Policy Analysis

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Executive Summary

> America is ungovernable. Those who have served the revolution have plowed the sea.
>
> -- *Simon Bollvar*

The Liberator's dying words are a fitting epigraph for Venezuela today. While much of Latin America is approaching an economic renaissance thanks to the adoption of free-market reforms, Venezuela is still following the discredited statist policies of the past, which could lead to nationwide catastrophe within a decade or less. Despite Venezuela's enormous natural resources, its economic, political, and social systems are disintegrating.

Since 1959 Venezuela, once viewed as a showcase of democracy, has been run by political and business elites that are unwilling to make needed changes that go against their own immediate self-interest. Furthermore, in the current political culture, market reforms are viewed with enormous suspicion, and the public yearns for the free-spending days of the 1970s.

Like many other Latin American countries faced with economic crises in recent years, Venezuela can resolve its problems only by introducing market reforms. A crucial component of those reforms is the privatization of the oil monopoly, which has been the lifeblood of the nation's mercantilist state. Other necessary changes include the constitutional recognition of widespread property rights and the elimination of corruption through judicial reform. Making those changes requires a wholesale change in the country's political culture, which may not come about until the crisis becomes more severe.

Introduction

Venezuela's economic decline has been dramatic. For decades U.S. officials spoke in warm terms of Venezuela's competitive democracy. Since 1959 the Venezuelan political system has been dominated by two parties of the democratic left, which on occasion have alternated in power, through peaceful and orderly elections. A Cuban-backed insurgency in the early 1960s was defeated without the gross abuse of human rights that marked similar struggles in Argentina and Uruguay. With a relatively small population (20.5 million in 1994), great size (double that of California), abundant natural resources (oil, iron ore, bauxite), and political stability, Venezuela seemed destined to succeed, to be "a showcase," to use a favorite New Frontier catchword, for the rest of the region. [1]

The judgment of President Kennedy's adviser on Latin America, Arthur Schlesinger, rendered in 1965, was more or less typical:

> Some of us in Washington saw Venezuela as a model for Latin American progressive democracy (remembering always that its oil revenues gave it a margin of wealth the other republics lacked). [2]

The parenthetical caveat, however, was often overlooked by U.S. and Latin American intellectuals who simply assumed that left-of-center politics gave rise to social democratic progress and prosperity.

That was an illusion. Missing from those judgments was the basic requirement of wealth creation: a legal framework that encourages entrepreneurship. In fact, Venezuela's unique natural resource base was developed by foreign capi- tal beginning in 1917 when the first oil contracts were signed by American, British, and Dutch companies that as- sumed the risks, generated the jobs, and paid substantial taxes to the Venezuelan national treasury.

As a result, by 1950 Venezuela had achieved the highest per capita income in Latin America ($1,019), which dwarfed that of its nearest rival, Chile ($484), and compared re- spectably with that of the United States ($2,538). [3]

Even at midcentury, those figures were deceptive, however, because the data masked huge disparities in in- come. While the middle and upper classes in the Venezuelan capital, Caracas, benefited from the oil wealth, the urban poor and most residents of rural areas had a far lower standard of living. Worse, Venezuela's regulation-happy bureaucracy constituted 15 percent of the labor force. Tight controls over foreign investment discouraged real job creation, higher productivity, and rising wages. Instead, some of Venezuela's poor were bought off with public housing and other subsidies--artificially low bus fares, for exam- ple--that were soon seen as rights that could not be taken away, at least not without violent protest.

Sic Transit Pecuniam

By the early 1970s Venezuela's mushrooming problems were already apparent as impoverished peasants moved to the big cities (especially Caracas) and took up residence in hillside slums and huge public housing projects, which were built and poorly managed by the central government.

But Venezuela got a reprieve. The oil price revolution sparked by the 1973 Yom Kippur War soon swamped Venezuela in petrodollars as a result of oil prices jumping from $2.20 to $8.18 a barrel in one year. [4] With the unearned wealth came a new hubris. The country's ambitious and irrepressible president Carlos Andres Perez 1974-79) declared that Vene- zuela would reclaim its natural resources by nationalizing the petroleum industry and constructing large-scale state- owned enterprises in mining, petrochemicals, steel and aluminum, shipping, and hydroelectricity. Indeed, as a model for public-sector development, Perez designated the entire southeastern region of Guayana for heavy industrial- ization. He placed steel and aluminum under one entity, the Corporacion Venezolana de Guayana, and provided transporta- tion, power, and communications infrastructure with public funds. [5]

The Perez administration also advanced subsidized loans, supplied cheap imports, and gave tariff protection to selected portions of the private sector to complement the new parastatal enterprises. Neither sector, however, proved particularly efficient at anything but absorbing state funds. [6]

The oil windfall also stimulated corruption. With the state taking an increasingly larger role in the economy, self-enrichment became embarrassingly easy for Venezuela's political class. And the politicians took full advantage of the situation. So did their cronies in top business and financial circles who were so familiar they even had nick- names. During President Perez's first term in office, his business associates became known as the "Twelve Apostles" as they made huge fortunes because of their ties to the politi- cal elite. The Apostles' bank of choice, incidentally, was the Banco Latino, which would subsequently gain notoriety. [7]

But the good times could not last. Even a second windfall in 1979, caused by the Organization of Petroleum Exporting Countries, which doubled oil prices again, did not help very much. By 1984 Venezuela's per capita gross na- tional product (GNP) began to stagnate. Worse, a decline in oil prices beginning in 1986 meant less revenue. In 1993 per capita income stood at $2,852, a mere $122 more than it had been a decade earlier. Oil revenues, on which the country had grown increasingly dependent, amounted to a paltry $300 per capita compared to the sunnier figure of $1,600 per capita two decades earlier. While revenues declined as oil prices dropped in constant terms throughout the 1980s and into the 1990s, Venezuela's public services, never at First World levels, began to deteriorate as well. Water, power, road repair, transportation, health, and education all suffered, making life increasingly intolerable for the nearly three-quarters of the population living in poverty. [8]

The Need for Real Change and the Return of Perez

By the end of 1989 even the most hardened optimist had to admit that Venezuela was in deep trouble. The growth rate of the gross domestic product (GDP) was a negative 8.6 percent, unemployment rose to 9.6 percent, inflation ran at more than 89 percent, corruption was rife, and the foreign debt of $27 billion was astronomical and unpayable. [9] Despite talk of diversifying the economy, the nation and its government still largely depended on petroleum, now under the control of the state oil monopoly, Petroleos de Venezue- la S.A. (PDVSA).[10]

Perhaps it was historic irony that Carlos Andres Perez returned to the presidency in February 1989, 10 years after having left that office. Venezuelan voters clearly were hoping that he would lead their country back to the golden age of easily acquired wealth. Perez certainly encouraged that belief in his campaign, never hinting that hard days were ahead.

Once he was in office again, reality intruded. Under pressure from the Bush administration and the international financial community, Perez promised, somewhat half-heart- edly, to rationalize Venezuela's economy in return for a bailout from the International Monetary Fund. Despite divisions within his own Accion Democratica (AD) Party, Perez did order cuts in government spending, subsidies, and tariffs and establish a more independent central bank. Some of Venezuela's smaller, publicly owned enterprises, includ- ing a handful of sugar mills and hotels, were sold off. But those privatizations principally benefited the president's circle of political friends, a flagrant breach of public trust that soon gave both privatization and neoliberalism a worse reputation than they already had.

More important, Perez remained, at best, a reluctant convert to capitalism. Unlike Argentina's president Carlos Saul Menem, Perez made no effort to convince his fellow citizens that another path needed to be taken. Nor did he try to persuade his own party to accept the necessity of wide-ranging reforms, including radical deregulation and a smaller bureaucracy, or try to overcome AD stalwarts' doubts about property rights and the role of foreign investors. [11]

Making Perez even more cautious was the popular reac- tion to the IMF style of austerity. When the subsidized price of gasoline was raised in early 1989, which led to higher bus fares, riots broke out in Caracas and other major cities, resulting in an official death toll of nearly 300. The violence was traumatic. Employing the military to put down the demonstrators provoked serious unrest within the security forces, already poorly paid and restless. That, in turn, helped provoke two coup attempts in 1992, the first of which nearly cost Perez his life.

But Perez's problems were only beginning. His prede- cessor, Jaime Lusinchi, had ridden a flood tide of corrup- tion and ineffectual economic policies meant to halt Vene- zuela's slide into penury. Although few officials charged with malfeasance were ever found guilty, the issue of cor- ruption was now out in the open. Indeed, Perez himself would soon be caught up in the wave of public disgust with the political class. He was accused with two associates of tapping secret funds for the purchase and sale of foreign exchange, which is said to have earned them a handsome $10 million profit. Although Perez denied all wrongdoing, he was impeached and removed from office in May 1993, before the end of his term, and he remains under house arrest. [12]

The impact of Perez's political troubles on economic reforms--he was replaced by two weak interim chief execu- tives until the December 1993 elections--was a slowdown in, then the total cessation of, the market-based reforms that had been in any case only fitfully in play since 1989. But the upheaval of the second Perez administration was not the end of Venezuela's troubles.

The Giant Step Backward

For good reason, Venezuelans had become disenchanted with the two principal parties, Perez's AD Party and the Christian Democrat party, Copei. Both had long been self- serving, unrepresentative political machines run by their chieftains with virtually no accountability to the elector- ate. The congress, judiciary, and public-sector parastatal enterprises were populated with their appointees, and many took advantage of the opportunities with scant regard for Venezuelans without pull. Elections meant no real change at all--or at least it seemed that way to frustrated Venezuelans. Thus, with the discrediting of Perez and members of his party came a rejection of the opposition Copei as well.

Unfortunately, there was no real alternative to either party, since no serious, pro-market political party ever developed in Venezuela. The groups forming an opposition to the prevailing establishment were much more explicitly socialist than the Social and Christian Democrats. Until the 1993 election, those fringe opposition parties had played only a marginal role in Venezuelan politics, frac- tured as they were by personal and ideological differ- ences. [13]

The Return of Caldera

In 1993 the electorate's rejection of the AD and Copei was coupled with its somewhat intermittent support for an extraordinary coalition of 17 minor parties that had only one thing--or rather, one person--in common: former president Rafael Caldera. [14] Riding a tide of relief that Venezuela's political crisis had apparently been overcome, President Caldera began his five-year term with high approval ratings after promising to move decisively on the country's problems.

Caldera had been president from 1969 to 1974, had the virtue of being personally honest, and was remembered for a comparatively successful first term during which Venezuela was at peace and the economy growing. He was, however, 78 years old when sworn into office in February 1994 and hardly a new face. Indeed, Caldera was one of the founders of modern Venezuela with its two-party system that monopolized all power, economic and political, thereby guaranteeing increasing corruption. His political formation as a young labor lawyer struggling against military rule had come in the 1930s and 1940s, and little in his populist thinking had changed since then--a time in which the government, meaning the political class, was viewed as the source of all good for Venezuelans. Of economics, Caldera knew next to noth- ing, and his rejection of Perez's attempted market reforms was virtually total. Nevertheless, before his inauguration, the president-elect did make vague assurances to the private sector and foreign investors alike that he was not an enemy of the free market and even favored some privatization.

The Eruption of the Banking Crisis

Once in the presidential palace, Caldera failed to live up to his assurances. To be sure, he had little time to collect his thoughts. As Caldera entered office he was confronted with a major financial crisis; the country's second largest bank, Banco Latino, had failed just days before his inauguration. Banco Latino had been the Perez administration's favorite bank, dependent on governmental support and protection. After Perez was ousted, Banco Latino's directors funded the former president's AD and its candidate, counting on another win; when that seemed hope- less, they threw their support to the Copei candidate, Oswaldo Alvarez Paz. With Caldera's victory, however, the bank's political protection ended altogether and failure became inevitable.

Like many (but not all) of Venezuela's banks, Banco Latino served the interests of its directors, not those of the depositors. Sweetheart loans went to the directors' companies, and depositor savings were diverted to high-risk stock market and real estate speculation. Again, such irresponsible behavior was made possible by the Perez administration's explicit protection of the banking industry and its cozy relations with leading bankers in the private sector. Foreign investment and participation in the banking industry, for example, were restricted, which encouraged shady activities that would have been precluded by interna- tional competition. Moreover, the relationship between some privileged bankers and government officials was so close that FOGADE, Venezuela's federal deposit insurance agency, held one-third of its funds in Banco Latino. Similar gov- ernment schemes benefited other banks.

When the economy began to go sour, so did the investments of Banco Latino's directors and the financial health of the bank. Meanwhile, the bank's managers reserved for themselves and their friends lavish perquisites--all at the expense of depositors. How much was taken is not yet known, but over 300 Venezuelan bankers have fled the country. To be sure, not all who have left are guilty. Some went hon- estly broke but understood (rightly) that under Venezuela's highly politicized legal system they would stand no chance in any criminal procedure. Indeed, the government of Caldera has made the entire banking class a scapegoat for Vene- zuela's shaky finances and has trampled on the legal rights of the accused. [15]

Banco Latino's corrupt ways had not gone unnoticed before the crash. The superintendent of banks, for example, wrote reports on illegal behavior, but during the Perez years Banco Latino could not be touched thanks to its connections. [16] Banco Latino's failure was not a singular event. When panicky depositors began a run on other banks, they, too, proved to be insolvent, which prompted the government to pump new liquidity into the system. In effect, the Caldera administration nationalized more than half of Venezuela's banking system, worsening an already bad sit- tion.

The bailout has proved expensive and expansive: more than 19 commercial banks (out of 43) and 10 of 19 mortgage banks have been taken over and most have been kept open at a cost of $7 billion, an amount equal to 15 percent of Vene- zuela's shrinking GNP. There is no evidence that the state- controlled banks are any better run now, since many of the same managers remain in place. But then, why should they be fired, since the government seems determined to remove all risk for depositors, regardless of the cost, rather than allow insolvent banks to fail, improve the legitimate super- viceroy function of government, or even better, create great- ER competition by permitting foreign banks to freely enter the market? [17]

The Central Bank's Loss of Independence

Equally costly was the compromise of the central bank's relative independence, which had been one positive achieve- ment of the brief Perez era. Its head, Ruth de Krivoy, had warned Caldera that destroying the central bank's autonomy and then arbitrarily reducing interest rates would promote capital flight--which it did, some $4 billion worth in the first half of 1994 alone. [18]

In a chain of economic mismanagement, negative capital flows threatened the value of the bolivar as Venezuelans and foreigners alike rushed to purchase dollars for safekeeping abroad. Exchange-rate pressures and a steady expansion in the money supply (which more than doubled in the first 20 months of the Caldera administration) led to an abundance of bolivars chasing relatively scarce dollars.

Currency Controls, Price Setting, and More Taxes

Consequently, in the second quarter of 1994 the value of the bolivar steadily dropped from 106 to 200 to the dollar. Panicked, the Caldera government intervened to suspend all currency trading in June of that year. It then reopened the market, but the exchange rate was fixed (and hugely overvalued) at 170 bolivars to the dollar. That rate was maintained until December 1995 when the bolivar was devalued by 41 percent. Although officials hinted in mid- 1994 that exchange controls would be maintained for only six months, they later said that controls would not be lifted until the first quarter of 1996. [l9]

Along with the new controls on capital and current accounts came stringent fines and jail terms for "currency criminals." As a result, trade and investment have become increasingly disrupted and distorted. More recent attempts to make obtaining foreign exchange easier have done little to remedy the situation. [20]

Having imposed the kind of currency controls most Latin American republics abandoned a decade ago, the Caldera government next dealt similarly with inflation, which was running at 60 percent in 1995. Caldera's instincts were once again unerringly dirigiste. Although his government did not impose wage controls, it did impose price controls on a range of basic goods. Those controls were enforced by a new agency, the Institute for the Defense and Education of the Consumer, which carried out well-publicized raids on merchants and manufacturers. The predictable consequences were shortages and black markets (and attendant government corruption), which have done little to slow price increases. And typically, the poor are bearing the brunt of the new scarcities as eggs, cheese, powdered milk, and sardines have disappeared from the shelves of stores in working-class neighborhoods. [21]

The federal government's budget deficit became steadily larger. By mid-1994 it had reached 3.5 percent of GNP, and the consolidated public-sector deficit had reached 15.2 percent of GDP by the end of the year. Caldera's response was to increase taxes, rather than reduce spending, to cover the gap that had begun to widen, largely as a result of the banking takeover. But there was a complication. Once in office, Caldera kept his campaign promise to end the easily collected value added tax. To replace that tax, the government boosted taxes on luxury goods and wholesale trade as well as corporate and income taxes--thus discouraging trade and investment even further.

In early 1996 the deficit, according to independent economists, is running at 10 percent of GDP, but all such estimates, especially government ones, are uncertain and perhaps too low. The only way left to finance government spending--other than obtaining aid from the international financial institutions--is to print more money, which a captive central bank will surely continue to do. [22]

Violating Basic Liberties

Along with Caldera's neostatism comes more than a whiff of authoritarianism. In addition to cracking down on price violators, the Venezuelan government suspended civil liberties--later restored by the congress--a move that gave it the right to seize property and detain individuals without warrant. Meanwhile, Venezuela's courts have hauled up managers of pharmaceutical companies on charges of price gouging--and stimulated yet more capital flight.

Critics also have been harassed and press freedoms restricted. The latter is accomplished primarily by indi- rect means. Newspapers need foreign exchange, which the government can refuse to provide, for newsprint. Bureau- crats also control satellite dishes, so the electronic media tread carefully as well. Moreover, under a new press law, newsmen must obtain licenses from the National Board of Journalists. The unlicensed can serve jail terms of up to six months. Not surprisingly, few in Venezuela's media at first dared criticize directly the government's economic policies--behavior that Caldera has announced is not only unwarranted but un-Christian, since Christians should remain optimists (an odd rendering of Catholic theology--especially in secular affairs that are forever tainted by original sin). [23]

The Results

Nearly two years and nine economic plans after Cal- dera's inauguration, what has been achieved? Not much that is good, even by the government's calculations. The economy has not rebounded; it is entering its fourth year of reces- sion. Inflation has not been reduced, as once confidently predicted; it continues to rise, currently at a 70 percent rate. Lifting price controls--which government officials suggest may occur sometime in 1996--will bump prices up even further. Unemployment, at approximately 15 percent, is growing, and half the workforce is in the underground econo- my as formal businesses fail under the weight of new taxes, regulations, and an inability to purchase critical imports. Domestic savings and investment have plummeted. Foreign investment outside the petroleum sector has slowed consider- ably as government-encouraged economic nationalism re- vives. [24]

Venezuela's huge foreign debt remains unpaid, and its chances of receiving a loan from the IMF appear dim for the moment despite the optimism government ministers have ex- pressed about securing a letter of intent in the near fu- ture. Although Caracas has reportedly promised the IMF to eliminate the deficit by 1998 and loosen exchange controls sometime in 1996, the fund's directors apparently remain wary, as well they should. [25]

The government's piecemeal efforts to impose some economic order have proved highly dubious. For example, in September 1995 the government belatedly doubled the price of fuel. In fact, it drove up the price of higher quality gasoline while slightly lowering the prices of diesel and lower octane fuel. The net effect has been a mass shift of consumption to the cheaper fuels while the oil monopoly's bottom line has remained the same. [26]

Even that tortured and timid step sparked violent protests in three cities, leaving Caracas less willing to abandon the subsidy altogether. Instead, new taxes have been imposed, their adverse effect on economic activity not taken into account. And despite government ministers' claims that they would like to reduce spending, officials have resisted doing so since a major part of the budget supports the bloated bureaucracy.

The Caldera economic team did manage to announce a fairly ambitious privatization program for 1995. On the block were hotels, racetracks, a bank, and the port of La Guaira, among other entities. But the attempted sale of a domestic airline, Aeropostal, failed to draw a single offer, and the privatization minister, Carlos Bernardez, one of Caldera's few genuine free marketeers, was fired. Given the current climate, it is highly unlikely that foreign or domestic investors will be making any bids. That is espe- cially true of domestic investors who, as Venezuelan jour- nalist Carlos Ball has pointed out, spend most of their money purchasing dollars. [27]

Paralleling Venezuela's economic malaise is the coun- try's social disintegration. Crime is now rampant. Cara- cas, a city of 4 million, currently averages some 200 mur- ders a month, most of them in the capital's festering slums where 60 percent of the population live and the quality of life steadily deteriorates. For most Venezuelans, in fact, the fear of criminals far surpasses the fear of politicians, despite the economic chaos the latter have brought. [28]

Dim Prospects for Improvement

Prospects for correcting policy mistakes in the near future are dim indeed. The Caldera government has three years left in its term and is in a much weakened condition politically. Caldera's coalition fared poorly in the December 1995 gubernatorial and municipal elections, and the political system as a whole received another body blow when a mere 30 percent of the electorate bothered to vote--a record low figure. In any case, it is improbable that the government will undertake any significant change. While Caracas may want IMF credits and may even implement IMF-type measures--such as more tax increases--it is unlikely to lift the suffocating apparatus of state control. Indeed, IMF subsidies to Caldera's government, despite conditionality, would surely relieve pressure on the regime to reform. Were political difficulties to arise under such a scenario, promises of market-oriented initiatives would be cavalierly ignored by a president who consistently prefers blaming the much battered private sector for Venezuela's problems. [29]

There are two other obstacles to reform that need to be considered: oil revenues and popular sentiment. The Vene- zuelan government can count on $10 billion to $15 billion in oil revenues every year, and that amount could increase dramatically if present government plans to double production over the next decade are carried out. [30] No other Latin American republic has a cushion that large, not even Mexico, which means Venezuela's political class can drag out the crisis and postpone making difficult decisions. That has not been atypical in Latin America. In the end, howev- er, Venezuela will discover, as did Brazil and Argentina, that revenues from its oil monopoly cannot simultaneously sustain the industry and the state budget indefinitely. For that reason, and because Venezuelan politicians remember well the 1989 outburst, they are disinclined to offer sub- stantive reforms.

Market reforms have worked elsewhere in South America because large majorities came to believe no other option existed. Tired of economic decline, poor public services, and excuses from politicians, Chileans, Argentines, Peruvi- ans, and other Latin Americans have expressed popular sup- port for budget cuts, privatizations, lowered tariffs, and market liberalization in general. Moreover, a class of new leaders and support institutions has over the years created the intellectual climate for reform.

Not so in Venezuela, where more than half the popula- tion receives some sort of subsidy. According to one recent poll, 90 percent of Venezuelans believe their country is rich and its major problems can be solved by a more egali- tarian distribution of existing wealth. [31] Foreign investors are looked upon as exploiters and government as the source of benefits for all social classes. It appears that those well-entrenched entitlements cannot be taken away without a bitter reaction. There is little or no awareness that Venezuelans, like people in the rest of the world, cannot continue living in an economy based on redistribution rather than wealth creation. Few members of the political class have ever bothered to tell Venezuelans otherwise. Reform-minded intellectuals are still too few, their politi- cal access still limited.

Many Venezuelans do not yet understand that statist solutions are, in fact, no solutions at all. There is some good news, however. In a recent poll, 71 percent of respon- dents blamed the government for rising prices while only 23 percent held the private sector responsible. But the reme- dies recommended by the public are distinctly retrograde. In another poll nearly 60 percent of respondents favored such actions as hiring more price police, while only 3.4 percent advocated removing price controls altogether. [32]

Prognosis

That combination of circumstances does not bode well for Venezuela's future in either the near or the distant term. Politically, however, all is not entirely bleak. Some members of Copei and AD now realize that the old system is not working. Therefore, a few political reforms have been undertaken. Primary elections now select party candidates, and congressional and municipal elections are "semi-district" affairs, rather than mere party lists, in the hope that politicians will respond to constituents instead of to party bosses. But those reforms are tardy and have done little to restore confidence in the political parties or Venezuelan democracy. [33]

Moreover, Caldera's revolving-door economic teams would not suggest a continuity of policy even if the right measures were eventually adopted. [34] So matters can and proba- bly will worsen. The present regime may well pursue its statist course for the next three years in the hope that a Mexican-style bailout will be mounted by the international financial community. Such a rescue seems unlikely since skepticism abounds about the Caldera administration's intentions. But talk of expanding the IMF's General Arrangements to Borrow facility to prevent "another Mexico" is only likely to encourage a Venezuelan belief that Caracas, too, will be rescued. [35]

In fact, the chance of any IMF-style agreement succeeding is slimmer than that of the failed 1989 accord, because Perez was more interested in market reform than his succes- sor appears to be. More likely, no real reform of any kind will take place until Venezuela enters a hyperinflationary stage, as did Bolivia, Argentina, and Peru. When that will occur, however, is anyone's guess. IMF-assisted "reforms" may indeed prevent hyperinflation from occurring soon, but the Venezuelan illness will not be cured, merely palliated, by half remedies.

Venezuela's decline ought to be a matter of concern to U.S. officials, especially if the military were to intervene to prevent social chaos. A coup is not likely in the short term since those officers sympathetic to the 1992 revolts have been removed and President Caldera has improved the standard of living for the officer class at least. But that, too, is a stop-gap measure. A prolonged crisis may stir other thoughts. It should be added that Venezuela's armed forces provide no solution either: consistent with their authoritarian tendencies, many officers espouse the same sort of economic nationalism that has become the warp and woof of Venezuelan politics.

The Clinton administration has largely ignored Venezue- la, publicly intervening only once during the 1994 election when Assistant Secretary of State Alexander Watson flew to Caracas and gave an unveiled warning about the costs and consequences of military intervention. Keeping a low U.S. profile on Venezuela may be the best course for the present. Under no circumstances should Washington encourage the belief that a Mexican-style financial rescue operation will be mounted--even if present policies are abandoned. The United States has no obligation, moral or otherwise, to sustain Venezuelan illusions about finding a nonmarket route to recovery or that it can be bribed to follow free-market reforms.

Treatment

Venezuela's problems are almost entirely man-made. Furthermore, its natural resource base, properly used, could provide the margin that would make the painful transition to the market bearable. Oil, the chief resource, is one key to recovery. There is no one road to the market, and there is most certainly no single way to privatize, but clearly the mainspring of a market-based growth strategy for Venezuela is the dissolution of the state oil monopoly. Considering Venezuela's vast reserves, its sale could raise $130 bil- lion, or about $2 a barrel for proven reserves alone. That amount, according to Carlos Ball, would be

> more than enough to pay both foreign and domestic debt, rebuild the nation's decaying infrastruc- ture, establish a professional and efficient po- lice force to protect the lives and property of the people, pension off two-thirds of the bureau- crats, fund and later privatize the bankrupt Social Security system, and allow Venezuelans to live, work, and prosper in a free country once again. [36]

The purchase price of the state oil monopoly could be offered by a consortium of foreign petroleum companies. Such an arrangement would lower the costs of production, stimulate further exploration, and keep the political class from further plundering--at least to some extent. Given that class's reputation in Venezuela, such a move would certainly raise problems, however. It would be better if the privatization of PDVSA, instead of favoring the few, were achieved under a voucher system benefiting all Venezue- lans who for once would have a real share in the country's wealth.

More realistically, perhaps Venezuela could adopt the Bolivian "capitalization" approach--"privatization" also has a sour sound in Bolivia--which combines capital and management from foreign investors and a domestic voucher system--an idea borrowed in turn from the Czechs.

The international financial community had low expecta- tions for Bolivian privatization when the scheme was first proposed. Yet three state-owned industries--electricity, telephones, and the airlines--have been sold to a mix of American, Italian, and Brazilian investors. In return for much-needed cash, the new owners acquired a 50 percent controlling interest in the enterprises. The rest of the equity was distributed equally to all adult Bolivians through deposits in individual accounts. Those accounts will be handled by outside pension fund managers. Upon retirement, Bolivians can either take the accumulated cash or let it become an annuity. That bit of Bolivian ingenuity has solved three problems simultaneously. Capitalization has privatized expensive, low-quality services; raised cash for their improvement by better qualified management; and replaced a bankrupt government social security program. More important, it is proving to be increasingly popular with Bolivians, in part because they see an immediate return in a society that has long held grievances against both the private sector and foreign investment. [37]

The applicability of many features of the Bolivian scheme to Venezuela and its oil industry is obvious, al- though the undertaking would be much larger, at least with respect to the capital required and the benefits distribut- ed. Nevertheless, it is a question of degree, not of kind.

"Capitalizing" the oil sector would also have the added advantage of easing the transition to the market, permitting a reduction of the bureaucracy, the lifting of controls, the elimination of subsidies, and the privatization of public services. In addition, taxes could be cut and red tape reduced, moves that would especially reduce the start-up costs for small businesses, making market entry for entrepreneurs considerably less burdensome. Above all, property rights must be enshrined in the Venezuelan constitution. The present document grants virtually every other "right" ever to enter the mind of man but makes property rights conditional on overall social needs. [38]

Venezuela also desperately needs a currency board or a truly independent central bank along the lines of New Zealand's Reserve Bank, created by law in 1992. That bank, by statutory requirement, must meet a target of zero or near-zero inflation, which, in effect, forbids monetary authori- ties to print money at the request of the politicians. [39]

Corruption also must be attacked directly by the creation of an independent, depoliticized judiciary and an effective system of inspectors general. However, implement- ing such a system would require a new generation of politi- cal leadership (perhaps that leadership could be found in a merger of the more economically sophisticated factions within the two major parties).

But more than intelligence and courage are required. The French government's recent mishandling of the public- sector employee strike should remind us of that. There is no question that the French need to make radical adjustments to their version of the welfare state, which has burdened the economy and the budget with an unmanageable deficit. But Prime Minister Alain Juppe addressed the issue in typical dirigiste fashion by announcing an austerity plan without properly preparing public opinion. The approach result- ed in costly strikes that placed pressure on the government to make concessions that virtually eviscerated the partial reforms.

A far better approach is the one adopted by Czech prime minister Vaclav Klaus. Since assuming office in June 1992, Klaus has masterfully engineered the Czech Republic's trans- formation while retaining his popularity. The Czech experience contrasts with that of other East and Central European states, inter alia Poland, Hungary, and Lithuania, which have seen a return of communists to power. Klaus's secret was not simply the blueprint he followed but his political skills in explaining in simple terms the rationale for making the required changes. Klaus has not been content to do that through the mass media alone. He has also toured the country explaining his policies to small groups. [40]

Reforming Venezuela will hardly be a simple affair. Yet it can be done, and Argentina provides a clear example of how it can be accomplished. In many ways, the Argentina of the late 1980s resembled today's Venezuela. That country for decades had lived on the natural wealth of the pampas with fewer and fewer Argentines contributing to the creation of real wealth. Moreover, five decades of statism had assured Argentines that they had the same spurious "rights" that are guaranteed by the Venezuelan constitution. Proper- ty rights, of course, were another thing entirely. In Argentina, too, one could find nationalistic xenophobia combined with a well-entrenched bureaucracy and a cozy relationship between government and selected portions of big business that resulted in the usual protection from global competition. More important, thanks to the feeble and inconsistent economic measures of the late 1970s and early 1980s, neoliberalism had been discredited in Argentina. When the bubble finally burst in mid-1989 after the Raul Alfonsin administration collapsed in the face of hyperinfla- tion and consequent food riots in the major cities, the incoming Peronist government had no choice but to act, despite President Menem's initial uncertainty about what course of action to take. [41]

Argentine recovery has been neither smooth nor easy. There have been violent reactions to change, especially in the poorer provinces. Indeed, even now with a high rate of unemployment (a record 18.6 percent), economic recession (negative GDP growth of 2.5 percent in 1995), and an over- valued peso, Argentina is not yet out of the woods. But deep and very likely permanent changes have been made. Those accomplishments took strong and skillful political leadership on the part of Menem himself--once he became convinced of the need for liberal reforms--and the toughness and sheer durability of his finance minister, Domingo Cavallo, who has managed to survive in office for a modern record of five years. Another critical ingredient was the emer- gence of a young generation of Peronists who were supremely aware that a market-driven economy alone could generate wealth to meet Argentineans' aspirations. [42]

Deep-rooted policy change is a lot to expect from Venezuelan political leaders who have seldom faced up to economic reality. Moreover, no one can be sure that public opinion will be supportive of such change once the final crisis hits. Nor is it certain that the right leadership will emerge. But a decision point is sure to come: either Venezuela will introduces market reforms or it will see some form of social catastrophe.

Avoiding the Worst

Venezuela is more vulnerable to catastrophe than are other Latin American countries. Although the latter share or have shared many of the same flaws, Venezuela seems to have accumulated more and worse versions of them than its neighbors. Nowhere else in South America is there a politi- cal culture that has so thoroughly divorced reward from work and acquired a political class so loathed. Nowhere else is social mobility so restricted by a poor educational system and a regulatory maze that totally discourages entrepreneurship. In no other country have the marginalized poor been so thoroughly urbanized, their daily life deteriorating (in Peru and especially Bolivia many people, mostly Indians, still live in rural areas). Add to that a middle class that is being impoverished, a security force that is demoralized, and a tiny sector of enormously wealthy people who have done little to earn their wealth. Those are the ingredients of a societal Molotov cocktail.

There is time--though not much--to avoid the worst. Caldera's administration reminds one of the end of Alan Garcla's presidency in Peru (1985-90) when economic reality was vigorously denied. But Peru did come back from the dead thanks to an unheralded agronomist, Alberto Fujimori, who immediately upon assuming office administered shock therapy and won the applause of most poor Peruvians. That can be done and must be done in Venezuela as well.

Fortunately, most Latin American countries have chosen the market-oriented path. Because the benefits have been apparent and popularly supported, there is little risk that Latin Americans will abandon such policies. But there is also no guarantee that they will be maintained indefinitely. Political pressures and populist temptations can always steer countries off course. In that regard, Venezuela serves as a reminder to all Latin American countries of what can happen if the path toward market economics is not fol- lowed. The Venezuelan government, in turn, must learn from the countries that have done the most to reform their econo- mies and introduce widespread radical reform. In the meanwhile, Bollvar's dying words still serve as a warning: anything less will mean a continued plowing of the sea.

Notes

1. Data taken from Central Intelligence Agency, *The World Factbook, 1995-1996* (Washington: Brassey's, 1995), pp. 424-25. Proven petroleum reserves are about 65 billion barrels.

2. Arthur M. Schlesinger Jr., *A Thousand Days: John F. Kennedy in the White House* (Boston: Houghton Mifflin,

1965), p. 766. Venezuela's democratically elected president of the period, Romulo Betancourt, was a favorite of the Kennedy intellectuals. In the 1930s Betancourt had been a commu- nist, but exile in Puerto Rico had convinced him of the virtues of social democracy. He was a strong supporter of Kennedy's Alliance for Progress, which was saturated with statist assumptions.

3. International Monetary Fund, *International Financial Statistics*, April 1960, cited in Hubert Herring, *A History of Latin America: From the Beginnings to the Present* (New York: Alfred A. Knopf, 1964), p. 822.

4. Pedro-Pablo Kuczynski, "The Economic Development of Venezuela--A Summary View as of 1975-1976," in *Contemporary Venezuela and Its Role in International Affairs*, ed. Robert D. Bond (New York: New York University Press, 1977), p. 87n. 4.

5. Ibid., pp. 72-73.

6. Alejandro J. Sucre, "Mexicans Beware! What IMF Austerity Did for Venezuelans," *Wall Street Journal*, February 24, 1995, p. A11; and Carlos Ball, "Fracas in Caracas," *Reason*, October 1992, P. 54.

7. Jose de Cordoba, "A Conglomerate Reels from Bank's Failure and Caracas Politics," *Wall Street Journal*, November 16, 1994, p. A1. See also Tod Robberson, "Venezuela, Once Oil-Wealthy, Now Seeks International Aid," *Washington Post*, September 28, 1995, p. A10.

8. Figures are in constant 1993 dollars. U.S. Arms Control and Disarmament Agency, *World Military Expenditures and Arms Transfers*, 1993-1994 (Washington: Government Printing Of- fice, February 1995), p. 88. See also William Perry and Norman A. Bailey, *Venezuela 1994: Challenges for the Caldera Administration* (Washington: Center for Strategic and Inter- national Studies, and Caracas, Center for the Analysis of the U.S.A., 1994), p. 14.

9. Perry and Bailey, p. 15; James Brooke, "Venezuela Vic- tor: Will Vows Be Kept?" *New York Times*, December 7, 1993, p. A3; and Matt Moffett, "For Venezuela's President-Elect, Promises Collide with Problems," *Wall Street Journal*, Decem- ber 7, 1994, p. A13. See also Tod Robberson, "Venezuela, Once Oil-Wealthy, Now Seeks International Aid," p. A20.

10. Franklin Tugwell, "Venezuela's Oil Nationalization: The Politics of Aftermath," in *Contemporary Venezuela and Its Role in International Affairs*, pp. 91-119. For nearly 60 years, Venezuelan politicians have been talking about "sow- ing the oil"--a phrase first coined by Arturo Uslar Pietri in July 1936. In 1954 oil accounted for 94 percent of total exports; in 1992 it was nearly 80 percent. See Herring, p. 825; and *Britannica Book of the Year: 1995*, ed. Charles Trumbell (Chicago: Encyclopedia Britannica, 1995), p. 748.

11. Ball, "Fracas in Caracas," pp. 54-55.

12. Meanwhile, ex-president Lusinchi is residing in Costa Rica avoiding any difficulty with the Venezuelan courts. "Venezuela: The Heirs of Bolivar," *The Economist*, January 28, 1995, p. 41.

13. Nevertheless, by the 1993 election, a new force on the left was emerging. Venezuela's fastest growing party, the unrepentant Marxist Radical Cause (Causa R), managed to capture almost 22 percent of the vote in the presidential elections, two years after the fall of the Soviet Union. Even more disturbing, the vote for Causa R nearly matched the Adeco and Copei totals. Central Intelligence Agency, p. 424.

14. Caldera's first presidency (1969-74) inspired little hope for economic policy. He nationalized utilities, im- posed price controls, and restricted foreign participation in the banking system. For a more thorough list of Cal- dera's statist actions, see Carlos Ball, "Venezuela, A Mira- cle in Reverse," Address to the *Wall Street Journal* Confer- ence on the Americas, October 27, 1994. It might be added that Caldera, having been denied Copei's nomination in 1993, accepted the National Convergence candidacy and won 30.45 percent of the vote. But it was enough. The so-called chiripero (cockroach) coalition, however, failed miserably in its congressional bids. In the 52-member Senate, the National Convergence captured only 5 seats. In the 201- member Chamber of Deputies, Caldera's coalition won a mere 26 races. Central Intelligence Agency, p. 424.

15. Carlos Ball, "Bank's Failure Signals End of Cronyism in Venezuela," *Wall Street Journal*, February 4, 1994, p. A11; and Craig Torres, "Venezuelan Bank Cashes In on a Crisis," *Wall Street Journal*, November 3, 1994, p. A15. The low expectations of justice in the country's politicized legal system have been reinforced by President Caldera's state- ments that Venezuela's economic problems are due to private- sector crooks. Carlos Ball, personal communication, Decem- ber 13, 1995.

16. Carlos Ball, personal communication, December 7, 1995.

17. Tod Robberson, "Venezuelan Economy Reeling Despite Controls," *Washington Post*, October 2, 1995, p. A15; "Vene- zuelan Banks: From Bad to Worse," *The Economist*, March 25, 1995, pp. 80-81; and Carlos Ball, personal communications, December 7 and December 16. 1995.

18. By politicizing the central bank, Caldera broke his promise, made immediately after his election, that the bank's independence was "absolutely indispensable." To make matters worse, he appointed as de Krivoy's replacement a close personal friend. See Stephen Fidler, "Golden Years Are Tarnished," *Financial Times*, December 7, 1993, p. 14; and Perry and Bailey, pp. 4, 19.

19. Stephen Fidler, "Caracas Devalues Currency by 41 for All Business," *Financial Times*, December 12, 1995, p. 9. Devaluation by fiat will accomplish little except spur further inflation over the medium to long term, leaving Venezuelan exports no more competitive than they were before the devaluation.

20. The official parallel market rate of exchange was 270 bolivars to the U.S. dollar. See James Brooke, "Venezuela's Tight Grip Has Investors Gasping," *New York Times*, August 19, 1994, p. D1; Hugo Faria, "A Venezuelan Rescue Plan: Dollarize the Economy," Wall Street Journal, October 6, 1995, p. A15; and Carlos Ball, "Venezuela Keeps Swimming against the Tide," Wall Street Journal, June 2, 1995, p. A9. For details on the latest foreign exchange decree designed to speed up allocations of dollars, see Matt Moffett, "Vene- zuela's Sinking Dollar Reserves May Force a Devaluation of the Bolivar," Wall Street Journal, October 6, 1995, p. A10; and Caracas Venezolana de Television, October 19, 1995, in Foreign Broadcast Information Service, Latin America Daily Report, October 25, 1995, p. 45.

21. Matt Moffett, "Venezuela Is Suffering, Its Economy Strangled by Too Many Controls," Wall Street Journal, August 18, 1995, p. A1; and Diario de Caracas, May 9, 1995, p. 15, in Foreign Broadcast Information Service, Latin America Daily Report, June 12, 1995, pp. 65-66. Wages have actually been boosted by government decree and employers ordered to absorb the loss. Price criminals can go to jail for six months to three years. See Ball, "Venezuela Keeps Swimming against the Tide," p. A9.

22. Faria, p. A15.

23. More recently, however, press criticism has been mount- ing, especially in El Nacional, the leading opposition newspaper. See Matt Moffett, "Venezuela Sends Mixed Signals on Oil," Wall Street Journal, September 7, 1995, p. A11; "Venezuela: The Price of Rights," The Economist, April 29, 1995, pp. 54-56; Deroy Murdock, "Venezuela's Attack on the Press," Washington Times, June 15, 1995, p. A21; and James Brooke, "New Leader Is Squeezing Venezuelans," New York Times, September 4, 1994.

24. The new foreign investment law on oil passed in July 1995 by Venezuela's congress is a good example of contempo- rary Venezuelan nationalism. By current standards, the legislation is highly restrictive and discouraging; it calls for a 90 percent tax rate on profits instead of the usual 85 percent. See Moffett, "Venezuela Sends Mixed Signals on Oil," p. All.

25. Robberson, "Venezuela, Once Oil-Wealthy, Now Seeks International Aid," p. A10. Since every economically liter- ate person in Venezuela knew a devaluation would come after the December 3 elections (it came a week later, in fact), companies and individuals exploited every loophole in the regulations to buy dollars, shrinking the country's reserves at an even faster rate and thus forcing an even earlier devaluation date. Venezuela's reserves dropped by 20 per- cent from May to September 1995. A secondary effect was that the government tightened the rules on dollar purchases

leaving many companies unable to import critical spare parts and machinery. Meanwhile, an artificially cheap dollar stimulated some imports, despite relatively high tariffs, forcing Venezuelan manufacturers out of business. See Moffett, "Venezuela's Sinking Dollar Reserves May Force a Devaluation of the Bolivar," p. A10. For the promise of a balanced budget, see Caracas Venezolana de Television, in Foreign Broadcast Information Service, Latin America Daily Report, October 26, 1995, p. 43.

26. Ball, personal communication, December 13, 1995.

27. Ball, personal communication, December 7, 1995; "It's All Talk," The Economist, December 2, 1995, p. 44; Robber- son, "Venezuelan Economy Reeling Despite Controls," p. A15; Joseph Mann, "Venezuela to Boost Sell-off Programme," Finan- cial Times, September 29, 1994; and Joseph Mann, "Caracas Renews Economic Plan, Financial Times, July 10, 1995, p. 4. Potential investors might consider the experience of GTE, which led a consortium that purchased 40 percent of the state-owned telephone company, CANTV. Since 1991 its manag- ers have been harassed by government officials, investigated by congressional committees, and marched against by left- wing trade unions; its biggest customer, the government, has been delinquent in payments. See James Brooke, "Yankees, Phone Home!" New York Times, June 21, 1995, p. Dl; and Stephen Fidler, "Cantv grapples with Its Brave New World," Financial Times, October 26, 1995, p. 22.

28. "Venezuela: Crime Wave," The Economist, October 29, 1994, p. 48.

29. The last IMF package to Venezuela in 1989 included $4.6 billion to help the government restructure the economy. See Robberson, "Venezuela, Once Oil-Wealthy, Now Seeks Interna- tional Aid," p. A10. For the December 3, 1995, election re- sults, see United Press International, "Opposition Claims Venezuela Victories," Washington Times, December 4, 1995, p. A13.

30. Sam Dillon, "Cash-Short Venezuela Turns to Foreign Oil Companies," New York Times, March 6, 1996, p. D9.

31. See Moffett, "Venezuela Is Suffering, Its Economy Stran- gled by Too Many Controls."

32. For the poll on inflation, see El Universal, December 7, 1995, pp. 2-4, in Foreign Broadcast Information Service, Latin America Daily Report, December 11, 1995, pp. 43-44. For the results of the second poll, see Moffett, "Venezuela Is Suffering, Its Economy Strangled by Too Many Controls," p. A1. Although some of the younger leaders of Copei and especially Adeco have an awareness of Venezuela's backward ness, they are distributed over two parties and are not in control of either. See Perry and Bailey, pp. 9, 14.

33. Ibid., p. 2.

34. James Brooke, "Venezuela Bank Failure Undercuts Govern- ment," New York Times, March 30, 1995, p. D8.

35. For a discussion of the General Arrangements to Borrow, see W. Lee Hoskins and James W. Coons, "Mexico: Policy Failure, Moral Hazard, and Market Solutions," Cato Institute Policy Analysis no. 243, October 10, 1995, pp. 14-15.

36. I am indebted to Carlos Ball for suggestions on what to do with the PDVSA. Ball, "Venezuela, A Miracle in Reverse," P. 3.

37. For details of Bolivia's capitalization scheme, see Sally Bowen, "Bolivia Wins Applause for Its Capital Idea," Financial Times, November 15, 1995, p. 8. It is important to note that a Venezuelan capitalization program could improve on the Bolivian scheme. The Bolivian program, for example, mandates a certain amount of private investment in each newly privatized enterprise. Such an approach is shortsighted, however, since it does not allow the market to discover the best use of resources and may actually encour- age unnecessary and wasteful investment. That is particu- larly unfortunate since the scheme foresees 50 percent of capitalized firms' shares being held by Bolivian citizens, who would suffer the consequences of risky or unprofitable investments. A Venezuelan capitalization program, by con- trast, should allow the market to establish the value of each enterprise and allow Venezuelan shareholders to sell their shares to whomever they wish in the newly created capital market.

38. For an analysis of the Venezuelan constitution, see Carlos Ball, "Seeds of Venezuelan Revolt Found in Statist System," Wall Street Journal, February 7, 1992, p. A15.

39. On the New Zealand Reserve Bank, see Terry Hall, "New Zealand Stands Firm on Monetary Policy," Financial Times, September 15, 1995, p. 4; and Terry Hall, "Strong Growth Challenges NZ Governor's Inflation Contract," Financial Times, December 14, 1995, p. 4. See also Terry Hall, "NZ Money Tightened after Tax Cut Pledge," Financial Times, December 14, 1995, p. 4; and Terry Hall, "NZ Markets Fall on Brash Move," Financial Times, December 15, 1995, p. 6. Despite political pressures over the last two years, New Zealand Reserve Bank governor Don Brash has stuck to the statutory requirements.

40. For a recent review of the Czech Republic, see "Survey of the Czech Republic," Financial Times, November 22, 1995, pp. 22-26.

41. On Argentina's rush to the market, see William Ratliff and Roger Fontaine, Changing Course: The Capitalist Revolu- tion in Argentina (Palo Alto, Calif.: Hoover Institution, 1990); and William Ratliff and Roger Fontaine, Argentina's Capitalist Revolution Revisited: Confronting the Social Costs of Statist Mistakes (Palo Alto, Calif.: Hoover Insti- tution, 1993).

42. For a current analysis of the Argentine economy, see David Pilling, "Argentina's Markets Love This Economic Crisis," Financial Times, December 13, 1995, p. 4.