

Venezuela's Economic Crisis: A Keynesian IS-LM Analysis

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Introduction

The Bolivarian Republic of Venezuela is sitting on the world's biggest oil reserves, and is the region's poorest performer in terms of GDP growth per capita. The country is in the middle of an economic crisis with a hyperinflation rate forecasted to be north of a staggering 4000% by the end of 2018, and is in a state of emergency wherein the border to Columbia has been reopened to allow citizens to purchase essential commodities such as food and toiletries. Panic about the future and seemingly bleak prospects for the progress of the economy lie in a calamitous coincidence of a number of factors: The country hosts not one, but three exchange rates, it succumbed to unsustainable socialist policies under Chavez's reign, and a 13-year low is being witnessed in terms of plummeting exports. Both state sanctioned and private players play a hand in corruption – and the country, which owes \$196 billion to bondholders and other entities, has been drained and left with a mere \$9.6 billion.

This paper attempts to analyze Venezuela's monetary and fiscal policies, the history of its economic crises, the current day scenario in context of its inflation rate and GDP growth rate with the help of the Keynesian Investment-Saving Liquidity-Money model.

Macro-Economic Indicators

1. **Inflation:** Since the economic crisis of 1980, the level of inflation has been on a rise. Government decisions such as allowing interest rates to fluctuate in tandem with the market forces of money demand and money supply helped in bringing temporary relief, but market determined interest rates were declared illegal, bringing about a massive relapse. The measure of inflation in terms of Consumer Price Index (measures expenditure on necessary commodities of daily survival) was 800% in 2017. A rise beyond 4000% is predicted by the end of 2018.
2. **Balance of Payments:** The BoP situation has been sharply deteriorating in the nation since 1990 mainly on account of the economic recovery programme undertaken by the Government. Exports (except oil due to OPEC regulations) have declined due to currency exchange problems.
3. **GDP growth rate:** On account of the large fiscal deficit due to a negative BoP, the GDP growth rate has been negative over the past few years.

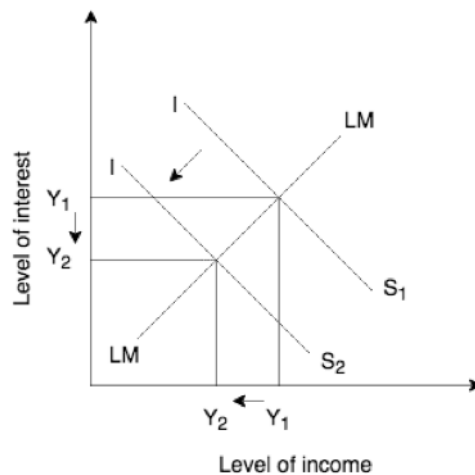
Venezuela's Economic History

Pre-1980s: In Venezuela, price stability was the norm and inflation was a healthy 3 percent from 1930 to 1970. During the 1970s, the country's oil windfalls were invested and managed in a way that prevented price instability.

1980s: Being a member of the OPEC, Venezuela is heavily dependent on the export of petroleum products which account for more than 50% of its GDP. A crash of oil prices in this period marked the beginning of economic downfall, causing national debt to multiply. Financial deterioration, multiple devaluations, and fiscal deficits combined to push consumer prices and inflation up exponentially, leading to unemployment and poverty. The government issued a policy allowing the bank rate to fluctuate freely with the money market equilibrium, and abandoned its earlier policy of import substitution by allowing the inflow of foreign direct investments in order to maintain its social spending and to expand income and employment. An attempt to reverse the economic crisis through devaluations of the currency was made, through a multi-tier exchange-rate system, greater import protection, and increased producer and consumer subsidies, and these reforms stimulated a recovery from the negative growth rates. This marked the first step undertaken by Venezuela towards liberalisation. On 2nd February 1989, Venezuela undertook a macroeconomic adjustment program which aimed at dismantling protectionist policies and deregulating prices supplemented by the withdrawal of the Government from key areas of the economy.

1990s: Most price controls were abolished, liberalisation made it possible to improve the effectiveness of monetary policy, and the Bank initiated an open market. A system of exchange controls was introduced by the Government, which placed further constraints on the conduct of monetary policy. Other related policies sought to eliminate budget deficits, to liberalise trade, and to abolish most subsidies and price controls.

2000s: In 2003, Chavez installed price controls for essential consumer products, which increased supply shortages from an average of 5 percent to 22.2 percent. The Supreme Court declared the free fluctuation of the Bank rate in accordance with the market forces to be illegal. This drastically affected foreign direct investments in the nation reducing the net revenue generated by the Government, which in turn led to problems of financial deficit government policy. The official exchange rate in terms of dollars was pegged, and dissuaded imports and foreign business from operating in Venezuela. The government, due to lack of financial resources, failed to come up with an adequate plan to combat the sudden depression in foreign investments. This led to the relapse of inflation, which increased the poverty rates as well. In 2016, the new exchange rate was set to 1,600 Bs. per dollar. A currency black market emerged, fuelled by the reliance on imports that required payments in foreign currency. In 2017, the inflation rate, which had been over 50% since 2014, reached 536.2% due to the rapid depreciation of the local currency on the black market. Venezuela's currency weakened sharply on the black market and its oil production, which has been falling by about 20,000 barrels per day (bpd) since 2016, fell by at least 250,000 bpd in 2017. As of 2018, Venezuela and its state-run oil company PDVSA owe over \$196 billion. Venezuela eliminated its heavily



subsidized DiPro exchange rate used for imports of food and medicine in an effort to revamps its exchange control system amid an economic crisis. It was replaced by its new crypto-currency Petro.

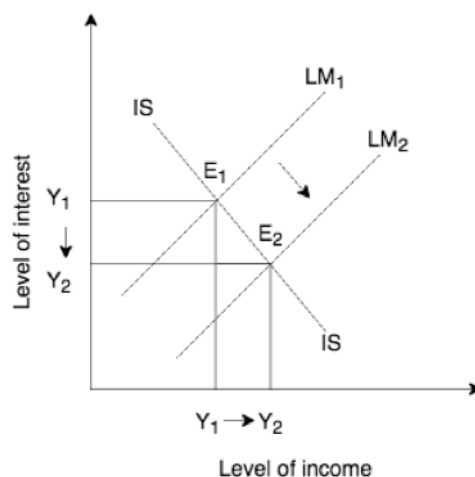
IS-LM Analysis

Venezuela's monetary and fiscal policies have had a jagged trajectory, with remedial measures being introduced to this day. The country is plagued with hyperinflation which reduces its capacity to save income and thereby leads to lower levels of investment (under circular flow of income, savings = investment), and therefore lower levels of aggregate supply, leading to a vicious cycle.

The Investment-Saving (IS) curve displays the equilibrium in the goods and services market for various interest rates. The determining factors for the IS curve are, (a) elasticity of investment demand curve, i.e. the responsiveness of investments to a change in rate of interest, and (b) level of investment. The position of the IS curve is determined by autonomous investments in the economy. In Venezuela, the percentage of government expenditure has only fallen, as will be explained further.

The Liquidity-Money (LM) curve is used to determined equilibrium in the money market. The determining factors of the LM curve are, (a) the supply of money, and (b) the responsiveness of demand for money to a change in income. The position of the LM curve depends on the change in supply of money. In current day Venezuela, there is a shift in the position of the LM curve due to a change in liquidity preference in the economy given the introduction of the new crypto-currency. In terms of Venezuela's fiscal policy, the government expenditure has been decreased as a remedial measure for hyperinflation. Aggregate demand hence decreased, and this has led to a leftward shift in IS curve. As there is a shift in the IS curve but LM remains constant, the equilibrium changes. As rate of interest falls, income level also falls. Hence we can say that Venezuela has a contractionary fiscal policy.

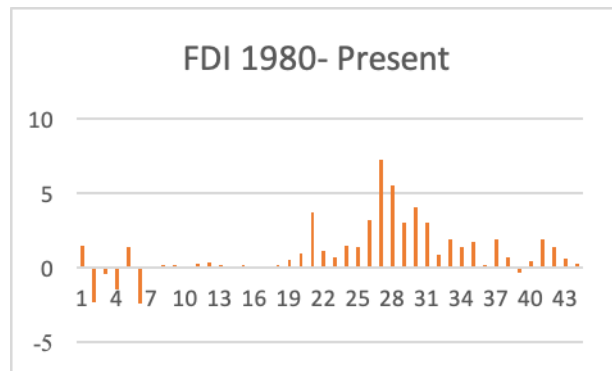
The country's monetary policy is an expansionary policy and to lift the country out of recession, measures are taken to increase the money supply in the economy. This leads



to fall in the rate of interest, and due to this, the cost of investing is lesser and therefore the rate of investment is higher. This will lead to a remedial rise in aggregate demand and income.

If the money supply of the economy increases either in liquidity or cryptocurrency, this should ideally result in the fall in the rate of interest offered by commercial banks. In Venezuela, due to its expansionary monetary policy, there is a fall in its rate of interest leading to a fall in income. The government is trying to bring about greater investments to induce more production in the economy. The inward shift in the IS curve also leads to a fall in NI on account of reduced autonomous expenditures by the government.

The intended aims of the Venezuelan monetary policy have not been achieved. In spite of a sharp increase in money supply since 2010, especially in 2016 with the launch of a new crypto currency, we note that the levels of private investments continue to remain minimal. This is because the commercial banks, despite the ready availability of cash for credit creation are reluctant to give out loans. This is because given the very high levels of investment and the strict government regulation making it largely difficult for private firms to sustain themselves, the banks find it more profitable to invest in financial assets, specifically government bonds in order to avoid the risk of bad debt. Secondly, even though the new crypto currency has added to the money supply, the banks cannot give loans against it on account of its anonymous mining nature which makes its regulation uncontrolled and supply unpredictable, further there is a large risk of hacking and international acceptability for payments. Lastly, the advent of an expansionary monetary policy in times of inflation has led to greater cash availability,

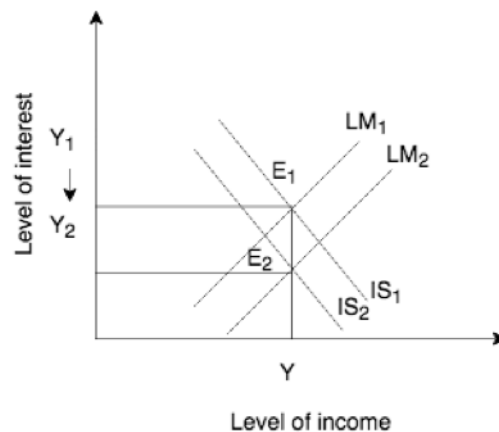


but as mentioned above the supply has not increased in correspondence. Thus, we note that the aggregate demand further increases while aggregate supply remains low leading to the problem of hyperinflation. Under such a dire state, the level of savings in the economy by households remains low (since most of the income is spent on consumption) thereby reducing the nations capacity to invest (since under the circular flow of NI, Savings= Investments).

In terms of fiscal policy, the government of Venezuela, by reducing its level of expenditure, brought about a fall in the level of income as well as the rate of interest prevalent in the nation, however the inflation levels continued to rise. This is because the Government, to combat inflation employed a supply side approach, i.e. it created conducive conditions for private investments which would add to the nations aggregate supply. However, no efforts were made to curb the level of aggregate demand in the economy which continued to stay high. The corporate and personal income tax have remained the same over the past decade, no increase was undertaken which would reduce the disposable income in the economy thereby negatively affecting aggregate demand.

Further, even in the face of decreased interest rates, the anti FDI policy in effect since the advent of the 21st century acts as a deterrent to foreign ventures in Venezuela, thereby foreign production in Venezuela remains low, the pegging of exchange rates by the Chavez government has further discouraged imports which has in turn reduced the aggregate supply further.

The private firms find it largely difficult to compete with the state-owned enterprise that have easy access to foreign currency. This has reduced their area of activity to domestic boundaries only. Therefore, the dominant companies are the state-owned enterprises, and these too have failed in being profit making. This has adversely affected their



productive capacity. The Government too has a large fiscal debt which has limited its capacity to pump more capital in these companies, making production growth stagnant. Lastly, the Venezuelan economy is largely dependent upon oil trade, the market for which is largely elastic. Both upswings and down swings are common. This risk factor dissuades private investors and makes the condition of the Venezuelan economy highly volatile, which is largely evident from the crash of oil prices in the 1980 which changed the face of Venezuela's governance, ideology and the nature of its economy.

The country's policy failure is due to a number of reasons. There has been no change in taxation to reduce the aggregate demand as an immediate measure to combat inflation. Moreover, the anti-FDI policy under the Chavez government has been a strong deterrent to investments in infrastructure from abroad. There has been a failure to channelize private investments for the following reasons:

1. Hyperinflation leading to minimum savings and hence no investments
2. Pegging of exchange rates and lack of availability of foreign credit readily makes it enormously difficult for the private sector to compete with the public sector.

There has been a steadily performance of state-owned enterprises to produce adequate quantity of goods. Venezuela also has a history of excessive dependence on the oil trade which has a largely elastic market demand, due to which the income of the people working in the sector also tends to fluctuate.

Other contributing factors include the pegging of interest rates and other socialist policies followed by the Chavez government, and the reluctance of banks to give out loans under the danger of bad debt in spite of increased capacity to give out loans which is channelized towards purchasing Government bonds and securities.

In the simultaneous equilibrium of the IS and the LM curve, we note the combined effect of the 2 policies, fiscal and monetary, as mentioned earlier, a contractionary fiscal policy reduces both rate of interest and income, while an expansionary monetary policy reduces rate of interest while increasing the level of income. Therefore, the fall in income caused by the Venezuelan fiscal policy counter balances the increase in income caused by its monetary policy, thereby keeping aggregate demand intact.

The double negative effect on the rate of interest causes the interest rates to fall

drastically, therefore the intention of the Venezuelan government was to combat its massive inflationary pressure by increasing the aggregate supply in the nation based on the assumption that a lower rate of interest would lead to greater levels of private investments of a real nature. However, the resultant impact was not achieved due to the individual failures of the 2 policies as mentioned earlier in the analysis.

Conclusion

It is necessary to reinstate the 1990s liberalisation plan that was implemented in reaction to the oil crisis of the 1980s. From the analysis above, we have established that the government's capacity to invest and to increase aggregate supply by state owned enterprises is highly limited. Further, given the large scale financial debt of the government over the last decade, the government's capacity to pump more capital into SEPs is also limited. This creates the need for private investments from abroad. It is necessary to revise the taxation policy to approach inflation from a demand perspective. In order to simulate such FDIs, it is necessary to allow the currency rates to fluctuate freely as opposed to pegging which deters foreign investors.