Morela Arocha
Edgar Rojas

The banking crisis in Venezuela: Background, development and implications*

I. INTRODUCTION

Latin American financial markets, in different eras and financial circumstances, have become vulnerable when their economies have been liberalized following years of rigid regulation by the State. The Venezuelan financial system was no exception and, after decontrol in 1989, within an adjustment program that involved a drastic change in previous political-economic management, its structural deficiencies worsened until a severe systemic crisis erupted in 1994.

This work attempts to present a complete panorama of the worst crisis ever faced by the Venezuelan financial sector, which accentuated macroeconomic imbalances and inexorably influenced the authorities who manage the economy.

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The second and third sections explain the antecedents of the banking crisis, depicting the Venezuelan financial system before the adoption of the 1989 adjustment program that promoted financial repression, and the effects of the program on the system's evolution. In the fourth section we deal with the banking crisis that arose in January 1994, describing how the government dealt with the problem, and the behaviour of the Central Bank of Venezuela (CBV) at the time. Finally, in the fourth section we frame some thoughts on the implications and influences of a weak, vulnerable financial system within an economic framework marked by strong macroeconomic imbalances requiring the immediate formulation and execution of a global economic plan.

II. THE VENEZUELAN FINANCIAL SYSTEM BEFORE 1989

1. Economic framework

Since the beginning of the democratic period in 1958, a political-economic model based on state intervention and protectionism predominated, molding a particular kind of mixed economy. The development of this traditional model was determined by a constant growth of oil earnings that permitted sustained growth of the Venezuelan economy until the middle of the seventies, within a framework of prolonged monetary stability that resulted in low inflation rates similar to those of Venezuela's main trade partners.

After the oil boom in 1973 and 1974, a fiscal policy based on growing public expenditures was accentuated, mainly financed by the foreign sector; this established the bases for a chronic fiscal deficit, eroded the monetary stability that existed until then, and induced inflationary pressures. The expansive fiscal policy maintained a growing economy, but it also led to more government intervention in economic activities in open competition with the private sector, thus contributing to an increasing structural public deficit which had to be financed by new foreign debts.

The beginning of the eighties was also characterized by expansive fiscal orientation. At the same time, there were failed attempts to liberalize the economy, among them the conciliation of prices of goods and services in 1979 and 1980, and the decontrol of interest rates in August of
1981. However, increased returns on domestic financial assets were not enough to stop capital flight at the end of 1982, brought on by a weakened oil market and a lack of foreign financing due to the debt crisis, as well as by strong devaluation expectations generated by these events.

In February, 1983, the National Executive (NE) and the CBV decided to abandon the fixed exchange rate system, and established a multiple exchange regime that lasted until March of 1989. At first, this regime produced a notable improvement in the balance of payments, linked not only to the imposition of administrative controls and the resulting devaluation, but also to the fiscal discipline observed in 1984 and 1985. Nevertheless, the resurgence of increased fiscal expenditures produced a strong monetary expansion that exerted pressures on the exchange rate, prices and the balance of payments.

Interest rates remained decontrolled between 1981 and 1984, during which time real interest rates became slightly positive. In March of 1984, at the beginning of a new government, the CBV again took over the administration of interest rates in order to reactivate economic activity, in conjunction with flexible credit assistance to the financial system and selective reserve measures.\(^1\)

In addition, during most of the eighties, the fiscal deficit and its difficult financing determined that the CBV's monetary management should often be tied to indirect financing of the government insofar as the legislation of the time would allow. The evolution of economic policy produced serious imbalances in the Venezuelan economy's domestic and foreign sectors until 1988 (see Table 1).

By 1988, the fiscal deficit was 8.6% of the gross domestic product (GDP), 4.3 in 1987; inflation reached 35.5%; interest rates for assets and liabilities, in real terms, were at -11.7 and -15.6% respectively; the balance of payments, despite existing controls, showed a deficit of 5 809 million dollars in the current account and 2 011 million dollars in the capital account; operative international reserves fell 41.9% in 1987 to 2 044 million

\(^1\) Other adopted measures were fixing an interest ceiling on loans for the agricultural sector, increasing the portfolio that commercial banking must allocate to financing that sector, and programs to provide liquidity for mortgage banking and the National System of Savings and Loans. These measures accentuated existing elements of financial repression.
dollars,\(^2\) covering only two months of imports; and the monetization degree (\(M_2/GDP\)) substantially decreased from 47 in 1983 to 38.3\% in 1988.

**TABLE 1. MACROECONOMIC INDICATORS, 1983-89 (in percentages and in millions of dollars)**

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<tbody>
<tr>
<td>Non-oil GDP growth(%)</td>
<td>(1.7)</td>
<td>0.2</td>
<td>3.3</td>
<td>6.0</td>
<td>5.6</td>
<td>5.7</td>
</tr>
<tr>
<td>Public account balance (% of GDP)</td>
<td>(3.7)</td>
<td>6.5</td>
<td>4.1</td>
<td>(1.7)</td>
<td>(4.3)</td>
<td>(8.6)</td>
</tr>
<tr>
<td>Current account balance ($)</td>
<td>4,427</td>
<td>4,651</td>
<td>3,327</td>
<td>(2,245)</td>
<td>(1,390)</td>
<td>(5,809)</td>
</tr>
<tr>
<td>Capital account balance ($)</td>
<td>(3,402)</td>
<td>(1,757)</td>
<td>(650)</td>
<td>(742)</td>
<td>707</td>
<td>(2,011)</td>
</tr>
<tr>
<td>Net international reserves ($)</td>
<td>11,149</td>
<td>12,469</td>
<td>1,750</td>
<td>9,858</td>
<td>9,376</td>
<td>6,671</td>
</tr>
<tr>
<td>Real lending rate (%)</td>
<td>11.9</td>
<td>4.1</td>
<td>4.3</td>
<td>2.5</td>
<td>(10.7)</td>
<td>(11.7)</td>
</tr>
<tr>
<td>Real deposit rate (%)</td>
<td>7.9</td>
<td>0.8</td>
<td>(0.1)</td>
<td>(2.4)</td>
<td>(14.7)</td>
<td>(15.6)</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>7.0</td>
<td>15.7</td>
<td>9.1</td>
<td>12.7</td>
<td>40.3</td>
<td>35.5</td>
</tr>
<tr>
<td>Monetization (%) (M_2/GDP)</td>
<td>47.0</td>
<td>42.2</td>
<td>43.6</td>
<td>48.3</td>
<td>41.8</td>
<td>38.3</td>
</tr>
</tbody>
</table>

SOURCE: Central Bank of Venezuela

With the express purpose of reducing these profound macroeconomic imbalances, an adjustment program was established in Venezuela in March, 1989 whose fundamental aspects covered a financial reform based, as in other Latin American experiences, on the diagnosis of an underlying financial repression.

2. **Financial repression**

The economic framework within which the Venezuelan financial system developed before 1989 shaped a financial repression characterized by:

i) a monetary policy sustained mainly by the direct and discretionary management of interest rates,\(^3\) as well as financial assistance facilities for

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\(^2\) Although operative international reserves increased during the first three years of the new exchange control regime, when the price of oil exports fell by half in 1985 they began to be affected, experiencing a reduction of 47.9\%.

\(^3\) Nonetheless, since 1987 the CBV emitted time deposits through the money desk whose yields reached levels significantly higher than those fixed by the institution for other operations, in order to absorb excess liquidity.
banking with differential rediscountrates and a selective legal reserves system depending on the kind of instrument and institution per the CBV Law.

In addition, so-called "drawers" were common to encourage growth in certain economic sectors, such as the obligatory credit portfolio that financial institutions must set aside to finance the agricultural sector.

ii) As a result of administrative fixing of nominal interest rates, these became negative in real terms within a framework of growing inflation, creating an ever greater imbalance in the monetary, exchange and real markets. Bank financing tended to favor consumption and trade and services activities, whose earning capacity was overestimated in the framework of strong negative real interest rates.

iii) The financial legal code was also inadequate to support growth of the financial system at the same pace as economic expansion. Among its limitations was the entry of financial intermediaries, primarily foreigners. The legal lag fostered bank specialization, separation of short and long term credit, and banking concentration in financial consortiums.

iv) An inadequate banking regulation and supervision code. In effect, the Banking Superintendancy was an agency without administrative or functional autonomy since its funds came mainly from budget assignments (the Superintendancy was attached to the Ministry of the Treasury), which involved delays in the acquisition of equipment, personnel qualification and the adoption of advanced accounting techniques. This inefficiency in the supervision of banking resulted in the following problems:

- Inefficient allocation of funds and high risk generated by an elevated loan portfolio to associated companies or individuals which, to a great extent, were made without the proper risk analysis or guarantees.

- Management practices that did not take into account sound portfolio policies and equity adjustments required by credit concentration, loans and subsidies.

- The public's ignorance concerning banking risk, caused by lack of information from the Superintendency on the operation and solvency of banking; this prevented adequate analysis and monitoring of financial institutions by the public.

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4 The partial reform of the General Law for Banks and other Credit Institutions of 1975 eliminated participation of foreigners in the domestic banking business. This legislative disposition was consistent with the nationalistic turn of the government at the time, reflected by nationalization of the oil industry in 1974 and the CBV Law reform that same year.
v) Strong intervention by the State as a financial agent through the creation of various *ad-hoc* institutions to attend to the financial needs of certain economic sectors.\(^5\) The wide range of public financial institutions formed in this way contributed to the lack of a precise credit strategy and to inefficient allocation of resources by diverting funds to the financing of activities that had been established by the NE. In addition, its presence in the banking business contributed to the expansion and specialization of the system and its preponderance in the stock market.

vi) Quasifiscal operations of the CBV in transactions involving pre-payments, discounts and rediscounts that its charter allowed it to fulfill with the financial system, in which, for a long time, there was preferential treatment for transactions with the agricultural sector in order to channel a significant flow of funds to the sector.\(^6\)

The existence of a multiple exchange system from 1983 to 1989 became, through the exchange subsidy involved, the most important quasifiscal operation of the CBV from a quantitative point of view,\(^7\) and continued to appear negatively in CBV accounts even after the adoption of a new exchange system in 1989.\(^8\)

This framework of financial repression within an increasingly deficient fiscal scene generated inflationary pressures and devaluation expectations that were progressively accentuated beginning in 1986. A large amount of credit demand was oriented toward anticipated consumption and the acquisition of foreign currency in the free market, reflecting the shrinking demand for domestic financial assets and the sparse development of appropriate institutions to channel domestic financial resources from savings.

\(^5\) With this objective, the following were created: the Agriculture and Cattle-Raising Credit Institute, the Agriculture and Cattle-Raising Development Bank, the Industrial Bank of Venezuela, the Venezuelan Development Corporation, the Regional Development Banks, the Urban Development Fund, the Agriculture and Cattle-Raising Credit Fund, the Industrial and Technological Development Fund, the Small and Medium Enterprise Development Corporation (Corpoindustria), the Venezuelan Workers' Bank, the Fruit Industry Development Fund, FONCACAIO and FONCAFE.

\(^6\) The CBV fixed the agricultural sector rate as a percentage of the general rediscount rate, which was fixed lower than the interest rate for other banking transactions.

\(^7\) The acquisition of non-interest Treasury Notes, a usual practice of the CBV until 1990, and losses in monetary operations through the money desk with interest rates that reflected fiscal insolvency, should also be classified as quasifiscal operations.

\(^8\) Mainly because of the need to deliver foreign currency at preferential exchange rates for imports that used notes of credit during the differential exchange regime.
into productive investments. This explains the behaviour of the intermediation coefficient, that relates the flow of non-oil placements in the financial system to the GDP, which grew from 2.3 in 1985 to 11.4 in 1988, after having fallen from 7.1% in 1982.

3. The institutional framework

In this framework with strong elements of financial repression, the institutional area of the financial system was equally inadequate given the existence of various regulatory entities with ambiguous functions and responsibilities, while solvency problems surfaced in some public as well as private financial institutions. The eighties ended with an institutional framework as follows:

- In the financial area, it was necessary to define and rationalize the role of the State as a financial intermediary through its banks and development funds.

- The CBV's activities were severely limited by formal legal arrangements related to the government and the financial system that imposed conditions on forming and executing an efficient monetary policy.

- The Superintendency of Banks was not adequately prepared to carry out its functions of supervision and control to establish conditions, correctly and precisely, for the adoption of remedial actions, sanctions and/or deposit insurance measures.

- The bank deposit insurance administered by the Fund for Deposit Guarantee and Banking Protection (FOGADE)\(^9\) needed substantial improvement in technical, legal, accounting and financial areas in order to set and rationalize procedures to provide financial aid for the banking system. It was also necessary to establish the most appropriate premium to be paid by banks to FOGADE, to strengthen its capacity to manage and solve banking difficulties.

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\(^9\) The Deposit Guarantee and Banking Protection Fund was created in March of 1985 in order to guarantee the public's deposits in domestic currency up to 250 thousand (18 169 dollars) per depositor in the case of liquidation. FOGADE could give financial aid to troubled institutions in order to reestablish normal performance, and equity would be made up by contributions from banks, benefits resulting from management, amounts contributed by the NE and funds from CBV advances.
- The existence of specialized financial institutions grouped in financial consortiums, overextending the banking sector\(^\text{10}\) and increasing intermediation costs. By 1988 commercial banking, as the most important financial subsystem, showed certain weaknesses such as: a low capital/assets ratio (5.5%), a high immobility of assets and portfolio with relation to equity (291.6 and 21.2% respectively), and a high level of debt against capital (1 730 per cent).

III. THE 1989 MACROECONOMIC ADJUSTMENT PROGRAM

1. Principal measures

The economic strategy established in February, 1989 limited itself, in its initial stage, to a group of measures to correct the imbalances shown by the monetary and exchange markets, and to introduce adjustments in the earnings and expenditures programs of the public sector in order to reduce the public financial debt at short term and, at medium term, achieve fiscal equilibrium. With these goals in mind, and to efficiently allocate available resources, a fundamental strategy was established to leave almost all prices in the hands of market forces.

With reference to economic stabilization, the program's main adjustments were the establishment of a sole floating free exchange rate, decontrol of nominal interest rates, conciliation of public prices and tariffs and the elimination of subsidies, increased domestic taxes and the rationalization and reduction of fiscal expenditures, as well as adjustment of monetary liquidity to the real requirements of the economy using indirect instruments of monetary policy in market conditions. These measures were meant to reduce aggregate demand and limit the expansion of domestic credit in order to correct domestic and foreign imbalances.

Simultaneously, a group of structural reforms was introduced, with medium and long term effects, to modify the productive structure of the country. A trade reform was initiated, based on total opening, to reorient production toward the country's competitive advantages and increase non traditional exports. A program to restructure and privatize public enterprises was stipulated to redefine the role of the State in the econ-

\(^\text{10}\) By 1988 there were 38 commercial banks with 454 branches and 1 185 agencies, 17 mortgage banks, and 41 financial companies.
omy. In addition, the process of opening to foreign investment was initiated, as well as restructuring the foreign public debt and reforming the Venezuelan financial system.

2. Financial reform

Faced with the magnitude of the economic reforms included in the adjustment program, and to guarantee its viability, it was indispensable to modernize the financial system so that it would be able to support and enhance growth. This could be accomplished by an integral reform to establish greater liberalization of financial activities in a framework of healthy competition, without the State giving up its role as regulator. The integral character of the reform was of vital importance, and included public and private sector intermediaries, short, medium and long term financial segments, administrative measures, legal modifications and agency adjustments.

Because of the complexity of needed changes in the financial system, from 1989 the government and the CBV relied on multilateral agencies for support. In 1990 an agreement was signed with the International Development Bank and the World Bank for a total of 600 million dollars to finance costs linked to the reform program.\(^\text{11}\)

The adjustment program included the following monetary and financial changes: a) interest rates became more flexible in order to promote positive real returns;\(^\text{12}\) b) the preferential interest rate for credit to the agricultural and industrial sectors was linked to market rates;\(^\text{13}\) c) the rediscount rate was adjusted until it approximated the lending rate, in order to limit banking access to the CBV's credit assistance to "last in-

\(^{11}\) For the government, these costs included capital contributions required by FOGADE, costs linked to the rehabilitation or liquidation of some State-owned financial institutions and the pass-through of its foreign debt, and increases in servicing the domestic public debt due to the new policy of emitting public debt at market interest rates.

\(^{12}\) Decontrol of interest rates faced legal impediments, and the CBV had to continue fixing rates, trying to keep them at the same levels that would be freely determined by the market. However, periodic adjustment of interest rates generated difficulties and the CBV decided, in April of 1990, on de facto decontrol by fixing a fifty percent differential between the minimum liability rate (10%) and the maximum asset rate.

\(^{13}\) The annual rate to be charged by commercial banking for credits to the agricultural and industrial sectors was fixed at 85% and 90%, respectively, of the average asset interest rate of the six commercial banks with the largest volume of deposits.
stance" cases and avoid its use as a permanent source of funds; and d) the proportion of the total credit portfolio that financial institutions must dedicate to the agricultural sector was gradually reduced.\textsuperscript{14}

As for monetary policy, the CBV emitted bonds to initiate active operations in the free market,\textsuperscript{15} which became the basic control instrument of monetary aggregates since, by their very nature, such operations are the most transparent and effective. The CBV intervened in the monetary and exchange markets with operations on the free market and daily sales of foreign currency through the money desk to simultaneously reach anti-inflation goals and foreign stability of the currency. In January of 1990 the CBV also unified the legal reserves rate on sight deposits, savings and time deposits at 12%\textsuperscript{16} in order to simplify the scheme and improve its supervision and control.

In order to achieve all the goals of the financial reform it was obviously imperative to modify the regulations of the financial system. Several legal reforms were considered, chiefly the CBV Law and the General Law of Banks and other Financial Institutions,\textsuperscript{17} which would allow restructuring public intermediaries, decontrolling asset and liability operations of private intermediaries and strengthening control agencies. Within the framework of these legal reforms, it was also planned to revise capital structure and bank debt limits.

However, it was not until June, 1991 that the financial reform bill was submitted to the National Congress, leaving a significant lag between ratification of the legal framework and decontrol of the key prices of the economy in 1989. This lag seriously limited the supervision and regulation of banking activities which, given the economic-financial liberalization in which it was already operating, undoubtedly generated an in-

\textsuperscript{14} From 22.5 to 17.5 in 1990, to 12.5 in 1991 and to 12% in 1992.

\textsuperscript{15} Since the CBV did not have a sufficiently attractive public stock portfolio and the government securities market was undeveloped, free market operations had to be carried out through CBV bonds emitted at short term and placed at a discount (zero coupon bonds). These securities were first offered on the Stock Market in November of 1989, and starting in August of 1990 through auction facilities and the CBV monetary operations desk.

\textsuperscript{16} In May of that same year, the reserves rate was increased to 15% in order to complement liquidity absorption by means of free market operations.

\textsuperscript{17} Proposed changes in the legal framework also included reforms in the Superintendency of Banks Law, the FOGADE Law, the Organic Law of Public Credit, the Agriculture and Cattle-Raising Credit Fund Law, the Industrial Credit Fund Law, the National System of Savings and Loans Law, the Capital Market Law and the Insurance and Reinsurance Law.
creasing fragility and vulnerability in the system, which was not identi-
fied in time.

3. 1989-91

a) General effects of the program

After the initial impact of the program in 1989 on fundamental
macroeconomic variables because of the adjustment of relative prices,
the following years showed important positive signs of domestic and
foreign equilibrium. In 1991 the non-oil product had a real growth of
8.6% the inflation rate was 31, after having been 81% in 1989; the fi-
nancial management of the Consolidated Public Sector closed with a
surplus of 0.6% of the GDP; the balance of payments passed from a
deficit of 1 055 million in 1989 to a surplus of 3 183 million dollars in
1991; and the degree of monetization (M2/GDP), after an initial drop in
1989 as a consequence of price adjustments, recuperated to 32.8% in
1990 and 36.7% in 1991.

Against all expectations, savings in the private sector systematically
decreased from 15.5 of the GDP in 1988 to 8% in 1991, while domestic
financial assets (financial savings) increased. The latter did not at first
translate into increased savings and investment, as can be seen in the ev-
olution of the flow of gross fixed investment of the private sector, which fell
from 17.2% of the GDP in 1988 to -2% in 1990 and 8.6% in 1991.

The discrepancies between financial savings, global savings and in-
vestment can be explained by the increased interest rates that reflected
macroeconomic imbalances at the outset of the program, by the tradi-
tional predominance of banking intermediation over the capital market
which stimulated the monetary market and by the decontrolled banking
system's funding in a framework of insufficient supervision and control.

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18 We must point out the positive impact of the 1991 foreign oil crash caused by the Per-
sian Gulf war on the foreign sector, the public profit and loss and the evolution of the real
product, as well as the expansive effects on liquidity and price levels. The public balance
also includes earnings from the privatization of two important State companies.
19 The CBV contributes to this situation through the progressive growth of its free market
operations with the emission of very short term liabilities.
b) Impact of the program on the financial system

Rapid decontrol of the financial market, until then severely controlled, produced a significant increase in nominal interest rates, which determined an important readjustment of real interest rates: the real asset rate rose from -11.7 in 1988 to 6.8 in 1991, while the real liability rate increased from -15.6 to 0.6% in the same period. Increased interest rates generated the recomposition of the public's financial assets in favor of time deposits and savings certificates, manifesting greater mobilization of financial savings in response to the interest rate adjustment. In effect, quasimoney as a proportion of the GDP increased from 20.4 in 1988 to a maximum of 24.7% in 1991.

Increased nominal and real interest rates determined that the banking system's funding grew by 18.9% in real terms during the period 1988 to 1991. However, despite substantially increased resources, credit activities showed a decrease of 31.7% in banking placements in real terms for the same period. This was due to higher financing costs, but also to the effects of the program in general, especially because of less economic activity during the initial stage of the adjustment and decreased financing of sectors that were no longer income-producing at the new interest rates.

Thus, the financial intermediation index (placements/funding) progressively decreased from 96.4 in 1988 to 55.4% in 1991, the lowest level registered in decades. We should point out, however, that 1991 showed a significant increase in banking placements (24.6%) in real terms, after decreasing during the previous two years) that was not reflected in an increased intermediation coefficient due to a strong increase (28.6% in real terms) in the financial system's funding (basically through official deposits) because of higher oil earnings generated by the Persian Gulf war in 1991.\(^{20}\)

The behaviour of banking placements was also reflected in the evolution of the coefficient of the flow of commercial bank placements with

\(^{20}\) To avoid the distorting effects of a substantial inflow of foreign currency, a contingency facility was established by means of a stabilization fund that did not function effectively, and the CBV accentuated its restrictive orientation, mainly with free market operations. However, by the middle of 1991, it was impossible to restrain the impact of the oil crash completely, and the goals that had been established by the Financial Program for that year were adjusted upward.
the non-oil GDP, which decreased from 8.9 in 1988 to 5% in 1990, recu-
perating to 8.4% in 1991.21

Financial non-intermediation was generating excess reserves, especially in com-
commercial banking. At first, part of these reserves were used to cancel debts,22 and later to generate minimum risk returns from government and, especially, CBV securities. The average return from zero coupon bonds was 35.2% in 1991, while the asset market rate was 37.7%, which converted an investment in stocks into a less risky alternative than credit activities. By 1991, investments in stocks represented 11.8% of total assets, with a propor-
tion of public stock equal to 82.3%.

Free market operations with zero coupon bonds lasted longer than usual for a short term instrument, first used to remedy transient deviations of monetary aggregates, due to the absence of a true fiscal adjust-
ment that would contribute to monetary stability and a reduced in-
flation rate. This would have required a permanent restrictive mone-
tary policy that would need ever increasing placements of CBV bonds to counteract monetary expansion from other public spheres, and to prevent the maturities of these securities from becoming an additional injection of banking liquidity.

Thus, these operations became insufficient and inefficient; they could not control monetary expansion in 199123 and impose, at the same time, ever higher financial costs on the CBV. Actually, CBV dis-
bursements for free market transactions were 52% of total disburse-
ments for 1991.

In this context, the lag in updating the program's institutional and legal framework again stands out as a distorting element in the effects of the stabilization plan on the financial system. The delay in passing

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21 The principal operations of the joint financial system were in line with those of the commercial banking subsystem. In effect, funding had a real growth of 53.6% and place-
ments decreased by 10.2% in real terms during 1988-91. The intermediation index (placements/funding) went from 96.5 in 1988 to 56.4% in 1991, and the coefficient of financial system placements and non-oil GDP was 5. 7 in 1990 and 10 in 1991, after reaching 11.4% in 1988.

22 During 1991 commercial banking canceled its total debt thanks to credit assistance from the CBV.

23 This determined the need to complement free market operations with modifications in the legal reserves system during 1991. In May, a special reserve of 80% on official de-
posits in the banking system and monetary market was established, and in August a facili-
ty was adopted to gradually increase reserve requirements on private sector deposits from 15 to 25%.
the tax laws conditioned the improvement of public financial profit and loss statements, requiring ever greater efforts from monetary policy. Insufficient credit demand in the face of excess banking reserves led to increasingly high investments in high-income zero coupon bonds, so that intermediation lost relevance and the solvency of financial institutions deteriorated due to the lack of strong banking supervision and regulation.

Important financial indicators for 1991 already showed low solvency levels. In effect, equity represented only 5.6% of total assets, and the heading other assets (basically made up of goods and real estate) was equal to 213.5% of equity for that year. The immobile portfolio as a proportion of equity was 18.1%, while the debt level (liabilities/equity) reached 1 752.5% in 1991.

Just as happened in other countries, Venezuela did not take into account that the financial system was not used to working in a liberalized framework and that the State did not have enough experience to weigh the importance of opportune adjustment of legislation, and supervision of the financial sector to new conditions.

After the delayed introduction of the reform bill, the National Congress did not consider rapid approval to be important\(^{24}\) until the 1993 political crisis came up and took over parliamentary discussions for a long time, again delaying the passing of important fiscal and financial laws.

4. 1992-93: the Twilight of the adjustment program

a) General framework and evolution of the financial sector

During 1992-93 the Venezuelan economy was stricken by economic and political elements that seriously affected its evolvement and that finally resulted in the failure of the adjustment program. For one thing, two coups were attempted in February and November of 1992 that spotlighted the uneasiness of the popular classes about the social effects of some of the economic measures that were being implemented.\(^{25}\) For another, the resurgence of fiscal imbalance\(^{26}\) in 1992,

\(^{24}\) The government that was installed in 1989 did not have sufficient political support to carry out the profound, but necessary changes that the program contained.

\(^{25}\) The first symptom of popular discontent was observed a few days after the new economic measures were announced (February, 1989), in a civil uprising. The 1989 adjust-
added to political instability, generated a climate of uncertainty in economic agents, which led to falling money demand, net capital flight, pressures on the exchange rate and, in general, strong instability in the monetary and exchange markets.

**TABLE 2. MACROECONOMIC INDICATORS, 1988-93 (in percentages and in millions of dollars)**

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<tbody>
<tr>
<td>Non-oil GDP growth (%)</td>
<td>5.7</td>
<td>(9.4)</td>
<td>4.6</td>
<td>8.6</td>
<td>7.7</td>
<td>(1.5)</td>
</tr>
<tr>
<td>Public account balance (% of GDP)</td>
<td>(8.6)</td>
<td>(1.1)</td>
<td>0.2</td>
<td>0.6</td>
<td>(5.5)</td>
<td>(2.7)</td>
</tr>
<tr>
<td>Current account balance ($)</td>
<td>(5 809)</td>
<td>2 161</td>
<td>8 279</td>
<td>1 736</td>
<td>(3 365)</td>
<td>(2 223)</td>
</tr>
<tr>
<td>Capital account balance ($)</td>
<td>(2 011)</td>
<td>(5 266)</td>
<td>(3 294)</td>
<td>2 962</td>
<td>2 822</td>
<td>1 159</td>
</tr>
<tr>
<td>Net international reserves ($)</td>
<td>6 671</td>
<td>5 344</td>
<td>7 397</td>
<td>10 264</td>
<td>9 181</td>
<td>8 324</td>
</tr>
<tr>
<td>Real lending rate (%)</td>
<td>(11.7)</td>
<td>(24.8)</td>
<td>(0.7)</td>
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</tr>
<tr>
<td>Real deposit rate (%)</td>
<td>(15.6)</td>
<td>(27.3)</td>
<td>(7.3)</td>
<td>0.6</td>
<td>6.8</td>
<td>21.0</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>35.5</td>
<td>81.0</td>
<td>36.5</td>
<td>31.0</td>
<td>31.9</td>
<td>45.9</td>
</tr>
<tr>
<td>Monetization M2/GDP (%)</td>
<td>38.3</td>
<td>30.7</td>
<td>32.8</td>
<td>36.7</td>
<td>32.0</td>
<td>30.5</td>
</tr>
</tbody>
</table>

**SOURCE:** Central Bank of Venezuela

The economy's profit and loss at the end of 1993 reflected a generalized imbalance in the domestic as well as the foreign sector (see Table 2). In effect, the real non-oil GDP shrank by 1.5% while the domestic aggregate demand shrank by 4.8% compared to 1992 levels; the inflation rate rose to 45.9; the consolidated public sector deficit reached 2.7% of the GDP; the monetization degree (M2/GDP) fell to 30.5% in 1993 reflecting an abrupt fall in the demand for money, and net international reserves fell to 9 181 million dollars in 1992 and 8 324 million dollars in 1993, while the nominal depreciation rhythm of the exchange rate acce-

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26 The financial surplus generated by the oil sector after the Persian Gulf war enabled the government to attend to intermittent social pressures by reorienting funds to finance social programs. In 1992, however, the NE had to confront a plunge in oil earnings and the need to deal with costs associated with social pressures that were accentuated by political instability; this resulted in a considerable fiscal deficit that was confronted only partially by various fiscal adjustment measures, on earnings as well as costs.
erated (29 and 33.2% in 1992 and 1993 respectively) without aligning with the inflation rate.

In the difficult circumstances associated with political instability and economic uncertainty in 1992 and 1993, the CBV intensified its use of the instruments at its disposal, which increased the amount of zero coupon bonds in circulation.\(^{27}\) Interest rates also reached unprecedented levels in nominal and real terms, reflecting higher inflation expectations associated with the fiscal deficit, as well as the increased country risk premium generated by the political and social milieu. The sustained bullish tendency of interest rates was reflected in a strong foreign imbalance that management of the nominal exchange rate was not able to correct.\(^{28}\) The average nominal lending rate increased from 37.7 in 1991 to 60.8% in 1993, while the liability interest rate increased from 31.2 to 51.8% during the same period. The lending liability real rates increased from 6.8 and 0.6 in 1991 to 27.6% and 21% in 1993.

In response to this evolution of interest rates, in March, 1993 the CBV decided to make them more flexible since the maximum rate in force (60%) was already restrictive, and it linked their ceiling to the average yield of free market operations.\(^{29}\)

The strong increase in interest rates did not, however, hold back a fall in demand for local financial assets; funding by the banking system decreased by 10.6% in real terms in 1993 compared to 1991. In the face of significant withdrawals, banking institutions funded through money desks for subsequent transfer to off-shore operations and maintained a policy of high returns on time deposits, driving the market liability rate to nearly 70% by the end of 1993. This strategy generated a substantial increase in the cost of deposits (financial outflow/deposits that generate

\(^{27}\) To reinforce monetary restriction during the most unstable period, funding operations were reestablished through the emission of deposit certificates by the institute's money desk.

\(^{28}\) In October of 1992, the CBV replaced the managed floating exchange system, which had been in force since the program began in 1989, by a predetermined exchange rate (crawling peg) in order to facilitate a stable slippage of the exchange rate and transmit this stability to the rest of the economy, especially to prices. This exchange scheme was unable to correct existing real appreciation, which was 9.7 in 1992 and 8.1% in 1993.

\(^{29}\) Given the discounted placement of zero coupon bonds, from the time of their appearance the earnings associated with the average price of each auction became the principal reference for market interest rates.
financial cost), which increased from 24.9 in 1991 to 34.2 in 1992 and to 46.6% in 1993.

By the end of 1993 banking liquidity was accentuated, and was dealt with by the CBV through traditional measures of credit assistance, registering a net assistance in November of 24,752 million bolivars.\textsuperscript{30} Although the decrease in banking reserves was due in great measure to massive withdrawals, it was undoubtedly a sign of the graveness of the general problem of banking solvency.

High interest rates during an economic recession, persistent falls in the demand for money, and capital flight seriously affected banking credit portfolios, which were already of poor quality. The immobile credit portfolio rose from 2.2 in 1991 to 6.4% in 1993, calculated over total placements; in 1991 it was 18.1 of total banking equity, reaching 38.6% in 1993.

Highly delinquent credit portfolios and persistent capital flight led to the adoption by many financial institutions of very risky growth strategies in the framework of deficient supervision. Inadequate monitoring of banks because of the delay in approving the new regulations allowed for excessive risk and cloudy accounting practices since the beginning of the program in 1989; these practices became more acute beginning in 1992 and led to the eruption of the 1994 financial crisis.

Political instability, joined to economic deterioration and a general ambience of uncertainty provoked liquidity problems in the banking system that compounded the bad practices of some banks which, without taking risk into account, were already concentrating a high proportion of their credit portfolios in loans to associates.\textsuperscript{31} This propitiated inappropriate conduct by banking management,\textsuperscript{32} emphasizing credit to associ-

\textsuperscript{30} Banks affected by the lack of liquidity also had recourse to the interbank market and to risky operations with associated institutions.

\textsuperscript{31} Many of these associated companies were recently constituted or acquired, or even fictitious, with capital that was not consistent with credits received, without real guarantees, and uncertain operations and profits. Accounting "makeup" could feign solvency for the various companies of a group, when in reality, funds were artificially transferred from one company to another.

\textsuperscript{32} This behaviour permitted banking placements to decrease by only 6.7% in real terms during 1991-93, versus the greater decrease of real funding, which placed the financial intermediation index (placements/funding) at 57.8% during 1992 and 1993, reflecting the impasse of banking operations in financing economic activities in general.
ated companies and individuals, increasing portfolio risk and jeopardizing solvency.\footnote{Portfolio concentration in associated institutions and the transfer of funds abroad through off-shore operations, in amounts not yet calculated, strongly shrank the financial sector's contribution in generating and distributing the product during 1992 and 1993. The coefficient of banking placement flows and the non-oil GDP went from 8.4 in 1991 to 6.6 in 1992 and 4.1\% in 1993.}

During 1992-93, institutions or investors did not seem to consider risk as an important factor, probably because of the premise that any problem would be resolved by a government rescue operation through the bank deposit insurance system.

The lack of banking supervision and control became evident when new banks were established just when insolvency problems were showing up. During 1989-91 five new banks were established, in 1992-93 seven new commercial banks were authorized, and right in the middle of the 1994 financial crisis, two additional banks were created.\footnote{In the period following application of the adjustment program, the following banks were authorized: Amazonas, Banesco, Canarias, Empresarial, Ganadero, Insular, Noroco, Plaza, Profesional, Progreso, Sofitasa, Tequendama, Confederado and Monagas, of which five were later involved in the financial crisis.}

The reform program of 1989 did not open the financial sector to foreign competition, and banking appeared to have less reasons than other economic sectors to improve its efficiency and make necessary changes. As a result, the banking sector was overextending itself with indifferent administration, reflected in the inefficient administration index (transformation costs/average assets) which increased from 5.4 in 1991 to 8.1\% in 1993.

In addition a great number of banking institutions depended on income apart from those generated from credit activities. For some banks, the highest investment within total assets was in stocks, even more than the credit portfolio.\footnote{For example, in December of 1993 Banco Progreso's investment in securities was 26.4\% of assets, while the credit portfolio was 26\%, including the immobile portfolio.} Some institutions showed worrisome levels of equity returns when adjusted by extraordinary income.

\textit{b) The lag in making the legal framework effective}

The lack of appropriate banking supervision facilities was due to the lag in approving the general regulatory framework of the financial system.
This delay definitely added strength to the harmful effects of the macroeconomic deterioration and political instability observed since 1992.

The first concrete legislative step in the reform that had been initiated in 1989 was taken in December of 1992, with the new CBV Law that established institutional autonomy through the removal of functions associated with economic development, provision of subsidies, and diverse services to the public sector. Among the most important adjustments was the reduction of political influence on the election and composition of the Board of Directors, elimination of direct or indirect financing of the public sector, replacement of equity losses by the government, as well as wide faculties concerning interest rates and legal reserves.

Nonetheless, it was not until the middle of 1993 (when the political situation had turned into a national emergency and a transitional government took over the outgoing Constitutional President) that long-delayed laws were passed. In November, within the framework of the Finance Law (Ley Habilitante), the NE approved the General Law for Banks and other Financial Institutions to take effect on January 1, 1994, four years after the initiation of the process on liberalization and opening of the Venezuelan economy. Among the most important changes of this new law is the concept of financial groups as units that encompass financial institutions, affiliated branches, subsidiaries and associated companies. This permitted better control and supervision of group activities by consolidating financial statements and strengthening equity capacity. The concept of Universal Banking was also incorporated, and would promote the integration of financial services, reducing costs and increasing the efficiency of these services.

In addition, the sector was opened to foreign investors to form new financial institutions and/or be stockholders in domestic institutions under

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36 This law, ratified by the Congress of the Republic, empowered the new NE to take extraordinary economic and financial measures in the space of a few months.

37 The new National System of Savings and Loan Law came into effect at the same time as the new Banking Law. It permits the decontrol and enlarging of Savings and Loan entities as corporations; obliges these institutions to submit to requirements similar to those for other financial institutions; and redefines the role of the National Savings and Loan Bank (BANAP). The Insurance and Reinsurance Law was ratified in December of 1994, establishing the autonomy of the Insurance Superintendency, opening the sector to foreign capital and requiring higher funds for insurance companies. Thus, only the reform of the Capital Market Law is still in abeyance to fulfill the original plans to reform the financial system.
equal conditions; limits were fixed on credit to associated companies by financial institutions or their main stockholders or executives; and, finally, banking regulation, supervision and control were strengthened by redefining the functions of the CBV, the Superintendency of Banks and the Deposit Guarantee and Banking Protection Fund.

Unfortunately, this new legal instrument no sooner came into effect in January of 1994 exactly when the grave banking problem surfaced. Given the preventive orientation of this law, which gave the Superintendence wider powers to intervene in the financial sector and established and independent financing facility, the Lag in its approval undoubtedly delayed application of measures to correct the structural deficiencies of Venezuelan banking.

In fiscal matters, it was not until the second half of 1993 that the Special Law of Public Debt was authorized and, within the framework of the Finance Law, the NE later approved a group of tax laws: the Value Added Tax (IVA), the Tax on Company Assets Law and the Fiscal Stamp Law.

1994 was initiated with the inauguration of a new government, marking a peaceful transition within a democratic continuity, after much political turbulence. Nevertheless, the year began with high inflation pressures generated by an increased, difficult to finance fiscal deficit, in a deteriorating economic scene with enormous expectations concerning the new government's economic policy. In addition, the lag between macroeconomic stability measures and legal and institutional updating was already big enough to produce the financial crisis of January, 1994.

IV. DEVELOPMENT AND MANAGEMENT OF THE BANKING CRISIS

1. Managing the problem

The Venezuelan financial crisis developed in several stages and was managed by the government by various strategies; they were initially characterized by improvisation due to lack of preparation because of its magnitude and rapidity, and because of the inability of public institu-

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38 The December 1993 elections signified the break-up of biparty hegemony; a coalition government was elected by less than 30%, of votes from numerous parties with different ideologies.
tions to deal with it. Subsequently, the strategy was less traumatic for the general public, although a precise accounting of its magnitude still seems to be lacking.

The severe crisis that the Venezuelan financial sector is still experiencing, and which reflects on the rest of the economy with destabilizing effects, erupted when the Banco Latino, the second most important bank in deposits at the end of 1993, was excluded by the Compensation Chamber; intervention was then decreed by the High Council of the Superintendency of Banks, created by the new General Law of Banks and other Institutions, effective January 1, 1994.\(^{39}\)

The government paralyzed the bank's activities and of all the group's financial companies until facilities to solve the problem were decided, which generated strong distrust in the public, manifested by deposit runs in other institutions.\(^{40}\) Financial instability increased, first in two associated banks and later in other entities that the public believed to be financially weaker and which were affected by the liquidity crisis,\(^{41}\) leading to massive withdrawals and finally uncovering chronic banking insolvency problems.

Since there was no precise information on the true financial situation of institutions affected by the liquidity crisis, and given the urgent attention required by the velocity and intensity of the resulting instability, FOGADE established a financial aid program in February in order to avoid a systemic crisis and the virtual collapse of the country's payments system. With the same goals, the CBV initiated direct assistance to institutions with liquidity problems through traditional facilities.

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\(^{39}\) The High Council of the Superintendency of Banks and other Financial Institutions would be made up by the Minister of the Treasury, who would preside, the President of the CBV and the President of the Deposit Guarantee and Banking Protection Fund. The Superintendent of Banks would be legally entitled to attend meetings and give opinions.

\(^{40}\) As to repercussions, the failure of the Banco Latino was very different from previous bankruptcies. Intervention of the Banco Nacional de Descuento in 1978 and the Banco de Comercio in 1985 had no consequences on the rest of the financial system. The same occurred with eleven institutions, most of which were financial companies, that collapsed between 1980 and 1984, as well as four other institutions that were intervened in 1985.

\(^{41}\) In addition to massive withdrawals of private and official deposits, the liquidity problems of the affected banks were accentuated because the overnight interbank market ceased to function for them. There was also a massive withdrawal of funds from the money desks and from off-shore units of Venezuelan banks which were under injunction because of the Latino Curazao N.V. case.
In addition, although the magnitude of the crisis was unknown, thinking that it involved a few non-liquid banks that could be rescued by the rest of the system, the CBV designed facilities for institutions with excess resources to channel these to banks with liquidity problems. These facilities included reopening of overnight credit through agent banks, and reducing the legal reserves rate from 15 to 12%. The CBV also established the cash reserve for banking debts in foreign currency in the same currency, and promoted a temporary facility of selective decontrol of legal reserves.

From the beginning of February, however, it was obvious that FOGADE had insufficient funds to cope with the crisis, and the CBV had to increase its support of financial aid to banks through FOGADE to avoid total destabilization of the system. This had been provided for in the new General Law of Banks and other Financial Institutions, as well as in the Special Law for Protection of Depositors and Regulation of Emergencies in Financial Institutions approved in March, which established conditions for the rehabilitation and reopening of Banco Latino, and raised the guarantee on deposits from 1 million bolivars, established in the new General Banking Law, to a maximum of 4 million bolivars per depositor and per bank or financial institution.

In June, however, in the absence of concrete plans by the government and the authorities to attack the banking problem, the CBV decided to suspend the FOGADE financial aid program. In the same month, the government decided to intervene eight financial institutions behind closed

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42 The CBV created favorable conditions within the framework of the adjustment program to establish and develop the interbank market in order to stop recurrent use of its credit assistance facilities by the banking system. At the end of 1992, the "overnight" credit facility was established to provide the interbank market with liquidity through a group of commercial banks that acted as agents, and which granted loans to banks with liquidity problems that did not have access to direct credit from the CBV because of inadequate guarantees. This facility would help to avoid erratic fluctuations in the interbank "overnight" rate, which had reached 300% by October of that year. It lasted about a month because of little demand, probably due to its high cost and complaints concerning the selection of agent banks.

43 Legal reserve requirements had been revised in 1992 with the object of reducing and unifying them at 15% for public and private sector deposits. In addition, in 1993 the CBV fixed a sole reserves rate for all funding instruments and institutions (15%), with the obligation of depositing the entire amount of reserves in the CBV.

44 This law was passed to establish regulations to protect the financial transactions of depositors and creditors of banks and other financial institutions, facilitate the recuperation of credits, protect confidence in the banking system, and regulate financial emergencies. We should point out the speed with which Congress passed this law, which was criticized by many specialists, and the delay in ratifying the new General Banking Law.
doors. After an evaluation of their situation uncovered a grave solvency problem because of accumulated capital losses. At the time of intervention, these banks had lost 64% of their deposits compared to 1993.

Intervention of these institutions led to the creation of the Financial Emergency Meeting, made up by the Minister of the Treasury, who presided, the President of the CBV, the Superintendent of Banks, the President of FOGADE, and three members designated by the President of the Republic. Among its powers, this Meeting has the authority to act as the financial system's agent in financial emergencies, assuming the powers of the High Council of the Superintendency of Banks.

The distrust and uncertainty generated by financial instability during the first half of the year generated a foreign drain of existing funds as well as of new funds from financial aid, and a consequent decrease in international reserves that resulted in a decision to impose currency controls in July.

In August, in response to strong rumors concerning the financial situation of two, seemingly solid, important commercial banks (Consolidado and Venezuela), there was a new deposit run and the government decided to intervene openly after excessive liabilities were exposed. Open intervention was possible through recapitalization of these banks by stockholders and the State, involving a change in ownership from private hands to the government, and allowing them to remain in operation; the public perceived this as less traumatic.

The Progreso and Republica Banks had received aid during all this time, and they were finally nationalized in December. The first was immediately liquidated when serious irregularities in its accounting systems were brought to light, while the second is still in operation. This new episode in the financial crisis was treated differently from the previous ones; deposits that were not duly reflected in their financial statements were transferred to other State-controlled banks. The "migration" of deposits moderated the adverse impact of a new bank failure, but it

45 This group of institutions was made up by the following commercial banks: Amazonas, Bancor, Barinas, Construccion, La Guaira, Maracaibo and Metropolitano (which held 20.8% of total deposits on December 31, 1993), as well as the Fiveca financial company.
46 This Meeting was also empowered to establish the special rule for the supervision and control of financial institutions; should the established regulations not be fulfilled, it has the power to remove all or part of the directors or administrators of the financial group, take over its capital stock in the name of the State and suspend or revoke operations.
47 Per instructions from the Financial Emergency Meeting, the State bought the capital stock of these banks at a symbolic price of one bolivar per share.
seriously affected the financial load of receiving institutions because no assets were transferred, adding to the financial system's vulnerability.

In January of 1995 it was decided to liquidate Grupo Latinoamericana Progreso,\(^48\) and in February the Profesional, Italo Venezolano and Principal banks were closed by the State by transferring deposits through a strategy similar to the one applied to Grupo Progreso; this accentuated the problems generated by the "migration" of deposits.

### TABLE 3. COMMERCIAL BANKS THAT HAVE BEEN INTERVENED AND APPROPRIATED BY THE STATE, 1994-95 (deposits as of December 1993)

<table>
<thead>
<tr>
<th>Institutions</th>
<th>Intervention or appropriation date</th>
<th>Deposits</th>
<th>Total deposit participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latino(^a)</td>
<td>January 16 1994</td>
<td>134 290</td>
<td>8.6</td>
</tr>
<tr>
<td>Amazonas(^a)</td>
<td>June 14 1991</td>
<td>5 461</td>
<td>0.3</td>
</tr>
<tr>
<td>Bancor(^a)</td>
<td>June 14 1994</td>
<td>22 259</td>
<td>1.4</td>
</tr>
<tr>
<td>Barinas(^a)</td>
<td>June 14 1994</td>
<td>20 738</td>
<td>1.3</td>
</tr>
<tr>
<td>Construcción(^a)</td>
<td>June 14 1994</td>
<td>57 567</td>
<td>3.7</td>
</tr>
<tr>
<td>La Guaira(^a)</td>
<td>June 14 1994</td>
<td>26 631</td>
<td>1.7</td>
</tr>
<tr>
<td>Maracaibo</td>
<td>June 14 1994</td>
<td>130 738</td>
<td>8.4</td>
</tr>
<tr>
<td>Metropolitano(^a)</td>
<td>June 14 1994</td>
<td>62 514</td>
<td>4.0</td>
</tr>
<tr>
<td>Tequendama(^b)</td>
<td>June 14 1994</td>
<td>125</td>
<td>0.0</td>
</tr>
<tr>
<td>Popular(^b)</td>
<td>June 14 1994</td>
<td>5 400</td>
<td>0.3</td>
</tr>
<tr>
<td>Venezuela(^c)</td>
<td>August 9 1994</td>
<td>143 378</td>
<td>9.2</td>
</tr>
<tr>
<td>Consolidado(^c)</td>
<td>August 25 1994</td>
<td>62 901</td>
<td>4.0</td>
</tr>
<tr>
<td>Andino(^c)</td>
<td>Nov.10 1994</td>
<td>6 072</td>
<td>0.4</td>
</tr>
<tr>
<td>Progreso(^c)</td>
<td>Dec. 13 1994</td>
<td>64 308</td>
<td>4.1</td>
</tr>
<tr>
<td>República(^c)</td>
<td>Dec. 13 1994</td>
<td>34 822</td>
<td>2.2</td>
</tr>
<tr>
<td>Italo-Venezolano(^c)</td>
<td>February 2 1995</td>
<td>29 644</td>
<td>1.9</td>
</tr>
<tr>
<td>Principal(^c)</td>
<td>February 2 1995</td>
<td>32 100</td>
<td>2.1</td>
</tr>
<tr>
<td>Profesional(^c)</td>
<td>February 2 1995</td>
<td>11 862</td>
<td>0.8</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>850 839</td>
<td>54.4</td>
</tr>
</tbody>
</table>

\(^a\) Intervened. \(^b\) The shares of these banks were transferred as advanced payments to FOGADE. \(^c\) Appropriated.

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\(^48\) This financial consortium was made up by the following institutions: Banco Progreso, Banco Republica, Banco Hipotecario Latinoamericana, Banco de Inversion Sofilatin, Arrendadora Financiera Latinoamericana, Sociedad de Capitalizacion Progreso, Seguros Latinoamericana, Seguros Anauco, Casa de Cambio Latinoamericana and Fondo Mutual Progreso. Grupo Latinoamericana Progreso was also the proprietor of a number of non-financial companies, primarily in the area of radiocommunications.
By the first half of 1995, 18 commercial banks were affected (see Table 3), that as a group accounted for 52.7% of the subsystem's total assets and 54.4% of its funding by December 31, 1993. Nine mortgage banks were also affected, as well as seventeen investment banks and fourteen financial leasing companies, which in some way were associated with the intervened and/or nationalized banks. The financial crisis caused a large part of the commercial banking subsystem's assets (56.4%) to be taken over by the State, and concentrated deposits in the three commercial banks that seemed most secure to savers; at the end of the first half of 1995, these accounted for 60.9% of total deposits.

2. Action of the Central Bank

The financial crisis imposed severe conditions on economic policy decisions, involving strong restrictions on the CBV in the formulation and execution of monetary policy. During the first half of 1994, price stability was subordinated to the stability of the financial system, and the CBV assumed its role as last-instance money lender to avoid a collapse of the country's system of payments.

The magnitude of the crisis that exploded at the beginning of 1994 required financial support from the CBV through the injection of large amounts of resources into the economy, equal to 10.1% of the GDP (see Table 4); this accentuated the monetary imbalance and required free market operations to counteract the impact on inflation and falling international reserves, since the crisis itself accentuated the falling demand for money that had been registered since 1992.49

Intensification of monetary imbalance was reflected in strong pressures on international reserves during the first six months of 1994 (they fell more than 45%) that could not be neutralized by nominal exchange rate adjustment, which devaluated 88.4%, or by a restrictive monetary policy. This situation determined the adoption of extraordinary measures

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49 In effect, a growing lack of confidence in the solvency and solidity of an important segment of the financial system and uncertainty about the application of efficient measures to confront the banking crisis as well as economic policy in general, accentuated adverse expectations that surfaced in 1992.
that included the suspension of certain constitutional guarantees and the application of exchange and price controls in July.\textsuperscript{50}

**TABLE 4. GUARANTEE FUND OF DEPOSITS AND BANKING PROTECTION: ORIGIN AND APPLICATION OF FUNDS, 1994 (in millions of bolivars and in percentages of GDP)**

<table>
<thead>
<tr>
<th>Sources</th>
<th>$</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions of financial institutions</td>
<td>1 236 590</td>
<td>14.9</td>
</tr>
<tr>
<td>Income of portfolio investments</td>
<td>34 240</td>
<td>0.4</td>
</tr>
<tr>
<td>Advanced payments of CBV</td>
<td>14 429</td>
<td>0.2</td>
</tr>
<tr>
<td>Placement of gobernment securities/transfers</td>
<td>839 529</td>
<td>10.1</td>
</tr>
<tr>
<td>Settlement of assets from intervened banks</td>
<td>293 375</td>
<td>3.5</td>
</tr>
<tr>
<td>Financial assets variation</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>CBV account variation</td>
<td>33 159</td>
<td>0.4</td>
</tr>
<tr>
<td>Uses</td>
<td>21 859</td>
<td>0.3</td>
</tr>
<tr>
<td>Financial aids</td>
<td>1 203 002</td>
<td>14.5</td>
</tr>
<tr>
<td>Intervened bank dep. dev.</td>
<td>1 037 043</td>
<td>12.5</td>
</tr>
<tr>
<td>Migration financial costs</td>
<td>162 799</td>
<td>2.0</td>
</tr>
<tr>
<td>Operative expenditures</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Others</td>
<td>3 161</td>
<td>0.0</td>
</tr>
<tr>
<td></td>
<td>33 588</td>
<td>0.4</td>
</tr>
</tbody>
</table>

**SOURCE:** FOGADE.

The magnitude of the banking crisis had already overrun its ability to sustain an efficient monetary system, and adoption of the new exchange regime supposed deepening monetary imbalance that required even greater efforts from the CBV.\textsuperscript{51} Bullish pressures would have been ap-

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\textsuperscript{50} The CBV coped with exchange pressures with various facilities to supply the market with foreign currency, such as accelerating the programmed depreciation of the exchange rate and subsequently adopting two different systems to auction foreign currency; but these facilities collapsed in the middle of June due to intervention in eight banking institutions, and exchange controls became necessary. We should mention that in April the president and other members of the CBV's board of directors resigned because of disagreements about the new government's economic orientation, accentuating uncertainty and stimulating exchange pressures.

\textsuperscript{51} During the second half, the CBV intensified its restrictive actions via the free market with the only available instrument with acceptable qualities: the zero coupon bond. Circulation increased from 70 852 million at the end of 1993 to 744 713 million bolivars in 1994 (9% of the GDP), indicating that the financial crisis introduced severe restrictions on the effectiveness of monetary policy and elevated its cost.
plied to interest rates, which was potentially dangerous in the existing financial vulnerability. Thus, the end of 1994 saw a less restrictive monetary policy during a period of decreasing demand for money and increasing monthly inflation rates (despite price controls on certain basic products) and a pronounced fall in the nominal interest rate (the liability rate going from 51.2% in June to 26% in December) that resulted in highly negative real interest rates by more than twenty percentage points.

1995 began with limitations similar to those observed in 1994 concerning the financial crisis and the lack of a clear economic policy. In January the CBV resumed free market operations, after having suspended them in December,\textsuperscript{52} with Monetary Stabilization Securities (TEM) instead of zero coupon bonds.\textsuperscript{53}

Resumption of free market operations was characterized by low dynamics (with TEM supply lower than zero coupon bond maturities) with the intention of leaving needed monetary space for an announced government financing plan.\textsuperscript{54} However, due to the lack of definition of such a plan, in March the institute resumed restrictive action, which raised the effective yield of the TEM, recuperated interest rate levels and progressively shrunk excess banking liquidity. This last was also helped by greater dynamics in the exchange market generated by more flexible facilities to allocate foreign currency.

During 1994 and the first half of 1995, monetary policy developed in an adverse framework in which, at first, it was decided to make absorption more flexible in order to safeguard the stability of the financial system and payments. Later, when it was necessary to drain liquidity excesses associated with last-instance lending and avoid a plunge in inter-

\textsuperscript{52} At the end of December, 1994, the CBV temporarily suspended placement of zero coupon bonds, reducing their circulation with the intention of using asset instruments rather than liabilities in free market operations. This would also facilitate the placement of public securities to pay the foreign debt and recapitalize FOGADE.

\textsuperscript{53} The main difference between zero coupon bonds and TEM lies in that TEM can be placed at par, with a premium or discount, at a fixed interest rate, and only through direct allocation by the monetary operations desk of the CBV.

\textsuperscript{54} This financing plan largely consisted in the emission of shares in dollars, providing funds to enable FOGADE to cancel the debt it incurred with the CBV for financial aid during the banking problem. This strategy would contribute to the elimination of excess banking liquidity in the system.
est rates, the general uncertainty and lack of fiscal discipline caused monetary policy to lose effectiveness and credibility.

The question remains whether present management of economics is contributing to reflating the Venezuelan financial system, or whether it will later severely restrict a coherent macroeconomic policy by imposing elevated costs.

V. THE PRESENT FINANCIAL SYSTEM FACING THE NEED FOR A NEW STABILIZATION PROGRAM: GENERAL CONSIDERATIONS

1. Economic balance at the end of the first half of 1995

All the elements we have pointed out make the present economic situation in Venezuela a transcendental challenge for the authorities in charge of formulating and executing economic policy. In fact, the effects of the still latent financial crisis impose strong restrictions on the adoption of coherent measures to resolve present severe macroeconomic imbalances.

Monetary policy has been conditioned to attempt to counteract the monetary impact of the financial crisis while trying to maintain interest rates at levels that can be supported by the weakened financial system. Experience has taught us that an isolated monetary policy is not enough to correct the country's macroeconomic imbalances; it is evident that a more active fiscal policy is needed and, in general, a clearer and more coherent economic policy, within which monetary policy can be assembled.

In the fiscal area, the banking crisis had a negative impact on the profit and loss of public finances by generating a significant increase in the financial deficit of the government and the consolidated public sector. The increased deficit originated in direct financing to FOGADE

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55 In September, 1994 the CBV decided to make the minimum liability interest rate more flexible (10%) by fixing it according to yields of the zero coupon bonds. Later, during the first half of 1995, several interest rate measures were adopted, apparently to stimulate increased funding by the banking system and more dynamic credit activities as well as discretionary decreases in the differential between asset and liability rates to provide incentives for efficient financial management. After several changes, in June the CBV resumed direct fixing of the maximum assets rate (46%) and the minimum liability rate (24%), freeing them from the yields of free market operations.
through the placement of domestic public debt bonds for 400 billion bolivars to capitalize the fund and attend to the needs of troubled financial institutions, and by the cost of CBV quasifiscal operations to slow down the monetary expansion created by financial aid.

The fiscal deficit situation is presently fueled by persistent quasifiscal losses of the CBV; by interests on public sector debts, basically of the central government and FOGADE with the CBV,\textsuperscript{56} and by pressure from servicing the foreign debt, subsidies for prices and tariffs of goods and services, the paralyzed privatization programs, and structural rigidity of public expenditures.\textsuperscript{57}

All of these elements point to significantly defective fiscal management if severe corrective measures are not adopted. Financial management of the government during the first half of 1995 shows an estimated deficit of 2.5\% of the GDP,\textsuperscript{58} the result of expenditures 30.6\% higher than the fiscal income collected during that period, despite the positive effects of improvements in tax collection and control\textsuperscript{59} and increased domestic taxes.\textsuperscript{60}

The magnitude of the fiscal deficit and its difficult financing requires a solution other than inflationary financing to insure that monetary policy will not lose credibility. Delaying the adoption of such measures

\textsuperscript{56} At the close of the first half of 1996, FOGADE's total debt with the CBV rose to 1170773.9 million bolivars (18.8\% of the GDP), a balance that reflects past due advances as well as ordinary and delinquent interests. The National Government owes the CBV 388155.6 million bolivars (6.2\% of the GDP).

\textsuperscript{57} 32.3\% of fiscal spending was due to entries related to interest payments on the public debt, quasifiscal operations of the CBV and transfers to FOGADE, pointing out the significant weight that servicing the public debt imposes on the government, and the continued impact of the financial crisis.

\textsuperscript{58} The 1995 Fiscal Budget Law and its respective Financing Law forecasted a deficit of 3\% of the GDP that, once adjusted by underestimated expenditures and overestimated earnings, raised the financing needs of the Central Government to 7.7\% of the GDP for the entire year.

\textsuperscript{59} Within the framework of the Finance Law (Ley Habilitante), ratified by the National Congress in April of 1994, the NE approved the Consumption and Wholesale Sales Tax Law, created the Tax on Banking Debits (in force until 31/12/94) and reformed the Organic Tax Code, the Income Tax Law and the Taxable Regime of Fiscal Stamps. In addition, to modernize tax administration and control and improve tax collection at short term, the NE created the National Integrated System of Tax Administration (SENIAT), an agency with functional and financial autonomy, dependent on the Ministry of the Treasury.

\textsuperscript{60} Tax collection from domestic economic activities was 56.2\% of tax income for the first half of 1995, while oil contributed 43.8\%. 
leads to unfavorable expectations that translate (as one of its most visible and pernicious effects) into a higher inflation rate, which manifested itself during the first half of 1995 as 61.2% per annum.

This high inflation rate, produced during an economic contraction (1% fall of the non-oil GDP in the first half of 1995), has generated, on the one hand, very negative real interest rates (assets: -14.7%; liabilities: -26.9%) that distort the allocation of resources and, on the other hand, a marked appreciation of the real exchange rate\(^61\) that stimulates leakages in exchange control and pressures on the capital account.\(^62\)

As can be clearly seen, the economic balance at the close of the first half of 1995 shows the immediate need for a global and integral macro-economic reform program that will help to guarantee sustainable growth in time, and that will promote the adjustment and stability of the financial system. The latter, in turn, is indispensable for a stable, orderly and sustained growth of the economy.

### 2. Economic stabilization with a weakened financial system

The close connection that exists between macroeconomic and financial stability poses the challenge of coordinating the adoption of reforms in both areas in order to avoid lags that might jeopardize the success of a global reform. Recent experiences in Venezuela ratify the need for economic and financial reform programs that include, above all, not only clear and explicit signals of the decision to stabilize the economy, but also establishment in the financial area of a body of adequate regulations and effective supervisory facilities in order to reduce the risks and costs of banking failures.

The new General Banking Law has the potential to modify the financial sector substantially. It pursues a more efficient banking system by promoting competence, complementing the formal improvements previously adopted in supervision and equity strengthening by resolutions

\(^61\) Indicators of quotations for Brady Bonds at the end of June, 1995 show an annual appreciation of the real exchange rate of approximately 37%.

\(^62\) Preliminary numbers for the first half of 1995 on foreign accounts of the Venezuelan economy show a deficit in the global balance of payments, due mainly to a deficit in the capital account, whose balance could not be completely financed by savings generated by the current account surplus, resulting in a loss in gross international reserves of approximately 959 million dollars.
stipulated by the Superintendency of Banks in July, 1990. Although its effects are yet to be seen, the new Banking Law is a major advance that should generate more efficiency, competence, transparency and confidence in the Venezuelan banking sector.

As for prudential regulations now in force, we have the aforementioned equity strengthening stipulation of the General Banking Law. It established that the equity-assets ratio suggested by the Basel Committee (8%) should be reached within two years from the date that this law came into effect (January 1, 1994). It is evident that one lesson learned from the financial crisis is the need to increase government supervision of the financial sector by means of qualified personnel and advanced accounting techniques, and to watch over constant fulfillment of the legal rules that regulate banking activities.

Truly preventive and efficient banking supervision must be based on transparent, precise and continuous measuring of financial risks and individual bank portfolios, so that excessive risk-taking can be covered rapidly by larger provisions and/or equity. As this information reaches the market, systematically transmitting the condition of each bank in aspects like equity adjustment or portfolio quality, it will encourage the sector to assume more self-control, making each institution less disposed to take excessive risks and more likely to conciliate financial statements, thus permitting an early resolution of potential banking problems.

In the hope of developing an effective prudential regulation, in 1994 the Superintendency of Banks decreed that financial institutions should present a monthly statement of assets and contingent operations in order to determine the appropriate equity level according to risk; at the end of each semester they must present an evaluation of the credit portfolio to determine, according to risk, the generic or specific provision that is

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63 Among these resolutions we find criteria for evaluating goods received as guarantees, methods to consolidate or combine the accounts of financial groups, criteria for registering and evaluating extraordinary income, disincorporating book assets, criteria for evaluating assets in foreign currency, classifying and provisioning the loan portfolio, limits on loan concentration, measuring the quality of and provisioning the investment portfolio, regulations on information to be provided by authorized foreign banks, definition of restructured credits, uniform criteria for external audit reports and published balances, regulation of offshore operations, and regulations to authorize the promotion and performance of banks.

64 In 1988 the Basel Committee agreed to establish capital fitness at 8% for 1992 (in that year, Venezuelan banking had 6.4% capitalization). Today, it is argued that this coefficient should be 10%.
needed. Each quarter, banks must also present calculations for ten financial indicators of solvency, liquidity and profitability,\textsuperscript{65} as additional information for the public, at the foot of the published balance. These requirements should be complemented by the application of appropriate sanctions and penalties when the dispositions of the Banking Law and the Superintendency have not been fulfilled; these measures are found in that law and in the Financial Emergency Law.\textsuperscript{66}

A prudential banking regulation should precisely define the limits of State support or responsibility for potential banking losses in a pattern of greater freedom and competition, in which motivations regarding risk will not be distorted when a deposit insurance exists. Among the measures that could reduce problems associated with "moral hazard", and which have been prudently adopted in other countries, are a reduction in this insurance, alternative private facilities in cases of a solvency crisis (rescue of a bank by the private banking system, and conversion of a percentage of its deposits in new capital stock), as well as compulsory capital and liquidity requirements. The legal framework already contains measures in this context, such as limiting CBV financing of the financial system to transient liquidity problems of solvent institutions, and high capital adjustment requisites.

However, the Venezuelan financial system has not yet recovered completely from the 1994 crisis. In the first place, the State found it necessary to assume direct control of institutions affected by the banking problem. This was first done by the Chief Executive and later delegated to the Financial Emergency Meeting, that has done so through FOGADE and the Superintendency of Banks; the number of state-owned banks currently serving the public increased from four in December, 1993 to

\textsuperscript{65} These indicators are: i) total equity/assets, ii) other assets/equity, iii) other assets/total assets, iv) productive assets/total assets, v) financial margin/average assets, vi) transformation costs/average assets, vii) liquid profits/average assets, viii) liquid profits/average equity, ix) (Deposits in the CBV + securities emitted by the Nation)/(total funding = demand liabilities).

\textsuperscript{66} The highest physical penalty provided in the General Law of Banks and other Financial Institutions is for elaborating or emitting documents and using false data to commit fraud: prison for from three to six years (Article 291). The situation becomes more complicated when crimes against the public good are added to irregularities in Bank administration.
nine in June, 1995.\(^{67}\) This means that the government is retaking the administration of an extemporaneous activity, with the consequences this will have on fiscal accounts and the quality of banking management.

Another consequence of the banking problem has to do with a massive concentration of deposits in one group of the system's financial institutions. This could be beneficial because it facilitates banking supervision and employs important flows of resources in economic activities with different risks. However, some of the institutions that grew significantly because others failed face a serious problem in adjusting the flow of assets and liabilities, because of the unprecedented growth of the latter. Given the weak demand for credit, financial equilibrium is jeopardized by large disbursements in interest payments since, in addition, the first half of 1995 saw a resurgence of deposits that generated financial costs. This situation is even more serious for those institutions that received, for accounting purposes, the deposits of liquidated institutions, whose assets have not yet been compensated by FOGADE.

The "migration" of deposits added costs to public finances that would unfavorably affect the fiscal year since FOGADE had to obtain funds to reinforce the equity of the institutions that received these deposits.

Changing from private to public by some of the banks that had negative solvency and liquidity indexes has also resulted in a bad credit load that must be assumed by the Nation. There was a significant increase in bank placements during the first half of 1995, although concentrated in the second quarter in a small number of commercial banks; only 4 banks granted 65.3% of total credits during the semester.\(^{68}\) There is also a high proportion of stock acquisitions in the assets of some banking institutions, with emphasis on a strong increase in CBV credit securities, which went from 34.4% in the second half of 1994 to 42.4% in the first half of this year.

However, returns from credit and stock investments do not seem to compensate for disbursements for interest payments and, particularly,

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\(^{67}\) To this we must add the eleven State acquired banking institutions that closed their doors from the moment of intervention or nationalization.

\(^{68}\) This increase in funding could be associated with strong devaluation expectations that, in the presence of negative real asset interest rates, stimulated the demand for credit to acquire foreign currency.
the associated operating expenses of many banks, which has led to reduced profits, financial margins and intermediation levels.

The present situation of the financial system is very heterogeneous (see Table 5); one of the essential steps to disencumber and strengthen the financial system is a thorough, exhaustive and frank examination of the institutions that continue in operation in order to adopt needed measures without interrupting their performance. Recapitalization of institutions that survived the crisis should be required as soon as possible; low equity levels have been observed in some banking entities that are not obvious when taking into account the total banking equity-assets ratio (8.1%). Delays in managing troubled institutions and in eliminating the causes of their problems can be very costly, not only in terms of the fiscal resources needed for their rescue, but also in terms of negative consequences of a bad performance by the decontrolled financial market.

Appropriate preventive measures must be taken to avoid new situations of financial instability. It is very probable that diverse procedures will surface: fusion, associations, utilization of idle capacity, specialization in market niches and areas, systemizing operations, as well as the use of foreign sources of banking services, all of which can strengthen the banking system without resorting to nationalization.

An important point to be considered in a macroeconomic reform program is the interest rate policy. In a situation such as the present depressed economy, a sudden and brusque decontrol of interest rates could take them to levels that would affect the payment capacity of loan companies of the banking system, endangering not only their financial situation, but also that of banking institutions, especially in the present vulnerable system. The reforms, however, pursue positive real interest rates to stimulate funding and retention of domestic savings. It follows that during the preliminary stages of the reform program, and while the bases for the free performance of banking are strengthened, an appropriate balance must be reached to manage interest rates in terms of the financial stability of banks and protection of savings.

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69 Because of the need to invest more in personnel and new agencies, caused by the transfer of clients, there is little possibility of reduced costs for some banking institutions. Many have opted for "invisible" barriers, such as high limits and other requirements to open accounts and increased minimums to maintain them, to limit the number of new clients and accounts that are too costly for the banks.

70 With reference to this, in June of 1995 the Superintendency established criteria to control fusions of banks and other financial institutions.
<table>
<thead>
<tr>
<th>Banks</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
<th>(8)</th>
<th>(9)</th>
<th>(10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large bank (provincial)</td>
<td>34.5</td>
<td>25.1</td>
<td>139.9</td>
<td>91.3</td>
<td>5.7</td>
<td>34.7</td>
<td>39.7</td>
<td>95.2</td>
<td>3.5</td>
<td>21.6</td>
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<tr>
<td>Medium bank (external)</td>
<td>37.1</td>
<td>18.9</td>
<td>73.1</td>
<td>93.9</td>
<td>9.6</td>
<td>12.5</td>
<td>44.9</td>
<td>99.8</td>
<td>3.7</td>
<td>49.0</td>
</tr>
<tr>
<td>Small bank (Banesco)</td>
<td>34.9</td>
<td>24.2</td>
<td>92.9</td>
<td>93.2</td>
<td>10.6</td>
<td>11.2</td>
<td>39.9</td>
<td>93.0</td>
<td>3.7</td>
<td>49.0</td>
</tr>
<tr>
<td>Appropriated bank (Venezuela)</td>
<td>28.9</td>
<td>16.3</td>
<td>351.9</td>
<td>86.2</td>
<td>4.9</td>
<td>121.1</td>
<td>33.5</td>
<td>83.7</td>
<td>3.9</td>
<td>12.1</td>
</tr>
<tr>
<td>Public Bank (Guayana)</td>
<td>53.7</td>
<td>48.8</td>
<td>68.5</td>
<td>80.1</td>
<td>9.5</td>
<td>24.7</td>
<td>18.7</td>
<td>99.9</td>
<td>5.9</td>
<td>-2.1</td>
</tr>
<tr>
<td>Recently opened bank (Confederate)</td>
<td>17.2</td>
<td>46.0</td>
<td>144.7</td>
<td>93.6</td>
<td>20.6</td>
<td>0.3</td>
<td>15.4</td>
<td>64.1</td>
<td>6.72</td>
<td>-2.6</td>
</tr>
<tr>
<td>Foreign bank (Citibank)</td>
<td>64.9</td>
<td>27.5</td>
<td>36.0</td>
<td>86.8</td>
<td>8.1</td>
<td>9.8</td>
<td>16.1</td>
<td>100.0</td>
<td>3.5</td>
<td>36.1</td>
</tr>
<tr>
<td>Total active commercial banking</td>
<td>37.2</td>
<td>24.8</td>
<td>123.7</td>
<td>90.4</td>
<td>8.1</td>
<td>23.4</td>
<td>35.6</td>
<td>93.5</td>
<td>3.6</td>
<td>14.8</td>
</tr>
</tbody>
</table>

1) Intermediation: Placements/funding. 2) Immediate liquidity: broad money/deposits. 3) Bank cost assets: other assets/wealth. 4) Short term indebtedness: deposits/liabilities. 5) Wealth/assets ratio. 6) Bank cost portfolio/wealth. 7) Investment on securities as a percentage of assets. 8) Investment on government securities as a proportion of the total of investments. 9) Management: transformation expenditures/average asset. 10) Adjusted yield: (liquid utility-extraordinary income)/average wealth.
The coexistence of positive real interest rates with low nominal interest rates requires a substantial reduction of the inflation rate which, in turn, requires an important and permanent adjustment of the fiscal deficit. The Venezuelan experience shows that the success of an economic reform program depends on the adoption of severe fiscal adjustment measures as well as the simultaneous, perhaps previous, establishment of a strict formal plan for banking regulation and supervision.

Finally, it is important to point out some practical aspects that should be faced immediately. The development of the financial crisis compromised FOGADE’s responsibility for managing financial aids as well as managing, structuring and receiving goods that the rescued financial institutions gave as guarantees. As a consequence, FOGADE, an agency that had not been designed for these functions, received assets whose value or market price were unknown. The financial and administrative problem it faces is highly complex, since it has received as payment or guarantee a series of goods that are difficult to administer or liquidate, when the national economy is uncertain and there is little inclination to invest.

A possible solution to this particular FOGADE problem would be the use of an independent entity to take charge of evaluating the market value of goods received as guarantees and their subsequent liquidation. The entity in question should have qualified personnel with ample experience in banking management, evaluating and liquidating financial assets and recuperating credits; ideally, it would be a financial entity with acknowledged solidity.

The foregoing could partially resolve FOGADE’s financial problem and enable this institution, after a reasonable length of time, to cancel the obligations acquired by the CBV because of the crisis, which are a seriously rigid element in the institute’s accounts.

It is also important that, after a prudent lapse of time, the nationalized banks should be privatized; international experience proves that in the long run, state and national banks are inconvenient, and the State has had to reprivatize them.

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71 Real estate transferred to FOGADE includes banking agencies, commercial premises, real estate lots, buildings, apartments, parcels of land, offices, houses or villas, tourist complexes, cattle ranches or farms, parking lots and sheds.

72 In the United States, the Mellon Bank Corporation was the administrator for liquidation of the assets of the Grant Street Bank, part of the same holding company. It was compensated by 3% of the resulting cash flow.
Reprivatization should, of course, take into account strict criteria for the establishment or acquisition of financial institutions as stipulated in the current regulations, to avoid the admission of unqualified persons from the points of view of ethics and banking experience.

**VI. CONCLUSIONS**

The origin of the Venezuelan banking crisis is basically associated with the 1989 liberalization of a financial system (rigidly repressed until then) within the framework of a structural adjustment and reform program in which there was a significant lag between new conditions and updating the regulatory and supervisory framework, propitiating unorthodox practices by banking institutions.

- This situation was aggravated, beginning in 1992, by political and economic deterioration that generated falling demand for money, as well as massive withdrawals that banking confronted with policies of high interest rates and outside funding. This strategy did not hold back severe liquidity problems that were, no doubt, manifesting the seriousness of the structural problem of banking insolvency, and which culminated in the explosion of the crisis at the beginning of 1994.

- The financial crisis came to light with the intervention and closing of the second most important bank in deposits, followed by the intervention of eight other institutions within a period of six months, the predominant policy being massive financial aid, including the CBV. Despite this, the climate of distrust was so intense that exchange controls were adopted in July of 1994, temporarily restraining capital flight, but generating deepening imbalances that are a serious challenge and can become an important element in retarding a viable solution to the banking crisis.

- The economic balance at the end of the first half of 1995, primarily made up by a significant fiscal deficit in a framework of stagflation, a strongly appreciated real exchange rate and pressures on international reserves, shows up the immediate need for an integral and credible economic program to help guarantee sustained future growth, and promote the strengthening, adjustment and stability of the financial system. The latter, in turn, is indispensable for stable, orderly and sustained growth of the economy.

- A global economic plan is necessary because the financial system is still weakened by the crisis. In the first place, it was necessary for the
State to assume progressive and direct control of the affected institutions. There is also a stronger concentration of financial activities, in both deposits and credits, to which we must add the vulnerability of institutions that received "migrant" deposits.

- The Venezuelan experience demonstrates that the success of an economic reform program depends on the adoption of severe fiscal adjustment measures as well as the simultaneous (perhaps previous) establishment of a strict and formal scheme of banking regulation and supervision.

- It is necessary to take special pains with actions oriented toward fortifying government supervision of the financial sector and, especially, overseeing the fulfillment of legal regulations for banking activities. A prudential banking regulation should precisely define the limit of state support or responsibility for potential banking losses.

- An essential step in adjusting and strengthening the financial system is a thorough, exhaustive and frank examination of the institutions that are still in operation, in order to adopt needed measures without interrupting their performance.

- Finally, it is important to deal immediately with FOGADE's financial problem. A possible way out would be to have an independent entity take charge of evaluating the market value of goods received as guarantees for financial aid and, later, liquidating them. Resolving this problem would enable this institution to take measures, after a reasonable time, to cancel obligations acquired by the CBV because of financial aid loans.

- It is also important to privatize the nationalized banks after a prudent lapse of time, taking into account, of course, the strict criteria for establishing or acquiring financial institutions that are stipulated in current regulations.

- As a fundamental conclusion, the events experienced by Venezuela and other Latin American countries because of vulnerable financial systems reveals the need to take pains with measures that will develop a solid and stable financial system, capable of supporting economic growth efficiently. It is essential to adopt opportune actions that will guarantee permanent strengthening of the system, some of which have been noted in this paper, and toward which Venezuelan authorities should direct their efforts without delay.
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