FOR AGENDA

EBS/89/107
Supplement 1

CONFIDENTIAL

June 7, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Venezuela - Staff Report on the Request for an Extended Arrangement

Attached for consideration by the Executive Directors is the staff report on Venezuela's request for an extended arrangement (EBS/89/107, 5/26/89), which will be brought to the agenda for discussion at an early date to be announced. Draft decisions appear on pages 33 and 34.

Mr. Elson (ext. 8477) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

VENEZUELA

Staff Report on the Request for an Extended Arrangement

Prepared by the Exchange and Trade Relations and
Western Hemisphere Departments

(In consultation with the Fiscal, Legal,
and Treasurer's Departments)

Approved by S. T. Beza and Eduard Brau

June 6, 1989

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I. Introduction

Discussions on an economic program to be supported by an extended arrangement for Venezuela were held in Caracas during April 17-28, 1989 and at Fund headquarters during May 12-23, 1989. 1/ The Venezuelan representatives in these discussions included the Minister of Finance, the Minister of Planning, the President and First Vice President of the Central Bank, the Minister of Development, the Minister in Charge of the Venezuelan Investment Fund (FIV), and other senior officials. Mrs. Filardo, Executive Director for Venezuela, participated in the discussions.

The Government's medium-term economic program is described in a letter from the Venezuelan authorities dated May 24, 1989 (EBS/89/107) in which they request a three-year extended arrangement in an amount equivalent to SDR 3.7 billion (270 percent of quota), equivalent on an annual basis to 90 percent of quota. The authorities have requested that a proportion (25 percent) of the resources to be made available under the requested arrangement be set aside to support debt reduction operations. They have also indicated that they intend to request an additional 40 percent of quota for interest support in connection with debt or debt service reduction operations. The exceptional circumstances clause under the enlarged access policy may need to be invoked in granting additional access.

Upon approval of the arrangement, an initial purchase of SDR 246.87 million would be available to Venezuela followed during the first year of the arrangement by four purchases of the same amount after August 15, 1989, November 15, 1989, February 15, 1990, and May 15, 1990 conditional upon observance of applicable performance criteria. A review on the progress made in securing external financing is to be completed prior to the availability of the second purchase, and a special review on interest rate policy is to be concluded before October 31, 1989. Reviews of the program supported by the extended arrangement would be made on a six-monthly basis beginning in January 1990.

Full use of the requested amount under the extended arrangement would raise the Fund's holdings of Venezuelan bolivares from 125 percent of quota at end-May 1989 to 389 percent of quota at the end of the period of the proposed arrangement (Table 1). The staff believes that the proposed access level is appropriate in view of the strength and amplitude of Venezuela's adjustment effort and its balance of payments need; the policies adopted by the authorities and the medium-term prospects give assurances that Venezuela will be able to meet its obligations to the Fund.

1/ The staff members participating in these discussions were R. A. Elson (Head), H. Ghesquiere, G. Le Fort (all WHD), A. de la Torre (ETR), J. Martelino (RES) and A. Eyzaguirre (Secretary-WHD).

Table 1. Venezuela: Purchases and Repurchases During Extended Arrangement

	1989				1990				
	April	May-June	July-Sept.	Oct.-Dec.	Jan.-Mar.	Apr.-June	July-Dec.	1991	1992
				(In millions of SDRs)					
Transactions under tranche policies (net)	342.9	246.9	246.9	246.9	246.9	246.9	617.2	1,234.4	531.5
Purchases	342.9	246.9	246.9	246.9	246.9	246.9	617.2	1,234.4	617.2
Ordinary resources	342.9 1/	246.9	246.9	246.9	246.9	246.9	617.2	68.6	—
Borrowed resources	—	—	—	—	—	—	—	1,165.8	617.2
Repurchases	—	—	—	—	—	—	—	—	85.7
Ordinary resources	—	—	—	—	—	—	—	—	85.7
Borrowed resources	—	—	—	—	—	—	—	—	—
Total Fund credit outstanding (end of period)	342.9	589.7	836.6	1,083.5	1,330.4	1,577.2	2,194.4	3,428.8	3,960.2
				(In percent of quota) 2/					
Transactions under tranche policies (net)	25.0	18.0	18.0	18.0	18.0	18.0	45.0	90.0	38.8
Total Fund credit outstanding (end of period)	25.0	43.0	61.0	79.0	97.0	115.0	160.0	250.0	288.8

Source: Fund staff estimates.

1/ First credit tranche purchase.
2/ Venezuela's quota is SDR 1,371.5 million.

The present request for an extended arrangement is the second arrangement requested by Venezuela since it became a member of the Fund in 1945. (A one-year stand-by arrangement for SDR 100 million was in effect in 1960, but no purchases were made thereunder.) Venezuela made a purchase of its first credit tranche in early April 1989 following the Board's discussion of the Government's economic program for 1989 (EBS/89/34) and the conclusion of the 1989 Article IV Consultation with Venezuela (EBM/89/34, 3/29/89). At that time Venezuela's restrictions evidenced by external debt service arrears and multiple currency practices were approved until July 5. The staff's review of recent developments through the end of 1988 and policy prospects, including an assessment of the Government's economic program for 1989, was contained in EBS/89/34, Supplement 1 (3/14/89) and SM/89/57 (3/22/89).

Since May 1985 consultations with Venezuela have been held on semiannual basis under the Enhanced Surveillance procedure. In the letter of the authorities mentioned above, the Government of Venezuela has requested that this procedure be terminated upon approval of the proposed extended arrangement.

II. Background

Following two years of substantial adjustment in 1984-85 in response to the decline in oil prices, Venezuela shifted to financial policies aimed at expanding demand in an attempt to promote a recovery of output and employment. This policy shift coincided with a further sharp drop in oil prices in 1986, and although a higher rate of growth was achieved, major internal and external imbalances developed that the authorities tried to address by intensifying direct controls.

In 1988 both the overall public sector deficit (including the exchange losses of the Central Bank) and the external current account deficit widened to approximately 8 percent of GDP. The 12-month rate of increase in consumer prices rose from 12 percent in late 1985 to 35 percent in December 1988. Over the same time period, net official international reserves declined by US$9 1/4 billion, and gross reserves fell to five weeks of goods and services at the end of 1988. At the same time, the value of the bolivar in the free exchange market rose to around Bs 35 per U.S. dollar compared with Bs 14.50 per U.S. dollar in the main controlled market.

In February 1989, a newly elected administration adopted a comprehensive adjustment program which was described in a Memorandum on the Economic Policies of Venezuela (EBS/89/34). To restore external viability and establish the conditions for sustained economic growth, the program designed by Venezuela called for a major strengthening of the public finances, exchange rate and interest rate flexibility, a liberalization of price controls and trade reform.

From the outset, the Venezuelan authorities framed their program with a view to obtaining Fund support under an extended arrangement. Executive Board approval of a first credit tranche purchase at the end of March 1989 was seen as a signal of early support by the international community of the Government's adjustment effort until structural reforms were more fully defined.

During the period February-April 1989, a number of key policy actions were implemented by the Venezuelan Government.

(1) On March 14, the Government eliminated the multiple exchange rate system and established a unified, market-determined exchange rate that applies to all transactions with the exception of the settlement of exchange rate guarantees for certain import and private debt service payments outstanding before the adoption of the new exchange system. Since mid-March, the value of the bolivar in the new unified market has fluctuated within a range of Bs 35-38 per U.S. dollar which is close to the range of fluctuation of the bolivar in the previous free exchange market prior to the exchange reform. It is estimated that as a result of the recent exchange reform, the bolivar depreciated in real effective terms by around 50 percent (Chart 1).

(2) Under transitional arrangements that will be in effect for the remainder of 1989, the Government announced on March 13 guidelines for the settlement of administrative exchange rate guarantees on certain import-related obligations that had been granted during 1988. Guarantees on imports authorized at an exchange rate of Bs 7.50 per U.S. dollar are to be fully honored. Also, guarantees on imports authorized at an exchange rate of Bs 14.50 per U.S. dollar will be fully honored provided that the imports cleared customs before end-May 1988. For imports landed after June 1, 1988, the proportion of imports paid at the guaranteed exchange rate is to be reduced by one sixth a month. Imports landed after November 1, 1988 would be settled at the unified market exchange rate prevailing at the time of payment. Under these arrangements, the total value of exchange rate guarantees accepted by the Central Bank for the period April-December 1989 amounted to US$2.7 billion, or roughly 50 percent of pending obligations.

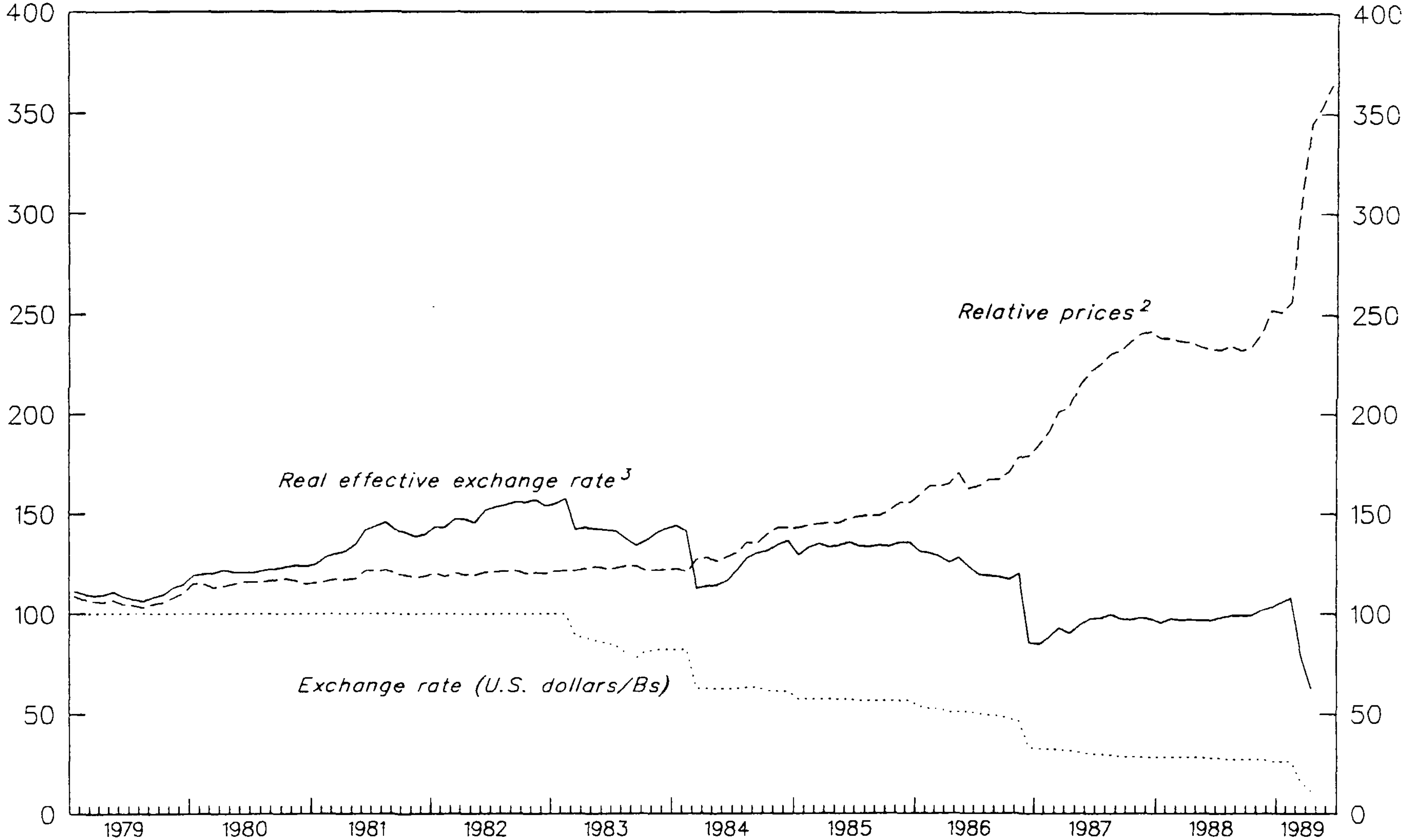
(3) On February 17, the Central Bank abolished the system of interest rate ceilings. As a transitional arrangement, the Central Bank and banking institutions agreed to limit the maximum lending rate to 28 percent a year (and the central bank rediscount rate to 23 percent) until March 13. As of that date, interest rates were unrestricted; however, on April 7 the Central Bank re-established a minimum deposit rate of 23 percent and a maximum lending rate of 35 percent for the banks as a result of a ruling of the Supreme Court on March 27 that the earlier abolition of interest rate controls was unconstitutional. On May 4, the Central Bank raised the minimum and maximum interest rates for the banking system by 2 percentage points.

CHART 1

VENEZUELA

EXCHANGE RATE DEVELOPMENTS[1]

(1974=100)



Source: Staff calculations.

[1]Weighted by 1980 import shares of principal trading partners. A decrease in the index represents a depreciation. Since February 1983 weighted averages of multiple exchange rates are used.

[2]Index of Venezuelan home goods prices divided by index of partner countries export unit value.

[3]Based on relative prices (footnote 2) in a common currency.

(4) On February 26, domestic prices of petroleum products were increased by an average of around 110 percent. In addition, on March 1, the list of essential goods subject to price control was reduced from 55 to 18 basic items. At the same time, the prices of goods on the reduced list were raised, on average, by 38 percent.

(5) A number of public enterprise tariffs were raised on April 1. In the case of the electricity companies (CADAFE and ENELVEN), commercial and industrial tariffs were raised by 65 percent, while residential tariffs were raised by 35 percent. It was also announced that beginning in May these tariffs would be adjusted upward on a monthly basis by rates of around 5 1/2 percent and 3 percent, respectivly, for a period of two years. The program of tariff adjustments just mentioned would bring electricity charges in line with long-run marginal costs plus a reasonable return on equity at the end of the period. On April 1, the prices of aluminum products sold in the domestic market were raised by 70 percent; also in April, prices of other goods sold by export enterprises (steel, iron ore) were raised, on average, by 60 percent. As a result, domestic steel prices were brought to within 30 percent of international prices and aluminum prices approximated international price equivalents.

(6) On March 1, urban minimum wages were raised by 50 percent to Bs 4,000 per month and public sector wages were adjusted according to a sliding scale starting at 30 percent for the portion of wages below Bs 5,000 per month and ending at 5 percent for the portion of wages exceeding Bs 10,000 per month. In addition, a general increase of Bs 2,000 in the monthly wage was decreed for private and public sector employees subject to collective bargaining contracts and a four-month freeze on lay-offs was imposed. It is estimated that public sector wages rose by an average of around 45 percent as a result of these adjustments.

Following two months of a relatively low rate of price increase, consumer prices jumped by 21 percent in March and 13 percent in April. On a 12-month basis, the rate of price increase accelerated from 35 percent in December 1988 to 94 percent in April 1989. This rate of price increase significantly exceeded that originally projected under the economic program, which can be explained by the concentrated impact of the economic policy adjustments described above (which as regards controlled prices were larger than originally planned), delays in the implementation of trade liberalization measures and some speculative activity surrounding the outbreak of violence in the first week of March 1989.

In other respects, the preliminary outturn for the first quarter of the year was reasonably close to the benchmark projections that were set out in EBS/89/34. The net international reserves were above, and the net domestic assets of the Central Bank below, the respective targets of the program at the end of March 1989, excluding the effect of interest arrears (US$386 million) on external debt to foreign commercial banks which is subject to negotiation. The emergence of these arrears, which were not contemplated initially in the program, may be attributed to higher than projected import payments in respect of goods ordered last year and lower capital inflows. During the first quarter of 1989, apart from the emergence of arrears, Venezuela maintained a comfortable margin below the external debt limits of the program.

The combined deficit of the Central Government and exchange losses of the Central Bank exceeded the program limit, mainly because of an administrative delay in final income tax returns for last year and the impact of the special Bs 2,000 a month wage adjustment for workers subject to collective bargaining which was not contemplated in the program (Table 2). 1/ In addition, the exchange losses of the Central Bank were larger than programmed because of the cash payment of pending exchange guarantees on imports. However, this excess was more than offset by a better outturn for the National Petroleum Company (PDVSA) and other state enterprises, reflecting higher than projected realized oil prices and delays in the start-up of investment projects. As a result, the combined deficit of the reduced public sector and the exchange losses of the Central Bank was below the program limit by Bs 2,378 million.

III. The Medium-Term Policy Framework

The Government of Venezuela's medium-term adjustment framework was outlined in the Economic Policy Memorandum which was circulated to Executive Directors in early March 1989 (EBS/89/34). This strategy is designed to restore high rates of growth of output and employment in an environment of low inflation and balance of payments viability, and is oriented to achieve a fundamental restructuring and diversification of the economy. These objectives are to be achieved through the implementation of sound financial policies and structural reforms that will strengthen national savings, encourage private investment (including the participation of foreign capital), and increase economic efficiency. In addition, these policies and reforms would increase the foreign trade orientation of domestic production, reduce Venezuela's dependence on oil, and expand the scope of private sector exports.

The Government's program also envisages a significant reduction in the country's external debt burden. To this end, Venezuela has embarked on discussions with its commercial bank creditors on a financing package to include various operations that would result in significant reductions in both external debt and debt service payments. At the same

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1/ In the original program, wage increases for public sector workers subject to collective bargaining were to be negotiated during the year according to the expiration of existing contracts. Instead, the Government in consultation with the labor and employers' associations decreed a once-and-for-all increase which replaced regular contract negotiations.

Table 2. Venezuela: Targets and Outturn for First Quarter 1989 Under Economic Program

	Targets	Prel. Results	Margin (+) /Excess (-)
	(In millions of U.S. dollars)		
Stock of net international reserves	4,994 1/	5,063 2/	69
Public sector short-term external borrowing	--	--	--
Public sector medium-term external borrowing			
1-5 years	30	--	30
1-12 years	30	386 3/	-356
	(In millions of bolivares)		
Borrowing requirement of the reduced public sector	4,010	1,632	2,378
Borrowing requirement of the Central Administration	265	14,159	-13,894
Stock of net domestic assets of the Central Bank	-82,700 1/	-85,799 2/	3,099
Stock of reserve money 4/	57,100	55,965	1,135

Source: EBS/89/34 and Venezuelan authorities.

1/ Original targets adjusted to allow for data revisions and changes in foreign reserves of the Venezuelan Investment Fund.
2/ Excludes increase in interest arrears on reschedulable public external debt.
3/ Increase in interest arrears on reschedulable public external debt.
4/ Indicative target.

time, Venezuela is seeking increased access to new resources from official bilateral and multilateral creditors.

1. Overall macroeconomic objectives

Over the medium term, the Government of Venezuela seeks to establish the conditions for a sustained expansion in output and employment opportunities in a manner that reduces the country's dependence on petroleum exports. The growth in real non-oil GDP is expected to be around 4 1/2 percent a year, as a minimum, by 1992-93 in the Government's low-growth scenario and around 6 percent a year in the alternative historical growth scenario. 1/ This expansion in output would originate primarily in the agricultural and mining sectors, where Venezuela is endowed with abundant natural resources and export potential, and in manufacturing the focus of which is expected to shift from import-substitution to exports. Consistent with the process of opening up the economy to foreign competition, the domestic rate of inflation is targeted to decline significantly over the next few years to approximate that of Venezuela's major trading partners (Table 3).

It is estimated that achievement of the growth targets of the Government's medium-term program, taking into account the efficiency gains of the proposed economic reforms, would require an increase in gross domestic investment from around 20 percent of GDP in 1988 to 26 1/2 percent of GDP in 1992-93. In order to finance this expansion in investment in a manner consistent with a strengthened balance of payments position, gross national savings would need to nearly double as a percent of GDP over the same time span. It is expected that most of the projected rise in national savings would be derived from a strengthening in the public sector finances which would shift from an overall deficit position to a surplus position over the next few years. This improvement would also make possible a significant expansion in private sector investment.

2. Structural reforms

Over the next few years, the Venezuelan authorities will be implementing significant structural reforms in the public sector, trade, and financial areas which seek to (a) reduce the scope of public sector activity in the economy; (b) enhance the efficiency of resource use by giving greater play to international competitive forces; and (c) broaden the scope and depth of financial intermediation. These reforms would complement actions already taken by the Government to liberalize investment regulations and limit the scope of price controls.

1/ During the period 1951-78, total GDP and non-oil GDP in real terms rose at an average annual rate of around 6 1/2 a year, and 9 1/2 percent, respectively. In the decade 1979-88, these growth rates dropped to around 1 percent.

Table 3. Venezuela: Medium-Term Macroeconomic Targets

	Actual		Projections 1/			
	1987	1988	1989	1990	1991	1992
	(Percentage change)					
Output and prices						
Real GDP	3.0	4.2	-2.7	3.9	4.6	5.4
Of which: non-oil GDP	3.6	4.6	-3.0	4.0	5.0	6.0
GDP deflator	41.4	19.4	80.0	27.6	15.0	11.2
Consumer prices						
Year-end	40.3	35.5	62.2	18.2	12.0	10.0
Money and credit						
Total bank credit	30.9	72.2	46.2	30.9	22.7	21.9
Broad money	23.6	23.1	45.1	33.2	25.6	24.8
Reserve money	17.1	21.5	40.0	30.0	22.5	21.8
	(As a percent of GDP)					
Gross domestic investment	24.3	20.3	14.5	20.0	24.5	26.5
Public	12.6	13.7	10.4	13.1	13.5	13.5
Private	11.7	6.5	4.1	6.9	11.0	13.0
Gross national saving	21.7	12.2	11.2	17.1	21.6	23.1
Public	7.4	6.0	6.5	13.1	14.0	14.5
Private	14.2	6.2	4.7	4.0	7.6	8.6
Public sector borrowing requirement	5.2	7.8	4.0	--	-0.5	-1.0
Revenue	26.6	23.3	28.7	32.6	33.1	33.1
Expenditure	31.8	31.1	32.7	32.6	32.6	32.1
Central government deficit	5.7	5.4	4.3	-0.2	-0.3	-0.7
External current account deficit	2.6	8.1	3.3	2.9	2.9	3.4
Total external debt	68.2	59.0	78.8	83.2	86.7	86.2
Debt service 2/	44.6	47.0	57.5	52.9	48.4	46.6

Source: Venezuelan authorities.

1/ Based on historical growth ("high growth") scenario.
2/ As a percent of exports of goods and nonfactor services.

(a) Public sector reform

The Government's public sector reform is designed to facilitate the achievement of overall fiscal balance by means of significant changes in public sector pricing (including domestic prices of oil products), improvements in public enterprise efficiency, and a reform of domestic taxation.

In the area of public sector pricing, the authorities have adopted a policy that public enterprise prices (including domestic fuel prices) should be set according to economic criteria, i.e., export opportunity prices in the case of tradable goods and long-run marginal cost in the case of nontradable goods and services. In line with this policy, since February 1989, the Government has raised public utility tariffs and the domestic prices of exportables produced by public enterprises and of fuel derivatives sold by the National Petroleum Company (PDVSA). In addition, the Government has established certain formulas to ensure that prices of steel, iron ore, and aluminum are maintained approximately in line with international price equivalents, while in the case of electricity and telecommunications monthly tariff adjustment will be carried out over the next two years to bring these prices in line with long-run marginal costs of the respective enterprise. In the case of oil products and fertilizers, the plan is to raise the domestic prices of these goods to approximate export opportunity cost levels over a period of three years.

Coupled with the price reform just described, the Government intends to improve the efficiency of the public enterprise sector through the application of better cost-control systems and strengthened management practices. In addition, the Central Administration's oversight of public enterprise operations has been increased through the creation of an interministerial committee to monitor developments in the enterprise sector. It is also the Government's intention to streamline the public enterprise sector by divesting certain entities which it is judged to be more profitable under private ownership. The authorities have already begun the privatization of certain financial institutions controlled by the Central Bank and a number of tourist hotels are being considered for public sale. Before the end of 1989, the Government expects to develop a formal plan of divestment with technical assistance from the World Bank. In some cases, it is expected that foreign and domestic private investors would be sought as majority partners in existing enterprises (e.g., in the Guyana region).

In the tax field, the Government is preparing a revision of the income tax system and the establishment of a value-added tax. With technical assistance from the Fund, 1/ the authorities have begun the preparation of legislative changes which would be submitted to the National Congress around the end of the year with a view to implementation by mid-1990. The income tax reform would be aimed at improving the efficiency and equity of the system by means of a reduction of income brackets, a rationalization of deductions and exemptions, and possibly the integration of the corporate and personal tax regimes. The value-added tax (which is likely to be of the consumption variant) would significantly broaden the small base of indirect taxes which now exists (mainly specific and ad-valorem duties on alcoholic beverages and cigarettes) and provide a potentially important domestic revenue base for the future. According to tentative calculations, a 10 percent VAT would yield the equivalent of 3 percent of GDP on annual basis.

(b) Trade reform

The authorities are planning to launch in June 1989 a fundamental revision of the trade regime, entailing the elimination of import duty exemptions and quantitative import restrictions, a reduction in maximum duty rates and a simplification of the tariff rate structure over time. At the same time, export controls will be abolished, import monopolies accorded to certain public enterprises will be terminated, and a duty rebate scheme for exporters will be established. As a first step, in June 1989 the authorities plan to remove quantitative restrictions on the domestic manufacturing industry (some 2,000 tariff items), to eliminate all duty exemptions, and to reduce the maximum tariff rate from around 135 percent to 80 percent while reducing the number of tariff rates from over 100 to 8. 2/ Over the next four years, the maximum tariff rate will be gradualy reduced to 20 percent and the number of tariff rates to 4.

For the time being, the agricultural sector is not covered by the trade reform, but it is the intention of the authorities to bring this sector within the orbit of the new trade regime at a later stage on the basis of studies to be carried out over the next several months with technical assistance from the World Bank. Also, the Government has indicated that it intends to seek membership in the GATT in 1990.

The proposed changes in the trade regime represent a fundamental revision of Venezuela's trade policy which traditionally has been oriented to the promotion of import substitution through the protection of domestic industry and agriculture. Together with a flexible exchange

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1/ A technical assistance mission comprising Mrs. Casanegra-Jantscher (Head), Mr. Silvani (both FAD), Professor A. Harburger, Mr. Medina (both consultants), and Ms. Montero (Secretary-FAD) visited Caracas for discussions on tax reform in the period March 22-April 8, 1989.

2/ The initial impact of the tariff reform is expected to result in higher public sector revenues because of the elimination of import duty exemptions and the substitution of tariffs for quantitative restrictions on consumption goods.

rate policy, the trade reform is expected to generate strong incentives for export development.

(c) Financial sector reform

In the financial sector, the authorities intend to embark on a number of legislative and institutional reforms to improve the efficiency of financial intermediation and protect the soundness of the financial system. During the rest of this year, the authorities plan to complete a study of the General Banking Law with a view to proposing legislative changes to the congress which would simplify the operation of the monetary policy instruments and make more uniform the application of financial regulations among different categories of institutions. In this endeavor, the authorities have indicated in their letter of intent that they would like to request technical assistance from the Fund. The legislative revisions to be developed also are expected to reduce existing barriers to entry of new institutions, including for foreign banks. Finally, the role of the superintendent of banks would be strengthened with a view to facilitating enforcement of changes in the management and operations of weak financial institutions.

3. Medium-term external outlook

(a) Balance of payments scenarios

Over the medium term, the Government's economic program aims for a significant improvement in Venezuela's balance of payments position, on the basis of the adjustment measures being put in place this year, a recovery in international oil prices and the mobilization of exceptional financing in connection with the requested extended arrangement from the Fund. 1/

During 1989-90, the current account deficit would be reduced significantly. However, under the Government's historical growth scenario it would tend to widen in future years as the growth in real non-oil GDP recovers to around 6 percent. Following a sharp contraction in 1989, imports would recover at a faster pace than real GDP during 1990-92 owing to the expected expansion in investment, some rebuilding of inventories, and the marked reduction in trade barriers being contemplated. Exports are projected to grow strongly over the medium term, with oil exports expanding at a steady pace and non-oil exports responding to the incentives of the economic program. In line with recent WEO assumptions, realized prices for Venezuelan oil exports are projected to rise from US$14.76 a barrel in 1989 to US$16.53 a barrel in 1992, and US$18.32 a barrel in 1995 (about 4 percent growth a year, on average). Oil export volume is projected to expand at a similar pace. Non-oil, private exports are projected to expand by around 10 to 15 percent a

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1/ The Government's low-growth and historical high-growth scenarios for the balance of payments are summarized in Table 4 and presented in more detail in Appendix IV.

Table 4. Venezuela: Medium-Term Balance of Payments and External Debt Scenarios

(In billions of U.S. dollars, unless otherwise indicated)

	1987	Prel. 1988	Projected 1989	1990	1991	1992	1993	1994	1995
Historical Growth Scenario									
Current account	-1.3	-4.7	-1.6	-1.4	-1.5	-1.8	-2.2	-2.5	-2.8
(As percent of GDP)	(-2.6)	(-8.1)	(-3.3)	(-2.9)	(-2.9)	(-3.4)	(-3.7)	(-3.9)	(-3.9)
Exports, f.o.b.	10.6	10.1	10.5	11.7	12.8	13.9	15.2	16.7	18.3
(Private exports volume growth)	(-24.5)	(-7.9)	(10.0)	(10.0)	(12.5)	(13.5)	(14.5)	(14.5)	(14.5)
Imports, f.o.b.	-8.8	-10.9	-8.2	-9.0	-10.1	-11.2	-12.5	-14.0	-15.5
(Import volume growth)	(7.2)	(16.0)	(-27.5)	(6.4)	(7.0)	(6.9)	(6.9)	(6.6)	(6.0)
Interest payments	-2.9	-3.1	-3.9	-4.0	-4.1	-4.4	-4.7	-5.0	-5.3
Other (net)	-0.2	-0.8	—	-0.1	-0.1	-0.1	-0.2	-0.3	-0.4
Capital account	0.2	-0.1	-3.2	-2.1	-1.4	-1.2	-1.6	-1.6	-1.7
Direct investment	—	0.1	0.2	0.3	0.3	0.4	0.4	0.5	0.6
Long-term capital	-1.6	-1.5	-0.7	-0.9	-1.0	-0.7	-1.1	-1.2	-1.5
Short-term capital	1.8	1.3	-2.7	-1.5	-0.8	-0.9	-0.9	-0.8	-0.8
Overall balance	-1.1	-4.8	-4.7	-3.5	-2.9	-3.0	-3.8	-4.1	-4.5
Net international reserves (increase -) 1/	1.1	4.8	-0.1	-0.4	-0.6	-0.8	-0.9	-0.9	-1.0
Of which: IMF (net)	—	—	1.4	1.4	1.6	0.7	-0.3	-0.4	-0.5
Financing gap	—	—	4.8	3.9	3.6	3.9	4.7	5.0	5.4
Rescheduling	—	—	1.8	1.9	1.9	1.9	2.2	2.3	2.5
Private capital reflows	—	--	1.0	1.2	0.9	0.9	0.9	0.9	0.9
New money/bonds	—	—	2.1	0.8	0.8	1.0	1.6	1.8	2.1
Total external debt	34.4	34.1	37.4	40.1	43.6	46.8	49.2	51.6	54.3
As percent of GDP	68.2	58.9	78.8	83.2	86.7	86.3	82.7	79.1	76.0
Debt service 2/	5.0	5.2	6.6	6.8	6.8	7.2	8.2	8.8	9.5
As percent of exports GNFS	44.6	47.0	57.5	52.9	48.4	46.6	48.7	46.9	45.9
Non-oil GDP growth	3.6	4.6	-3.0	4.0	5.0	6.0	6.0	6.0	6.0
Lower Growth Scenario									
Current account	-1.3	-4.7	-1.6	-1.4	-1.3	-1.4	-1.6	-1.7	-1.8
(As percent of GDP)	(-2.6)	(-8.1)	(-3.3)	(-2.9)	(-2.6)	(-2.6)	(-2.7)	(-2.6)	(-2.5)
Exports, f.o.b.	10.6	10.1	10.5	11.7	12.8	13.9	15.1	16.4	17.8
(Private exports volume growth)	(-24.5)	(-7.9)	(10.0)	(10.0)	(10.0)	(10.0)	(10.0)	(10.0)	(10.0)
Imports, f.o.b.	-8.8	-10.9	-8.2	-9.0	-9.9	-10.9	-12.0	-13.2	-14.4
(Import volume growth)	(7.2)	(16.0)	(-27.5)	(6.4)	(5.6)	(5.2)	(5.4)	(5.2)	(4.7)
Interest payments	-2.9	-3.1	-3.9	-4.0	-4.1	-4.4	-4.6	-4.8	-5.0
Other (net)	-0.2	-0.8	—	-0.1	-0.1	--	--	-0.1	-0.1
Capital account	0.2	-0.1	-3.2	-2.1	-1.5	-1.2	-1.6	-1.6	-1.7
Direct investment	--	0.1	0.2	0.3	0.3	0.4	0.4	0.5	0.6
Long-term capital	-1.6	-1.5	-0.7	-0.9	-1.0	-0.7	-1.1	-1.2	-1.4
Short-term capital	1.8	1.3	-2.7	-1.5	-0.8	-0.9	-0.9	-0.9	-0.9
Overall balance	-1.1	-4.8	-4.7	-3.5	-2.8	-2.7	-3.2	-3.3	-3.5
Net international reserves (increase -) 1/	1.1	4.8	-0.1	-0.4	-0.6	-0.8	-0.9	-0.9	-0.9
Of which: IMF (net)	—	—	1.4	1.4	1.6	0.7	-0.3	-0.4	-0.5
Financing gap	—	—	4.8	3.9	3.4	3.5	4.1	4.2	4.4
Rescheduling	—	—	1.8	1.9	1.9	1.9	2.2	2.3	2.5
Private capital reflows	—	—	1.0	1.2	0.9	0.9	0.9	0.9	0.9
New money/bonds	—	—	2.1	0.8	0.6	0.7	1.0	1.0	1.0
Total external debt	34.4	34.1	37.4	40.1	43.5	46.2	48.0	49.6	51.3
As percent of GDP	68.2	58.9	78.8	83.2	85.1	84.1	80.5	76.6	73.1
Debt service 2/	5.0	5.2	6.6	6.8	6.8	7.1	8.2	8.6	9.1
As percent of exports GNFS	44.6	47.0	57.5	52.9	48.4	46.5	48.6	46.6	45.6
Non-oil GDP growth	3.6	4.6	-3.0	4.0	4.0	4.5	4.7	4.7	4.7
Memorandum items									
Oil price (US$/barrel)	16.32	13.51	14.76	15.30	15.91	16.53	17.14	17.78	18.32
Six-month LIBOR (% per annum)	7.3	8.1	9.9	9.2	8.8	8.8	8.8	8.8	8.8

Sources: Tables 10a and 10b.

1/ Includes valuation change.
2/ Includes repurchases from the Fund. Before projected rescheduling.

year in volume terms, albeit from a relatively small base, and to increase as a share of total exports from 20 percent to 30 percent over the next six years.

On the basis of these export and import trends, Venezuela's trade balance under the historical growth scenario would shift into surplus and strengthen over time. The expected improvement in Venezuela's trade balance, however, would be more than offset by an increase in interest payments (including those on borrowing to cover the financing gap). In this situation, the external current account deficit would rise gradually over the medium term from 3 percent of GDP to 4 percent of GDP at which level it would tend to level off.

Venezuela's capital account is likely to remain weak in future years because of rising repayment obligations on medium-term external public debt, which would only be offset in part by increased utilization of credits from multilateral development agencies. Direct investment inflows are projected to rise gradually over time, in line with the Government's relaxed stance on foreign investment and intention to allow debt-equity conversions on a limited scale. It is also assumed that these flows would be supplemented by some repatriation of private capital held abroad of about US$1 billion a year, which is classified as an item of exceptional financing in Table 4. These private inflows would be offset to some extent by negative entries for short-term private capital corresponding to the capitalization of imputed interest earnings (around US$1 billion) on assets held abroad by Venezuelan residents. 1/

On this basis, and allowing for some needed rebuilding of the gross liquid gross reserves of the Central Bank from their present low levels, Venezuela's residual external financing gap would amount to US$4.8 billion in 1989 and around US$4 1/2 billion a year, on average, over the period 1990-95. Somewhat less than half of the latter amount could be covered by the rescheduling of principal obligations, but most of the remainder would have to come from new commercial bank loans, as well as the reflows of private capital held abroad by Venezuelan residents mentioned above.

In these circumstances, the Venezuelan authorities consider that the conventional approach of requesting rescheduling and new money loans from the foreign commercial banks would not represent a viable solution to the country's balance of payments problem, as the external debt ratios would stay high over the medium term and the financing gaps would tend to grow over time. Even under the lower growth scenario in which the external current account deficit would be around 1 percentage point of GDP less than in the historical growth scenario, there would be large

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1/ In Venezuela's balance of payments, imputed interest earnings by Venezuelan residents on assets held abroad are recorded as a credit entry in the current account and a debit entry in the capital account.

new money requirements and growing rescheduling needs without any significant improvement in the external debt and debt service ratios. 1/

In view of these results, the Venezuelan Government has approached its commercial bank creditors with the proposal to develop a comprehensive financing package including rescheduling, new money loans, and a menu of options that would allow for a significant reduction in external debt and debt service payments over the medium term. Discussions with the banks are still ongoing and it is expected that the final arrangement would allow for a combination of debt buy-backs, bond exchanges (with interest and/or principal enhancement), and to a more limited extent, debt-equity conversions. The staff considers that the approach taken by the Venezuelan authorities is broadly appropriate, in that it would appear to reconcile pursuit of their growth objective with the restoration of external viability and a return to normal market borrowing in the future.

In order for such a program of debt reduction to have a significant impact on the balance of payments, the Venezuelan authorities believe that large transactions are needed. For example, if a program of debt buy-backs were carried out over the next three years using borrowed resources of US$4.5 billion (including, among other things, the proportion requested to be set aside under the proposed extended arrangement), net external public debt could be reduced by around US$5 1/2 billion (assuming a discount in the secondary market of 55 percent) and the ratio of total debt service to exports of goods and nonfactor services would be reduced by around 14 percent by 1992 with respect to the historical growth scenario described above.

(b) Capacity to repay the Fund

The strong commitment of the Venezuelan authorities to the adjustment program, which includes major structural reforms and appropriate macroeconomic policies, provides assurance that the balance of payments position will be strengthened over the medium term. Fund exposure to Venezuela would account for a relatively small share of Venezuela's total external debt at the end of the contemplated extended arrangement. During the period of repurchases after the expiration of the extended arrangement, total debt service to the Fund would account for less than 10 percent of Venezuela's total debt service and around 4 percent of exports of goods and nonfactor services under the historical growth scenario. Given Venezuela's long record as a creditor member of the Fund and its excellent record of debt service in the past, the staff believes that the proposed use of Fund resources by Venezuela under the extended arrangement is consistent with the need to safeguard the revolving character of these resources.

1/ Additional sensitivity analysis on the balance of payments in relation to changes in oil price and interest rate assumptions is set out in Appendix IV.

4. Relations with the World Bank

Venezuela regained eligibility for World Bank lending in December 1986 as a result of the decline in per capita income in U.S. dollar terms during the preceding years associated with the sharp drop in oil prices. At the authorities' request, the Bank staff contributed to the development of policy options for the economic reform program that was launched in February 1989. Since then negotiations have been concluded on a structural adjustment loan (SAL) and a trade policy reform loan (TPL). Both loans are scheduled for Executive Board consideration on June 15, 1989--the first request for loan approval for Venezuela since 1974.

The SAL, in an amount of US$402 million, complements the proposed extended arrangement with the Fund and is designed to support the Government's medium-term policy reform program. The main objective of the SAL is to support policy initiatives that will strengthen the economy's productive potential, while improving the effectiveness of the Government's poverty alleviation programs within a sustainable macroeconomic framework. Particular emphasis is being given under the SAL to improvements in public sector efficiency that will result from a revision of the investment program, the reform of public sector pricing, a review of the operations of the FIV, greater transparency of government support for enterprises, and the formulation of restructuring plans for a number of public enterprises (including a program of divestment). The SAL also will fund technical assistance to support several aspects of the adjustment program, including the design of social program, privatization, tax reform, public investment evaluation, and external debt management.

Poverty alleviation is a critical area for policy reform. The SAL supports the introduction and subsequent expansion over the medium term of a series of direct social programs that are designed to meet urgent health, nutritional, and housing needs of the most vulnerable social groups, mainly children and mothers in low-income areas. The social programs also would include the development of generic food products of high nutritional value as part of a targeted subsidy program.

The Trade Policy Loan, in an amount of US$353 million, is intended to support the trade reform described above and has as its major objectives: (a) the creation of a more open, transparent trade regime to encourage competitive behavior by producers of traded goods and to enhance productive efficiency; (b) a reduction in the misallocation of resources that has arisen in the past from high, variable protection; (c) the rationalization of export incentives and procedures to create free trade status for exporters; and (d) institutional reforms to support the new trade regime. It is envisaged that a second trade loan will be developed in 1990 to support the elimination of agricultural import restrictions and further reductions in tariffs.

The SAL and the TPL are expected to usher in a significant program of renewed World Bank assistance to Venezuela that will evolve mainly in support of policy reform. Areas to be covered in subsequent lending operations include financial sector reform, public enterprise reform, industrial restructuring, nutrition, and agriculture. The annual amount of commitments is expected to average around US$750 million over the next several years.

IV. The Program for 1989-90

The Government's economic program for 1989-90 builds on and extends the framework which was set out in its Economic Policy Memorandum that was issued in late February 1989. A number of the targets and projections that were originally proposed for 1989 have had to be revised in the light of the higher rate of domestic price increase now envisaged for this year. On the basis of price developments during the first four months of 1989, domestic consumer prices are now projected to increase by 76 percent, on average, in 1989 (compared with an earlier projection of 35 percent) and by 25 1/2 percent in 1990. These price projections imply a deceleration in the 12-month rate of inflation from a peak of around 100 percent in April-May 1989 to a little less than 20 percent in June 1990, the end of the first year of the proposed extended arrangement. This result will require a significant decline in the monthly rate of price increase over the next few months. The early estimate for consumer price increases in May (around 6 percent) would seem to suggest that such a trend is under way. At the same time, economic growth is now projected to be negative in 1989 (a decline in real non-oil GDP of 3 percent) because of a sharp contraction in real aggregate demand, and to recover by around 4 percent in 1990 as inflation subsides and the economy begins to respond to the new incentive arrangements of the reform program.

In the view of the authorities, the first year of the extended arrangement is seen as critical from the standpoint of putting in place all the major economic reforms of the Government's medium-term adjustment strategy and ensuring that an inflationary process does not take hold as a result of the substantial corrective price adjustments that are taking place. For this reason, they have emphasized in their letter of intent the need for restrained fiscal, monetary, and wage policies.

1. Fiscal policy

The Government's economic program aims at a substantial reduction in the combined deficit of the nonfinancial public sector and exchange losses of the Central Bank in 1989 and overall fiscal balance in 1990 (Table 5). In view of the revised fiscal outturn for 1988 (reflecting mainly adjustments in the accounts of the National Oil Company), the

Table 5. Venezuela: Consolidated Reduced Public Sector 1/

	1986	1987	1988	Projections EBS/89/34 1989	Projections Rev. 1989	1990
	(In billions of bolivares)					
Total revenue	131.9	191.5	209.2	395.4	452.0	681.3
Oil revenue	51.8	94.9	100.0	203.2	257.7	385.7
Surpluses of enterprises	19.6	18.6	22.1	35.5	52.1	68.6
Other	60.5	78.0	87.1	156.7	142.2	227.0
Total expenditure	153.6	228.9	278.8	431.4	514.7	681.3
Current	82.4	135.3	155.5	297.0	350.5	407.7
Salaries	...	34.7	44.4	57.9	67.6	91.7
Exchange losses	—	12.9	19.2 2/	48.0	77.4	5.0
Interest payments	...	28.0	28.5	89.3	74.4	106.7
Other	...	59.7	63.3	101.7	131.0	204.3
Capital and net lending	71.2	93.6	123.4	134.4	164.2	273.6
Fixed capital formation	...	63.9	92.2	105.0	134.4	213.2
Other	...	29.7	31.2	29.4	29.8	60.4
Overall surplus/deficit	-21.7	-37.4	-69.6	-36.0	-62.7	--
Financing	21.7	37.4	69.6	36.0	62.7	—
External 3/	-4.6	8.3	-1.7	35.4	82.9 4/	61.3
Domestic banks	30.4	21.2	59.5	11.6	-9.2	-55.3
Domestic nonbanks	-4.1	7.9	11.8	-11.0	-11.0	-6.0
	(In percent of GDP)					
Total revenue	26.7	26.6	23.4	32.5	28.7	32.6
Oil revenue	10.5	13.2	11.2	16.7	16.4	18.5
Surpluses of enterprises	4.0	2.6	2.5	2.9	3.3	3.3
Other	12.3	10.8	9.7	12.9	9.0	10.9
Total expenditure	31.1	31.8	31.1	35.5	32.7	32.6
Current	16.7	18.8	17.4	24.4	22.2	19.5
Of which: exchange losses (net)	(--)	(1.8)	(2.1)	(4.0)	(4.9)	(0.2)
Capital and lending	14.4	13.0	13.8	11.1	10.4	13.1
Of which: Fixed capital formation	10.0	8.9	10.3	8.6	8.5	10.2
Overall surplus/deficit	-4.4	-5.2	-7.8	-3.0	-4.0	--

Sources: Central Bank of Venezuela; Central Office of the Budget (OCEPRE); and Fund staff estimates.

1/ Comprises operations of the Central Government (including extrabudgetary operations), the Venezuelan Investment Fund (FIV), the National Petroleum Company, other nonfinancial public enterprises, the Exchange Differentials Compensation Funds (FOCOCAM/FICAM), the Deposit Insurance Corporation (FOGADE), and the Venezuelan Institute for Social Security (IVSS).
2/ Total exchange losses (Bs 21.9 billion) reduced by a special retention of Central Bank's profits.
3/ Includes change in international reserves of the FIV.
4/ Includes borrowing to fill residual external financing gap.

proposed reduction in the public sector deficit for 1989 remains the same in relative terms as in the original program, notwithstanding an upward revision in the burden of exchange losses (from 4 percent to around 5 percent) projected for this year. While the U.S. dollar amount of exchange guarantees giving rise to exchange losses is the same or lower than estimated earlier in the year, the local currency cost of these exchange subsidies has increased because an exchange rate of Bs 38 per U.S. dollar has been used in the calculations, compared with Bs 28 per U.S. dollar earlier. Excluding these exchange losses, the overall balance of the public sector would be in a surplus position this year.

The fiscal improvement in prospect for 1989 and 1990 stems almost entirely from a strengthening of revenues attendant upon an increase in foreign trade taxes and enterprise surpluses (mainly oil-related) that is derived from the exchange, trade, and public sector pricing adjustments described earlier. With respect to projections made earlier in the year, the main revision to the revenue projection for 1989 relates to the estimated yield of import taxes which has been lowered because of a three-month delay in the start of the customs tariff reform and an overestimation of the impact of the reform on the effective duty rate. In addition, the revision of nominal GDP for 1989 has reduced the ratio to GDP of several revenue items fixed in nominal terms, for example income and excise taxes.

In 1990, public sector revenues are projected to rise to 32 1/2 percent of GDP (from less than 29 percent of GDP in 1989) as a result of further increases in the value of domestic and foreign sales of petroleum, the full year's effect of the customs tariff reform and the introduction of the value-added tax. These effects, together with the virtual elimination of exchange losses, 1/ would be reflected mainly in a substantial improvement in the overall fiscal position of the Central Administration (Table 6).

Apart from the increase in exchange subsidies, most of the rise in current fiscal outlays relative to GDP in prospect for 1989 relates to an increase in foreign interest payments (associated with an increase in LIBOR and the depreciation of the bolivar) and direct and indirect subsidies. Foreign interest payments (including transfers to cover foreign interest payments by selected entities outside of the consolidated public sector) are estimated to increase by around 3 percentage points of GDP in 1989. Indirect subsidies, which have been incorporated in the central administration budget beginning in 1989, cover the production of selected essential goods (powdered milk, sugar, and fertilizer) and mortgage credits for certain low- and middle-income housing that will amount to Bs 19 billion (1.2 percent of GDP). Direct subsidies for the poor (the so-called social program) are being initiated this year as

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1/ A small provision for exchange losses has been included in 1990 to cover the cost of exchange guarantees for certain private medium-term commercial debt which has been guaranteed by official export credit agencies.

Table 6. Venezuela: Central Government Operations

	1986	1987	Rev. 1988	EBS/89/34 Prog. 1989	Proj. Rev.1989	Proj. 1990
	(In billions of bolivares)					
Total revenue	91.9	126.2	158.8	285.9	319.4	487.5
From petroleum sector	42.9	66.2	91.6	159.9	207.5	318.1
Nonpetroleum income taxes	14.3	23.4	25.6	31.6	30.1	36.2
Import taxes	8.8	15.7	21.1	66.6	55.1	86.7
Other	25.9	20.9	20.5	27.8	26.7	46.5
Expenditure and net lending	105.8	167.3	207.0	316.2	387.8	484.3
Current	72.6	125.3	143.8	268.5	320.5	360.4
Salaries	24.2	31.7	40.9	53.0	61.4	83.8
Interest payments	11.8	24.8	23.6	70.3	52.6	76.6
Other transfers	30.3	50.3	52.3	83.2	116.0	173.6
Exchange losses	--	12.9	19.2	48.0	77.4	5.0
Other	6.3	5.6	7.8	13.9	13.1	21.4
Capital	33.2	42.0	63.1	47.8	67.3	123.9
Fixed capital formation	9.5	12.3	27.6	12.8	27.6	52.7
Other	23.7	29.7	35.5	35.0	39.7	71.2
Overall balance	-13.9	-41.1	-48.1	-30.3	-68.4	3.2
Financing	13.9	41.1	48.1	30.3	68.4	-3.2
External	-6.0	5.5	-2.2	14.6	72.6 1/	41.2
Domestic banks	14.6	44.9	48.6	26.7	6.8	-38.9
Domestic nonbanks	5.3	-9.3	1.7	-11.0	-11.0	-6.0
	(As percent of GDP)					
Total revenue	18.6	17.5	17.7	23.5	20.3	23.3
From petroleum sector	8.7	9.2	10.2	13.2	13.2	15.2
Nonpetroleum income taxes	2.9	3.3	2.9	2.6	1.9	1.7
Import taxes	1.8	2.2	2.4	5.5	3.5	4.2
Expenditure and net lending	21.4	23.3	23.1	26.0	24.6	23.2
Current	14.7	17.4	16.1	22.1	20.3	17.3
Salaries	4.9	4.4	4.6	4.4	3.9	4.0
Interest payments	2.4	3.4	2.6	5.8	3.3	3.7
Other transfers	6.1	7.0	5.8	6.9	7.4	8.3
Exchange losses	—	1.8	2.1	4.0	4.9	0.2
Capital	6.7	5.8	7.1	3.9	4.3	5.9
Overall balance	-2.8	-5.7	-5.4	-2.5	-4.3	0.2

Sources: Central Bank of Venezuela; Central Budget Office; and Fund staff estimates.

1/ Includes borrowing to cover residual external financing gap.

part of the Government's anti-poverty program and will amount to Bs 9 billion. These latter outlays are projected to expand in 1990 (and in future years) as indirect subsidies are phased out.

Total investment expenditure of the public sector is projected to decline significantly in relation to GDP in 1989 as a result of the completion of special investment programs established under the previous administration and delays in the start-up of new projects. During the second half of 1989 and in 1990 the Government expects to implement a special investment program involving labor-intensive projects amounting to Bs 20 billion. It is also expected that other investment programs of both the Central Administration and the state enterprises will be expanded.

All of the public sector deficit in 1989 is projected to be covered by external borrowing including policy-based loans of the World Bank, project loans from the Inter-American Development Bank, and a financing package from the foreign commercial banks involving rescheduling of principal obligations and new money. The provision of these resources would allow for a reduction in net indebtedness of the public sector with the domestic financial system.

2. Monetary policy

The credit program for 1989-90 has been framed with a view to achieving an increase in net official international reserves of US$100 million in 1989 and US$400 million in 1990 and a significant decline in inflation during the first year of the requested extended arrangement. Consistent with these objectives, total bank credit has been targeted to grow by significantly less than the increase in domestic prices in the revised program for 1989 and by somewhat more than the rate of price increase in 1990 as a recovery of economic activity begins to take hold (Table 7).

Under the revised program of the Central Bank for 1989, roughly two thirds of the exchange losses projected after the reform of the exchange system would be registered during the third quarter of this year with the issue of special three-year dollar-denominated bonds carrying an interest rate related to LIBOR. These bonds would be issued only for the portion of unpaid letters of credit subject to exchange guarantee under the guidelines issued in mid-March. Other import obligations and pending private sector debt service will be settled throughout the remainder of the year. In order to offset the monetary impact of these losses, the Central Bank intends to maintain a tight control of its rediscount operations and to engage in open market operations as required. For this purpose, the Central Bank has recently increased the minimum maturity of its "money-desk" operations from 2 to 15 days and has established the facility to issue its own bonds at varying yields and maturities in order to absorb liquidity from the financial system.

Table 7. Venezuela: Summary Accounts of the Banking System

	1986	1987	Prel. 1988	Proj. EBS/89/34 1989	Proj. Rev. 1989	Proj. 1990
	(Flows as percent of GDP) 1/					
	I. Central Bank					
Net domestic assets	6.7	2.6	7.0	0.4	1.5	0.5
Net credit to public sector	6.6	3.0	5.0	0.7	-1.4 2/	-2.6
Credit to financial system	0.6	0.2	2.1	0.2	2.6	1.6
Other	-0.5	-0.6	-0.1	-0.4	0.3	1.6
Reserve money	0.8	1.0	1.2	1.3	1.5	1.2
	II. Banking System					
Total credit	14.2	11.4	15.6	10.9	12.3	9.0
Net credit to public sector	6.3	3.0	6.6	1.0	-1.3 2/	-2.6
Credit to private sector	7.6	8.1	6.2	10.4	13.8	10.7
Other	0.2	0.3	2.8	-0.4	-0.2	1.0
Liabilities to private sector	8.2	8.7	10.1	11.8	12.0	9.7
Money and quasi-money	7.7	8.3	8.4	11.0	11.5	9.0
Private capital and surplus	0.5	0.4	1.7	0.8	0.5	0.6
	(Annual percentage change in relation to liabilities to the private sector at the beginning of the period) 1/					
Total banking system credit	31.7	30.9	45.6	32.3	46.2	30.9
Net credit to public sector	13.8	8.3	17.7	2.8	-5.0 2/	-9.1
Credit to private sector	17.1	22.0	18.2	30.7	52.1	35.5
Other	0.9	0.5	7.4	-1.2	-0.9	4.5
Liabilities to private sector	20.0	23.6	27.6	35.0	45.1	33.2
Memorandum items						
Liabilities to the private sector (in billions of bolivares)	261.7	328.1	418.7	553.9	607.7	809.2
Money and quasi-money (M2) (annual percentage change)	17.9	23.4	23.8	35.0	46.3	32.9
Nominal GDP (in billions of bolivares)	493.8	719.4	895.5	1,213.2	1,575.9	2,088.0

Sources: Central Bank of Venezuela; and Fund staff estimates.

1/ Calculated using a constant valuation for foreign exchange.
2/ Reflects foreign borrowing to cover residual external financing gap.

In view of the Supreme Court ruling earlier in the year, the Central Bank has been forced to reinstate maximum lending and minimum deposit rates for the banking system. These rates will be reviewed on a weekly basis and adjusted as needed to ensure that the legal maximum and minimum rates reflect market forces and allow for the establishment in the near future of interest rates which are positive in real terms. Currently, interest rates are significantly less than the 12-month rate of price increase. As the rate of inflation decelerates significantly over the next few months, interest rates measured against expected inflation may be less out of line. In the policy discussions the staff underscored the critical importance for the success of the program of allowing maximum flexibility of interest rates, within the legal constraints imposed by the recent Supreme Court decision. It was agreed that this matter needed to be kept under close review, and for this reason interest rate policy is to be the subject of a special review under the proposed extended arrangement that must be completed before the end of October 1989. As the rate of price increase declines to more moderate levels toward the end of the year, the authorities have indicated that they intend to reduce the spread between the lending rates for commercial and agricultural activities in the banking system and the subsidy for mortgage credits referred to earlier.

Consistent with the price and balance of payments objectives of the program, the growth in the net domestic assets of the Central Bank will be limited to Bs 23 billion in 1989 and Bs 11 billion in 1990. In the event that central bank reserve money should grow at a faster pace than projected in the program during any given quarter, the ceiling for the net domestic assets of the Central Bank in the following quarter would be reduced by one half of the unplanned growth in reserve money that is matched by an increase in net international reserves above program targets. This adjustment was built into the program in order to reduce the risk that larger than projected growth in reserve money would translate into a sustained high rate of price increase and to facilitate the sterilization of windfall gains in the balance of payments.

3. Price and wage policies

With a view to improving resource allocation, the Government's economic program calls for a greatly increased flexibility of prices. To avoid disruptions in supply, the revised system of price controls established in February 1989 will be administered in such a way as to ensure that prices of controlled goods and services reflect production costs and move broadly in sympathy with the overall trend of consumer prices.

Following the adjustment of public and private sector wages in March 1989, the Government has indicated that no further wage adjustments will be made in 1989. The authorities also have indicated that the public sector wage adjustment in 1990 will be consistent with the fiscal and price objectives of the program. In the fiscal projections for 1990, the public sector wage bill as a ratio to GDP would remain unchanged from 1989 following three years of decline.

4. External sector policies

During 1989-90, the authorities expect that Venezuela's balance of payments will strengthen significantly as a result of the adjustment measures that have been implemented this year, some increase in international oil prices, and the external resources that are expected to be mobilized in connection with the requested extended arrangement from the Fund. The centerpiece of the Government's adjustment strategy is the maintenance of a unified, market-determined exchange value of the bolivar and the progressive reduction of trade barriers which is scheduled to commence in June 1989.

Under the new exchange arrangement established in March 1989, the Central Bank will continue to be a major supplier of foreign exchange to the market as a result of its role as sole purchaser of foreign exchange earnings from PDVSA. From these purchases, the Central Bank will retain what it needs to meet the gross and net international reserve targets of the program and to satisfy public debt service payments and government purchases abroad. The targeted increase in net foreign reserves has been reduced to US$100 million from the US$400 million specified earlier mainly because of a modification in the balance of payments outlook that reflects higher debt repayments than projected before and lower inflows in the form of bond placements and private capital repatriation. Notwithstanding a decline of US$0.4 billion in the external current account deficit compared with the earlier projection, the overall balance of payments deficit for 1989 is now projected at US$3.7 billion (compared with US$3.0 billion earlier in the year), and is expected to decline to US$2.3 billion in 1990.

During 1989 and 1990, gross official foreign reserves would rise by an amount somewhat in excess of the value of prospective purchases from the Fund in order to replenish the Central Bank's liquid gross reserve position, which had dropped to a critically low level at the beginning of 1989. The net (and gross) international reserve targets of the program will be increased to the extent that petroleum export receipts exceed by 10 percent or more the baseline projection of the program (less a deductible amount of 5 percent).

Venezuela's residual external financing gap is estimated at US$4.8 billion in 1989 and US$3.9 billion in 1990. Around US$1.8 billion of these amounts is expected to be covered by rescheduling of debt repayment obligations to foreign commercial banks. On the assumption that reflows of private capital held abroad amount to US$1.0 billion in 1989 and US$1.2 billion in 1990, the remaining gap would have to be covered by new money from banks. The Venezuelan authorities have requested a new money loan of US$2 billion from the banks in 1989 and expect that the residual gap (of US$0.8 billion) in 1990 and future years can be covered by the effect of debt and debt service reduction operations. 1/

1/ Once Venezuela's debt reduction plan has been established, modifications may be required in respect of the net international reserve targets of the program.

In their letter of intent, the authorities have indicated that arrears on interest payments have arisen in respect of reschedulable debt 1/ with such arrears amounting to US$380 million at the end of April 1989. The authorities have requested a bridge loan of US$600 million from the banks in order to become current in their interest payments. In the absence of interim financing and pending the completion of a financing package with the banks, the authorities will minimize arrears on interest payments; if unavoidable, they will be tolerated temporarily under the program to the extent they do not exceed the amount of new money being requested from the banks for 1989. However, the authorities have indicated that debt service arrears will not be incurred on other commercial bank loans not subject to rescheduling or in respect of other external indebtedness. Since the beginning of this year, principal repayments to the banks have been rolled over under a standstill agreement.

The program for 1989-90 includes limits on net external borrowing by the public sector in the 1- to 5-year and 1- to 12-year maturity range which take into account projected disbursements of suppliers' credits, as well as the new money loan from the banks mentioned above. Zero limits on net short-term external borrowing by the public sector are also included which reflect the existing regulations in Venezuela that prohibit such borrowing by the state enterprises.

V. Performance Criteria and Program Monitoring

Quantitative performance criteria, which have been specified on a quarterly basis for the first year of the extended arrangement beginning end-June 1989, include: (1) a limit on the combined borrowing requirement of the reduced public sector and exchange losses of the Central Bank; (2) a limit on the combined borrowing requirement of the Central Administration and exchange losses of the Central Bank; (3) a floor on the net international reserves of the Central Bank; (4) a limit on the net domestic assets of the Central Bank; (5) limits on net external borrowing by the public sector in the 1- to 12-year and 1- to 5-year maturity range; and (6) a limit on net external borrowing of the nonfinancial public sector of less than 1-year maturity (Table 8).

The performance criteria for the net international reserves and net domestic assets of the Central Bank and the public sector borrowing requirement will be adjusted (with a one-quarter lag) for oil export receipts in excess of 10 percent over the baseline projection. In addition, the net domestic asset limit will be adjusted downward (with a one-quarter lag) by one half of the amount by which reserve money growth exceeds program projections to the extent matched by an increase in net international reserves over program projections. The two adjustments just mentioned are intended to sterilize windfall gains from balance of

1/ Reschedulable debt is defined as medium- and long-term public and publicly guaranteed debt to foreign commercial banks originally contracted prior to 1984.

Table 8. Venezuela: Quarterly Performance Criteria of the 1989-90 Economic Program

	1988	1989 QII	1989 QIII	1989 QIV	1990 QI	1990 QII
	(In millions of U.S. dollars)					
Net international reserves 1/ 2/	5,412	4,660	5,115	5,435	5,535	5,590
Short-term external borrowing of the public sector	--	--	--	--	--	--
Net disbursements of public sector medium-term external credits 3/						
1-5 years 3/	...	40	40	110	110	110
1-12 years 3/	...	1,085	1,530	2,055	2,090	2,370
	(In millions of bolivares)					
Borrowing requirement of the reduced public sector 3/	69,619	12,365	50,785	62,690	63,285	68,200
Borrowing requirement of the central administration 3/	48,131	25,370	68,240	68,440	69,310	72,015
Net domestic assets of the Central Bank 2/	-135,000	-105,000	-117,000	-112,000	-114,000	-115,000

Sources: Central Bank of Venezuela; Ministry of Finance; Ministry of Planning; and Fund staff estimates.

1/ The net international reserve target will be adjusted for any change in the net international reserves of the (FIV), which are not managed by the Central Bank. These reserves are estimated at US$488.3 million as of March 31, 1989.

2/ Outstanding at the end of period.

3/ Amounts shown for 1990 are cumulative from January 1989.

4/ Net international reserves were valued at Bs 35.9 per U.S. dollar in 1988 and the program year.

payments developments that exceed baseline projections in the program. The arrangement also contains the usual performance criterion on exchange and trade restrictions, as well as a performance criterion governing debt service arrears except in respect of public and publicly guaranteed medium-term debt to foreign commercial banks originally contracted pior to 1984 and subject to negotiation. If unavoidable, arrears on interest payments in respect of such debt may not exceed the amount of new financing requested from the banks for 1989 (US$2 billion).

During the first year of the arrangement, three reviews will be completed. The first, to be concluded by mid-August 1989 prior to the second purchase under the arrangement, will review progress in concluding a financing arrangement with foreign banks. A second review, which must be completed before October 31, 1989, will focus on the conduct of interest rate policy, as well as external financing if negotiations with the banks have not been concluded. A mid-term review of the program is to be completed by January 31, 1990. Based on the above-mentioned performance criteria and program reviews, the schedule of purchases during the first year of the extended arrangement is set out in Table 9.

Understandings on the economic program for 1990-91 and 1991-92, including appropriate performance criteria, will be reached during reviews to be completed by June 30, 1990 and June 30, 1991, respectively. In addition, mid-term reviews of the 1990-91 and 1991-92 programs will be completed by January 31, 1991 and January 31, 1992, respectively. All these reviews, which constitute performance criteria under the arrangement, will involve an assessment of exchange rate and interest rate policies and the progress made in the structural reforms.

It is envisaged that 25 percent of the purchases made by Venezuela under the extended arrangement be set aside for debt reduction operations. 1/ The rights to draw on this set-aside would accrue subject to observance of performance criteria under the arrangement. The use of the set-aside would be conditional upon the completion by the Board of a review of the authorities' debt reduction plan. This review would need to find that the proposed operations would be consistent with the objectives of Venezuela's adjustment program and would represent an efficient use of set-aside resources.

The Venezuelan authorities have indicated that they intend to request augmentation of the amount of the requested arrangement by 40 percent of Venezuela's quota on the understanding that the financing arrangements concluded with commercial bank creditors would provide for

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1/ Under the proposed arrangement, the authorities have requested that the set-aside begin after the initial purchase. Accordingly, a proportion of 31.25 percent will be deducted from the purchases made after August 14, 1989 through August 14, 1990, and 25 percent thereafter.

Table 9. Venezuela: Proposed Schedule for
Purchases During First Year of the Extended Arrangement

Date of Drawing	Purchases Dependent on	Amount (SDR million)
June 1989	Approval of extended arrangement	246.87
August 15, 1989	Observance of quantitative performance criteria for June 30, 1989 and completion of special review on external financing arrangements.	246.87 1/
November 15, 1989	Observance of quantitative performance criteria for September 30, 1989 and completion of review on interest rate policy and, if necessary, external financing arrangements. 2/	246.87 1/
February 15, 1989	Observance of quantitative performance criteria for December 31, 1989 and completion of mid-term program review. 3/	246.87 1/
May 15, 1990	Observance of quantitative performance criteria for March 31, 1990.	246.87 1/

1/ Before deduction of 31.25 percent for debt reduction operations.
2/ To be completed before October 31, 1989.
3/ To be completed not later than January 31, 1990.

appropriate debt service reduction. In connection with a request for such support, it may be necessary to allow for exceptional access to use of Fund resources. Such augmentation may take place upon an appropriate review by the Executive Board.

The staff will monitor the progress of Venezuela's negotiations with commercial bank creditors, and will inform the Board of notable developments at appropriate intervals. As noted above, developments in this area will be subject to review by the Fund before the second purchase under the extended arrangement.

Pending the completion of those negotiations, the authorities have indicated that delays in interest payments to the banks will be kept to a minimum, and in any event below the level of the financing that is being requested from the commercial banks in 1989. Such delays will be nondiscriminatory among creditor banks, and will be limited to public sector (and publicly guaranteed) medium-term commercial bank debt contracted prior to 1984 (so-called reschedulable debt). Moreover, the Government has affirmed that it will not accumulate debt service arrears to other external creditors.

VI. Staff Appraisal

Following a period of several years in which severe distortions had built up in the Venezuelan economy and internal and external imbalances widened significantly, a new administration embarked on a bold adjustment program beginning February 1989. During the past few months, the Government has adopted a number of major policy adjustments including the replacement of a complex multiple exchange rate system with a unified, market-determined exchange value for the bolivar; a significant increase in regulated interest rates; a substantial easing of price controls; and sharp upward adjustments of public sector prices, including oil products sold in the domestic market.

These measures have had a pronounced impact on prices and were associated with an outbreak of violence at the end of February and early March. The authorities have remained committed to their adjustment program and have expanded it as planned to include key structural reforms in the trade, fiscal, and financial areas. They have also initiated an important social program which is designed to alleviate the impact of the adjustment program on the poorer segments of society.

The authorities have framed their adjustment strategy within a medium-term context and expect to bring about a major restructuring of the Venezuelan economy which would reduce its dependence on oil exports and enable Venezuelan producers to compete more effectively in the international market. The staff strongly supports these objectives of the authorities, and would underscore the critical importance of sound financial and incomes policies in the first year of the program to prevent an inflationary process from taking hold and thus to ensure that the incentives intended in the program are in fact delivered. The early indications of price increases for May 1989 would seem to indicate that a return to a more moderate rate of price increase is under way.

Fiscal policy has a key role to play in the Government's stabilization effort in terms of controlling demand and making room for an eventual recovery and expansion in private sector activity. In this connection, it should be noted that the size of the Government's exchange subsidies in respect of guarantees issued last year will now be larger than projected earlier in the year. In order to achieve the desired reduction in the overall fiscal deficit this year, a tight rein will need to be held on other public sector outlays. This requirement is all the more important in view of the shortfall in revenues which has emerged in this year's program because of the delay in implementing the customs tariff reform and the lack of buoyancy in the domestic tax regime. The staff therefore welcomes the Government's plan to implement during 1990 a reform of the income tax system and to introduce a value-added tax to reduce the dependence of the public sector on foreign trade-related revenues. The planned reform of the public enterprise sector also is important as it would help to place the state enterprises on a more solid financial footing, improve public sector efficiency, and reduce the scope of the public sector.

Monetary policy needs to be conducted in a manner consistent with the program objective of restoring a relatively low rate of price increase within a short period of time and facilitating a rebuilding of the net international reserve position of the Central Bank. In this regard, interest rate flexibility is critical from the standpoint of encouraging domestic financial savings (including the repatriation of private capital held abroad) and reducing credit demands on the Central Bank. The staff regrets the fact that interest rates do not at present reflect market forces and are significantly less than the prevailing rate of inflation. The staff is aware that, with the expected sharp deceleration in prices increase, interest rates in real terms may quickly attain a more appropriate level. In any event, this area of policy needs to be kept under very close review and the proposed arrangement calls for a review of interest rate policy before the end of October 1989. Notwithstanding the legal requirement for the Central Bank to set maximum and minimum interest rates for the financial sector, the authorities will need to make every effort to ensure that the interest rate limits are sufficiently flexible to allow actual interest rates to reflect market forces. Interest rate flexibility also will have a bearing on the degree to which the Central Bank can conduct open market operations with a view to maintaining the growth of reserve money within program targets.

Beyond the concern of short-term policy considerations, attention must also be focused on measures to enhance the efficiency of financial intermediation and to protect the soundness of the financial system. In this regard, the staff notes the intention of the authorities to simplify the structure and use of monetary policy instruments and to revise the financial legislation, including a strengthened role for the superintendent of banks.

During a period of sharp upward pressures on prices, it is vitally important that the authorities pursue a restrained wage policy. In view of the significant wage adjustments effected in March 1989, the staff strongly supports the stated intention of the authorities to refrain from further generalized wage adjustments during the remainder of 1989. Failure to follow this course would run the risk that expectations of sustained inflation would set in, undermining the chances for the program's success and ultimately frustrating the desired growth in employment opportunities. Beyond 1989, the Government will need to ensure that public sector wage adjustments are consistent with reasonable price stability.

Venezuela's economic program aims at achieving a viable balance of payments position over the medium term. The sustained implementation of the Government's adjustment strategy, especially in the exchange and trade policy areas, can be expected to have a beneficial effect on the trade balance over time. However, under the authorities' historical growth scenario the external current account deficit would remain relatively unchanged over the medium term, and significant financing needs would persist. In this connection, the staff would note the contribution that private capital reflows and foreign direct divestment can make to the external financing of the program and would stress the importance of ensuring that the conditions for such inflows are strengthened to the extent possible.

In the circumstances of Venezuela, it would seem that achievement of real GDP growth consistent with gains in per capita income will require new financial arrangements with commercial banks that allow for debt and debt-service reduction in addition to rescheduling and new money. The staff is of the view that Venezuela's strong adjustment program and external debt position make the country a good candidate for debt and debt-service reduction operations. For this reason, the staff supports the request of the authorities to set aside a proportion of Fund resources (25 percent) under the proposed arrangement for debt reduction operations and believes that such a request is consistent with the guidelines adopted by the Executive Board on May 23, 1989. In the near term, Venezuela's residual external financing gaps, which are estimated at US$4.8 billion in 1989 and US$3.9 billion in 1990, will require a combination of new money loans from the commercial banks and reflows of private capital held abroad.

The success of Venezuela's economic program will depend in large measure on the full support of the international financial community. Venezuela will need to pursue vigorously an agreement with its foreign commercial bank creditors on a package that will address the long-term financing requirements of the program, as well as the short-term cash-flow needs of the country. In this connection, the staff strongly supports the Government's request for interim financing from the banks while a financial arrangement is being negotiated. The staff will monitor negotiations between Venezuela and the banks and would note that a review of financing assurances is required prior to the second purchase under the proposed arrangement. In the meantime, approval of the proposed extended arrangement for Venezuela and the policy-based loans of the World Bank will provide important multilateral support for Venezuela's adjustment effort that will bolster confidence and strengthen the hand of the authorities in implementing the program.

Venezuela's exchange restriction evidenced by external payments arrears and multiple currency practice have been approved until July 5, 1989. Pending the Board discussion scheduled for mid-July of a staff paper on Fund policy on exchange restrictions evidenced by external payments arrears and in light of the Board's recent decision in connection with Costa Rica's request for a stand-by arrangement (EBM/89/58, 5/19/89), the staff recommends that Venezuela's multiple currency practice be approved until January 31, 1990.

To sum up, the Venezuelan Government has initiated a major medium-term adjustment strategy and has demonstrated its commitment to the full implementation of the program. The staff believes that Venezuela's program is deserving of Fund support and recommends Executive Board approval of the requested extended arrangement.

VII. Proposed Decisions

Accordingly, the following draft decisions are proposed for adoption by the Executive Board:

I. Extended Arrangement

1. The Government of Venezuela has requested an extended arrangement for the period from June --, 1989 through June --, 1992 in an amount equivalent to SDR 3,703.05 million.

2. The Fund approves the extended arrangement as set forth in EBS/89/107, Supplement 1.

3. The Fund notes the intention of the Venezuelan authorities to request augmentation of the amount of the extended arrangement as set forth in paragraph 1 above, by an amount up to the equivalent of forty (40) percent of Venezuela's quota of SDR 1,371.5 million. The Fund will be prepared to consider an augmentation in the event that the arrangements for the financing of Venezuela's program provide for appropriate debt service reduction and upon the determination by the Fund that such arrangements are consistent with the objectives of the program, and the guidelines on Fund involvement in the debt strategy adopted at EBM/89/61 (5/23/89).

4. The Fund waives the limitation in Article V, Section 3 (b)(iii).

II. Enhanced Surveillance

Pursuant to the request of the Government of Venezuela to terminate the enhanced surveillance approved for Venezuela in May 1985 under the Fund's policy on enhanced surveillance, the Fund decides to terminate the enhanced surveillance effective as of the date of this decision.

III. Exchange System

Venezuela continues to retain exchange restrictions on payments and transfers for current international transactions pending the negotiation of restructuring agreements with foreign creditors, and a multiple currency practice arising from exchange guarantees on certain repayments of private sector debt and trade credits outstanding before the adoption of the new exchange system, which are subject to Fund approval under Article VIII, Sections 2(a) and 3.

The Fund notes the intention of the authorities to eliminate these restrictions and the multiple currency practice after a temporary transitional period, and grants approval for the retention of the multiple currency practice until January 31, 1990.

Venezuela: Selected Economic and Financial Indicators

	1986	1987	Prel. 1988	Projections EBS/89/34 1989	Rev. 1989	1990
(Annual percentage changes, unless otherwise specified)						
National income and prices						
GDP at constant prices	6.8	3.0	4.2	-0.3	-2.7	3.9
GDP deflator	-0.5	41.4	19.4	35.9	80.8	27.6
Consumer prices (end-year)	12.7	40.3	35.4	20.0	62.2	18.2
External sector (in US$)						
Exports, f.o.b.	-37.8	15.8	-4.3	4.5	4.2	11.4
Imports, f.o.b.	4.4	12.3	23.1	-20.8	-24.5	10.2
Public sector (in Bs) 1/						
Revenue	-12.7	39.9	13.4	88.0	115.8	50.9
Total expenditure	13.2	45.0	25.1	54.1	84.6	32.5
Money and credit						
Net domestic assets 2/	31.7	30.9	45.6	32.3	46.2	30.9
Of which: public sector	13.8	8.3	18.0	2.8	-5.0	-9.1
private sector	17.1	22.0	16.8	30.7	52.1	35.5
Broad money (M3)	18.3	23.6	27.6	35.0	45.1	33.2
Velocity (GDP relative to M3)	1.89	2.19	2.14	2.19	2.59	2.58
Interest rate 3/	9.0	9.0	9.0	...	...	...
Real effective exchange rate (end-year index, 1974=100) 4/	85.0	97.8	103.4	69.9	69.8	67.1
(In percent of GDP)						
Public sector 1/						
Revenue	26.7	25.6	23.4	32.4	28.7	32.6
Total expenditure	31.1	31.0	31.1	35.4	32.6	32.6
Overall surplus or deficit (-)	-4.4	-5.3	-7.7	-3.0	-4.0	---
Domestic bank financing	6.2	3.1	6.6	1.0	-0.6	-2.6
Foreign financing 5/	-0.9	1.2	0.2	2.9	5.3	2.9
Other domestic	-0.8	1.1	1.3	-0.9	-0.7	-0.3
Central government surplus or deficit (-)	-2.8	-5.7	-5.4	-2.5	-4.3	0.2
External current account (deficit -)	-3.2	-2.6	-8.1	-4.7	-3.3	-2.9
(In billions of U.S. dollars, unless otherwise specified)						
Overall balance of payments	-4.7	-0.7	-4.1	-3.0 6/	-3.7 6/	-2.3 6/
Change in net international reserves	-3.8	-0.9	-4.5	0.4	0.1	0.4
Gross official reserves (end of year)	11.8	11.1	7.1	9.2	8.7	10.3
(in months of imports of goods and nonfactor services)	14	12	6	10	10	11
(in months of imports of goods and services)	11	10	5	7	7	8
Change in arrears 7/	-0.1	-1.4	-1.2	-0.2	--	--
Total external debt (end of year)	32.7	34.4	33.6	37.7	37.4	40.1
(In percent of exports of goods and nonfactor services)						
Debt service ratio 8/	54.1	44.6	47.0	54.5	57.5	52.9
Interest payments 8/	34.0	25.5	28.0	32.8	34.1	31.3

Sources: Venezuelan authorities; and Fund staff estimates.

1/ Comprises the Central Government, the National Petroleum Company, other nonfinancial public enterprises, the Venezuelan Investment Fund, the Exchange Compensation Funds (FOCOCAM-FICAM), the Social Security Institute, and the Deposit Insurance Fund (FOGADE).
2/ In relation to liabilities to the private sector at the beginning of the period.
3/ End of year annual rate on 180-day time deposits.
4/ An increase in the index shows an appreciation of the bolivar.
5/ Includes change in international reserves held by the Venezuelan Investment Fund.
6/ Includes arrears reduction as part of private sector amortizations and excludes gap financing.
7/ Includes cash payments and rescheduling.
8/ Debt service actually paid. Private debt service takes into account the accumulation and cash reduction of arrears and public debt amortization is after the multi-year rescheduling arrangement.

Venezuela: Summary of the Economic Program, 1989-92

I. Objectives

1. Non-oil real GDP growth, which was 1 percent on average in the period 1979-88, is projected to rise steadily from minus 3 percent in 1989 to 5 percent in 1991, and to 6 percent in 1992 and subsequent years. The historical annual average non-oil GDP growth (1950-88) was about 7 percent.

2. The 12-month rate of inflation, which increased from 36 percent in December 1988 to 94 percent in April 1989, is projected to decline to 12 percent in December 1991, and to a rate roughly in line with that of Venezuela's trading partners thereafter.

3. Following average losses of US$3.2 billion a year in 1986-88, net international reserves are projected to increase by US$100 million in 1989, by US$400 million in 1990, and by about US$700 million a year during 1991-92.

4. Poverty alleviation and the sheltering of the poor from the negative effects of the adjustment process are also important objectives of the economic program.

II. Assumptions

1. The external economic environment is assumed to evolve in line with the projections contained in the recent World Economic Outlook exercise. Accordingly, realized prices of Venezuelan oil exports are projected to rise by about 4 percent a year from US$14.8 a barrel in 1989 to US$16.5 in 1992. Oil export volumes are projected to average 1.6 million barrels a day in 1989 and 1.7 million barrels a day in 1990-92. The international interest rate (six-month LIBOR for Eurodollar deposits) is projected to increase from 8 percent in 1988 to 10 percent in 1989, before declining to an average of 9 percent in 1990-92.

2. The program assumes that Venezuela would be able to obtain the required external financing in the form of private capital flows, debt rescheduling, new money, and debt service reduction to cover residual external financing needs of US$4.8 billion in 1989 and US$3.8 billion, on average, in 1990-92.

3. Domestic real interest rates, which were highly negative in 1988 and during the first half of 1989, are projected to become positive by the end of this year. Income velocity of broad money, defined as the ratio of nominal GDP to M3 at the end of the year, is assumed to increase from 2.1 in 1988 to 2.6 in 1989 due to the acceleration of inflation and to gradually decline back to 2.1 in the following years.

III. Structural policies

1. In early 1989 the Government abolished the multiple exchange system and established a unified, market-determined exchange rate that applies to all transactions with the exception of the settlement of exchange guarantees for certain imports and private debt service outstanding before the adoption of the new exchange system amounting to US$2.7 billion.

2. In early 1989, the Central Bank abolished the existing interest rate ceilings. However, following a Supreme Court ruling, the Central Bank had to reinstate a band of maximum and minimum interest rates on March 27, 1989. The Central Bank will review the interest rate band each week with a view to ensuring that actual interest rates reflect market forces. Other reforms of the financial system will involve the elimination of restrictions on interest rates; the establishment of more uniform regulations for different categories of financial institutions; and improvements in the supervision of financial institutions.

3. In June 1989 the Government plans to initiate a comprehensive reform of the trade system. The first steps to be taken during 1989 involve the elimination of quantitative import restrictions, export quotas, import duty exemptions, and import monopolies. In addition, the maximum tariff rate will be reduced to 80 percent and the number of tariff rates will be significantly reduced. Over the next four years, the maximum tariff rate will be reduced to 20 percent and the number of tariff rates to 4.

4. The Government has initiated a broadly-based structural reform of the public sector including the revision of public sector pricing, the reform of the tax system, and a strengthened supervision of public enterprises. Over a three-year period prices will be gradually adjusted upward to roughly equivalent export opportunity cost or relevant international price in the case of tradable goods, or long-run marginal costs in the case of nontradable goods. The tax reform will involve the introduction of a value-added tax and the simplification of the income tax structure. The enhanced supervision of public enterprises will be directed at reducing operating costs, improving the efficiency of their investment programs, and divesting a number of enterprises that no longer can be justified as part of public sector operations.

5. The system of generalized price controls was revamped in March 1989 and now applies only to some 17 essential goods and services including mainly food items and medicines. In addition, after a five-year price freeze, controlled prices have been sharply increased to bring them in line with actual cost levels. Price controls will be flexibly managed to reflect developments in the general price index and the production costs of the individual items.

6. The social program under implementation consists of the subsidization of certain goods and services, the targeting of selected transfers to the poorest segments of society, and the reorientation of public spending to bolster social services, including health and education, and to emphasize labor-intensive investment programs.

IV. Financial policy framework

1. Fiscal policy: In the fiscal area, the 1989-90 economic program calls for a reduction in the overall public sector deficit from 7.8 percent of GDP in 1988 to 4 percent in 1989 and the achievement of overall balance in 1990. In accordance with the public sector targets, the combined deficit of the Central Administration and exchange losses of the Central Bank is targeted to fall from 5.4 percent of GDP in 1988 to 4.3 percent in 1989 and to shift to a small surplus position in 1990.

2. Monetary policy: Consistent with the growth objective and the observed acceleration of inflation, broad money is targeted in the monetary program to grow by 45 percent in 1989 and by 33 percent in 1990. Private credit expansion is projected at 52 percent of the initial broad money stock in 1989 and 36 percent in 1990. Private credit expansion exceeds that of broad money due to the improved fiscal position and the increased availability of public sector external financing.

3. External policies: The current account deficit is projected to fall from 8 percent of GDP in 1988 to about 3 percent of GDP in 1989-90. In the initial years of the program, external financing will be obtained mainly through additional public sector foreign indebtedness. To limit public sector foreign indebtedness, the existing debt-equity conversion scheme is being revised with the aim of attracting additional private foreign investment and encouraging capital repatriation.

V. Performance criteria

The economic program for 1989-90 establishes quarterly performance criteria on the borrowing requirements of the public sector and the Central Administration (both including the exchange losses of the Central Bank), the public sector's net use of short-term and long-term external credit, and the net international reserves and net domestic assets of the Central Bank of Venezuela. The targets for net international reserves and the public sector borrowing requirement will be adjusted if oil export revenue of the previous quarter exceeds by 10 percent or more the projected value in the program (less a deductible amount of 5 percent). Also, the net domestic assets ceiling will be adjusted downward by one half of the amount by which reserve money exceeds the program target to the extent matched by an increase in net international reserves above program targets. The arrangement also includes a performance criterion on external debt service arrears and the usual performance criterion regarding exchange and trade restrictions. A review of external financing arrangements must be completed prior to the second purchase under the arrangement and a review on interest rate policy is to be concluded before end-October 1989. Semi-annual program reviews will begin in January 1990.

Venezuela - Relations with the Fund and the World Bank
(As of April 30, 1989)

A. Fund Relations

I. Membership Status

(a)	Date of membership	December 30, 1946
(b)	Status	Article VIII

Financial Relations

II. General Department

(a)	Quota	SDR 1,371.5 million
(b)	Total Fund holdings of bolivares	SDR 1,714.4 million or 125.0 percent of quota
(c)	Reserve tranche position	none
(d)	Outstanding lending to the Fund (supplementary financing facility)	SDR 13.3 million

III. SDR Department

(a)	Net cumulative allocation	SDR 316.9 million
(b)	Holdings	SDR 61.1 million or 19.3 percent of net cumulative allocation

IV. Administered Accounts

None

V. Use of Fund Resources

A first credit tranche purchase was approved by the Executive Board on March 29, 1989 (EBS/34/89).

Indebtedness to the Fund SDR 342.9 million

Nonfinancial Relations

VI. Effective March 14, 1989, the authorities abolished the multiple exchange system and established a unified market-determined exchange rate that applies to all transactions with the exception of the settlement of overdue payments for imports and the servicing of registered private debt outstanding before the adoption of the new exchange system, which will continue to be transacted at exchange rates of Bs 7.50 and Bs 14.50 per U.S. dollar under a transitional arrangement. Venezuela retains an exchange restriction on payments and transfers for current transactions as evidenced by arrears on certain debt service payments pending the conclusion of a new financing arrangement with foreign commercial banks.

VII. The 1989 Article IV consultation was concluded on March 29, 1989 jointly with the approval of a first credit tranche purchase (EBS/89/34 and Supplements 1 and 2, and SM/89/57). The last midyear Article IV consultation (under enhanced surveillance) was concluded on September 16, 1988 (EBM/88/88). The Executive Board granted temporary approval for the retention of Venezuela's exchange restriction and multiple currency practice. This approval will be reviewed by the Executive Board no later than July 5, 1989. Venezuela is on a 12-month consultation cycle; the authorities have requested the termination of the enhanced surveillance procedure at the time when their request for an extended arrangement is presented to the Executive Board.

VIII. Fund technical assistance missions, which visited Caracas in October 1988 and January 1989, discussed with the authorities the implications of alternative ways to unify and enhance the flexibility of the exchange system. In addition, technical assistance from FAD was provided to the Central Bank and the Central Budget Office in August-September 1988 in the areas of public sector accounting and fiscal analysis, and in March 1989 in the area of tax reform, with particular emphasis on the introduction of a value added tax.

B. Relations with the World Bank

As a result of the decline in per capita income in recent years (expressed in U.S. dollar terms), Venezuela became eligible in December 1986 for World Bank lending (no World Bank loan had been approved since 1974). In May 1987, the IFC approved a US$10 million loan and a guarantee for a US$27.6 million domestic bond issue for a privately owned cement company. In January 1988, the IFC approved a US$75 million lending operation, involving a group of Japanese banks, for a hot briquetted iron plant. Venezuela also began discussions with the World Bank during 1987 on a possible sector loan in support of trade policy reform. Originally, the authorities had expected to proceed with a reform program in late 1987 or early 1988; however, work on this program was delayed because of the electoral process. Since February 1989, negotiations on a structural adjustment loan and trade sector loan in support of the Government's reform program have been concluded, and these loans are expected to be approved in mid-June 1989. The SAL would support programs directed to improve the effectiveness of government social programs, establish a competitive economic environment, improve the efficiency of public enterprise operations and strengthen public investment priorities and procedures.

Venezuela: Balance of Payments Sensitivity Analysis

The two balance of payments scenarios described in the main body of the report differ in their growth assumptions (and therefore in their saving-investment balances) but have common assumptions in other respects, particularly with regard to external parameters, which are based on World Economic Outlook indicators that were available at end-March 1989 (Tables 10a and 10b). The external financing framework, which does not explicitly incorporate debt or debt-service reduction operations, assumes that residual gaps will be filled by the traditional rollover of principal and concerted bank lending on broadly commercial terms. This annex describes the sensitivity of the balance of payments projections to deviations in two key external parameters; namely, oil export prices and international interest rates. It also presents, for illustrative purposes, the effect on debt burden indicators of various amounts of debt reduction through buy-back equivalent operations.

1. Changes in external parameters

Despite vigorous growth projected for nonpetroleum exports, Venezuela's balance of payments will continue to be highly vulnerable to changes in international petroleum prices over the medium term because of the large share of oil in total merchandise exports. (Under the higher growth scenario, this share is projected to decline from over 80 percent in 1986-88 to 70 percent by 1995.) A reduction of US$1 a barrel in petroleum export prices throughout the projection period, other things equal, would reduce the trade surplus by about US$600 million a year under either one of the balance of payments scenarios. The cumulative residual gap for the program period (1989-92) would increase by US$3 billion and, taking account of interest payments on gap financing, the annual current account deficit would widen by about 1.5 percentage points of GDP (Table 11).

Over 90 percent of Venezuela's external debt is subject to variable interest rates (mainly LIBOR) and denominated in U.S. dollars. Contractual interest payments on total debt reached US$3 billion (5 1/2 percent of GDP, or 28 percent of exports of goods and nonfactor services) in 1988 and, in the absence of debt reduction operations, are projected to rise to over US$5 billion (7 1/2 percent of GDP or 25 1/2 percent of exports) by 1995, under the higher growth scenario. Venezuela's medium-term external position is thus highly sensitive to changes in international interest rates. In particular, an increase of 1 percentage point in LIBOR throughout the projection period, other things equal, would raise interest payments by an average of about US$500 million a year. Partly offset by higher interest earnings on official reserves, these higher interest payments would increase the cumulative residual gap for the program period (1989-92) by about US$1 billion and widen the annual current account deficit by about 0.5 percentage points of GDP.

Table 10a. Venezuela: Medium Term Balance of Payments Projections
(Historical Growth Scenario)

(In billions of U.S. dollars)

	1987	Prel. 1988	Projected 1989	1990	1991	1992	1993	1994	1995
Current account	-1.3	-4.7	-1.6	-1.4	-1.5	-1.8	-2.2	-2.5	-2.8
Exports, f.o.b.	10.6	10.1	10.5	11.7	12.8	13.9	15.2	16.7	18.3
Of which: petroleum	9.1	8.2	8.4	9.4	10.0	10.7	11.5	12.2	13.0
Imports, f.o.b.	-8.8	-10.9	-8.2	-9.0	-10.1	-11.2	-12.5	-14.0	-15.5
Interest payments	-2.9	-3.1	-3.9	-4.0	-4.1	-4.4	-4.7	-5.0	-5.3
Of which: on medium-term bank debt	-2.4	-2.5	-2.8	-2.8	-2.7	-2.7	-2.8	-2.8	-2.9
Other (net)	-0.2	-0.8	--	-0.1	-0.1	-0.1	-0.2	-0.3	-0.4
Capital account	0.2	-0.1	-3.2	-2.1	-1.4	-1.2	-1.6	-1.6	-1.7
Direct investment	--	0.1	0.2	0.3	0.3	0.4	0.4	0.5	0.6
Long-term capital	-1.6	-1.5	-0.7	-0.9	-1.0	-0.7	-1.1	-1.2	-1.5
Public sector	-0.7	-0.8	-0.9	-1.0	-0.8	-0.7	-1.1	-1.2	-1.4
Disbursements 1/	0.7	0.6	1.5	1.4	1.4	1.5	1.5	1.5	1.5
Amortization and other	-1.4	-1.3	-2.3	-2.4	-2.2	-2.1	-2.6	-2.7	-2.9
Private sector	-0.9	-0.7	0.2	0.1	-0.1	--	-0.1	--	--
Disbursements	--	--	0.7	0.5	0.4	0.5	0.6	0.7	0.7
Amortization 2/	-0.9	-0.7	-0.5	-0.4	-0.5	-0.5	-0.7	-0.7	-0.7
Short-term capital	1.8	1.3	-2.7	-1.5	-0.8	-0.9	-0.9	-0.8	-0.8
Public	0.1	-0.2	--	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Private	1.7	1.5	-2.7	-1.4	-0.7	-0.8	-0.8	-0.8	-0.7
Counterpart interest	-0.9	-1.0	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	-1.1
Letters of credit 3/	2.5	2.5	-1.5	-0.3	0.3	0.2	0.3	0.3	0.3
Overall balance	-1.1	-4.8	-4.7	-3.5	-2.9	-3.0	-3.8	-4.1	-4.5
Valuation change	0.2	-0.1	--	--	--	--	--	--	--
Net international reserves (increase -)	0.9	4.9	-0.1	-0.4	-0.6	-0.8	-0.9	-0.9	-1.0
Gross reserves	0.7	4.1	-1.6	-1.6	-2.2	-1.5	-0.4	-0.2	-0.4
IMF (net)	--	--	1.4	1.4	1.6	0.7	-0.3	-0.4	-0.5
Other reserve liabilities	0.3	0.8	0.1	-0.2	-0.1	-0.1	-0.2	-0.3	-0.1
Financing gap	--	--	4.8	3.9	3.6	3.9	4.7	5.0	5.4
Rescheduling	--	--	1.8	1.9	1.9	1.9	2.2	2.3	2.5
Bonds	--	--	--	0.4	0.4	0.4	0.4	0.4	0.4
Private capital reflows	--	--	1.0	1.2	0.9	0.9	0.9	0.9	0.9
Residual gap	--	--	2.1	0.4	0.4	0.6	1.2	1.4	1.7
Memorandum items									
Current account (as percent of GDP)	-2.6	-8.1	-3.3	-2.9	-2.9	-3.4	-3.7	-3.9	-3.9
Net resource transfer (percent of GDP)	0.5	-5.1	2.4	3.0	2.7	2.3	1.9	1.6	1.5
Non-oil GDP (real percent growth)	3.6	4.6	-3.0	4.0	5.0	6.0	6.0	6.0	6.0
Private exports volume (percent change)	-24.5	-7.9	10.0	10.0	12.5	13.5	14.5	14.5	14.5
Import volume (percent change)	7.2	16.0	-27.5	6.4	7.0	6.9	6.9	6.6	6.0
Oil price (US$/barrel)	16.32	13.51	14.76	15.30	15.91	16.53	17.14	17.78	18.32
Net international reserves (US$ bn)	10.7	5.8	5.9	6.3	6.9	7.8	8.7	9.6	10.5
In months of imports GNFS	11.8	5.1	6.9	6.7	6.6	6.7	6.6	6.6	6.5
Total debt (US$ bn)	34.4	34.1	37.4	40.1	43.6	46.8	49.2	51.6	54.3
As percent of GDP	68.2	58.9	78.8	83.2	86.7	86.3	82.7	79.1	76.0
Debt service (US$ bn) 4/	5.0	5.2	6.6	6.8	6.8	7.2	8.2	8.8	9.5
As percent of exports GNFS	44.6	47.0	57.5	52.9	48.4	46.6	48.7	46.9	45.9
Six-month LIBOR (percent per annum)	7.3	8.1	9.9	9.2	8.8	8.8	8.8	8.8	8.8

Sources: Data provided by the Venezuelan authorities and Fund staff estimates and projections.

1/ Assumes about US$700 million per year in World Bank policy-based lending (including co-financing).
2/ Includes (cash) reduction in arrears in 1987-88 and pre-payment (US$81 million) in 1989.
3/ Includes other inflows and errors and omissions in 1987-88.
4/ Including repurchases from the Fund. Before projected rescheduling.

Table 10b. Venezuela: Medium Term Balance of Payments Projections
(Lower Growth Scenario)

(In billions of U.S. dollars)

	1987	Prel. 1988	Projected 1989	1990	1991	1992	1993	1994	1995
Current account	-1.3	-4.7	-1.6	-1.4	-1.3	-1.4	-1.6	-1.7	-1.8
Exports, f.o.b.	10.6	10.1	10.5	11.7	12.8	13.9	15.1	16.4	17.8
Of which: petroleum	9.1	8.2	8.4	9.4	10.0	10.7	11.5	12.2	13.0
Imports, f.o.b.	-8.8	-10.9	-8.2	-9.0	-9.9	-10.9	-12.0	-13.2	-14.4
Interest payments	-2.9	-3.1	-3.9	-4.0	-4.1	-4.4	-4.6	-4.8	-5.0
Of which: on medium-term bank debt	-2.4	-2.5	-2.8	-2.8	-2.7	-2.7	-2.7	-2.7	-2.7
Other (net)	-0.2	-0.8	--	-0.1	-0.1	--	--	-0.1	-0.1
Capital account	0.2	-0.1	-3.2	-2.1	-1.5	-1.2	-1.6	-1.6	-1.7
Direct investment	--	0.1	0.2	0.3	0.3	0.4	0.4	0.5	0.6
Long-term capital	-1.6	-1.5	-0.7	-0.9	-1.0	-0.7	-1.1	-1.2	-1.4
Public sector	-0.7	-0.8	-0.9	-1.0	-0.8	-0.7	-1.1	-1.2	-1.4
Disbursements 1/	0.7	0.6	1.5	1.4	1.4	1.5	1.5	1.5	1.5
Amortization and other	-1.4	-1.3	-2.3	-2.4	-2.2	-2.1	-2.6	-2.7	-2.9
Private sector	-0.9	-0.7	0.2	0.1	-0.1	--	-0.1	--	--
Disbursements	--	--	0.7	0.5	0.4	0.5	0.6	0.7	0.7
Amortization 2/	-0.9	-0.7	-0.5	-0.4	-0.5	-0.5	-0.7	-0.7	-0.7
Short-term capital	1.8	1.3	-2.7	-1.5	-0.8	-0.9	-0.9	-0.9	-0.9
Public	0.1	-0.2	--	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Private	1.7	1.5	-2.7	-1.4	-0.7	-0.8	-0.8	-0.8	-0.8
Counterpart interest	-0.9	-1.0	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	-1.1
Letters of credit 3/	2.5	2.5	-1.5	-0.3	0.3	0.2	0.2	0.2	0.3
Overall balance	-1.1	-4.8	-4.7	-3.5	-2.8	-2.7	-3.2	-3.3	-3.5
Valuation change	0.2	-0.1	--	--	--	--	--	--	--
Net international reserves (increase -)	0.9	4.9	-0.1	-0.4	-0.6	-0.8	-0.9	-0.9	-0.9
Gross reserves	0.7	4.1	-1.6	-1.6	-2.2	-1.5	-0.4	-0.2	-0.3
IMF (net)	--	--	1.4	1.4	1.6	0.7	-0.3	-0.4	-0.5
Other reserve liabilities	0.3	0.8	0.1	-0.2	-0.1	-0.1	-0.2	-0.3	-0.1
Financing gap	--	--	4.8	3.9	3.4	3.5	4.1	4.2	4.4
Rescheduling	--	--	1.8	1.9	1.9	1.9	2.2	2.3	2.5
Bonds	--	--	--	0.4	0.4	0.4	0.4	0.4	0.4
Private capital reflows	--	--	1.0	1.2	0.9	0.9	0.9	0.9	0.9
Residual gap	--	--	2.1	0.4	0.2	0.3	0.6	0.6	0.6
Memorandum items									
Current account (as percent of GDP)	-2.6	-8.1	-3.3	-2.9	-2.6	-2.6	-2.7	-2.6	-2.5
Net resource transfer (percent of GDP)	0.5	-5.1	2.4	3.0	3.0	2.9	2.7	2.7	2.6
Non-oil GDP (real percent growth)	3.6	4.6	-3.0	4.0	4.0	4.5	4.7	4.7	4.7
Private exports volume (percent change)	-24.5	-7.9	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Import volume (percent change)	7.2	16.0	-27.5	6.4	5.6	5.2	5.4	5.2	4.7
Oil price (US$/barrel)	16.32	13.51	14.76	15.30	15.91	16.53	17.14	17.78	18.32
Net international reserves (US$ bn)	10.7	5.8	5.9	6.3	6.9	7.8	8.7	9.6	10.5
In months of imports GNFS	11.8	5.1	6.9	6.7	6.7	6.9	6.9	7.0	7.0
Total debt (US$ bn)	34.4	34.1	37.4	40.1	43.5	46.2	48.0	49.6	51.3
As percent of GDP	68.2	58.9	78.8	83.2	85.1	84.1	80.5	76.6	73.1
Debt service (US$ bn) 4/	5.0	5.2	6.6	6.8	6.8	7.1	8.2	8.6	9.1
As percent of exports GNFS	44.6	47.0	57.5	52.9	48.4	46.5	48.6	46.6	45.6
Six-month LIBOR (percent per annum)	7.3	8.1	9.9	9.2	8.8	8.8	8.8	8.8	8.8

Sources: Data provided by the Venezuelan authorities and Fund staff estimates and projections.

1/ Assumes about US$700 million per year in World Bank policy-based lending (including co-financing).
2/ Includes (cash) reduction in arrears in 1987-88 and pre-payment (US$81 million) in 1989.
3/ Includes other inflows and errors and omissions in 1987-88.
4/ Including repurchases from the Fund. Before projected rescheduling.

Table 11. Balance of Payments Sensitivy Analysis 1/

	1989	1990	1991	1992	Average 1993-95
1. Impact of US$1 per barrel lower petroleum export price on					
Trade balance (US$ bn)	-0.6	-0.7	-0.6	-0.6	-0.7
Current account balance					
In US$ bn	-0.6	-0.7	-0.8	-0.9	-1.1
As percent of GDP	-1.2	-1.4	-1.6	-1.6	-1.7
2. Impact of 1 percentage point higher LIBOR on					
Interest payments (US$ bn)	0.4	0.4	0.5	0.6	0.7
Current account balance					
In US$ bn	-0.1	-0.2	-0.2	-0.3	-0.4
As percent of GDP	-0.3	-0.4	-0.5	-0.4	-0.5
3. Impact of buy-back equivalent debt reduction operations 2/					
Variant A					
In US$ billion					
Gross debt reduction	1.1	1.1	1.1	--	--
Net debt reduction	0.6	0.6	0.6	--	--
Change in residual gap	-0.1	-0.1	-0.2	-0.2	-1.0 3/
In percentage points					
Change in debt service ratio	-0.5	-2.1	-3.6	-5.4	-6.8 4/
Change in debt to GDP ratio	-2.4	-4.9	-7.3	-7.3	-6.7 4/
Variant B					
In US$ billion					
Gross debt reduction	2.2	2.2	2.2	--	--
Net debt reduction	1.2	1.2	1.2	--	--
Change in residual gap	-0.1	-0.2	-0.4	-0.5	-2.1 3/
In percentage points					
Change in debt service ratio	-1.1	-4.3	-7.2	-10.0	-10.8 4/
Change in debt to GDP ratio	-4.8	-9.8	-14.6	-14.4	-13.3 4/
Variant C					
In US$ billion					
Gross debt reduction	3.3	3.3	3.3	--	--
Net debt reduction	1.8	1.8	1.8	--	--
Change in residual gap	-0.2	-0.3	-0.6	-0.7	-2.9 3/
In percentage points					
Change in debt service ratio	-1.6	-6.5	-10.7	-14.4	-14.6 4/
Change in debt to GDP ratio	-7.3	-14.8	-21.5	-21.0	-19.4 4/

Source: Fund staff estimates.

1/ Based on the higher growth scenario described in the main body of the report.

2/ Buy-back equivalent debt reduction operations are defined to include those operations that would yield (in net present value terms) the same amount of net debt reduction as a buy-back, per dollar of cash resources used, for a given secondary market price. These operations are assumed to be conducted using borrowed resources, on three separate occasions (once per year during 1989-91), at an average price of 45 cents per U.S. dollar of face value of old debt. The resources used to finance buy-back equivalent operations are assumed to be US$0.5 billion, US$1 billion, and US$1.5 billion per year under Variants A, B, and C, respectively.

3/ Cumulative amounts.

4/ In 1995.

2. Sensitivity to debt and debt-service reduction operations

As mentioned above, the balance of payments scenarios described in this report assume a traditional approach to gap-fill financing, based on full payment of contractual interest payments, the rescheduling of principal repayments, and concerted new money on broadly commercial terms, without explicit incorporation of voluntary debt and debt-service reduction operations. However, present negotiations with commercial bank creditors contemplate a number of options for debt and debt-service reduction which, in the view of the authorities and the staff, could greatly enhance an early restoration of normal market access for Venezuela, improve incentives for investment and capital reflows and, thus, help sustain the implementation of adjustment and structural reform efforts and the consequent achievement of growth and external viability.

The staff has not made a quantitative determination of the optimal level of debt and/or debt-service reduction and does not wish to prejudge the outcome of the present negotiations with commercial bank creditors by favoring certain modalities of debt or debt-service reduction over others. Optimal quantities of debt reduction and unambiguous rankings of specific avenues to achieve it are, furthermore, very difficult to ascertain considering, inter alia, that the precise linkages between secondary market prices, domestic investment, growth, and capital reflows are not well known. In addition, the prices that alternative debt or debt-service reduction instruments could command in the context of debt exchanges (and, thus, the exchange ratios) cannot be easily calculated a priori, given the potentially wide range of expectations among market participants regarding a country's capacity and willingness to service its debt, and the uncertainty regarding the effects that debt reduction and various modalities of credit enhancement new instruments may have on these expectations.

For these reasons, the sensitivity analysis in this appendix has been limited to a simple illustrative exercise: an indication of the first-round direct effects of various amounts of debt reduction on debt burden indicators and the residual gap, holding all other variables and parameters constant. In the three variants presented in Table 11, debt reduction is assumed to be achieved via cash buy-backs or other mechanisms with equivalent relief in present value terms effected on three separate occasions (once per year during 1989-91), at an average implicit price of 45 cents per dollar of face value of old debt, and using borrowed resources (which include the use of official reserves, given that interest earnings would be foregone). Buy-back equivalent debt-service reduction options include those operations that would yield the same level of net debt reduction (in terms of net present value) as a straight buy-back, per dollar of cash resources used, for a given secondary market price. These operations could include, for instance, the exchange of old debt for new bonds with collateralized principal or reduced-interest-rate bonds with some degree of interest collateralization. The amount of cash resources used to finance debt reduction under the three variants is assumed to be, respectively, US$0.5, US$1, and US$1.5 billion per year during 1989-91.

The illustrative exercise summarized in Table 11 indicates that buy-back equivalent operations could lead to a gradual but substantial decrease in the debt service ratio over time, ranging from 5 percentage points under Variant A to 14 percentage points under Variant C by 1992. The debt to GDP ratio would also be reduced significantly, by 21 percentage points under Variant C by 1992. The favorable effect on the residual gap would also be felt gradually but would accumulate rapidly. Under Variant A, the cumulative decrease in the residual gap in 1989-92 would be about US$600 million, compared with about US$1.8 billion under Variant C.

Venezuela--Basic Data

GDP (1988)	US$57.8 billion
GDP per capita (1988)	US$3,071

	1984	1985	1986	1987	Prel. 1988
Origin of nominal GDP			(percent)		
Agriculture	5.3	5.8	6.6	5.9	5.9
Petroleum (crude and refining) and mining	21.7	18.8	13.1	14.9	13.7
Manufacturing, construction and utilities	20.1	20.7	24.5	23.0	23.4
Commerce	14.1	15.9	18.4	18.3	19.6
Transport, storage, and communications	5.9	6.3	7.3	6.8	6.5
General government	8.7	8.6	8.9	7.8	7.9
Other services	24.3	24.0	21.1	23.2	23.1
Ratios to GDP at current prices					
Exports of goods and nonfactor services	28.1	24.7	20.7	22.3	19.0
Imports of goods and nonfactor services	16.8	15.2	20.6	21.5	23.9
External current account	8.1	5.8	-3.2	-2.6	-8.1
Public sector revenues	32.0	32.5	26.7	25.6	23.4
Public sector expenditures	27.9	29.2	31.1	31.0	31.1
Public sector savings	13.5	12.9	9.2	7.3	6.0
Public sector overall balance	4.1	3.3	-4.4	-5.3	-7.7
External public debt (end of year)	48.3	41.9	51.1	50.4	46.4
External total debt (end of year)	59.8	53.4	66.9	68.2	59.0
Gross national savings	23.8	23.0	16.9	21.7	12.2
Gross domestic investment	15.7	17.2	20.2	24.3	20.3
Money and quasi-money (end of year)	47.9	46.1	51.1	43.9	42.0

Annual changes in selected economic indicators	1984	1985	1986	1987	Prel. 1988
			(percent)		
Real GDP	-1.3	1.3	6.8	3.0	4.2
Real GDP per capita	-4.1	-1.5	4.0	0.4	1.2
GDP at current prices	19.6	13.5	6.3	45.7	24.5
GDP deflator (excluding petroleum)	13.3	15.0	6.3	37.9	20.8
Wholesale prices (annual average)	17.5	15.2	16.9	45.7	19.1
Consumer prices (annual average)	12.2	11.4	11.6	28.1	29.5
Public sector revenues	46.0	15.2	12.7	39.3	13.4
Public sector expenditures	9.8	18.7	13.2	45.0	25.2
Money and quasi-money (M2)	8.3	9.0	19.6	23.4	19.1
Money	3.8	12.6	27.5	34.2	33.6
Quasi-money	10.6	7.4	15.7	17.6	10.1
Net domestic bank assets 1/	0.2	3.2	31.7	30.9	45.6
Credit to public sector (net)	-8.5	-3.9	13.8	8.3	18.0
Credit to private sector	8.1	8.3	17.1	22.0	16.8
Merchandise exports (f.o.b., in U.S. dollars)	6.2	-7.4	-37.8	15.8	-4.3
Merchandise imports (f.o.b., in U.S. dollars)	7.1	3.7	4.4	12.3	23.1

	1984	1985	1986	1987	Prel. 1988
Public sector finances 2/		(billions of bolivares)			
Revenue	131.2	151.1	131.9	184.5	209.2
Expenditure (including net lending)	114.3	135.7	153.6	222.7	278.8
Current account surplus or deficit (-)	55.2	60.0	45.4	52.7	53.4
Overall surplus or deficit (-)	16.9	15.4	-21.7	-38.2	-69.6
External financing (net)	-6.4	-7.0	-4.6	8.3	-1.7
Domestic financing (net)	-6.2	-9.2	31.0	23.6	71.3
Balance of payments		(millions of U.S. dollars)			
Merchandise exports, f.o.b.	15,840	14,660	9,122	10,567	10,113
Merchandise imports, f.o.b.	-7,260	-7,530	-7,862	-8,832	10,872
Investment income (net)	-1,760	-2,196	-1,597	-1,575	-1,707
Other services and tranfers (net)	-2,000	-1,317	-1,248	-1,486	-2,214
Balance on current and transfer accounts	4,820	3,617	-1,585	-1,326	-4,680
Official long-term capital (net)	-874	-1,291	-1,641	-700	-770
Private long-term capital (net) 3/	-1,616	-1,499	-1,652	-410	-363
Short-term capital and errors and omissions 4/	-767	196	211	1,960	1,570
Change in net international reserves (increase -)	-1,874	-1,848	3,786	949	4,521
Change in arrears 5/	311	825	881	-473	-278
Official international reserves					
Central Bank (gross)	12,341	13,690	9,876	9,402	6,554
Central Bank (net)	12,318	13,667	9,818	9,091	5,413
Venezuelan Investment Fund	1,341	1,840	1,903	1,681	828

Social and Demographic Indicators

Area	Population	Density
912,050 sq. km. (total)	18.3 million (end-1987)	20.3 per sq. km.
307,692 sq. km. (arable)	Annual rate of growth 2.9 percent (1980-87)	59.3 per sq. km.

Population characteristics (1987) (per '000)	
Crude birth rate	31
Crude death rate	5
Infant mortality	31

Health	
Population per physician (1987)	1,200
Population per hospital bed (1987)	2,700

Income distribution (1985)	
% of household labor income	
highest quintile	44.9
lowest quintile	5.9

Distribution of land ownership	
% owned by top 3% of owners	76.5
% owned by smallest 42.9% of owners	1.0

Access to safe water (1987)	
Total as % of population	80
Urban	80
Rural	79

Access to electricity (1984)	
% of households	79.1

Nutrition (1987)	
Per capita caloric intake (calories per day)	2,485
Per capita protein intake (grams per day)	66

Education (1985)	
Adult literacy rate 25 and over	84.3
Primary school enrollment rate	85.2

1/ In relation to banking system liabilities to the private sector at the beginning of the period. Includes counterpart unrequited foreign exchange and valuation adjustments.

2/ Comprises operations of the Central Government (including extrabudgetary operations), the Venezuelan Investment Fund, the National Petroleum Company, other nonfinancial public enterprises, and the Exchange Differentials Compensation Fund (FOCOCAM).

3/ Includes direct investment.

4/ Includes valuation change.

5/ Excluding arrears rescheduling.

Venezuela: Extended Arrangement

Attached hereto is a letter dated May 24, 1989 from the President of the Central Bank of Venezuela, the Minister of Finance and the Minister of Planning (EBS/89/107) requesting

(a) an extended arrangement and setting forth:

(i) the objectives and policies that the authorities of Venezuela intend to pursue for the period of this extended arrangement;

(ii) the policies and measures that the authorities of Venezuela intend to pursue for the first year of this extended arrangement; and

(iii) understandings of Venezuela with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Venezuela will pursue for the second and third years of this extended arrangement;

To support these objectives and policies, the International Monetary Fund grants this extended arrangement in accordance with the following provisions:

1. For a period of three years from June -- 1989, Venezuela will have the right to make purchases from the Fund in an amount equivalent to SDR 3,703.1 million, subject to paragraphs 2, 3, 4, 5 and 6 below, without further review by the Fund.

2. (a) Purchases under this arrangement shall not exceed, without the consent of the Fund, the equivalent of SDR 246.87 million until August 15, 1989, the equivalent of SDR 493.74 million until November 15, 1989, the equivalent of SDR 740.61 million until February 15, 1990, the equivalent of SDR 987.48 million until May 15, 1990, the equivalent of SDR 1,234.35 million until August 15, 1990, the equivalent of SDR 1,851.53 million until February 15, 1991, the equivalent of SDR 2,468.71 million until August 15, 1991, the equivalent of SDR 3,085.89 million until February 15, 1992 and the equivalent of SDR 3,394.60 million until May 15, 1992.

(b) Each of the amounts that would be available in accordance with paragraphs 1 and 2(a) above, after August 14, 1989 through August 14, 1990, shall be reduced by an amount equivalent to 31.25 percent, and each of the amounts that would be available in accordance with paragraphs 1 and 2(a) above after August 14, 1990 during the remaining period of this extended arrangement, shall be reduced by an amount equivalent to 25 percent. The amount equivalent to corresponding reductions in the purchases made by Venezuela under this extended arrangement shall be made available subject to the following conditions:

(i) Venezuela represents that it has a need to make a purchase because of use of its reserves or impending payments for the discharge of liabilities under debt reduction transactions;

(ii) the Fund, after examination of the request, has determined that the requested purchase is needed for the replenishment of Venezuela's reserves or for the making of payments in connection with debt reduction operation; and

(iii) the Fund, upon a review of the financing of Venezuela's program supported under this extended arrangement, has determined that the debt reduction involved is consistent with the objectives of the program.

(c) Pursuant to a review under (b)(iii) above and if requested by Venezuela, the Fund may decide to make available to Venezuela, notwithstanding the phasing specified under (a) above and subject to the conditions specified in (b)(i) and (ii) above, an amount equivalent to 31.25 percent of the total of purchases that may be made by Venezuela during the period from August 14, 1989 through August 14, 1990, or an amount equivalent to twenty-five (25) percent of the total of purchases that may be made by Venezuela during each of the annual segments of the remaining period of this extended arrangement. In the event, the right of Venezuela to make purchases under this extended arrangement shall be subject to such phasing of purchases and designation of amounts for debt reduction, as shall be determined.

(d) If requested by Venezuela, the Fund may decide to discontinue the designation of amounts for debt reduction under (b) and (c) above, provided that the Fund determines that the objectives of Venezuela's program supported under this extended arrangement can be achieved.

3. Purchases under this extended arrangement shall be made from ordinary resources until the outstanding use of ordinary resources in the upper credit tranches and under the Extended Facility equals 140 percent of Venezuela's quota in the Fund of SDR 1,371.5 million. Thereafter, purchases shall be made from borrowed resources, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Venezuela will not make purchases under this extended arrangement:

(a) during any period in which the data at the end of the preceding period indicate that

(i) the limits on the borrowing requirement of the reduced public sector referred to in paragraph 23 and Table 2 of the authorities' letter, or

(ii) the limits on the borrowing requirement of the Central Administration referred to in paragraph 24 and Table 3 of the authorities' letter, or

(iii) the targets for the net international reserves of the Central Bank of Venezuela referred to in paragraph 31 and Table 4 of the authorities' letter, or

(iv) the ceilings on the net domestic assets of the Central Bank of Venezuela referred to in paragraph 37 and Table 5 of the authorities' letter, or

(v) the limits on net short-term external borrowing referred to in paragraph 38 and Table 6 of the authorities' letter, or

(vi) the limits on the net disbursements of nonconcessional external loans with 1-12 year maturities, including the sublimit on the net disbursements of nonconcessional loans with 1-5 year maturities, referred to in paragraph 38 and Table 7 of the authorities' letter,

are not observed; or

(b) after August 15, 1989, and October 31, 1989, respectively, until the reviews contemplated in paragraph 40 of the authorities' letter on the Government's external financing plan and interest rate policy have been completed; or

(c) after January 31, 1990, June 30, 1990, January 31, 1991, June 30, 1991 and January 31, 1992 respectively, until the reviews contemplated in paragraph 40 of the authorities' letter have been completed and suitable performance criteria for the second and third years of the arrangement, respectively, have been established or, after such performance criteria have been established, while they are not being observed; or

(d) if Venezuela

(i) fails to carry out its intention with regard to debt service arrears as described in paragraph 33 of the authorities' letter, or

(ii) imposes or intensifies restrictions on payments and transfers for current international transactions, or

(iii) introduces or modifies multiple currency practices, or

(iv) concludes bilateral payments agreements that are inconsistent with Article VIII, or

(v) imposes or intensifies restrictions on imports for balance of payments reasons.

When Venezuela is prevented from purchasing under this extended arrangement because of this Paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Venezuela and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Venezuela will not make purchases under this extended arrangement during any period in which the member has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action with respect to a noncomplying purchase.

6. Venezuela's right to engage in the transactions covered by this extended arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Venezuela. When notice of a decision of formal inegilibility or of a decision to consider a proposal is given pursuant to this Paragraph 6, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Venezuela and understandings have been reached regarding the circumstances in which purchases can be resumed.

7. Purchases under this extended arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Venezuela, the Fund agrees to provide them at the time of the purchase.

8. The value date for purchases under this extended arrangement involving borrowed resources will be determined in accordance with Rule G-4(b) of the Fund's Rules and Regulations. Venezuela will consult the Fund on the timing of purchases involving borrowing resources in accordance with Rule G-4(d).

9. Venezuela shall pay a charge for this extended arrangement in accordance with the decision of the Fund.

10. (a) Venezuela shall repurchase the outstanding amount of its currency that results from a purchase under this extended arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchases as Venezuela's balance of payments and reserve position improves.

(b) Any reductions in Venezuela's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this extended arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that the repurchase will be completed not later than seven years from the date of purchase.

11. During the period of the extended arrangement Venezuela shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Venezuela or of representatives to the Fund. Venezuela shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Venezuela in achieving the objectives and policies set forth in the authorities' letter.

12. In accordance with the last paragraph of the authorities' letter, Venezuela will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultations because any of the performance criteria in Paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Venezuela has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Venezuela's balance of payments policies.