short run, Mr. Coumbis recognized. However, in the medium term, they created severe imbalances in the economy and should be abolished. In that respect, he welcomed the authorities' intention to unify all fixed exchange rates by 1985 and to ease import restrictions and rely more on tariff protection by 1986. The authorities ought to move faster on both fronts. The balance of payments crisis had ended, but it was urgent to reactivate the economy in order to adjust the cost/price structure further.

He welcomed the authorities' determination to continue their adjustment policies vigorously in 1984 and beyond, Mr. Coumbis continued. The economy was still facing serious imbalances: in 1983, real GDP had fallen by 5 percent after stagnating in 1981 and 1982, while the unemployment rate had jumped to 13 percent. In the same year, the capital account had continued to register outflows, while an overall deficit had again emerged in the balance of payments, which, although smaller than that in 1982, had been financed through the accumulation of arrears and private sector external debt.

He agreed with the staff that outstanding arrears were extremely damaging to Venezuela's creditworthiness and posed the main obstacle to refinancing both public and private debt, Mr. Coumbis said. Merely the public and publicly guaranteed external debt with commercial banks maturing in 1983 and 1984 would amount to $14 billion. Both the authorities and the staff agreed that tight fiscal and monetary policy accompanied by wage restraint would be necessary conditions for sustained growth in subsequent years. However, there was some disagreement about how long the authorities would continue to apply selective controls on prices, imports, exchange rates, employment, and credits to agriculture; they would prefer to phase out such measures gradually, although the staff recommended immediate action. He agreed with the staff that the authorities should proceed at a faster pace in abolishing selective controls.

As to the medium-term projections, real economic growth in Venezuela could be sustained until the end of the 1980s, with real GDP increasing after 1985 by some 4-5 percent annually, Mr. Coumbis considered. The external debt could be amortized, provided that the authorities continued to apply prudent policies and were able to secure equilibrium in the consolidated private sector accounts, and also provided that $14.5 billion of Venezuela's external debt could be approximately rescheduled. In addition, the projections of export earnings were marked by a large degree of uncertainty because they were seriously influenced by developments in the world oil market. According to the staff's calculations, each change in the price of oil by $1 was equivalent to a change of $500 million in Venezuela's export receipts.

Mr. Donoso said that he was in broad agreement with the staff appraisal. During 1979-82, the combination of real exchange rate appreciation and expansionary fiscal and wage policies, together with the fall in export earnings from petroleum in 1982-83, had precipitated a balance of payments crisis. Since 1983, Venezuela had taken significant steps to adjust its economy. The reported improvement in the current economic situation had been the result of strong adjustment efforts implemented by the authorities. They had already adopted a series of measures such as a cumulative average effective devaluation of the bolívar by 40 percent since early 1983, an average doubling of domestic prices for petroleum products, an austerity program for the public sector, a freeze on wages for most public sector employees, and a general tightening of fiscal and monetary policies.

He welcomed the reduction of the public sector deficit from 11.3 percent of GDP in 1982 to 4.7 percent in 1983, as well as the projected elimination of the overall public sector deficit in 1984, Mr. Donoso noted. Higher revenues from petroleum sales, adjustments in domestic petroleum prices, cuts in operating and maintenance expenditures of the Government and public enterprises, and wage reductions constituted a strong set of measures designed to achieve the authorities' fiscal objectives. They were to be commended for trying to preserve the level of expenditures and investment and to concentrate on current revenue and expenditure. He hoped that the authorities' estimates proved correct and that there was no need to curtail capital outlays.

The authorities intended to pursue monetary policies to complement the fiscal effort and also to engage in interest rate management to protect the balance of payments, Mr. Donoso observed. With the staff, he considered it important to avoid the use of interest rate policies to provide support to specific sectors of the economy; rather, prices should be allowed to direct the allocation of resources. He welcomed the authorities' intention to eliminate gradually the subsidy implicit in interest rates applied to agricultural loans while they shifted agricultural imports to a higher exchange rate and relaxed controls over agricultural prices. Moreover, the authorities ought to be prepared to offset the effects of possible financial support from the Central Bank to troubled financial institutions in order to avoid any potential pressures on the balance of payments or inflation.

He welcomed the improvement in the current account from a deficit in 1982 to a surplus in 1983, which reflected the strength and consistency of the measures applied, Mr. Donoso remarked. The implementation of the present economic policies should make it possible to preserve that improvement, ensure rescheduling of the country's external obligations, and promote a steady reduction in external indebtedness.

For a program to be sustainable, it needed the support of a country's population, Mr. Donoso said. Thus, he understood the importance attached by the authorities to avoiding an excessively drastic elimination of the distortions and rigidities present in the economy. However, he would urge the authorities to consider unifying exchange rates and also eliminating price controls and quantitative restrictions on imports as soon as possible so as not to imperil the growth of the economy. In that respect, they should avoid rigidities in labor practices and should therefore apply flexibly the guidelines for a 10 percent increase in private sector employment. Greater reliance on prices and the elimination of rigidities should favor Venezuela's economic performance. The authorities had defined a comprehensive and appropriate program to deal with their difficulties. He was impressed by the improvement in the external accounts and expected that, with the elimination of distortions being contemplated, the economy would become able to sustain high rates of growth.

Mr. de Vries said that the present Government had done a great deal to put the Venezuelan economy back on track, but full confidence had yet to be re-established, perhaps because of a certain lack of focus in the policy approach. Nonetheless, the budget had been moving close to equilibrium in 1984; the improvement in parastatals had been significant; and the consensus with respect to wage restraint was of significance for the economy's future development.

In certain respects, he agreed with both the staff and the Venezuelan authorities on the approach to be taken to the exchange rate, Mr. de Vries continued. The staff seemed to be arguing that everything would turn out well, as long as the exchange rate was unified and an appropriate budgetary and monetary policy installed, but even then it was uncertain whether the authorities could actually maintain the present freedom of capital transactions taking place at the free-market rate, given the large capital outflows that had been occurring. How could they reconcile the twin objectives of obtaining a unified exchange rate and preserving the freedom of capital movements? On the other hand, he was not fully happy with Mr. Senior's explanation of the authorities' position, which seemed to be that the present complex system was appropriate for 1984 but would no longer be so by 1986. Furthermore, the staff had projected errors and omissions for 1984 to be zero; it might have done better to count on a tendency toward capital outflows from Venezuela and to consider what the probable continuation of such outflows would mean for the country's exchange rate problem.

Another point not adequately addressed in the staff's analysis of the policies in place was the consequences of the predominance of petroleum as an export product in Venezuela, Mr. de Vries said. What were the implications of that predominance for exchange rate policy and, more particularly, for the desired diversification of the economy? Moreover, was the increase in private sector employment by 10 percent intended to stimulate a rise in production by 10 percent? It was unlikely that such an increase would lead to equilibrium in the labor market. Was it then intended that some workers would be hired without producing much? In that event, the commitment would be a scheme to guarantee full employment and public work and was also unlikely to succeed.

As the staff pointed out, the authorities were relying greatly on transitional mechanisms, Mr. de Vries observed; not only in the exchange rate field proper, but also in import restrictions and price controls, they did not seem to suit the medium-term direction of policy. There was also an urgent need to deal with the restructuring of Venezuela's external debt, both public and private. Mr. Senior had mentioned that the harsh international economic climate had been causing difficulties in Venezuela's adjustment. On the other hand, there were international marketing arrangements for Venezuela's main export commodity that were quite favorable and could not be counted upon to remain in place indefinitely. Finally, he could endorse the staff appraisal as well as the proposal not to approve the complicated present exchange system.

Mr. Zhang said that the adjustment programs undertaken by the Venezuelan authorities since early 1983 had been successful in bringing about the intended results in many sectors, particularly in public finance and the balance of payments. Negotiations on external debt had proceeded satisfactorily, and a settlement was expected soon. Moreover, the authorities should be congratulated for having framed their overall adjustment position and their development strategy in the context of a sustainable social pact that corresponded to social and political realities. Their adjustment efforts had been built upon programs conceived and structured by the authorities themselves without using Fund resources.

The staff report did not discuss explicitly the distribution of income, Mr. Zhang noted. In fact, large changes in relative income shares had taken place in 1983, and similar changes were expected in 1984. As indicated by the staff, real wages had declined by some 10 percent during 1982 and 1983, while the unemployment rate had risen by about 4 percentage points, so that the total wage bill had fallen by some 14 percent. In the same period, total real income as measured by real GDP had fallen by only about 4 percent; it was therefore clear that a large redistribution of income had occurred in favor of nonwage incomes. For 1984, real GDP was projected to show no change, but real wages were expected to decline further, as prices were projected to rise by 15-20 percent and no general wage adjustments were contemplated. In addition, the unemployment rate had increased by 4 more percentage points in February and March 1984. Thus, for the year as a whole, a further large fall would occur in the total wage bill as a share of national income. Incidentally, the staff had expressed reservations about the arrangement to seek an increase in private sector employment, an objective included in the Government's adjustment program. What were the implications of those developments? Was it fair that although the initial drop in income had been caused by exogenous factors, the adjustment burden was being borne primarily by wage income? Furthermore, would not such a large continued fall in wage income, by itself, lead to a price and wage spiral if wage earners tried to regain--or at least prevent a further decline in--their relative income share?

According to Table 1 in SM/84/192, Mr. Zhang continued, demand management policies had resulted in a fall in domestic expenditure in 1983, accounted for entirely by the sharp fall in investment; total consumption expenditure, both public and private, had actually increased slightly. As current expenditure by the consolidated public sector had also fallen in 1983, private consumption expenditure must have increased in relation to GDP or perhaps even in absolute terms. If wage income had actually declined, the rise in consumption would mean that spending on consumption by higher-income groups had actually risen or had not fallen adequately as a result of income redistribution and despite demand management policies. For 1984, the staff projected a complete reversal: investment was to increase sharply, while consumption was to decline. Were those targets realistic and attainable?

The staff recommended that fiscal and monetary policies should be geared to achieving unification of the exchange rate, Mr. Zhang observed. In view of the other basic adjustments that would have to be implemented in coming months, was it advisable to set unification of the exchange rate as the main objective of fiscal and monetary policies? Furthermore, in discussing the various tax reforms, the staff seemed not to have given a clear indication whether it would recommend increases in personal and corporate income taxes as a main source of higher government revenue.

As the overvaluation of the bolívar, the most important cause of price distortions, had been fully corrected, Mr. Zhang asked, what were the remaining causes for price distortions? Other so-called transitional measures--multiple exchange rates, exchange and import restrictions, and price controls--formed an integral part of current policies of demand management and had proved effective in realizing balance of payments objectives. Was it advisable to urge the authorities to draw up a timetable for eliminating such measures, something that they had already promised to do when the situation warranted? After all, it was expected that the exchange rates of Venezuela's main trading partners would be volatile and that world oil markets would continue to be subject to uncertainties. Furthermore, was it really true, as the staff said, that confidence in the economy could not be fully restored merely because those transitional measures were still in place?

For the period 1985-90, Mr. Zhang inquired, what were the growth rates and investment ratios being projected by the staff for the Venezuelan economy? What would be the main factors expected to reactivate and sustain the economy after an extended period of stagnation?

Mr. Malhotra said that he was impressed by the progress made by the Venezuelan authorities, particularly the sharp turnaround from a fiscal deficit of 11.3 percent of GNP in 1982 to a small surplus in 1984. At the same time, the current account deficit of the balance of payments had been turned around, and the rate of inflation was in healthy contrast to the high rates encountered in other Latin American countries; the increase in the inflation rate expected for 1984 was largely attributable to changes in administered prices and aftereffects of the large devaluation of the bolívar. The staff's statement that much of the adjustment was anchored on purely transitional measures overstated the significance of such measures. In making adjustment, Venezuela had paid a high price: output had declined, and unemployment had risen. Indeed, the authorities had already initiated substantial steps to adjust, which would have to be pursued for some years.

The authorities intended to keep the budget broadly in balance for several years to come, Mr. Malhotra remarked. He agreed with the staff as well as with several Executive Directors that raising the domestic price of oil products would contribute quickly to improving government revenues and would enable the authorities to maintain a strong fiscal position.

On monetary policy, he agreed with the staff that, especially in the light of the stagnation or decline in output during the past two or three years, the expansion of the money supply had been on the high side recently, Mr. Malhotra went on. There was a liquidity overhang, and he agreed that reserve requirements might need to be tightened. At the same time, a target of 12 percent expansion in the money supply against a likely inflation rate of 15 percent showed that the authorities were going in the right direction, controlling the growth of monetary aggregates relative to inflation. Persistence in that direction should be helpful.

As to wage policy, he noted the beneficial effect of the social compact arrived at among the authorities, private employers, and labor, Mr. Malhotra said. Although he had some questions about the requirement of a 10 percent increase in employment by private companies, the matter should be approached as a whole, for the compact could hardly survive if the authorities accepted suggestions for furthering one element and discouraging another, a point made by Mr. Alhaimus. Still, like Mr. de Vries, he wondered how the authorities were going to ensure that the proposed increase in employment would not result in private companies' or public corporations' carrying staff members who might not contribute to productivity. Could the staff or Mr. Senior throw some light on the subject? If the reduction in expenditure and the advantage that might accrue as a result of wage restraint were being converted into more employees, questions regarding efficiency could well arise. A more pragmatic interpretation of the guidelines on creation of additional employment was needed if adverse effects in the medium term on the performance of the companies concerned were to be avoided.

On the external side, he agreed with Mr. Zhang that one major price distortion had been reduced, Mr. Malhotra remarked. With reference to the staff recommendation that Venezuela's four-tier exchange system should not be approved by the Executive Board, he noted that the objective of unification appeared to be shared by the authorities and the staff. It was merely the speed at which such unification should be brought about that was in question.

As Mr. de Vries had asked whether the interim arrangements for 1984 would be suitable after 1985, Mr. Malhotra recalled that those arrangements were designed to meet an immediate situation; the authorities doubtless foresaw that, as conditions improved, they would be able to do away with them. Therefore, while encouraging the authorities to work toward achieving unification of various exchange rates by the deadline, the Fund should say that it appreciated the problems being faced by the authorities and found the interim arrangements understandable. It should not be forgotten that Venezuela had been able to keep inflation under control, particularly considering developments elsewhere in Latin America. The relative control of inflation had a healthy impact on Venezuela's external account as well as on the possibility of maintaining the social compact that had been arrived at. Nonetheless, he would agree that the authorities should continue progressively to reduce or eliminate some interim measures.

A disturbing feature of Venezuela's external account was the continued persistence of large payment arrears, especially on account of private debt, Mr. Malhotra noted. He shared the view of those who thought that continuing arrears did create some credibility problems for Venezuela. Fortunately, the staff reports showed that the authorities had made progress in registering private debt and that some improvement had become visible in authorizations. Greater progress in reducing arrears and in accelerating authorizations--especially as Venezuela's reserve position looked satisfactory--would further the objective of securing a reasonable restructuring of the country's debt, which was already being negotiated with commercial banks. He would judge the adjustment effort made so far as considerable. Thus, anything that the Fund could do to help the country to obtain reasonable multiyear rescheduling would not only contribute to improving overall perceptions about the debt situation in Latin America but also help a member that had not tapped the Fund's resources but had undertaken a major adjustment effort nonetheless.

Mr. Jaafar commented that he was impressed by the strength of the comprehensive adjustment measures taken by the Venezuelan authorities since 1983. They had brought about substantial improvements in Venezuela's external position and had managed to rein in the previously excessive expansion in domestic demand while maintaining a comfortable level of international reserves and a relatively low rate of inflation. The policy measures adopted had been especially strong and appropriate in reducing the public sector deficit, restraining wage increases, and adjusting the exchange rate. In the meantime, the authorities had adopted a gradual, cautious approach in eliminating rigidities in pricing, interest rates, and the exchange and trade systems. As Mr. Senior had said, such a gradual approach was required to ensure broad acceptance and support by different sectors of the economy for the Government's stabilization efforts and represented a transitory mechanism. He hoped that the authorities would continue to demonstrate steadfastness in dismantling any remaining sources of inefficiency and resource misallocation, so that a sound base could be created for strong, sustained economic growth, coupled with price stability and a viable balance of payments position.

He would appreciate clarification about the staff's position on the Venezuelan authorities' policy of granting foreign exchange at preferential rates for servicing certain public sector debts contracted before the 1984 devaluation of the bolívar, Mr. Jaafar went on. The authorities had stated that such a policy was needed to induce foreign banks to agree to a rescheduling of those debts and to ensure their financial stability, which would have been severely jeopardized by the large exchange rate adjustment. They also felt that the policy would serve to prevent, or minimize, the accumulation of external arrears. On the one hand, the staff expressed concern at the magnitude of the subsidies involved but, on the other hand, emphasized the importance of quickly eliminating external arrears by expediting and streamlining the implementation of the authorities' policy.

He welcomed the authorities' intention to unify the fixed exchange rates by the end of 1985 and to unify the entire exchange rate system after 1986, Mr. Jaafar observed. In the current month, the transfer of many foodstuffs and pharmaceuticals from the preferential exchange rate to the highest rate in the controlled sector, as well as the plan for further transfers in September, furnished proof of the authorities' commitment to the objective of restoring a free, market-determined exchange system. Nevertheless, he joined the staff in encouraging the authorities to accelerate unification and liberalization. First, the present multiple exchange rate system was causing many distortions in resource allocation. Second, with the exchange rate already corrected and demand policies already tightened, exchange and trade restrictions would be not merely unnecessary for balance of payments protection, but also counterproductive. Third, the longer unification was delayed, the higher would be rate at which unification would have to take place, with predictable consequences on prices and wages. In that connection, he noted the staff's suggestion that fiscal and monetary policies should be geared to the unification of the official rates at Bs 7.5 per U.S. dollar by the end of 1985, which, according to the staff, would restore the parity in real terms to the level existing before the 1979 oil price rise, providing that the underlying rate of inflation in Venezuela remained the same as its trading partners'. He was doubtful, however, that unification at that rate would be sufficient, in view of the annual inflation rate of some 15-20 percent projected for 1984 and 1985.

A significant discrepancy emerged between the authorities and the staff in the estimates of the overall public sector balance, Mr. Jaafar noted. The staff projections for 1984 pointed to an overall deficit equal to about 1 percent of GDP, compared with a surplus of 1 percent of GDP in the official estimates. Whatever the cause of the discrepancy, the staff had cautioned that the existence of a public sector deficit of some Bs 3 billion, together with the planned net external amortization of Bs 5 billion, could not be financed without crowding out the private sector or creating inflationary pressures. He was concerned about those developments, especially in the light of the recent weakening of oil prices in international markets. He would appreciate comments from the staff on how the weakening in the price of oil would affect their estimates for Venezuela.

Mr. Blandin remarked that the results obtained in a number of areas had been quite impressive during the previous year. In particular, he welcomed the restoration of the current account surplus, the large reduction in the public sector deficit, and the slowdown of the inflation rate from 10 percent to 6.4 percent. Overall performance during the previous few months, however, appeared uneven, as real GDP growth had been negative in 1983 and substantially lower than the slight positive growth experienced in 1982. As a consequence, the rate of unemployment was still estimated to be quite high. Among the most important problems with which the Venezuelan authorities had to deal, was external debt. The staff had rightly pointed out the need for the authorities to improve the debt profile by obtaining rescheduling "in order to facilitate economic management and re-establish confidence." Although he agreed with the staff on that point, he would reverse the idea by saying that sound economic management and the re-establishment of confidence were also prerequisites for a rescheduling.

A conservative fiscal policy, supported by a more restrictive monetary policy, seemed appropriate, Mr. Blandin considered. The overall public sector was likely to be in equilibrium in 1984. Nonetheless, some more specific measures, such as cuts in subsidies, reorganization of public enterprises, or reform of the tax system, had to be taken. In view of the staff's conclusion that the authorities should keep interest rate policy flexible in order to ensure that domestic interest rates were not out of line with foreign rates, it should be noted that private capital outflows had continued during 1983, whereas the savings ratio--22 percent of GDP--could still be considered correct. Those two developments seemed somewhat contradictory and led him to question how sensitive savings were to interest rates. Actually, it was not that interest rates were too low, but rather that there appeared to be no incentives or possibilities to invest, as shown by the sharp decline in the rate of investment between 1982 and 1983.

Incomes policy had also contributed to the progress achieved so far: successful negotiations with labor unions had brought a decline in real wage rates that had permitted the lowering of domestic demand, Mr. Blandin pointed out. Nevertheless, some clauses in the social pact, such as the transportation bonus and the requirement for private sector companies to increase employment by 10 percent over the levels of January 31, 1984, were a cause for concern because they would impair labor productivity. It should be recalled that, between 1979 and 1983, employment had increased by 8 percent but output had stagnated: in the tertiary sector, real output had declined by 6 percent while employment had risen by 14 percent.

The staff had correctly stressed that transitional mechanisms such as multiple exchange rates, import restrictions, and price controls had flourished during the previous 18 months and were tending to become permanent features of the Venezuelan economy, Mr. Blandin said. Thanks to the adjustment being undergone, a strong case could be made that the elimination of those practices could not but lead to a better allocation of resources and a reduction in the distortions in the functioning of the economy. He welcomed the authorities' intention to unify the four-tier exchange rate system, although he would tend to agree with the staff's view that they should set a timetable for doing so. As for the trade system, he could certainly agree that simplification and liberalization should occur, but he had some difficulty in understanding the exact meaning of the statement on page 12 of SM/84/192 that "the restrictions would be eased and more reliance placed on tariff protection." He would appreciate further information from the staff in order to appreciate the progress represented by such a shift.

The staff projections were highly sensitive to fluctuations in oil prices, petroleum representing some 95 percent of Venezuela's exports, Mr. Blandin concluded. What efforts had the authorities made to diversify exports, and what results could be expected from their efforts? Venezuela had great potential for growth, but, in the short term, some problems still had to be adequately tackled in order to restore the country's creditworthiness. In that connection, the resumption of inflation in 1984 was a worrisome development. In addition, the settlement of pending claims or arrears would be a test for the international financial community. Especially in negotiations affecting debt, the Venezuelan authorities had demonstrated a great sense of responsibility in dealing with the problems of Latin America, and he was confident that they would show the same commitment to resolving the problems of their own country.

Mr. Salehkhou observed that, despite a contraction in real GDP in 1983 and prospective stagnation in 1984, Venezuela's performance had been generally satisfactory: improvements had taken place in the balance of payments, public sector finances, and the containment of inflation. The improvement should be credited mostly to the series of adjustment measures implemented in early 1983, further strengthened by the newly elected Government in 1984. Although debt rescheduling remained unsettled and the country's private and public external debt remained substantial, the strong adjustment measures implemented or envisaged had put Venezuela in a better position to deal with its international obligations. They were also paving the way for a resumption of strong economic growth and employment, in spite of the distortions that might be introduced or intensified by some of the adjustment measures based on controls and restrictions. It was encouraging that the authorities viewed the restrictive measures mostly as transitory mechanisms that should be gradually removed as Venezuela's economic and financial situation improved.

Externally, the problems of foreign debt and payments of arrears continued to exist, Mr. Salehkhou went on, but the current account balance had turned from a deficit in 1982 to a substantial surplus in 1983, with a further sizable surplus projected for 1984. Although a substantial devaluation of the bolívar had eliminated the large appreciation recorded since 1979, the country's performance--achieved despite continued weakness in the world oil markets--had been due principally to a large decline in imports resulting from the restrictions introduced by the authorities as well as their new demand management policies. He had been impressed by Mr. Senior's statement defending the authorities' gradual approach to adjusting the exchange rate. The particular structure of Venezuela's exports--of which 95 percent consisted of petroleum, a commodity fully controlled by the Government--made the case for a general depreciation of the bolívar much less urgent.

As to domestic financial policies, the elimination within two years of an overall public sector deficit equivalent to more than 11 percent of GDP represented a clear indication of the authorities' determination and responsible attitude toward adjustment, Mr. Salehkhou noted. They had achieved fiscal adjustment through a broad set of corrective measures, including more than doubling the prices of domestic fuel, generally reorganizing the public enterprise sector, and imposing considerable restraint on public spending. The reorganization of public enterprises should be particularly bold, encompassing mergers, divestment, and liquidation of inefficient agencies; it should help to return the country to its traditionally conservative financial policies.

As the staff had stated in its report, however, despite the progress toward fiscal adjustment, the authorities would have to carry out additional fiscal measures in order to avoid crowding out credit to the private sector or stimulating inflationary pressures, Mr. Salehkhou suggested. The staff's recommendation of further cuts in planned public investment might have an adverse impact on the authorities' efforts to revive the economy and to halt the expansion of unemployment. However, the ratio of savings to GDP allowed the authorities to embark on a more ambitious investment program without concern for a domestic resource gap. It seemed better to carry out other suggested additional measures, such as the implementation of the tax reform program, the accelerated liquidation of some public enterprises, and upward adjustment of electricity tariffs. At any rate, in view of the excessive liquidity of the banking system, concern about possible crowding out should not be exaggerated.

Wage and price policies had also contributed to the success of Venezuela's adjustment efforts, Mr. Salehkhou remarked. Although sharing many of the staff's concerns about the impact on enterprises' production costs and profitability, he agreed with Mr. Senior that those policies were essential to broadening political support for other components of the program and also to cushioning the adverse impact of adjustment on low incomes. As suggested by the staff, however, the authorities should allow some flexibility to private enterprises in fulfilling their commitment to expanding employment.

Venezuela's performance during the past two years indicated that the broad objectives set by the authorities for the medium term were attainable, and should enable them to reach an early agreement with foreign creditors on realistic and acceptable terms for a long-term one-time rescheduling of external debt, Mr. Salehkhou concluded. Having decided not to seek Fund financial support for their adjustment program, the authorities had maintained contact with the Fund throughout the negotiations with their foreign creditors. Such a position seemed appropriate, as Venezuela had no real need for new lines of external credit, unlike most other major debtors.

The staff representative from the Western Hemisphere Department explained that more than half of the difference, amounting to 2 percent of GDP, between the Venezuelan authorities' estimated outturn on the fiscal accounts and the Fund staff's estimate was due to the different assumptions being used by the staff for the amount of outstanding external arrears and by its assumption that Venezuela would regularize all external arrears on private debt by the end of 1984. Those arrears would be liquidated at the rate of Bs 4.3 to the dollar, and the exchange profits of the Central Bank would be a good deal lower under the Fund staff's assumptions. A second reason was that the staff was taking a slightly less optimistic position than the authorities on the effectiveness of controls on expenditure during 1984.

The amount of Venezuelan aid to Central American and Caribbean countries as shown under the item "international cooperation" in Table 62 in SM/84/201 had been some $176 million in 1983, the staff representative noted. In the staff report for the next consultation with Venezuela, an attempt would be made to provide more detailed information on the recipients of Venezuelan aid.

As for the potential of agriculture in Venezuela, the staff representative continued, the main emphasis so far had been placed on subsidized credit; the staff and the authorities believed that a more appropriate long-term stimulus should be given through appropriate pricing policies. Indeed, in April 1984 the authorities had already raised the domestic price of beef by 40 percent, by no means an easy political decision. Furthermore, the authorities were expected to announce new minimum prices in the near future, which would provide additional incentives. Perhaps the main incentive to agriculture was the depreciation of the exchange rate for the bolívar, which would provide greater protection for locally produced food products. Largely for that reason, the staff would urge the authorities to move even more quickly toward ensuring that the transactions involving agricultural products occurred at a rate of Bs 7.5 to the dollar.

The bulk of the staff's forecast of a 16 percent rate of inflation in 1984 reflected corrective price adjustments and the impact of previous devaluations, particularly in gasoline prices, the staff representative noted. So far, indicators suggested that the annual rate of inflation might turn out to be somewhat below the staff's estimate of 16 percent. Partly for that reason, the staff had recommended that the process of unifying the exchange rates and increasing basic food prices could be accelerated, since there had been an understanding by the unions to accept a certain rate of inflation. Thus, there was a margin for the authorities to move more quickly in adjusting prices without disturbing the social pact.

According to Mr. Templeman, the authorities' projection for a 12 percent increase in the rate of growth of M-2 for 1984 was conservative, the staff representative recalled; the staff would regard the projection as somewhat high. Although it was true that the expected growth of M-2 was lower than in the past and lower than the projection for nominal GDP, much of the rapidly increased buildup in liquidity in 1982 and 1983 had been a counterpart of the external arrears on private debt, which resources had remained blocked in the banking system. It was expected that, with the payment of those arrears, the growth of M-2 should return to its historical trend rate. On the assumption that all arrears were paid, the staff would estimate that M-2 should grow by perhaps 5-6 percent in 1984 rather than by 12 percent. The projection was borne out by the figures for the first half of the year, which showed almost no increase in M-2.

Certain assumptions had to be made in formulating demand management policy, and the target recommended by the staff of unifying the exchange system at a rate of Bs 7.5 did not seem unfeasible, the staff representative considered. However, as the staff papers also pointed out, a flexible approach would be needed eventually; a judgment on the level at which the exchange rates could be unified should be taken in the light of developments in 1984 and 1985, both domestically and abroad.

An appropriate fixed unified exchange rate and freedom of capital transactions were not necessarily incompatible, the staff representative continued, if demand management policies were kept appropiately tight. Nonetheless, the authorities were moving in two stages, so that by 1985 there would be a single unified fixed rate, together with a free-market rate covering most capital transactions that would remain in place for at least another year. At that point, the authorities could judge the compatibility of unifying the two markets.

As to whether the projection of a unified exchange rate at Bs 7.5 per dollar would turn out to be adequate in real effective terms, given the expectation of a 16 percent rate of inflation in 1984, Chart I in SM/84/192 showed that, by May 1984, the real effective exchange rate for the bolívar had been at least 10 percent below the 1979 rate, the staff representative noted. The staff had taken account of expected further inflation in noting that at the end of 1985, the real effective exchange rate would be similar to that prevailing before the second round of oil price increases.

The balance of payments projections for 1984 contained in Table 4 of SM/84/192 did specifically make provision for some further private capital outflows, the staff representative observed. The projection for the private nonbank sector showed a reversal compared with the 1983 estimates, with the staff estimating an outflow of $800 million for 1984 under that heading. The principal improvement in Venezuela's private sector capital accounts for 1984, however, was projected to occur because of the staff's expectation that, once the external debt had been renegotiated and the payment of external arrears had been made, banks would begin restoring lines of credit to the Venezuelan economy. It had been the cutting back of lines of credit in 1982 and 1983 that had deepened what appeared as private capital outflows in the balance of payments statistics.

Real wages might indeed have declined by perhaps 10 percent in 1982 and 1983, while real GDP had declined by some 5-6 percent, but the relevant comparison was real wages and national income, rather than real GDP, the staff representative commented. As Table 27 in SM/84/201 showed, national income in Venezuela had declined by more than 10 percent during 1982 and 1983, suggesting that the adjustment of real wages had been more or less in line with the general adjustment of income in the country. The implication was that the burden of adjustment was being equally shared in Venezuela, instead of resulting in significant changes in income distribution.

The main assumptions for the medium-term scenario were spelled out in Table 6 of SM/84/192, the staff representative explained. The major sources of growth in the future were expected to be import substitution, nontraditional exports, and agricultural products. The projections implied room for increases in real imports; in other words, the external constraint was unlikely to be severe enough to prevent an adequate rate of growth of domestic incomes. The expected improvement in the structure of relative prices, particularly the restoration of an appropriate exchange rate, together with a renegotiation of the country's external debt, should establish the domestic conditions for economic growth to resume in an environment of reasonable internal and external equilibrium. As a number of Directors had pointed out, the projections hinged on the prospects for oil. The staff projections were based on an assumption of production in line with OPEC ceilings and no change in OPEC prices for 1984 and 1985.

At the time of the staff mission to Caracas in May, oil prices, if anything, had been strengthening; there had been some question whether the staff should raise the price projection to be used in the report, the staff representative recalled. Similarly, while oil prices might be displaying some weakness at present, producing countries had been taking steps to ensure that production quotas would be observed. The staff saw no reason to change its assumptions. However, for every $1 change in the price of a barrel of oil, Venezuela's export earnings from petroleum would rise or fall by $500 million. The medium-term projections were based on the assumption that the authorities would stabilize foreign exchange reserves of the Central Bank at the equivalent of nine or ten months' imports. It would be prudent for the authorities to keep such large reserves in case the country had to adjust at some future stage to lower export earnings because of developments beyond its control in the international oil market.

The proposed 10 percent increase in employment under the recently promulgated employment guidelines did not cover public enterprises but only the private sector, the staff representative continued. The base being used was January 31, 1984; unemployment had risen by some 7 percentage points during 1983, so that enterprises were starting from a position of low employment. The important measure would be the growth of total labor costs. Clearly, even with wage stability, a large increase in employment--and therefore in labor costs--would have implications for Venezuela's competitiveness. However, the increase in employment would be most likely to take place in the lowest wage categories, so that an increase in employment by 10 percent would not necessarily result in a 10 percent rise in total labor costs.

The staff had expressed concern about such a heavily subsidized exchange rate for external debt servicing during discussions preceding the 1983 Article IV consultation, the staff representative noted. The authorities had felt strongly that the financial stability of enterprises needed to be preserved, following five years of low growth or stagnation. For enterprises to be suddenly faced with servicing debt at a rate of Bs 16 to the dollar--the free-market rate at the time--from Bs 4.3 to the dollar would represent a tremendous burden, and the authorities were concerned about safeguarding the financing integrity of enterprises and financial institutions. As the new Government was also committed to giving enterprises the preferential rate, the staff regarded the issue as closed and had made no specific comments on the wisdom of such subsidies in its latest report. Nonetheless, the future costs of that policy would not be negligible by any means, and the authorities would need to take account of them specifically in future financial planning.

The main areas of export diversification had been in heavy industries--particularly aluminum and steel--using cheap hydroelectric power, the staff representative remarked. In 1980, for example, the aluminum industry had increased production substantially as a new production unit had been completed. Further expansion was expected during the next few years. As for the steel industry, like other developing countries, Venezuela had been encountering serious difficulties in finding markets for steel exports.

The staff did not have direct information on the debt rescheduling discussions, the staff representative from the Western Hemisphere Department concluded. Nor did it have more recent information on the process of private sector debt registration.

The Deputy Director of the Exchange and Trade Relations Department, in response to Mr. de Vries and Mr. Alhaimus, explained that the staff could not be confident that there was a single exchange rate that, of itself, would serve all purposes. Clearly, as one commodity accounted for nearly all export receipts, an exchange rate that satisfied the requirements of the petroleum sector might well not satisfy the rest of the economy, so that some fiscal intermediation had to take place. Similarly, in the capital account, there should be other policies besides the exchange rate policy in order to equilibrate capital flows, assuming that was what the authorities intended. As Executive Directors had expressed widespread support for the view that the segmented exchange market in Venezuela had been unhelpful to the country, and as there was a consensus among the authorities about the need to unify the rates, the only question remaining was the speed at which unification would take place. Policies aiming in that direction should put Venezuela back into the position of using fiscal and monetary policies as the fundamental weapons to regulate the economy and inflation, thus enabling a unitary and stable exchange rate to become possible.

Mr. Senior observed that the economic and financial situation of Venezuela appeared to have greatly improved since the previous Article IV consultation: substantial adjustment had taken place as a consequence of strong and courageous measures adopted by the authorities. Perhaps the most salient feature of their current adjustment effort was that they had conceived it as structural and implemented it on their own, thus accurately reflecting the social and political realities of the country. That characteristic, together with the favorable performance that had been taking place, should guarantee the continuation of adjustment in the future as well as the prompt implementation of the adjustments in the present program if circumstances should warrant. During the next few years, they should also demonstrate to Venezuela's creditors that they were serious about promoting adjustment and quite capable of implementing it without any need for an external supervisory body to guarantee or monitor the expected outcome. The recently established high-level committee would monitor economic performance under the program and the implementation of the required adjustments, should they be needed.

Although substantial adjustment had already taken place, his authorities were well aware that the restoration of internal and external equilibrium in Venezuela was not yet fully completed, Mr. Senior said. Some progress had been achieved by the use of transitional mechanisms under the gradual approach chosen by the authorities, who stood ready to adopt additional measures if necessary. Nevertheless, they considered the program already in place to be sufficiently comprehensive and firm to achieve the objectives set. The restoration of equilibrium was a difficult task requiring perseverance; it could not be compressed into a short period without risking explosive repercussions that would in the end invalidate the process itself. Nor could the authorities draw it out too long without running the risk of increasingly stronger measures to deal with widening imbalances. The path chosen by the Venezuelan authorities had proved to be the correct one for carrying out sustained efforts that ought to lead to complete redressment of the economy.

Many Executive Directors had referred to the pledge by enterprises to raise employment by 10 percent, suggesting that it might be well to allow some flexibility in carrying out that pledge, Mr. Senior recalled. His Venezuelan authorities had always favored flexible handling of specific policies, taking into account the particular circumstances in each case. Nevertheless, the specific pledge to raise employment played a key role in defining what had come to be called the social pact in Venezuela. For the adjustment effort to succeed, various sectors would have to give it broad backing, so that the burden of adjustment should not fall unduly only on one or two sectors while others benefited from it. Only under an economic program calling for fiscal and monetary discipline along with wage restraint could Venezuela's traditional stability of prices and the exchange rate be re-established. The authorities' commitment to expanding employment was essential to the maintenance of the social pact and thus to the success of the adjustment program.

Only two days previously, Mr. Senior remarked, he had been in New York with the team negotiating Venezuela's external debt. Substantial progress had been made, and a settlement was at hand, which ought to be beneficial for all parties involved. His authorities were aware of the negative effect arising from outstanding arrears, and they were moving as fast as possible to eliminate them promptly.

The general timetable for exchange rate unification in the future represented a transitional mechanism that had been put in place to avoid the most immediate effects on prices of certain products in order to seek the full backing that was needed for the social pact, Mr. Senior concluded.

Furthermore, one characteristic of production and exports in Venezuela was that a devaluation of the bolívar would not bring about major increases in production in the short term. In the long term, the authorities considered that the current complicated exchange system would bring about many problems that would greatly outweigh any benefits obtained in the short run. Thus, he did not find the authorities' use of transitional exchange mechanisms to be contradictory.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal.

Directors warmly welcomed the significant steps taken by the authorities to adjust the Venezuelan economy. A major improvement had been secured in public finances, and the real effective exchange rate of the bolívar had been restored to the level prevailing prior to the 1979 oil price increase. These policies had contributed to a considerable strengthening in the current account of the balance of payments to a surplus position. Directors encouraged the Venezuelan authorities to continue in their efforts at monetary, fiscal, and wage restraint in order to consolidate the gains already made in adjusting the economy. Directors welcomed the efforts made to tackle structural problems, particularly to improve the operations of the parastatals and to reduce certain subsidies, and they noted the success of the authorities in holding down inflationary pressures.

Directors observed that in spite of the adjustment measures adopted, confidence in the economy had not been fully restored. Directors were of the view that this was in part the result of what they saw as an excessive reliance on transitional mechanisms to protect the balance of payments. These mechanisms included a four-tier exchange rate system as well as exchange and import restrictions. In addition, confidence had been affected by the unsettled situation in respect of private sector external debt.

Directors commended the authorities on their wage policy and noted particularly the cooperative attitude of the social partners in that area. They emphasized the importance of wage restraint in the re-establishment of price and exchange rate stability. A number of Directors expressed reservations, however, about the longer-term consequences of the authorities' requirement that private sector enterprises increase employment by 10 percent, and they counseled flexibility in the implementation of that requirement in order to keep cost increases to a minimum.

In regard to fiscal policy, Directors commended the reduction in the budget deficit by the equivalent of some 10 percent of GDP in 1983-84 to near balance. They underlined the need for continued efforts to strengthen fiscal policy, particularly in view of the inflationary pressures, in view of the need to avoid crowding out private investment, and in view of the constraints stemming from external debt amortization payments. Directors welcomed the measures taken in the area of domestic petroleum prices, but noted that domestic petroleum prices still remained well below international levels; hence, further fuel price adjustments would be useful. While spending would need to be curbed further, Directors also believed it advisable to proceed with the reform of the tax system to ensure diversification of the revenue base.

Directors agreed that a cautious fiscal policy would need to be supported by tight monetary and credit policies, especially in view of the excess liquidity built up in the economy. In this connection, they noted the appropriateness of further raising bank reserve requirements and of pursuing a flexible interest rate policy that would assure that rates were positive in real terms and in line with rates abroad. Directors counseled the authorities to phase out the subsidy on agricultural loans and to use instead the price mechanism to foster growth in the agricultural sector.

Although Directors noted that the price control system needed to be viewed in the context of the social pact, they expressed concern that its application would give rise to distortions. Directors were of the view that the authorities should liberalize the control mechanism as soon as possible to encourage the efficient diversification of the economy.

Directors were concerned about the large distortions that resulted from Venezuela's extremely complex four-tier exchange system. While they welcomed the authorities' intention to unify the fixed exchange rates by the end of 1985, they urged that this should be seen as a firm deadline, and they encouraged the authorities to adopt a timetable for that purpose. Directors also urged the authorities to make a start in the process of relaxing quantitative import restrictions and prohibitions, as well as in the simplification and rationalization of the tariff structure, with a view to returning to the trade liberalization policies that had been interrupted in 1981.

Directors stressed the need for a rescheduling of Venezuela's external debt in order to facilitate economic management and to re-establish confidence. In that regard, Directors underlined the urgency of completing the process of registering the private debt and of authorizing debt service payments in order to eliminate the large and disturbing stock of external payment arrears. Directors were particularly concerned by the continuation of arrears on private debt despite the improvement in the external position and the existing level of reserves. They urged the prompt elimination of these arrears, which were hampering the restoration of confidence and the creditworthiness of the country. Directors reiterated that the Fund should stand ready to assist Venezuela in its efforts to reschedule the debt. A number of Directors encouraged the authorities to draw up a quantified financial program and a schedule for the elimination of arrears, controls, and other transitional mechanisms. This would help to reinforce confidence in economic policies and facilitate the normalization of Venezuela's relations with its creditors and its efforts to reschedule the debt. The Fund could play a useful role in assisting Venezuela in this task.

Directors commended Venezuela's development assistance, particularly in alleviating the financial burden of oil imports in the balance of payments of several countries in Central America and the Caribbean area.

It is expected that the next Article IV consultation with Venezuela will be held on the standard 12-month cycle.

The Executive Directors concluded the 1984 Article IV consultation with Venezuela.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/129 (8/29/84) and EBM/84/130 (8/31/84).

2. EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation concerning the representation expenses of Executive Directors as set forth in EBAP/84/176 (8/17/84).

Adopted August 30, 1984

3. 1984 ANNUAL MEETING - EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation concerning representation expenses at the time of the 1984 Annual Meeting as set forth in EBAP/84/177 (8/17/84).

Adopted August 30, 1984

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to an Executive Director as set forth in EBAP/84/184 (8/23/84).

Adopted August 29, 1984

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to an Executive Director as set forth in EBAP/84/186 (8/27/84).

Adopted August 30, 1984

6. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 84/39 through 84/41 are approved. (EBD/84/224, 8/22/84)

Adopted August 29, 1984

b. The minutes of Executive Board Meetings 84/42 through 84/44 are approved. (EBD/84/225, 8/24/84)

Adopted August 30, 1984

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/187 (8/28/84) is approved.

APPROVED: May 30, 1985

JOSEPH W. LANG, JR.
Acting Secretary