COLLAPSE
THE VENEZUELAN BANKING CRISIS OF '94

BY RUTH DE KRIVOV

GROUP OF THIRTY, WASHINGTON DC
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The Group of Thirty

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To Saúl, Fanny, Daniel and Clara, and to the memory of my parents.
Introduction by Paul A. Volcker

Foreword by John G. Heimann

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Writing this book has been difficult and, at times, unappealing. It is something I felt compelled to do, and have done, out of concerns for my country and for other nations on the brink of dire banking crises. I lived through a very critical series of events, which I wouldn’t want to see repeated anywhere in the world. This book is my way of helping future generations in Venezuela and elsewhere learn from our experience, so they might avoid the series of mistakes that led to our crisis and lengthened its resolution.

This is not academic research. It is the view of a practitioner, an account of the experience of a central banker working in turbulent times.

Drawing on my memory, my notes taken in critical days and papers I wrote over the years, I have aimed at providing a comprehensive and objective explanation of what happened, why it happened and how it happened. Readers might say that I am simply defending my record as central banker and that I was too close to be able to provide a dispassionate judgment. I cannot claim to be detached, but I have tried to put together a truthful recollection of the problems that I attempted to solve, to the best of my knowledge and ability.

This book tells the story of the Venezuelan banking crisis of 1994. Macroeconomic mismanagement and shocks are part of the story, but bad banking practices, poor regulations and the connection between economics and politics, long embedded in the Venezuelan way of life, are, to me, the most powerful explanation of all. People mattered more than institutions, and our fragile regulatory system was put in charge of overseeing extremely powerful bankers running weak banks in a volatile economy. Sooner or later, disaster had to come.

Bank insolvency in Venezuela built up silently, over decades, papered over with the help of oil money. This was part of the country’s rentier mentality, which lingered on past the means that allowed it to flourish. When
new global and national economic realities forced Venezuela to change its habits in the late 1980s, the country's economic and political weaknesses came into the open. But the banking system looked good for some time, even though many of the banks were rotting due to lending to affiliates, poor investments often deleted from their balance sheets and bad loans that were masked by new loans, in a never-ending cycle. Depositors continued pouring money into them. Some of them were not informed. Others assumed theirs was a riskless gamble, and that the government would bail them out, as it had done so many times before. The crisis exploded when depositors began to doubt the validity of the implicit government guarantee everyone was betting on; when they tried to get out, they pushed bank insolvency into the open.

Many signs of the problems that were waiting for us around the corner were consistently missed by regulators, politicians and bankers for years. Although the Central Bank perceived the systemic implications of the banks' weaknesses when there might still have been a chance to avert a crisis, everyone else seemed to be looking away, and alone we could do too little to prevent it. By the time the crisis erupted and caught the country's attention, the damage had already been done. Then we had to pay the cost of protracted leniency and procrastination.

*Collapse* deals with public policies and bank management. I make no judgment about allegations of improper influence and corruption. Although I realize it is an issue, it is not one that I intended to cover. This book is not an investigation.

The Venezuelan banking crisis provides many lessons about macroeconomic management, economic reforms, banking regulation and supervision, and crisis management. The two overarching ones, though, are the need to get politics out of banking regulation and supervision, and never to underestimate systemic risk.

Ruth de Krivoy
Geoffrey Bell and Mohsin Khan helped me shape the idea of this book many years ago and guided me through the writing process.

Paul Volcker and John Heimann encouraged me to write it and gave me their most valuable support.

Stanley Fischer led me to focus on sharing my experiences as a central banker.

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Marlys Harris, Jill Hamburg and Mary D'Ambrosio were my editors. They practically turned this effort into a book. Mary went beyond the call of duty by helping me steer the production of this book through its crucial last stages.

Fanny Krivoy, my daughter, designed the book.

The Group of Thirty and the Tinker Foundation provided the backing and the resources for all of it to happen.

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My husband, Satúl, and our children, Fanny, Daniel and Clara, are the source of my strength and endurance. They proved it, once again, with their unending and loving support for this endeavor.

To all of them, my deepest gratitude.
Each financial crisis is defined by its own specific circumstances—some combination of an adverse economy, particular market excesses, government policy miscues, corrupt business practices and failed supervision. What is typically the case is that they also have something in common—similarities that are as striking and as important as the particulars.

What is surely true is that we haven’t seen the last of financial crises. In our globalized economic system, they seem to have the characteristics of a new virus, from which no country is entirely immune.

We may not eliminate the virus, but we surely must learn from past mistakes to minimize the damage. In that respect, Ruth de Krivoy’s personal and detailed account of her experiences in Venezuela’s 1994 banking crisis is particularly useful. It offers a blow-by-blow account of the collapse of a banking system from one on the firing line. While the number and severity of problems that converged in Venezuela may have been extraordinary, their essential elements will be familiar to anyone who has experienced a national banking crisis.

The Group of Thirty has been pleased to support Ruth’s efforts to record the history of this disaster and draw lessons from her experience. It is the saga of how one knowledgeable, honest and courageous woman could not, alone, turn back the destructive forces unleashed once the crisis was well underway. It all emphasizes once again the need for a strong financial structure and alert supervision to keep the virus at bay.

Paul A. Volcker
The proposition that effective supervision and regulation of banking systems is critical to the sustained growth of emerging markets, and developing nations generally, is increasingly accepted as an article of faith. In every discussion of the new financial architecture, in virtually every official communiqué, well-supervised banking systems have been recognized as one of the most important foundations of international financial stability.

This new-found faith is the result of hard lessons learned just within the last few years. In many countries, rather than domestic financial systems playing the expected role of economic stabilizer, just the opposite has been the case: the financial system has proven to be a magnifier of economic problems. In effect, bad banking systems have made bad economic situations worse. For this reason, the spotlight of attention has been correctly beamed on financial supervision and regulation as an area of major vulnerability, badly in need of correction.

Ruth de Krivoj’s book sorts through the rubble of one such disaster and provides powerful, personal testimony to its impact: from the man in the street, to public officials, to the national economy. Her book might be considered a primer in disaster. Venezuela must lie at the outer reaches of the probability distribution, in that everything that could possibly go wrong did. The book paints a vivid picture of how badly conditions can deteriorate when erratic government policy, weak institutions, insider dealing and volatile global capital all converge in an economy. These are elements that will be familiar to anyone who has been involved in such a crisis.

Rare among economic analyses, however, the book is also an insider’s story that presents a vivid account of the collapse of a banking system. This was a system characterized by historically high profit margins, protection from international competition, connected lending—condemned in the 1997 Asian economic crisis as “crony capitalism”—and preferential treatment that
was endemic to the political structure. The story is one of the short-sightedness of the domestic bankers seeking to preserve their privileged status; the stubborn refusal of government to face up to a banking problem; despite the Central Bank's documentation of its dimensions in grim detail; the tragic underfunding of domestic financial supervisory activities; the lack of political will on the part of entrenched political interests that chose to ignore the problem in hopes that it would go away; all compounded by spectacularly unfortunate timing. The country lurched from the impeachment of one President, to an interim administration in which no one had the appetite to acknowledge the crisis, to a newly-elected President whose failure to attack the crisis head-on increased its severity and ultimate cost. This unfortunate mix proved highly volatile, eventually costing the taxpayers a sum that neared 11% of GDP.

*Collapse* underscores the lesson that critical building blocks of a sound financial system, like independent monetary policy, effective supervision and clear authority to intervene in a crisis, are complicated and require sustained political will to implement. They can as easily succumb to politics-as-usual as to a crisis. In good times, no one wants to rock a smoothly-sailing boat, and political influence and institutional inertia make action difficult. In bad times, everyone is too busy bailing to worry about the trim of the boat.

Ruth's personal story is as horrifying as it is fascinating, and makes for page-turning reading. But the most important part of her book is the final chapter, "A Call for Action," where she offers sensible advice and a series of recommendations that apply to all nations, developing and developed alike. The basic principles underlying sound banking supervision do not change with a country's stage of development. The only issue is matching the implementation and enforcement of these basic principles to the stage of development of a country's banking and financial system.

The chapter parses the many elements necessary to make a supervisory system work well, to avoid crisis and, if a crisis strikes, to deal with it effectively. Worthy of particular note is the valuable guidance Ruth offers on how to build the political constituency that will be needed for tough action in the event of a crisis. Sensible advice, indeed.

Since this mission is very broad, she then has the wisdom to divide her views and recommendations according to the audiences to which they are addressed. These include central banks, bankers, lawmakers, bank regulators and supervisors, economic policymakers, the international financial community and, finally, Latin American countries in general and Venezuela in particular.

This book should be required reading for any country worried about the structure and effectiveness of its central bank and supervisory regime. Furthermore, it should be on the reading list of the Group of Seven, the Group of Twenty-Two, the International Monetary Fund, the World Bank, the re-
gional development banks and all institutions concerned with financial sector development and reform. It provides a taste of the real world and a dose of reality about financial sector management in developing nations. Any reform proposals that fail to comprehend the lessons and recommendations offered by Ruth are certain to fall short of the mark.

John G. Heimann
COLLAPSE
On January 16, 1994, one of Venezuela’s most powerful financial institutions collapsed. Venezuelans were thunderstruck. Banco Latino was Venezuela’s second largest bank and held 10 percent of the bank assets of the nation. Its late president, Pedro Tinoco, had been my predecessor as Central Bank president, and had been considered a close friend of Carlos Andrés Pérez, a recent President of the Republic. Although Banco Latino had been giving out signs of weakness for months, most people took the optimistic view that such a prominent, politically secure bank could never come to harm.

When it did, depositors rushed to rescue their funds, not only from Banco Latino branches around the country, but from affiliates abroad, and finally from other banks Venezuelans suspected were just as weak.

Runs seemed unstoppable.

The banking system began to tumble like a house of cards.

Within three weeks, almost one-third of the Venezuelan banking system was either forced to shut down or was being kept open only with heavy government financial backing. Nearly $2 billion flew out of the country.

Eighteen months later, the Venezuelan government found itself running 53 failed financial institutions and reluctantly controlling thousands of other associated companies. Some 7 million depositors—more than a third of the population—suffered tremendous uncertainty.

It was the most violent banking shock in Venezuelan history, and though it was not the most costly in dollar terms, it was expensive in many ways. The crisis cost the country a staggering 11 percent of its GDP. It also robbed us of development progress: it triggered the suspension of Constitutional rights, led to intrusive economic controls and helped derail free-market economic reform initiatives.
Although the banking crisis seemed to surge up suddenly, to a few of us it was not a total surprise. It had in fact been brewing for many years.

ROOTS OF THE BANKING CRISIS

As soon as Banco Latino collapsed, Venezuelans began casting about for someone to blame. The crumbling of such a powerful bank created an overwhelming sense of public insecurity. Everyone—Congressional representatives, the Venezuelan public, foreign bank regulators who oversaw Latino’s offshore affiliates—demanded answers. Why did this happen? Who was responsible? How would it be fixed? There was hunger for a quick diagnosis and, more to the point, a quick solution.

Banco Latino’s managers blamed the collapse on rumors that had been flying around the country for most of 1993. They complained that people were whispering that the bank was weak and accused government officials of fueling the gossip. That poisonous climate, they argued, triggered a run on deposits. But some outsiders, among them leading Venezuelan bankers and analysts, said Banco Latino had been mismanaged. And many others accused the Office of the Superintendent of Banks—a small, weak and underfunded government agency that reported to the Finance Ministry—of having underestimated Banco Latino’s problems. *The Economist* simply acknowledged the complexity of the whole affair, suggesting: “A witches’ brew of mismanagement, lax regulation and possibly fraud have been at work.”

But the crisis could not just be ascribed to an evil group of schemers breaking the law, or to incompetent regulators ignoring the problem.

Instead, the blame lay with many people, from different sectors, acting over many years. The problem was bound up in our very way of operating as a country.

Tinoco had been one of Venezuela’s leading bankers and president of the National Banking Council as well. He resigned the presidency of Banco Latino in 1989 to become president of the Central Bank. But he remained an important shareholder in Banco Latino. Although in Venezuela that wasn’t against the law, the situation suggested a conflict of interest. His close relationship with Carlos Andrés Pérez, the President who appointed him to the Central Bank, was perceived as offering special government protection to Banco Latino, perhaps to the extent of lulling Latino clients into believing that the bank simply would not be allowed to fail. Even after Tinoco’s

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2 Venezuela’s official bankers’ association.
death in 1993, the idea that a halo of protection floated over Banco Latino remained.

Yet the problems that brought down Banco Latino and more than a third of the banking sector in 1994 went far beyond personalities. They were decades in the making. They involved Venezuela's historical approach to managing its economy, its traditional style of melding business with politics and policy, and the weakness of its institutions—in this case, the fragility of our bank regulatory system.

Banco Latino depositors were livid when their funds were frozen, but they shared some responsibility, too. They quickly forgot the extraordinary returns they had been enjoying over many months. The weakening bank had been obliged to pay depositors much higher interest rates than healthy banks did, in order to convince people to risk their funds. Although one could argue that many depositors were unable to assess the risks, the more sophisticated among them understood they were gambling.

Many citizens and commentators suspected Latino bankers of wrongdoing, and politicians of complicity. And after Banco Latino closed, depositors hurled bitter accusations at the Central Bank, charging that high interest rates had forced the bank—and then the banking system—to crash.

While it is true that interest rates rose to unprecedented levels in 1993, as the country went through severe financial and political troubles, the bad assets that would bring the banks down had already been in place for a long time.

OIL: THE VENEZUELAN NARCOTIC

No explanation of the 1994 banking crisis is possible unless one begins with the matter of oil, the nation's most important resource and its most valuable export.

Venezuela is highly dependent on oil, and its economy is extremely sensitive to international oil prices. The oil sector accounts for about one-quarter of GDP. More than 50 percent of ordinary fiscal revenues and 75 percent of export income comes from the sale of oil. As a result, the state of the budget and the value of the currency are highly interdependent.

Copious oil revenues that began flowing in the 1920s paved the way for a state-centered economy. We developed what economists call a rentier society—in which each sector feeds upon government largesse, sometimes depending on the state for its very survival. In Venezuela, this tradition is very old:

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5 Venezuela's dependence on oil is exceeded only by that of large Middle East oil exporting countries such as Saudi Arabia, Kuwait and the United Arab Emirates.
The government has controlled all subsoil wealth since 1829, shortly after the country won independence from Spain. For many years, the state shared oil wealth around via jobs in a hefty bureaucracy, cheap gasoline and public services, low tax rates for individuals, and low-interest loans for borrowers. Imports for consumers and industry were subsidized by an intentionally overvalued currency, a situation made possible by the great profits oil sales brought. Domestic business also enjoyed market protection, since high tariffs were imposed to limit competition from the exports of more powerful and productive foreign business. This policy, known as import substitution, was originally intended to give domestic industry breathing room to grow.

An oil boom in the 1970s made Venezuelans imagine themselves living in a paradise, a world of unlimited resources. We embarked upon a massive program of public and private investment, expanding our productive capacity far beyond the availability of natural markets for our products. The government and state-owned companies, themselves made artificially large in order to keep unemployment low, spent to expand the domestic market and to accommodate the oversupply of goods.

This state of affairs allowed the country to paper over inefficiencies that most other countries could not afford to ignore. Money-losing state-owned companies and institutions, and numerous entitlements supported by a bloated public administration, grew up to redistribute oil revenues. The preeminent

![Chart 1-1](image-url)

*Source: Central Bank of Venezuela*
role of the state became an accepted feature of Venezuelan public life. Spectacular windfall oil profits only further expanded the state’s power and reach.

But dependence upon oil also bred economic and budgetary instability, by carrying Venezuela on an eternal roller coaster ride. Although rising oil prices invariably translated into higher government expenditures, spending did not decline when oil prices fell.

The result was a pattern of booms, followed by busts or declines that brought fiscal and balance of payments deficits.

Chart 1.2
Oil and Foreign Reserves

![Chart showing oil price and foreign reserves](chart.png)

Source: Central Bank of Venezuela

Each time the price of oil plunged, the political establishment regarded the decline as temporary. Governments did their best to muddle through the difficult times, until a new surge in oil demand or prices bailed them out. Controls on domestic prices, salaries, imports and foreign exchange transactions became the usual policy response to lean times. Attempts to cut public spending were always short-term fixes, and whatever measures were taken would be abandoned as soon as oil prices recovered. This was the approach of virtually every Presidential administration, regardless of its political leanings.

With its economic health rising and falling with world oil demand, and
its cycles of stop-and-go policy responses to external shocks.\footnote{This was in sharp contrast to the stability Venezuela enjoyed between the end of World War II and the mid 1970s, a period when healthy government accounts, free convertibility of the bolivar and a stable exchange rate kept inflation at less than 2 percent per year.} Venezuela became one of the most volatile economies in Latin America.\footnote{For further analysis of Venezuela’s macroeconomic volatility, see Inter-American Development Bank, \textit{Overcoming Volatility: Economic and social progress in Latin America}, 1995 Report.} Along with the economy, real interest rates, prices and the real value of banking system assets fluctuated wildly. Managing a bank under such circumstances was as challenging as commanding an airplane during a storm.

![Chart 1-3: Oil and Current Account](image)

Oil wealth had another peculiar effect. It created two economies, consisting of an oil sector and a non-oil sector.

In the oil sector, long-term investment strategies in exploration, production, refining and global marketing translated into sustained growth and competitiveness.

There was no such sensible management of the non-oil sector. Non-oil enterprises were treated like poor cousins, with government policy forcing much business and industry into heavy dependence upon state oil revenues.
This practice had two main impacts. First, it allowed many non-oil businesses to grow and develop in the absence of productivity and efficiency. Protectionist and monopoly-building policies, and an array of government supports, allowed businesses of all sorts to expand artificially, building up capacity for which they lacked real markets. Venezuelan companies naturally concentrated on selling into the highly-protected domestic market. As a result, many grew unfit to penetrate the far more competitive international markets.

Second, non-oil businesses fell into a politically convenient dependence upon the state. Since companies' profits, productivity—and sometimes their survival—depended heavily upon favorable government policy, companies across the non-oil sector easily fell prey to demagoguery and populism. The trade protections and price subsidies companies enjoyed had a price: companies were required to accept price controls on the goods they sold, employ unnecessary workers, and allow their industry's wages to be determined by presidential decree.

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6 Regulating and subsidizing the non-oil sector was a way to keep unemployment under control. The oil industry employs no more than 1 percent of the labor force. The rest work in the non-oil sector.
Banks were treated like other companies in the non-oil sector. Government rules forced them to extend credit in support of government policy aims and to accept interest rate controls. In compensation for the cost of such populist policies, banks were allowed to operate in a lax regulatory framework.

**Chart 1-5**

Real Assets of the Banking Sector

[Graph showing percentage change in real assets of the banking sector from 1970 to 1998.]

Source: Central Bank of Venezuela

**GOVERNMENT OVERPOWERS THE PRIVATE SECTOR**

In this way, the government became the key player in the Venezuelan economy. Today the state directly controls more than one-third of Venezuela’s GDP, through the public administration, state companies and the oil industry. It also dictates the fate of the other two-thirds, via pervasive intervention and massive purchasing power.

When Venezuela left behind its last military dictatorship in 1958 and began moving toward modern democracy, opportunities for government intervention in the economy increased. A democratic system, it turned out, put heavier demands on the government.  

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7 Among the very few who warned about this risk was Ernesto Peltzer, at the time chief economic advisor to the Central Bank. "Evolución financiera y monetaria de la economía venezolana en 1998," In: *Ensayos sobre economía*, (Caracas: Banco Central de Venezuela, 1997), p. 367.
Rarely was there the political will or consistent support for structural reforms that might foster the non-oil sector's independent development, expand its markets and improve its ability to stand on its own two feet. Now and then those ideas would surface, but they always faded away. As former U.S. Federal Reserve Chairman Paul Volcker would often say, "Bad policies in Venezuela might not last for more than ten minutes, but good policies don't either."

A vicious circle was thus perpetuated. Exaggerated government intervention limited and paralyzed private activity, while the resulting lack of private initiative seemed to demand more government intervention. Non-oil sector growth became increasingly sluggish, raising Venezuela's dependence on oil; this, in turn, stunted the development of the country's legal and institutional framework. Over time, government expenditures became increasingly ineffective, less and less able to be the economy's locomotive.

So much oil money flowing into government coffers expanded the political power of the state, and especially of the president. Like most Latin American presidents, the Venezuelan President was extremely powerful. The Constitution gave him the last word on monetary and financial policy, taxes and tariffs, defense and foreign affairs. The President had the power to declare a state of emergency. He appointed cabinet ministers, state governors, the heads of state companies and the president of the Central Bank. Oil money saw to it that he could basically run the economy, too.

Congress was supposed to serve as a check upon Presidential power and to limit the dangers of free-for-alls among political parties. But it also had another important role: distributing the benefits of oil income. Both large political parties that controlled Venezuelan politics after 1958, the center-left Acción Democrática and the center-right Social Christian party Copei, saw to it that oil funds were shared out among various favored sectors.

This political system was a breeding ground for corruption, since labor, agriculture, industry—and banks—competed for the subsidies, controls and bureaucratic favors that would benefit them most.

Thus we grew accustomed to subsidies on milk, corn and rice; on gasoline, on public services, on interest rates and even on wages, since salary increases were likewise not determined by the market or by employers but often based upon loose consensus with labor unions and special interests, and then formalized by a Presidential decree. No one seemed to get upset when government bureaucracies wasted money, or state companies went bankrupt. The prevailing notion was that oil profits would bail us out of our blunders and that markets didn't matter.

Monetary policy traditionally had a secondary role, too, as there was no concern about inflation. The government steadily expanded the money sup-

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* This was Volcker's standard introductory line when he talked about Venezuela.

* In 1989, direct election of state governors replaced the system of presidential appointment.
ply by monetizing oil revenues. Under the fixed exchange rate system that Venezuela maintained until the early 1980s, imports and capital flows almost automatically regulated the money supply. Excess money would lead to higher imports and capital outflows, and vice versa. Interest rates were low and stable. Inflation was thus not a problem.

In such a climate, politicians naturally made monetary policy subordinate to the twin priorities of low interest rates and subsidized credit for favored sectors. The idea was that cheap money would foster private investment, and generate more jobs in the non-oil sector. Although it seemed to work for a time, over the long term artificially low interest rates did not foster private investment. And the policy hampered the development of the financial sector, too.

DEPOSITORS SEEK HIGHER RETURNS ABROAD

Real interest rates turned negative in the mid 1970s, with the Venezuelan inflation rate rising above the rate of interest banks offered depositors. It meant that any funds kept in a bank would have less buying power—perhaps much less—after six months or a year. Depositors began to secede from the national banking system. In search of more lucrative returns, they sent their money abroad. Borrowers benefiting from cheap loans had a strong incentive to place their savings abroad, too, and highly leverage their investments in bolívares.

So, instead of bringing about more investment, cheap money interfered with it, by reducing the availability of credit.

Cheap money policies failed to take into account that the cost of money is only one reason that investors commit funds to projects. Notwithstanding the benefits that negative real interest rates provided to would-be investors throughout most of the 1970s, private investment declined. This was due to a buildup of excess capacity, a lack of markets, uncertain time horizons due to abrupt and often unpredictable economy policy changes, price controls and mandatory wage increases. Public investment also declined, as government funds were increasingly allocated to covering day-to-day needs: rising payroll costs, subsidies, transfers to money-losing state-owned enterprises, and debt service.

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Because government expenditures have been largely financed by oil revenues and foreign borrowing, rather than by domestic taxation, the government creates high-powered money even if the budget is balanced.
Chart 1-6
Interest Rates

Source: Central Bank of Venezuela

Chart 1-7
Public and Private Investments

Source: Central Bank of Venezuela
In the 1980s, as oil income dwindled, the gap between the nominal and real interest rate widened. Domestic savings and investment failed to rise, and the financial sector shrank further.

We could see the impact in the declining levels of monetization, measured by the ratio of M2 to GDP. Venezuelan M2 plunged from 49 percent of GDP in 1983 to 33 percent in 1988. As in other large Latin American countries that followed state-centered policies, financial sector development languished, largely falling behind that of developed countries.

It is true that much of Latin America was following similar state-centered policies in the 1970s and early 1980s. Import substitution, for example, was a developmental strategy generally favored around the region. It was intended to temporarily nurture vulnerable domestic sectors, in the belief that they could thereby strengthen and become fit to compete internationally. But market-oriented reforms in the region began as early as the 1970s, famously in Chile, and then in Mexico in the early 1980s, as it grew increasingly clear that the

\[ M2 = \text{cash + demand, savings and term deposits} \]

This course was for decades recommended by the influential Economic Commission on Latin America and the Caribbean (ECLAC), a United Nations agency with a leading voice in the region’s economic policy strategies.
protectionist approach often failed to achieve its desired result. In general, protectionist policies engendered inefficient rather than internationally competitive industries and were a burden on economies besides.

Even though warning signs were surfacing in Venezuela at about the same time—the economy’s performance was dismal, and in 1984, we had to restructure payments on our foreign debt—faith in the revival of an oil boom encouraged the Venezuelan government to cling to these policies longer than other Latin American countries did. They were an enormous drain on our national budget.

Chart 1-9
M2 / GDP Ratio

THE PARTY ENDS

The state-centered economy began to break down in the late 1970s. Paradoxically, this was a consequence of the unprecedented oil boom. Difficulties surfaced abruptly when world oil prices crumbled in the early and mid 1980s. It grew increasingly difficult for the Venezuelan government to keep artificially propping up the economy.¹³

Now it became evident that the state-centered import substitution development model was a drag on Venezuela’s economic performance. Real GDP growth averaged a depressing 0.8 percent in 1980-1988, compared with more than 5 percent in the previous decade. Unemployment rose steadily to 13 percent in the mid-1980s, against only 5 percent the decade before. And some 40 percent of the so-called employed worked in the informal sector, usually producing little, earning little and paying no taxes at all.14

A short-lived upturn in economic activity from 1985 to 1988 rested on shaky foundations. It was accompanied by a rapid deterioration in the balance of payments, higher budget deficits, repressed inflationary pressures, and growing distortions in foreign exchange and financial markets. An appreciating real exchange rate and widespread expectations of devaluation spurred imports. This, together with weaker oil exports, wiped out the trade surplus for the first time since 1978 and led to a wider current account deficit, equal to 10 percent of GDP. Foreign reserves fell steadily. Then in 1988, plans to obtain financing from the IMF, the World Bank and foreign commercial banks were delayed by the government’s unwillingness to adopt required policy changes in the runup to a Presidential election.

By 1988, we were out of funds. The state-centered model had clearly burnt itself out. It looked as though the time had come for the government to put an end to its meddling and interference, and adopt policies that would encourage private economic activity.

We Venezuelans hardly knew what that meant. Although the notion lingered that hardship was temporary and that an upturn in the oil market would, as usual, bring relief, in truth we had spent ourselves to the wall. There was no easy way out.

HOW BANKS WEAKENED

The Venezuelan financial sector suffered from ghettoization in the non-oil sector. It concentrated on non-oil activities, with the goal of channeling domestic deposits into private investments, and also provided convenient lending to the government and to state enterprises. Because the financial system developed under the aegis of import substitution policies, it was geared to meeting the requirements of the domestic market. As a result, the Venezuelan banking sector was relatively small compared to that of countries at the same level of development.

14 It is true that much of Latin America suffered from recession during that so-called “lost decade.” The fact that Venezuela suffered less than others—evading hyperinflation, for example—was again due to the mixed blessing of its oil cushion.
By the end of 1988, total banking system assets were $43.5 billion, 72 percent of GDP, and bank credit played a secondary role in the economy. The Venezuelan financial sector was smaller than those of developed countries and certain other major Latin American economies, such as Brazil and Chile.

Chart 1-10
Bank Credit / GDP Ratio

Despite its modest size, the Venezuelan financial system was fairly sophisticated and firmly in private sector hands. By December 1988, it consisted of 38 commercial banks, eight of them government-owned and four foreign-owned. There were also 124 other highly specialized financial institutions.15

Commercial banks were the most important financial intermediaries, accounting for about 70 percent of the assets of the financial system, while government-owned banks were relatively unimportant. Since the 1920s, the government had been setting up a variety of financial institutions to make

15 Insurance companies are excluded from this analysis.
oil revenue-subsidized loans. Regulators typically gave such institutions preferential treatment, and the government sometimes used them to influence market conditions (and, hence, distort competition). Over time, almost all of these institutions failed because of huge loan losses. By December 1988, government-owned banks accounted for 12.5 percent of total deposits. In 1989, the government designed a plan to restructure some of these institutions and close others, and by December 1993, state institutions held barely 3.5 percent of national deposits.\textsuperscript{16}

\textsuperscript{16} This process, although difficult and costly, bore no relation to the development and subsequent explosion of the 1994 banking crisis.
Table 1-1
Institutional Structure of the Banking System
December 1988

<table>
<thead>
<tr>
<th></th>
<th>Number of Institutions</th>
<th>Total assets Millions US$</th>
<th>(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks</td>
<td>38</td>
<td>29,925.3</td>
<td>68.9</td>
</tr>
<tr>
<td>* private</td>
<td>30</td>
<td>24,514.1</td>
<td>56.4</td>
</tr>
<tr>
<td>* o/w foreign</td>
<td>3</td>
<td>206.1</td>
<td>0.5</td>
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<tr>
<td>* public</td>
<td>8</td>
<td>5,411.2</td>
<td>12.5</td>
</tr>
<tr>
<td>Mortgage banks</td>
<td>18</td>
<td>4,271.4</td>
<td>9.8</td>
</tr>
<tr>
<td>Finance companies</td>
<td>30</td>
<td>4,761.6</td>
<td>11.0</td>
</tr>
<tr>
<td>Leasing companies</td>
<td>26</td>
<td>1,244.0</td>
<td>2.9</td>
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<tr>
<td>Savings and loans</td>
<td>20</td>
<td>3,246.4</td>
<td>7.5</td>
</tr>
<tr>
<td>Money market funds (*)</td>
<td>30</td>
<td>–</td>
<td>–</td>
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<tr>
<td>Total</td>
<td>162</td>
<td>43,448.7</td>
<td>100.0</td>
</tr>
</tbody>
</table>

(*) Assets placed with commercial banks
Source: Office of the Superintendent of Banks

A CONCENTRATED MARKET,
WITH CONCENTRATED OWNERSHIP

While there was free competition in the banking industry, there was nevertheless a high degree of concentration. Seven commercial banks dominated the market: Banco Provincial, Banco de Venezuela, Banco Mercantil, Banco Union, Banco Latino, Banco Consolidado and Banco Maracaibo (which became part of the Latino group in 1991). By the end of 1988, these seven held 63 percent of national deposits. The remaining 31 banks held 36 percent of deposits, and most had market shares of less than 1 percent each. The concentrations at the top and a dearth of competition led to increasing inefficiency, and a tint of favoritism in bank-client relationships.

Ownership of banks and financial groups was highly concentrated, too. Groups of individuals or families usually controlled the banks. The Caracas Stock Exchange listed only 15 banks, and the proportion of their shares that actually were traded was very small. Shareholders of the same firm would often swap stock on the exchange in order to qualify for tax breaks.

Although Venezuela’s superintendent of banks had the power to veto ownership changes of 10 percent or more, I never heard of the supervisors

17 Five non-bank financial institutions and four real estate investment companies linked to banks were also listed on the Caracas Stock Exchange.
denying participation to any prospective owner. Disclosure rules on beneficial or true ownership were lax, and outside or minority shareholders were generally unwelcome. Only two banks—Banco Provincial and Banco de Venezuela—were true publicly-held companies in the late 1980s, and both later reverted to private ownership.

Because majority shareholders had an iron grip on the boards of directors and on management, corporate governance was poor. Internal controls were loose, and external auditing, although it became mandatory in 1985, was in most cases meaningless.

This situation allowed banks to lend to affiliates, a practice that severely weakened the Venezuelan banking system. Most Venezuelan financial groups were linked by common ownership to a variety of other commercial enterprises to which they tended to grant loans on the basis of affiliation, whether or not the projects were financially sound. This followed a typical Latin American pattern: instead of relying on independent banks, large industrial enterprises, farmers and merchants set up their own banks as a natural and more secure way to expand their businesses. When credit rationing intensified during prolonged periods of negative real interest rates, industrial and commercial companies linked with banks had the distinct advantage of access to loans from their affiliates.

Banks had cozy relationships with governments, too. The government and the wide array of institutions and companies it controlled were such important sources of profitable business that whether a bank was in the government’s good graces or not could often determine whether the institution prospered or floundered. Banks profited by taking low-cost or non-interest-bearing government deposits and readily lending to government enterprises, suppliers and contractors. As a result, many banks became vulnerable to the ups and downs of politics, and to the government’s ability (and willingness) to repay its debts on time. For its part, the government depended on banks for ready money, and had little incentive to get tough about regulation. The national banking law was amended several times in the 1970s and 1980s, in order to allow banks to increase their loans to the government.

But the most prudent banks stayed away from government business as much as they could.

AN INEFFECTIVE REGULATORY REGIME

Some government regulations actually had negative impacts. Under Venezuelan banking law, financial institutions were rigidly segmented by type, restricted to performing highly specialized functions. Commercial banks were
directed to focus on short-term borrowing and lending. Finance companies were ordered to focus on medium-term loans, for fixed assets and consumer goods, and to support the development of commercial and industrial companies. Mortgage banks were supposed to specialize in long-term loans and lend for construction, property purchase and home improvement. Savings and loan institutions likewise were to focus on long-term and home mortgage lending.

Requiring banks to specialize so narrowly limited their opportunities to diversify their assets, improve their profitability and limit their risk. The official straightjacket also led to fictitious product differentiation. Financial institutions tried to attract deposits by issuing instruments they called savings deposits, savings certificates, savings bonds, quigrophary bonds or financial bonds with mortgage guarantees, for varying terms. In reality, these instruments could be quite similar: the public would, in fact, hardly distinguish among them.

Financial groups also worked out arrangements that allowed their banks and financial affiliates to form groups of legally independent entities controlled by common shareholders. A commercial bank was usually the core of the group, which also might include mortgage banks, finance companies, investment banks, leasing companies, insurance firms, brokerage houses, trusts, money management funds and offshore banking operations. Thus, a group could offer a client a full array of financial services and diverse instruments, while shareholder risk was spread across the various firms. This creative adaptation to inadequate law created de facto universal banking, except that it was not as efficient. It was also far less transparent and nearly impossible to properly monitor.

At Banco Latino and many other banks, not only had problems been dispersed and obscured through a wider group of holdings, but the group structure provided a sort of bailout insurance: it allowed a struggling bank to get last-minute loans from more solvent affiliated companies offshore.

The Venezuelan regulatory regime was intrusive and detail-oriented, yet curiously ineffective. In a miss-the-forest-for-the-trees style, banking supervisors had to scrutinize financial transactions to the last detail. They ended up looking for formal compliance rather than for the main objective: bank solvency and overall risk.

As a result of such detailed regulations, there was little flexibility in the banking business. Everywhere a banker turned, there were restrictions on the types and terms of assets, liabilities and instruments that could be issued. Even opening or closing a branch was subject to lengthy and cumbersome regulatory reviews.

The underlying explanation for this messy state of affairs is that banking policies were simply not aimed at creating a growing, prosperous banking sector; thus, the health and profitability of banks was not a policy priority. A
sound banking sector was not considered crucial to national development; neither the government nor other business viewed banking as a source of national wealth and savings. Rather, banking was treated as a convenience mechanism, with its most important roles the distribution of subsidies and the running of payment services.

Essentially, the government used the banking system and controls on interest rates to subsidize borrowers and left depositors with the short end of the stick. As a result, general credit dried up, and a loan became something of a favor, a gift. Banks increasingly directed their lending to companies with which they or their shareholders were affiliated, and to their friends. Because the government controlled interest rates most of the time, banks could not outdo the competition by offering more attractive deposit and lending rates. Instead they drew customers by offering payment services, through large, expensive networks that spawned more than 2,000 branches around the country. Heavy advertising, labor and technology costs also drove up overhead.

Regulations allowed interest rate spreads to expand to the level needed for the most inefficient banks to survive, while the more efficient banks became very profitable.

OUTSIDERS SHUNNED

Outsiders had little hope of entering the banking business. Getting a new bank license often depended upon having political connections, and winning approval was an obscure ritual, enigmatic and complex. Having a sound business plan and a suitable background were never central to the approval process.

The exclusion of foreign banks was almost total. As part of import substitution philosophy, the government imposed an array of discriminatory rules on foreign banks. This was intended to give Venezuelan banks an advantage, under the belief that they would eventually grow strong enough to compete with the more powerful foreign banks. For example, banks in which foreigners held a stake of 20 percent or more had to meet higher standards for capitalization and were not allowed to increase their capital or open new branches. They were also banned from trading in foreign currency purchased from the Central Bank.

These restrictions were so onerous that few foreign banks bothered to try to enter the Venezuelan market. For many years, the 70 or so representa-

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18 This was particularly true after a 1970 reform of the banking law, which allowed licenses to go only to Latin American banks, and then only if their home countries granted reciprocity to Venezuelan banks.
tive offices of foreign banks would carry on any limited international banking activities that were open to them.

Because it was so hard to enter the banking business, those who already owned banks commanded assets with tremendous franchise value. These bankers grew extremely powerful.

The capital markets didn't provide would-be borrowers with much of an alternative for medium- and long-term financing, either. The stock and bond markets were thin and underdeveloped. Thus, commercial banks became the main loan providers. In violation of basic asset-liability management rules, banks used short-term borrowing to conduct long-term lending, booking 90-day loans to finance medium- and long-term projects. They would roll over these short-term loans again and again, without much concern for the medium-term repayment capacity of a borrower who took out a five or 10-year loan. In many cases, banks even fully capitalized the interest.

Banks skirted interest rate ceilings by tacking fees and commissions onto a loan; these could easily double its price. Disclosure of effective lending and deposit rates was so poor that most people could not fathom what the cost of funds should logically be or determine what lending terms were fair. The first regulation requiring banks to fully disclose effective interest rates for loans and deposits was not issued by the Central Bank until August 1992, four months after I became its president.19

Over time, the banking industry also developed a relatively closed structure that offered scant access to small investors. Concentrated ownership, high barriers to entry, licensing practices marked by cronymism and unequal treatment of minority shareholders created a banking industry dangerously immune to public scrutiny.

SUPERVISORY FAILURES

Government controls only led to more controls, not to better bank performance. In the 1970s, banking regulations became more interventionist and further weakened the banking system.

Banks were obliged to direct a fixed portion of their loans to priority sectors, such as agriculture20 and low-income housing, and to lend at extended terms. Lending-rate ceilings and selective reserve requirements were designed to "protect" borrowers, creating incentives for some transactions

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19 Central Bank of Venezuela, Resolution No. 92-08-01, Gaceta Oficial No. 35.025, August 12, 1992.
20 The cost to commercial banks of government-directed lending to agriculture at below-market rates averaged 15 percent of the commercial banks' net interest income from 1981 to 1989.
and discouraging others. In a disappointing blow to the intent of this policy, these measures did not foster economic activity in the favored sectors. Indeed, the only activity they encouraged was the growth of sophisticated new practices to evade the regulations. Banks began looking for ways to conduct financial intermediation without so many hindrances, while the favored borrowers increasingly spent their cheap loans on personal luxuries, invested them in other businesses, squirreled the funds away in dollar-denominated deposits, or even deposited them at a premium in the same bank that gave the loans.

This situation took a dramatic turn for the worse in the 1980s, as politically-set interest rates stiffened. Banks had already learned to survive in an unfavorable monetary climate. Now credit rationing increased, and financial groups became ever more devoted to raising funds and handing them over to their friends and affiliates. Loans to shareholders were not specifically restricted, and there were few limits on credit exposure to individual debtors.

Banks grew progressively less sound. And firms not part of conglomerates were further starved for credit.

Bank supervision barely focused on these problems, and the banking law was constructed so narrowly that credit risk issues were rather easy to evade. Borrowers (individuals or corporations) were only deemed related to each other if either controlled 50 percent or more of the other's capital and if the two were engaged in the same economic activity in the same state. Lending vast amounts of money to affiliated companies turned out to be relatively easy. It grew popular to do this by transferring money via a third party offshore, by using a wide array of special purpose companies, or by setting up the loans through friendly banks that would get similar favors in return.

Not every financial group was so irresponsible, of course. Some managed their banks prudently. They understood that, besides making a profit, they had a social responsibility to act as financial intermediaries and to maintain the stability and soundness of their institutions. But too many others chose to take advantage of the lax regulatory framework and used general deposits to speculate on business projects whose soundness they never objectively evaluated.

As the difference between interest and inflation rates widened in the late 1980s, government policies were in effect stimulating an implicit income transfer, from savers to borrowers. Businesses in non-financial areas, such as agriculture and industry, enjoyed a triple benefit since they were also favored with high levels of tariff protection and tax exemptions. Thus it became a smart business strategy to operate undercapitalized businesses that were highly leveraged at local banks. Those who borrowed from Venezuelan banks typically operated with very low levels of capitalization.
Financial groups also developed ways to circumvent the regulations. They set up special purpose companies that issued deposit-like liabilities at interest rates slightly higher than those paid by the banks, and on-lent the money without booking it. Such transactions escaped reserve requirements and government lending regulations and were not subject to interest rate ceilings. A thriving off balance sheet banking business thus developed and came to flourish on the fringes of the law. The earliest of these instruments were known as money market funds, or fondos de activos líquidos, followed by operations called money desks, mesas de dinero.

“Affiliates” also began to spring up all over the world—in the Netherlands Antilles and Panama, in Miami and New York, in Zurich and in Paris, even in the Channel Islands. In the 1980s, offshore business grew more important, when banks used their affiliates to attract a deluge of capital fleeing Venezuela. Gradually, these offshore operations became hiding places for problem assets.

All of these practices were, slowly and silently, undermining the Venezuelan banking system. By the late 1980s, these practices had been going on virtually exempt from public scrutiny for years.

REGULATION IN MANY HANDS WEAKENS SUPERVISION

While banks found creative and sophisticated ways to overcome an uncomfortable macroeconomic environment and unfavorable rules, supervision failed to keep up with banks’ new off balance sheet and offshore activities. Until 1993, Venezuela’s bank regulatory framework hardly changed at all. Modernizing it without an overhaul of the country’s legal framework was especially difficult.

The minister of finance was the top authority for financial regulation and supervision. But supervisory duties were shared out among multiple agencies whose responsibilities sometimes overlapped. Furthermore, one regulatory agency often had to seek the approval (or at least the opinion) of another regulatory agency before taking certain actions.

Overall responsibility for the health of the banking system was thus neither clear nor situated effectively in any single authority. That also

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21 According to Venezuelan law, the minister of finance is in charge of carrying out all the responsibilities of the national executive on economic and financial policies, including monetary policy, and regulation and supervision of banks and all other financial institutions. Ley Orgánica de la Administración Central, article 26. Gaceta Oficial No. 3,945 — Extraordinario. December 30, 1980.

22 Under Venezuela’s civil code system, a public institution must limit itself to the powers explicitly vested in it by law (Article 117 of the National Constitution, as interpreted by the Supreme Court on April 6, 1989). The system tends to paralyze public administration whenever several public institutions have overlapping powers and operational rules are not clearly spelled out.
made it easier for politics to interfere with oversight.

All financial sector regulatory authorities reported to the minister of finance. The minister, appointed by the President, had tremendous personal power in deciding how banks would be treated. The superintendent of banks, who reported to him, was in charge of regulating, supervising and sanctioning banks. Yet he lacked the power to take key actions, such as intervening in ailing financial institutions, authorizing the establishment of new ones and approving changes in a bank’s capital base. The superintendent could not authorize the sale, merger or dissolution of a financial institution, or suspend or revoke its operating license. The minister of finance had control over these areas, and highly discretionary powers. That meant a bank depended directly on the will of a minister for its survival. Thus, the most important rules could be, and often were, managed on a political basis.

Meanwhile, the Comisión Nacional de Valores (CNV), the Venezuelan equivalent of the U.S. Securities and Exchange Commission, had authority over the banks listed on the Caracas Stock Exchange and a say in approving changes of those banks’ capital and dividend policies. The CNV was also in charge of certifying the independent auditors who made periodic analyses of the banks. To be certified, applicants merely had to prove their academic degree and membership in the local association of certified public accountants. Their activity was not subject to any meaningful oversight.

Deposit insurance was the responsibility of the Fondo de Garantía de Depósitos y Protección Bancaria, known as Fogade. Fogade was established in 1985, and was intended to function like the U.S. Federal Deposit Insurance Corporation (FDIC). Fogade was also in charge of recapitalizing or liquidating banks and granting long-term loans to shore them up. But it needed the approval of the Central Bank and the minister of finance before granting any financial assistance.25

The Central Bank was responsible for monetary policy and for managing foreign reserves. It had a stake in the health of the banks since it oversaw the payment system and served as lender of last resort. Yet it had no direct control over banking supervision.24 The Central Bank did have one crucial regulatory power. It ran the check-clearing system, and in a stroke, could freeze a bank’s operations by stopping all of its checks. But that was the most drastic of measures, akin to amputating a gangrenous leg to save a patient’s life. The Central Bank had no bandages or

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25 Fogade financial assistance could go for liquidity support or for bank rehabilitation and was provided at preferential rates and for long terms. A bank could receive Fogade funds even if bank ownership and management remained in place.

24 The Central Bank, established in 1940, was never responsible for banking supervision. A reform of the Central Bank law drafted by the Rómulo Gallegos government in 1948 included moving the powers for banking supervision from the ministry of finance to the Central Bank. This reform could not be enacted, as the government fell shortly afterward. The issue never officially came up again.
antiseptics to keep an infection from deteriorating.

Venezuelan law also failed to recognize the way banking had changed in the 1970s and 1980s. It did not take into account the increasing importance of financial groups or allow the superintendent of banks to exercise consolidated supervision over them. Had it done so, the Office of the Superintendent of Banks would have been able to evaluate financial groups in an integral way—and have had at least a chance to spot problems. Nor did the superintendent have the power to supervise the networks of offshore establishments. If it did, perhaps it would have been able to assess the overall risk created by offshore balance sheet accounts and transactions. Instead, the authorities officially "knew nothing" about these offshore financial operations.

Accounting rules and prudential norms, covering areas such as loan classification, asset valuation, provisioning, income accounting and lending to affiliated parties, were also inadequate. The Office of the Superintendent of Banks received mountains of data, undertook ritualistic scrutiny of financial statements and remained largely in the dark. The longstanding requirement that banks publish their monthly balance sheets and half-yearly income statements in newspapers was also inconsequential. Instead of providing real information, these statements were often riddled with window dressing and misleading creative accounting. Because the regulations themselves were meaningless, bank supervision became generally lax and ineffective in practice. Additionally, the Office of the Superintendent of Banks carried the stigma of corruption.\(^{25}\) Bluntly put, supervision had become a meaningless ritual, no matter who held the job. There may have been formal monitoring of compliance, but there was no ongoing analysis of the solvency of Venezuela's financial institutions. As a result, bank assets were simply not what they appeared to be.\(^{26}\)

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\(^{26}\) The problems were numerous. lax rules on asset valuation gave banks ample room to choose the reference prices used to show the value of assets. This could significantly affect a bank's equity position, especially in categories such as holdings in companies (in which banks could hold up to 20 percent of capital) and fixed assets (where banks could own up to 120 percent of capital). Assets, and therefore equity, could be overstated due to inadequate classification of non-performing assets, inadequate provisions, and the recognition of interest payments accrued but not received. Accounting on non-performing loans was also questionable. Banks frequently removed them from the books by selling non-performing assets to an affiliate. Or, they were rolled over into new loans, which were considered current for 90 days more. Only losses from writing off uncollectible accounts were tax deductible, so banks usually wrote off a portion of the loan portfolio for each fiscal year. Therefore, it was reasonable to assume that the provisions were lower than what was prudently required. Furthermore, banks customarily reinvested or reserved a portion of their profits. Shareholders (and often, supervisors) considered these reserves to be equity—and not a contingency fund for absorbing primary portfolio losses. Vague accounting rules often left it up to the banks to decide how to account for certain income and expenditure items.
SLAPS ON THE WRIST

Punishment for violating the law was similarly behind the times. In the 1980s, inflation and repeated currency devaluations made the fines on the books meaningless, and the moral sanction—listing fined institutions in the government's public record, the *Gaceta Oficial*—didn't seem to bother bankers much. Even the risk of imprisonment, possible under a 1987 reform of the banking law, seemed to pose no real threat. Ailing banks were allowed to go on operating peacefully, as long as they could muster enough political support. But banking law still did not allow the Office of the Superintendent of Banks and Fogade to swiftly intervene to shore up or liquidate problem banks, and any decision those offices did make continued to be subject to the will of the minister of finance.

All of this could be highly impractical. For example, the superintendent of banks could only take corrective action if a bank had lost at least 25 percent of its capital. Government intervention followed, unless shareholders were willing to recapitalize the bank. Yet another option did exist: the government could permit the bank to operate with less capital. The superintendent could also impose special measures and/or appoint advisors if a bank had severe liquidity or solvency problems (though what that meant was not clearly stipulated in the law), or if it engaged in recurrent violations of the law. If the bank was recalcitrant, it could be taken over.

Technological, financial and personnel resources with which the government could have implemented supervision dwindled with the deterioration of public finances, reaching record lows after 1989. Neither the government nor most legislators cared. Banking supervision was simply not a political priority. On the eve of the 1994 banking crisis, the Office of the Superintendent of Banks had a staff of 60 to supervise more than 150 financial institutions. While the banking system's technological capabilities were state-of-the-art, the Office of the Superintendent of Banks had virtually no data processing capability. Banking law required supervisors to conduct an on-site inspection of each bank at least once a year. Yet the superintendent's annual budget had dwindled to about $8,000 per financial institution—less than the annual salary of a mid-level clerk. On-site inspections—when conducted—were largely ceremonial, hand-shaking affairs. Many banks were not inspected for years.

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2 Its budget increased in 1992 as a result of a World Bank financial sector adjustment loan.
In short, politics had a strong hand in governing the banking system, and there appeared to be no political will to address systemic weaknesses. Banks operated in a regulatory and supervisory vacuum, without effective disclosure requirements or any meaningful supervision of their activities, and without real punishment for imprudent or questionable practices. The few steps the Office of the Superintendent of Banks took served mainly to create the misleading impression that financial institutions were being watched.

For all of these reasons, long before the Venezuelan banking system collapsed in 1994, the stage was set for disaster.

RECESSION CATCHES UP WITH WEAK BANKS

By the time recession arrived in the late 1980s, imprudent risk-taking had been going on in the banking system for a long time, and better regulation was sorely needed.

The available data on banks' balance sheets—though deficient both in quality and breadth—gave reasons for concern. The weakness of bank supervision made the implications even more serious.

The financial system was poorly capitalized. Capitalization had declined rapidly and substantially over the previous decade. Banks' debt to equity
ratio (the measure that was then used to set minimum capital requirements) was far below international norms. It had widened from 6:1 to 8:1 in 1970, further to 10:1 in 1974 and then to a stunning 20:1 in 1975, when oil prices soared and a boom mentality took hold.

Things were even worse than those numbers suggested. Many liabilities were exempt from any capital requirements, and as time went by, the government permitted more and more exemptions. The government had the power to exempt from any capital requirement a wide variety of contingent liabilities, including letters of credit for import and export transactions, irrevocable letters of credit for the government and public sector institutions, and any guarantees to the private sector required by foreign exchange regulations. The calculation of debt to equity further left out a series of liabilities (e.g., debt to the Central Bank), thus helping the banks that more heavily relied upon Central Bank credit. Moreover, in all banks, numerous memorandum accounts revealed paper trails pointing to significant off-balance sheet contingent liabilities. These sums were never included when the debt to equity ratio was calculated.

The increasing number of exempted operations powerfully undermined minimum capital requirements. Commercial banks’ capital/asset ratio fell from 13 percent in 1970 to about 5 percent between 1983 and 1988.26

Chart 1-13
Commercial Banks: Capital / Asset Ratio

Source: Central Bank of Venezuela

26 Until 1994, Venezuela did not implement risk-adjusted capital adequacy requirements established by the Basic Accord of 1988; risk-weighted capital/asset ratios could thus not be calculated.
Poorly capitalized banks took the greatest advantage of these exemptions. Central Bank loans became a steady source of funds for Banco Industrial de Venezuela, a government-owned bank, and for a group of private banks seeking to operate with the minimum required capital. In December 1988, 73 percent of outstanding Central Bank loans to private banks were with the group of banks that failed in 1994. Notably, about 38 percent of the loans were to Banco Latino, an amount equal to 16 percent of the bank’s deposits.

The superintendent of banks should have been able to require capital increases. Oddly, he lacked the authority to do so. The bureaucratic process to approve capital increases in a bank was long and cumbersome. The minister of finance, the superintendent of banks, the CNV and, to a lesser degree, the Central Bank, were involved at different stages of the process, and many months would typically elapse before a capital increase was approved.

The rules were intended to assure the quality of bank capital, but red tape actually hampered the capitalization process: infuriatingly, banks interested in increasing their capital would have to lobby for approval to do so, while the agencies involved seemed more keen on enforcing endless bureaucratic hurdles than in getting bank shareholders to put up the capital to strengthen their banks.

There were also signs that 38 banks were too many for Venezuela. Real assets per branch (valued at 1984 prices) had fallen by about 25 percent over the previous two decades, from Bs. 44.3 million in 1978 to about Bs. 32 million in 1988.

Banks’ operating profits were also trending down. As a sector, banks were not making money in the traditional banking business: taking in deposits and on-lending. There they were breaking even at best; on paper, their costs nearly matched their revenues. Instead, many banks were artificially boosting profits with one-time revenues from asset sales, often conducted with affiliated parties.

Even so, bank shareholders were watching their equity disappear. In real terms, return on equity had been negative or barely worth counting. Banks refused to acknowledge this publicly: they kept posting large nominal profits. Their apparently outrageous returns were always the target of public criticism.
### Table 1-2
Commercial Banks Efficiency Indicators

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<th>Year</th>
<th>Cost - Revenue Ratio (%) 1)</th>
<th>Real Assets/Branch 2)</th>
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<tbody>
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<td>1970</td>
<td>85.4</td>
<td>22.1</td>
</tr>
<tr>
<td>1971</td>
<td>85.8</td>
<td>22.9</td>
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<tr>
<td>1972</td>
<td>85.0</td>
<td>23.9</td>
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<tr>
<td>1973</td>
<td>83.3</td>
<td>25.3</td>
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<tr>
<td>1974</td>
<td>82.5</td>
<td>27.7</td>
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<tr>
<td>1975</td>
<td>81.1</td>
<td>33.1</td>
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<tr>
<td>1976</td>
<td>85.0</td>
<td>37.0</td>
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<tr>
<td>1977</td>
<td>85.6</td>
<td>41.6</td>
</tr>
<tr>
<td>1978</td>
<td>85.5</td>
<td>44.3</td>
</tr>
<tr>
<td>1979</td>
<td>90.2</td>
<td>40.6</td>
</tr>
<tr>
<td>1980</td>
<td>91.2</td>
<td>34.8</td>
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<td>1981</td>
<td>94.8</td>
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<tr>
<td>1982</td>
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<td>99.2</td>
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<tr>
<td>1985</td>
<td>99.7</td>
<td>30.7</td>
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<tr>
<td>1986</td>
<td>98.6</td>
<td>32.2</td>
</tr>
<tr>
<td>1987</td>
<td>98.4</td>
<td>32.2</td>
</tr>
<tr>
<td>1988</td>
<td>90.7</td>
<td>31.7</td>
</tr>
</tbody>
</table>

1) Costs / Revenues (excluding extraordinary revenues)
2) Total assets in million Bs. valued at 1969 prices / number of branches

Source: Office of the Superintendent of Banks and published financial statements
### Table 1-3
Commercial Banks  
Main Financial Indicators

<table>
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<td><strong>Profitability</strong></td>
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<tr>
<td>1. Interest income</td>
<td>6.66</td>
<td>8.56</td>
<td>9.04</td>
<td>10.38</td>
<td>9.30</td>
<td>8.79</td>
<td>8.73</td>
<td>8.27</td>
<td>8.27</td>
<td>8.67</td>
<td></td>
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<tr>
<td>2. Interest expenses</td>
<td>2.15</td>
<td>3.76</td>
<td>4.52</td>
<td>5.79</td>
<td>5.31</td>
<td>4.63</td>
<td>3.33</td>
<td>3.76</td>
<td>3.66</td>
<td>4.23</td>
<td></td>
</tr>
<tr>
<td>4. Non interest expenses</td>
<td>3.58</td>
<td>4.02</td>
<td>4.11</td>
<td>4.34</td>
<td>4.39</td>
<td>4.06</td>
<td>4.27</td>
<td>4.33</td>
<td>4.48</td>
<td>4.81</td>
<td></td>
</tr>
<tr>
<td>5. Contingent loss reserves</td>
<td>0.39</td>
<td>0.57</td>
<td>0.60</td>
<td>0.71</td>
<td>0.79</td>
<td>0.89</td>
<td>1.06</td>
<td>1.20</td>
<td>1.60</td>
<td>0.93</td>
<td></td>
</tr>
<tr>
<td>6. Intermediation margin (4-1-5)</td>
<td>0.74</td>
<td>0.21</td>
<td>-0.19</td>
<td>-0.46</td>
<td>-1.00</td>
<td>-0.79</td>
<td>-0.94</td>
<td>-1.02</td>
<td>-1.48</td>
<td>-1.29</td>
<td></td>
</tr>
<tr>
<td>7. Fee income</td>
<td>0.83</td>
<td>0.74</td>
<td>0.80</td>
<td>0.88</td>
<td>1.08</td>
<td>0.92</td>
<td>0.99</td>
<td>1.18</td>
<td>1.72</td>
<td>2.56</td>
<td></td>
</tr>
<tr>
<td>8. Operating profit (6+7)</td>
<td>1.57</td>
<td>0.94</td>
<td>0.61</td>
<td>0.42</td>
<td>0.09</td>
<td>0.13</td>
<td>0.05</td>
<td>0.16</td>
<td>0.24</td>
<td>1.27</td>
<td></td>
</tr>
<tr>
<td>9. Extraordinary income</td>
<td>0.20</td>
<td>0.18</td>
<td>0.19</td>
<td>0.26</td>
<td>0.38</td>
<td>0.37</td>
<td>0.53</td>
<td>1.14</td>
<td>0.98</td>
<td>0.53</td>
<td></td>
</tr>
<tr>
<td>10. Net income before taxes (8+9)</td>
<td>1.77</td>
<td>1.12</td>
<td>0.80</td>
<td>0.68</td>
<td>0.67</td>
<td>0.49</td>
<td>0.38</td>
<td>1.51</td>
<td>1.22</td>
<td>1.80</td>
<td></td>
</tr>
<tr>
<td>11. Income tax</td>
<td>0.45</td>
<td>0.13</td>
<td>0.10</td>
<td>0.07</td>
<td>0.12</td>
<td>0.05</td>
<td>0.02</td>
<td>0.03</td>
<td>0.08</td>
<td>0.23</td>
<td></td>
</tr>
<tr>
<td>12. Return on assets (ROA) (10-11)</td>
<td>1.32</td>
<td>1.00</td>
<td>0.70</td>
<td>0.62</td>
<td>0.55</td>
<td>0.45</td>
<td>0.56</td>
<td>1.27</td>
<td>1.14</td>
<td>1.57</td>
<td></td>
</tr>
<tr>
<td>14. Adjusted return on equity (AROE) 2/</td>
<td>12.01</td>
<td>11.99</td>
<td>7.72</td>
<td>5.12</td>
<td>-0.38</td>
<td>1.35</td>
<td>0.35</td>
<td>2.21</td>
<td>2.78</td>
<td>16.60</td>
<td></td>
</tr>
<tr>
<td>15. Real return on assets (RROA)</td>
<td>-5.73</td>
<td>-15.58</td>
<td>-8.87</td>
<td>-6.61</td>
<td>-6.11</td>
<td>-13.18</td>
<td>-7.91</td>
<td>-10.15</td>
<td>-27.90</td>
<td>-25.05</td>
<td></td>
</tr>
<tr>
<td>16. Real return on equity (RROE)</td>
<td>-4.47</td>
<td>-14.14</td>
<td>0.13</td>
<td>1.05</td>
<td>1.91</td>
<td>-6.05</td>
<td>0.95</td>
<td>7.94</td>
<td>-14.92</td>
<td>-7.75</td>
<td></td>
</tr>
</tbody>
</table>

### Intermediation ratios

| Credit / Deposits (%) | 82.6 | 85.5 | 79.8 | 88.0 | 70.8 | 72.8 | 73.1 | 79.9 | 88.2 | 95.2 |

### Capital adequacy

| Capital / Assets (%) | 9.2 | 6.4 | 6.1 | 6.8 | 5.5 | 5.0 | 5.2 | 5.2 | 5.2 | 5.3 |
| Liabilities / Capital | 10.9 | 14.7 | 15.4 | 13.8 | 17.5 | 19.2 | 18.2 | 18.4 | 18.2 | 17.5 |

### Asset structure (%)

| Cash | 25.0 | 21.2 | 21.2 | 17.8 | 23.1 | 21.9 | 23.2 | 20.4 | 19.5 | 19.7 |
| Loans | 64.0 | 64.8 | 60.7 | 63.8 | 52.1 | 52.4 | 53.3 | 54.8 | 59.0 | 59.0 |
| Securities and equities | 5.0 | 4.1 | 8.4 | 5.9 | 8.0 | 8.7 | 8.3 | 8.1 | 6.3 | 5.7 |
| Real estate | 1.3 | 1.2 | 1.3 | 1.3 | 2.4 | 2.6 | 2.7 | 2.5 | 2.2 | 2.4 |
| Other assets | 6.7 | 8.7 | 8.3 | 11.2 | 14.4 | 14.4 | 12.3 | 14.2 | 13.0 | 13.1 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

1/ as a percentage of total assets  
2/ net income before extraordinary revenues

Source: Office of the Superintendent of Banks
THIRTY YEARS OF BAILOUTS

For Venezuelan banks, the problem economists call moral hazard was acute. It means that investors, if they are sure of having losses covered, tend to take bigger risks. Venezuelan bankers and their clients had the best of reasons not to fear repercussions from imprudent lending or risky deposits: history demonstrated that the government would always step in, pay for losses and, if necessary, run failed banks for years. When banks failed, shareholders usually lost their little equity capital, but depositors never lost their funds. Moreover, in more prosperous times, depositors were surprisingly patient and peacefully awaited eventual reimbursement. It was a track record that bred overconfidence all around.

The government consistently demonstrated a willingness to spend copiously to bail out banks, even when there was evidence of mismanagement, heavy insider lending and fraud. It exhausted the equivalent of 28 percent of GDP paying for a 1961-1963 systemic collapse that was triggered by the coincidence of the fall of Venezuela’s last military dictatorship in 1958 and the end of an oil boom. Deep political and financial uncertainties in the early years of modern democracy led to heavy capital flight, and 16 banks, controlling 40 percent of total banking system deposits, ran into deep trouble. Even though cronyism, loans to affiliates and fraud were blamed as the fundamental source of the banks’ problems, the government and the Central Bank refloated most of these institutions. Nobody was punished, and depositors, at least, lost no money.\(^*\)

The next crisis arrived in 1978. It involved Banco Nacional de Descuento, then the largest bank in the country. BND had lent heavily for real estate, construction and development. It ran into severe problems, in the wake of several years of oil boom and speculative excesses. BND was owned by the influential González Gorondona family and was very powerful. In trouble during the banking crisis of the early 1960s, it had at that time, in exchange for liquidity support from the Central Bank, posted as collateral the shares of other banks it owned. As a result, the Central Bank became the majority owner of Banco República (holding 53.0 percent of equity capital), Banco Occidental de Descuento (68.4 percent) and Banco Italo-Venezolano (95.6 percent).

\(^*\) The workouts were protracted, in some cases lasting more than 20 years. The government assumed two banks outright. Three the Central Bank helped—Banco Táchira, Banco Nacional de Descuento and Banco Construcción, together nine percent of the market—were allowed to pay with real estate, securities and part of their loan portfolios. Banco Táchira was closed in 1961, unable to operate even after huge state loans; its liquidation lasted more than 20 years. Likewise, Banco de Fomento Comercial de Venezuela, which went bankrupt in 1965, was taken over by the government, recapitalized and reopened, but closed in 1983.
BND had appeared to recover then, and an aggressive growth strategy soon turned it into Venezuela’s top bank. Apparently, it had not learned its lesson.

When in 1978 BND stood on the brink of failure once again, the Central Bank stepped in as lender of last resort. Eventually BND could no longer qualify for Central Bank loans. On December 7, right after a new President was elected, it was excluded from the check-clearing system, and taken over by the government the same day. A report issued by the Office of the Superintendent of Banks highlighted persistent noncompliance with reserve requirements, substantial loans to friends and affiliates, improper accounting of non-performing loans and imprudent lending.

Political influences, cronyism and insider lending were the real causes of BND’s collapse, a fact widely recognized at the time by the Central Bank, government officials and the general public.  

The Central Bank liquidated BND and sold most of its assets. Its deposit clientele, performing loan portfolio and branches were bought by other Venezuelan banks. Again, depositors got all their money back. Yet, for more than a decade, the Central Bank kept the banks BND had given as collateral. Holding banks fit the national strategy of expanding the government’s role in the economy. The practice gave the Central Bank a means of influencing market conditions and provided politicians with ready access to bank loans.

There was a third wave of bank failures in the early 1980s, again because of financial institutions’ penchant for making unsound loans to insiders and engaging in risky investments. Banco de Desarrollo Agropecuario, a state-owned agricultural development bank, failed in 1981. Banco de los Trabajadores de Venezuela, owned by Venezuela’s main labor confederation and the largest bank at the time, collapsed in 1982. Three small banks, Fomento Regional del Zulia, Comercial de Maracaibo and Fomento Comercial de Venezuela, followed suit in 1983.

Banco de Comercio, a medium-sized bank, went bankrupt in 1985. The government provided the usual aid and, in cleaning up the mess, discovered the usual unsound behavior. An investigation into the failure of Banco de Comercio determined that some 70 percent of the bank’s loans had gone to about 300 companies controlled by the bank’s shareholders. An external auditor’s report observed that loans had been approved without any documentation, and none had real collateral. Subsequent investigations helped explain why 33 government institutions had placed substantial funds there, even though the bank was practically insolvent: officials in charge of choos-

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81 They were privatized in 1990-1991.
ing depositories for state funds were found to be receiving kickbacks of 2 percent to 5 percent of their deposits. Fogade assumed Banco de Comercio's deposits and kept the bank running. Later, it was closed and liquidated at Fogade's expense. Depositors, once again, suffered no losses.

Such episodes intensified the moral hazard problems that would later help create the banking crisis of 1994. Each time the government took over a bank, it saw to it that all depositors were repaid. Shareholders lost their equity capital but had already earned abundant profits from investments in related businesses, generously financed by depositor money. A bank failure, in their eyes, wasn't necessarily the end of the world.

As a rule, the banks in the worst shape made imprudent loans to insiders and engaged in risky investments. Both state and private banks were suspected of offering loans to public sector corporations for political reasons and of receiving kickbacks. Government action always came too late; after banks had run out of resources to pledge as guarantees for assistance and capital was effectively gone, leaving no possibility of recovery.

Despite the regulatory changes that came after each major bank failure, the fundamental problems were never addressed. Supervision and regulation, rather than improving, weakened over time.

Regulations governing the workout of insolvent banks also failed to improve. Venezuela's insolvency rules were extremely lax, and the resolution process for failed banks was protracted. The criteria that would cause the government to intervene in a bank remained unclear. As bank intervention required the approval of the minister of finance, the process was vulnerable to political pressures, a situation that often led to prolonged delays. While a bank was going under, bank managers typically remained in place and so could freely continue their improper banking practices. Upon intervention, getting anything done took at least four months. Liquidation could take forever.

The Venezuelan banking crisis of 1994 demonstrated that, over 30 years, not much had changed.

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54 In the case of Banco de Comercio, the external auditor's report for the first half of 1984 found fraudulent practices and lack of compliance with the Office of the Superintendent of Banks, as more than 20 percent of the bank's loan portfolio was lent to companies linked to the bank's owners. The audit for the second half of 1984 showed that the situation had deteriorated, with 37 percent of the bank's loans concentrated in the group's companies. The government did not intervene in the bank until June 1985.

55 Carlos Rafael Silva, *op. cit.*, pp. 156-158.

56 The government appointed conservators and asked them to recommend within 90 days whether a bank should be reorganized or liquidated. The government then had 30 days more to decide what to do.
Our latest crisis was also rooted in bad regulation, bad supervision and bad banking, even though an economic shock played a part in the story, too.

An important difference was that, after more than three decades during which the government dictated, funded and solved so much, the belief that the state would be standing by with its safety net was so firmly entrenched that Venezuelans failed to recognize a sea change.

Since oil was no longer generating enough wealth, by the late 1980s our way of life was about to be turned on its head. And that meant banks involved in risky business would soon be operating in a far more precarious landscape.
THE SHIFT

Venezuelans thought they knew the President they elected in December 1988. Carlos Andrés Pérez, vigorous candidate of the center-left Acción Democrática party, had been President before, from 1974 to 1979. During his previous term, an unprecedented oil boom was in full force. That allowed his government to liberally distribute jobs and subsidies. The Pérez administration had also borrowed heavily, to keep its costly programs afloat. Unsurprisingly, the President had enjoyed great popularity.

When Venezuelans reelected him, they hoped he might somehow restore the prosperous times of the past. But this time, Pérez lacked the resources to give people what they wanted. The borrow and spend binge that began in the 1970s had continued through the 1980s, even though by then plunging oil prices and a shaky economy meant succeeding governments could not afford to repay those loans. By 1988, inflation had risen to an uncomfortable 35.5 percent. The government’s budget was deeply in the red: the deficit, at 6.2 percent of GDP, was at its highest level in 20 years. Venezuela had less than $1 billion in liquid foreign reserves—too little to pay for imports.

With little money, and no access to foreign credit, the new President quickly understood that we had reached the end of an era. He realized we would have to change the flawed way the country ran.

So, although Pérez was elected on a populist platform, he decided to take a radically different approach to his second term. He announced a program of free-market reforms of a style later dubbed the “Washington Consensus.” These were measures encouraged by the International Monetary Fund and its supporters. Chile, Mexico and Argentina were already applying them, with some success. Soon Venezuela’s new administration
would also embrace policies to lift controls on prices and the currency, eliminate subsidies, heighten business competition and sell off money-losing state companies.

Pérez certainly was not the first Latin American president to conclude that a closed, state-controlled, subsidized economy could not keep a country growing forever. Beyond our borders, the world had already changed. Fewer and fewer countries were following statist policies.

Pérez called his economic program the *gran viraje*, or the great turnaround. It aimed to finish off what remained of our rentier economy and to launch Venezuela on a path to stable rather than volatile growth.

The President and his team set out make three categories of changes.

Stabilizing the economy and rebuilding foreign reserves were the government’s first tasks. That meant cutting the budget deficit and ending the practice of financing it by printing money.\(^{57}\) The government needed to boost revenues, and planned to do it by reducing subsidies and eliminating tariff exonerations. The prices of goods and services produced by the public sector would therefore need to rise. Interest rates were deregulated too, in order to enhance the effectiveness of monetary policy, to allow rates to fluctuate in response to changing market conditions and to help draw capital back into the country. Though a Supreme Court decision prohibited full rate deregulation,\(^{58}\) interest rates rose sharply, and by the end of 1989 rates had turned positive in real terms for the first time in almost five years.

A second set of policies aimed to liberalize and open up the economy. The President planned to free controlled prices and to abolish foreign exchange controls. Instead of multiple fixed exchange rates, the system then in force, the country would now have a single exchange rate that would float according to market conditions, rather than being set at politically convenient levels. The government would also ease its battery of protectionist tariff and non-tariff barriers. Now more imports would be allowed in, forcing Venezuelan business to compete with more efficient foreign companies. Businesses would have to prosper or fail on their own merits.\(^{59}\)

Third, the government planned to privatize money-losing state companies—even though that would mean sacrificing thousands of public jobs—and promised a more welcoming attitude toward foreign capital. Restrictions

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\(^{57}\) Fiscal and monetary policy would be restrained by the government’s commitment to achieving a substantial recovery in foreign reserves.

\(^{58}\) In March 1989, the Supreme Court obliged the Central Bank to set interest rate floors and ceilings.

\(^{59}\) The initial plan called for reduction of tariffs to a maximum of 80 percent in 1989, dropping to 20 percent by 1993, a date soon moved up to 1992. Tariff cuts were also soon expanded to include the agricultural sector, for which a more protracted trade liberalization schedule had originally been planned. Almost simultaneously, the government gave a boost to regional integration, abolishing tariffs on imports from Andean Pact nations and from the Caribbean Economic Community (CARICOM).
on foreign direct investment were eased, except in banking, insurance and media, where foreign investment was forbidden by law. A debt-to-equity swap program was also put in place. This allowed certain Venezuelan creditors to "swap" their claims on Venezuelan government loans for equity stakes in Venezuelan companies and projects, a mechanism intended to boost investment and to ease our foreign debt burden.

The President also acknowledged that the only way forward was for Venezuela to honor its international obligations: his government would negotiate with foreign creditor banks to restructure and begin repaying $20 billion in defaulted external debt. Pérez sought the help of the IMF: in June, the government signed a loan agreement for more than $3 billion, which the IMF would lend to Venezuela in stages contingent upon the government's enacting its economic program.40

RESISTANCE TO CHANGE

Pérez's changes brought Venezuela into the global economy. They also forced the private sector to re-evaluate its old ways of doing business. Making its debut on the global stage, Venezuela had to make a commitment to competitiveness and learn to succeed in a world based on open and deregulated markets, transparency of information and incredibly mobile international capital.

The government faced three major challenges. One was to convince Venezuelan society of the need to change, or risk a weak political foundation for the reform process. Another was to strengthen government institutions responsible for putting the reforms into practice. The third was to build up the non-oil economy and thereby reduce our dependence on oil income.

None of these things would be easy to do. First and foremost, in 1989 most people did not see any need for change. It was like telling a sick patient whose symptoms were still slight that he needed a serious and painful operation; not everyone was convinced of the need to pull together in this direction. Adding to the difficulties, Venezuelan politics had become much more combative: the years of peaceful conflict resolution were gone.

So Pérez's reform program was predictably controversial. In fact, his years in office were some of the most socially unstable since Venezuela

40 The Venezuelan government signed a standby agreement with the IMF shortly after it took office in February 1989 and then moved on to a three-year extended fund facility in June 1989. Under an EFF, a country may obtain loans subject to meeting specific economic targets in such areas as fiscal deficit reduction, money supply growth, real exchange rate changes, fewer restrictions on trade and current account transfers, maintaining adequate international reserves and implementing structural reforms. The country submits to IMF surveillance in exchange for receiving funds.
became a democracy in 1958. The changes he tried to make inspired terrifying riots and two coup attempts and finally forced him out of office early.

In the end, the Pérez administration had little choice but to take a zigzagging approach to economic reform. Eventually, these half-measures and about-faces would contribute to a national financial crisis.

SOCIAL BACKLASH

Pérez wasted no time: he launched his program as soon as he took office in February 1989.

He announced that his government would end the system of fixed exchange rates and lift price controls on subsidized goods. Consumers were surprised and angry. The end of exchange controls would mean devaluation of the bolivar, and thus a cut in real income. Interest rate deregulation especially worried the urban middle class, as mortgage rates would quickly shoot up. Mortgage debtors panicked.41

While the government argued that a prosperous future awaited the Venezuelan economy and the free market economic stance bolstered investor confidence, the reaction of the Venezuelan public was negative. People knew that the new policies would hurt their pocketbooks. The new administration's frightening announcements created a gloomy spirit that turned out to be fertile ground for a social outburst.

And then came the gasoline price hike.

One of Venezuelans' most symbolically significant subsidies was the privilege of buying gasoline at very low prices. In early 1989, we Venezuelans paid $0.10 per liter to fill up the tank—our only tangible, everyday way of sharing in the country's vast oil wealth.

The government had announced that a 90 percent hike in gasoline prices would take effect at the end of February. On February 27—the day before payday, when workers are usually out of money—a group of bus drivers anticipated the hike by a day. In Guarenas, a working class suburb of Caracas, they demanded higher fares from their empty-pocketed passengers.

That act unleashed a violent revolt. Within hours, the protest exploded into three days of rioting and looting in Caracas and other major cities. Several hundred people were killed.

The events of the 27th highlighted the fragility of the social fabric and warned all reform-minded policymakers of how easily it could be torn asunder. Those days came to be known as El Caracazo, or the bang that started

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41 Public protest against rising mortgage rates quickly led Congress to approve a law subsidizing mortgage borrowers.
in Caracas. For years, the memory of the riots would be a critical factor in slowing the pace and content of the government’s ambitious reform program. The general impact was to backpedal, to pump more money into the economy and to spend more, rather than to confront painful free market reforms head on.

It didn’t help that the rest of 1989 was nearly as tough as the beginning. That year the economy shrank by 8.6 percent. Non-oil GDP fell by 9.4 percent. Unemployment rose to nearly 10 percent, and inflation shot up to an unprecedented 81 percent. The depth of the recession frightened the whole political establishment. Among the reforms deferred were those designed to reduce dependence on oil. Congress rejected a government proposal for a value-added tax. Many legislators also opposed the privatization of state companies, so plans for downsizing the bloated public sector, a project that would have crippled a patronage network built up over decades, were postponed. Instead, the government focused on ambitious investments in oil, steel and aluminum. Indeed, this was not a downsizing, but an expansion.

Changing the way Venezuela had worked for decades would prove very difficult. The price would be high—for the President, for the public and for the banks as well.

BANKING WEAKNESSES IGNORED

What at first seemed like a golden opportunity for Venezuelan banking was in fact a new nail in its coffin.

The new administration was in a hurry. Aided by his key ministers, the President issued a series of decrees in rapid succession, hoping speed and momentum would firmly launch his program and make it hard to reverse. What he could not impose, he delayed; even if he could not get consensus, he pressed on. With respect to financial institutions, the patchwork of policies that emerged turned out to be destabilizing.

Bankers celebrated the Central Bank’s moves to deregulate interest rates. At last, rates would be more or less free. If the policy worked properly, depositors could be attracted back into the banking system, and domestic lending could also become a profitable enterprise. Barriers to capital flows would likewise be lifted, allowing money to freely move in and out of the country.

But the Venezuelan banking community succeeded in delaying and watered down financial sector reform plans that could have kept euphoria in check, such as stronger regulatory measures and a plan to open the Venezuelan financial marketplace to competition from foreign banks.

Many of these plans were supposed to be included in a bill to reform the
national banking law, drafted with the help of the World Bank. But when it could not secure the cooperation of Venezuelan banks, the government turned away from supervisory issues in general. Instead it focused on drafting a set of financial sector bills, in order to meet a 1991 World Bank (and self-imposed) deadline for passage of some sort of reform law.\footnote{To accomplish this, the Central Bank set up a technical unit (Unidad para la Reforma del Sector Financiero) and the government created a Negotiating Committee (Comité de Concertación) to facilitate dialogue with the banking industry. Venezuela's leading bankers participated in the committee, which conducted interminable discussions, but still managed to avoid the subject of tightening bank supervision.}

In the end, not much was done to address the deterioration of the banking system. Yet, the deadline was met: in July 1991, the executive branch introduced into Congress eight bills for reforming the Central Bank, the Office of the Superintendent of Banks, Fogade, the private banking system and several government-owned financial institutions.

The new banking law eventually drafted in 1989-1991 had its shortcomings. It would not give the Office of the Superintendent of Banks jurisdiction over the financial holding companies as a whole. And it would not open the industry to foreign competition. But it contained some very promising provisions: it would end the rigid specialization among financial institutions and authorize full-service or universal, banks. It would also raise capital requirements, and enhance the powers of the superintendent of banks.

Sadly, these financial system reform plans languished in Congress for two years. A political crisis and the deterioration of the working relationship between the Pérez administration and Congress were partly to blame. Ironically, some members of Congress seemed to mistrust the reform package chiefly because Tinoco, the first president of the Central Bank under Pérez, supported it. The unspoken suspicion was that, if Tinoco favored it, it must somehow be biased in favor of banks. But more importantly, vested interests with considerable political influence opposed the reforms. In any case, regulation and supervision were left sorely unimproved.

The IMF, the World Bank and the Inter-American Development Bank helped the government shape its financial system reform program. They understood that we needed to strengthen the banking system, modernize regulations, stimulate competition and make bank supervision more effective. The World Bank offered a $300 million financial sector adjustment loan. The loan was intended to help capitalize Fogade, revive or liquidate banks that had fallen into government hands in past crises, and help pay the higher domestic debt service that would result from higher interest rates. Yet the targets to be met were formal, rather than fundamental: they mainly focused on drafting and submitting the legal reforms to Congress.

The package originally included $7 million in technical assistance to bolster the regulatory agencies and to finance studies on the condition of
private financial institutions. Inexplicably, Congress rejected this portion of the loan, and funding for it was withdrawn.

Venezuelan bankers were pleased with the outcome: they would have a lucrative macroeconomic environment that promised an investment boom, a protected market in which to exploit it and little regulatory interference.

But it would not be the easy ride they anticipated.

The reform program exposed financial services and banking to heavier competition since it forced institutions to share their markets with new domestic banks. Liberalization of capital flows was a double-edged sword: money could flow unimpeded into the country but could also more easily flee. Meanwhile, the real economy was suffering a major shock.

The damage was done quickly.

Borrowers suffered the consequences of rapidly rising interest rates, as lending rates climbed from 14 percent to more than 30 percent in a matter of weeks. Corporate borrowers were especially hurt by the government’s decision to apply the new exchange rate retroactively, to all outstanding trade credits for imports made between May and October 1988, and by recession, inflation and tougher international competition.

In the third quarter of 1989 alone, banks’ past due loans skyrocketed by 50 percent, according to a careful evaluation of the banking system prepared by the World Bank. Bad loans held by the six largest private banks, while still few, more than doubled; by June 1989 nine of the 38 private banks had non-performing portfolios that exceeded their total capital bases. Portfolio quality was rapidly deteriorating. Several banks would have to be recapitalized, merged, sold or liquidated, the World Bank suggested. This trend was even more worrisome when one considered that poor supervision and loan rollovers were hiding many non-performing loans.

The World Bank report might have served as a wake-up call. But government officials and the rest of Venezuelan society were so insensitive to the risk of problems in the banking sector that the report received very little attention outside of the banking community.

What the banking system urgently needed in 1989 was recapitalization and more competition, while the regulatory framework needed a thorough overhaul. It is true that financial sector reform proposals took aim at those objectives, but only in an unhurried way, and with no clear focus.

Action was needed much sooner, to strengthen the capital base, close loopholes in regulations and establish incentives for more efficient, stronger financial intermediation. Clearly, the Venezuelan banking system could not

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13 The old controlled exchange rates of Bs. 7.5 and Bs. 14.5 per dollar would be retained only for $3 billion of outstanding trade credits and $250 million of private sector external debt payments. A 197 percent devaluation was applied to other outstanding loans.

solve these problems on its own.

The Pérez government, though, decided to plunge ahead with reforms without first building the foundation for a sounder banking system. Officials' reasoning was that, by the time such a foundation was firmly in place, the window of opportunity for economic reform might be shut. The banks' problem would be solved later, Venezuelan style: "como vaya viniendo, vamos viendo."

The banking industry, the thinking went, would be able to grow its way out of its problems by conducting business in the new liberalized economic climate. Letting banks take the reins was surely easier than acting to staunch the debilitating impacts of reform on the banking system. Bankers naturally agreed wholeheartedly with this strategy since they feared that a stricter regulatory and supervisory system would clip their wings during the economic takeoff that reform was supposed to bring.

Two special programs eased the banks' way through the initial stage of the reform process. Central Bank loans helped the banks cope with the impact of the 1989 devaluation on outstanding letters of credit. Then in 1990, the Central Bank bought the banks' fixed-rate agricultural loan portfolio, which was burdening them in the newly-deregulated environment.

The government gave the banks another piece of protection: it kept the door shut to competition from foreign banks. For a little longer, Venezuelan banks would have the national territory to themselves. This was a protection bankers fought for fiercely. Ironically, the argument put forth to justify this was identical to the one that had created the failed import substitution policies—that Venezuelan banks needed an incubation period to gain strength to compete with foreign banks. Predictably, the period of expansion and protection would end up nothing but a wasted opportunity. Not only did many banks fail to improve their position; they actually became weaker.

But the main successes of Pérez's first year were the byproduct of financial deregulation, too. The balance of payments deficit declined, as devaluation of the currency and deep recession depressed imports. Balancing the budget was a priority, and the budget deficit did in fact fall sharply, to just 1.0 percent of GDP in 1989. But the improvement was the result of the impact of the devaluation on government oil revenues, rather than a gain in income from higher taxes.

MONETARY POLICY SHIFTS TO MARKET-ORIENTED INSTRUMENTS

Monetary policy now shifted from direct government control of interest rates to open market operations that the Central Bank conducted by issuing zero-coupon bonds. The Central Bank sold these bonds to remove currency from
circulation, and banks bought them. Nominal interest rates rose. The intent was to slow inflation; with the freeing of prices and currency devaluation, prices were rising rapidly.\textsuperscript{45}

The volume of outstanding bonds quickly grew. The fact that more than half of the Venezuelan government's expenditure is financed by oil revenues (rather than by domestic taxes) implies that high-powered money is constantly created by the government, ballooning the money supply. Monetary policy therefore has always had a restrictive role, in order to compensate for the government-created monetary expansion.\textsuperscript{46} Yet, the efficacy of monetary policy instruments has usually been limited, especially when there are high and persistent fiscal deficits.

\begin{center}
\begin{tabular}{c}
\textbf{Chart 2-1} \\
Monetary Impact of Fiscal Accounts
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\begin{figure}
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\includegraphics[width=\textwidth]{chart21.png}
\caption{Monetary Impact of Fiscal Accounts}
\end{figure}

Zero-coupon bond issuance was a basically sound policy. But the bonds also had controversial and negative aspects. They were expensive for the

\textsuperscript{45} The Central Bank also lifted its rediscount rate above the banks' lending rates. This forced the banks to quickly attract deposits in order to repay their debts to the Central Bank.

\textsuperscript{46} The concept used to gauge the impact of the government budget on money supply is the net domestic fiscal deficit, which represents the amount of domestic government expenditures financed by external revenues, essentially from oil and foreign borrowing. High and persistent fiscal deficits have traditionally undermined the efficacy of monetary policy instruments. Reforms did not correct this problem. In fact, the government's net domestic deficit rose in 1989 and 1990 and thus increased the pressure on monetary policy.
Central Bank. And because commercial banks invested in these bonds instead of lending, they seemed to deprive other sectors of the economy of capital. Finally, because of Tinoco’s close links to the banking sector, critics and bankers alike saw the bonds not as a dispassionate monetary policy tool for controlling inflation but as a partisan one, a mechanism to help bankers make money. The image problem persists today. Such bonds are inflation-fighting tools widely used by central banks, yet neither they (nor any other monetary policy instrument) can counteract chronic monetary imbalances.

FINANCIAL EUPHORIA TAKES HOLD

While the country was absorbing the impact of the reform program and long before the public could thoroughly understand it, the Persian Gulf War brought an unexpected increase in oil prices.

As usual, the oil price spike was a decidedly mixed blessing.

The price of oil, at a low $13.70 per barrel in 1988, rose to $17.80 in 1989 and $24.70 in 1990. Venezuela was again awash in money. Windfall oil revenues in 1990 reached an astounding $4.3 billion (8.8 percent of GDP). Capital flowed in and GDP rebounded by 6.5 percent. Instead of setting aside the extra revenue to help ease economic pains of years come, the government increased its spending. Budget expenditures, which had fallen the previous year, expanded to 33 percent of GDP.

Unsurprisingly, commitment to stabilization and structural reforms slackened. In the traditional Venezuelan pattern, the oil bonanza overshadowed the need for reforms that were painful, poorly understood, lacking in political support and tainted in the eyes of the political establishment.

A small but highly visible privatization program began to bear fruit in 1990, generating $615 million. That, and the liberalization of investment rules, created tremendous (and unrealistic) optimism among investors; foreign reserves and asset values rose. Share prices on the Caracas Stock Exchange increased by 668 percent in real terms in the two years preceding January 1992. Local and foreign investors made huge, quick profits in the capital markets and in real estate. The markets were full of speculative bubbles.

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A portion of this windfall went into a special treasury account in the Central Bank, which was to be used in the event of a drop in government revenues. Eighteen months later, the entire fund had been exhausted.
But even as Venezuela enjoyed the fruits of the boomlet, oil prices were already declining as the Gulf War ended, leading fiscal accounts to deteriorate once more. ⁸⁸

Of course, the rebound eased the tensions the reform program had triggered. But it also fed a general confusion: if the country was so rich, why did we need more painful measures? Recognizing the risk of reversals, the Perez government tried to nail down the reforms it had succeeded in passing, in trade, foreign investment and privatization. Unfortunately, it was forced to make serious compromises.

First, the passage of a backward-looking labor law made the labor market more rigid, raising wage expenses for government and business. ⁹⁹

Second, fiscal accounts were again becoming more dependent on oil

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⁸⁸ Though the government achieved a balanced budget in 1990 and 1991 (with small surpluses of 0.2 percent and 0.7 percent of GDP in those years, respectively), it was due to non-reocurrent events: the sharp currency devaluation, Gulf War-related oil revenues, privatizations and foreign debt restructuring. The reduction of debt service payments due to foreign debt restructuring added $7 billion to government accounts over the succeeding five years, while paving the way for $1.2 billion in new borrowing.

⁹⁹ In 1991, Congress approved a reform of the labor law. It was a step in the wrong direction. It made it tough to cut jobs, increased labor costs and put a brake on new employment, especially for young and unskilled workers.
revenues. Changes in the income tax system, the introduction of a value-added tax, privatizations to downsize government, and the restructuring and liquidation of government institutions all required legislative changes in order to move ahead. These measures were subject to heated and protracted discussions, as the main political parties hesitated to take on the cost of passing such reforms, and vested interests worked effectively against the needed changes.

Third, even in those boom times, the financial sector was getting weaker by the day. Banking lagged the restructuring that was beginning to take place in the rest of the economy. Bankers had no incentive to rationalize and consolidate operations or reduce overhead. Rather, they were rushing to take advantage of the business opportunities at hand, betting that the government would get them out of trouble if their strategies went wrong.

In a short time, profits of many banks would become highly dependent on one-time revenue generated by asset sales—often to affiliated companies—as clear a sign of weakness as one could imagine.

Predictably, the oil price spike did nothing to strengthen the Venezuelan economy, and attempts to accompany reform with new laws and updated regulations were stillborn. A period of economic good times, rather than easing the way toward modernizing the financial sector, broadened and made more visible the inequalities tearing at Venezuelan society. Suddenly, rich stock market speculators were riding around Caracas in luxurious imported cars. Meanwhile, the common citizen was having a hard time finding the means to get his old car repaired. Real estate prices soared, making housing inaccessible to the middle and working classes. That chasm between richer and poorer began to stimulate more strident attacks on the reform program. The social and political situation was roiling.

By the end of 1991, nearly three years into the reform program, political conditions were less conducive than ever to continuing it. The political climate was hot with strikes, student riots and criticism of the government. Pérez had lost the support of sectors of his Acción Democrática party; not all members were thoroughly committed to seeing his program through. In the end, the program would be left unfinished.
BANKS' GREAT GAMBLE

The poor quality of the banks' portfolios and the inadequacy of their capital bases and of loan loss provisioning surfaced abruptly. Financial deregulation was not enhancing the banking system's role in the economy. Although commercial bank lending increased, especially in 1991, the ratio of commercial bank loans to GDP nearly halved between 1988 and 1993, from 52.6 percent to 31.3 percent. Loan operations shifted to the capital markets, as corporations increasingly resorted to issuing commercial paper—guaranteed by the banks—to lower their financing costs. Often, they also turned to off balance sheet and offshore operations.

Table 2-1
Commercial Banks
Lending Activity Indicators

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<th>Loans % Change</th>
<th>Real Loans % Change</th>
<th>Bank credit % GDP</th>
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<tr>
<td>1988</td>
<td>29.36</td>
<td>(9.08)</td>
<td>32.6%</td>
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<tr>
<td>1989</td>
<td>14.81</td>
<td>(51.76)</td>
<td>36.58</td>
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<tr>
<td>1990</td>
<td>24.92</td>
<td>(11.91)</td>
<td>31.48</td>
</tr>
<tr>
<td>1991</td>
<td>40.07</td>
<td>(10.34)</td>
<td>32.80</td>
</tr>
<tr>
<td>1992</td>
<td>57.51</td>
<td>6.62</td>
<td>33.90</td>
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<tr>
<td>1993</td>
<td>12.10</td>
<td>(18.84)</td>
<td>31.27</td>
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1/ Adjusted by CPI, 1984 = 100
Source: Central Bank of Venezuela

Doing it their way, the most seriously impaired financial groups resorted brazenly to risky, aggressive investments, in an effort to improve profits. A bidding war for customers' funds broke out. The weaker banks, all of them undercapitalized and closely held, were particularly audacious. Most of them collapsed in the 1994 crisis.

Banco Latino was one of the most aggressive competitors. In 13 months, between January 1, 1988 and January 31, 1989, it moved from fifth to second ranking in terms of deposit market share. The bank's total deposits grew by 97.4 percent, and its market share rose from 8.4 percent to 11.2 percent. After this, Banco Latino's share remained relatively stable through 1993, which suggests that much of the group's subsequent growth was channeled through other parts of the Latino group (e.g., trusts, money market funds and offshore operations) and through newly-acquired financial institutions.
But Latino was not the only one. Most of the banks that crumbled a few years later likewise saw their market shares rise sharply between 1989 and 1991, while the more prudent banks restrained themselves, at the price of watching their market shares shrink.51

Chart 2-3
Commercial Banks: Failed vs. Survivors
Change in Deposit Market Share, 1989

Despite their problems, the banks' performance seemed to recover toward the end of 1989. The banks' use of Central Bank loans declined, as the liquidity of the banking system began to improve and interest rate liberalization allowed banks to strengthen their balance sheets through a temporary

51 Two of the banks that failed in 1994, Banco de Venezuela and Banco Consolidado, were among the moderates during the 1990-1991 boom. They joined the group of openly financially distressed banks only in the second half of 1993.
widening of interest rate spreads. Demand for money recovered, and bank deposits grew in real terms during the 1990-1991 oil boomlet. The shock, it appeared, had been a short one.

The weaker banks developed a common pattern: they were less well-capitalized, yet sought to grow more quickly. As they scrambled for depositors, they began to pay far higher interest rates. Their spreads ended up being much lower, and they grew ever more dependent on one-time revenues from asset sales.

Chart 2-4
Commercial Banks: Failed vs. Survivors 1/
Changes in Deposit Market Share, 1980-1993 2/

1/ Excludes government banks, foreign banks and domestic banks established after 1992
2/ Private deposits

Source: published financial statements
Chart 2-5
Commercial Banks 1/
Capital/asset Ratio

1/ Excludes government banks, foreign banks and domestic banks established after 1992
Source: published financial statements

Chart 2-6
Commercial Banks 1/
Capitalization and Growth 1989-1992
Average Capital Asset ratio (%)

1/ Excludes government banks, foreign banks and domestic banks established after 1992
2/ The following banks are not presented as they exceeded the 12% capital asset ratio:
Survivors: Vziana, de Crédito (16.4%); Plaza (32.4%). Failed: Emprasanal (64.5%) and Profesional (21.3%)
Source: published financial statements
Chart 2-7
Commercial Banks 1/
Operating Profits and Dependence on Extraordinary Revenues 1989-1992

Extraordinary revenues / avg. asset (%)

But only part of the financial groups' new resources showed up as increased lending. Depositors' funds increasingly were channeled into other investments, such as securities and fixed assets, especially through the finance companies of the groups, as these institutions operated under a much more flexible regulatory framework. While the more prudent finance companies focused on lending (53 percent of their assets), the more aggressive ones placed their bets on private stocks and bonds (52 percent of assets) and heavily depended upon one-time revenues (42 percent of total revenues).
Chart 2-8
Finance Companies. Structure of assets
7.1.90 to 6.30.92

Survivors (46%)
- Loans 24.5%
- Government bonds 12.3%
- Private shares and other securities 10.5%
- Others 52.7%

Failed (53%)
- Loans 52.3%
- Government bonds 10.8%
- Private shares and other securities 7.1%
- Others 29.8%

Source: published financial statements

Chart 2-9
Finance Companies. Composition of Revenues
7.1.90 to 6.30.92

Survivors (46%)
- Loans 25.5%
- Fixed income investment 2.5%
- Extraordinary 15.5%
- Others 2.9%
- Services 54.7%

Failed (53%)
- Loans 41.5%
- Fixed income investment 2.4%
- Extraordinary 2.9%
- Others 27.1%
- Services 26.1%

Source: published financial statements
Some of these investments were quite risky. Even long-term projects in tourism, real estate, agriculture and export-oriented industries were often highly speculative. On their face, such loans looked like good credits and investments since the economy was expanding. But the funds raised to finance these long-term investments usually carried short-term maturities. The lenders did not seem to consider this a problem. Nor did the rising number of past-due loans seem worth worrying about since total loans were increasing at a rate that was, bankers believed, fast enough to compensate for any that might turn bad.

Everyone seemed convinced that the Venezuelan economy was “condemned to success,” a saying Ricardo Hausmann, minister of economic planning and member of the board of the Central Bank, would often repeat. Indeed, no one was willing to bring the party to a close.

If all government agencies had acted in concert and raised the banks’ capital adequacy requirements during that short-lived period of economic good times in 1990-1991—when the investment climate was favorable and restrictions would have been easier to absorb—that might have put the brakes on the runaway banking industry. Since it did not happen, bankers were free to gamble on survival.

SPECULATION AND LENDING TO AFFILIATES: A LETHAL COMBINATION

As the boom reached its pinnacle, the banks’ loans and investments in affiliated companies flourished. Information on exactly how big a percentage of their loan portfolios had gone to affiliates and friends surfaced only after bank seizures by the government several years later. By the fall of 1994, it was reported that more than half of the assets that the failed banks offered to Fogade as guarantees were loans or investments in affiliated companies.32

These loans were usually made on extremely favorable terms, without collateral, and would routinely be rolled over. Entrepreneurs came to accept that they would have to take a bank in as a partner in any new venture if a project was to take off. Some bankers even bragged about their power to make or break a deal.

Later, published reports alleged that the banks, flush with resources and under the spell of financial euphoria, directed some funds into illegal or fraudulent activities.33

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While the stock market and real estate booms were inflating asset values and masking the banks' loan portfolio problems, the industrial sector was in trouble. Its productivity fell, as manufacturers and farmers failed to generate wealth at the pace they had before. Tariff barriers had been pared back, yet nothing had been done to create a new competitive advantage for Venezuelan producers. Their subsidies gone, they were now supposed to sink or swim on their own. As they struggled for survival, many companies found it tougher to repay their loans.

So, while the financial sector was riding high on the new reforms and their privilege of protection from foreign competition, the nation's manufacturers were being dragged under.

This inequity gave rise to disagreements in the private sector. Big business remained fairly satisfied with its access to banking services because it could access credit through wider conglomerates. But small and medium-sized businesses protested that they had been shut out of credit markets. In business quarters, support for the Pérez economic agenda was slipping away.

REGULATORY FAILURES

At the same time, other government actions further weakened the shaky financial sector.

In 1990 and 1991, the Central Bank privatized a group of banks the government had seized decades before.54

While the sales proceeded smoothly, generating $157 million,55 sadly, the selloffs hurt the system as a whole. The financial groups that acquired the government-held banks had done it as a part of risky growth strategies. The acquisitions themselves were undercapitalized, some with assets of questionable quality. Instead of recapitalizing the banks prior to privatization, the government made the buyers commit to recapitalization plans—plans that never materialized. The new owners soon got caught by the 1992-1993 economic downturn. All of these institutions

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54 Banco Occidental de Descuento, Banco Italo-Venezolano and Banco República were sold, in sales the government expected to help plug the deficit and reinforce the credibility of the reform program by providing early success stories in privatization. It seemed a logical time for the sales, given the banks' value in the boom years, especially because regulation was lax and the banks' franchise value was high.

55 This was 6.7 percent of all privatization revenue in 1990-1992. Only the $1.9 billion privatization of the national telephone company C.A. Nacional Teléfonos de Venezuela (CANTV) was larger.
would fail once the banking crisis hit.\textsuperscript{56}

The government also decided to increase competition in the banking industry. This was basically a sound idea, but instead of doing it by opening the Venezuelan market to foreign banks, the government opted for a more liberal licensing policy within the closed domestic market. Following the traditional approach to licensing, 22 new licenses for financial institutions were approved in 1989-1993.\textsuperscript{57} This allowed more Venezuelan investors to enter the banking business and also allowed existing financial groups to expand their reach.

Meanwhile, updating prudential regulations turned out to be very cumbersome. The legal basis for more dynamic and effective prudential regulation did not yet exist. All new regulations had to be carefully crafted and negotiated with the banking industry. The negotiating committee set up in 1989 to craft the new laws was a venue for these talks. Proposed regulations were often watered down and delayed; “Gradualism” was the key word.\textsuperscript{58}

THE STRUGGLE FOR BANKING LAW REFORM

In 1992, Congress began considering bank law reform after letting it languish for over a year. The banks’ consent to being regulated came, in the end, largely because banking regulations changed abroad.

The precipitating event was one that sparked united action by supervisors around the world. The collapse and closure of the Bank of Credit and

\textsuperscript{56} In 1993, Banco Popular (a very small regional bank) was privatized. The buyer, Banco Barinas, was prevented from executing the purchase by the Office of the Superintendent of Banks and given the order to sell. Official approval for a capital increase in Banco Barinas was also pending, and lagged for some time. The transaction fell into limbo, and Banco Popular reverted to government ownership when Banco Barinas collapsed in early 1994. Banco Popular was again privatized in December 1997, bought by Banco Provincial, the largest bank in the country.

\textsuperscript{57} Eight commercial banks, six finance companies, five money market funds, two leasing companies and one savings and loan institution were authorized. The number of bank branches also rose, from 2,090 in 1989 to 2,646 in 1993.

\textsuperscript{58} To be sure, several prudential regulations were issued by the Office of the Superintendent of Banks, but they took years to institute and were too late to avert the banking crisis. These included rules on asset valuation, loan portfolio classification and collateral (1990); provisioning requirements for mortgage banks (1991); foreign exchange exposure accounting, consolidation of financial statements in groups/conglomerates, gradual reduction of risk concentration in loans to related parties; and provisioning requirements on investment in private sector bonds and shares (1992); loan classification and provisioning rules applicable to commercial banks; mortgage banks, financial companies, leasing companies and capitalization societies (1993); disclosure by applicants for new bank licenses and before the transfer of significant amounts of shares (1995); accounting rules for extraordinary revenues (1993); and a risk-weighted capital adequacy ratio (1993). Some of these regulations were required by the World Bank as a condition for its financial sector adjustment loan. Other regulations on key issues, such as offshore banking, money desk operations, asset classification and external audit standards, were delayed until 1994.
Commerce International (BCCI) in July 1991 and, to a lesser extent, the evasion of rules by the Atlanta branch of the Banca Nazionale del Lavoro, made clear the urgency of stepping up banking supervision with a global scope.

In late 1991, the U.S. Congress enacted the Foreign Banking Supervision Enhancement Act, which increased the Federal Reserve's powers to supervise foreign bank branches in the United States. The Basle Committee, a group of bank supervisors from around the world working under the auspices of the Group of 10 industrialized nations and the European Community, also set out to revise its principles. As a result, the Group of 10 adopted Basle Committee rules for the supervision of international banking groups. These rules improved the supervision of international banking, by determining precisely the role of home and host country authorities, eliminating loopholes and regulatory vacuums of the sort that complex holding companies such as BCCI managed to slip through. The rules aimed at preventing banks from moving to the least-regulated jurisdictions. Venezuela was forced to climb on board because these new rules indirectly penalized countries where bank regulation was weak.

Venezuelan banks had significant relationships in the United States, their single most important foreign market. Five banks had U.S. branches: Mercantil, Venezuela, Unión, Consolidado and Banco Industrial de Venezuela. Two U.S.-based Edge Act corporations were linked to Venezuelan banks through common ownership: Banco Latino International and Banco Consolidado International. And four U.S.-chartered banks were owned by Venezuelan financial groups: Union Chelsea Bank, Consolidated Bank, Eastern National Bank and Commerce Bank.

As the leaders of the Venezuelan banking community felt the pressure of stepped-up supervision by the Federal Reserve system, they belatedly realized that more rigorous supervision had become an unavoidable cost of doing business at home. After two years of fighting proposed regulatory improvements, they grasped that the weaknesses of Venezuelan banking regulation and supervision would harm their business, regardless of the strength of individual banks.

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61 The new Basle Committee standards established four principles: 1) All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision. 2) The creation of a cross-border banking establishment should receive prior consent of both the host country supervisory authority and the bank's, and if different, the banking group's home country supervisory authority. 3) Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are home country supervisor. 4) If a host country determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures with these minimum standards, including the prohibition of the creation of banking establishments.
Although Congressional debate of the financial reform proposal began
to move by mid-1992, it took until the fall of 1993 to get the bill passed.
Other crises seemed to loom much larger.

Coup d'état Attempt Shatters the Financial Bubble

On February 4, 1992, the roller coaster plunged to earth. An attempted coup
d'état crushed the nascent business optimism, and as during the unstable
days of the early 1960s, capital rapidly fled the country. Lt. Col. Hugo Chávez
Frías was the most visible leader of the military revolt. Military dissidents had
been preparing for a coup for about 10 years, we Venezuelans later discov-
ered, and after the catastrophe of El Caracazo, had worked with a group of
prominent civilians to set their plans in motion.

The coup-makers chose an opportune moment: Pérez’s popularity was
at an all-time low, due to the hardship and general confusion brought forth
by economic reforms, and widespread dissatisfaction over the failure of
Venezuela’s 35-year old democracy to fulfill the population’s needs.

The fragility of Venezuelan democracy caught the world—and most of
us in Venezuela—by surprise. In a thunderclap, the financial bubble burst.
Real estate and share prices plummeted. Polls revealed that 71 percent of
Venezuelans considered the economy in a disastrous state, and 60 percent
opposed the government’s economic reform program.

The optimistic environment of the early 1990s then gave way to two
years of riots, strikes and demonstrations. According to the New York Times,
Venezuela experienced more than 1,400 riots in 1992. While political insta-
bility was on the rise, fiscal problems emerged, as oil prices declined and
windfall profits dried up. The public sector deficit in 1992 shot up to 5.9
percent of GDP.

All year, financial market investors worried about the weakness of gov-
ernment and its finances, and feared inflation and recession. Falling oil prices
now made things worse. The situation meant higher risk ratings from inter-
national rating agencies, forced interest rates up, and brought periodic specu-
lative attacks on the currency. Foreign investors began to exclude Venezuela
from their plans. Prices on the Caracas Stock Exchange plunged by 43 per-
cent between February and November 1992. Short-term capital flows be-
came ever more erratic, highly sensitive to episodes of political instability.

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62 There were large deficits both in government accounts (3.6 percent of GDP) and at the state
oil monopoly Petroleos de Venezuela S.A., or PDVSA (2.3 percent of GDP).
63 By the end of 1992 Venezuelan country risk was considered so high that even PDVSA, one
of Latin America’s biggest companies, had already approved loans revoked.
Chart 2-10
Caracas Stock Exchange

+1.2591 %

Source: Central Bank of Venezuela

Chart 2-11
Demand for Money Balances

Source: Central Bank of Venezuela
After the coup attempt, new crises seemed to erupt every few weeks, and each political shock translated into heavier capital outflows. Although declining oil prices and concerns over the fiscal deficit further damaged confidence and added to the problem, we could see how closely capital flight was linked to political uncertainties. Now we suffered from a drawback of financial markets liberalization: investors could liquidate bolivar-denominated investments rapidly and, unimpeded, rush their funds out of the country.

**THE DAM DEVELOPS CRACKS**

Like water rising against a dam, bank asset deterioration over the years had placed increasing pressure on the Venezuelan banking system. With the coup attempt, the dam began to crack: banking system weaknesses began to leak into the open. This happened through four avenues. First, the political system was fractured. Government-Congress relations eroded, and so did the relations between the President and his own party. Both developments damaged the government's ability to execute its program. Second, political instability hurt the economy, further weakening both the borrowers and the banks. Third, the coup attempt hurt the credibility of government agencies in general, undermining people's confidence in the stability and validity of the decisions made by Venezuelan authorities. And fourth, it eroded regulators' ability to supervise banks in a tough way.

Macroeconomic instability exacerbated the weaknesses of the fragile banking system. Interest rates and bank deposits fluctuated sharply. Banks were hurt by the loss of deposits, the decline in stock, bond and real estate prices, and also by their debtors' financial woes. The combination of high interest rates, declining economic activity and rising inflation was devastating. Creative accounting became commonplace. Various sectors demanded government aid; powerful farmers, for example, fought for a renewal of interest rate subsidies.
Loans and investments in affiliated companies made without regard for borrowers' financial health now began looking like time bombs. Many of these projects were not yet productive—they were business startups or facilities still under construction. Those banks with the highest proportion of their portfolios locked up in such ventures grew desperate to attract more funds. They became increasingly aggressive: “No way will you leave here without doing business with us!” became the bankers’ desperate cry, as they fought frantically for market share. As they turned more and more to the interbank money market for badly-needed liquidity, they tended to pay higher and higher rates for their funds, in some cases solely to cover interest payments they had promised their depositors—a dangerous and all too common vicious cycle. The problems mounted further as the government, strapped for cash, fell further into arrears on payments to state agencies and private contractors, who as a result fell further behind in their debt service to banks. The government built up arrears on repayment of domestic bond issues, another blow to banks.

The situation was putting all banks under pressure. Interest rate spreads were not sufficient to support the banks’ basic operating costs, which had risen with inflation, the cost of their big networks, investments in
Chart 2-13
Commercial Banks. 90-Day Term Deposit Rate
June 1992 to December 1993

Survivors: Caracas, Caribe, Exterior, Mercantil, Provincial, Unión and Venezolano de Crédito
Failed: Latino, Consolidado, Venezuela, Maracaibo, Gualra, Italo and Amazonas
1/ Excludes Consolidado and Venezuela

Source: Central Bank of Venezuela

Chart 2-14
Commercial Banks. Interest Rate Spreads
June 1992 to December 1993

Survivors: Caracas, Caribe, Exterior, Mercantil, Provincial, Unión and Venezolano de Crédito
Failed: Latino, Consolidado, Venezuela, Maracaibo, Gualra, Italo and Amazonas
1/ Excludes Consolidado and Venezuela

Source: Central Bank of Venezuela
technology, swollen advertising budgets and the general extravagance of the times.

But for the ailing banks, it was especially difficult. Their deposits became much more volatile. The rates they paid rose steeply, their spreads shrank dramatically, and the poor quality of their assets sank them into deeper trouble.

The banks that lacked the financial strength to absorb losses hid them by resorting to a variety of devices. Some booked loans to affiliated parties to generate fictitious income. Some transferred funds through special purpose companies or generated one-time revenues by selling assets. Creative accounting became commonplace. Some banks even distributed dividends based on these mythical profits—in regulators' full view.

The ailing banks were now passing on their problems to the rest of the economy. Cash-strapped banks often offered deposit rates more than 25 percent higher than healthier ones did. Since it was the second largest bank in the country, Banco Latino's higher deposit rates tended to pull up the rates of others. Banks had no choice but to compete. As capital outflows put additional pressures on the banking system's liquidity, interbank rates also rose tremendously. Some banks, for example, would pay up to 2,000 percent interest for an overnight loan, at a time when general lending rates were about 50 percent.69

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69 In Venezuela's thin and underdeveloped interbank money market, collusion also made interest rates spike when certain banks were perceived to be desperately looking for funds.
### Table 2-2
#### Commercial Banks
Main financial indicators

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<tbody>
<tr>
<td><strong>Profitability</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Interest income</td>
<td>8.67</td>
<td>17.80</td>
<td>18.86</td>
<td>20.75</td>
<td>25.38</td>
<td>32.80</td>
</tr>
<tr>
<td>3. Net interest income (1-2)</td>
<td>4.45</td>
<td>5.28</td>
<td>5.01</td>
<td>5.03</td>
<td>5.83</td>
<td>6.46</td>
</tr>
<tr>
<td>4. Non interest expenses</td>
<td>4.81</td>
<td>6.18</td>
<td>6.32</td>
<td>5.95</td>
<td>6.60</td>
<td>7.71</td>
</tr>
<tr>
<td>5. Contingent loss reserves</td>
<td>0.93</td>
<td>1.79</td>
<td>1.14</td>
<td>0.96</td>
<td>1.23</td>
<td>1.46</td>
</tr>
<tr>
<td>6. Intermediation margin (3-4-5)</td>
<td>-1.29</td>
<td>-2.69</td>
<td>-2.45</td>
<td>-1.87</td>
<td>-2.01</td>
<td>-2.81</td>
</tr>
<tr>
<td>7. Fee income</td>
<td>2.56</td>
<td>2.77</td>
<td>2.61</td>
<td>2.01</td>
<td>2.31</td>
<td>2.64</td>
</tr>
<tr>
<td>8. Operating profit (6+7)</td>
<td>1.27</td>
<td>0.08</td>
<td>0.16</td>
<td>0.14</td>
<td>0.31</td>
<td>-0.17</td>
</tr>
<tr>
<td>9. Extraordinary income</td>
<td>0.53</td>
<td>1.62</td>
<td>1.72</td>
<td>1.50</td>
<td>1.32</td>
<td>1.70</td>
</tr>
<tr>
<td>10. Net income before taxes (8+9)</td>
<td>1.80</td>
<td>1.70</td>
<td>1.88</td>
<td>1.64</td>
<td>1.63</td>
<td>1.53</td>
</tr>
<tr>
<td>11. Income tax</td>
<td>0.23</td>
<td>0.13</td>
<td>0.13</td>
<td>0.05</td>
<td>0.06</td>
<td>0.07</td>
</tr>
<tr>
<td>12. Return on assets (ROA) (10-11)</td>
<td>1.57</td>
<td>1.75</td>
<td>1.59</td>
<td>1.57</td>
<td>1.46</td>
<td></td>
</tr>
<tr>
<td>13. Return on equity (ROE)</td>
<td>23.00</td>
<td>24.24</td>
<td>27.08</td>
<td>24.34</td>
<td>21.98</td>
<td>18.53</td>
</tr>
<tr>
<td>14. Adjusted return on equity (AROE) (3)</td>
<td>16.60</td>
<td>-0.83</td>
<td>0.47</td>
<td>1.38</td>
<td>3.48</td>
<td>-2.96</td>
</tr>
<tr>
<td>15. Real return on assets (ROA)</td>
<td>-25.05</td>
<td>-43.9</td>
<td>-25.4</td>
<td>-22.5</td>
<td>-23.0</td>
<td>-30.5</td>
</tr>
<tr>
<td>16. Real return on equity (RROE)</td>
<td>-7.75</td>
<td>-51.4</td>
<td>-6.9</td>
<td>-3.1</td>
<td>-7.5</td>
<td>-18.8</td>
</tr>
<tr>
<td>17. Real adjusted return on equity (RAROE)</td>
<td>-13.95</td>
<td>-45.2</td>
<td>-26.4</td>
<td>-22.6</td>
<td>-21.5</td>
<td>-33.5</td>
</tr>
</tbody>
</table>

**Intermediation ratios**

| Credit / Deposits (%) | 95.2 | 75.0 | 55.8 | 54.6 | 61.8 | 56.9 |

**Capital adequacy**

| Capital / Assets (%) | 5.5  | 5.8  | 5.4  | 5.4  | 6.4  | 7.0  |
| Liabilities / Capital | 17.3 | 16.2 | 17.7 | 17.5 | 14.6 | 13.5 |

**Asset structure (%)**

| Cash | 19.7 | 24.9 | 27.0 | 31.2 | 30.8 | 28.5 |
| Loans | 59.0 | 53.6 | 44.4 | 45.1 | 49.7 | 44.4 |
| Securities and equities | 5.7  | 7.2  | 14.2 | 2.6  | 9.6  | 15.7 |
| Real estate | 2.4  | 3.1  | 3.0  | 2.9  | 3.1  | 4.0 |
| Other assets | 13.1 | 10.8 | 10.7 | 8.5  | 6.5  | 7.5 |
| **Total** | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

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1/ as a percentage of total assets
2/ net income before extraordinary revenues

Source: Office of the Superintendent of Banks
MY BATTLES AS CENTRAL BANKER

Two months after the coup attempt, President Pérez appointed me to head the Central Bank. When I took office on April 2, 1992, the political climate was as hot as it had ever been. Tinoco had resigned just after the coup attempt. Miguel Rodríguez, a fine economist who was Pérez's minister of planning and a primary architect of the government's economic reform program, briefly succeeded Tinoco. But program opponents exerted strong pressure against his remaining in Pérez's cabinet, and he held the Central Bank job for less than two months.

The administration's reformist ideas gave me hope that I might be able to modernize the Central Bank and to make it independent from the government. I strongly believed—and still believe—that Central Bank autonomy is essential for monetary stability, economic development, and the well being of a country's citizens.

This was a conviction born of my long years of working at the bank. Much of my career had been spent working closely with three Central Bank presidents. We would try to find ways to strike a balance between sound economic judgment and politics, and to avoid submitting to political interests. I saw how important it was for a Central Bank president to be able to say no—to demands for loans that could be inflationary, for example, or to a President's insistence that interest rates or the exchange rate be set at some arbitrary level. Dr. Ernesto Peltzer, a wise German economist who came to Venezuela in 1939 to help set up the Central Bank, had taught me the value of independent, nonpartisan monetary policy. When I took the job as president of the Central Bank, I felt the time had come for me to apply his teachings.

Over time, Central Bank decisions had become increasingly subordinate to the ruling government's objectives. For many years, the Central Bank had been treated chiefly as a source of funds for the government and powerful interest groups. The political and economic needs of whatever government was in power, rather than the Central Bank's evaluation of the country's requirements for long-term economic health, controlled monetary policy.

So, I intended to make gaining independence for the bank my mission and the chief project of my four-year term.

I was briefly successful. We were able to establish, and for a time enforce, real autonomy for the Central Bank. Unfortunately, our independence was short-lived. In any case, it was only one thing Venezuela needed to stabilize its economy and to move toward market-led growth.

Throughout my tenure, I made strong efforts to raise awareness about the need to reduce the fiscal deficit. And while I thought making the bank independent and dealing with monetary policy issues would be my main focus, things did not work out that way. I was drawn increasingly into moni-
toring the health of the national banking system, although we at the Central Bank had no supervisory powers over Venezuelan banks.

In this crisis climate, I knew that everything I did would be closely watched, and much of what I attempted would anger somebody.

Two measures we took to level the playing field for the banking system and help bring in incentives for safe and sound banking as part of monetary policy implementation upset the managers of weaker banks, particularly at Banco Latino.

In the early 1990s, the Central Bank had repeatedly increased financial institutions' cash reserve requirements, in an effort to limit monetary expansion. But these requirements had been inconsistently designed, and had grown wildly out of hand. By the time I took office, the banking system as a whole was forced to keep, on average, 23 percent of its private sector deposits on reserve at the Central Bank; this amounted to a 27.7 percent tax on banks' net interest income. But the deposits they took from state institutions were subject to a much more draconian requirement: banks had to keep 80 percent of these deposits on reserve. Meanwhile, money market funds enjoyed a loophole: they were subject to no reserve requirement at all. Naturally, this produced a gargantuan incentive for banks to take deposits through money market funds. The system was also not helping to control money supply growth, was difficult to enforce, and distorted competition in the financial sector.

So in September 1992, the Central Bank approved a new system, whereby reserve requirements on all financial sector liabilities (including the money market funds) would gradually converge to a 15 percent rate. We also set a schedule for reserve requirements on public sector deposits to decline. Although reserve requirements gradually declined to 18.8 percent of deposits in 1992, the change in the rules hurt the banks that relied heavily on money market funds and other off-balance sheet operations. Latino was one of these. *Reporte*, a Caracas newspaper linked to Latino shareholders and associates, launched angry attacks on the Central Bank.

A few weeks later, the Central Bank designed a short-term loan program
aimed at reducing extreme bouts of volatility in the overnight money market. We chose Venezuela’s eight most solvent banks to be broker-dealers; they would then channel the funds to the banks in the system, at a small profit. Choosing banks on the basis of soundness, rather than friendships or political power, went against traditional clientelistic practices, and some of the bankers who had been excluded from the program were outraged. Banco Latino had been left out since it was not among the banks we considered the healthiest.

Tinoco’s successor both at the helm of Banco Latino and its umbrella company, Consorcio Financiero Latino, was Gustavo Gómez López. Gómez López had been Tinoco’s highly visible second-in-command; he was also the son-in-law of an important Latino shareholder. He worked to increase the visibility of Banco Latino and strengthen the Latino group’s presence in the banking community.

The Central Bank and I became the target of Banco Latino executives’ ire. Reporte launched a new wave of attacks on us for our “inappropriate and unfair” decision. Venezuela’s only bank rating agency, owned by one of the members of the board of directors of Reporte, issued what seemed a less than impartial rating on the health of Banco Latino: AA.

We were trying to do what we could to promote safe and sound banking. We wanted to raise the quality of banking information the public received. We did this with our August decision by requiring banks to fully disclose effective interest rates for loans and deposits; by creating a level playing field; by enhancing competition; and also by creating (admittedly weak) incentives for banks to be solvent. Our moves clearly displeased many bankers.

Still, our main concern at the time was getting the government to cut its budget deficit since that seemed the chief barrier to our efforts to bring down inflation, then running at about 26 percent and rising. With a significant deficit, at 3.3 percent of GDP that year, monetary policy could not be especially effective in fighting inflation. Dealing with instability in the money and foreign exchange market was also a major problem, as we had to counteract sharp, often unexpected, declines in the demand for money.

Our strategy was basically this: we aimed to keep money supply growth in check, to protect the country’s foreign reserves, the basis of Venezuela’s long-term stability, and to provide an anchor for expectations in those highly uncertain times. We chose to maintain a competitive exchange rate and gradually moved to a steady “crawling peg” bolivar depreciation that ac-

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knowledged the difference in inflation between Venezuela and its major trading partners. This kept the exchange rate fairly stable in real terms. Our loans to the banking system were kept to a minimum. Open market operations (the issuance of zero-coupon bonds) were conducted sparingly through weekly auctions that served as the leading indicator for interest rates. Very short-term certificates of deposit (of three to 15 days) were issued only in critical periods, to dampen attacks on the currency by quickly mopping up excess liquidity, and to stop the bolivar from depreciating excessively.

Our policies helped Venezuela weather more than two years of financial instability. While we were not successful in bringing inflation down, we were able to maintain foreign reserves and free convertibility between dollars and bolivares, in spite of larger fiscal deficits, thin financial markets, highly volatile capital flows and a weak banking system.

I knew, though, that a weakening banking system would seriously impair monetary policy. So I kept a close watch over the banking system from the moment I took office. The potential for a banking crisis haunted me.

I first set out to strengthen the Central Bank’s understanding of the banking system. Rather than assessing the situation of individual banks, my aim was to find out to what extent the banking system as a whole was at risk. Though it was not our job to regulate and supervise banks, it was our duty to make the most of our advisory powers.\(^7\) The banking sector’s weaknesses were hampering the Central Bank’s ability to conduct monetary policy. It was also our duty to avoid the risk of a systemic crisis. We planned to conduct a thorough technical analysis and then alert the government to what we found.

THE CENTRAL BANK SOUNDS THE ALARM

I asked my staff to analyze the soundness of Venezuelan banks and financial institutions. Finance Minister Pedro Rosas was very interested in getting the Central Bank’s views on the banking system. For too long, the Central Bank had been disengaged from monitoring the banking sector. It was also a challenging assignment. Even for us, reliable data was not easy to get.\(^8\) Nonetheless, a general picture emerged. Serious problems were brewing.

Throughout 1992, several banks, among them Banco Latino, gave off signals that they were in trouble. It was reasonable to assume they were

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\(^7\) The Central Bank Law mandated that the Central Bank’s board of directors and president must recommend to the executive the measures it deems appropriate to avoid impediments to the normal progress of the Central Bank’s activities or to avoid damage to the economic or financial life of the country.

\(^8\) On-site inspections could only be conducted by the Office of the Superintendent of Banks.
desperate for cash; their interest rates had risen far above those of their competitors. It was also widely reported that Banco Latino and others had in recent years invested heavily in large, multi-year projects in agriculture, industry, construction, tourism and real estate, often through affiliated companies. Loans went to luxury hotels on the coast, state-of-the-art plantain cultivation, rice processing plants, fancy apartment buildings, and industries of all sorts. Bankers had lent optimistically rather than cautiously. Breaking every financing rule in the book, the banks were financing these long-term projects with very short-term deposits. In extreme cases, some banks and finance companies financed 12- to 14-year projects with eight-day funds. Unsurprisingly, many of these institutions later failed.\(^\text{53}\) Exacerbating matters, many financial groups had also heavily invested in the stock of companies whose prices on the Caracas Stock Exchange were now plummeting.

In November 1992, a Central Bank staff report classified the banking system into three risk categories: low, medium and high. Nine financial groups—15 percent of total financial sector liabilities—were classified as high risk, and 10 groups—30 percent of liabilities—were deemed medium risk.\(^\text{54}\) Five of the banking groups classified as high risk (Confinanzas, Construcción, La Guaira, Cordillera and Principal) were among those that failed in the succeeding 18 months. Seven of the groups that failed in 1994 (Latino, Maracaibo, Andino, Consolidado, Profesional, Amazonas and Fiveca) were classified as medium risk.

Because they were operating at a loss, the riskier banks had become highly dependent on one-time revenues, which they mainly generated by selling real estate and past due loans—or, more accurately, shuffling them—to affiliated firms owned by the same holding company. Furthermore, at most of these banks profitability was low, and they were very highly leveraged. Several banks clearly needed to be recapitalized, merged, sold or liquidated. If political instability continued and pushed the economy into a recession, only bold prudential requirements and strict supervision could save the banks from sliding deeper into trouble.

Our report arrived at a conclusion that turned out to be prescient: A run on a single bank could easily widen into a banking crisis.

I presented our findings to Rosas and to Superintendent of Banks Roger Urbina. On November 24, I called them to a special meeting at the Central Bank. We agreed that the report should be presented to the full Central Bank board. I placed the subject on the agenda for November 30.

My staff and I recommended that a foursome of government agencies

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\(^{53}\) When a crisis environment sent the value of these projects plummeting in 1992-1993, banks had to roll over these short-term financings at increasingly expensive terms. It was a debilitating progression.

\(^{54}\) On the other hand, nearly half of the system—44 percent of liabilities, held by 12 financial groups—was found to be low-risk. The 11 percent of liabilities not evaluated belonged to smaller and new banks.
involved in banking regulation and supervision address the problem together: the Ministry of Finance, the Office of the Superintendent of Banks, Fogade and the Central Bank. We further suggested that:

- The government should compel shareholders of problem banks to recapitalize them and improve their liquidity
- Regulators should set and monitor targets, and impose sanctions if banks failed to meet them
- The government should encourage mergers and acquisitions of less healthy banks with healthy ones
- The Office of the Superintendent of Banks should step up enforcement of existing prudential regulations until Congress could enact new legislation, and enhance the quality and breadth of information available to the public
- Asset classification, valuation and provisioning rules should be made stricter and more uniform to ensure proper reporting by the external auditors and better public information disclosure
- The government should allocate additional resources to the Office of the Superintendent of Banks to enable the agency to perform its duties
- Fogade and the Office of the Superintendent of Banks should jointly develop a contingency plan.

When we briefed the Central Bank board, a body that included the finance minister, two other key ministers and sectoral representatives from banking, business and labor, everyone acted appalled. Some exhorted the government and regulators to face up to their obligations. Others questioned our interest: they believed it was not the Central Bank's job to get involved in these issues.

I felt it was part of my duty. Yet, I was not optimistic that I could stimulate much action. The presentation was intended to raise the board's awareness and, we hoped, would prompt the supervisor to act. But the Central Bank's board was scheduled to change soon. The new Central Bank law was about to be passed by Congress, and all of the current board members would be leaving their jobs, as the new law would do away with having ministers and sectoral representatives serve as board members. Perhaps grappling with such controversial issues was not the board members' idea of how they wanted to spend their last weeks in office.

And our November 30 meeting came in the middle of a new political crisis. Bank regulation could hardly be the priority item on the ministers' minds.
SECOND COUP ATTEMPT SHOVES BANKING OFF THE SCREEN

I awoke at dawn on Friday, November 27, to the news that another armed forces uprising was underway. Another group of officers, led by General Francisco Visconti, Vice Admiral Hernán Grüber Odremán and General Alberto Müller Rojas, had unsuccessfully attempted a military coup. Caracas ground to a standstill. By mid-morning, the sound of the rebels' air force planes could be heard roaring across the skies, strafing the city with bombs, primarily targeting the Presidential palace and its surroundings. Central Bank headquarters were just a few blocks away.

The financial markets closed for the day.

We at the Central Bank were determined to see that the foreign exchange market reopened Monday morning. A longer closure, we knew, would interfere with the normal flow of international payments and look to all the world like a sign of frailty. That left me only the weekend to find a way to minimize the effects of the coup attempt on the bolivar, to see that the markets opened in an orderly fashion and to avoid a major foreign exchange crisis.

The odds were against us. Most citizens took it for granted that Monday would see a bolivar devaluation. It was hard to fault their logic. All year, devaluations had followed episodes of political disarray. In Venezuela's thin foreign exchange market, speculative pressures were easy to unleash. Banks' foreign exchange operations were highly speculative, and spiced up with occasional collusion among traders. We had no effective rules for limiting foreign exchange risk. The only law on the books set limits that were so outdated they were meaningless and virtually unenforceable. It called for banks to hold no more than 5 percent of their bolivar-denominated deposits in the form of foreign currency-denominated assets—limits international businesses had long ago outgrown.

To add to the stress, an unexploded bomb had landed about 30 yards from the Central Bank headquarters, in the heart of downtown Caracas. We evacuated our building, and a group of my top aides and I moved to temporary quarters.

The bomb also threatened to impede another crucial task we had to accomplish that weekend: moving cash from our vaults to bank branches and ATMs across the country. We knew that because the coup attempt had created so much fear, depositors would be withdrawing as much cash as they could all weekend long. If any bank were to open without cash on Monday morning, that could touch off runs.

My staff and I set out to draft regulations that would avert the risk of a devaluation of the bolivar. All year, we had been considering ways to cope with sudden episodes of capital flight. The international operations team had gathered a lot of experience in understanding the inner working of the
speculative episodes that had repeatedy affected the foreign exchange market in the three years since free convertibility had been reestablished in Venezuela. Now the time had come to put some of our research into practice.

We all agreed that allowing the bolivar to fall substantially was out of the question. We had experienced a 5 percent devaluation only six weeks earlier, and its result was a competitive bolivar exchange rate we thought should be maintained. We faced a delicate balancing act. We wanted to put a clamp on commercial banks' and foreign exchange traders' highly speculative operations. On the other hand, we also wanted to keep the normal flow of foreign exchange transactions going. Slapping on any form of exchange controls would alarm the markets and could bring back the full array of government controls that had so crippled our economy in the past.

Instead, we decided to impose new regulations that would limit interbank foreign exchange transactions—the main cause of instability—and simultaneously limit the commercial banks' exposure to foreign exchange risk.

We limited banks' foreign exchange sales in the interbank market to 30 percent of their total foreign exchange purchases. Our intention was to induce banks to purchase foreign exchange from the Central Bank and sell it primarily to their customers, rather than to other banks or foreign exchange traders. Foreign exchange risk exposure was capped at 25 percent of a bank's capital. Capital assigned to international branches was exempt from the restriction, but foreign exchange transactions between banks and their independent foreign exchange affiliates were considered interbank operations. A bank had to report its transactions to the Central Bank each week. To comply with ratios, banks could sell excess holdings to the Central Bank before the end of each week.

These rules were a way to ensure that foreign currency would be available in the market, yet would limit speculation—and allow it to be carefully monitored. If this worked, we could avoid a major devaluation (as well as foreign reserve losses and interest rate hikes) and restore confidence in the markets faster.

By Sunday morning, the coup attempt had already been put down.

I met with Rosas and leading bankers. I explained the new rules and said they would take effect the next day. I managed to persuade the banks that our new regulations would smooth operations without inconveniencing customers and would decrease volatility in the future. The banking community was receptive and cooperative. Nobody wanted the situation to deteriorate. Still, there was one big risk: local traders accustomed to profiting from such turbulence might erroneously interpret these rules as a set of creeping exchange controls—even purposely deceive their clients into believing that—

56 The Central Bank supplies more than 80 percent of the dollars used for international payments.
to force the Central Bank to repeal them. Indeed, in the weeks that followed, certain foreign exchange traders would spread a rumor that we were doing just that. They were just attempting to engineer a bolivar devaluation and to profit from it.

Rosas and I also ruled out both devaluation and exchange controls. The Central Bank’s Monday morning offer rate on the bolivar—Bs. 77.65 to $1 US—would be the same as at Thursday’s closing. We did not offer any foreign exchange guarantee, but we would show the market that the Central Bank had not been forced into a quick devaluation.

By late Sunday night, we were ready. At midnight, an army bomb squad finally disarmed the bomb on our corner. Our action plan was in place. The banks had agreed to honor the new foreign exchange regulations. And we had a plan to distribute cash from the vaults.

On Monday morning, the Central Bank reopened the foreign exchange market and offered the dollar at Bs. 77.65. It held! It was clear evidence that the financial system had weathered the year’s second coup attempt without panic.

Thereafter, the Central Bank was able to keep the bolivar on its course. Our new foreign exchange market rules remained in effect. They would serve the country well for more than two years.

Nine days later, the Venezuelan financial markets sailed smoothly through nationwide gubernatorial and mayoral elections. The Central Bank had been able to show that trust could be built even in the most difficult of times.

THE CENTRAL BANK WINS INDEPENDENCE

Amid all this, the Central Bank was about to be transformed. On December 4, Congress granted the Central Bank statutory independence, and with it the right to determine monetary policy.70

It was a hard-won battle. Venezuelan politics had governed interest rate levels for decades. Politics had created lending booms to mask fiscal problems, pleased borrowers at the expense of the depositors, fueled inflation and distorted the economy. Beginning in 1974, the executive branch had made the Central Bank a virtual extension of itself. Ministers were appointed to serve as members of the board of the Central Bank; the Central Bank president attended cabinet meetings, where the cabinet often approved all key economic and financial policy decisions, or simply presented such policies as fait accompli.

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I had worked with Congress for the preceding six months to ensure passage of independence legislation because I believed strongly that Venezuela would benefit if monetary policy were free from day-to-day political influence.

The new law also intended to remove interest group politics from the Central Bank. For nearly 20 years, government, banks, private business and labor were all represented on the board. Political negotiation and bickering preceded every decision, and most of the board members could easily be removed if they ran afoul of the government’s intentions. A hothead of conflicts of interest, such a board was certainly no useful vehicle for crafting clearheaded monetary policy.

Private banks had been very influential since the Central Bank was established in 1940. Many bankers who served on the Central Bank board did a good job; at one time, it was an unwritten rule that a banker had to run a sound bank in order to be appointed there. Decisionmaking occasionally became the servant of banks’ private interests, though. Not surprisingly, the changes in the board of the Central Bank were fought powerfully by the banking community.

The new seven-member Central Bank board would be entirely different. Only one person would represent the government, and it could not be the minister of finance. The other five members would serve staggered six-year terms, and the Central Bank president would serve for five years. All would be forbidden from engaging in political activities. Unimpeachable ethical standards and professional expertise were the prerequisites. The President of the Republic could dismiss Central Bank board members only for grave malfeasance. The new law seemed to rule out policy disagreement as a ground for dismissal.

A few weeks later, on December 22, Pérez appointed six experienced and highly respected men to form the first independent Central Bank board. Although it did not have to, Congress ratified me as president. I took that as a vote of confidence in my performance. The new board members had no party affiliations, and unselfishly took on extremely complex responsibilities in very difficult times as a contribution to their country. Eloy Lares Martínez, a prominent lawyer and professor, brought a deep understanding of admin-

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77 Four of the seven board members were direct government representatives, usually a group of ministers led by the minister of finance. The President of the Republic appointed the other three people from lists provided by three interest groups: the Consejo Bancario Nacional, the Banking Council; Fedecámaras, the private industry association; and the Confederación de Trabajadores de Venezuela (CTV), the umbrella labor organization.

78 As further protection against arbitrary dismissals, the new law required the government to publish the President’s decision to dismiss any member of the board, and his reasons for doing so. The President would also have to provide Congress with at least two days’ advance notice before removing the president of the Central Bank.

79 The rule requiring that the appointment of any Central Bank president would have to be ratified by two-thirds of Senate was explicitly defined to begin with my successor.
istrative law. Alfredo Lafée, former president of the Central Bank (1971-1975) and a distinguished businessman, added a tremendous amount of real-life experience, as did Carlos Guillermo Rangel, a lawyer who had a career in banking and insurance and held top positions both in private and public organizations. Luis Rivero was a professor of monetary policy at the Universidad de Los Andes in Mérida, and Carlos Hernández Delfino was a respected civil servant with a long career at the Central Bank and other public institutions. Ricardo Hausmann, minister of planning and a fine economist, was the government’s representative.80

Even our most heated discussions ultimately led to unanimous decisions, always after thoughtful analysis, because we shared one goal: furthering our country’s best interest.

With the new Central Bank law in place, the board had the power to decide and implement monetary policy autonomously, though it would make foreign exchange policy decisions in conjunction with the government. The Central Bank could approve its own budget. It could no longer lend directly to the government, and it could only hand over net realized gains.81 The new law also required the government to recapitalize the Central Bank, to compensate for losses caused by monetary policy. The government was required to give us detailed information on the treasury’s cash flow and budget, tools we desperately needed for effective monetary programming and monitoring. The Central Bank was also to serve as advisor to the executive and Congress,82 and would present semi-annual policy reports to both.

SHORTCOMINGS IN THE CENTRAL BANK LAW

Unfortunately, prudent practices and good laws were not going to be enough by themselves.

The new board was a great asset. Its members immediately grasped the gravity of the banks’ situation, in marked contrast to the many other officials who failed, even unto the end, to understand the dangers. But there was a glaring deficiency in the new legislation, which I did not appreciate suffi-

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80 Hausmann served on the board until the Pérez government was ousted in May 1993. He subsequently became chief economist of the Inter-American Development Bank.


82 The Central Bank was called upon to give Congress its opinion on the annual public sector borrowing law, as part of the budgetary process.
ciently at the time; the Central Bank received no powers to regulate and supervise banks. Those remained with the small, ill-funded Office of the Superintendent of Banks.

None of us involved in the reform process could have envisaged the damage that weak banking supervision would do to the country and to the Central Bank in the months to come. In any case, I doubt that Congress would have given the Central Bank the power to regulate banks. The prevailing assumption was that banking supervision and regulation would be enhanced in the imminent reform of Venezuelan banking laws. Insolvencies did not seem to be on the lawmakers’ minds at the time.

With the benefit of hindsight, I now believe that our new law also ought to have set transparent rules for conflict resolution. Policy conflicts between the government and the Central Bank are a fact of life. After all, the Central Bank and the government share responsibilities when it comes to the well-being of the population, and the Central Bank’s duty to pursue monetary stability obliges it to serve as a check on government policies. If the Central Bank and the government disagree, it is better for the country—and for the Central Bank—to tackle the issues openly. One of the parties should have overriding powers, though. This would end conflicts, and would also set clear responsibilities about the scope and consequences of decisions. Strained relations between the Central Bank and the government, or back-door pressures on the Central Bank to try to get it to bend, end up costing the country more. This also can undermine the Central Bank’s independence because the nature of discrepancies and their consequences might be misunderstood. The Venezuelan Central Bank’s conflict with the government in 1994 demonstrated this.

THE IMPEACHMENT OF THE PRESIDENT

By the spring of 1993, the banks’ condition still had not improved. In fact, a new political crisis was damaging them further.

The President was being impeached.

Throughout March and April, the nation was mesmerized by Pérez’s Supreme Court trial. The President had been charged with corruption, but in truth, his reform program had grown so unpopular, with both vested interests and the public at large, that too many people simply wanted to see him go. Pérez lost his case and was forced out of office in disgrace on May 21, less than nine months before the end of his term.

His impeachment had two impacts on the banking system. First, with their jobs on the line, few top government officials could focus seriously on
addressing the deterioration of the banking system. Second, markets feared the notion of a political vacuum. Who would lead the country now? What sort economic policy would emerge? These uncertainties exacerbated capital flight, robbing the banking system of funds.

Several banks, including Banco Latino, needed loans from the Central Bank in order to stay liquid. From time to time, Banco Latino’s cash reserves dipped below the legal minimum. On the sidelines, a hostile takeover bid of Banco de Venezuela, Venezuela’s third largest bank, by the Consolidado Financial Group, was weakening both banking groups.85

By April, the percentage of financial assets the Central Bank staff had classified as high risk had climbed to an alarming 30 percent—double its level of six months before. A key factor in the worsening asset quality was the deterioration of the Latino Group and the Latino-owned Maracaibo Group. We shifted the ratings of both institutions, from medium to high risk.86 Together, these two entities accounted for 16 percent of total financial sector deposits.

We at the Central Bank grew concerned that no one seemed to be paying attention. We feared that no government entity would act decisively to safeguard the banking system.

Even though the timing was bad, we alerted the members of the embattled Pérez government. The results were presented to Rosas and Urbina in early May.87 Our warnings—nearly identical to those of the previous November—exhorted them to design and implement stricter regulation and to address the problems faced by the financial groups we had previously identified. We also urged the government to prepare the Office of the Superintendent of Banks and Fogade to deal with bank failures, and to impress upon Congress the importance of approving the rest of the banking law reform package.

When the official response was delivered to us at the Central Bank on May 25, it was clear that Rosas understood that the banking system was in danger. Yet by then there was not much he could do. President Pérez had left office four days earlier, and Rosas and the other ministers were waiting for their replacements to be appointed by the President’s successor.

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85 Launched by financier Orlando Casiró in 1990 and then taken up by the Consolidado Financial Group, the prolonged battle boosted the price of Banco de Venezuela shares and raised costs, weakening both Banco de Venezuela and Banco Consolidado. As this affected the U.S. operations of both financial groups, it raised concerns at the U.S. Federal Reserve.
86 The Latino Group had acquired the Maracaibo Group in 1991.
87 An official letter followed a few days later. See letter to Minister Pedro Rosas, May 19, 1993, p.229.
LENIENT BANK SUPERVISION IN AN INTERIM GOVERNMENT

Senate President Octavio Lepeage stepped in briefly as interim President, as set forth by law. Two weeks later, on June 5, a transition government took office. It was to play a caretaker role for nine months, until a new President and Congress could be elected that December.

Ramón J. Velásquez, a highly respected senator in his 70s, was named acting President. Velásquez had a reputation for prudence, and many considered him able to capably steer the government through the difficult months ahead.

Velásquez chose Carlos Rafael Silva as his finance minister. I knew Silva very well. In fact, he had been my professor at the Central University of Venezuela and at one time my boss at the Central Bank. He had served as Central Bank president from 1979 to 1981, and for eighteen years was first vice president and second-in-command there. He had also held various official posts, as minister of education and president of the Venezuelan Investment Fund. He had even been superintendent of banks during Venezuela’s first democratic government, the Rómulo Betancourt administration that began in 1958. Now Silva was the president of a financial company, Sociedad Financiera del Caribe, and a member of the board of directors of its commercial banking affiliate, Banco del Caribe.

So Silva was well qualified to be finance minister. But he expressed sharp disagreement with the concepts of banking regulation and supervision embodied in the new banking law that, after a long delay, was at last being discussed by Congress. Silva openly disagreed with the principle of deregulation, and of substituting incentives for direct government intervention. He was also against opening the Venezuelan market to foreign banks.

I immediately pointed out to Silva the seriousness of the banking problems. Our analysis failed to impress him.

Then Central Bank staffers and I met with the managers and shareholders of some of the shakier banks to encourage them to address their institutions’ problems. It was clear that they felt no real pressure from the government to recapitalize or to take other corrective action. Unsurprisingly, the bankers did not take our requests seriously, largely because the Central Bank had no authority to enforce them and because they had already gambled aggressively. For better or worse, they had made their choices. These managers let their institutions self-destruct because of misplaced faith that they would never go under, just as teenaged drivers who get drunk are certain they will not be the ones in the car crash.
When, two months later, a new commercial bank got off to a bad start, it was treated with surprising leniency. In its first three days of business, this bank got involved in highly-leveraged stock purchases with a brokerage firm owned by the bank's shareholders. The bank quickly failed to honor its check-clearing obligations. The Central Bank barred it from the check-clearing system and immediately informed both the finance minister and the superintendent of banks, as set forth by law, expecting the government to apply harsh sanctions. I knew that the possibility of revoking this bank's licence had been discussed in the government. But, in the end, the Finance Ministry only temporarily suspended the bank and ordered the shareholders to increase the bank's capital and to make some changes in its board of directors. This slap on the wrist conveyed the message that the country's chief financial regulator was unwilling to punish banks that played fast and loose with their licenses.

BANKING LAW REFORMS ARE ENACTED AT LAST

In August 1993, Congress gave the Velásquez government the authority to push through a reform of the banking law.\textsuperscript{86} Four years had elapsed since the need for reform had been identified.

President Velásquez appointed a working group headed by Hernán Anzola, minister of planning and member of the board of the Central Bank. Anzola's group would pick up the work where Congress had left it. Silva did not participate in the group and for some time promoted alternative plans for crafting parts of the new legislation. Dissent on banking issues within the cabinet became public. Anzola, who had also served as president of the Central Bank in 1986 and 1987, would assume an increasingly greater role in banking reform initiatives. He received technical support from the Central Bank staff, which was headed by Hugo Romero.

Velásquez used his power of decree to institute a substantial and credible law by the end of October. In what seemed a gesture of protest against it, Silva did not attend the ceremonial signing of the law. His deputy had to sign in his place.

The reformed banking law, adopted on October 28, 1993,\textsuperscript{87} promised to enhance the regulatory system. It would take effect on January 1, 1994,

\textsuperscript{86} Congress passed an enabling law authorizing President Velásquez to act by decree to approve the new banking law and the new savings and loans system law, and also to establish new taxes (a value added tax and a tax on corporate assets). Ley Habilitante. \textit{Gaceta Oficial} No. 35,280, August 23, 1993.

\textsuperscript{87} Ley General de Bancos y Otras Instituciones Financieras. \textit{Gaceta Oficial Extraordinaria} No. 4,641, November 2, 1993. Reprinted due to material misprint in \textit{Gaceta Oficial Extraordinaria} No. 4,649, November 19, 1993.
almost five years after financial deregulation had begun.

It required a substantial increase in banks' minimum capital requirements and imposed the Basle risk-weighted capital adequacy recommendations. It largely deregulated the banking business and established the option of universal banking. The law allowed banks to open, move or close branches without prior authorization. Trust operations and fiduciary obligations were more clearly specified.

The law also threw open the door to foreign banks. It eliminated all of the regulations that had discriminated against foreign financial institution participation in the Venezuelan market and permitted them to open branches, subsidiaries and joint ventures.

The law improved the supervisors' ability to exercise consolidated supervision, both on a domestic and global scale. It established the legal concept of "financial group"—a conglomerate of banks, financial institutions and firms that constitute one decisionmaking or management unit. This classification was based on "control ownership," defined as control over one-third or more of the vote of the boards of directors or other governing boards, or control over the decisions of these boards through contractual clauses, statutory clauses or any other means. The Office of the Superintendent of Banks could determine which banks, non-bank financial institutions and firms formed part of a financial group, in order to make them explicitly accountable. In order to avoid conflicts among regulatory agencies, such as with the Superintendent of Insurance Companies or the CNV, the law specified that the coordinating supervisory authority for a financial group would be the agency with oversight powers over the business that held the largest percentage of a group's assets.

External auditors were made accountable to the Office of the Superintendent of Banks, and subject to sanctions for noncompliance with the law. The law also empowered the Office of the Superintendent of Banks to commission special audits on banks and financial institutions by their external auditors, and also to undertake special bank audits at banks' expense. These measures would allow the Office of the Superintendent of Banks to enhance supervision and—at least temporarily—to supplement its staff.

In order to overcome the chronic budget shortages for banking supervision, the law required all regulated financial institutions to contribute funds toward supervisory costs.

Recognizing the need to improve bank ownership information, the law established that all banks and financial institutions would have to submit full information on their shareholder structures.

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88 The minimum risk-weighted capital adequacy ratio was set at 6.5 percent effective June 30, 1994, gradually increasing to 8.0 percent in December 1995.
The superintendent of banks was also given much wider powers. He or she could approve and revoke bank licenses, call for government intervention in banks, issue rules on all relevant banking operations and set the rules to be followed by bank auditors. The superintendent would be appointed by the President with approval of two-thirds of the Senate—and could only be dismissed for lack of integrity, acts of violence, immoral conduct, malfeasance, criminal offenses or failure to perform the responsibilities of the job.

Much tougher penalties against banks also came into force. They were obviously largely opposed by the banking community. Violations by bank directors, management and auditors (such as providing false information, and improper lending to affiliates) were defined much more specifically. Fines were set as a percentage of a bank's capital, in order to make sure their real value would not decline via currency devaluation or inflation. The law also allowed for imprisonment in the event of unauthorized financial intermediation (taking in money from depositors without being a legally authorized financial institution), fraudulent approval by bank directors or management of loans to affiliates, providing false information to the authorities, or publishing financial statements containing false information. In the event that the bank involved distributed dividends based on such false information, the penalty would be increased by a factor of one-third. Imprisonment was also possible for external auditors who fraudulently failed to fulfill their obligations. Individuals found guilty of crimes would be prohibited from holding positions at banks or other financial institutions for ten years from the date they completed their sentences.

All of these measures promised to significantly strengthen banking regulation and supervision in the future and could ultimately improve the banking system’s health. But by that point, the legal changes could not lift the banks out the swamp of problems in which they were mired. Banks desperately needed remedial action.

Preparations to implement the new law were sluggish. By enacting the law in October, two months before it was to take effect, the government intended to allow the supervisors and the banks to get ready for it. Yet nothing happened. The Office of the Superintendent of Banks gave no sign that it was attempting to define the financial groups or requesting information on affiliated loans or beneficial ownership. When the new law took effect January 1, the government was not prepared to enforce it.

That meant that when the banking crisis erupted on January 13, the government was as much in the dark as ever. In fairness, perhaps knowing more would not have been enough to turn things around. Sadly, by the time the law was enacted, it was already too late to halt the banking system’s collapse.
BANKS NEAR CRITICAL CONDITION

By autumn, the high-risk group of financial institutions was still growing. Now it included 12 financial groups and an alarming 42 percent of total financial sector deposits. Among these were nine commercial banks that held 38 percent of Venezuela’s commercial bank deposits and five finance companies that accounted for 42 percent of their market. Banco de Venezuela, earlier a low-risk bank, was among those that rose to medium risk. Only 10 financial groups, holding 28 percent of the banking system’s liabilities, were now evaluated as low-risk.

The cost of funds was rising, as depositors shifted to shorter and shorter-term interest-bearing deposits. The financing needs of ailing banks were pushing interest rates up further. In addition to Latino, Construcción and others were now also scrambling for funds. Use of trust accounts rose sharply, probably an indication that depositor funds had been channeled to off balance sheet and offshore operations. Loan loss provisions were too low. Although a regulation setting more stringent accounting rules on one-time revenues had taken effect in the second half of 1993, the banks’ heavy dependence on these revenues persisted, and there were many hints that creative accounting was hindering the truthfulness of the information.

The banks that committed to aggressive expansion strategies were already giving off signs of distress. The increasing openness and competition in the domestic financial market exposed institutions’ credit quality differences. Ailing banks turning to the interbank money market found that they had to pay exorbitant rates. Banco Latino was at the forefront of these risky moves.

We often discussed this appalling situation with the Central Bank’s board. Hernán Anzola was usually there. Information about our activities was supposed to reach the President through him and through the finance minister.

It was not that Velásquez’s transition government was uninterested in regulating the banks. Anzola had worked hard to prepare the new legislation quickly. But the Finance Ministry did not seem to cooperate in this effort. Since the finance minister by rights was the nation’s top banking watchdog, that was bad news for bank regulation.

PRE-ELECTION PANIC STOKES CAPITAL FLIGHT

National elections to choose a new President and Congress were scheduled for December 5. Following 24 straight months of political instability, the public mood was one of exhaustion, confusion and frustration. Campaign rhetoric focused on economic issues, the obvious area for electoral divi-
dends. Rafael Caldera, a former President again a candidate, led the attacks. He unjustly attributed the poor performance of the economy to Pérez's 1989 paquete, the reform program that had ended up a patchwork quilt. It was easy to gather voter support to reject the old economic program. After all, reform meant, in essence, damage to special interests, the end of privileges, and confrontation with the hard reality of the international economy and our own limitations. In this environment, there was no room for messages about the principles of competitiveness, financial and monetary discipline, banking prudence and government austerity.

The scene was set for the return of controls.

Financial market investors detected this and were alarmed. Investors feared that Caldera, who was leading in the polls, would undo the limited progress reform had brought and put Venezuela back on a populist track. The Central Bank and the banking community both expected heavy capital outflows in November, when investors could be expected to dump bolivares and buy dollars. The maturity profile of bank deposits clearly indicated that depositors were lining up savings instruments to be redeemed on very short notice in November. We knew there would be a liquidity shortage, and that we could not reliably anticipate its duration or severity. But throughout 1993, we had seen money flee the country and then return once a crisis had passed. We expected capital to return and bank deposits to rebound on the heels of the election.

When flight from the banks and the bolivar began in early November, the outflow volume turned out to be heavier than our worst expectations. Both companies and individuals were making withdrawals. During the four weeks before the election, private capital outflows totaled $1.8 billion; at their peak, losses reached $170 million a day. The weaker banks naturally suffered most. The panic caused seven banks we had identified as high risk to lose deposits at an almost unmanageable speed. Liquidity problems put five of those seven institutions into deep danger. Their cash reserves dropped below the legal floor, as money exited like air from a punctured balloon.

Our loans to Banco Latino were increasing almost daily. By the end of November, Banco Latino owed the Central Bank Bs. 18 billion ($172 million), 12 percent of Latino's deposits. It had used up most of its legal cash

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The word paquete was a derogatory expression to describe Pérez's economic reform package.

Normal daily foreign exchange transactions were about $35 million.

The board of the Central Bank at that point approved a support program of four- and live-day loans to cash-starved banks at the rediscount rate, which fluctuated in the 60 percent to 70 percent per annum range (always higher than the commercial bank lending rate). By keeping the loans very short term, we could better fine-tune our lending, closely monitor the banks and set an incentive for them to fund themselves in the market.

At Bs. 104.88/US. At that point, our crawling peg bolivar devaluation policy was reducing the value of the bolivar by about 3 percent per month against the dollar. The average price of the currency in December 1993 was Bs. 104.88; in January 1994, Bs. 107.65; in February 1994, Bs. 110.38; and in March 1994, Bs. 115.38.
reserves with us and was relying heavily on overnight loans from other banks. The Central Bank normally monitored compliance with minimum reserve requirements; Banco Latino’s violations became chronic. We assessed the Central Bank’s penalty interest rates, and reported the violations to the Office of the Superintendent of Banks.

Throughout the month of November, the board of directors of the Central Bank watched the banking sector decline. We grew more and more concerned about the apparent inaction by the government agencies that should have been on top of it.

The time had come for us to alert President Velásquez directly. We knew his attention was focused on the elections; after all, the main goal of his government was to lead the country to a peaceful resolution of the 1992-1993 political crisis. But we wanted to make sure he comprehended the severity of the problems. There was no time to waste. I sent him a letter on December 1.93 For a Central Bank president, formally raising such issues to a President was an unusual act.

I told Velásquez of my regret that all of the Central Bank’s attempts since 1992 to inform the government about the banking system’s growing problems had gone essentially unheeded. Now the window of opportunity had almost shut. Short-term loans, provided by the Central Bank in its role as lender of last resort, were alleviating liquidity problems linked to pre-election jitters. But we were powerless to correct the banks’ structural problems. Only the minister of finance, the Office of the Superintendent of Banks and Fogade had that authority, yet the need to ensure safe banking did not seem to be their priority.

Finally, I emphasized the urgent need to design and carry out a coordinated action plan. Failing to act would, in the end, be far costlier and more disturbing, both to the people and the government. The specific responsibilities of the Ministry of Finance, Fogade and the Office of the Superintendent of Banks, I said, should be clearly spelled out in the plan. Finally, I wanted to be sure that the government had the relevant data. I attached a table to my letter which laid out the severe illiquidity of these banks.

One thing was certain: After reading it, the leader of the country would have a clear picture of the disaster waiting to happen.

Amazingly, my alert seemed to take the President by surprise.94

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93 See letter to President Velásquez, December 1, 1993, pp. 231.
94 In a March 1994 statement, after he left office, President Velásquez confirmed that my December 1, 1993 letter to him was the first information he ever received about the banking sector’s problems. "Exposición del Ex-Presidente Ramón J. Velásquez", in Velásquez and Silva, El Ejecutivo Nacional y la intervención del Banco Latino, (Caracas: Talleres Gráficos de Joaquín Ibarra Impresores, April 1994), p. 7.
BANCO LATINO DROWNS IN DEBT

Rafael Caldera was elected President with less than a third of the national vote. This distinguished gentleman, who had been President from 1968 to 1973, returned to the helm with almost no support in Congress: his Convergencia party won just 11 percent of the votes in the Chamber of Deputies and 9 percent in the Senate.

Caldera was scheduled to take office February 2. He and Velásquez had little contact during the transition months. Caldera did not follow the traditional custom of appointing the liaison committees usually organized to ease the transition from the outgoing to the incoming administration. So, during the transition, we had to continue dealing only with President Velásquez and his team.

After writing to Velásquez, I had new hope that something would be done. On December 3, Velásquez called Anzola, Silva, Urbina and Fogade President Esperanza Martínó to a meeting in his office. I was not invited. But I was disappointed when I heard my warnings had been dismissed as alarmist. The superintendent of banks was given a general instruction “to maximize [his] supervisory duties in the interest of depositors and the community.”

Runs on Banco Latino continued through December. Latino clients were taking their funds out of the bank mainly by drawing checks to be deposited in accounts at other banks. The more canny observers of the political landscape may have worried that Banco Latino could fall into disfavor with the incoming Caldera government, since Banco Latino President Gómez López had volubly supported the Presidential candidacy of Caldera’s chief opponent, Oswaldo Alvarez Paz.

Banco Latino’s cash dwindled, and its debt to the Central Bank rose steadily, failing to decrease even when capital outflows stabilized after the elections, and banking system deposits recovered. The bank’s inability to repay the Central Bank was a danger sign flashing red.

Deposits fled at an accelerating pace. Six other banks were also losing deposits. Two of them had past or present links to Banco Latino. Banco Barinas had belonged to the Latino group until the previous year. Latino still owned the other, Banco Maracaibo, but was negotiating to sell it back to its previous shareholders. All six institutions had engaged in aggressive growth

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95 Also attending were the minister of the interior, the minister of the secretariat, Deputy Superintendent of Banks Emilio Negrón and Hugo Romero. Op cit. p. 9.
96 Ibid.
97 Banco Barinas had been sold to new shareholders—the Cordillera group—in 1992, but it was still associated with Banco Latino in the minds of depositors. In the case of Banco Maracaibo, the original shareholders had been negotiating to regain control of the bank, and reached an agreement just a few days before the collapse of Banco Latino. By then it was already too late for the bank to become disassociated from the Latino group.
strategies and made risky investments. Now they were suffering the consequences.

Even though the superintendent of banks was supposed to be reporting banking problems to us and taking action, we felt pushed into the uncomfortable position of reporting problems to him and were seeing insufficient action. With no clear reason, Urbina had missed most of the Central Bank’s board meetings since the middle of 1993. People would also comment that he was not getting any support from his boss, the minister of finance.

On December 9, I invited Urbina and Martínó to a meeting at the Central Bank. I presented the facts and asked how they planned to cope with Banco Latino’s deterioration. Of course, they were not surprised to hear that some banks were in deep trouble. Urbina knew all about the banks’ liquidity problems, the difficulty that many of them had complying with the Central Bank’s cash reserve requirements, and the loans the Central Bank had given them. But I learned that the government agencies had made no preparations to address Banco Latino’s disastrous circumstance; there was no plan to speak of.

The next day I called a special meeting of our board. Urbina attended. We told him that the Central Bank would not continue to lend to Banco Latino unless he took bold, corrective action—immediately.

That was when Urbina suddenly revealed that he and Banco Latino’s management team had already worked out a plan. This plan contained all the necessary ingredients: recapitalization, downsizing and the sale of nonbanking assets. Urbina also pointed out to us that Banco Latino’s problems were partly the government’s fault.

There was some truth in this. The bank was suffering the consequences of the government’s delays paying its own debts, and government arrears in payments to contractors who were, in turn, defaulting on loans from Banco Latino. The Latino group was, of course, heavily involved in lending to government contractors. The bank was also hurt by delays in payments from cash-strapped government agencies, which were awaiting transfers from the Treasury. Anzola promised he would press the government to correct these arrears.

These commitments convinced our board to continue lending to Banco Latino. Shutting off Central Bank loans would have brought the bank down almost immediately.

Urbina also assured us that he was finally clamping down on Banco Latino’s lending policies and demanding that the bank increase its capitalization. He indicated he would even be attending bank board meetings himself to supervise the plan’s implementation. Yet, in the plan he described to us, there were no deadlines and targets. We demanded that he set them.

Not only did he agree, but he made a commitment to impose adjustment programs on other problem banks as well.
A week later, since we had heard nothing about any such moves, Anzola and I went to see President Velásquez. It was December 17, the anniversary of Simón Bolívar’s death, and a national holiday. We told him that five banks—accounting for 23 percent of total commercial bank deposits—were in trouble and that Banco Latino’s situation was particularly grave. Banco Latino was fast losing deposits. Its top management seemed mired in dissension with bank shareholders. A few days earlier, the shareholders had agreed to a recapitalization plan, but disagreements among them raised questions about the firmness of their commitment to putting in the funds. On the positive side, a key shareholder, Gustavo Cisneros, had reassured President Velásquez that he would support Latino’s recapitalization.

Another option would have been for Banco Latino to request support from Fogade, as both the Central Bank and the Office of the Superintendent of Banks had recommended. But the bank was unwilling to do it. Gómez López served on Fogade’s board; he was the banking community’s representative. Perhaps this played a role in the bank’s decision. Yet the bank was suffering from poor-quality assets and public wariness, we told the President. The day when we at the Central Bank would have no other option but to terminate Banco Latino’s participation in the check-clearing system seemed to be getting closer. That would probably fuel capital outflows and have dangerous implications for banking, payments and the social fabric of the nation. The Central Bank as lender of last resort was propping up the bank and preventing its collapse, but we could not do that forever. President Velásquez had to get his minister of finance, Fogade and the superintendent of banks to take action. And the government would have to be prepared to change the Latino board and bring in new shareholders, even take over the bank if necessary. Without a plan for an orderly resolution, the government risked triggering a terrible crisis. The more it delayed, the less likely it was that the bank could be kept afloat.

The President listened with great concern. He said he would consult with Silva and ask him to submit a special report.

BANCO LATINO SHAREHOLDERS IGNORE WARNINGS

Unbeknownst to me, Urbina had written a letter to the president of Banco Latino on December 23.\textsuperscript{28} It contained forthright instructions:

• Stop booking as income the accrued but uncollected interest on nonperforming loans;
• Strictly classify and account for past due and nonperforming loans;
• Avoid relying on one-time revenue items;
• Harmonize weekly accounting reports and monthly financial statements;
• Present true end-of-month deposit figures.

Urbina also ordered Banco Latino to take more drastic measures: he directed the bank to change its top management, implement a special asset recovery program, sell off its nonbanking assets, improve its liquidity management, cut costs and pay its debts to the Central Bank. He calculated that the bank needed a capital injection of Bs. 6 billion ($57 million) to make up for insufficient loan loss provisions.

None of these things happened.

Instead, we would later discover, several Banco Latino affiliates, in Venezuela and abroad, desperately stepped up their efforts to attract deposits. They issued approximately Bs. 245 billion ($2.3 billion) worth of deposit-like instruments, securities that were never posted on the bank’s books. These were funding the ailing bank and some of its commercial holdings.99

On December 20, Gómez López announced to us that he was resigning. He argued that his resignation would help the bank. But we did not see it as an encouraging sign. Gómez López tempered the news with the announcement that the bank would implement a reorganization program the superintendent of banks had mandated. All shareholders would participate in depositing new capital, he insisted, and thereby boost depositor confidence.

DEPOSITORS’ MISPLACED FAITH

There were, in fact, depositors willing to believe the outcome would be positive. Many Venezuelans assumed that the bank’s size and history of political power meant it was too big and too important to fail. Even though Tinoco, its chief power broker, had died, the popular perception was still that the bank could afford to make risky investments; to many, it was inconceivable that the government would let such an important bank collapse. Though some depositors and investors had been leaving the bank as they

99 In fact, many banks had these off balance sheet, so-called money desks and money market funds, born of a legal loophole, which allowed the banks to bypass capital adequacy rules and reserve requirements, while attracting eager depositors with higher interest rates. Many depositors mistakenly believed—and banks often misled them into believing—that their money was safe in the bank. These transactions had become increasingly significant to Venezuelan banks. But until Banco Latino collapsed, nobody knew just how important they were.
sensed the risk, many others stayed. They were either hoping they could reap their share of “riskless” profits or else were just unable to move their accounts so quickly. Christmas vacations might have led some of them to wait for January to make a decision.

Banco Latino and other weak banks had, for some time, been giving off signs that they were approaching an unsustainable situation. Yet many depositors continued to pour in their money. Why? First, many depositors surely did not understand the full dimensions of the problem. There wasn’t much information for them to go on, and what there was had been doctored by creative accounting. Even the superintendent of banks did not seem to realize how deeply troubled the banks had become. The media might have alerted the public, but they were dependent on banks for huge volumes of advertising revenue and were hardly likely to bite the hands that were engorging them.101

Second, the high rates of interest offered by banks were nearly irresistible to depositors. Some people actually sold or took a mortgage on their homes and deposited the proceeds to reap real returns of 12 percent or more.

And finally, depositors had every reason to believe that the government would protect them from a debacle, as it had so often done in the past.

REASONS FOR THE TIMING OF THE CRISIS

Pondering these events afterward, I came to believe that five factors contributed to the timing of the banking crisis. First, most of the banks that failed in 1994 were perceived as having close ties to the Pérez administration and may have been damaged by speculation that the subsequent governments of Velásquez and Caldera would be unwilling to bail them out. Second, expectations of improved prudential oversight and more rapid intervention and liquidation procedures under the new banking law may have prompted insiders, who had access to information on the true financial condition of insolvent banks, to withdraw their funds ahead of the more stringent law that would take effect in January. Third, the general climate of political instability, and uncertainty regarding the future direction of economic policies, led to large capital outflows throughout the year, and especially in November 1993, further hurting banks already in weak financial condition. Fourth, the rise in interest rates in 1993 contributed to further deterioration in the quality of bank portfolios, though this could not alone have accounted

101 Conflicts of interest went even deeper: some media companies were actually owned by banks or bank shareholders, or had a common parent company.
for a crisis of the magnitude we saw. And fifth, for four years, two govern-
m ents repeatedly failed to take supervisory actions that could have pre-
vented the crisis.

ENDGAME:

By early January 1994, Banco Latino was deeply in debt to the Central Bank, and its debts were growing daily. The bank owed Bs. 23 billion ($214 million) to the Central Bank—17 percent of its total deposits. It had a deficit of Bs. 3 billion ($28 million) in its required cash reserves at the Central Bank, had run out of secondary liquid reserves, and had no loans acceptable for rediscount. The Central Bank had requested several times in the last months of 1993 that Banco Latino voluntarily place a portion of its loan portfolio acceptable for rediscount in the Central Bank’s custody, as a precautionary move, but Banco Latino procrastinated. In early January, the bank had to cover net daily payments of Bs. 7 billion to Bs. 8 billion ($65 million to $74 million), which included depositors’ withdrawals and growing interbank loans that the bank kept rolling over. For these operations it needed cash and had to settle the transactions through the check-clearing system. By now, it could barely accomplish these things without Central Bank loans.

I would hear about Urbina’s early January letters to Banco Latino only later, on January 16, when he formally requested that the government intervene in the bank. And I only later found out about the size of Banco Latino’s off balance sheet liabilities and how its trust fund’s resources had been siphoned off to help finance bank operations.

Banco Latino ignored Urbina’s set of December orders, and on January 4, he increased their severity. He raised the bank’s additional capitalization requirement from Bs. 6 billion ($56 million) to Bs. 10 billion ($93 million), and issued a cease and desist order that prohibited the bank from making any new loans, making investments with maturities of over 30 days or undertaking new trust operations. He also ordered Banco Latino to sell the group’s nonbank assets and to suspend dividend payments to shareholders.

By then, Banco Latino was barely making it from one day to the next. The ailing bank needed growing amounts of cash to settle its daily clearing obligations and was struggling to get voluntary loans in the interbank market to cover its overdrafts at the Central Bank. Our board decided to convey a second urgent message to the President of the Republic. We received no hint that concrete action was in the works. The President, now in his last month in office, simply acknowledged the problem.

104 See letter to President Velásquez, January 4, 1994, p. 234.
On January 7, Urbina's deputy Emilio Negrón ordered Banco Latino's major shareholders to deposit Bs. 12 billion ($111 million) into Banco Latino, to rectify the bank's negative cash position. He also demanded that the Bs. 10 billion ($93 million) capital increase the superintendent had ordered earlier be paid in within four days.\footnote{He posited a request for Fogade help as the only alternative.}

It was a Friday. The drain on Banco Latino's deposits grew. Giácomo León, Banco Latino's acting president, appeared at the Central Bank. León was a longtime Banco Latino employee who had been hastily handed a time bomb of a job by Latino's shareholders. That day he brought good news: the bank's major shareholders would inject $200 million, in dollars, the following week. This would basically cover the cash and capitalization demands the superintendent had demanded.

\footnotetext[1]{The Finance Ministry corrected the error and re-published the decree in the \textit{Gaceta Oficial} on January 10, 1994.}

\section*{THE BATTLE OF THE BONDS}

At the same time, León complained bitterly that Banco Latino had not yet received Bs. 8.6 billion ($80 million) in bonds it was owed by a public urban renewal corporation in Caracas called Centro Simón Bolívar.

This was a case of government arrears, and a maddening one, complicated by the bungling of an official decree. The government owed Latino Bs. 8.6 billion for a troublesome development project commissioned by Centro Simón Bolívar and financed by Banco Latino. Once Centro Simón Bolívar received the government's bonds as payment, it would hand them over to Banco Latino to settle the claim. The transfer of assets should have been completed several months earlier. But due to a printing error in the \textit{Gaceta Oficial} that published the November 25, 1993 Presidential decree authorizing the bond issue, the bonds could not be officially issued.\footnote{The Finance Ministry corrected the error and re-published the decree in the \textit{Gaceta Oficial} on January 10, 1994.}

Banco Latino had thus not received the bonds.

These bonds were actually sitting in the vaults of the Central Bank, in custody for Centro Simón Bolívar, which had to sign them over to Banco Latino.

I went to speak with President Velásquez again on Monday, January 10. By this time the finance minister—by law the linchpin of rescue measures like this—seemed to have simply faded out of the picture. I realized that any effort to craft a last-minute bank rescue would fall to us at the Central Bank—even though we had neither the responsibility nor the legal power to do
much. We could really only do one thing—try to get the bank’s shareholders, the banking community and the government to work together to fashion some plan. The President agreed.

Because Velásquez would step down in a few weeks, we also agreed that I would inform the incoming government of the snowballing crisis. It seemed to me that nobody had done so until then. On the morning of January 11, I had a two-hour conversation in my office with Julio Sosa, whom President-elect Caldera had appointed as his chief liaison officer for economic and financial affairs. The scion of a prestigious Venezuelan family, Sosa would soon become Caldera’s finance minister, though he often protested that he never wanted the job.

I explained to Sosa that if we were forced to terminate Banco Latino’s participation in the clearing system, a government takeover and closure of the bank could follow, a highly undesirable and inauspicious course of action as the new President was taking office. Closing down the bank would create panic and heighten capital outflows, threatening other banks with collapse. I stressed that we needed a rescue operation, with four pillars of support: government commitment, new shareholder funds, the support of other banks, and Fogade’s participation.

Sosa listened carefully and said my suggestions seemed reasonable to him. That would thus be our immediate plan. He said he would tell Caldera about it.

One pillar that a rescue operation would require thus seemed in place. Later that day, I tried to shore up a second pillar: a group of Venezuelan bankers, who were now nervously pulling back from lending to Banco Latino. The shareholder funds which León had promised would not, it now turned out, be forthcoming. The bankers had offered to lend to Banco Latino if they received collateral, and also had offered to get more banks to participate in lending. But the only acceptable collateral instruments Banco Latino would offer were the Centro Simón Bolívar bonds, that it did not have yet.

After many phone calls, we were promised that Velásquez would see to it that the transfer of the bonds was authorized by his cabinet and that Centro Simón Bolívar would sign off on the transfer early Wednesday morning. Based on that promise, the banks agreed to lend to Banco Latino in order to allow it to cover its clearing payment for that day.

But on Wednesday, authorization for the bonds transfer failed to materialize.

The transaction had yet to be approved by the President and the cabinet. I was frustrated and mystified. The law called for the minister of finance to submit the request for approval of the transfer to the President. That afternoon, Banco Latino needed Bs. 4.8 billion ($45 million). The bankers who loaned to Latino on Tuesday now lost faith. Everyone doubted that the bonds transfer would be authorized.
So the banks refused to lend Latino any more funds. The Central Bank could not provide any more loans either, because Banco Latino had run out of acceptable collateral.

If we closed the check-clearing process on Wednesday afternoon at 4 p.m., the usual hour, Banco Latino would be unable to settle its outstanding claims and would have to be excluded. Its hundreds of thousands of outstanding checks—paychecks and insurance checks, checks for business deals, rents and government purchases—would bounce. Venezuela’s second largest bank would in effect fail.

A group of major Banco Latino shareholders I had called the day before met at the Central Bank on Wednesday morning. Unbelievably, some of them claimed to have been kept in the dark about the gravity of the situation.

Our plan was to shore up Banco Latino with shareholder money, loans from other banks and, if necessary, loans from Fogade as well.

But, by 4 p.m. Wednesday, no new funds had been committed.

We had just one more chance. So I approved an extension of the closing of check-clearing until Thursday morning at 8 a.m.

During the night, Banco Latino submitted a part of its loan portfolio to the Central Bank in exchange for cash, but none of it was acceptable. The loans did not fulfill the requirements set by law. Some bankers who were still at the Central Bank offered to purchase these loans. But after reviewing them, they changed their minds.

At 6:30 a.m. Thursday, Anzola and I called President Velásquez at home. We urged him to convene his cabinet immediately and arrange for approval of the transfer of the Centro Simón Bolívar bonds. Every hour counted. The President promised to convene an emergency cabinet meeting at 7 a.m.

It did not happen until 10 a.m.

Meanwhile, when banking operations started at 8 a.m., bankers grew alarmed, since they had not received the normal daily check-clearing information from the Central Bank. Rumors of Banco Latino’s precarious position began to spread in the business community.

We in these rooms at the Central Bank were among the very few who knew the seriousness of the matter, and our mood was one of gloom and foreboding.

Top members of the banking community were there and had offered to lend to Banco Latino, but would only do so with collateral, and there was no acceptable collateral to post. Banco Latino’s largest shareholders were there too, but had refused to come up with acceptable funds. Fogade was willing to lend, but Banco Latino was still refusing to submit to its conditions.

We had arrived at an impasse. But still the negotiations wore on, because the stakes were so high: the giant bank had the equivalent of more

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16 Some of them offered other assets and personal guarantees, but the Central Bank had no legal powers to accept such collateral.
than one billion dollars on deposit. Its failure could be devastating to Venezuela and could reverberate around the world.

While we waited, I sent a Central Bank team to Banco Latino to conduct a more thorough assessment of its loan portfolio in order to try to ferret out any acceptable securities that would allow the rescue operation to proceed. The team reviewed about Bs. 100 billion ($929 million) worth of assets, with no success.

The next day, Friday, was a payday for much of Venezuela. Many of Banco Latino’s clients would hand out payroll checks to hundreds of thousands of people. If the Centro Simón Bolívar bonds didn’t show up, those checks would be rejected. Edgar Romero Nava, the president of Venezuela’s top industry association, Fedecámaras,105 heard about what was going on. He phoned me, Silva and Velásquez on Thursday afternoon, entreating us all not to pull the plug on Latino. He was worried about the social consequences of hundreds of thousands of bouncing paychecks and feared our actions would unleash public rage. There was, I said, unfortunately nothing more I could do.

All day Thursday, we waited for two things: for the shareholders to commit to a capital increase and for the head of Centro Simón Bolívar to show up at the Central Bank and turn over the bonds to Banco Latino. Neither happened.

ZERO HOUR

The Centro Simón Bolívar affair was infuriating. It is true that those bonds were merely a last drop of cash and could provide only a brief respite. Had they been available earlier, they would have helped. Yet, they were clearly not enough to refloat the bank: both a recapitalization agreement and liquidity support were needed now.

I was told that César Rodríguez, the president of Centro Simón Bolívar, had left the Presidential palace after the cabinet meeting and had gone to his office in downtown Caracas, about 10 minutes away from the Central Bank. We waited impatiently for him to arrive. The President and his cabinet had authorized the transfer of the bonds, but Centro Simón Bolívar officials insisted that their legal counsel and internal auditors had to sign off on the transfer before the bonds could be released to Banco Latino.106

105 Fedecámaras is the acronym for Federación Venezolana de Cámaras de Comercio e Industria.
106 Although we had suggested a more expeditious procedure, of allowing Banco Latino to transfer the rights on these bonds to its would-be creditor banks and then transferring the bonds directly to those banks, Rodríguez didn’t agree to that. So we had to wait for him to come to the Central Bank to execute all the documentation before Banco Latino could get the bonds.
We stretched the 8 a.m. clearing deadline to 10 a.m., then to 2 p.m. We kept getting messages from Rodríguez's office that he was on his way. But nobody could tell us where he was. At 4 p.m., Banco Latino could not produce the funds needed to cover its clearing payments. We could not wait any longer. Venezuela's banking system had been paralyzed for 24 hours. The board unanimously approved Banco Latino's exclusion from check clearing, as was mandated by law.

Rodríguez showed up at the Central Bank at 4:15. He offered no explanation for his delay. He was ushered into a room, and he signed the transfer of the bonds. The notary public who had been waiting for him at the Central Bank since 8 a.m. certified the documents. The bonds were handed over to Banco Latino, which subsequently transferred them to its creditors and to the Central Bank.

Of course, it was all moot by then. The check-clearing process for January 12 and 13 was finished. The Central Bank board deliberated over whether to reverse its decision. Unanimously, we voted “no.” Reversal of check clearing would have created havoc in the rest of banking system.

Banco Latino would have collapsed in a day or two, anyway. Since early January, its net loss of funds had exceeded Bs. 7 billion daily, totaling about 5 percent of its deposits. Its cash reserves at the Central Bank were Bs. 12.4 billion below the legal minimum. It owed Bs. 23.3 billion to the Central Bank. No bank would lend it any money. Its shareholders refused to back it up. To regain its footing, Banco Latino needed much more than Bs. 8.6 billion in bonds. It needed a savior.

We had reached the end of the rope, and let go.

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107 In Venezuela, a notary public is a public official who normally serves in his office. In order to speed the transfer of the bonds, on January 13 a notary public had been asked to come to the Central Bank.
PANIC

We were not facing a single bailout, but an economic avalanche. What began as Banco Latino’s inability to clear checks was about to trigger widespread contagion, an illness that would eventually bring down a significant piece of Venezuela’s financial system.

Within minutes, television and radio spread the news of the Latino crisis around the country.

The government had not closed or taken over the bank, but obviously Banco Latino could not operate without the ability to clear checks. That left it in limbo. Banco Latino’s board of directors announced that, as recommended by the authorities, the bank would not open the following day.

This mattered to every Venezuelan. Some 2 million depositors, nearly 10 percent of the population, banked with the Latino group and its affiliates. Banco Latino itself was the second largest commercial bank in the country, with 700,000 depositors. It ran one of Venezuela’s largest trust operations, with total assets of Bs. 210 billion ($2.0 billion). It was the core of the Latino group of financial services companies that included two mortgage banks, an investment bank, several insurance carriers and a leasing company, with assets totaling another Bs. 275 billion ($2.6 billion). The group also ran affiliated financial institutions in the United States, Colombia, Switzerland and the Netherlands Antilles. And it owned numerous other enterprises in Venezuela, in real estate, farming and manufacturing.

The shutdown immediately froze about Bs. 357 billion ($3.3 billion) in depositor funds\textsuperscript{108} and Bs. 12 billion ($111 million) in interbank de-

\textsuperscript{108} This included Banco Latino deposits (Bs. 112 billion) and depositor funds taken in through the money desk (Bs. 95 billion) and the money market fund (Bs. 150 billion). Adding the affiliates in Venezuela (Bs. 275 billion) and the trust operation (Bs. 210 billion), total liabilities affected by the collapse of Banco Latino were Bs. 842 billion ($7.8 billion).
All told, a mammoth Bs. 842 billion ($7.8 billion) in liabilities were affected. Now other banks could run short of cash, especially given the capital outflows that were sure to follow. Even Fogade had Bs. 17.5 billion ($163 million) in a trust account at Banco Latino. And Fogade was very likely to need that money now for emergency loans to other shaky banks.

DEPOSITORS' FURY

In the past when a bank was taken over, depositors had to wait a long time to retrieve their funds. But they always did. Moreover, they seemed willing to wait. Both the economy and the political climate were more stable and predictable during the bank failures of the 1960s and the 1980s. Now, however, on the heels of two coup attempts and with a change in government only two weeks away, people panicked.

Friday morning, outraged depositors gathered in front of Banco Latino's 97 branches in 41 cities. All of the branches were closed, and at the larger ones, heavily-armed National Guardsman cordoned off the entrances. The front pages of the newspapers carried photographs of soldiers facing off with depositors at the main office in Caracas. The news reports were inflammatory and, in some cases, plain wrong. One Caracas daily announced in a dramatic headline that the government had taken over the bank. That deepened the panic; the paper circulated widely among working class people who comprised the bulk of small depositors. Just as I had feared, runs quickly enveloped other banks. Depositors worried that the government would allow other banks to fail since it had done the unthinkable and abandoned the powerful Latino. Few members of the public could really be sure of which banks were weak. Their perceptions were based on rumors and gossip. Depositors erred on the side of caution and withdrew their money, further weakening other banks.

Long queues formed at the branches of Banco Maracaibo, too. The Latino group had acquired control ownership of Banco Maracaibo and its affiliates in 1991. Banco Maracaibo was 100 years old and the strongest bank in the Western state of Zulia, where Venezuela's oil industry operations are headquartered.

109 This represented about one-third of the funds placed by Venezuelan commercial banks in the interbank money market.
110 In 1992, Fogade redeployed the deposits it had with the Central Bank to a group of commercial banks, as recommended by the World Bank-organized financial sector reform program. Fogade held an auction to select the banks and placed the funds with those that offered the highest yields. In this way, at the time of the crisis, Fogade's liquid assets were held mostly by the weakest group of banks.
Since mid-1993, Banco Maracaibo's original Zulia shareholders had been negotiating to repurchase their majority share. They had reached an agreement a few days before and had made public announcements distancing their bank from Banco Latino. Nevertheless, the links between the two banks were too strong in people's minds. Banco Maracaibo began to suffer heavy runs almost immediately, and within a few days it was on its way to collapse.

LAST TRIES

I phoned Silva Thursday afternoon to formally inform him of the Central Bank's decision. We had already warned him it was coming; in truth he did not need to be told. "When you bar the bank from the clearing system, let me know," he had told me a few days before. He once again seemed unmov ed and had little to say.

So, in what was becoming standard procedure, I again wrote directly to President Velásquez, urging him to address the Banco Latino situation immediately.112

Velásquez called a 7 a.m. emergency meeting for the next morning at Miraflores Palace. I was invited, along with Silva, Urbina, Martínez and José Bouza Izquierdo, the president of the Venezuelan Banking Council. Later, Ramón Espinoza, the minister of the President's Secretariat, and five leading bankers would join us. Ominously, Velásquez had also invited Minister of the Interior Carlos Delgado Chapellin. Our mission was to develop a plan of action to help Banco Latino reopen as quickly as possible.

The Central Bank board believed that we should avoid shutting down Banco Latino. If the government could marshal the capital, the bank could reopen as early as Monday morning.

In any case, we said, the superintendent of banks should immediately decide whether to try to restore Banco Latino to normal operations, to intervene in the bank with a government-organized rescue plan, or to liquidate it. Fogade would likely have to play a key role in restoring the bank's solvency and liquidity, or else prepare to make good on its deposit guarantee. The new banking law had quadrupled the guarantee to Bs. 1 million ($9,289) per depositor, but Fogade lacked the funds to back that commitment.113 In any case, I wanted them to avoid the

113 Neither the Velásquez nor the Caldera governments, nor Fogade, had said a word about plans to raise funds to cover this commitment. Fogade lacked the resources to pay, and the government in general was perceived to be in deep financial trouble. Furthermore, the disciplinary effect that the decline in the real value of deposit insurance should have had over the previous decade was meaningless; nobody believed that the nominal amounts of deposit insurance would be applied anyway; everyone betted on a full coverage.
latter option. The deposit guarantee could only be paid out if the bank were liquidated, a lengthy and cumbersome process. Rebuilding faith in the bank could take years, even decades. I thought the best strategy was to reopen the bank and to get it to honor its obligations to depositors.

That weekend, we made last-ditch efforts to avoid intervening in Banco Latino and shutting it down.

Only Silva was absent.

DAMAGES

At the Friday morning meeting, Urbina began discussions by repeating his office’s early estimates: he argued that Banco Latino needed a capital injection of Bs. 6 billion ($56 million) to make provisions for loan losses. He did not mention that in a letter to Latino shareholders 10 days before, he had already ordered the bank to put in nearly double that sum—Bs. 10 billion ($93 million). Nor did he refer to the fact that his deputy, Negrón, the previous week had written Banco Latino to insist that these funds be delivered by January 13 and had demanded that the major shareholders deposit an additional Bs. 12 billion ($111 million).

The superintendent’s requirements totaled more than the bank’s equity capital of Bs. 5.4 billion ($50 million) and more than half of its total capital. Nonetheless, the amount struck me as insufficient. Preliminary calculations suggested that a far heavier capital increase, and short-term emergency funding, would be necessary to allow Banco Latino to resume normal operations. We had already learned that Banco Latino assets were of questionable quality. None of the loans Banco Latino officers submitted as collateral were acceptable to the Central Bank, and they weren’t acceptable, either, to any of the major banks that had offered to purchase loans in order to inject some emergency funding.

Urbina agreed to send a team of his bank inspectors to Banco Latino’s head office Saturday morning to produce a closer assessment of the bank’s financial condition. The Central Bank, Fogade, and several senior commercial bank managers would participate. Although the inspection was the responsibility of the superintendent of banks alone, we all agreed that all parties who might be involved in a rescue should have ready access to relevant information.

Then the bankers raised a delicate issue. In two weeks, the government’s monthly payment of the beca alimentaria, a food subsidy for children of low-income families, was due to be paid out through the banking system. Registered beneficiaries could only collect at a designated bank branch. If
Banco Latino did not reopen, the government would have no choice but to reroute all those checks to other banks and notify the beneficiaries. Everyone around the table feared that if this was not done in time, it could fuel social unrest. The fact that this came up at the meeting almost as a surprise validated my suspicions: nobody in the government seemed prepared to deal with the consequences of Banco Latino’s collapse.

The CNV suspended trading of Banco Latino shares on the Caracas and Maracaibo stock exchanges. The stockholders were not the only investors in trouble. About $10 million in commercial paper issued by Latino affiliates—real estate company Inmobiliaria Latimer and several Banco Latino corporate clients—was to come due January 17. Now default looked likely.

Where was our political leadership? The outgoing government and the banks were reluctant to move ahead without the approval of President-elect Caldera. We all waited to hear his thoughts. We were in for a shock. At a January 15 news conference, Caldera announced: “Banco Latino’s problem does not concern me.”

The statement could only have worried depositors, but it downright stunned all of the board members of the Central Bank, and me. Policymakers, regulators, even bank owners, refused to acknowledge that Venezuela’s entire banking system was now in jeopardy. Indeed, many of them acted as though Banco Latino’s failure was a minor problem. Maybe they thought its difficulties would just fade away somehow, or that the Central Bank would grab the reins and perform a miracle bailout by itself. That had happened in the past. Now, because the law had changed, a Central Bank bailout was no longer possible. But few people realized it.

Indecision, delay and lack of political leadership had instant and lethal effects on the rest of banking system.

Within a week, three more financial groups, representing 13 percent of the country’s commercial bank deposits, required emergency support. By the end of March, the crisis had engulfed nine financial groups, more than one-third of the Venezuelan banking system.

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114 El Nacional, January 16, 1994,
INTERNATIONAL SHOCK WAVES

Even though the Venezuelan authorities seemed to have their eyes closed, regulators in other countries where Latino had affiliates were watching with alarm. Phone calls started pouring into my office from abroad, informing me of problems I knew too little about before. I was powerless to offer solutions.

Friday, I received tense phone calls from the U.S. Federal Reserve and from the president of the Central Bank of the Netherlands Antilles. Since 1983, Banco Latino had operated a bank in the United States through Banco Latino International (BLI). BLI was an Edge Act corporation based in Miami, fully owned by the Latino group through Banco Latino (76 percent) and Latino NV of Curacao (24 percent). After hearing the news at home, Venezuelans flew by the plane load to Miami to grab their funds, and when BLI opened Friday, depositors immediately withdrew $23 million. Naturally, that touched off alarm in Washington. On Friday morning, I received a call from a member of the U.S. Federal Reserve Board of Governors' staff. The official warned me that in case of a run, the Fed would immediately close and liquidate BLI, to protect its depositors.

BLI posed a grave risk. Since it was an Edge Act corporation, neither the Central Bank of Venezuela nor the U.S. Federal Reserve could support its liquidity in case of runs. Yet if the Miami affiliate of Banco Latino were liquidated, that might fuel a contagion and trigger runs on the U.S. operations of other Venezuelan banks. I was also worried that if the U.S. authorities liquidated BLI, its assets would go at fire sale prices, ultimately raising the cost to Venezuelan taxpayers. I asked the Fed to try to keep BLI running while we hunted for solutions to the larger crisis. That evening, William Ryback, deputy director for international banking supervision at the Federal Reserve Board, informed me that the Fed had gone in to make an inspection.

Ryback told me that in recent weeks, BLI had given parent Banco Latino an unauthorized loan. U.S. regulators detected it and demanded that Banco Latino repurchase the loan. Latino did. The Fed also asked BLI to refrain from

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115 Edge Act corporations are foreign banking corporations authorized to operate in the United States under section 25 (a) of the Federal Reserve Act. The U.S. Edge Act was the legislative mechanism that allowed non-U.S., non-bank financial services companies to operate in the United States. For a time, these rules governed most foreign banking operations in the United States. Such companies were prohibited from receiving loans from the Federal Reserve, which also could not act as lender of last resort.

116 The Central Bank of Venezuela could provide liquidity support in bolivares only to oversea branches of Venezuelan banks and to Edge Act corporations fully owned by a Venezuelan bank or financial group, through their head office or their bank holding company. Their dollar-denominated deposits could be covered by Fogade insurance if they consolidated into the Venezuelan bank or holding company and had paid an insurance premium, which they had not. Fogade deposit insurance did not cover U.S. residents' dollar-denominated deposits. Edge Act corporations linked to Venezuelan banks through common ownership, and U.S.-chartered banks owned by Venezuelan shareholders, could not receive support from the Central Bank of Fogade.
entering into any transaction with its parent or affiliates, to operate only with clients, and to suspend dividend distributions, measures to which it also agreed. We at the Central Bank had known nothing about any of this.\textsuperscript{117}

Fortuitously, U.S. banks would be shut for a holiday on Monday, January 17. But Federal Reserve officials feared there would be a run at BLI the following day. The Fed has no power to take over a bank unless it is insolvent. I was anxiously searching for a way to keep BLI open. Geoffrey Bell, a longtime advisor to the Venezuelan Central Bank, dreamed up the idea of having BLI file for protection from creditors under Chapter 11 of U.S. bankruptcy law. BLI was, in the eyes of U.S. law, a corporation rather than a bank. A Chapter 11 filing would give the Venezuelan authorities some breathing room. The Fed agreed, and BLI immediately filed for bankruptcy protection.

Emsley Tromp, president of the Central Bank of the Netherlands Antilles, called me about Latino NV, Banco Latino's Curaçao operation, Latino NV was 90 percent owned by Latimer Inversiones, one of the most important units of the Latino group.\textsuperscript{118}

Neither the Central Bank of the Netherlands Antilles nor the Venezuelan authorities could be sure of the size and financial condition of Latino NV. Tromp and I agreed to exchange information, and the Netherlands Antilles authorities placed Latino NV under special Central Bank surveillance.

Bad news began surfacing quickly.

Auditing reports eventually revealed that Latino NV’s loan portfolio was a groaning $900 million, against capital of only $51 million. Its bolivar-denominated loan portfolio of $74 million was highly concentrated among four borrowers, three of them directly linked to the bank and its shareholders. About a third of the dollar-denominated loans, or $311 million, had gone to shareholders, management and bank affiliates. Another third had gone directly to Banco Latino, especially in December and January. Latino NV’s $834 million in liabilities were essentially the deposits of customers and banks, including Banco Latino. Some $344 million belonged to Venezuelan depositors.

Just a month before, Latino NV had borrowed $170 million from a group of foreign banks, in an effort to help Banco Latino. Latino NV posted as collateral $349 million worth of Venezuelan Brady bonds\textsuperscript{119} acquired from Consorcio Financiero Latino. If the Latino group could not repay the loan, the banks would seize the bonds. The already desperate group thus stood to

\textsuperscript{117} The official contact for all foreign banking supervisors is the Office of the Superintendent of Banks.

\textsuperscript{118} Araven Finance Ltd., a Channel Island-based corporation belonging to the Latino group, owned the other 10 percent.

\textsuperscript{119} Named after former U.S. Treasury Secretary Nicholas Brady, these securities were created when defaulted Venezuelan government debt was restructured, during the early 1990s workout of the Latin American debt crisis.
lose another $170 million.

The Central Bank of the Netherlands was drawn in, too. In August 1993, Banco Latino had guaranteed a Latino NV issue of $40 million in six month zero-coupon commercial paper. Latino was the first Latin American bank to issue such an instrument. ING Bank, one of the top banks in Netherland, had served as the agent and placed the securities in the Eurodollar market. The issue was due to mature on February 16. A default would tarnish ING's image. And it would deal a blow to Venezuela's—and perhaps even all of Latin America's—creditworthiness. European banks and investors might avoid doing business in Venezuela for some time.

ING was prepared to purchase all of the outstanding bonds. The bank wanted to know what the Venezuelan government's official stance was on Banco Latino. Truly, we had no answers.129

The Latino group also had a two-year-old affiliate in Colombia. I spoke with José Elias Melo, Colombia's superintendent of banks. Fortunately, Melo was not concerned about Banco Latino's Colombian operation. It was small and solvent.

Problems burst forth on other fronts, as well. The U.S. Commodity Credit Corporation (CCC), an office of the U.S. Department of Agriculture, had guaranteed Banco Latino letters of credit for agricultural imports from the United States (mainly wheat, cereals and cooking oil). Now $1.3 million was coming due to U.S. commercial banks in March. If a single Venezuelan bank were to default, the CCC would suspend its operations with all Venezuelan financial institutions. To make matters worse, if Banco Latino defaulted, the U.S. government could use an acceleration clause and require full payment of all Banco Latino debt. Venezuelan banks and importers would lose a $300 million line of credit. This would increase the cost of food imports. The loan was coming due in two months. How would it be paid?

SOLUTIONS PROVE ELUSIVE

On Saturday, Hernán Anzola, key members of the Central Bank staff and I shuttled from room to room at the Central Bank, sitting down alternately with Banco Latino's major shareholders and with leaders of other banks. Fogade chief Esperanza Martino and Roger Urbina joined us from time to time.

Everyone had the same aim: to forestall government intervention and take over of Banco Latino, an act that would probably keep the bank shut for a long

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129 Banco Latino NV did default on its Euromarket issue. On January 26, the Central Bank of the Netherlands Antilles said it would liquidate Latino NV; loans to its parent company, affiliates, officers and shareholders had finally become too heavy a burden for the bank to bear.
time. When a Venezuelan government intervened in a bank, the normal procedure was to replace bank management with state-appointed conservators and let the government control the workout. But everyone feared that the red tape involved in this process could destroy what was left of the bank.

I strongly believed that Banco Latino's shareholders should play a material role in any rescue plan. Some major shareholders were willing to put up capital, but only the amount Urbina had initially asked for, Bs. 6 billion ($56 million) since that sum already had been approved at a general shareholders meeting. It was to be paid in the first half of 1994. But they reiterated that they could not commit to any additional funds saying they doubted that the rest of the shareholders would approve this. Their intransigence was unfortunate because we all knew by then that the amount on the table was not nearly enough. Furthermore, their reluctance to take strenuous steps to save their own bank encouraged the rest of the banking community to renego on its commitments.

Even if the shareholders remained in place, Fogade could provide financing and help restructure the bank. That was an option both the superintendent's staff and the Central Bank had been recommending for some time. But, as a condition of assistance, Fogade demanded that the bank change its management team. This Banco Latino's board and shareholders refused to do. That created an impasse: as long as Banco Latino was in private hands, Fogade could not begin an aid program unless the bank requested one. The Central Bank was involved in the search for solutions, yet our hands were also tied. In any case, Latino's owners seemed embarrassed by the whole idea of receiving Fogade assistance. Even now, the prospects for an aid agreement were slim. It was hard to understand why Latino shareholders seemed to consider a Fogade program more upsetting than the alternative—government seizure of the bank.

As our discussions hit wall after wall, we saw that it would be impossible to act until we knew the results of the superintendent's audit. The initial numbers were disturbing. A few bankers ventured that Banco Latino's losses could run up to Bs. 50 billion ($464 million). That figure had sounded outrageous three days before. It was almost 10 times the superintendent's loss estimate. Yet by Saturday afternoon, as we began to get early reports from the inspectors, it did not seem so far off the mark: they had counted losses of Bs. 15 billion ($139 million) thus far.

GOVERNMENT TAKEOVER

We spent all of Sunday at the Central Bank. Central Bank board members, the minister of planning, the president of Fogade, Banco Latino sharehold-
ers and officers, and a group of bankers all waited tensely for the superintendent's final report. Finally, at seven in the evening, Urbina arrived with the results. Auditors had so far counted Banco Latino's losses at Bs. 28 billion ($260 million).

There was more to come. Auditors determined that several Banco Latino affiliates had provided last-minute emergency funding to the bank and to some of its commercial affiliates, using the off balance sheet deposit-taking operation, the infamous *mesa de dinero*. We learned that Banco Latino's money desk operations totaled Bs. 95 billion ($882 million), a sum almost equal in size to the bank's official deposits. Its money market fund had deposit-like liabilities in excess of Bs. 150 billion ($1.4 billion). And the liabilities of Banco Latino NV, the Latino group's main offshore arm, would probably amount to billions of bolivares more.

By Sunday night, the superintendent's unofficial estimate was that Banco Latino's total losses probably exceeded Bs. 50 billion ($464 million), more than four times the bank's capital. And that was without taking into account the losses of the Latino group at large.

Eventually, the bank's losses were put at Bs. 300 billion ($2.6 billion).

As the accounting of losses mounted, our last hopes of keeping the bank open withered away. There was only one option left: government seizure. Venezuelan law mandated that if a bank lost more than 50 percent of its capital and was not quickly recapitalized by its shareholders, the government had to step in. The superintendent of banks had first to propose this to the Superior Council, a body established by the new banking law and presided over by the minister of finance. The board of the Central Bank also had to submit an official opinion on the matter.

At 7 p.m. Sunday, we set the wheels in motion. I convened a special meeting of my board to hear Urbina's proposal. Board members agreed to it immediately.

I also called Silva and suggested he hold the first-ever Superior Council meeting, at the Central Bank that evening. He agreed and convened the meeting at about 9 p.m. He could hardly have been in the mood. He had submitted his resignation to Velásquez that night, but the President did not accept it.

At midnight, the Superior Council approved government seizure of Banco Latino. Nobody argued. At that point, there was no other option. President-elect Caldera also agreed. Earlier that evening, Sosa had called to tell me

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121 The council included the president of Pogade, the president of the Central Bank and the superintendent of banks.
122 Silva's immediate complaint was unrelated to the Banco Latino affair. The President was pulling back from implementing the last stage of a new VAT on consumer products, a tax due to come into force that month. Silva supported the tax and was trying to resign in protest against the delay.
that the President-elect and his advisers had concluded that intervention was best. We should not waste any more time, he said, searching for other rescue options.

By law, Urbina now had to designate one or several conservators to run the bank. He had no list of potential candidates and so was forced to appoint himself.

Though I knew we had no other choice, I was deeply disturbed by the decision to place the bank under conservatorship. It signaled the failure of all our efforts to prevent a collapse. It also would deal a dangerous blow to an already weak banking system.

DEPOSITORS RIOT

Most Venezuelans expected Banco Latino to open on Monday, January 17. But it didn’t. Indeed, the bank would stay closed for 77 long days, and not once in all that time would depositors receive a clear explanation of when—or whether—they would get their money back.

The firestorm erupted Monday morning. There were riots in Caracas and in many other cities across the country. Stories about all the terrible cases of hardship filled the newspapers. The stream of sorry tales seemed to go on forever. Banco Latino’s high interest rates had enticed many people. Some had placed their life savings in the bank or its affiliates. Retirees had sold their homes and deposited their money, living solely from the interest income. Many small businesses relied on the bank and could not function without it. The funds of universities and local governments were frozen. None of them could pay their workers.

Depositors in major cities immediately began to organize defense committees, as a means of voicing their complaints and organizing their demands. These committees played a key role in subsequent months, lobbying the government and Congress, gathering information about Banco Latino and its affiliates and then negotiating with congressmen and organizing demonstrations.

Day after day, the media pumped out tales of misfortune. Companies large and small protested that they were facing ruin. Even the U.S. Embassy had deposits in Banco Latino. Whole towns were paralyzed, in cases where

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122 Before reopening, the bank had to be recapitalized by Fogade, but the banking law required that several steps be met: Fogade and the superintendent of banks had to determine that the bank was operationally viable and that rehabilitating the bank was less costly than liquidation. The superintendent of banks would also have to authorize the Central Bank to reinstate the bank to the check-clearing system. Without an action plan, there was no way the incumbents could comply with such rules in just a few hours.

123 Various congressmen represented the causes of different committees.
Banco Latino had been the only bank for miles around. Consecocommerce, the National Association of Commercial Establishments, reported that 15 percent of its members were directly affected by Banco Latino's closure. Oil industry contractors threatened to suspend operations unless they could get access to their funds. City governments, including the municipality of Caracas, threatened to halt public services. Creatively, people in some towns began to print their own money.

Depositors' loss of confidence immediately began jeopardizing other banks. Stores in Caracas and other cities began to place signs at their cash registers listing names of banks whose checks they would not accept. As rumors spread, people grew desperate to get their money out of any bank they thought was shaky and put it someplace safe: another Venezuelan bank, a foreign bank, or under their mattresses.

The collapse of Latino was the most violent shock in Venezuelan banking history. Some $1.9 billion in private capital fled the country in the two and a half weeks following the bank's failure.

**POLITICIANS' PARALYSIS**

To make matters worse, the crisis exploded during a particularly fragile political moment.

The Velásquez government was in no position to exert leadership. Not only was the acting President serving out his last two weeks in office, but his ministerial team was not necessarily the most appropriate one for managing a banking crisis. Velásquez had been forced to assemble his team in a rush; some appointees were more like firefighters than policymakers, available to serve nine-month emergency terms but unprepared to deal with the real complexities of governance.

By that point, Velásquez had little support. His government was opposed and criticized on nearly every front. Both Acción Demócrata andCOPEI had virtually withdrawn their backing, and the public was hostile.

Congress was about to step down, too. By January 23 a much more fractious Congress would be seated. At least five political groups were preparing to mount a struggle for control, and Caldera's party, Convergencia, had only about 10 percent representation. That meant legislation would be impossible to pass unless the President was able to persuade several parties to support him.

It all meant that everything seemed to happen in slow motion, at a time when rapid and decisive action was crucial to restoring confidence and halting runs on the banks.

Relations between the outgoing and incoming leaders were distant, al-
most confrontational. Caldera was in the habit of fiercely criticizing Velásquez. There were reasons for that. On the surface, it seemed to stem from policy disagreements about taxes, whether and how state-owned firms should be privatized, what sort of exchange rate regime was proper, and the conduct of monetary policy. But, more importantly, Caldera wanted to avoid any association with the old political establishment, with its legacy of unpopular free market policies led by a president who had been impeached. The President-elect seemed reluctant to endorse anything done by his predecessors. But the lack of communication was harming the outgoing government’s ability to run the country. It did not want to commit to any program that the next government might abandon.

The uncertainty spread beyond government. Bankers were unhappy that the government had no clear bailout plan and were hesitant to act by themselves. They likewise feared that whatever they did to help Velásquez’s government mount a rescue might be undone—or even held against them—by Caldera’s administration. This was not paranoia. It is business as usual in Venezuela for a new administration to investigate the members and associates of the previous one.

While the government was paralyzed, the markets seemed to have concluded that the banking crisis would drown the Venezuelan economy. Money left the country at the rate of about $140 million a day. Nonetheless, there was a deafening silence from the banking authorities.

Silva commented that Banco Latino did not have to be liquidated just because the government had taken it over. He correctly pointed out that the government had simply taken over a bank that had been run down by its management.125 Unfortunately, he announced no further steps to clarify how depositors would recoup their funds. After President Velásquez refused to accept his resignation, Silva was forced to stay on the job until Caldera took office February 2. In the interim, not much happened. The silence was unnerving. Political authority was weak just when it needed to be assertive. The picture was growing darker every day. Frustratingly, the fact that Venezuela was effectively between governments took precedence over the threat of a crippling financial meltdown.

CONTAGION

Now the rest of the banking system came under attack. Runs struck hardest at a group of seven banks ailing since the November bout of capital flight, and hit a financial company as well. Together, these institutions accounted

for nearly 25 percent of national deposits. Among these were institutions linked to Banco Latino through common ownership or business ties. Other banks were simply perceived to be weak. People queued up at branches across the country to get their cash or drew out their deposits by issuing checks that were deposited in other Venezuelan banks and eventually transferred abroad. The spike in transactions increased the amount each bank needed daily to settle its check-clearing obligations.

The situation deteriorated further as those troubled banks also began to lose interbank deposits, both overnight funds and time deposits. Almost immediately, the overnight interbank money market split into two groups. Stronger banks could get funds at very low rates, without collateral; the weaker ones had to pay extremely high rates and back up their borrowing.

The problems were compounded by the behavior of government agencies and state-owned companies, including those in the oil sector. They, too, began withdrawing their money from the ailing banks. It was hard to blame them. They could plainly see that Banco Latino’s closure had frozen government funds, that nobody had stepped forward with a solution, and that the government had issued no specific instructions or reassuring announcements of its plans.

The better-off banks were willing to help but were concerned about the risk that capital outflows posed to their own liquidity. The confidence shock was hurting the banking system as a whole.

The Central Bank was ready to step in as lender of last resort. We knew we had to be extremely cautious, striking a balance between the need to provide liquidity to the banks in order to keep the payment system running, and the risk of fueling inflation and capital outflows.

But short-term Central Bank loans were not enough to stem the overall crisis. Runs on banks continued, and capital hemorrhaged out of the country. I was convinced that to regain public confidence, the government needed to determine the fate of Banco Latino and decide how to reunite depositors with their funds. The banking system was also in desperate need of an overall plan to address the needs of other problem banks; indeed, the absence of a plan was most responsible for spreading fear.

THE CENTRAL BANK PRESSES FOR ACTION

Three days after Banco Latino shut, Caracas and other major cities were shaken. The branches and subsidiaries of Venezuelan banks around the world risked severe restrictions on their operations, and in some cases shutdown and liquidation. Venezuela’s international standing was on the line.

In the absence of government initiative, the Central Bank designed a
strategy to help us move out of the deadlock. Our plan was to get the
Venezuelan government to quickly state that it would support the banking
system. A bold policy could counteract the negative effect the political transi-
tion was having and reduce pressure on the banks and the government. It
was no secret that government institutions were weak and could hardly
cope.

To succeed, I knew, this plan (or any plan!) needed full political support:
from both the outgoing and incoming administrations, and from the main
political parties too. I also knew the banking community would need to be
part of it. Only if we gained bankers’ trust would the banks be prepared to
make available to the government the skilled people urgently needed to run
Banco Latino, and eventually the other troubled banks. They could also help
restore normal interbank lending operations and play a role in the mergers
and acquisitions we hoped would eventually provide an orderly resolution
for some of the troubled banks.

I strongly disagreed with the hands-off policy advocated by some fellow
citizens. There were those who insisted that the government should just let
ailing banks fail, to punish the greedy bankers and depositors who were
now getting their just desserts. That might have been a reasonable position
to take if Venezuela had not been mired in political and economic crisis; if
banking regulators had ensured the disclosure of financial information, so
that depositors could reasonably assess their risks; and if the impending
bank failures were less consequential. In retrospect, I still believe this mor-
alistic approach would have punished the defenseless more than the greedy.

Our plan envisioned the government extending blanket coverage to Banco
Latino depositors. Other creditors could be dealt with later; the priority was
getting depositors their funds. Moreover, the government, in my opinion,
could not limit itself to the Bs. 1 million deposit insurance payment ($9,289).
That would not be nearly enough to cover people’s normal payment needs.
I was pressing for a fast reopening of Latino. Each day it was closed, its
franchise value dwindled, pushing the government’s costs even higher. And
our very lack of ability to reopen it was contaminating the rest of the Ven-
ezuelan banking system. At that point it was impossible to determine how
much money would be needed to prevent the collapse of the banks that
were at risk of, or already experiencing, heavy runs. Nor could we guess at
how long a support program would last. I believed, however, that a bold
bank restructuring program, immediately followed by effective remedial ac-
tion (recapitalization, mergers and acquisitions), could restore confidence.
The plan also called upon both the Central Bank and Fogade to play key
roles. If need be, the Central Bank could lend to Fogade, as prescribed by

The Central Bank was empowered to lend to Fogade without limit for one-year terms. It
could also lend pre-set amounts for two-year terms.
law.\textsuperscript{126} And these amounts could be supplemented by returning to Banco Latino the funds its depositors were moving to other banks.\textsuperscript{127} We called for immediate action toward those ends.

We recommended that:

- All depositors in the Latino group covered by Venezuelan banking law should gain immediate access to their funds. A timetable could be set up to give preference to very small depositors during the first days and then quickly expand access. It would have been unfair to give government institutions preferential treatment. Banco Latino affiliates (both domestic and offshore) not subject to our banking laws should not be brought under the deposit insurance umbrella.

- The government should find a board of conservators to replace Urbina and appoint a full-time management team of bankers, rather than rely on part-timers, as is customary when the Venezuelan government calls upon its citizens for help. I believed three to five knowledgeable people with substantial experience in the banking business and solid reputations should be named jointly by Velásquez and Caldera. This would ensure confidence and continuity. The government should also name a part-time advisory board of five or six bank presidents, to consult with the conservators and the government. The outgoing and incoming presidential administrations should also jointly establish a steering committee to oversee things until a new minister of finance could take over.

- An exemption should be made to the banking law, which holds conservators liable for insolvencies. An exception to protect the new appointees from unfair punishment would be necessary, because it is very hard to find anyone willing to take on these important jobs. Nobody could envision how the takeover would unfold.\textsuperscript{126}

- To strengthen the other troubled banks—some of which were on the brink of failure—the superintendent of banks should raise capital requirements and impose heavy sanctions on banks that failed to comply.\textsuperscript{128} Shareholders would, however, need fair (and firm) warning, since it would be a sudden departure from the lax regulation of the past. Stepping up shareholder support would allow the banks to regain access to interbank funds and would boost depositor confidence.

- The banking community should be induced to participate in a fund recy-

\textsuperscript{126} These interbank deposits could be guaranteed by Banco Latino assets assigned to a special purpose trust, which could also carry a government guarantee.

\textsuperscript{127} Being a conservator was a thankless and highly risky job that qualified people tried to avoid. Our laws on conservatorship were still inadequate. We needed, for example, a way to limit conservators' legal liability. Conservators risked liability for bank losses that were the result of damage that occurred under the previous management.

\textsuperscript{128} The newly-enacted banking law gave him the power to do this.
clinging program, returning via loans to the ailing banks the deposits the banks had lost in the runs. Special purpose trusts could be used in these cases. The government needed, too, to foster mergers and acquisitions within the banking industry, to put weaker banks in stronger hands, while discouraging mergers that would weaken the system. And when the superintendent of banks had determined that all else had failed, government intervention should be careful, well-timed and organized, or it would only make things worse. I favored a style of intervention that would keep the banks open, instead of closures in the traditional way.

- Fogade would have to recapitalize Banco Latino, and probably other ailing banks as well. There was no way to estimate yet how much money would be needed, though clearly the sum would be huge. Fogade had about Bs. 65 billion ($604 million) in assets—hardly enough to cover lost deposits. Moreover, most of it was virtually illiquid: real estate and stocks acquired in previous bank failures, and trust funds frozen in Banco Latino and in other teetering banks. Fogade would have to withdraw its funds gradually, so it would not send these institutions hurtling toward insolvency. The Central Bank would have to grant short-term loans to Fogade until it could get capital contributions from the government and raise funds in the marketplace.

I presented this strategy to President Velásquez on January 19 and, with his consent, took it to Caldera the next day. The President-elect’s approval was indispensable. Sosa, who would soon become Caldera’s finance minister, arranged the meeting at Caldera’s home, and sat in. Caldera listened carefully. Both he and Sosa agreed to support the Central Bank’s program. They also said they would back a new Banco Latino management team, and a board of advisors appointed by the Velásquez government.

I felt relieved. I hoped we had reached a turning point.

Reporters were staking out Caldera’s house, but I managed to slip away. I felt that the hosts of the meeting should be the ones to make any public announcement. Within minutes, Sosa told the press that I had come to talk about ideas to protect depositors and enhance people’s trust in the banking system, though he gave no specific information or commitment that might have been comforting.

But suddenly, those with whom I had spoken leapt into action. That very day, the government lined up a team of conservators. The presidents and chief executive officers of eight banks agreed to participate in a board of advisors to assist them. We now had a first plan in place, albeit a temporary and partial one. These stopgap measures would not solve all our problems, but they were small steps in the right direction. To do more, agreements would have to be

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reached with the new administration and a new Congress.

PRESIDENTIAL REASSURANCES

That night the President tried to reassure the nation, and spoke publicly about the government's plans for Banco Latino for the first time. Velásquez was surrounded by his key ministers, and by top Congressional representatives. Leaders of the major political parties were also there: from Acción Democrática and Copet, from Convergencia, Caldera's new party; and from Movimiento al Socialismo (MAS), its ally. Banking leaders attended and, in a signal of President-elect Caldera's support, so did Julio Sosa.

Velásquez said the government would begin paying Banco Latino depositors up to Bs. 100,000 (US$29) beginning on January 28, and that the bank would resume its activities "soon." Government auditors would report on the bank's financial condition within 90 days. The President read off the names of the people who had agreed to serve on Banco Latino's board of conservators and advisors, and stressed the Central Bank's willingness to continue supporting the banking system as a lender of last resort.

The President also vowed that his government would pursue civil and criminal charges against those responsible for Banco Latino's collapse. The police would go after people and businesses found guilty of spreading dangerous rumors about banks, he warned.

He stressed that the political establishment and President-elect Caldera agreed with his plan, saying, "I trust that Caldera will continue with the program."131 Finally, he urged the political parties to bring a spirit of cooperation into the new Congress.

Meanwhile, the Central Bank was dealing with the banks' liquidity problems step by step. First, we reduced banks' minimum cash reserve requirements from 15 percent to 12 percent of total deposits.132 Doing that immediately freed up Bs. 26 billion (US$242 million) for banks to work with. It reduced the acute pressure on the overnight market.

The Central Bank also lowered reserve requirements for banks that agreed to lend to the less liquid ones.133 The system would work as follows: we would temporarily lower reserve requirements for banks that agreed to participate;

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the reduction in reserve requirements would equal the amount of a loan, for the duration of the loan; creditor banks would take collateral they found acceptable. The underlying "guarantee" for these loans was the borrowing bank's option to request aid from Fogadé, and the declaration of intent by Fogadé to lend to the banks and substitute the claim on the bank and the collateral. Eight banks agreed to participate in this program. It began on January 24 and lasted for about 10 days.138

Velásquez's speech seemed a promising beginning. But the public was not reassured. Panic continued unabated. People were terribly uncertain of what the Caldera administration would do. Perhaps Velásquez had not been specific enough. He had only announced some initial steps to restart Banco Latino; he did not say when the bank would reopen. Though there was probably no way he could honestly have done that, this of course was the main information people were waiting for. And depositors must have been displeased to hear that only 10 percent of their Fogadé-guaranteed payments would be available.

On Friday, January 21, all Banco Latino's affiliated companies were taken over by the government. Capital outflows hit a new high: $295 million left the country that day. Worsening matters, six more days were lost before the new board of conservators could begin work, as usual because of a bureaucratic tangle.139

BANKS FALL LIKE DOMINOES

Now banks began to fall like dominoes. The new Congress was seated Sunday, January 23, Monday, $200 million fled the banking system. Tuesday, Banco Maracaibo, which had Bs. 131 billion ($1.2 billion) in deposits and over 500,000 depositors, reached the end of its rope. It had exhausted all of its liquid assets and cash reserves at the Central Bank, and private banks would no longer lend to it. Unlike Latino's shareholders, Banco Maracaibo's new owners requested Fogadé assistance immediately. The Central Bank thus made short-term loans to Fogadé, which on-lent them to Banco Maracaibo. This at least kept the bank open. It was the best option at that point. To eject Maracaibo from the check-

138 We also decided to modify the cash reserves requirements system, by allowing banks to keep cash reserves for foreign currency-denominated deposits in that same currency. Previously, all cash reserves were maintained in bolivares so that the bolivar depreciation forced banks to set aside additional reserves. Rather than improving liquidity, this measure aimed to eliminate a source of uncertainty in the banks' cash management and lower transaction costs. The program was implemented in March after all procedural issues were resolved. Central Bank of Venezuela, Resolution No. 94-01-09, January 20, 1994. Gaceta Oficial No. 35,425. March 21, 1994.

139 Board appointments would become official only when published in the Gaceta Oficial. The superintendent of banks' resolution appointing the new board of conservators was not published until January 25. That slowed down the effectiveness of the new board of conservators in their crucial first days in office.
clearing system, closing it down while Banco Latino’s depositors were in limbo and government regulators at a loss, would have ground oil-center Zulia state to a halt. Banco Latino and Banco Maracaibo accounted for more than 60 percent of bank deposits there. Furthermore, Banco Maracaibo and its affiliates held the accounts of both the state of Zulia and its capital city Maracaibo; the accounts and pension funds of many oil companies and their suppliers and contractors; and those of Zulia University, its teachers and thousands of students. Most of the state’s private sector banked there, too.

Moreover, Banco Latino, Banco Maracaibo and their affiliated institutions together represented more than 17 percent of the national financial sector and held the funds of more than two and a half million depositors. A double failure would likely have triggered such a violent chain reaction in other banks that it could force the collapse of the payment system—one week before a new government took over.

The Central Bank had to step in. We had to act as lender of last resort and protect the payment system. Our board unanimously decided to approve a Bs. 30 billion ($277 million) loan to Fogade to cover Banco Maracaibo’s clearing payments of the next few days. Fogade set stringent terms for its on-lending.\(^\text{136}\) Loans were meant as short-term aid, to protect Maracaibo’s assets and pay its depositors. We could only expect that the superintendent of banks and Fogade would eventually find longer-term solutions.

Two days later, on January 27, Fogade had to include Banco Construcción and Banco Barinas in this triage lending program. A mere two weeks after the collapse of Banco Latino, four banks—23 percent of total commercial bank deposits—were either being directly managed by the government or surviving on public funds.

Only Banco Latino had been seized by the government and closed. The other institutions stayed open on Fogade’s Central Bank-infused life support and were allowed to keep their original boards and management teams in place. The positive side of this policy was that the banks could keep operating, and depositors could access their funds; anarchic collapse had been avoided. The negative side was that the banks’ capital base was not being strengthened. And the managements that had contributed to the downfall of their institutions were allowed to keep running them, as if nothing had gone wrong. As the months passed, that policy came increasingly into question.

\(^{136}\) Fogade’s measures regulated liquidity management, prevented the diversion of funds to loans or transactions with insiders, and imposed a moratorium on dividend distributions.
Central Bank board to send an urgent message to President-elect Caldera, who was preparing to take office on February 2. I could only hope he would move to stem a banking crisis that would tremendously hurt the Venezuelan people.

I first met him in December 1993, a few days after he was elected President. His key economic advisors had been in to see me at the Central Bank about a week earlier, with a copy of a document entitled “My Letter of Intent with the Venezuelan People,” the official version of his economic program. Since I knew Caldera was likely to be elected, I used the opportunity to alert his advisors to the two most important problems we at the Central Bank foresaw: the rising fiscal deficit and the deterioration of the banking system. I offered the Central Bank’s assistance in dealing with these issues, and we parted.

I visited Caldera after his victory, along with a group of Central Bank directors. We were terribly concerned, we said, about the extreme volatility of Venezuela’s financial markets, the size of the government deficit and the weakness of the banks. We said we believed that a prompt announcement of his government’s economic policies would restore some degree of stability.

THE BATTLE OVER INTEREST RATES

The conversation had turned to interest rates, a topic of deep concern to Caldera, and one of our chief areas of disagreement. The President-elect believed rates should be set at levels low enough to permit small businesses and individual borrowers to have comfortable access to credit. But during 1993, the Central Bank had been forced to let interest rates rise to about 60 percent. Obviously, such high rates had been very controversial; it meant many people could not afford to borrow, and those with floating-rate loans saw their debt payments shoot up. High rates also raised the government’s borrowing costs. The Central Bank had come in for severe criticism in the press. We had defended our policy; these rates, we explained, were a result of the way investors had reacted to two years of political instability and a soaring fiscal deficit. That volatile climate had sent millions of dollars out of the country, and Venezuela was obliged to offer high rates in order to attract and keep money in its financial system. High rates also reflected the poor health of some of our banks, I told Caldera. Those banks could not attract enough depositors unless they compensated them handsomely.

We pointed out that Venezuela was just now emerging from two years of extreme political turbulence. We had just had peaceful elections that produced a consensus, and Caldera had a tremendous opportunity before him
to begin fixing the nation’s problems. We offered him the Central Bank’s support and resources in dealing with these issues, as well as all the information available to us.

He thanked us for our visit. After that, the leadership of the Central Bank had no contact with the incoming administration until January 11, when I called Sosa to inform him about Banco Latino’s impending failure.

Now, with inauguration day almost upon us, the board of the Central Bank unanimously decided that we should once again warn the President-elect about the magnitude of the banking crisis, and tell him what we thought should be done. We felt sure that Caldera’s popularity and reputation would stem the panic and help restore some kind of normality. Indeed, we were all pinning our hopes on the new government. I expected that he would announce his new policies, particularly with regard to the banking crisis, in his inaugural speech. I wrote to him on January 29, to make sure he would have all the necessary information at hand.185 My letter stressed the need to rebuild confidence both in the banking system and in the country. The markets and the depositors needed assurance that the government would quickly deal with the banking crisis.

More specifically, I told Caldera that the government had to: a) decide what to do about Banco Latino; b) continue liquidity support to banks suffering massive withdrawals of deposits; c) design and implement a program to strengthen the group of ailing banks and the banking system as a whole; and d) clarify responsibility for the banking failures and apply sanctions where warranted.

I also said that his administration had to prevent the anarchic collapse of more banks. Loans from the Central Bank were only temporarily shoring up the payment system. A permanent solution was very daunting and would require more money and staff. The government had to capitalize Fogade, instead of allowing it to rely solely on inflationary Central Bank loans for funding. I urged Caldera to announce his program to deal with the banking crisis, and his economic policies, in his inaugural speech, a golden opportunity three days away.

I knew Caldera had discussed our proposal with some of his advisors, yet for some reason he had not responded to it.186 Still, my hopes were high when I attended his inauguration. During a 40-minute speech, he acknowledged that the recent collapse of Banco Latino had endangered the stability of the financial system. He called on all economic and political sectors, and

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185 See letter to President-elect Caldera, January 29, 1994, p. 238.
186 Furthermore, in the ensuing weeks, I learned that some of his key people never knew about it. Asdrúbal Baptista, a renowned economics scholar and one of Caldera’s chief economic advisors in the campaign months (and soon to be appointed as the government’s representative to the board of the Central Bank), never even heard of my proposal until he joined the board of the Central Bank. What this showed was a lack of teamwork, and perhaps also Caldera’s decision to handle these issues only with a very small group of close aides.
especially the banking community, to stop playing with depositors’ money, and to stop lending directly or covertly to insiders. He mentioned the government’s commitment to prosecuting all wrongdoers responsible for bank collapses. And he concluded with a vague promise that the government would guarantee that Latino clients would get their savings back. He also said Banco Latino depositors who needed their funds for urgent necessities would be taken care of “as quickly and efficiently as possible.” By the end, as the band played the national anthem, I was stunned. Caldera had been far too vague. He scarcely mentioned any strategy for managing the banking crisis, and had basically left the Central Bank holding the bag. I was deeply disappointed, but I still hoped he would soon lay out some specifics.

I would be disappointed again and again. For 18 months, the government would fail to spell out a comprehensive crisis strategy, reacting instead to each new development as it arose. In the absence of direction from the top, the banking crisis worsened.

DANGEROUS INACTION

To be fair, the Caldera administration faced a difficult situation. Banks were toppling like bowling pins in the weeks before and after his inauguration. And each new day brought more confusion and anger from depositors, and mounting outflows. The Central Bank’s daily disbursement of funds just to keep banks afloat was about Bs. 6 billion (554 million), and rising. The potential cost to the government was escalating by the day and widening an already huge budget deficit.

The new government also had to live up to campaign commitments to undo the market-oriented reforms championed by Pérez. Caldera never presented a formal economic plan but seemed to be leaning toward traditional Latin American populist policies: letting the fiscal deficit grow, overvaluing the currency, controlling currency outflows by dictate rather than by incentive, establishing artificially low interest rates and discouraging imports with protective barriers.

Caldera and his advisors dismissed the need for foreign funds to support an economic stabilization program, and saw no real need to care for Venezuela’s relations with the international financial community or to invite investment by overseas companies. The consensus among his top advisors was that the oil industry would be enough to reactivate the Venezuelan

economy. Making recovery even more difficult, the Caldera economic team rejected earlier plans to privatize money-losing state companies and refused to negotiate with the IMF for an assistance program.

The new government could say that it was merely following popular sentiment. Support for market-oriented reforms had never been too strong, and disappeared almost entirely after 1992 when falling oil prices erased funding for favored sectors and led to a deterioration in public services. The ouster of Pérez spoke eloquently to how unpopular these ideas had become. The lack of support for market reforms only worsened with the onset of the banking crisis. In the absence of action, or even policy statements, from the new administration, rumors and panic took over.

Political extremists tried to exploit the situation further; they sent thousands of faxes around the country spreading the “news” that the Caldera government intended to adopt exchange controls, freeze bank deposits and take other confiscatory measures. Obviously, their purpose was to stir chaos in the hope that people would grow desperate enough to reject the political establishment and open the doors to their platform. As a result, the new administration would soon find itself forced to decide whether it would adhere to campaign promises to roll back Pérez’s reforms, or accept those already in place.

The new administration, moreover, had weak support in Congress. Convergencia had won only 29 seats—11 percent of the Chamber of Deputies and 9 percent of the Senate—and would thus have to build political alliances to run the country and pass the legislation it needed. Instead of the 35-year old bipartisan system, where two parties made accommodations with each other to get the job done, five parties would now be jockeying for control of Congress. Confrontation was in the air. Caldera had positioned himself above Congress and the parties. There were even rumors that he intended to dissolve the legislature, although he did not have the constitutional power to do so. Yet at the same time, Congress itself had lost public support; its credibility was tarnished. The body was seen largely as a tool for traditional party maneuvering, a game that the citizenry was sick and tired of. Congress, it seemed, would have to move mountains to reestablish its own legitimacy.

After the President’s inaugural speech, the markets did temporarily calm down. While he did not announce any substantive plan to address the banking crisis, he emphatically ruled out exchange controls and devaluation, and investors breathed a brief sigh of relief. Foreign exchange outflow slowed to about $40 million a day and generally remained at about that level for the next two months. The pace at which banks were losing deposits also let up slightly.

The decrease in capital outflows was not enough to help the banks, though.
On February 3, the financial company Fiveca SF ran out of money and requested help from Fogade. Although it was not a commercial bank, Fiveca took deposits and operated money market accounts, and settled its payments through a commercial bank that faced no problems and would have suffered severely from Fiveca runs. After a lengthy debate, Fogade decided to include Fiveca in its assistance program and began disbursements.

On February 11, a fifth institution, Banco Metropolitano, ran out of money and asked for Fogade support. Five days later, on February 16, Banco La Guaira followed suit. By then, six banks, holding 32 percent of the nation’s deposits, had either closed, like Banco Latino, or were surviving solely on the infusion of funds provided by the deposit insurance fund, which in turn was being propped up by the Central Bank. It had all happened in just one month.

BOMBSHELLS

We soon had a glimpse of the new government’s style of banking crisis management. A few days after he took office, Sosa dropped a bombshell.

The new minister of finance testified during Congressional hearings on the Banco Latino collapse that “three or four banks could be taken over shortly by the government.” He hinted that the government was on to the their creative accounting, arguing that the banks’ balance sheets did not reflect their true condition. “It would be a tragedy to think that the banking system could be partially or totally nationalized,” he warned.10 Was the government contemplating seizing the banking system outright? No one could be sure, or understand what would happen to deposits if a seizure occurred. In the ensuing panic, runs on the ailing banks reached new highs. Fogade’s disbursements in two days, February 16 and February 17, mounted to an unprecedented Bs. 31 billion ($281 million).

Shortly afterward, the President tried to reassure depositors: no other banks would be closed, he promised.

The government also managed to embroil the Banco Latino workout in conflicts. Velásquez had appointed a team of three conservators a few weeks before. Despite his agreement to support his predecessor’s crisis-related ini-

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11 The government appointed a group of five bank CEOs and managers to the new board of intervenors of Banco Latino. They were linked to the Provincial, Mercantil, Caribe and Venezolano de Crédito financial groups. Except for the president of the board, all of them would serve on a part-time basis.
12 During their three weeks in office, the first team of conservators hardly moved anything ahead: they complained about the lack of information (they were unable to access the bank’s computers), their inability to take effective control over the Banco Latino operation because of the internal disarray, and the very little support from the government.
tiatives, Caldera and Sosa now created a directive board to oversee them. The original conservators, who had never been notified of their demotion, all resigned in protest on February 17. The new government was veering from one stopgap measure to the next, firing people and appointing new ones. It was shaking up what little public confidence remained. Caldera tried to fire Fogade President Esperanza Martínó, who had earlier offered her resignation to Velásquez and then withdrawn it. Now, she refused to step down. The President replaced several members of the Fogade board, but within days, some of the new appointees quit too. The press covered all of these confrontations in copious detail.

In the midst of this policy vacuum, angry Banco Latino depositors staged more fierce riots and demonstrations. President Caldera met with the leaders of the Banco Latino Depositors' National Front in Miraflores on February 18. He expressed sympathy with their anguish, and said to them: "If this were a time when the coffers were full, the government would not hesitate one instant in putting its resources into resolving the problem; however, despite the deficit, we have a way toward a solution." First he told the protesters that the government would require other banks to quadruple their contributions to Fogade. He also told them that the government was "considering the possibility of using public credit mechanisms to go to the Central Bank to obtain a portion of the funds that depositors are entitled to receive, and to offer them direct shares in Banco Latino." I was astonished. Preventing the Treasury from directly borrowing money from the Central Bank was one of the chief intents of the new Central Bank law; it was just this sort of abuse that drove up inflation and allowed governments to take a dangerously irresponsible approach to public finance.

The role of the Central Bank as lender of last resort had been misunderstood, and its statutory independence obviously was not taken seriously by the government. Officials and the public still viewed us as a source of unlimited support. This helps explain the general passiveness and lack of preparation for the banking crisis, as if a systemic meltdown was our problem—and our responsibility—to fix.

Fogade officials seemed to have the same view. On January 28, just three days after the Fogade program started, Fogade President Esperanza Martínó told the press that the Central Bank would provide "unrestricted" liquidity support to banks.

After Caldera intimated to depositors that government borrowing from us was even possible, public pressure on us rose. Some people thought we could singlehandedly bail out the banking system. Demonstrators began picketing the Central Bank. I met with a group of depositor association

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leaders. I was saddened to see what their members were going through. They were understandably angry at the Central Bank for letting Banco Latino fail, and for not informing people about what was coming. They did not understand why the Central Bank of Venezuela had not come up with the money to “save” Banco Latino. Only the previous month, the Bank of Spain had taken control of Banesto, a large and troubled bank, and had managed to reopen it after only one day’s closure. Everybody in Venezuela had read about the incident, and many people thought we ought to copy Spain’s example. I explained that our Central Bank, unlike the Bank of Spain and many other Central Banks around the world, had no power to regulate, supervise, sanction, or take over banks. I briefly told them the story of the efforts we at the Central Bank had made to stop Banco Latino from closing, the proposals we had made and the letters I had sent, trying for two years to catalyze government action. This was the first time I ever spoke to anyone about these letters. I explained that while it was my duty to inform the government, I could not have released the news to the general public without setting off a panic.

The meeting was an eye-opener for them, and a touching experience for me. I had the opportunity to meet face to face with people who had vociferously criticized us. I hope I was able to show them the true face of the Central Bank, and to disabuse them of the notion that the Central Bank was the culprit in Banco Latino’s collapse. I think I helped them better understand what we had done, and what we could not have done.

What people complained about most bitterly was the scant information they were receiving about reimbursement of their funds. I offered to convey their complaints to those in charge of making the decisions—the board of conservators of Banco Latino, Congress, Fogade and the government.

I held similar meetings with groups of depositors of Banco Hipotecario de Occidente, a mortgage bank affiliated with Banco Latino. It also fell into a sort of limbo for months, bringing pain to Andean mountain communities where the bank controlled a large market share. The paralysis spread to construction workers, suppliers, and homebuyers who had already prepaid part of the cost of their homes. Once again, I could see how confusion and uncertainty were the real enemies.

Depositors kept looking for people to blame. Some criticized the governments of Curacao and the Netherlands. In Maracaibo, there were demonstrations in front of the Dutch consulate.

125 The Central Bank Law mandated that loans to Fogade be given at the same rate as to other lending operations (i.e., rediscount window loans, usually the highest rate in the market), the philosophy being that subsidies (if any) should come from the government budget and should be channeled through Fogade’s financial assistance programs.
If the government was not forthcoming with information, neither was it forthcoming with contributions to Fogade. Fogade was left to depend almost entirely on expensive loans from the Central Bank.145

The government could have, and should have, stepped in at just this time with a plan to capitalize Fogade and pick up the cost of the bank restructuring program. But it did not. Instead, the idea that began to gain popularity within the government and on the Fogade board was that the Central Bank should start lending money to Fogade at preferential—below market—rates. That was against the law, too.

A LEADERSHIP VACUUM

By mid-February, Banco Latino had already been closed for over a month and the consequences had been devastating, with a third of the banks in the country either shut or living on government infusions of cash. The ailing banks needed new management, and new capital, be it from current shareholders, new investors or Fogade. Some of the banks still had sound assets and good franchise value, and some of their shareholders were actively seeking solutions.

Fogade’s program had served to stave off further bank closures, but alone could not solve the problems.

On February 18, 1994, I sent a letter to Sosa. I46 I told him that individuals, companies, banks, government institutions and the oil industry were still withdrawing deposits from the group of banks perceived to be weak. Fogade and the superintendent of banks had to join forces and begin with the obvious: reliable information about the banks and about government crisis management plans. So far, all of the data from the superintendent of banks had been inaccurate and outdated.

I urged him to get the government to use its deposits in the banking system to support the bank restructuring program. Neither the Velásquez nor the Caldera governments had ever formally told public administrators what to do with the bank deposits under their control. As a result, these civil servants were frantically withdrawing their institutions’ funds from the ailing banks, lest they get caught without sufficient money to run their agencies. It was understandable that they should act as they did: under Venezuelan law, they could be held personally responsible for their agencies’ losses.

But these massive withdrawals only deepened the banks’ liquidity problems and fed public fears. After all, citizens reasoned, if the government takes its money out of a bank, it surely must be on the verge of collapse.

Counterproductively, one government agency, Fogade, was spending taxpayer money to keep the banks open, while the withdrawals of other government agencies were fueling new runs.

I also suggested the government recapitalize Fogade. On February 16, the government required private banks to quadruple their contributions to Fogade, from 0.25 percent to 1 percent of total deposits every six months. That would raise Fogade's revenues to over Bs. 100 billion ($906 million) per year. But it still was not enough to see Venezuela's financial sector through the crisis. The government had to get authorization from Congress to borrow money to bankroll Fogade, a badly undercapitalized institution since its inception.

This reflected a traditional pattern in the Venezuelan public sector, where all institutions (such as industrial companies, banks and sectoral development funds) have been chronically undercapitalized. Popular needs were always more pressing. Perhaps it was also because nobody in government ever took too seriously the idea that the deposit insurance fund would be called upon to honor its commitments. In February, no one knew how big the bill for the crisis would be, but the government and Congress would have to decide how much of it would be paid for with taxpayer funds and then try to budget the money. I suggested that a proposal go to Congress at once.

I never got any answer to this letter, and nothing was done. A lack of teamwork aggravated the delay. The Office of the Superintendent of Banks and Fogade were both crippled. The chiefs of both agencies were in ambiguous positions, having officially resigned in recent months, but remaining on the job. For several months, neither institution had any real leadership. The new banking law called for these appointments to be approved by a two-thirds majority in the Senate. In late February the government finally did submit its first set of candidates, but without the customary consultation with Congress. Legislators took offense. Several senators protested that the candidates, Hugo Romero and Carlos Tinoco Garcia, had improperly close links to Sosa’s private banking business. This gave Congress the justification to give the nominations a thorough going-over in public hearings. After weeks of wrangling, Congress failed to approve any of the candidates.

Many weeks later, the government came up with a second slate of candidates, Tesatio Cadenas for superintendent and Norys Aguirre to head Fogade–candidates Congress finally approved. But they did not take office until the end of April.

167 Julio Sosa owned the Orinoco financial group, which included a commercial bank (Banco del Orinoco), a mortgage bank, a financial company, a leasing company and an insurance company. Carlos Tinoco was at the time the president of the group's leasing company, a job he was willing to resign if he were appointed. Hugo Romero had only helped set up a financial services company for the Orinoco group many years before.
ECONOMIC RIGHTS ARE SUSPENDED

On February 26, Caldera took a drastic step for a minor reason. The President suspended the Constitutional right to freely conduct economic activities, merely to block implementation of the last leg of the VAT tax approved under the Velásquez government. Had he addressed the issue in time, the President could have stopped the tax with an ordinary proposal to Congress. But his Finance Ministry had apparently overlooked the February 28 implementation date for the tax, and so it was too late for that.

Although the suspension of economic rights was unrelated to the banking crisis, the government’s action fed into general societal confusion and instability. For decades, suspending Constitutional economic rights was the way for presidents to impose government controls on rents, prices or interest rates. Nobody understood what Caldera intended to do with the measure now.

To the business community, suspension of the Constitution was a sign of the government’s readiness to return to controls and populist policies. It eroded investor confidence and fueled a new rise of capital outflows. At the same time, political parties in Congress applauded Caldera’s decision—at last the government was giving signs of its willingness to begin “acting”—and unions greeted it joyfully because it seemed to open the door to price controls and salary increases by decree.

It ended up being the worst of all worlds: for different reasons, all sectors were confused and disappointed. The government limited itself to changing the VAT, and the issue eventually faded away, though economic rights were not reinstated until four months later, in mid-June.

I deeply regretted Caldera’s decision. Adopting such a serious measure only to change a tax—something he could have achieved by ordinary means—told me he would be ready to override other institutional and economic principles to force policies to move his way.

CONGRESS TAKES THE REINS

While the Caldera regime dithered, Congress, pressured by constituents, turned its attention to the banking crisis promptly in early February. Amazingly, a fractious Congress managed to pull together and pass its own financial emergency legislation in less than two weeks.16 Since half the people in the country were affected, constituents were beating down congressmen’s doors.

16 Decree No. 51, Gaceta Oficial No. 35-110, February 26, 1994.
16 Ley Especial de Protección a los Depositantes y de Regulación de Emergencias en las Instituciones Financieras, Gaceta Oficial No. 35-118, March 10, 1994.
The legislation took up the depositors’ cause, proceeding from the assumption that Banco Latino and its affiliates had misled them by placing money they thought was going to be insured into uninsured, off balance sheet, and sometimes offshore accounts. To ingratiate itself with depositors, Congress extended the official safety net to cover all bolivar-denominated liabilities of the Latino group, no matter which individual institution had taken the funds, and whether deposits were made at home or abroad. Depositors got what they wanted.\(^{19}\) The new law also laid down conditions for reopening Banco Latino and protecting its assets, Fogade would take over and recapitalize the bank once the board of conservators submitted a plan. The plan itself would not be subject to a vote of Congress, but, practically speaking, reopening the bank would be impossible without the legislators’ approval.

The emergency law also put into force a number of other measures. It froze all assets belonging to Banco Latino directors and managers and gave Banco Latino’s conservators the power to request court orders to nullify payments, asset sales and transfers carried out by the bank during the two years prior to the government takeover. It also left open the possibility that Banco Latino’s depositors might be forced to recapitalize the bank, by obliging them to accept shares in exchange for any lost deposits. I found that disagreeable. The idea that deposits could suddenly turn into unredeemable bank shares would do nothing but further undermine the public’s confidence in the Venezuelan banking system.

The amendment also broadened everyone’s powers to rehabilitate troubled banks. It permitted Fogade to furnish loans more readily,\(^{181}\) it also authorized Fogade to lend to banks at below-market rates, and the Central Bank to lend to Fogade at below-market rates.\(^{152}\)
The legislation obliged the Caldera government to capitalize Fogade, though it did not set a deadline. Crucially, Congress formally stated its willingness to approve public sector borrowing, an unprecedented move in Venezuelan law.\(^{155}\) A week later, Congress passed the legal authorization for a government bond issue. It was crafted as an omnibus so that the government could use it progressively, as needs developed.\(^{154}\) Congress authorized the government to raise the funds by selling Bs 400 billion ($3.5 billion) in bonds, for Fogade to cover the cost of the cleanup. At that point, the amount seemed reasonable, and had the government moved swiftly to raise those funds in March, it surely would have relieved the pressure on the Central Bank and have sent a sensible message to the markets. But the government made no attempt to raise funds in the markets until July. Another provision gave the executive branch the power to levy a special contribution by the banks to Fogade to cover the cost of the Banco Latino bailout. Luckily, this measure was never enforced.

The new law also authorized foreign banks—long a controversial subject—to take equity stakes in troubled banks.\(^{155}\) After many years of fighting their entry, politicians and bankers alike began to see overseas banks as potential saviors. Yet the invitation was distinctly uninviting. The legislation not only required the new shareholders to repay all Fogade loans, but also to guarantee that they would repay all depositors and other creditors. No bank in the world with a sensible approach to risk management could be expected to commit to such an open-ended obligation. And no bank did.

The emergency law laid the groundwork for a solution. But laws do not by themselves solve problems; what counts is the way laws are used. For this one to be effective, the Caldera government had to take up the law and put its provisions into effect.

But Caldera and his team voiced reservations over the emergency law.

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\(^{155}\) This was the first time that Congress obliged the government to capitalize Fogade. Until then, capital contributions from the government to Fogade were an option laid out in the Fogade statute and, since January 1994, in the banking law, but no operational rule ever forced the government to do so. Second, Congress’ declaration of intent to approve a public credit law to this end was also a departure from the mechanism routinely applied, whereby the executive branch requests from Congress the authorization to borrow and is subsequently authorized by means of a specific public credit law.

\(^{154}\) Ley Especial que autoriza al Ejecutivo Nacional a realizar operaciones de crédito público destinadas a efectuar aportes al patrimonio del Fondo de Garantía de Depósitos y Protección Bancaria (Fogade) por la cantidad de cuarenta y cinco millones de bolívares. \textit{Gaceta Official} No. 35,424. March 18, 1994.

\(^{153}\) Foreign banks were already allowed to operate in Venezuela, under the 1994 banking law. Congress’ mention of the subject mainly served to underscore the invitation.

\(^{156}\) The emergency law gave Fogade the power to demand total or partial changes in the boards of banks getting financial assistance. When total loans from Fogade exceeded 20 percent of deposits, Fogade was forced by law to suspend at least one-third of the board of the bank until the general shareholders’ assembly selected new board members. The superintendent of banks had veto power over Fogade’s decision.
and everyone feared that he would reject it. In some areas, Caldera’s objections made sense. He wanted the power to immediately remove the private boards of financial institutions that received Fogade’s assistance. As things stood, the same managers who had run down the banks were allowed to keep running their institutions, even though Fogade was paying the bills.

The administration also wanted members of the board of conservators of Banco Latino to be allowed to run other intervened banks and financial institutions. Some legislators considered that a government maneuver to turn the banking system over to a small group of its favorites. On the government’s side, it should be said that perhaps placing the troubled banks in the hands of a single, unified management team might have helped matters.

Neither government nor Congress cared about mergers and acquisitions as a tool for banking sector restructuring. Both the banking law and the emergency law omitted it, and Caldera, at this crucial juncture, did not bring it up either.

Caldera focused most of his energies on blaming and punishing: his administration wanted the Procuraduría General, the attorney general’s office, to find and prosecute individuals responsible for the failure of banks, instead of leaving this up to Fogade, as stated by law.

To everyone’s relief, Caldera eventually agreed to sign the bill. He did so at a formal ceremony at Miraflores, where hundreds of guests watched and his action was broadcast across the nation. But before the ink was dry, he announced that he would ask Congress to amend the bill. Legislators—particularly those of Copei and Causa R—were furious at the implied insult to their plan.

HUNTING FOR SCAPEGOATS

Meanwhile, the board of the Central Bank and I were coming under ferocious political attacks. Banco Latino’s managers complained to the newspapers and anyone else who would listen that we had excluded their bank

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157 Neither the emergency law nor the banking law allowed Fogade to lend to banks and financial institutions to enable them to acquire controlling interests in ailing banks unless they had been previously taken over by the government. Legislators worried that such funding would enable the more powerful banks to take advantage of the crisis. Tax regulations also hampered bank mergers and acquisitions. The 1991 income tax law abolished the government’s power to grant special tax exemptions to banks that acquired (or merged with) ailing banks, and corporate income tax rules only allowed the banks to deduct losses after they had taken place—no provision allowed a more attractive treatment of potential losses from merging with problem banks.

158 Caldera’s team did draft a bill to amend the emergency law, but never submitted it to Congress.
from the clearing system too precipitously. On the other hand, some politicians, particularly on the left, were harshly criticizing us for having favored Banco Latino by waiting too long to take action.

Media commentators, analysts and politicians criticized the superintendent of banks and Fogade, and the taint inevitably spread to the Central Bank, an institution that was respected by the public but had no real constituency. The Central Bank had kept a low profile, and its voice was largely technical.

Suddenly, though, we found ourselves in an unfamiliar political role. We had been most frequently criticized for running a tight monetary policy, in a climate where interest rates stood at about 60 percent. We were later accused of letting Fogade assume an unmanageable debt burden.

The high interest rates were lambasted bitterly by consumers and businesses of all sizes. Politicians spoke out against them. Manufacturing representatives visited us. Farmers organized protests, traveling to Caracas with their tractors and cattle and demonstrating in front of our offices. Despite the attacks, however, the Central Bank's institutional prestige—and absolute adherence to the law—helped it keep the public's respect.159

The Central Bank's new independence didn't last intact for long, though. The banking crisis let the government to chip away at it.

Caldera wanted those rates to come down. Presidential associates, including members of Copei, the party Caldera had founded nearly four decades earlier, and leftists and radicals, criticized us publicly. Then several cabinet ministers accused the Central Bank, and me personally, of blocking the government's economic program. I imagine that feeding the popular furor against the Central Bank was a way for the government to distract the public, to buy time to scramble for solutions. Though we did not have many defenders, our side in the controversy was not without its adherents.

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159 In March 1994, a survey conducted in three major Venezuelan cities showed that 46 percent of the people polled assigned "some" responsibility to the Central Bank for Banco Latino's problems, while 85 percent believed that Banco Latino owners were mainly to blame. Fifty percent of the respondents thought that the actions taken by the Central Bank to solve Banco Latino's problems were appropriate, and 62 percent also thought that President Caldera was doing a good job. A survey conducted in October 1996 showed a shift in public perceptions. By then, the government, politicians and bankers were taking most of the blame. 70 percent of the people agreed with the Central Bank's policy of supporting the ailing banks in the first half of 1994. Some 68 percent believed that loans to banks helped overcome the crisis. Some 62 percent of the respondents believed that the money loaned to the ailing banks had been misused, to benefit the bankers. Finally, 76 percent said they did not know how much the crisis cost. Consultores 21, Percepciones sobre la actuación del BCV en el caso del Banco Latino, March 1994; Datanalysis, Imagen pública del BCV en el contexto de la crisis bancaria 1994-1995, October 1996.

160 The Central Bank borrowed from the IMF and the markets to on-lend to the government, so it could purchase U.S. Treasury securities to collateralize the new Brady bonds that helped fund the deal.
Central Bank-government relations were strained for another reason: the government already owed us $2.3 billion, funds the Central Bank had lent it in 1990 so it could restructure its debts to foreign banks.²⁰² The government had stopped repaying us in mid-1992. Now the banking crisis was driving the government's debts to us even higher.

On March 9, we began to fight back. The board of the Central Bank filed a complaint with the Fiscalía General, the public prosecutor's office, explaining in detail what we had done so far to stem the crisis and requesting legal protection for the board of directors and staff of the Central Bank. The Central Bank had become the target of a malicious public opinion campaign designed to undermine its autonomy and effectiveness. Unfounded and unattributed charges, innuendoes and criticisms were made in the media and on the floor of Congress, which we decided required prompt and unequivocal rebuttal. We also issued a public statement, explaining the process that led to Banco Latino's failure and the Central Bank's role in trying to prevent it.

At the same time, there were insidious efforts to sabotage daily check-clearing operations. Groups of Banco Latino depositors, led by local leftist radicals, pretended to demonstrate in front of the Central Bank's Maracaibo offices, where the daily check-clearing operations for the western part of the country take place. We were appalled to discover that their true intent was to block access to the bank at the hour documents move in and out, and cause check-clearing to fail. Simultaneously, in several major cities across the country, branches of the commercial banks in charge of the regional clearing operations suffered similar assaults and blockades. Were they trying to bring down the country? I informed Caldera and Sosa, but nobody did anything to protect the Central Bank. Instead, our staff stepped up security and made sure the private clearing banks were properly secured, too. We managed to keep the clearing operations running without a hitch. After several weeks of trying unsuccessfply to interfere with clearing operations, the groups behind the sabotage gave up. None were ever apprehended or prosecuted.

In March, the government began promoting a so-called heterodox stabilization program. Several ministers campaigned publicly for solidarity pacts—agreements among business, labor, banks, special interest groups and non-governmental organizations—in an effort to move the economy toward growth and price stability. It was our old way of running things. Much to my surprise, some ministers also complained to the press that the government was having difficulty negotiating a pact with the Central Bank.
We had not been asked to negotiate anything. In fact, we invited government ministers to present their economic program to us and to explain what they expected from the Central Bank. The few meetings they attended never arrived at any conclusion.

ARREST WARRANTS

The most powerful reaction to the collapse of Banco Latino was the thirst for punishment.

Rather than organizing a plan to handle the crisis, President Caldera focused on finding culprits. Fogade and the Central Bank were somehow considered just as blameworthy as Banco Latino. Banco Latino officials continued to maintain that politics and the Central Bank were responsible for the mess. But the sad fact of the matter was that Banco Latinó was so poorly managed that, even with all of its political influence, its officials could not build a bank that worked.

Of course, in a way, everybody connected was to blame.

Paraphrasing John Kenneth Galbraith, while the crisis was brewing, and everyone was betting to win, the winner-take-all mentality was a retreat from reality. After the crisis exploded, the financial bingeing looked like it had been "a retreat from sanity."

Once in a while, Caldera had a kind word for us, as in a speech he gave on March 2:

"I must say that—to face up to the crisis—the Central Bank of Venezuela has helped, going even a little bit beyond what could normally be expected from that institution and I believe, I am convinced, that all interested parties—savers, depositors, checking-account holders, those holding trust accounts or interests in Banco Latino—can rest assured that everything humanly possible is being done to face up to that terrible event in the most satisfactory way."

But we could not count on such faint praise. That very day, for example, I heard that the judge investigating the Banco Latino case planned to issue arrest warrants for more than 80 people, including me.

Most people who suspected they were on the list fled the country.

I stayed.

I went with the board of the Central Bank to visit President Caldera, to see what he had to say. He praised my work. But he did not promise to invoke the legal safeguards that protect high-ranking officials from being

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102 President Caldera's speech to the nation, March 2, 1994: Caldera, *op. cit.*, Tomo 1, p. 64.
arrested without due process. At the end of our conversation, he offered to let me be arrested at his house, if a warrant were issued. His offer was a courtesy, but one I declined.

That evening, the judge issued 81 arrest warrants, mostly for Banco Latino's directors and managers, and also for lower-level employees. They were all equally villainized as common criminals.

Urbina was the only public official to receive an arrest warrant. He was forced to step down, and was accused of complicity for allegedly allowing Banco Latino to publish deceptive information. He was acquitted a year later.\footnote{Emilio Negrón served briefly as acting bank superintendent and was replaced by Tesalio Cadenas (April 1994 to March 1995). Francisco Debera was named superintendent in March 1995 and was still serving in November 1999.}

Fortunately, I was spared.

Only five of the 81 were ever convicted of anything. Gómez López was one of them. But he was among those who ran away. He has remained outside of the country for years.

Criminal court judges also prohibited the board members of all eight banks receiving Fogade aid from leaving the country. That is the rather ham-handed standard operating procedure in Venezuela, a way to keep all possible suspects available for arrest in case an investigation uncovers wrongdoing. But in this case, it sent a particularly confusing signal; these officials were still running their banks, doing business with depositors, and receiving Fogade funds, to boot!

This aggressive approach unfortunately encouraged many qualified people to leave their jobs in Venezuelan financial institutions and emigrate, rather than risk getting caught by problems they had not known about. But it also had a positive effect. Venezuelan banking leaders were forced to rethink their roles and responsibilities. Members of bank boards, who had often held largely rubber-stamping roles, now refused to get involved casually.

**BANK DEBIT TAX DEEPENS THE CRISIS**

On April 18, Congress gave the government special legislative powers to implement its fiscal plan.\footnote{Ley Orgánica que autoriza al Presidente de la República para dictar medidas extraordinarias en materia económica y financiera. *Gaceta Oficial* No. 35412, April 18, 1994.} The Sosa Plan, as this program came to be known, was a set of tax measures shaped in the government’s first weeks in office, rather than a comprehensive economic program. Still, it was the only concrete economic proposal that the government had offered, and it came
about only after several weeks of heated debate between the executive and Congress. Ironically, it was Acción Democrática, the opposition party, that formally proposed and rallied behind the idea of giving Caldera special powers. No longer would the administration be able to accuse Congress of obstruction, the party’s rationale went. This tactic threw all of the responsibility back into the President’s lap.

The plan included a measure to tax bank debits, a concept that first gained currency in Venezuela in 1992. It was initially conceived as a 2 percent flat tax on all bank withdrawals. The government expected the tax to raise a hefty Bs. 170 billion ($1.6 billion), or 2 percent of GDP.165

I thought such a policy would have disastrous results. Brazil, Peru and Argentina had each tried this without success. People trying to elude the tax increased their use of cash, damaging financial sector development. Anecdotal evidence suggested that the tax produced two main beneficiaries: criminals who knew people were carrying large amounts of money, and the armored car services needed to protect the huge cash supplies that had to be shipped across the country to meet payrolls and bills. Fraud increased, as people increasingly resorted to bearer checks endorsed over and over. The policy encouraged corporations and wealthy individuals to spirit their money out of the country, reducing domestic savings and weakening the banking system.

The tax was also regressive and unfair, hitting salaried workers who could hardly avoid it, while allowing corporations and the wealthy to wriggle out of paying, mainly by moving their payments to offshore financial institutions or by arranging barter. Efficient firms with high inventory rotations and low profit margins would pay higher taxes. It would also have a calamitous effect on the securities market. It would sharply boost investment transaction costs because each purchase or sale of securities would be hit with several taxes as the payments passed through the seller’s, broker’s, exchange’s and the buyer’s accounts.

Furthermore, in my view the tax infringed on provisions in the Venezuelan Constitution, which forbids confiscatory taxes. The bank debit tax would not tax income, but would confiscate a part of a client’s assets each time a transaction involving bank deposits took place.

165 The new law allowed the executive branch to implement a variation of the value added tax that would be levied up to the wholesale level. It was to be coupled with a luxury tax on a wide array of consumer goods and services: automobiles, cable TV, private airplanes, yachts and boats, jewelry, fine rugs and furs. Consumers would not see the tax on their invoices, although they would be paying for the tax levied in all previous stages, and—to complete the masquerade—the name of the tax was changed from IVA, meaning value added tax, to ICSVM, meaning luxury consumption and wholesale sales tax. The government would set the rate for the wholesale tax each fiscal year between a minimum of 5 percent and a maximum of 20 percent. The luxury tax rate was 10 percent to 30 percent. Clearly, the combination was a less efficient tax than a retail VAT that would have raised up to 10 to 12 percent of GDP. Consequently, the government needed to make up (at least in part) for those lost revenues. The solutions: the corporate income tax rate would rise from 30 percent to 34 percent, and there would be a tax on bank account debits until December 31, 1994.
It also could lead to a shortage of bank notes. Unless planned for well in advance, it would be very difficult for the Central Bank to get enough currency to satisfy the added demand. I did not want to add a bank note shortage to the myriad problems we already had. When the idea of a bank debit tax was first proposed, under the Pérez government, the IMF and other experts helped me prevail upon Pérez’s team to drop the idea.

The idea of setting up a bank debit tax resurfaced in mid-1993, when the cash-strapped Velásquez government found it a quick fundraising option. I argued against it again, and once again persuaded the government to back off on the project.

In my early conversations with Julio Sosa, before the collapse of Banco Latino, I alerted him to the perils of the bank debit tax—which became all the more significant in light of the banking crisis. Some members of Caldera’s economic team agreed with me.

Nonetheless, the government instituted it, though only for eight months. The rate was eventually lowered from 2 percent to 0.75 percent.

The tax was in force from May 1 to December 31, 1994, and I believe that it harmed the Venezuelan financial sector severely, though its effects could not be clearly distinguished from problems generated by the banking crisis itself—runs and capital flight. Too many things were happening at the same time to allow for a more precise analysis. There were signs, however, that the tax contributed to capital outflows and larger cash holdings by the public. The percentage of cash in the money supply, or M2, rose from 7 percent in January to 9 percent in June-July, and reached 11 percent by December. The volume of cash in the hands of the public had more than doubled by year-end. Seeing people stuffing their coats, purses and wallets with huge packs of bank notes and paying cash for big-ticket items like refrigerators or cars became familiar scenes. Because the tax exempted transactions within the same bank, the policy intensified the flight to quality that was accumulating money at reputedly strong institutions while sapping the strength of the others.

This tax raised only Bs. 120 billion ($800 million), about 1.4 percent of GDP. That was 53 percent of the amount the government had hoped for. Opposition to it slowly grew, and the government eventually dropped the idea of renewing it.

A RESTIVE PUBLIC

As the public discerned that the government had no coherent strategy to address the Banco Latino crisis, demonstrations became common, though still disturbing events. Contradictory announcements kept coming out of the government and the regulatory agencies.
People did not understand the implications of a bank’s receiving Fogade assistance. In an effort to stem the unrest, regulators began instructing the ailing banks not to disclose their financial statements, which had previously been published monthly in newspapers. Of course, the lack of information alarmed people even more.

On March 22, a seventh bank, Bancor, asked for Fogade help. This institution had weathered substantial withdrawals for some time and had requested a loan from Fogade on February 20. Although Fogade approved the loan, the bank never used the funds, managing to survive with its own money. Its shareholders began negotiating to turn control over to Banco del Caribe. But when the negotiations failed, the bank was forced to seek Fogade support.

On March 23, Banco Hipotecario de Occidente, the mortgage bank of the Latino group, joined the Fogade assistance program. Banco Amazonas, a commercial bank, followed suit on March 29.

The banks depended on Fogade’s funds for day-to-day survival. And Fogade depended entirely upon Central Bank loans. Lacking clear government policies to guide the depositors, Fogade’s daily disbursements rose or fell depending on the market mood of the day. Some banks improved temporarily and began repaying their debts. Soon, though, they fell back into the red.

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Chart 3-1
Caracas Stock Exchange and Venezuelan Brady Bonds

![Graph showing CSE and DCB prices from January 1994 to April 1994.](image)

Source: Central Bank of Venezuela
THE CENTRAL BANK IN A BIND

By early spring, the Central Bank was forking over about Bs. 2.5 billion ($21 million) to Fogade each day. The bolivar was coming under increasing pressure. Foreign reserves were falling. Interest rates climbed to about 65 percent, and inflation was rising toward heights we had rarely seen before: it would pass 70 percent that year.

It was very hard for the Central Bank to conduct a sensible anti-inflationary monetary policy under these circumstances. We found ourselves trapped in a vicious circle: we were printing money to prevent the collapse of the payment system, an act that also could send inflation higher. But with the other hand we were trying to remove inflationary extra money from the system via our expensive zero-coupon bonds. This situation arose from the generalized loss of confidence caused, essentially, by the lack of a government solution for the problems of the ailing banks.

Unfortunately, the zero-coupon bond was the only tool we had to mop up excess liquidity. Yet with such high interest rates, this was also self-defeating, as the Central Bank’s interest payments were themselves increasing the money supply.

Raising banks’ reserve requirements would have been useless; the ailing banks had already been exempted from reserve requirements and the burden would have fallen disproportionately on the better-off banks.

The only way out of this problem now was for the government to come up with a crisis management policy that restored depositor confidence. Moreover, the government and Fogade had to pick up the tab for the crisis and start issuing their own bonds, as this would recycle the money supply.

Instead, Caldera and his team focused on harshly criticizing the zero-coupon bond policy, even as the government failed to offer any alternative. They would never admit that the Central Bank used the zero-coupon bonds as a key tool for minimizing the monetary expansion caused by the fiscal deficit and the bank financial assistance program. The fact that the bonds helped to minimize the impact of financial instability, and also helped maintain unrestricted foreign exchange arrangements and free convertibility of the bolivar, seemed unimportant to them, too.

The Superior Council met several times in March and April to discuss the banking problems and to assess the Fogade program. The Council always unanimously agreed to keep the program going until the Office of the Superintendent of Banks and the deposit insurance agency could make decisions. But the minister of finance, Fogade and the superintendent of banks could not agree upon a course of action. There seemed to be too many legal and operational difficulties in the way of capital increases, management changes or new business plans in the banks under Fogade’s control—though
those were exactly the things that they needed most. So, in spite of reaffirming the government's support to the ailing banks, the Council's announcements did not stave off the panic.

In a way, the ailing banks were also caught in a trap. Since the inception of the liquidity support program, Fogade had imposed “holding” restrictions on them. Their purpose was to ensure that the priority use for bank funds would be to service depositors and keep the bank running. The rules kept banks from making new loans, freeing collateral in the absence of loan repayments, engaging in transactions with affiliates or individuals on preferential terms, and selling or exchanging assets without permission from Fogade and the superintendent of banks. Although bank boards and management remained in place, Fogade appointed supervisors to the ailing banks to oversee the use of the funds they had lent. These government appointees could veto decisions of the boards of directors and were to serve for the length of the lending program.

These holding measures were appropriate as an interim solution. If kept for too long, however, they could interfere with a bank’s ability to conduct business. Moreover, with two different agencies supervising, and obligated to give joint approval of decisions, a bank could be completely hamstrung. Fogade and the superintendent of banks frequently had conflicting views. The two key institutions responsible for managing the crisis found it difficult to coordinate among themselves in normal times. Collaboration during the crisis became almost impossible. Consequently, owners and managers of banks in the assistance program complained that they submitted restructuring and recapitalization plans to the minister of finance and to the regulators, but never obtained any approval or resolution.

Regulators’ ideas could get lost, too. In early March, for example, the new superintendent of banks proposed a way to more precisely value bank assets. Investments in securities and foreign currency-denominated assets should be valued at cost or market value, whichever was lower. The superintendent also raised the possibility of converting the specialized lending institutions into universal banks. Here were good ideas that got drowned out by poor crisis management.

BANCO LATINO REOPENS

Once the emergency law was approved, Banco Latino’s management began preparing a plan to reopen the bank. It called, first, for recapitalization—to cover accumulated losses and restore capital ratios to acceptable levels. That would allow the bank to start taking deposits and lending again. There were also ideas to separate Banco Latino into a “good” bank and a “bad” bank, as
some Nordic countries were doing—separating the bad assets from the good ones in order to allow for a more orderly resolution process. Banco Latino’s board of conservators negotiated the plan with Congressional leaders and formally presented it in late March, after government-appointed auditors concluded their work.

Auditors concluded that the bank had lost over Bs. 300 billion ($2.6 billion)—50 times more than the superintendent of banks’ January 14, 1994 estimate. Fogade then recapitalized the bank in accordance with the financial emergency law.

The Central Bank funded Banco Latino’s rehabilitation, virtually single-handedly, also under the provisions of the financial emergency law. Fogade had infused Bs. 312 billion ($2.7 billion) into the bank: Bs. 300 billion ($2.6 billion) to cover losses and Bs. 12 billion ($106 million) to replenish its equity capital. About 94 percent of the money came from a Central Bank loan to Fogade (Bs. 294 billion, or $2.6 billion).

On April 4, 77 days after it closed, Banco Latino at last reopened to the public.

Depositors rushed to rescue their funds, but there were limits. Depositors could withdraw up to Bs. 10 million ($95,238) in cash. In a country where the basic salary was less than $2,000 per year, that covered the needs of the vast majority of individual clients. But amounts above that were paid in low-interest 10-year bonds, meaning that wealthier individuals, institutional and corporate clients were in effect obliged to pay for some of Latino’s losses. 100

Disturbingly, the reopening of Banco Latino did not restore depositor confidence. Not only did Latino suffer heavy withdrawals, but runs on the other ailing banks just kept on going.

Fogade fell into disrepute. It was clear that its program—known colloquially as the auxilios, or aid program—was not strengthening the banks. Indeed, it was just the opposite. The banks were still losing deposits. Their assets were pledged as collateral to Fogade. They could not conduct any new business. And their losses were increasing daily. The original bank managers remained in charge. Particularly because of their ambiguous legal positions, that policy came increasingly into question. The shareholders presented plans and entered into lengthy discussions with the authorities, but

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100 The yield on Banco Latino bonds was determined on the basis of the following scale:

<table>
<thead>
<tr>
<th>Amount of deposit in excess of Bs. 10 million</th>
<th>Percentage of the 90-day deposit rate1</th>
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</thead>
<tbody>
<tr>
<td>Up to Bs. 10 million</td>
<td>80</td>
</tr>
<tr>
<td>Bs. 10 - 20 million</td>
<td>50</td>
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<tr>
<td>Bs. 20 - 30 million</td>
<td>40</td>
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<tr>
<td>Bs. 30 - 40 million</td>
<td>30</td>
</tr>
<tr>
<td>Bs. 40 - 50 million</td>
<td>25</td>
</tr>
<tr>
<td>Over Bs. 50 million</td>
<td>20</td>
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1Calculation based on the average rate paid by the six largest commercial banks.
came to no conclusions. Although the government had announced that no more banks would be closed, high-ranking government officials would often make statements to the contrary. The mixed signals indicated to everyone that closures could never be completely ruled out. The international spillover effects also continued.\footnote{The offshore operations of the troubled Venezuelan banks ran into severe liquidity problems because depositors made so many withdrawals. The Central Bank of the Netherlands Antilles seized Banco Maracaibo NV in early March 1994. Offshore operations of other Venezuelan failed banks were subsequently taken over and liquidated by the authorities of Curaçao and Aruba.}

**Chart 3-2**
Fogade Assistance Program
Daily Disbursements
January 25 to June 14, 1994

Billions Bs.

Source: Central Bank of Venezuela

PRESSURE TO CUT RATES

The President had an autocratic nature. Throughout his public life as leader of Copei, and demonstrably during his first administration, he rarely accepted dissident views.

So I knew he was unlikely to brook much opposition from the Central Bank now. Caldera and the members of his team disliked the idea of a strong, independent Central Bank in the first place. There were strong disagreements on policy issues, too. His lack of receptiveness to our recommendations, and the fact that our views on economic policy dif-

fered, made me realize he had not changed.

One of our primary areas of disagreement was the monetary policy stance, Caldera’s team favored low interest rates—even if they were negative in real terms, even if they had to be set by administrative fiat. Some members of his team even blamed our monetary policy for the high rates they believed caused the banking crisis.

Was Central Bank monetary policy really to blame for high rates? Not in my view.

The factors that drove rates up in 1992 and 1993 were numerous and complex. Moreover, they were not simply the reflection of Central Bank’s policies.

First, since the 1970s, banks by law were obliged to give at least 17 percent of their total loans to the agricultural sector, at below-market rates. Banks managed to offset their losses by securing a convenient income tax exemption. But in 1992, that policy was abolished. To compensate for the loss of the tax break, banks raised their lending rates to all non-agricultural customers.

Higher interest rates also reflected the influence of distressed borrowing by the government and banks. And lending rates reflected borrowers’ higher credit risks, too. Recession, inflation and high operating costs were squashing real profits.

The 1992 coup attempts also drove interest rates higher. Since foreign investors backed away from anything Venezuelan that year, the government and PDVSA were forced to raise funds domestically. They were the country’s top-ranked borrowers, and their domestic borrowing led the debt and loan markets to charge an additional risk premium to private companies.

Once interest rates had jumped in response to instability and capital flight, banks would hold them there, and fail to lower lending rates again when new money came into the system. They were essentially just compensating themselves. Some banks seemed to have no choice: they paid exorbitant interest rates out of fear they would lose depositors if they did not. This increasing pressure kept the interest rate floor rising like a slow-moving elevator. And with each day that passed, the banks found it harder to get off.

Under these circumstances, a monetary policy aimed at preventing interest rates from rising, or an attempt to force them down with a stroke of the pen, would simply have caused a bigger crash, hastening capital flight, withdrawals by depositors and speculative attacks on the currency. Sooner, rather than later, this would have culminated in disastrous exchange controls.

Yet in the worst days of the banking crisis, Venezuelan society was crying out for just that sort of intervention. People wanted quick fixes, a return to the fondly-remembered comforts of the past. There were those who told me that it was not worth the pain of forcing the economy to operate with such high interest rates, just to preserve economic freedom and protect foreign reserves. Despite the fact that controls would have made Venezuela an international
pariah, some people considered controls the least painful of choices.

We at the Central Bank had a different view. Venezuela’s severe capital outflows in the 1960s and early 1980s were always triggered by large government deficits. Exchange controls had been the way to mask the problems, and at a terrible cost. Our experience in the 1980s with exchange controls and interest-rate regulation had been dreadful. To us, the lesson was clear. It would have been wrong to force interest rates down, and I was not going to do it. Addressing the macroeconomic imbalance and the banking sector’s problems, instead of seeking shelter in controls, was the only way to restore real confidence in the market.

Indeed, artificially lowering rates would not have prevented the banking crisis in the first place. The bad loans destined to bring the banks down had already been made—long before the crisis, and long before I took office.

CONTROVERSIAL ZEROS

Caldera also disapproved of the use of zero-coupon bonds, complaining that they were a subsidy for banks, and prevented banks from lending to businesses in need of credit.

And he objected to the crawling peg exchange rate system—a steady devaluation of the bolivar at regular intervals—that the Central Bank had held in place since end of 1992. Instead, he wanted a stable nominal exchange rate, even if it had nothing to do with the state of the economy and would be hard to maintain.

Finally, he seemed to have trouble working with the leadership of the Central Bank because we were not his team. Although none of us were politicians, he probably resented the fact that the Pérez government had originally appointed us all. With the exception of Alfredo Lafée (who served as Central Bank president under Caldera in 1971), none of us had ever been close to him.

Government criticism of the zero-coupon bond policy was particularly bitter. Members of the President’s team stepped up their criticism of them in March and April, claiming that zero coupons were a subsidy that killed banks’ incentive to lend. The zero-coupon policy was evil—perverso—according to Caldera officials, who refused to recognize their true role: to manage the money supply via open market operations.

I would be the first to admit that the zero-coupon policy was imperfect. First, because the Central Bank had to pay market interest rates, the bonds were costly, and their effect snowballed on the Central Bank. Second, it was true that the bonds provided banks with a risk-free investment, and to some extent, crowded out the supply of loan funds to other would-be borrowers.
However, the zero-coupon bond was less a cause of these problems than a consequence. The government’s fiscal policy continuously expanded the money supply, and there was limited demand for money in the recessionary and highly uncertain economic environment. The Central Bank had no other instruments to limit liquidity without further damaging the banking system’s soundness and, ultimately, the safety of depositors and borrowers.\footnote{Rediscount rates are ineffective in Venezuela, because the transmission mechanism from the Central Bank’s lending rate to market rates is extremely weak. Raising reserve requirements would have put strong pressure on the weaker banks. It was also the equivalent of a tax on financial services that would have quickly translated into lower deposit rates and/or higher lending rates, and further secession from the banking system. More banking operations would have been siphoned off to offshore jurisdictions and off-balance sheet instruments.} Moreover, the Central Bank’s bonds had been very effective in helping to stabilize the financial markets and in maintaining the country’s foreign reserves in the turbulent times of 1992-1993. The weekly bond auctions allowed us to better cope with the sharp declines in the demand for money, served as a leading indicator of market rates, brought more depth into the interbank money market, and attracted funds into bolívares instead of dollars.

We were very concerned with stability, and with maintaining an appropriate level of foreign reserves to guarantee that Venezuela could keep paying its bills abroad. In critical months, Venezuela could lose over $600 million per month in private capital outflows. Reserves were still respectable—about $11 billion, enough to cover nearly a year of imports. But if the Central Bank had stopped issuing zero-coupon bonds, the money supply would have ballooned, fueling inflation. And we would have had greater losses of foreign reserves since we would have had less ability to attract and keep capital in the country.

It is true that an interest rate rise to unprecedented highs of more than 65 percent by the end of 1993 aggravated the banks’ problems. But keeping rates artificially low would have shattered the foreign exchange market, increased inflation and ultimately deepened the country’s economic problems. Instead of helping the banks, that would have worsened their liquidity problems and pushed them much more quickly toward insolvency. Furthermore, there were clear signs that a group of problem banks (led by Banco Latino) had themselves pushed up interest rates in 1992 and 1993 in order to stay afloat. That move alone should have tipped off bank regulators that something was amiss.

Then there was the argument that the Central Bank should have prevented the crisis because we knew what was going on. Little was said about those government officials who had the duty to know and to act, and failed to do so. The fact that the Central Bank did everything in its power, and that I and my colleagues had often met with government officials and managers of troubled banks, and offered sound advice, seemed to have been forgotten.
CENTRAL BANK LOANS TO BANKS BALLOON

By mid-April, management of the banking crisis seemed to be getting under way at last. The emergency law had been in force for a month; Congress had empowered the government to launch a Bs. 400 billion ($3.5 billion) bond issue to fund bank recapitalization; negotiations with Congress to appoint a new president of Fogade and superintendent of banks were moving along; and Banco Latino was open again.

Nevertheless, the bank restructuring program was not progressing. We at the Central Bank were very concerned with the infamy the auxilios policy had acquired. Newspapers, social critics and street gossip all concluded that the agencies involved were just randomly handing out the money, without planning any clear resolution to the crisis.

In its Thursday, April 21 meeting, the Superior Council decided that Fogade’s program would continue until the end of May. Officials at Fogade and the Office of the Superintendent of Banks believed that the best way to implement corrective measures without taking over a bank was to get the shareholders to approve such measures.

And still, Fogade had no other source of funds but the Central Bank. As of April 15, we had lent the agency an unprecedented Bs. 500 billion, or $4.5 billion.

The board of the Central Bank unanimously voted to issue another stern alert to the government. The same day, I sent what would be my last letter to Julio Sosa. I told him that Fogade’s debits to the Central Bank were getting out of hand. That alone should be enough to indicate that the government had to change its crisis management policy. We recommended that Fogade develop a financial program covering the management and disposition of the assets it was receiving from the problem banks, and raise funds in the markets by issuing its own bonds. If banks and other investors purchased the agency’s bonds, that would enable Fogade to recycle funds within the economy, instead of passively relying on loans from the Central Bank. Fogade could also buy assets from the problem banks and pay with its bonds, as part of a rehabilitation program. It could then use its bonds to repay the Central Bank. The deposit insurance agency could also raise money by selling some of the bank assets under its control. We urged the government and Fogade to make some decisions.

But within a few hours, we received a signal that policy was about to move in an entirely different direction. Through news broadcasts, we found out that Caldera had appointed Gustavo Roosen as special com-

missioner to deal with the financial crisis. Roosen was already serving as president of Banco Latino's board of conservators, a post Caldera assigned him in February. He would now hold both posts.

Roosen was perceived as being close to both Pérez and Caldera. He was a former top executive of the conglomerate Grupo Polar, which also owned Banco Provincial, the largest bank in the country. Roosen had moved to work a few years before in the public sector. Pérez appointed him minister of education, and then tapped him to head the state oil company, PDVSA.

Some politicians and bankers feared that because of Roosen’s former ties to Banco Provincial, Provincial could end up taking over all of the failed banks and control a dangerous monopoly. Because it was a good bank, Provincial was attracting deposits. But so were other banks that depositors saw as refuges.

THE 96-HOUR SOLUTION

The day he was appointed, Roosen announced that the financial system would collapse if emergency measures were not taken within 96 hours.

He said he had a plan to stave off this catastrophe.

His goal was to solve four problems in the banking system: high lending rates, wide interest rate spreads, restructuring and privatization of the ailing banks, and the "vicious circle," in which financial assistance to ailing banks ended up as investments in Central Bank zero-coupon bonds held by the stronger banks.

Roosen reiterated the tired criticisms of the evil zero-coupon bonds and suggested that the Central Bank stop issuing them, so banks would be forced to invest in Treasury bills instead.

He announced that he would forge a consensus around his plan to rescue the financial system from its precarious situation: "A situation," he observed, "that doesn’t do anyone any good."

Instead of producing calm, his 96-hour deadline rattled investors, who must have comprehended the ludicrousness of this claim. On Friday, April 22, heavy capital outflows signaled the market’s opinion of his plan: $95 million left the country that day.

On Thursday afternoon Julio Sosa invited me to join him and President Caldera for a Friday morning meeting at Miraflores. I arrived promptly at 8 a.m., but the President’s aides said the President was not in. After a very long wait, I was ushered into the office of Andrés Caldera, the minister of the secretariat and the President’s son. Sosa, several other ministers and

Roosen were already meeting there. Sosa began the discussion by requesting that the Central Bank issue a special regulation on interest rates for the restructuring of bank loans to agriculture. He also voiced the government's wish that interest rates should decline.

There was a brief silence.

Then once again I repeated to the group what I (and the Central Bank board and staff) had already explained through previous weeks of intense one-on-one sessions with many of those present.

I could not give them much comfort about the agricultural debt, I said. While I wanted to be cooperative, the Central Bank could not just regulate interest rates without knowing a) overall agricultural policy, of which this debt restructuring was part; b) what kind of debt restructuring program the government had in mind; c) the amount of interest rate reduction needed to solve the problem; d) how the government planned to finance the implicit subsidy for agricultural borrowers; e) whether there would be an income tax exemption on revenues from agricultural loans or other measures for commercial banks; f) how this might affect overall bank solvency; and g) how it fit into monetary policy objectives.

When it came to interest rates, I had to take an even harder line. First, I explained the problems we were facing. The foreign exchange market was under pressure. In the first four months of 1994, Venezuela had suffered heavy capital outflows, and foreign reserves had fallen below $10 billion, down from $12.7 billion at the end of 1993. In our view, this was due to the loss of confidence caused by the banking crisis, the fiscal deficit, uncertainties about the government's economic program, the recent suspension of some economic rights, the government's solidarity pact proposals, the deteriorating conditions in world oil markets, the delay of the government's privatization program and a host of other problems. The monthly inflation rate was already at 3.2 percent, and the cost of the bank debit tax and of the imminent government decision to increase the minimum wage nationwide would make inflation even worse. Moreover, Venezuela was entering a recession, due to the contraction of public and private spending.

Simply lowering interest rates would not solve any of these problems, I said. Indeed, it would make some of them much worse.

Instead of focusing on interest rates, I suggested, the ministers should do something concrete about the banking crisis. For what felt like the thousandth time, I outlined the problems. The deposit base of the ailing banks had shrunk, reducing their franchise value (if any was left). With deposits flowing into only a few safe banks, assets were becoming concentrated in too few financial institutions. Fogade's program—and the $4.3 billion the Central Bank had spent on it so far—was insufficient to meet the banks' real needs, and it was also expanding the money supply rapidly, endangering foreign reserves. Bailing out the banks might cost Bs. 700 billion ($6.0 bil-
lion), up to 7 percent of GDP. And the government was taking far too long to raise the money.

And then, I added, the government's fiscal policies seemed to be aggravating the other problems. A substantial fiscal deficit was looming, with no hint of how the government planned to finance it. In the past, privatization revenues had supplied such deficit financing, but the government had not revealed any privatization plans. If the 1994 bank debit tax was only temporary, what would replace those revenues in 1995? Altogether, the government's fiscal program had many weak spots and was inadequately organized to allow an orderly financing of the deficit. Instead, the government was simply building up arrears, making it impossible to get any loans from abroad.

That, I continued, left the government with only one option: borrowing in the domestic market. This would squeeze private sector borrowing and push interest rates up even further. Finally, I expressed the Central Bank's concern about the government's price stabilization program. The government had announced a program under which solidarity pacts—deals between producers, merchants and workers—would keep prices low and inflation in check. Such plans did not stand a chance unless the government committed to a tough fiscal deficit reduction policy. And there appeared to be no plans to follow through.

In view of all the above, I said, I believed that it would be a mistake to center our conversations on high interest rates and what the Central Bank could do to lower them. Instead, we should be discussing solutions for the banking crisis, the government budget deficit, Fogade's program and the privatization and stabilization programs.

After my remarks, which were rather lengthy, one minister suggested that the government take over all the problem banks currently assisted by Fogade and freeze their deposits. That way, their depositors could receive the same treatment as Banco Latino depositors. He also thought that the Central Bank should stop issuing zero-coupon bonds and replace them with long-term bonds, in which banks should be forced to invest if necessary. He wanted to see a devaluation of the currency and lower interest rates. He believed capital flight was not interest rate-sensitive.

His statements led to a lively discussion. I strongly disagreed, and so did other members of the cabinet. One of the ministers rightly said that the government needed a coherent plan, that the interest rate issue was not an isolated one and that interest rates would not simply react to a specific Central Bank regulation. Unfortunately, the discussion did not lead to any meaningful conclusion.

Roosen asserted we needed to rebuild optimism. (I thought that we needed to rebuild confidence.) He laid out his own program for bank rehabilitation, which included a request that the government recruit top executives, private consultants and others to operate troubled banks. He agreed
that the banking system should be forced to invest in Treasury bills.

As the meeting wore on, with none of the issues I raised coming into the
discussion, I concluded that the main purpose of the gathering was to put
pressure on the Central Bank to lower interest rates. It was clear to me that
the government had absolutely no plan, the announcement of the Roosen
96-hour miracle solution notwithstanding.

No one cared to explain why the original meeting, scheduled with Presi-
dent Caldera, ended up as a free-for-all, and without him present. In any
case, this group was not the appropriate forum for discussion of banking
sector problems. Instead, I invited Roosen to meet with my staff and me at
the Central Bank that same afternoon.

**IMPASSE**

When he arrived at Central Bank headquarters later that day, Roosen reiter-
at ed his proposal to craft a solidarity pact for the financial sector. He wanted
parity of treatment for Banco Latino depositors and depositors of other ailing
banks; a mechanism to replace the current bank financial assistance
program; a Central Bank commitment to purchase bad loans in bank portfo-
lios; and an alternative to the zero-coupon bonds. He also insisted upon the
need to get skilled people to run the ailing banks.

He focused on the concept of a solidarity pact for the financial sector as
the first building block for the cooperative government economic program.
I believed it was the government’s duty to lead these social-political negotia-
tions with bankers and other sectors of society, so we agreed that he would
approach the banks. At a later stage, we would see what role the Central
Bank could play. He was going to meet with a group of bankers over the
weekend and inform me of what they had decided.

I talked all of this over with the Central Bank board on Saturday morn-
ing. We all felt that something was about to happen.

On Sunday morning I got a call from Andrés Caldera. He invited me to
come to Miraflores at 4 p.m., to join six ministers and five bankers who had
been meeting there since Saturday.

When I got there, I was told they had come up with a plan. There would
in fact be some sort of a solidarity pact between the government, the Central
Bank and private banks.

The government agreed to authorize the banks to convert into universal
banks, and offered them income tax exemptions and other incentives in
order to get them to lend more money to agriculture. The government also
agreed not to impose upon the banks a restructuring of agricultural debt.
And talks would not be conducted by sector or by organized groups of
producers; it would be left to each bank to negotiate with its borrowers.

The banks, for their part, agreed to start lending again, especially to agriculture, to reduce their lending rates to corporations (but not to consumers) and to refrain from foreclosing on past-due agricultural loans. They also pledged to reduce their interest rate spreads—subject to some kind of support from the Central Bank, such as loosening cash reserve requirements and/or remunerating banks in other ways.

Banks' basic motive, I knew, was survival.

They also committed to invest in Treasury bills, Fogade bonds, and longer-term Central Bank bonds, and agreed to support the government's reorganization program for problem banks by supplying 24 top executives to run the eight banks.

Then the group told me what they expected of the Central Bank. The main idea was to get interest rates down and to force the banks to pass on the benefits to the borrowers. They thought the Central Bank should assume the cost of strengthening Fogade by substantially reducing or eliminating the cost of the funds it lent Fogade; some of them also wanted us to purchase assets of the troubled banks, although that was against the law.

It was something close to a blank check. And the Central Bank would bear the full risk of potential losses. No one seemed to care that such a plan would fuel inflation and severely weaken the Central Bank.

An institution resembling the U.S. Resolution Trust Corporation would take over the assets of problem banks. The capital of the Venezuelan RTC, they planned, would be 51 percent private and 49 percent governmental, to allow it to function as a private company, and part of the banks' current contributions to Fogade would be used to fund the new institution.

No one mentioned the Congressionally-authorized plan to have the government float a bond issue to raise funds for Fogade or pay the cost of the crisis from the government budget.

The group also believed that the Central Bank should revise its exchange rate policy, as they perceived that the crawling peg system was no longer especially effective or credible. Some of them believed a system of letting the currency fluctuate within a stated band would be better, while others thought that we should impose a fixed exchange rate. They reiterated the request that the Central Bank remunerate the banks—pay a rate of interest—for the cash reserves that, by law, banks had to leave with us.

The banks requested that we bolster them, in effect, so that they could please the government by lowering their lending rates.

I took a hard line.

Right off the bat, I told them that the Central Bank could not fix the exchange rates, or lower interest rates without a commitment from the government to do something about its deficit. I reminded them that Venezuela's high interest rates were not the cause of its economic difficulties but a symptom: the
money markets were simply telling us that something was deeply wrong with the economy itself. I refused to continue discussing exchange rate and monetary policy in this forum. I would take the subject up directly with the minister of finance.

I also insisted that the Central Bank was not in a position to pick up the cost of the banking crisis. The government had to do it by capitalizing Fogade. I was not just being stubborn. Taking on such a heavy load would have weakened the Central Bank, institutionally and financially. Furthermore, I was not in favor of their proposal that the Central Bank join in signing a solidarity pact. No pact could be allowed to compromise our policies and our independence.

However, I offered to put the proposals up for a vote by the board of the Central Bank. I said I would call a meeting on Monday morning, April 25, to analyze a draft that Roosen offered to send us at 9 a.m.

It did not arrive until Monday afternoon. It came by fax, rather than by envoy.

The document, which was full of political rhetoric, sounded more like propaganda than an effective cooperative agreement on policy. It spoke only in vague generalities, calling for a macroeconomic stabilization program that would be "systematic, gradual, progressive, with coherent actions and visible results, technically and politically implemented in order to affect simultaneously the fiscal deficit, the exchange rate, interest rates, inflation and real wages." In order to achieve that goal, we needed *un gran acuerdo*, a comprehensive agreement, between all the actors in our society: the government, the Central Bank, the financial sector, business and labor. Activating this agreement would demand sacrifice from all but would create a climate of confidence that would allow for a true and enduring recovery.

Was this, I wondered, the 96-hour solution?

The first stage of the agreement would be a pact signed by the government, the Central Bank and the financial sector (the regulators and the banking system were discussed as though they were one and the same). The draft essentially reiterated most of the pledges we had discussed earlier. There were hints, however, that this text had been negotiated first with the banks and then sent on to the Central Bank, in hopes of a rubber stamp. It also included some aspects that had not been discussed on Sunday afternoon.

The government's financial commitment was vague. There was nothing new to reassure the Central Bank that it was serious about cutting its deficits. It did spell out, however, specific tasks it had in mind for the Central Bank: helping design "viable financing mechanisms" for the bad loan portfolio that Fogade had assumed; limiting the use of its zero coupon to "the purposes this instrument had been created for, i.e., to drain liquidity," and "stabilizing the bolivar."
The pact did not really advance an economic reform or stabilization program, nor did it draw up a management policy to address the banking crisis. As far as I was concerned, it was simply a gimmick to corner the Central Bank. By signing that agreement, the Central Bank would be committing to a stable nominal exchange rate policy and lower interest rates we had determined to be totally unwarranted by the country’s macroeconomic conditions and the government’s fiscal program. We would be virtually forced to lower interest rates largely to allow the government to off-load its debt.

Just as galling, the Central Bank would have to assume the cost of the whole crisis, acquire Fogade’s assets and restructure Fogade’s debt. We would be tied up in a straitjacket.

Tragically, the program would fuel inflation and eat up the country’s foreign reserves to no particular purpose. Exchange controls would become unavoidable, because huge capital outflows would quickly destroy whatever was left of the Venezuelan financial system. And, on top of everything else, if the Central Bank succumbed to such political arm-twisting, it would demonstrate to everyone that we had compromised the independence I had fought so hard for.

SHOWDOWN

The Central Bank board convened on April 25 at about 3 p.m. We were of a single mind: none of us wanted to be part of this.

Two hours later, Roosen and Sosa began phoning me, demanding to know what was delaying our approval.

We had voted not to sign, I said.

They tried to pressure us. The President had already scheduled a ceremonial signing of the pact. It would take place in less than an hour, they said. The private banks had accepted it. The Central Bank had to be there!

The 96 hours were almost up, and we were the only ones refusing to cooperate.

I reiterated our decision: the answer was no.

I realized I had run out of options. Clearly, President Caldera and his team were impervious to the Central Bank’s arguments; all of the points we had raised had been ignored. They had left no room for dialogue or policy coordination. We simply disagreed too powerfully on the correct approach to economic management and the appropriate role of the Central Bank. I was sure the government’s policies were inconsistent and would make it impossible for the Central Bank to discharge its duties under the law. These

policies were already leading to more inflation, capital flight and economic controls. I knew the Central Bank’s role would weaken and shrink, and its autonomy would slip away. I would not be able to do for my country what I believed should be done.

The government and the Central Bank leadership had reached an impasse. One of us had to back down.

Sadly, I decided to resign.

I sent my letter to the President the next morning.

"The decisions we had to make at the Central Bank over the past two years were neither easy nor without cost," I wrote. "But the results cannot be dismissed. In spite of political upheaval, enormous fiscal problems and the well-known deficiencies of other government bodies whose actions are required if this bank is to perform effectively, we managed to maintain foreign reserves, avoided aggravating inflation and gained time in which to implement, under the best conditions possible, the fiscal and economic policies needed to set the country on the road to healthy development.

"I have been guided at all times by my desire to contribute to the solution of the serious problems facing the Venezuelan economy. I can therefore say, in good conscience, that I spared no effort or sacrifice, and that I always sought to constructively support the four governments with which I worked throughout my tenure. All of this is well documented. My contribution, however, does have one limit: my personal beliefs...I [cannot] participate in actions that go against the basic principle which, to me, justifies my serving as head of the Central Bank..."174

Resigning hurt, but I knew I had no other choice. Two Central Bank directors, Eloy Lares Martínez and Carlos Guillermo Rangel, resigned with me. I imagine the President did not expect me to go at that point because he tried to get me to reconsider.

I felt even worse when the news of my resignation caused capital to flee and the bolivar to plummet. I could no longer do anything about such ills.

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174 See letter to President Caldera, April 26, 1994, p. 254.
From the day he was elected, Caldera made it clear that he intended to govern by centralizing power, and he powerfully discouraged dissent. The Central Bank was on a collision course with such a President, who sought to place himself above Congress, political parties and a legally independent Central Bank.

The Central Bank’s inclination toward monetary restraint did not match the Caldera government’s preference for a more expansionary monetary policy that would, his advisors hoped, mask the country’s problems.

His approach was a way of ignoring the complexities of Venezuela’s economic woes, and bypassing fundamental solutions. It also was part and parcel of the way we operated as a country. Caldera’s handling of the banking crisis demonstrated how easily Presidential and political power could still overwhelm our slowly-developing civil institutions. Despite some four years of work to create a legal framework for banking supervision and Central Bank independence, our freshly-minted rules and laws proved no match for the historical and Constitutional power of a Venezuelan leader, particularly one as strong-willed as Caldera. In his approach to economic policy, of which banking crisis management was part, he was able to override in a few strokes many of the provisions hundreds of citizens and legal experts had worked to embody in the law of the land.

Predictably, the Central Bank’s attempt to exercise its institutional power encouraged Caldera to see us as a threatening opponent. I strongly believed in—and pursued—coordination with the government, but Caldera could not bear to allow the Central Bank a single policy with which he disagreed. He and his ministers complained that the Central Bank was trying to build “a state within the state” (a pejorative phrase government officials frequently used), even though the Bank was simply doing its job under the law, serving as an institutional check on government policies. To me, independence boiled down to the right to say “no” when printing money threatened the value of
the currency.

The President saw the Senate’s power to veto his choice of Central Bank president as an infringement upon his own powers. He considered his lack of authority to unilaterally remove Central Bank directors intolerable. In his opinion, these laws had been passed “for some country other than Venezuela.”153 Sadly, in the early 1990s, the Central Bank had little support from Congress, anyway. Powerful pro-spending factions convinced Congress that tight monetary policy would just send the country into recession. To some extent, this was understandable. Times were extremely tough.154 But there were virtually no anti-inflationary constituencies in Venezuela to defend Central Bank independence.155 The country yearned to keep eating a delicious free lunch.

Congress' lack of support was also apparent in its efforts to make the Central Bank responsible for subsidizing certain groups of borrowers, including mortgage borrowers156 and agricultural interests.157 Nor were we properly funded. When the Central Bank advised Congress that the government’s budget forecasts did not include any money for the Central Bank, the legislators’ response was typically dismissive. “Tell that to the government,” was the attitude. The Central Bank had extended credit to the government and to Fogasde, yet repayment would probably never have even appeared on the government’s or Congress’ agenda had it not been for pressure from the IMF in 1996. There was no desire to finance the fight against inflation, when money could be spent on pork-barrel political objectives instead.

**MY SUCCESSOR IN A TOUGH SPOT**

I left believing there was nothing more I could have done. But saying goodbye to the Central Bank staff was especially tough. I worked with some of the finest civil servants in Venezuela. The day I stepped down, First Vice Presi-

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153 He said it bothered him that he could not remove the Central Bank’s board of directors, and ridiculed the rule that the directors were named for set terms and could not be removed except for, he said, “a series of causes that were laughable.” CalleÑa, op. cit., Tomo I., p. 289.

154 Congress had to deal with the prosecution of Pérez, appoint transition governments and cope with the fallout and social problems brought on by two coup attempts.

156 Agriculture and commerce were highly leveraged. Labor feared that strict monetary policy would trigger a recession and fuel unemployment. Weak banks also needed inflation to move out of their woes. I believe this has not changed much.

157 This was stipulated by the 1989 Law to Protect Mortgage Holders, passed to protect middle-class households from the impact of rising interest rates after rate deregulation in 1989. Both congressmen and bankers wanted the Central Bank to pay the subsidy.

158 Although the 1992 reform of the Central Bank law repealed most of the rules that allowed governments to use monetary policy as a development tool, Congress kept in the Central Bank law provisions allowing rediscount loans under more favorable terms when linked to agricultural development.
dent Omar Bello was appointed acting president. A longtime Central Bank staffer, Bello was an outstanding collaborator throughout my tenure.

A few days later, Caldera and Congress agreed that Antonio Casas González should replace me as Central Bank president. Casas had served as head of Cordiplan, the state economic planning agency, during Caldera’s first government, and had also been a member of the Central Bank’s board. Now, Casas resigned his post as head of PDVSA’s business office in the United Kingdom, and returned to Caracas to take the helm of the Central Bank.

I had nothing but good wishes for him. I knew a difficult road lay ahead. Casas immediately ran into many of the same troubles I had. The government continued to chip away at the powers of the Central Bank, even though its board now included a majority of Caldera appointees.

THE ECONOMY PERSONIFIED

Instead of acknowledging that Venezuela had joined the global economy and learning from other Latin American presidents who had begun experimenting with free-market economic management, Caldera turned the clock backward. In contrast to Pérez, who had the foresight to understand that what had worked for Venezuela before would not, in this new era, necessarily work again, Caldera reached for precisely the tools he had used two decades earlier: populism and a paternalistic, autocratic style to push his ideas through. This meant a tendency to reimpose price controls and subsidies, and economic management by government-organized political decisionmaking rather than by market incentives.

The new President behaved as if he and a small group of key advisors could singlehandedly control the Venezuelan economy, and with it, the workout of failed banks. Caldera would not acknowledge that economic behavior works by incentives—that, for example, capital ebbs and flows from an economy based on risks it perceives and rewards it receives, and that negative interest rates will always powerfully drive funds out of a banking system. Instead, for Caldera, economic behavior was personified: when something went wrong with one of his economic ideas, some person or group had to be at fault. Not only did Caldera steamroll over the Central Bank’s independence, but he also focused on finding villains and scapegoats who could bear the blame for the collapse of a significant part of the banking

\[78\] For example, a law passed by Congress at Caldera’s request in May 1995 gave the executive branch full powers to unilaterally impose exchange controls; until then this had to be approved jointly by the Central Bank and the minister of finance. Although the law did not formally repeal joint decisionmaking in setting the exchange rate, the move obviously weakened the role of the Central Bank in determining exchange rate policy.
system. So, even though the President guaranteed the economic conditions for capital flight by fixing interest rates well below the level warranted by inflation and exchange rate risk, he excoriated "evil" speculators for attacking the currency. When Venezuela's international standing crumbled due to his government's economic policy mistakes, he accused the *vitidás del paquete*\(^{79}\) of conducting smear campaigns against the Venezuelan government. According to this world view, the woes of the banking crisis were, of course, the bankers' fault.\(^{185}\)

This approach was counterproductive, as subsequent events demonstrated. It overshadowed the need for bank restructuring policies to face up to our chronic banking problems and raised new hopes in the population of a grand return to our glory days. It worsened recession and inflation, made the workout even more painful and costly than it might have been, and damaged both domestic and foreign investor confidence. It would take Caldera nearly two years to acknowledge that running the country like a private fief was the least savory way of solving the banking crisis. His methods eroded public support for his government in the end.

POWER WITHOUT A PROGRAM

Once it had vanquished institutional voices, the Caldera government had no economic program to speak of. Or, rather, it had too many of them. First there was the Sosa Plan, a set of fiscal measures too weak to address the budget deficit. Next, in the turbulent days following my resignation, Caldera turned to the proposals of close economic advisor Asdrúbal Baptista\(^{186}\) and promoted them as the Baptista Plan, though the President's interest in it was little more than a pretense. Then came the Corrales Plan, named after Planning Minister Werner Corrales. Its centerpiece—salary, price and interest rate controls based on deals among various sectors—was something Caldera's aides had been planning for a long time. Crafted along the lines of the anti-inflationary pacts applied successfully at times by Mexico, Bolivia and Israel, it hoped to reverse inflationary trends. But such deals depend on government commitment to tough cost-cutting and stronger fiscal accounts, since

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\(^{79}\) This was a swipe at the technocrats who supported Pérez's reform package, were left bereft of their project by Caldera's defeat of it, and left the country to work in multilateral organizations or foreign banks.

\(^{185}\) Caldera painted bankers as members of organized mafias, who purportedly lured depositors with high interest rates and then diverted the money to other businesses. Caldera, *op. cit.*, Tomo I, p. 295.

\(^{186}\) Asdrúbal Baptista's proposal, "En razón del futuro. líneas maestras de la estrategia económica," outlined long-term economic development policies. He was appointed non-cabinet minister for the reform of the economy and member of the board of the Central Bank in February 1994, but resigned that May.
only confidence in those policies can compel labor and business to commit, in turn, to price and salary targets. Though this discipline was clearly absent in Venezuela, Corrales, who became planning minister in mid-1994, continued hopefully to promote the idea of pacts. There were no real negotiations, though. The planned agreements, even though they were formally signed, turned out to be nothing more than hollow, grandiloquent pronouncements.

BOILING POINT

The political climate sizzled in the months following my departure. There were public transportation strikes, violent student protests and episodes of looting, as unemployment soared and recession deepened. Confusing government announcements that people interpreted as warnings of new currency devaluations triggered periodic panics. Asset values on the stock market plunged. Now pressures on monetary policy stemming from loans to Fogade climbed further and contributed to inflation, which rose toward 70 percent.

Since putting money in the bank meant it quickly lost its buying power, especially now that the government was taxing bank transactions, too, Venezuelans predictably began holding more and more of their assets in cash. Mugging and robbery rates climbed, and Venezuelans grew obsessed with personal safety. Law and order seemed impossible to impose.

By spring, things were so bad that nobody seemed to notice that oil prices were rising, something that in more placid times would have meant national celebration. The instability of the financial system led to sustained capital outflows and constant, strong attacks on the currency. Venezuelan creditworthiness was sinking; government debt was downgraded and placed on “watch” by the major international credit rating agencies. The yield premium on Venezuelan government bonds over U.S Treasuries reached almost 13 percent, nearly as high as Nigeria’s. Many overseas observers concluded that the Caldera administration was shooting itself in the foot.

The Central Bank’s attempts to stabilize the exchange rate via several intervention techniques failed. Currency speculators and investors naturally tested the Central Bank’s ability to defend the bolivar, and in the next few

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182 The atmosphere in the country was so poisoned by the problems in the banking system, the lack of effective crisis management, and the pervasive feeling that the economy was sinking into a deep recession that there was little public comment on the fact that Venezuelan oil prices increased by 25.5 percent in the second quarter of 1994.

months the Central Bank lost another $1 billion in foreign reserves trying to prop up the currency. Nevertheless, the bolivar depreciated by 23.9 percent in May—and plunged by another 28.2 percent in June.

Inevitably, one of Caldera’s money-saving ideas was to declare a moratorium on payments on Venezuelan foreign debt, only recently restructured. The external debt burden had been one of Caldera’s leitmotifs throughout his campaign. The gossip in international financial markets was that Venezuelan government officials were seeking the support of other Latin American debtor countries for such a moratorium. When Caldera appealed to Latin America to “join forces in solidarity” in a June 14 speech to a gathering of heads of state in Colombia, the issue came into the open. Leaders of important Latin American governments, however, having recently begun repaying their own debts to foreign banks, were keen on reestablishing their international credibility. They quickly distanced themselves from the Venezuelan proposal, and Caldera dropped the issue soon afterward.

THE GOVERNMENT SEIZES 11 BANKS

Since he had grabbed the upper hand, Caldera’s failure to effectively use his power had a particularly catastrophic effect, both on the banking system and the economy. Four months without a clear economic program or bank workout strategy meant that runs on the ailing banks continued unabated. Bank clients were not reassured by the massive government loans to the banks or by government officials’ vague attempts to instill calm. Scared depositors voted with their feet; they moved their funds to institutions that seemed sounder. The group of banks that depositors perceived to be the strongest—Provincial, Mercantil, Caribe, Citibank and Venezolano de Crédito—reaped new business. Some politicians angrily accused these banks of profiteering. But again, the real problem was the critics’ failure to understand markets. People were largely just seeking out safer banks.

The confusion at the top seeped down into bank regulatory institutions, which now fell into disarray. Fogade and the Office of the Superintendent of Banks made contradictory requests of bank managers, failed to communicate, and dithered when bankers offered up recovery plans. Information was in short supply and regulatory procedures were far too inflexible.

The upshot was a state of paralysis. The government hoped to avoid more bank takeovers, but they appeared ever more likely.

884 Mexico, Argentina and Chile used the IMF/World Bank annual meeting in Madrid in October 1994 to make their stance clear.
In May, government appointees to the boards of the eight banks receiving Fogade help began to report contingent liabilities not previously identified by the bank supervisors. Losses were mounting, and franchise values were fast evaporating. The strategy of leaving banks open under their original managements and pumping in Fogade funds was obviously not improving their condition. In fact, Fogade funds were never meant to do that: the funds were supposed to be short-term emergency aid, to give the government room to devise a workout strategy, or at least to allow Fogade to seriously recapitalize the banks. Clearly, the ability of the Fogade aid policy to shore up the banks had reached its limit. And leaving the bank managers in the ludicrous position of continuing to run these institutions while they were barred from leaving the country in advance of possible charges of fraud or malfeasance could not have helped matters. The persistent outflows gave rise to public suspicions that these managers were siphoning off Fogade funds.

By June, the Caldera administration was backed into a corner on nearly all fronts. The government was still refusing to fund Fogade or to oblige it to raise funds of its own.

Now Fogade announced that it could no longer aid the ailing banks. Their losses, Fogade said, were much higher than expected. The agency claimed it no longer had sufficient resources to keep them afloat.

So, on June 14, while Caldera was addressing Latin American heads of state in Colombia, the government seized 11 financial institutions outright and shut them down. The President did not have many other options at that point, having failed in so many other initiatives along the way.

This act created extreme public consternation, particularly because the administration had promised that none of those banks would be closed. Depositors who had trusted this statement and had left their funds in the banks were trapped. They reacted with outrage.

The massive takeovers, broadcast by media worldwide, set off widespread panic in the foreign exchange market. Whatever funds were left in the system fled, and the bolivar careened downward, after two months during which it had already lost 40 percent of its value.

Eight of the seized banks had been receiving Fogade assistance throughout the first half of 1994: Banco Maracaibo, Banco Barinas, Banco Construcción, Banco Metropolitano, Banco La Guaira, Bancor, Banco Amazonas and the finance company Fiveca. The government also took

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180 Banco Tequendama, originally a Colombian bank and based in Colombia, had been acquired by the Construcción group.
181 Banco Popular, a small commercial bank in the Zulia region, had been privatized very recently, in late 1993. After Banco Barinas bought it, the superintendent of banks objected to the sale and ordered the bank to divest. However, the crisis broke out before that order could be executed. In spite of the problems that the parent bank confronted throughout the first half of 1994, Banco Popular was unlimied. It was bought by Banco Provincial in 1997.
over Banco Hipotecario de Occidente (Banco Latino’s mortgage bank), Banco Tequendama\(^n\) and Banco Popular\(^o\). All banks were placed under state conservatorship.

Now arrest warrants were issued for directors of these institutions. The charges were imprecise, but they involved accusations of fraud, including questions about what happened to the lost Fogade funds. All of the directors went into hiding.

Two days after the bank seizures, the banks’ unfortunate depositors learned they would be treated in a discriminatory manner. They would get only Bs. 4 million per depositor, less than half of what Banco Latino depositors received\(^p\). The disparity of treatment unleashed a new firestorm of anger.

Bank seizure seemed to many people a clean, decisive step. In reality, it was a desperate reaction to events. Even now, the government was without a banking crisis strategy. While one official announcement called for reopening some of the banks six days later, on June 20, another, by the superintendent of banks, stated that they would be closed for at least two months\(^q\). When the banks did not open on June 20, and a plan to begin partial payment to depositors was also postponed, Sosa announced that the government was considering declaration of a “financial emergency,” in order to stop capital flight. For good measure, the superintendent of banks admitted that he could not rule out additional bank seizures\(^r\).

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A COUNTRY UNDER SIEGE

A few days later, the other shoe dropped. The shutdown of the banks had caused such a pervasive stampede of funds out of the country that, on June 27, the government slammed on foreign exchange controls and suspended Venezuelans’ Constitutional rights. That stripped Venezuelans of their right to freely conduct economic transactions and deprived them of their basic civil rights, including the right to privacy in their homes and to move freely around the country. People could also be detained without charge, and property could be confiscated without due process.

One purpose of the suspension of Constitutional rights was to satisfy a public thirst for retribution against the fugitive bankers: the Caldera government was now empowered to seize bankers’ personal property in compen-

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\(^m\) *Economía Hoy*, June 16, 1994.
\(^n\) *El Universal*, June 16, 1994.
\(^o\) *Diario de Caracas*, June 23, 1994.
sation for their supposed thefts. The other was to halt the upheaval the seizure of the banks had caused: this was the last resort, the most drastic measure, because the government had failed in all of its efforts to rebuild confidence in the banking system. In a speech to the nation, President Caldera gave the official reason for his actions. He said the government needed to "halt the unhealthy and criminal trend to ruin the national currency." 101

When exchange controls were slapped on, Caldera was actually applauded for his bold stand against "profiteers." Venezuelans were not, on the whole, concerned about the reversal of market-oriented policies. The deeply embedded culture of economic controls over the years had led many people to believe government intervention would ease, not worsen, the country's problems.

The Venezuelan Constitution stipulates that Congress must ratify a suspension of Constitutional rights within 10 days. Caldera refused to allow this. The atmosphere quickly grew ominous. Some people suggested the President was laying the groundwork for an autogolpe. Caldera was compared to Peruvian President Alberto Fujimori who, instead of compromising with a recalcitrant Congress, simply dissolved it. 102 In a retaliatory move some three weeks later, Congress voted on July 22 to restore Constitutional rights. 103 But Caldera refused to back down. He immediately issued a new decree reinstating the suspension. He also threatened to call a referendum, to show that he had public backing. 104

As the Central Bank would report in September 1994, bank seizure "led to a major disturbance in the money market, including massive capital flight and accelerated depreciation of the exchange rate. The magnitude of the disturbance was an important factor leading to the adoption of extraordinary measures. Among these, the most significant was suspension of Constitutional guarantees and implementation of foreign exchange and price controls." 105

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102 Ignacio Ramonet, in Le Monde Diplomatique. (Paris, July 1995.)
103 Congress focused on civil rights but delayed restoring economic freedoms. Those were to be reinstated only after the country's consumer protection law was beefed up, to protect the citizenry from "speculative market practices."
104 A referendum was not necessary in the end because his decree stood.
ASSET SEIZURES

Politically, the most important objective of Constitutional rights suspension was to be able to seize assets failed banks, their wide network of affiliated companies and even from borrowers. The government set the rules and the mechanisms to take control of the assets of individuals and companies linked to failed banks, as well as all assets (real estate, loans and other rights) that had been pledged by the ailing banks as collateral to Fogade in the first half of 1994. The first rules, allowing for legally questionable expropriation without due process, were issued on July 15, 1994 and fine-tuned by further decrees in August and October. From there, the attorney general, the Procuraduría General de la República, began to take possession of these assets and widely publicize his actions. Simultaneously, the government took over a large number of non-financial companies related to the failed banks.

THE IMPACT OF EXCHANGE CONTROLS

Exchange controls abruptly brought all foreign payments to a halt. Corporate debt service, payments for imports and funds destined for tourism and overseas education were suspended. Not even in the volatile days of 1992 and 1993 had there been such a serious foreign exchange vacuum. The freeze on foreign currency purchases would last for two long weeks, until July 11. No official explanation was offered. People perceived that government policymakers were struggling to agree on what sort of exchange regime to impose. Predictably, the government and the Central Bank had different opinions.

On July 11, the foreign exchange market was declared open under a new set of rules. A controlled rate policy was imposed, such as Venezuela had used unsuccessfully in the past. The bolivar was fixed at Bs. 170 to $1US, slightly lower than the prevailing market rate. This new rate was to apply to all transactions outlined in a highly-detailed set of regulations that included imports, government and private sector debt service, foreign investment, and personal remittances. Credit card purchases

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166 Decree No. 278, Gaceta Oficial No. 35,503, July 15, 1994.
168 The term used in Venezuela at the time was ocupación, meaning the government was forcibly taking possession.
169 At the time of the first attempted coup d'état in February 1992, the foreign exchange market was closed for only four days. Thereafter, it operated without interruption throughout 1992 and 1993, in spite of enormous political and financial turbulence.
abroad were limited, too.

In practice, this meant that access to dollars and other foreign currencies dried up. The sale and management of foreign exchange was entrusted to a new, all-powerful Foreign Exchange Board, the *Junta de Administración Cambiaria,* or JAC, whose members were directly appointed by Caldera.

Exporters were ordered to sell all of their dollars and other foreign currencies to the Central Bank in exchange for the devalued bolivar. Any transaction not specifically covered by the exchange control regulations was considered a criminal offense, and unless petitioners could prove that requests fit into one of the pre-set categories, no foreign currency was given. Violators were threatened with fines and prison.

Another seven days passed before commercial banks were able to begin processing their clients' applications for foreign exchange (the first step before hard currency could flow to the private sector). The banks resisted entering into any type of transaction until all the legal aspects and operational technicalities of the cumbersome controls were clarified. Nobody wanted to risk punishment. Moreover, it took two more weeks for the JAC approvals to start flowing. They began very slowly; a new bureaucracy had to be set up, rules crafted and systems put in place. When all was said and done, foreign exchange transactions were paralyzed for about a month. Venezuelans complained bitterly, and the government blamed the banks for the delays, claiming they were uncooperative.

Uncertainties quickly spread to all private sector economic decisionmaking, and bottlenecks for obtaining coveted dollars developed. Airlines, telecommunications firms and others who had overseas operations could not get funds to pay their suppliers. In an indication of negative investor opinion of the economic outlook, the prices of Venezuela's international bonds plummeted, and their yields surged by more than four percentage points.²⁰⁰

Foreign currency for private debt service payments was extremely difficult to obtain. Even major private borrowers, including CANTV, the Venezuelan telecommunications company, which had recently borrowed in the international capital markets, had no choice other than to default.²⁰¹ Nor did investors have any way to procure capital.

Predictably, these rigid restrictions encouraged the growth of a black market in foreign currency. It first arose in the exchange houses operating on the Colombian-Venezuelan border.²⁰² A bolivar market also developed in

²⁰⁰ The yield on one type of Venezuelan Brady bonds (debt conversion bonds, known as DCBs) rose from 15.7 percent above U.S. Treasury bonds in late June to 20 percent above U.S. Treasury bonds in late July 1994.

²⁰¹ Months later, a special regime allowing exporters to use their dollar proceeds to service their external debt and pay for their imports was approved by the government.

²⁰² The black market price therefore came to be known as the "border rate."
New York, initially at 15 percent above the official rate (Bs. 195 vs. Bs. 170). The spread steadily widened thereafter.

Real interest rates became ridiculously negative, as exchange controls fenced in capital and the money supply began to grow under the influence of the government's deficit.\textsuperscript{203} The banks benefited, though depositors were penalized once again. Meanwhile, the government-appointed conservators arranged for some of the banks to pay out the deposit guarantee shortly after they were seized. Other institutions began paying months later. Finally, in July 1995, their depositors received parity treatment with Banco Latino depositors.\textsuperscript{204}

Controversy over the 11 seized financial institutions continued all year. Although government officials repeatedly declared that these banks were "recoverable," and attempts were made by the Zulia banking community to refloat Banco Maracaibo and some of its affiliates, the government's stance grew no more decisive. Some officials favored liquidation; others, including the banks' state-appointed conservators, favored rehabilitation. By the end of the year, the government just gave up and decided that all of those banks, except Tequendama and Popular, would be liquidated.\textsuperscript{205}

PIECEMEAL CRISIS MANAGEMENT

The combination of exchange controls, bank seizures and suspension of Constitutional rights gave the administration carte blanche for any style of bank workout it chose. But the lack of an overall strategy to handle the crisis was a problem until the end. The government dealt with failed institutions on a case-by-case basis. It now had the power to seize all assets of the banks it had taken over, and appropriate assets from the banks' wider networks of affiliates, too. Besides taking over real estate, corporations and loans, the government could take possession of assets the failing banks had pledged to Fogade in exchange for aid in the early months of the crisis, including their coveted works of art. Markets feared a full-fledged nationalization of the banking sector, in spite of repeated government denials.\textsuperscript{206}

\textsuperscript{203} In July-August deposit rates and lending rates fell by 19.2 percent and 16.1 percent respectively.

\textsuperscript{204} Ley de Regulación de la Emergencia Financiera, Art. 55. Gaceta Oficial No. 4,931 Extraordinario. July 6, 1995.

\textsuperscript{205} Attempts to salvage Banco Maracaibo and one of its affiliates lingered in Zulia for some time. Meanwhile, employees of these banks suffered. Many went on strike in September 1994 to demand their salaries. They were still on the banks' payrolls, yet were not getting paid. They had not been officially laid off, and thus could not receive severance benefits.

\textsuperscript{206} Euromoney, May 1995.
Simultaneously, the government moved to consolidate control of all banking and financial decisionmaking under the finance minister and a small group of Presidential advisors. A Presidential decree, No. 248,267 established a Financial Emergency Board (the Junta de Emergencia Financiera, known as JEF). It was presided over by the finance minister, who had the right to cast an extra vote in the event of a tie. This agency replaced the 5-month-old Superior Council established by the 1994 Banking Law. Its real purpose was to place under the direct authority of the President all the decisionmaking powers that had previously been distributed among the Central Bank, Fogade and the Office of the Superintendent of Banks. It is true that the workout of the banking crisis needed stronger coordination; yet one might argue that the lack of coordination in the first six months of 1994 was not so much due to the government’s lack of power but rather due to its lack of a plan.

The members of the JEF were the president of the Central Bank, the president of Fogade, the superintendent of banks, and three political appointees whom the President could freely name and remove.268

The JEF was empowered to supervise and control troubled financial institutions, and could appoint bank officers with veto rights over the banks’ operations. It had the power to impose strong sanctions. The JEF also had the power to regulate the interbank money market and to commandeer funds “available” in that market. The intent of this was to force more solvent, liquid banks to lend to those that were facing runs. It was a sort of compulsory recycling of funds, through a distortionary mechanism that was never clearly spelled out and, fortunately, never put into operation. The government’s decree also widened the Central Bank’s powers to lend to Fogade and to troubled financial institutions. These provisions turned out to conflict with other laws on the books and were unenforceable.

None of these moves calmed the storms that were roiling the banking system. The contagion effect the government let loose when it seized the 11 banks fueled runs against other banks, chiefly Banco de Venezuela, Banco Consolidado and Banco Progreso. They were Venezuela’s second, fourth and sixth-largest banks, all of them the core of financial groups, and they accounted for 23 percent of total commercial bank deposits.269 Their offshore operations were particularly hard-hit by massive withdrawals.

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268 The Office of the Superintendent of Banks was effectively stripped of many powers given to it by the January 1994 Banking Law, e.g., suspending or revoking bank licenses, authorizing capital increases, intervention and liquidation of financial institutions, approving change of control ownership of financial institutions, approving prudential regulations, supervising credit card companies, and suspending or prohibiting dividend payments.

269 As of December 31, 1993.
THE THIRD WAVE OF BANK FAILURES

Longstanding and bitter personal and business feuds may not have been the sole reason for the next stage of the crisis, but they appeared to be at least one important factor. Over the summer, there were runs on banks owned by the enemies of a close Caldera associate, former Banco de Venezuela President Carlos Bernárdez. The source of dissension was four years old: a hostile takeover of Banco de Venezuela that began in 1990. It all started when Cuban-born financier Orlando Castro, who owned Banco Progreso and a wide array of companies, bought 4 percent of Banco de Venezuela and fought to be given the right to appoint one member of the bank’s board. 209 His initiatives were not accepted by the rest of the shareholders, and Castro set out to reach the 20 percent ownership that gives shareholders the legal right to appoint a board member. Meanwhile, Banco de Venezuela’s share price rose from Bs. 175 ($4) to more than Bs. 2,000 ($42). The fight over control of the bank created personal feuds, financial battles and lawsuits. In 1991, Castro sold his Banco de Venezuela shares to José Alvarez Stelling, a leader in the banking community, who held a controlling majority of Banco Consolidado. Alvarez Stelling pursued the takeover, which was very expensive, and succeeded in taking over the bank. Both Stelling and Castro gained Bernárdez as an enemy.

Throughout this battle, banking regulators did nothing to limit the damage to the institutions involved. This had worrisome international implications. Overseas branches of Banco de Venezuela and Banco Consolidado were involved, and U.S. regulators were concerned that Consolidado would be unable to finance its purchase.

A weakened Banco de Venezuela group was born in 1993, after the conflict among shareholders was finally settled. The Consolidado group was also hurt. Interpersonal rivalries, some said, were sinking those banks. That was not the only factor, though. As much to the point, the purchase of shares in Banco de Venezuela had been financed by loans to itself, as well as loans from Banco Consolidado through its offshore affiliates. The increased debt from the takeover attempt was thus partly responsible for the difficulties these banks were experiencing. It also contributed to a surge in interest rates.

Banco Progreso also lost substantial government deposits, 210 and allegations that this was an intentional government slight against Progreso floated

209 According to the Capital Markets Law, a 20 percent ownership is required to appoint a member of the board of directors.
210 In 1994, government deposits in Banco Progreso fell steadily from Bs. 11.5 billion (19.2 percent of total deposits) in May to Bs. 5.1 billion in June (11.2 percent of total deposits), and further to Bs. 2 billion (4.5 percent of total deposits) in September.
in the air. By midsummer of 1994, Banco de Venezuela, Banco Consolidado and Banco Progreso were all struggling with heavy runs. Other depositors were not going to take unnecessary risks at this point, especially if there were hints of political ill will. The idea that the banks were politically out of favor may have contributed to the exodus.

Banco de Venezuela and Banco Consolidado were large retail banks, with more than 3.4 million depositors. Adding the Progreso group put a total of 4 million depositors at risk. The government had to avoid closing those banks, or risk adding to the general turmoil.

Since bank seizure had obviously been a miserable experience for all concerned, the government now looked for a new idea.

On August 8, the JEF approved the purchase of Banco de Venezuela from Alvarez Stelling for a token Bs. 1 per share. The government appointed new management of its own choosing and had Fogade recapitalize the bank, while keeping it open. In this way, the government avoided formally taking over Banco de Venezuela and placing it under conservatorship—a measure that would have led unavoidably to at least temporary bank closure.

Simultaneously, Banco Consolidado and Banco Progreso entered into strict recapitalization agreements with the government, which forced the owners to pledge personal assets to ad-hoc trusts and to post their bank shares as collateral. In both cases, Fogade was supposed to provide financial support until the owners could raise new capital to buy back their banks.

Although this approach was questioned from a legal perspective, depositors it was an improvement over the June fiasco. At least, the ailing banks were not closed. No restrictions were applied to withdrawal of deposits. Fogade took control of Banco de Venezuela and assumed its losses. Initially they were estimated at Bs. 40 billion, almost double the bank’s equity capital of Bs. 19 billion, but were later discovered to be nearly six times as high, about Bs. 112 billion. Banco de Venezuela eventually regained depositors’ confidence and stabilized.

The attempt to resolve banking problems through low-priced buyouts and subsequent attempts at recapitalization reflected the government’s determination to avoid the mistakes it made during the first two waves of bank failures. Despite the acrimony these latest policies caused, they were less expensive for the government. They would also end up being less disrup-

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212 Banco Progreso’s management had been complaining about runs since early spring and attributed the situation to intentionally-spread rumors.
213 Banco de Venezuela was also one of the two private clearing banks for the Central Bank.
214 There was no rule giving the JEF the power to impose this kind of operation. The government’s decision to seize these banks was challenged in the Supreme Court; in 1997 and 1998 the Supreme Court declared that the suits were not admissible.
tive to the financial system.217

But Banco Consolidado and Banco Progreso continued suffering runs. The banks' owners were unable to comply with the terms of the government's recapitalization plan. In September, Banco Consolidado was taken over by the government under the same mechanism as Banco de Venezuela: Fogade bought Alvarez Stelling's shares for a nominal price. The bank's management team was replaced, its deposits were all guaranteed and the bank also remained open. Again no restrictions were placed on the withdrawal of funds by depositors.218 As in the case of Banco de Venezuela, runs ceased when the bank was taken over by the government.

Problems with Banco Progreso also continued, and the government seized Banco Progreso, along with Banco República and the rest of Orlando Castro's financial group, in December 1994. Again, the JEF purchased the shares at a nominal price, kept the banks open and appointed new management.219 But unlike in the other cases, this did not stem the runs on Banco Progreso: the government takeover did not dispel the depositors' worries. The government eventually closed the bank in January 1995.220 Its deposits were transferred to the government's expanding bank holdings.

The collapse of Banco de Venezuela and the Consolidado group banks also decimated the leadership of the banking community, as the heads of two of these banks were also the presidents of the two national banking councils. José Bouza Izquierdo, president of Banco de Venezuela, was president of the National Banking Council and thus the chief spokesman for the banking community. Juan Tomás Santana, president of Banco Hipotecario Consolidado (the Consolidado group's mortgage bank) was the president of the Venezuelan Bankers' Association. This made the collapse of these banks particularly visible and politically-charged, and both bankers' associations were left without presidents.

Controversies over alleged government favoritism arose when a small regional bank, Banco Andino, began showing signs of problems in August. Banco Andino received treatment distinctly different from all the other banks. As a means to avoid seizing the bank or placing it under conservatorship, Andino was temporarily placed under the management control of Banco Industrial, a government-owned bank, which was given the option of de-

217 Fogade spent Bs. 201 billion recapitalizing Banco de Venezuela, Banco Consolidado, Banco República and Banco Andino, and Bs. 110 million to support Banco Progreso; roughly $2 billion in all. Banco de Venezuela, Banco Consolidado and Banco República were privatized in 1996 and 1997. Banco Andino was merged with Banco Popular and also privatized. Banco Progreso was liquidated.

218 Banco Consolidado's estimated losses at the time were reported at Bs. 96 billion, 43 times the bank's equity capital as of July 1994. VenEconomia Semanal, Vol. 12, No. 50, November 23, 1994, p. 2.

219 The group had been receiving Fogade financial assistance since August, while heated discussions among the government agencies involved took place.

signing a restructuring plan for Andino. This decision gave rise to heated criticism since the president of the bank, Senator Bernardo Celis, was a prominent member of Convergencia and chairman of the Senate Finance Committee. The government finally seized Banco Andino in November, after several recapitalization proposals had gone unfulfilled. 221 Later on, the official version would be that Fogade, not Banco Industrial, had been in charge of recapitalizing Banco Andino.

THE MIGRATIONS POLICY

After the June 1994 fiasco and the January 1995 failure of Banco Progreso, the government knew it had to find ways to avoid hurting depositors when closing a bank. By January, the JEF had devised a way to transfer the deposits of failed banks to other government-owned banks. Decree No. 526 formalized the process by authorizing the JEF to approve the transfer of deposits from problem banks to government-owned banks. These were called migraciones, as deposits were “migrating.” 222

This new policy was applied to Banco Progreso, and then again in February 1995 to three medium-sized banks, Banco Profesional, Banco Italo and Banco Principal, that reached the point of no return. Together they accounted for only 5 percent of total deposits in commercial banks. They had been suffering runs since mid-1994, and their shareholders were unable to comply with recapitalization agreements. The government bought out the majority shareholders for a token Bs. 1 per share, and closed them all. A fourth bank, Banco Empresarial, was taken over in August 1995 by similar means, after having suffered protracted runs. A common denominator in all these banks was their small size and low (if any) franchise value.

Fogade was put in charge of ordering transfers of assets and liabilities from weak banks to stronger, government-owned banks.

This worked well for depositors. The deposits of Progreso, Profesional, Italo, Principal and Empresarial were thus transferred to the government-owned banks: Latino, Venezuela, Consolidado and República. Once the uncertainties due to the lack of information were overcome, transferring the deposits from failed banks to banks that were operating normally spared them from having their deposits frozen.

221 Its shareholders also committed to recapitalizing the bank but failed to do so for over three months. Celis repeatedly announced that groups of foreign investors were willing to contribute to recapitalization, and the JEF waited until November 1994 to take action. Finance Minister Julio Sosa would subsequently state in the press that Celis lied to the JEF when he promised new investors were ready to join. El Nacional, August 24, 1995.

Unfortunately, the migrations policy was clumsily implemented. The government-owned banks that assumed the deposits (the liabilities) did not get any assets until much later. This nearly bankrupted some of them. Throughout 1995, the government’s delay in funding these banks via Fogade conveyed a sense of irrationality, which led bankers and analysts to fear that the group of banks that assumed the deposits would go bankrupt before they could be privatized. Had the two operations been done concurrently, that would not have been a danger.

It was not until late December 1995 that Fogade would finally solve the funding problem with a Bs. 367 billion bond issue.

THE CRISIS WINDS DOWN

Throughout 1995, Venezuela was alight with rumors predicting new “waves” of bank failures. But gradually runs subsided because depositors saw that no more banks failed.

By mid-August, 18 months from the day Banco Latino was barred from the clearinghouse, 18 financial institutions223 had failed, and were either owned and run by the government or had been closed. The government had also taken over 35 other institutions: eight mortgage banks, 14 investment banks and 13 leasing companies. Many other holdings had been seized along the way: more than 1,000 non-financial companies related to these financial groups224 and innumerable other assets. The government was controlling one-third of the deposits of the banking system.225

The confrontational political climate seemed to ease, as well. By mid 1995 Caldera and Congress had agreed to a quid pro quo: Caldera would restore Constitutional rights suspended a year earlier, and Congress would pass laws the Caldera government said it needed to manage the crisis. Namely, Congress would give the President the power to unilaterally impose exchange controls when he thought necessary and to continue his banking policy.

So Congress passed a foreign exchange regime law in May 1995,226 and a new financial emergency law in July.227 The same day, the government issued a decree228 restoring the rights that had been suspended

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223 This included 17 commercial banks and one finance company.
224 This, however, represented a great depletion in the size of the failed banks. In December 1993, this same group had accounted for more than 60 percent of total deposits.
the year before.\textsuperscript{229}

The new Financial Emergency Law codified the wide array of rules that the government had set by decree, clarified issues related to Fogade’s loans to banks, and set deadlines for the attorney general to legalize the seizure of assets performed during the period when Constitutional rights had been suspended. The law also set the framework for restructuring the Central Bank’s loan to Fogade, by now worth Bs. 840 billion.\textsuperscript{230} Deposit insurance payments would no longer have to wait for the liquidation of a failed bank, but could be paid out within 150 days of a government takeover.\textsuperscript{231} Depositors treated in a discriminatory way in the June 1994 payouts were offered special compensation, so they would have parity with Banco Latino depositors.\textsuperscript{232} But the Bs. 4 million deposit insurance, set in the Financial Emergency Law passed by Congress in March 1994, was kept in place as the future new standard if other banks were to fail.

Mechanisms were instituted to dispose of the failed banks’ assets. Works of art were to be handed over to the Central Bank in partial payment of Fogade’s debts. Other reforms clarified how Fogade would manage the non-financial companies it had taken over, and how it would make severance payments to employees of the failed financial institutions.

\textsuperscript{229} The government kept foreign exchange and price controls in place until April 1996. The discussion between government and Congress focused on civil and political rights. Restoring economic rights was not a priority for the political establishment.

\textsuperscript{230} The amount owed by Fogade mushroomed as the loan accrued interest and Fogade failed to pay. Negotiations between the Central Bank and Fogade could not be settled by the two institutions on their own. A legal framework authorization was needed if below-market rates were to be applied. The emergency law set the framework for the settlement: a 20 to 30-year maturity, at a deep-subsidized rate of 5 percent per year. But the two agencies failed to reach a final agreement. As of November 1999 the issue was still pending.

\textsuperscript{231} Deposit insurance would become due 60 days after a bank was subject to government intervention, and Fogade would be obliged to pay during the following 90 days.

\textsuperscript{232} This included raising to Bs. 10 million the cash payout, and the possibility of settling the rest of the deposits in bonds, for the depositors of the banks intervened in June 1994, as they had received the least favorable treatment and the inequality was being severely criticized.
## Table 4-1
Banking crisis episodes

<table>
<thead>
<tr>
<th>Commercial Banks</th>
<th>Date Fogade Assistance Began</th>
<th>Date of Government Takeover</th>
<th>Deposits Market Share</th>
<th>Number of Depositors</th>
<th>Percent of Total</th>
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<tbody>
<tr>
<td>Latino</td>
<td>01/16/94</td>
<td>06/14/94</td>
<td>9.23</td>
<td>675,558</td>
<td>5.67</td>
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<td>Maracaibo</td>
<td>01/25/94</td>
<td>06/14/94</td>
<td>8.33</td>
<td>505,678</td>
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<td>Barinas</td>
<td>01/27/94</td>
<td>06/14/94</td>
<td>1.32</td>
<td>63,576</td>
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<td>Construcción</td>
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<td>06/14/94</td>
<td>3.67</td>
<td>172,685</td>
<td>1.45</td>
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<td>06/14/94</td>
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<td>Metropolitano</td>
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<td>06/14/94</td>
<td>3.98</td>
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<td>06/14/94</td>
<td>1.42</td>
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<td>06/14/94</td>
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<td>4,809</td>
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<td>10.65</td>
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<td>Italo</td>
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Total: 62.26, 6,360,209, 53.41

1: Estimated depositors for Latino group: 2 million
2: As of December 31, 1993

Source: Fogade
STUMBLING TO RECOVERY

In the second half of 1995, a measure of stability returned to the Venezuelan banking system. Mainly, this was because the damage had run its course: most troubled banks had been taken over by the government and shut. As depositors saw that the process of bank seizures and closures had stopped, the atmosphere of panic subsided, and there were no more runs on banks. It had been a war for survival of the fittest. The weakest banks—politically or financially—were wiped out. That gave the stronger ones a greater role in the financial system.

Caldera’s government did eventually stabilize the banking system, albeit in a very piecemeal and painful way. Instead of crafting a strategy to deal with the banking crisis up front, and building political consensus to implement it swiftly and effectively, his administration behaved as if it were overwhelmed by the crisis. Caldera was also lured by the opportunity to make the crisis work to his political advantage—he used it to defuse criticism of his economic policies, and also to win more power and more control over Venezuela’s institutions. The clout our institutions lost during this time still has not been fully restored.

The exchange controls forced funds into the banking system since depositors were prevented from seeking higher returns outside of the country. Increased government spending and easy monetary policy created further liquidity. Banks thus functioned more comfortably, even though the economy subsequently entered a two-year recession.

Paradoxically, while the economy was choked off by exchange controls intended to maintain foreign reserves, reserves were dropping. The loss of foreign reserves and the growing gulf between the official and black market exchange rates forced the authorities to devalue the official exchange rate by a sharp 70 percent on December 11, 1995. This devaluation brought only more inflation, as it was not part of any program aimed at correcting the fundamental problems in the economy.

By the spring of 1996, Caldera seemed ready to cave to pressures to institute free-market economic policies. He allowed a new economic team to organize an about-face in economic policy management. Teodoro Petkoff, a prominent leader of the socialist party MAS, which was a Caldera ally in Congress, agreed to become minister of Cordiplan. Petkoff had been doggedly criticizing Caldera’s policies all through the previous year. Freddy Rojas Parra, a respected businessman and a former president of Fedecámaras, was named minister of industry and, shortly afterward, minister of finance. Together these two men took it upon themselves to undo the government’s economic policy mess.

Petkoff quickly became the government’s most respected spokesman on economic policy issues.
In April, Caldera announced the sweeping economic adjustment program that would bring Venezuela into step with the rest of the region, and with the economics of the real world. There were to be no more quests for less painful alternatives and no more heavy controls, but an all-out, full-speed-ahead shift toward a free economy.

To cut the budget deficit, the government imposed a steep rise in the wholesale sales tax, from 12.5 percent to 16.5 percent, and a fivefold increase in gasoline prices.

Exchange controls were abolished a few days later, and a single exchange rate at the prevailing market level would serve from then on to settle all international payments.

In tandem with this decision, the Central Bank raised short-term interest rates, and thus made a significant contribution to the program’s credibility. Against all odds, the exchange rate quickly stabilized, at around Bs. 460 to $1US.

As a result, in April 1996 the IMF approved a $1.5 billion loan for Venezuela. Venezuelans were relieved. IMF Managing Director Michel Camdessus, at one time persona non grata for this government, metamorphosed into Caldera’s guest of honor. When he visited Caracas in June 1996, he was handed the government’s economic policy memorandum at a Miraflores Palace ceremony broadcast on national TV. The government euphemistically called its new economic program “Agenda Venezuela,” to convey a sense of independence and ingenuity.

Chastened commentators declared the new measures “horrible but necessary,” and complained that they should have been instituted sooner. Few cared to remember that they had supported Caldera’s pledges to roll back the market-oriented reforms in 1994.

Venezuela’s comeback to commonsense economic policies was preceded by another opening to the outside world: the successful first round of auctions of PDVSA oil fields to foreign oil companies, a move that allowed foreign investors into the Venezuelan oil market for the first time in 20 years. Oil fortuitously helped Venezuela out, as it always had. A short-lived oil bonanza brought $7 billion in windfall profits in 1996-1997. Venezuela’s international standing rebounded.

More benign economic conditions helped the banks as well.

Highly negative interest rates throughout 1995-1996 led to net wealth transfers from depositors to banks and borrowers on a massive scale. Interest rate spreads increased substantially and helped the banks cover their traditionally high operating costs. They were able to write off problem loans and set aside larger contingent loss reserves. The banks also benefited from 1995 and 1996 currency devaluations; the profits went largely to boost reserves.

This allowed banks to comply with the more stringent capital and provi-
sioning requirements, as there was no meaningful infusion of new money into the banks, or significant new business, until late 1996.

Asset quality also improved. The loan portfolio benefited, first, from the decision of large corporate borrowers to repay their bolivar-denominated debt in a climate of lower interest rates in 1994 to 1995, as they expected a new surge in interest rates. The markets behaved as if real interest rates were high, when in fact the opposite was the case. Low interest rates also helped borrowers service their bank debts, and laid the groundwork for banks and borrowers to work out problem loans.

Facing low demand for loans, banks increased their investments in government and Central Bank securities. The new risk-weighted capital adequacy ratios, enacted as part of the 1994 Banking Law, were a very strong incentive: all of these bonds were zero-risk assets and automatically boosted the banks' capital ratios. Despite Caldera's hostility toward the Central Bank's zero-coupon bond policy, after I was gone, the Central Bank did not stop issuing them.

Regulations calling for higher capital and loan loss provisions also helped push the banks in the right direction. By December 1995, the banks were required to reach the minimum 8 percent risk-weighted Basle capital adequacy ratio. The Office of the Superintendent of Banks also imposed higher provisioning requirements, and stepped up asset quality supervision. External auditors are now accountable to the banking supervisor.

The health of the Venezuelan banking system was already improving when the idea of establishing a special fund to support systemic restructuring came up, during the government's negotiations with the IMF for a loan program.

It was suggested that a $1 billion fund be set up with the help of the IMF, the World Bank, the Inter-American Development Bank and the Andean Development Corporation (CAF). Caldera appointed a special recapitalization committee, the Comisión para la Recapitalización y Fortalecimiento del Sistema Financiero, to get the ball rolling, even though its functions overlapped with those of existing regulators.

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### Capital adequacy ratios in the 1994 banking law were as follows:

<table>
<thead>
<tr>
<th>Deadline</th>
<th>Risk-weighted Capital/asset ratio (minimum)</th>
<th>Nominal Capital/asset ratio (minimum)</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30, 1994</td>
<td>6.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>December 31, 1994</td>
<td>7.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>June 30, 1995</td>
<td>7.5%</td>
<td>5.5%</td>
</tr>
<tr>
<td>December 31, 1995</td>
<td>8.0%</td>
<td>6.0%</td>
</tr>
</tbody>
</table>

---

222 *El Universal*, July 8, 1996.
The bank recapitalization project was designed to provide loans for mergers and acquisitions, and to assist banks unable to comply with the minimum 8 percent capitalization rule. In order to gain access to these funds, a bank would have to meet capital adequacy requirements, pose an "acceptable" financial risk, and submit to audits by the recapitalization committee and the superintendent of banks. Bank shareholders would also have to match every bolivar granted to them.

Unfortunately, the project was stillborn. Predictably, the idea found little support among local bankers. Moreover, Congress would have hardly approved new government debt to support the banking system, especially as the banks' solvency was improving without the infusion of more public funds.

A thorough restructuring of Fogade, separating its bank resolution and deposit insurance functions, was another objective of the project. The legal problems that handicapped Fogade's asset management functions were truly nightmarish and directly interfered with any banking sector restructuring plan. But these ideas were not acceptable to government officials and were also dropped.286

Banking sector restructuring went ahead anyway, driven by market forces and improved regulations. The government did not have to pump any more money into the banking sector after 1996, and wisely refrained from doing so.

FOREIGN BANKS RECAPITALIZE THE SYSTEM

Beginning in December 1996, the government began to sell off the banks it had acquired. The idea was to raise cash, and also to put banks in the hands of owners who could make capital commitments to them. Foreign banks, a few of which had established branches in Venezuela in previous years, were obviously the most fit potential buyers.

The entry of foreign banks had already been approved as part of the 1994 Banking Law, so the Caldera government could take advantage of the new legal framework.

Privatization deepened the penetration of foreign banks into the Venezuelan banking market. All four Venezuelan banks privatized in 1996 and 1997 were bought by foreign banks. Banco Santander of Spain bought Banco de Venezuela. Infisa, the Chilean leader of a group of global investors, bought Banco Consolidado. Davivienda, a Colombian financial group, bought Banco República. And little Banco Popular ended up as part of Banco Bilbao Vizcaya's large stake in the Venezuelan banking system.

286 Fogade's asset management and deposit insurance functions remain commingled as of November 1999.
In fact, BBV was the first foreign entity to buy a Venezuelan bank. The Spanish bank purchased controlling ownership of Venezuela’s largest bank, Banco Provincial, in December 1996. Banco Provincial held $2.7 billion in deposits and controlled a powerful 24 percent of the Venezuelan banking market. Banco Popular of Ecuador purchased the small investment bank Fivenez, and subsequently transformed it into a universal bank. By then, a few foreign banks had already entered the Venezuelan market independently, and set up operations of their own. In September 1994, ING Bank established a branch in Caracas. ABN Amro followed suit in early 1995. 237

The Venezuelan banking scene was transformed within a few years. By December 1998, foreign-owned banks accounted for 40 percent of total deposits. Foreign financial institutions also gained significant minority ownership in major Venezuelan banks.

It was a sweeping change. A country virtually without foreign banking for years suddenly acquired one of the strongest foreign banking presences in Latin America.

Bank privatizations officially brought the crisis to an end. The government had disposed of all of the banks that had landed in its hands.

All except for one.

Banco Latino was also supposed to be privatized, and refloated. Plans to sell it were announced—and postponed—countless times.

But after more than two years of bailout attempts, the bank’s condition was even worse than everyone had calculated. Over the years, government appointees had spent huge amounts of money in promotion and advertising campaigns to prepare for privatization. Efforts to collect debts were ineffective. There were allegations of mismanagement by Banco Latino conservatives. There were political complications, too.

With time, the franchise value of Banco Latino evaporated. Its deposit base shrank, and it continued generating operating losses. The bank was kept afloat mainly by revenues from asset sales. Eventually the bank ran out of marketable assets. 238

The government finally gave up and dismembered it. It sold off the bank’s remaining assets, business units and branches, piece by piece.

237 While the reform of the Banking Law was debated in 1991-1993, overseas institutions were seen as a “threat to national interests.” But when the 1994 Banking Law allowed foreign banks to enter the Venezuelan market and to operate under the same rules as Venezuelan banks, the principle of equal treatment was accepted. In February-March 1994, legislators began to hail foreign banks as potential lifesavers for the Venezuelan banking system. Foreign banks entered eagerly in 1996 and 1997, when low asset values and interesting business prospects made Venezuela attractive for international banks seeking to expand into Latin America.

238 By contrast, the effort to save Banco Latino International from liquidation paid off. Its assets were sold to Sun Trust, a U.S. bank. Banco Latino reported a $16 million profit on the sale. El Nacional, July 19, 1996.
And so, in June 1997, Banco Latino ceased to exist.\footnote{In August 1998, Venezuela’s highest administrative court confirmed the legality of the Superior Council of the Superintendency of Banks' January 1994 decision to seize Banco Latino and place it under conservatorship. That decision officially brought the case to an end.}

The main task since then has been to recover Bs. 100 billion of long-overdue loans, and to sell off the group’s remaining assets. Roberto Cuahonte, appointed by Fogade in December 1996 to manage Banco Latino’s liquidation and closure, stated that the government knew at the outset that its investments in the bank would be forever lost. “From the beginning,” he said, “we were aware of the fact that the Bs. 322 billion that were invested by the government in Banco Latino during the crisis would not be recovered.”\footnote{Revista Inversiones, June 1997.}

LESSONS OF THE CRISIS

Naturally, trust in the Venezuelan banking system was severely damaged during the crisis. Big banks—once considered solid—stopped being the places people put their money and were superseded by investments in real estate.\footnote{Surveys found that real estate rose in status as the preferred investment, from 30 percent of those polled in February 1994 to 45 percent 10 months later, while banks' status as the “preferred investment” plunged from 43 percent to 8 percent.} The public concluded that the banking crisis occurred because of poor bank management, imprudence and corruption, rather than perceiving that a wider crisis in the economy and the country as a whole also played a large part in the banks’ ill health.

Venezuelan depositors had learned an important lesson. Before the crisis, high interest rates and services were the most important factors when selecting a bank. Afterward, people were paying more attention to a bank’s strength, as indicated by a Venezuelan Banking Association survey:

<table>
<thead>
<tr>
<th>Why do you choose your bank?</th>
<th>July 93</th>
<th>Feb 94</th>
<th>Dec 94</th>
<th>June 95</th>
<th>Dec 96</th>
<th>July 99</th>
</tr>
</thead>
<tbody>
<tr>
<td>High interest rates</td>
<td>18%</td>
<td>9%</td>
<td>8%</td>
<td>5%</td>
<td>8%</td>
<td>4%</td>
</tr>
<tr>
<td>Strength of the bank</td>
<td>8%</td>
<td>43%</td>
<td>80%</td>
<td>72%</td>
<td>19%</td>
<td>21%</td>
</tr>
<tr>
<td>Convenience</td>
<td>20%</td>
<td>2%</td>
<td>1%</td>
<td>2%</td>
<td>17%</td>
<td>15%</td>
</tr>
<tr>
<td>Other</td>
<td>38%</td>
<td>46%</td>
<td>11%</td>
<td>19%</td>
<td>56%</td>
<td>60%</td>
</tr>
</tbody>
</table>

Source: Dataanalysis

It is, however, too soon to know whether moral hazard problems have disappeared. Financial memory is short. And although depositors suffered great uncertainty, in the end, most of them did not lose money.
Bankers also learned a lesson that improved corporate governance in the banking industry. Under the aegis of the suspension of Constitutional rights in 1994, the Caldera government created special penal courts to deal with banking "crimes." The justification for special courts was reasonable: the issues that came up at the time of the crisis were—and continue to be—technically complicated, and judges needed special training to handle the task properly. The creation of a special penal system is, however, questionable from a Constitutional standpoint, as it violates the right of the accused to be tried by sitting, rather than specially-appointed, judges.  

The widespread and highly-publicized indictments and arrest warrants have served to dispel the notion of banker impunity that lingered in the 1970s and 1980s. Even though just a few bankers gave themselves up and went to trial, the persecution that bankers faced became living proof of what can happen to a bank director or manager who fails to perform his or her duties.

Members of bank boards are, hopefully, less likely to obediently follow shareholders' instructions or to rubber stamp whatever proposal management presents to them. And management teams are also more cautious.

### Table 4-2
Number of Financial Institutions

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks</td>
<td>38</td>
<td>47</td>
<td>59</td>
<td>38</td>
<td>40</td>
<td>42</td>
</tr>
<tr>
<td>Private</td>
<td>30</td>
<td>42</td>
<td>51</td>
<td>31</td>
<td>36</td>
<td>39</td>
</tr>
<tr>
<td>OW foreign</td>
<td>3</td>
<td>5</td>
<td>7</td>
<td>7</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>Public</td>
<td>8</td>
<td>7</td>
<td>8</td>
<td>4</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Mortgage banks</td>
<td>18</td>
<td>17</td>
<td>9</td>
<td>6</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Financial companies</td>
<td>30</td>
<td>57</td>
<td>20</td>
<td>17</td>
<td>14</td>
<td>12</td>
</tr>
<tr>
<td>Leasing companies</td>
<td>26</td>
<td>36</td>
<td>18</td>
<td>16</td>
<td>12</td>
<td>9</td>
</tr>
<tr>
<td>Savings and loans</td>
<td>20</td>
<td>21</td>
<td>21</td>
<td>21</td>
<td>17</td>
<td></td>
</tr>
<tr>
<td>Money market funds</td>
<td>50</td>
<td>55</td>
<td>21</td>
<td>18</td>
<td>12</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
<td>162</td>
<td>193</td>
<td>128</td>
<td>116</td>
<td>104</td>
<td>94</td>
</tr>
</tbody>
</table>

Source: Office of the Superintendent of Banks

In some ways, the banking system is better off. We are somewhat less overbanked: the number of financial institutions in Venezuela has been steadily declining. Although we still have no mergers and acquisitions policy, a mar-

---

212 It was unsuccessfully challenged in the courts.
ket-driven mergers and acquisitions process is slowly creating larger and more efficient institutions.

Many financial groups have also been transformed into universal banks, mainly by merging all of their financial institutions. Disclosure has improved. Banks now report monthly on the quality of their assets, the status of their loan portfolios, and on loan losses. The loan portfolio discloses information on non-performing loans previously never published. And, at last, we have consolidated supervision; authorities have the power to view the assets of a conglomerate of which a bank is part, both at home and abroad.

But we cannot sing victory yet. We still have a very concentrated banking market. The five largest banks account for more than 53 percent of total deposits, while 19 of the 44 banks have a market share of 0.5 percent or less. Moreover, Venezuelan banks are still privately held. Bank shares are still not actively traded on any stock exchange; share prices therefore are not an indicator of investor attitudes about the banking system.

Market surveillance has not dramatically changed either. Information on true ownership, credit concentration, and loans to affiliated parties is still not disclosed to markets or to the public. The powers the 1994 Banking Law granted to the bank superintendent have been largely usurped by political bodies. In 1994, the JEF stripped the Office of the Superintendent of Banks of many of its functions, responsibilities that as of 1999 have not been restored. And the government has refused to repeal the financial emergency legislation that concentrated banking regulatory and supervisory powers in the JEF.

\[\text{As of December 1998, 14 commercial banks, accounting for 64 percent of total deposits, were universal banks.}
\]
\[\text{The superintendent of banks no longer has the power to suspend or revoke bank licenses, authorize capital increases, or approve government takeover and liquidation of financial institutions or changes in control ownership.}
\]
\[\text{As of November 1999, the JEF still existed.}\]
Venezuela's roller coaster economy would soon put the new Venezuelan banks, and their bankers, to the test. Oil revenues increased in 1996 and 1997, with a rise in prices and the opening of the oil sector to foreign investment. The timeless pattern was repeated: government spending and stock prices soared. Then came the decline, when the effects of the Asian economic crisis sent oil prices plunging in 1998. We were socked with a giant fiscal deficit and falling foreign reserves and currency attacks, and the economy entered a recession. National elections in December 1998 spiced up the crisis with political uncertainties.

The banks had begun to lend again during the 1996 and 1997 economic recovery, but, inevitably, were hit by the bust. This time though, higher capital and provisions proved to be a cushion.246

The Venezuelan economy is still weak, and highly dependent on oil. But our banking system has grown more resilient.

246 To be fair, the lending boom also did not last long enough to cause deeper damage.
| Table 4-3 | Commercial Banks. |  |
| Profitability || |
| 1. Interest income | 32.80 | 24.62 | 25.98 | 24.88 | 17.68 | 20.01 |
| 2. Interest expenses | 26.44 | 15.40 | 14.05 | 10.38 | 4.55 | 6.03 |
| 5. Contingent loss reserves | 1.46 | 6.64 | 4.30 | 3.28 | 1.19 | 1.57 |
| 6. Intermediation margin (3-4-5) | -2.81 | -4.68 | -1.64 | 1.63 | 2.92 | 1.56 |
| 7. Fee income | 2.64 | 4.73 | 2.02 | 2.34 | 2.28 | 1.92 |
| 8. Operating profit (6+7) | -0.17 | 0.05 | 0.58 | 3.97 | 4.30 | 3.48 |
| 9. Extraordinary income | 1.70 | 3.11 | 3.78 | 4.53 | 0.44 | 0.99 |
| 10. Net income before taxes (8+9) | 1.53 | 5.16 | 4.17 | 8.50 | 4.75 | 4.47 |
| 11. Income tax | 0.07 | 0.52 | 0.39 | 0.32 | 0.21 | 0.31 |
| 12. Return on assets (ROA) (10-11) | 4.16 | 2.6 | 3.8 | 8.2 | 4.5 | 4.2 |
| 13. Return on equity (ROE) | 18.53 | 34.0 | 56.4 | 50.3 | 28.2 | 28.2 |
| 14. Adjusted return on equity (AROE) | -2.96 | -6.1 | -0.1 | 22.5 | 25.5 | 21.5 |
| 15. Real return on assets (RROA) | -30.5 | -39.9 | -35.7 | -46.8 | -24.0 | -19.8 |
| 16. Real return on equity (RROE) | -18.8 | -21.5 | -12.9 | -26.0 | -6.8 | -1.3 |
| 17. Real adjusted return on equity (RAROE) | -33.3 | -45.0 | -36.2 | -39.7 | -8.8 | -6.5 |

Intermediation ratios
Credit / Deposits (%) 36.9 35.6 38.5 45.4 65.4 64.1

Capital adequacy
Capital / Assets (%) 7.0 6.9 8.6 12.9 13.1 13.5
Liabilities / Capital 13.3 13.4 10.6 6.7 6.6 6.4

Asset structure (%)
Cash 28.5 25.2 19.2 20.9 23.1 24.7
Loans 44.4 27.6 30.9 33.4 49.4 45.9
Securities and equities 15.5 38.0 38.0 36.4 20.1 19.2
Real estate 4.0 4.1 4.4 3.8 3.1 4.4
Other assets 7.5 5.1 7.6 5.5 4.3 5.7
Total 100.0 100.0 100.0 100.0 100.0 100.0

1/ as a percentage of total assets
2/ net income before extraordinary revenues
Source: Office of the Superintendent of Banks * 1998: published financial statements
The banking crisis was costly for Venezuelans in many ways. There were social costs: a decline in living standards that forced many of our brightest young people to search for opportunity abroad; a delay of necessary steps to build a free-market economy; and a protracted loss of Constitutional rights, a situation that created public distrust in yet another of our governments.

There were institutional costs, too. The banking crisis derailed years of efforts to strengthen our democratic institutions, and triggered a process that ended up wiping out the Central Bank's independence. It demonstrated how deeply weak banking supervision can harm a Central Bank.

THE BOTTOM LINE

Then there was the literal cost. The direct cost to the government of the Venezuelan banking crisis reached about $7.3 billion, including revenues realized from the sale of banks' assets as of December 31, 1998. Losses ate up the equivalent of 10.9 percent of our GDP.

Such dismal results are among the worst in the world for any banking crisis.

These losses are the result of several factors.

First, delay exacted a heavy cost. Two administrations squandered opportunities to stop or contain the crisis, failing to heed early warnings that problems were building. Congress contributed to the problem by postponing legislative actions that could have forced the banking system into more prudent risk management strategies. The Venezuelan habit of ignoring problems until there is no choice but to face up to them exacted, in this case, a very high price.
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Central bank loans to Fogade</td>
<td>839.53</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>839.53</td>
</tr>
<tr>
<td>Capital contributions to Fogade</td>
<td>400.00</td>
<td>200.00</td>
<td></td>
<td></td>
<td></td>
<td>600.00</td>
</tr>
<tr>
<td>Fogade net assets as of 12/31/93</td>
<td>64.89</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>64.89</td>
</tr>
<tr>
<td>Total</td>
<td>1,304.42</td>
<td>200.00</td>
<td></td>
<td></td>
<td></td>
<td>1,504.42</td>
</tr>
</tbody>
</table>

| Reimbursements                                                |            |            |            |            |          |           |
| Repayment of loans                                           | 41.46      |            |            |            |          | 41.46     |
| Fogade payments to Central Bank                               |            |            |            |            |          |           |
| (restructured debt)                                          |            | 0.50       | 26.17      | 20.12      | 36.16    | 82.95     |
| Residual assets                                              |            |            |            |            |          | 810.03    | 810.03    |
| Total                                                        | 41.46      |            |            |            |          | 846.19    | 934.44    |

| Net cost (current bolivars)                                   | 1,262.96   | -0.50      | 173.83     | -20.12     | -846.19  | 569.97    |
| Net cost (constant bolivars)                                  | 1,262.96   | -0.32      | 54.63      | -0.05      | -0.15    | 1,163.89  |
| Net cost (US$)                                                | 8.48       | 0.42       | -0.04      | -1.61      |          | 7.25      |

| Fogade's residual assets                                      | Billion Bs.|
| Total assets as of 12/31/98                                   | 1,793.54   |
| Minus deferred credits (pending provisions)                  | 900.00     |
| Minus other liabilities                                      | 0.16       |
| Minus ordinary bank contributions 1994-1998 (0.5%)            | 88.90      |
| Plus operative expenses 1994-1998                            | 20.47      |
| Minus financial revenues (income on ordinary contributions)  | 14.93      |
| Net assets available for transfers to the government or Central Bank | 810.02    |

Source: Fogade financial statements as of December 31, 1998
1/ Repayment received from banks in the first half 1994.
2/ Adjusted by CPI 1984=100
3/ Based on average annual exchange rate
4/ Includes only crisis-related Fogade assets. Excludes assets assigned to deposit insurance
5/ June 1998
Methodological Note:
The calculation of the net cost of the crisis to the government is based on Fogade as cost center for the crisis, being the institution in charge of handling bank insolvencies.
Total resources allocated to Fogade to handle the crisis included Fogade’s assets as of December 31, 1993 (before the crisis broke out), the Central Bank’s short-term loans to Fogade and capital contributions made by the government to Fogade in 1994-1996 (with funds raised through the issuance of bonds to this purpose). Several deductions are made in order to determine the net cost:
1) repayment of loans by Fogade to the Central Bank, reflecting the repayments made by the banks to Fogade in the first half of 1994;
2) repayment of interest and principal by Fogade to the Central Bank (restructured debt);
3) assets held by Fogade as of December 31, 1998, as a result of the crisis resolution process.
Several adjustments are made in order to determine the portion of Fogade’s current assets that are linked to the crisis (as opposed to Fogade’s deposit insurance function):
1) Total revenues due to bank contributions up to 0.5 percent of total deposits and the revenues generated by these funds are deducted, as these resources are deemed to be linked to deposit insurance. Revenues due to the additional 1.5 percent of deposits (since February 1994) are not deducted, as they are considered as resources raised by the government through a special tax, levied in response to the crisis and made available by the government to Fogade.
2) Fogade’s operational costs are added, as available information precludes determining which portion of the institution’s expenses is linked specifically to banking crisis related operations.
3) Loan loss provision is deducted, to reflect the market value of the failed banks’ loan portfolio assumed by Fogade. There are substantial assets yet unaccounted for in Fogade’s balance sheets, as the legal transfer of property is still pending. These include assets of the Latino, Italo, Profesional, Principal and Progreso financial groups. The net cost of the crisis will gradually decline as the transfer of such property progresses.
Second, closing Banco Latino in January 1994 was an unfortunate and unnecessary step. It exacerbated a violent contagion effect that scared depositors away from other banks they perceived to be weak, and also fueled a full-fledged foreign exchange crisis.

Third, once the banks were crumbling, the Caldera government's inadequate crisis management policy proved expensive. The lack of a clear strategy for managing bank failures, a steady diet of contradictory policy statements, the withdrawal of government deposits from ailing banks, and delays in implementing solutions all exacerbated the public's loss of confidence in the banking system. Simultaneous selling of assets by banks, prompted by common shocks and rumors, further fed into the decline in asset prices and ultimately wiped out the franchise value of some institutions. As a result, the crisis lasted longer, ended up costing more, and destroyed more banks than it might have.

Fourth, payments to depositors turned out to be larger than expected. Congressional efforts to mollify all depositors, and inadequate accounting, drove up the price tag. Congressional decisions in March 1994 to quadruple deposit insurance payments, and to extend the official safety net to deposits and other bolivar-denominated liabilities not originally covered under the 1994 Banking Law, turned out to be expensive.65 Then in 1995, Congress raised deposit insurance payments further, in order to give the depositors of the 11 banks seized in June 1994 parity treatment with Latino depositors. This was fair, but costly.

Then, the bill for unrecorded off balance sheet liabilities came in. The real size of liabilities covered by the official safety net turned out to be more than double the levels accounted for on the financial groups' official balance sheets.

Lastly, Venezuelans paid unnecessarily high costs for the workout of Banco Latino. Instead of downsizing and quickly privatizing the bank once it was clear that it was a lost cause, the government let it limp along, open but bleeding funds, for three years more. Its deposits declined and its operational expenses swelled, while losses were masked by revenues from one-time asset sales. Instead of recovering funds via privatization, an option that might have yielded larger revenues if done with dispatch, between 1994 and 1997 the government just let Banco Latino burn through the money. It meant an extra bill for taxpayers in the end.

65 In March 1994, Congress extended the official safety net to cover the off balance sheet liabilities of Venezuelan financial groups, and the bolivar-denominated offshore deposits belonging to Venezuelan depositors.
Table 5-2
Official Deposits vs. Post-facto Covered Liabilities
Billion bolívares

<table>
<thead>
<tr>
<th>Financial groups</th>
<th>“Official” deposits 1/ December 1993</th>
<th>Post-facto covered liabilities 2/</th>
<th>% difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amazonas</td>
<td>8.5</td>
<td>12.0</td>
<td>41.2</td>
</tr>
<tr>
<td>Bancor</td>
<td>24.9</td>
<td>59.5</td>
<td>138.1</td>
</tr>
<tr>
<td>La Guaira</td>
<td>42.0</td>
<td>78.6</td>
<td>87.1</td>
</tr>
<tr>
<td>Barinas</td>
<td>24.4</td>
<td>25.4</td>
<td>4.1</td>
</tr>
<tr>
<td>Construcción</td>
<td>54.0</td>
<td>84.4</td>
<td>56.3</td>
</tr>
<tr>
<td>Fivere</td>
<td>11.9</td>
<td>22.8</td>
<td>91.6</td>
</tr>
<tr>
<td>Maracaibo</td>
<td>162.9</td>
<td>209.5</td>
<td>28.6</td>
</tr>
<tr>
<td>Metropolitano</td>
<td>94.6</td>
<td>232.6</td>
<td>145.9</td>
</tr>
</tbody>
</table>

1/ Includes official balance sheet information on deposits and deposit-like instruments of the financial group: commercial bank, mortgage bank, financial company and leasing company.
2/ Additionally includes money desk liabilities (mesa de dinero), money market funds (Fondo de Activos Liquidos) and off-shore operations.
Source: Fasade

THE FATE OF PUBLIC FUNDS

The Caldera government heaped damning invective upon the “fugitive bankers” who fled the country to avoid being tried. With neither a functioning economic strategy nor a comprehensive banking rescue battle plan, the administration focused on chasing scapegoats. Some people thought the President took advantage of the crisis to take revenge on bankers who supported his political opponents, and to amass greater power. Others believed he was indifferent to judicial impartiality when the reputations of certain public officials were on the line.

In any case, the tone of the times was to find culprits, and hang them. Countless people were hounded by investigators looking for something—anything—that would allow the placement of blame.
Stories alleging sightings of bankers in places like Miami, Monaco and Spain, even in Slovenia and Israel, made for exciting front page headlines, stoked the public thirst for vengeance, and distracted voters from the fact that nothing else was going right in Venezuela either. The government mounted an expensive international manhunt for some of these bankers, claiming that banks had defrauded depositors, misused public funds and fiddled with accounts reporting. The government also sued Banco Latino NV bankers for $1 billion in Curaçao and brought a case against offshore bankers in Miami. Later other bankers—some of them considered political enemies of Caldera associates—were accused of money laundering and fraud. The basic implication was that rich bankers were living it up abroad, on misappropriated Fogade money and the stolen deposits of suffering Venezuelans. The idea still resonates deeply in Venezuela.

These tactics were also most effective in boosting Caldera’s popularity. Even though all of his other policies were failing, by June 1994 the President’s approval ratings were running at 70 percent.

Few people have been convicted of anything. Five years later, the disputes and appeals are still in the courts.

I have no independent information about whether bankers committed wrongdoing with depositors’ funds. Available data does, however, explain the fate of the funds Fogade used to prop up ailing banks.

Allegations of fraudulent use and mismanagement of these funds were one justication for seizure of these banks in June 1994. Eduardo Roche Lander, Venezuela’s comptroller general, further claimed that only 20 percent of these funds ever reached depositors. He implied that the rest had been frittered away, or pocketed by bankers.

But the Fogade money did go largely to depositors, just as it was supposed to.

The figures speak for themselves. Evaluation of the assets and liabilities of the financial groups that received government aid shows that at least 97 percent of the funds disbursed by the government reached depositors and other lawful bank creditors.

Although Roche never explained how he arrived at his 20 percent figure, it appears to be the result of a large oversight: he counted only the decline in the commercial banks’ deposits—and ignored the liabilities of the other institutions that were part of the financial groups. That is, he did not

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248 Four years later, journalists were still using Spain’s Banesto case to argue that only civilized countries knew how to make bankers pay for their crimes. “Today...the president of Banesto is in jail, and paid many millions of dollars back to Spain,” complained one newspaper column. “But Latino’s fugitive bankers protest in the press. No one is under arrest. They haven’t paid anything. And even worse, they look for scapegoats to justify themselves.” See El Nacional, March 15, 1998.

249 The Office of the Comptroller General is the arm of Congress charged with the oversight of public administration, but for administrative purposes only. If legal violations are found, they must be submitted to the courts for adjudication.
evaluate banks' offshore operations and affiliated companies that were covered by the official safety net. When all of these are included, we can see that 97 percent of Fogade funds were paid out to depositors.

The Venezuelan banking crisis of 1994 ranks 13th in severity among the world’s recent banking crises, and fifth in Latin America.

<table>
<thead>
<tr>
<th>Table 5-3</th>
<th>Where the Money Went</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Billion Bs.</td>
</tr>
<tr>
<td>Fogade cash disbursements in 1994-1996</td>
<td>1,399</td>
</tr>
</tbody>
</table>

Use of funds:
1. Net reduction of liabilities of the 8 financial groups receiving Fogade assistance in the first half of 1994 | 448 |
2. Net reduction of liabilities of Banco Progreso before seized by the government | 52 |
3. Banco Latino recapitalization | 294 |
4. Banco de Venezuela and Banco Consolidado recapitalization | 191 |
5. First tranche of deposit insurance payment to depositors of the banks seized in June 1994 | 172 |
6. Other Fogade payments in 1996 | 200 |
**Total use of funds** | 1,357 |

Cash disbursements/use of funds | 97 percent |

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1/ Includes additional deposit insurance payment to depositors when parity treatment with Banco Latino was approved, partial payment of "migraciones" and partial payment of other off balance sheet liabilities.

Source: Central Bank of Venezuela
<table>
<thead>
<tr>
<th>Country</th>
<th>Period</th>
<th>Estimated Cost /GDP (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>1980-82</td>
<td>55.3</td>
</tr>
<tr>
<td>Chile</td>
<td>1981-83</td>
<td>41.2</td>
</tr>
<tr>
<td>Israel</td>
<td>1977-83</td>
<td>30.0</td>
</tr>
<tr>
<td>Côte d'Ivoire</td>
<td>1988-91</td>
<td>25.0</td>
</tr>
<tr>
<td>Uruguay</td>
<td>1981-84</td>
<td>24.2</td>
</tr>
<tr>
<td>Senegal</td>
<td>1988-91</td>
<td>17.0</td>
</tr>
<tr>
<td>Benin</td>
<td>1988-90</td>
<td>17.0</td>
</tr>
<tr>
<td>Mauritania</td>
<td>1984-93</td>
<td>15.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>1990s</td>
<td>12-15</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1990s</td>
<td>14.0</td>
</tr>
<tr>
<td>Philippiñés</td>
<td>1981-87</td>
<td>13.2</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1991-98</td>
<td>12.0</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1994-95</td>
<td>10.9 2</td>
</tr>
<tr>
<td>Hungary</td>
<td>1991-95</td>
<td>10.0</td>
</tr>
<tr>
<td>Brazil</td>
<td>1994-95</td>
<td>5-10</td>
</tr>
<tr>
<td>Finland</td>
<td>1991-94</td>
<td>8.4</td>
</tr>
<tr>
<td>Spain</td>
<td>1977-85</td>
<td>3.6</td>
</tr>
<tr>
<td>Colombia</td>
<td>1982-87</td>
<td>5.0</td>
</tr>
<tr>
<td>Sweden</td>
<td>1991</td>
<td>4.0 2</td>
</tr>
<tr>
<td>Norway</td>
<td>1987-89</td>
<td>3.3 2</td>
</tr>
<tr>
<td>Turkey</td>
<td>1982-85</td>
<td>2.5</td>
</tr>
<tr>
<td>United States</td>
<td>1980-82</td>
<td>2.4</td>
</tr>
</tbody>
</table>

1/ includes all depository institutions
2/ estimate
3/ large portion of this cost has subsequently been recovered
Sources: Caprio and Klingebiel; Lindgren, García and Saal;
Rojas-Suárez and Weisbrod.
A PERSONAL COST

Even though I was never charged with anything, I did not escape harassment. When I became Central Bank president, I knew my actions would be subject to public scrutiny. That is a responsibility of any public official in a democratic country. During those trying times, I was forced to make difficult decisions. It was clear to me that any decision I made would wind up angering someone.

But I never thought it would go so far. Over the past five years, my former Central Bank colleagues and I have been forced to defend ourselves against a long and baseless smear campaign over the loans we gave Fogade. The Office of the Comptroller General led this campaign, even though both the Supreme Court and the country's highest penal court for the safeguard of public patrimony absolved both Fogade and Central Bank officials of any wrongdoing.256

On June 15, 1994, the day after the government seized the group of banks receiving Fogade assistance, the penal court began an inquiry. Even though there were those who thirsted to see us punished in some way, the court found on December 13, 1995 that both the Central Bank and Fogade acted in accordance with the law. The Supreme Court confirmed this decision about two and a half years later, on July 1, 1998.

Almost simultaneously, in mid-1994, the comptroller general launched his own investigation.251 During the court cases, and well after they were over, Roche pressed a drawn-out campaign to discredit the Central Bank, and to condemn the Central Bank directors who had approved loans to Fogade. The campaign was conducted with public and television appearances, official press releases, and a Web page.

The Office of the Comptroller is akin to the U.S. General Accounting Office. It had no authority to pass judgment on the Central Bank's policy decisions; it could only check on the appropriateness of the Central Bank's accounts. And though managing the banking crisis was the responsibility of many parties, it was the Central Bank that became the focal point of Roche's dissatisfaction.

In December 1995 a new law of the Office of the Comptroller General was passed. Although it still did not give the comptroller the power to judge the Central Bank's policy decisions, the new law expanded the office's prosecutory powers. Roche set out to make the most of this. As soon as it

256 Tribunal Superior de Salvaguarda del Patrimonio Público.
251 As the Office of the Comptroller General has no authority to pass judgment on the Central Bank's policy decisions, Roche decided to put investigations of the Central Bank on hold until a reform of the Comptroller's law enacted in early 1996 would expand his prosecutory powers.
took effect February 1, he immediately reactivated his investigation against current and former Central Bank officers. His staff summoned us to a deposition and tried to file charges against us based on the new law. This violated the Constitutional principle that prohibits applying laws that were not in effect at the time an event occurred.252

This investigation affected both Antonio Casas and me as presidents, plus 13 Central Bank board members. We all had to hire lawyers and pay them ourselves.

The comptroller general argued that we had wrongly overburdened Fogade with debts it could not repay, and claimed that the terms of our loans to the deposit agency violated banking laws. He seized upon a statute which he interpreted to mean that the Central Bank could not lend Fogade more than Bs. 13 billion ($123 million) in the event of a systemic crisis.253

That we Central Bank directors had resisted and started fighting in the courts—daring to pose a challenge, something unheard of previously—helped turn his inquiry into a sort of personal vendetta. Roche publicly predetermined our guilt, violating our presumption of innocence.

In June 1996, we filed two appeals with the Supreme Court. One sought to clarify the content of the two articles of the Bank Law we supposedly violated.254 The other was an appeal for relief to prevent the comptroller general from bringing to judgment the policies of public officials who were acting within the legitimate scope of their powers.255 We asked the Supreme Court to limit the Comptroller General's prosecutorial powers.

But Roche just kept pressing his campaign. He coined the term "amparitis"256 to cast aspersions on our appeal for relief. He accused us of trying to block the investigations. Some news organizations even reported that Roche had pressured judges to decide the case his way. The Comptroller General and his staff blatantly violated the guarantees of objectivity and impartiality established in the laws that governed their agency.257

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252 Article 44 of the Venezuelan Constitution.
253 According to Article 225 of the banking law, the Central Bank can lend to Fogade an unlimited amount of funds; loans must have one-year terms and be guaranteed with Fogade's assets and future contributions. According to Article 314, the Central Bank could also lend for two-year terms, without collateral, up to Bs. 13 billion. The Office of the Comptroller General argued we could only apply Article 314 at the time of the crisis.
254 Appeal of Collision of Laws, with reference to articles 314 and 225 of the Bank Law.
255 We requested that the Office of the Comptroller General be prevented from sanctioning us for a nonexistent crime, by applying Article 113, Number 15, of its law as a blank statute (a statute which imposes a sanction without describing in detail the subject matter to which it applies).
256 The Spanish term for Appeal for Relief is amparo.
Almost a year later, on April 15, 1997, the Supreme Court handed down two decisions. One confirmed the legality of the actions taken by the Central Bank. It held that there was no conflict between articles 314 and 225 of the banking law. The charges brought by the Office of the Comptroller General thus had no legal basis.

The second sought to interpret Number 15 of Article 113 of the law of the Office of the Comptroller General, which had been invoked to try to convict the Central Bank officers of malaesance. The Supreme Court advised the Office of the Comptroller General that the application of the law called for punishment only for illegal and imputable conduct. Such standards had not been met in our case. His charge was therefore baseless.

It seemed clear to us that the comptroller general’s proceeding ought to end right there.

But Roche just would not give up. Instead, he filed new charges for alleged violations of other norms of the Banking Law—regulations that were not even within the Central Bank’s powers. In the new attacks, Roche alleged that the Central Bank had acted irresponsibly by lending Fogade sums that it would not be able to repay within the period set by law. Roche would not even look at contradictory evidence: for example, that while Central Bank loans to Fogade during the first half of 1994 did amount to Bs. 504 billion, in the ensuing twelve month period Fogade’s assets in kind plus cash revenues were about Bs. 1.8 trillion. Even if we allow for hidden losses, it is clear that the reason for Fogade’s arrears and mounting debt to the Central Bank was the agency’s financial strategy, not its inability to pay.

Finally, Roche charged that we had not overseen the guarantees that Fogade should have received from the banks that were given assistance. Of course, the Central Bank had neither the authority nor the responsibility for oversight of the guarantees that Fogade (as creditor) received from its borrowers. As the Supreme Court confirmed in its April 1997 decisions, Central Bank loans went to finance Fogade, not the banks. Managing the bank loans was Fogade’s responsibility.

Along the way, the Office of the Comptroller General attempted to sanction all Central Bank officials for administrative wrongdoing. We appealed for relief at the highest administrative court. When the court granted that relief, Roche publicly demanded that the Supreme Court dismiss all its magistrates. After conducting a thorough investigation, the Supreme Court concluded there was no reason to file charges.

Beyond the legal issues, it would be helpful to place these events in context.

In the first half of 1994, the Central Bank was coping with the risk of the imminent collapse of the payment system. Allowing normal payments to come to a halt would have dealt a catastrophic blow to na-
tional economic activity.

In addition, Fogade received assets whose nominal value matched the amounts of its loans to banks. In those turbulent days, when every hour brought new challenges to the banking system, no agency could have assessed the real market value of the assets the banks were transferring as collateral. Their actual value has not—to this day—been fully disclosed by Fogade;\textsuperscript{258} doing so would allow a more specific determination of the true losses in the crisis.\textsuperscript{259}

The comptroller's claim was senseless, in any case, because it implied that the government should have incurred no losses in the banking crisis.

If bank assets at market value had covered the value of their liabilities, there would have been no crisis to begin with. Roche's argument was tantamount to a claim that there was no insolvency problem in the Venezuelan banking system, and that the banking crisis was just a joke!

\textsuperscript{258} As of November 1999, at least.
\textsuperscript{259} The first set of accounting rules for Fogade was issued by the Office of the Superintendent of Banks in October 1997.
In the five years since the Venezuelan banking crisis erupted, I have reviewed events over and over, questioning my actions and the actions of others. I wanted to distill key lessons, so that Venezuela might avoid suffering through the same experience again, and so other countries might avoid such fiascoes.

In some ways, our crisis was unique, because virtually all of the factors that could possibly lead to a crisis were present simultaneously: a souring economy, severe and protracted social instability, political interference, a poor bank regulatory framework, weak supervision of banks—and bad banking, too.

On the other hand, banks can fail, no matter how vigilant governments and bankers may be. The key is to prevent bank failures from spreading like a plague from one bank to another and to spare taxpayers the price tag.

Below, I will lay out my ideas for avoiding and containing a banking crisis. The acknowledgment that there will always be bank failures does not relieve us of the obligation to do everything we can to prevent them.

Because no one person or institution can keep a banking system healthy, I will make separate recommendations to bank owners and managers, central bankers, bank regulators, lawmakers, economic policymakers, and the world community of bankers and supervisors. Finally, I will make some observations about the special problems of Latin America and Venezuela.

MANAGING IN A CRISIS

For a central banker, the blowup of a banking system is like the arrival of a tropical hurricane. Trees are toppling, the windows are shattering and the shutters are being ripped from their hinges. You know you must do some-
thing to keep your house from being destroyed. But what? The actions of any human being seem ineffective against the force of the storm. It is useless by then to wish you lived in some calmer clime.

But a banking crisis need not be a catastrophe. Efficient management and preparation can help contain losses and restore confidence in the banking system and in the country relatively quickly.

Developing a comprehensive strategy, forging political consensus, getting reliable information about banks, communicating regularly with depositors, and taking action quickly are the crucial components of successful crisis management.

Sweden's management of its early 1990s banking crisis provides one example to follow. When real estate loan losses plunged the financial sector into turmoil, the Prime Minister, Cabinet and Parliament quickly stepped in to support depositors, ensure the stability of the payment system and safeguard the credit supply. Watching the crisis brew, the ministry of finance spent several months preparing an emergency plan. The government's chief tool was a provision guaranteeing payments and capital injections into the entire banking system. The guarantee did not discriminate among banks: it also covered the subsidiaries of foreign banks, and some institutions that were wholly or partly state-owned.260

Early on in the crisis, the Swedish government determined the size of the losses and thoroughly briefed Parliament in order to build support across party lines, even as the restructuring plan was taking shape. A framework for crisis management was hammered out, with discrete roles for the ministry of finance, the Riksbank (the Central Bank), the financial supervisory authority and the Bank Support Authority (BSA), an agency created by Parliament for the purpose of coordinating the plan. In December 1992, when Parliament passed the bill guaranteeing that financial institutions would meet their commitments on time, representatives of opposition parties were involved in key meetings and appointed to the BSA board. Throughout the crisis, the government reported regularly and extensively to depositors and investors, and paid the costs directly from the national budget.

Sweden's total commitments (including guarantees) amounted to 85 billion kronor, or 5.9 percent of GDP. There was almost no need, however, to pay out the guarantees. The guarantee was carefully crafted in order to ensure banks and certain other credit institutions could meet their commitments on a timely basis, but was not linked to specific individual claims.

260 Most of the government's assistance went to two large banks, Gota Bank and state-owned Nordbanken, and their associated asset management companies, Reuna and Securum, which were set up to deal with non-performing loans. Nordbanken and Gota Bank were merged in 1993, retaining the name Nordbanken. Nordbanken is today one of Sweden's largest banks. The asset management companies were also merged in December 1995.
thus giving the government maximum discretionary room.\textsuperscript{251} Government support to banks turned out to be mainly in the form of capital injections to banks (86 percent), share subscriptions or share purchases (10 percent), and interest subsidies (2 percent). The direct cost to the taxpayer was 61 billion kronor, or 4.2 percent of GDP—about 70 percent of what government officials originally expected. Moreover, the net cost is diminishing over time, with successful asset recovery efforts. Parliament terminated its guarantee after four years, in 1996.\textsuperscript{252}

Venezuelan authorities, unfortunately, could not match the Swedes’ methodical and organized approach.

Some of the lessons I have drawn from our upheaval:

\textbf{Be hypervigilant.} A fragile banking system plus a shock-prone economy is a lethal combination. The risk that a sudden negative political or economic event could escalate into a full-fledged financial catastrophe is very high. And once a crisis begins, it can accelerate rapidly.

Strong banking regulation and supervision can limit the severity of a crisis. We saw this dramatically demonstrated. Even as Venezuelan banks and their offshore operations failed, all subsidiaries and related financial services companies that complied with regulations in United States, the United Kingdom, Switzerland and Colombia remained solvent.

\textbf{Watch the markets for danger signs.} In countries with mature capital markets, the prices of bank shares or bonds are reliable signals of investors’ evaluation of banks’ financial health. In emerging market economies, where ownership of banks is usually concentrated and the capital markets are small, mind the money market instead.

If a bank consistently offers much higher deposit rates than its competitors, there is probably more than aggressive pricing going on. In Venezuela, high deposit rates offered by some of the ailing banks were an obvious sign of approaching problems. Though this was evident two years before the crisis erupted, the situation was largely left unattended.

Volatility and segmentation in the interbank market is another powerful early warning signal. Banks that begin losing deposits tend to fund themselves with increasing frequency in the interbank market, and soon have to pay exorbitant rates for overnight money. The interbank lending rate becomes more volatile as tensions build, leading to widening gap between the best rate, offered to solvent banks, and the top-dollar rate problem banks are forced to pay.

\textsuperscript{251} The Swedish government guaranteed that banks would pay depositors but did not offer to pay depositors directly. This way, depositors continued to have relationships with their banks. If pressed for funds, a bank could apply to the government for relief, and the government would decide on a case-by-case basis which aid provisions to offer it, so it could in turn make good on depositors’ claims.

\textsuperscript{252} Financial Supervisory Authority (Sweden). \textit{Experiences from the Swedish financial crisis from a supervisory perspective}. March 1996.
Once the market begins to single out weaker banks in this way, supervisors should act swiftly. As in Venezuela, if such problems go unchecked, ailing banks will soon have no choice but to put up collateral for short-term interbank loans, by pledging specific assets or setting up ad-hoc trusts. By that time, with their weakness so obvious, the danger of runs will be acute.

Be proactive. Banking problems won’t go away on their own. Many countries have learned that lesson painfully. Late decisions, and an aura of uncertainty, make it much more difficult to restore public confidence in the banks and in the currency.

A central bank is in a position to compel action from both banks and the government, essentially because of its ability to restrict access to the rediscount window. It can thereby force both parties to tackle the problems at hand. However, if confronted with a systemic crisis, the central bank might find itself constrained from taking such drastic measures by the need to protect the payment system. Once a widespread crisis has broken out, simply shutting the rediscount window will not solve much.

Get meaningful, reliable information on the state of the banking system, especially on problem banks. During a banking crisis, it is crucial to do this in order to avert disaster. Don’t expect information to be absolutely accurate, just make sure it is coherent and manageable. The ability to design a management strategy, and to persuade private banks to become partners in the resolution process, is heavily dependent upon the quality of the information available to decisionmakers. No sound bank asked to participate in a rescue will step into a problem of unknown dimensions, and no responsible authority should push it to do so. The failure of the rescue plans for Banco Latino, and the ensuing eighteen months of trial and error in handling many other failing banks in Venezuela, can be traced largely to the lack of proper information.

Involve the executive branch and congress. It is important that the message reach government leaders, so a strategy can be developed. If the government remains uninterested, the country will inevitably be run over by the crisis. Congress should also be alerted to the dangers and consequences, and should be urged, if necessary, to pass appropriate legislation. The challenge lies in finding the way to convey such sensitive information to a wide enough audience of influential leaders without unleashing depositor panic and runs on the banks.

Involve bankers. Bankers are ultimately responsible for their banks. A timely injection of private sector money into ailing banks is essential, and bank owners should be the first to commit it. Bankers will, however, be reluctant to put good money into their bad banks unless the inducements are powerful indeed. If they refuse to deposit capital, that is a bad sign; it suggests they don’t believe in their banks.

Make the most of persuasion. Persuasion, however, works only if
your requests are backed up by the power to act. Venezuela suffered because its crisis erupted in an atmosphere of arrogance, in which some bankers believed themselves to be above the law. The Central Bank’s polite requests to persuade bankers to recapitalize must have seemed naïve. Bank executives knew the Central Bank did not have the power to force them to do anything, and decided to simply turn a deaf ear. They instead chose to gamble on being rescued.

Develop a crisis plan in advance. Conflicting public policy objectives will have to be dealt with mid-crisis, when tensions are at a maximum, and the trade-offs among them raise very sensitive issues. It is therefore better to be prepared. A crisis plan might help strike a balance between short- and long-term goals, helping to minimize the cost to the government, restoring confidence in the banking system, and getting the banks lending again quickly, so as not to deepen the inevitable recession. There should also be provisions to identify and bring to justice those whose behavior was negligent or criminal (as opposed to those who simply made bad business decisions).

This approach can trigger necessary changes in the structure and practices of the banking sector, and preserve market discipline. Although a plan might not work perfectly in practice, it could lay out some of the options and induce everyone involved to be more focused and effective. In fact, any plan is better than having no plan at all.

Build political consensus. The depths of a banking crisis is a time for government leaders to build alliances, not to foment conflicts. Governments should not fall into the trap of pretending to handle a crisis on their own as a public relations exercise or use it to win a political advantage. All key institutions in a country are needed and must be mobilized to rescue the financial system, rebuild national and international confidence, and ensure the well-being of the citizenry. A banking crisis threatens a country’s social fabric; a united front should be presented. If partisan politics or personal battles are allowed to deepen societal rifts, crisis management will be even more difficult, the damage to the economy will be worse, and the wounds will take much longer to heal.

During the Venezuelan crisis, there was little attempt to forge a political consensus. Not only was there lack of consensus on a strategy to handle the crisis, but there was no agreement on the key economic and financial issues, either. To make matters worse, many politicians were ideologically biased against the banking industry.

Avoid suspending bank operations, especially if the public could lose confidence in other banks. Shutting the doors of a bank to depositors can be extremely disruptive, especially if the banking system is weak and there is no plan to deal with the financial and social consequences of closures. Deposits get frozen, banks are unable to settle their payments, and the chain reaction threatens the payment system. Closing banks can destroy
public confidence in banks for years. It is much better to look for solutions that don't interfere with banks' relations with their customers.

That doesn't mean keeping bankrupt banks open, however, or avoiding liquidation if a bank deteriorates beyond rescue. The longer hopelessly bankrupt banks are kept alive, the greater the cost to taxpayers and deposit insurance funds, and the bigger the benefit to uninsured depositors, other creditors and shareholders. That's why it is so important for regulators to take early action, while there is still a positive net worth in a bank; the franchise at least has some value then, and the risk of contagion can be contained.

If a bank is deemed insolvent, if its shareholders don't pledge new funds at that critical stage and if other investors are nowhere in sight, the government should be ready to take over the bank. The legal framework to deal with such a delicate operation must be built very early on—preferably before the crisis breaks into the open. Solutions that allow the government to "close" the bank, wipe out the shareholders, replace the board and top management, and open the next morning to customers will end up being less costly for the government and for society.

In the first months of the crisis, we at the Central Bank tried to make this happen. We sought ways to achieve it within the prevailing legal framework and tried to motivate both government agencies and bankers to cooperate. Our efforts failed for several reasons. The main troubles were that the legal framework was not conducive to following such procedures; that Fogade and the Office of the Superintendent of Banks were in disarray; and that the government offered no leadership.

If a bank must close, a government must immediately tell depositors what to expect. Leaving them in suspense causes unnecessary suffering and inflames inevitable social conflicts. That also weakens other banks because depositors at other institutions will reasonably fear their own banks could suffer the same fate. Turbulence in the early stages of the Venezuelan banking crisis can be traced to the decision to close Banco Latino, an action that left its depositors in limbo for two and a half months. Other banks immediately came under great strain, and when banks being propped up by the government were closed six months later, again leaving depositors struggling with uncertainties, it spelled disaster for the system.

Don't improvise on burden sharing. Determine at the outset who will bear the expense of a bank failure—bank shareholders, uninsured depositors or taxpayers. Improvisation inevitably ends up placing most of the burden on the taxpayer, as depositors press to get their money back and bank shareholders also start lobbying for relief. To prevent that from happening, the executive branch and congress ought to state beforehand that

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203 Improvisation on burden-sharing also had a negative impact on income distribution in Venezuela. For further analysis see Francisco Vivanco, "Algunas lecciones sobre la crisis financiera venezolana," Banca, Volumen I, No. 1, 1997, p.31.
shareholders will lose their money if the bank fails, and should also lay out clearly who will be paid by deposit insurance, making sure depositors are treated equitably. The government must also make it clear from the start that the cost of the banking crisis will be properly accounted for in fiscal accounts and that taxpayer money will go only to depositors. Confusion and turmoil make such explanations much more difficult to convey mid-crisis.

**Keep the payment system running at all costs.** Central banks are primarily concerned with inflation. But if the operation of the payment system is endangered by the inability of one or several participants to settle, the central bank should be prepared to extend special credits to protect the payment system and help maintain confidence in the national financial system. Detrimental as that may be to the mission of containing inflation, the collapse of the payment system is considerably worse. In Venezuela, we had a taste of what the collapse of a payment system might look like, when almost one-third of the banking system crumbled in the space of four weeks. Albania, the only country in recent times where the government did virtually nothing to address the disintegration of its banking system, provides an extreme example of the disruption that the collapse of a payment system can cause. The 1997 crisis brought down the government and wiped out nearly half of Albania’s GDP. There were social consequences, too: Albania disintegrated into anarchy. Most of the army and police forces deserted; there was widespread weapons looting; and some 2,000 people were killed.

A central bank can support the payment system in several ways. It can temporarily reduce reserve requirements, establish overdraft facilities, give banks access to discount window lending, use money market refinancing instruments such as repos and reverse repos, and support the banking system’s liquidity through open market operations. The central bank can also provide financial support to a bank resolution agency, as we did in Venezuela. Such credit facilities help troubled banks meet their obligations and weather a period of adversity until they either regain strength (and investors’ confidence), or until the authorities arrange a more permanent solution. The key issue is that the central bank’s lender of last resort capability will help limit the contagion and thus soften the impact of the crisis.

But protecting the payment system cannot be left to the central bank alone. When there are heavy runs, depositors—insured and uninsured alike—are telling the government they have lost confidence in their banks. The government must thus come boldly into the picture to guarantee the central bank’s or bank resolution agency’s bank loans, and assure depositors that the banks will be able to honor their commitments. The government must also quickly produce funds to back the banks. The crisis will be far more expensive if the public is left clamoring for answers, or if depositors are prevented from accessing their funds until after the bankrupt institutions have been liquidated.
Centralize decisionmaking. As the Venezuelan experience demonstrates, unless there is a clear voice and a single, accountable authority with a crisis-management mandate, it is almost impossible to restore depositor confidence. The government and the central bank should establish an emergency decisionmaking body to avoid the confusion of having several overlapping regulatory agencies pursuing independent crisis management strategies. This body could draft laws and interact with congress, and also coordinate government support to ailing banks. As in the Swedish case, the emergency body should dissolve as soon as the acute phase of the crisis is over. The minister of finance should preside over this body, and the president of the central bank and the chief banking supervisor should sit on its board. This body could also oversee the troubled banks. Don’t complicate matters by forcing management to report to more than one government authority.

Impose deadlines on stopgap measures. Short-term fixes have a way of haunting their creators and lingering long past their usefulness. In Venezuela, the Fogade emergency support program started as a short-term plan to help banks cope with runs. But over time, it locked ailing banks into dependence upon this aid, since the government crafted no substitute plan. Deadlines discipline everyone involved.

TO CENTRAL BANKS

To improve the prospects for lasting monetary stability, central banks must work to institutionalize safe and sound banking. They owe it to the public. They are remiss if they limit themselves to macroeconomic policy issues and take for granted that banking supervisors can solve banking problems alone.

Indeed, central bank officials may find they have to take the lead in coping with banking crises in developing countries and offer guidance to government policymakers.

Intervene only temporarily, and at market rates. If a central bank extends financing to banks or to a deposit insurance agency, it should do so only temporarily, and at market rates. The cost of rehabilitating banks (and paying insured depositors) must come from the government’s budget. The Venezuelan experience shows that it is difficult to get congress to allocate taxpayer money to reimburse a central bank for crisis-related losses. This delays fiscal adjustment and weakens the central bank, financially and institutionally. Ultimately, as in Venezuela, it can translate into looser monetary policy and higher inflation.
The Venezuelan Central Bank did lend at market rates, intending those loans to be temporary. But the lending dragged on because other institutions failed to come in and play their roles. Eventually, there was no other way to keep the payment system functioning. When there are widespread solvency problems, ailing banks clearly cannot pay market rates for loans: that is why government must be in the picture from the beginning. This is another reason for a crisis management plan. It can ensure that government assumes the costs, and that regulators impose corrective measures and implement restructuring plans.

**Play a role in banking supervision, since the central bank is the lender of last resort.** I cannot see the advantage of assigning a central bank crucial responsibilities as lender of last resort, then leaving it up to others to create and enforce banking regulations. In Venezuela, the Central Bank was the only institution in the country with the money to address the crisis—but it didn’t have the power to prevent or resolve any of the complex problems it saw brewing. Banking rules and the authority to enforce them must emanate from the same institution called upon to provide the funds needed to keep the system running.

It is true that price stability is the primary job of a central bank, and that conducting monetary policy is therefore its chief function. And I’m aware that my assertion that central banks should be directly involved in bank supervision might be disputed. Countries have chosen very different institutional arrangements in assigning responsibility for monetary policy and banking supervision. While the U.S. Federal Reserve Board is getting more powers to regulate and supervise banks, the Bank of England has been stripped of such powers. About half of Latin America’s central banks have bank supervisory responsibilities, but differing institutional arrangements have been applied to banking, securities and insurance regulation, and to central banks and ministries of finance.

Obviously, then, there is no universally applicable system. Country-specific issues determine what kind of arrangement serves each nation best.

I would, however, emphasize three requirements. The institutional framework will best serve to promote stable money and sound and safe banking if it:

- rests upon politically independent institutions,
- allows proper coordination between monetary policy and banking regulation and supervision, and
- enables officials to anticipate systemic risk and to react to it in a timely and efficient manner.

Giving supervisory powers to an independent central bank is especially advantageous if public institutions are weak, coordination between different public sector agencies is troublesome, or skilled human resources are scarce. Central banks are usually among a country’s most prestigious and well-
equipped institutions, and are in a good position to hire, motivate and keep skilled staff.

The central bank’s involvement in banking supervision has been opposed, however, on two grounds. One is the fear that an independent central bank in charge of banking supervision would become too powerful. The answer to this problem lies in central bank accountability. An independent central bank needs to be accountable to another authority, regardless of whether its goal is limited to monetary stability or whether it also has bank supervisory responsibilities. If a country has democratic checks and balances and the central bank is accountable to the other branches of government, the potential risks of concentration of power are minimal.

A second concern is that there might at times be a conflict between optimal monetary policy and optimal banking supervision, and that it is therefore better to center each function in a different authority. Such seeming conflicts of interest appear more important than they really are. If banks are strong, it doesn’t matter if the central bank is in charge of supervising them because there will be no conflict between the two roles. If, on the other hand, the central bank perceives that systemic risk is rising, monetary policy decisions will inevitably be conditioned by concerns over the payment system. Central banks can never elude systemic risk issues. Consequently, the question is not one of conflicts of interest. It is, rather, whether safe and sound banking—and proper coordination of banking supervision and monetary policy—can be ensured through other means. If the answer is other than a resounding yes, it is better to place banking supervision under the responsibility of the central bank, via a division within the central bank or an independent agency operating under central bank authority.

Call upon fellow central bankers and regulators for help and advice. Being a central banker is a lonely job. In times of crisis, it gets even lonelier. I counted on the valuable assistance of Francisco Ortega, former president of the Central Bank of Colombia; Brian Quinn, director for banking supervision of the Bank of England; José Saralegui, chief inspector of the loan cooperatives deposit insurance fund in Spain; and Harrison Young, director of the division of resolutions of the FDIC. There is a need to enhance the support network and to strengthen personal contacts, an activity that could be supported by international organizations such as the IMF, the World Bank, the Bank for International Settlements, the Financial Stability Institute, the Toronto Center, or perhaps private fora such as the Group of Thirty.

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TO BANKERS

Bankers today face unprecedented challenges. First among them is a more competitive business environment, as more companies and financial institutions expand abroad. There are new opportunities, and also new risks. In response to those risks have come new global regulations, such as international banking and capitalization guidelines drafted over the past decade by the Basle Committee, a public body set up by central bank governors under the auspices of the Group of 10 and the European Community. Doubtless there will be more rules in time. Traditional banking business is fading out, and new types of financial services linking banking, securities, pension funds and insurance are taking its place. Bankers who can't rise to the task will find their competitors elbowing them out of the market. To succeed and prosper, banks must:

Rope in good shareholder capital first. It is best if banks in emerging market economies rely primarily on equity, or tier one capital, including common and preferred stock. This has the advantage of allowing banks to avoid issuing sophisticated financial instruments for which there may not yet be proper legislation or developed markets. Depositors will trust their banks more if shareholders have substantial capital of their own at stake.

Turn second to the markets for capital. Add capital by raising funds in the domestic or international capital markets, or by bringing in new partners. But realize that tier two and tier three capital, involving funds raised with medium- and long-term instruments (and which bankers and investors often find attractive for tax purposes), are of mixed value. Their main virtue—flexibility gains—is not much of an advantage in countries with thin and underdeveloped capital markets. And if the activation of tier two and three capital will require major regulatory changes that would entail getting sidetracked from key risk management issues, leave them aside.

Disclose relevant information on ownership, loans and investments. Build trust in your bank by offering more information to the market, especially when bank ownership is concentrated and the bank is linked to commercial and industrial companies. Markets know too well the incentives, and the dangers, of weak banks' engagement in affiliated-party lending.

Avoid excessive reliance on government bonds to improve your bank's capital ratio. The push to comply with stricter capital requirements gives banks an incentive to invest in government bonds that appear, in some countries, to be low or no-risk. However, they are far from risk-free. They carry market risk, as the volatility of the secondary market for emerging markets sovereign debt clearly demonstrates. Their price is also subject to political risk. Cash-strapped governments in many countries easily get away with shirking their debt obligations to domestic
banks. When governments run deficits, they love to raise funds by inducing banks to invest in government bonds, even though that deprives the private sector of capital. Bankers might have to resist such pressures.

**Lend responsibly.** Affiliated-party lending doesn’t serve any bank’s long-term (or even short-term) interests. All borrowers should meet the same credit standards. Economic cycles are a fact of life; don’t get swept away by euphoria. As Venezuela’s experience demonstrated, the banks that collapse when a bubble bursts are the ones that fail to protect their institutions when things are going well.

**Strengthen corporate governance.** It is in bank owners’ best interests to have good internal controls, strong and independent directors, and skilled managers. Strong corporate governance is even more necessary if a bank’s ownership is concentrated. Avoid running a bank with yes-men; too many banks have failed because of poor internal controls. Craft management incentives carefully. Prudent banking should be rewarded at least as handsomely as aggressive business development.

**Enhance your bank’s risk management capability.** Free-market economic reforms put pressure on banks and reshape the business of banking. Deregulation and financial discipline bring positive real interest rates, slower growth and more competition. Margins get compressed, high overhead costs are no longer sustainable, and banks are pushed to expand their lending activity or other lines of business. Such reforms also bring volatility because transition is always more difficult than governments would wish and plan for. Changing economic conditions may impair borrowers’ ability to pay. Banks must learn to assess the new risks new business opportunities bring.

**Join with banking associations to develop a code of ethics.** This will help instill the general principles of safe and sound banking.

**Stop lobbying against strong bank supervision.** If regulations are meaningless, local and overseas investors will lose confidence in your bank and in your country, capital will flee, and your institution will find it is paying a risk premium and has lost its competitive edge. Weak regulation means weak banks, a situation that hurts healthy banks, too. Bankers’ input should be welcomed when legislation is being shaped, but trying to undermine the law is senseless. Banking is a business, but it is also a public trust. Bankers are custodians of people’s futures and the well-being of nations.
TO LAWMAKERS

Legislation must keep pace with changes in the financial industry. Legislators must stay abreast of changes in the market, and update laws as often as needed, to allow banks to remain safe, sound and competitive.

Denmark’s success in banking supervision is largely rooted in its efforts to keep provisions covering financial legislation up-to-date. A prudential supervision law adopted in 1975 has since been amended more than twenty times, either to adapt to new developments or to implement E.U. directives on banking and companies.\(^5\)

The best bank supervisory system is not intrusive, but flexible, allowing banks to keep pace with today’s rapidly changing global marketplace. Banking laws in many countries are overly rigid and detailed. Financial institutions are often restricted to operating in narrow milieus, and compliance is a tedious ritual that in many cases fails to do its job. Simpler laws—and strong penalties for violating them—establish incentives for safe and sound banking, and foster innovation and competition.

**Make bankers ultimately responsible for the health of their banks.** The paramount challenge for legislators is to ensure that bank directors and managers are strongly risk-averse. They will then become the government’s best allies in the quest for safe and sound banking.

How can lawmakers design and implement regulations to protect the public interest, eradicate systemic risk, put the proper incentives in place, and make bankers responsible for their businesses?

**Make bank supervisors strong and independent, and give them enough political support to allow them to perform their duties.** Regulators should be accountable to both government and congress. Yet they must be given clear powers and shielded from improper political influence; otherwise they will not be respected. Persuading bankers to follow the rules is very important for high-quality supervision, but is an ultimately ineffective exercise unless the supervisor has the clout to enforce laws and levy fines and other punishments. Supervisors must also be provided with appropriate resources to accomplish their goals. The Venezuelan experience demonstrates what can happen when weak supervisors lack funds and political backing.

**Work to overcome both legal and cultural barriers present in developing countries, in order to move toward modern prudential supervision.** In a banking context, the word “prudential” means creating rules and incentives that encourage banks to act prudently. Setting loss loan provisions to keep losses manageable and requiring shareholders to deposit a

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\(^5\) I thank Eigil Molgaard for bringing this to my attention.
certain level of capital to encourage them to care about their banks, are examples of prudential regulation. Prudential supervision emphasizes the role of the private sector, since it makes banks responsible for following the rules. This is an Anglo-Saxon legal concept and therefore seems easier to institute in common law countries. The common law framework provides basic principles and guidelines, which are then enriched by jurisprudence and experience. Regulators operating in such a climate can more readily take preventive measures when they find that a bank is behaving imprudently, craft more flexible regulations, and seek formal commitments from banks to fill gaps in the legislation, as long as the rule of law prevails.

By contrast, it is much more difficult to conduct nuanced negotiations in most of Latin America and Eastern Europe, where relatively rigid legal systems leave public officials and judges little room for discretion. Legislation under these systems tends to be very detailed, spelling out precisely what can and cannot be done. Judges are seen as confirmers of the written legal code rather than interpreters of the law, and the powers of banking supervisors, like those of most public officials, are meticulously determined. This climate gives supervisors little opportunity to use their judgment, or to negotiate with bankers to forestall unsound banking practices before they grow serious. Rather, the emphasis is on post factum punishment.

This style of law encourages supervisors to act later rather than sooner, since measures that don't fall clearly into legally-defined categories can be challenged in court and lead to protracted lawsuits.

Strengthen the central bank's independence by making sure central bank officials are fairly judged. No public agency should have the legal power to judge the merits of central bank policies. Judging the merits of policy decisions is a political act and must thus be left only to Congress. Independent judges should review the lawfulness of a central bank's actions and decisions without getting to analyze the content of those decisions; judges should not be allowed to impose their views upon policy actions that fall within a central bank's scope of responsibilities. They should not judge, for instance, the appropriateness of an interest rate rise, but rather should assess whether the law allowed the central bank to raise interest rates.

Protect central bankers and banking supervisors from personal liability for their official decisions. If central bankers are personally held liable for their official decisions, they will be exposed to political pressures, and their effectiveness will be seriously impaired.

Get government out of the banking business. A private banking community cannot flourish when faced with unfair competition from government-owned banks. State banks are prone to politically-influenced lending and investing, and are often favored by regulatory leniency. Governments should sell state banks and financial services companies, and use the proceeds to improve banking supervision. Government ownership that has come
about as a consequence of bank failure is no exception. The state's role should be terminated quickly and in an orderly fashion.

**Pass legislation that builds confidence in the banking system.** Banking regulations have various aims, such as the preservation of the stability and soundness of the financial system, monetary policy and the payment system; the protection of individual small depositors, the protection of investors; limits on undue concentration of financial resources and power; and allocation of credit to underserved sectors, such as small enterprises, communities or agriculture.

The ultimate goal of banking regulation is, however, to safeguard confidence in banks. To this end, legislators should focus on three goals: bank safety and soundness, bank efficiency, and government neutrality in the allocation of credit. Getting good capital into the banks, fostering competition and eliminating laws that cause market distortions are the best ways to achieve this.

The regulatory system must therefore balance the need to protect the stability of the banking system with the need for banks to make a profit.

Banking laws should be effective, and violators should be criminally liable. Legislation should address the essentials, taking a minimalist rather than maximalist approach. Banking regulation around the world is converging on the Basle Committee core banking principles, which stress healthy competition in banking while improving discipline through sufficient capitalization.

Enforcement, however, is the key. Laws must therefore be simple, easy to comply with, and also easy to supervise.

The fundamental goal of solvency should not be compromised by the lure of sophisticated—but often unnecessary—technical requirements that easily become an excuse to procrastinate. Experience in many countries—and certainly in Venezuela—has shown that policymakers and supervisors risk being trapped by a lengthy implementation process when new rules are being established. Vested interests avail themselves of the excuse of technical difficulties in order to avoid complying with higher capitalization requirements, or to stop imprudent risk-taking, especially if the investment climate in the country is unfavorable.

**Set strict rules limiting loan concentration and lending to affiliated groups.** This is where the seeds of the Venezuelan banking crisis lay.

**Set stringent capital adequacy rules.** This will make banks stronger and better-prepared to overcome economic crises. The capital adequacy ratio established by the Basle Committee in 1988 requires capital to be equal to at least 8 percent of the risk-weighted total assets of the bank (including off balance sheet activities).

The 8 percent figure was, however, meant to apply to international banks based in industrial countries, where economies are stable and diversified, capital markets are developed, and there are long traditions of strong bank-
ing supervision. It works under the assumption that the quality of bank assets is well-known to supervisors and accurately measured.

These conditions are rarely present in developing countries. As in Venezuela, banks in developing countries operate in volatile environments, where markets are thin and many years of weak banking supervision have led to bad assets, hidden losses and significant off balance sheet risks. It might thus be more appropriate to target a capital adequacy ratio in the 10 percent to 12 percent range, as a way to make up for economic volatility, weak assets and accounting deficiencies. It might well be set even higher. Countries might also choose to increase requirements for tier one capital, above the present 50 percent level recommended by the Basle Committee. That, after all, is the most powerful component of a bank's capital.

When setting out to modernize the banking legislation in an emerging market economy, it is usually the time to introduce tier two and tier three capital.

But capital adequacy rules are not a panacea and can even be ineffective if they are not part of a comprehensive overhaul of a country's banking regulations. In order to assure that higher amounts of capital really strengthen banks, legislators must see to it that high-quality capital is actually put into the banks, and oblige banks to value their assets prudently and set up appropriate loan and investment loss provisions.

**Eliminate restrictions that may hinder bank capitalization.** Since a bold recapitalization program should focus on attracting new capital, it may be wise to eliminate or modify restrictions that limit foreign investment or ownership concentration. In times of crisis, some extra sweeteners may be necessary to induce owners or new investors to put fresh money into banks. These could include tax breaks, debt-equity conversions or other measures.

When confronted with banking problems, Latin American governments have generally stepped in to recapitalize banks, using public funds. This is only a second-best approach because it increases the chance that investors and depositors will keep taking big risks, expecting the government to be standing by with a safety net in case of trouble. It is much better for governments to attract private investors into a bailout strategy.

**Do not lower capital adequacy requirements for the sake of bank competitiveness.** Legislators will likely face strong opposition whenever they set out to raise bank capital requirements. Bankers might argue that they will become less competitive in the global marketplace, and push for a minimum 8 percent capital adequacy rule. Remember that a uniform capital adequacy level for all countries does not assure bankers a level playing field or a competitive position. The competitive advantage of a more highly-leveraged bank may be (and frequently is) wiped out by other factors. If a country's higher risks and market volatility are not duly recognized in its regulatory framework, the markets
will inevitably impose higher funding costs.

Bankers will also protest that more stringent capital requirements will inflict higher costs on banks. However, theory and empirical evidence suggest that capital costs are independent of capital structure. A great many of the world’s well-capitalized banks are also profitable.

Repeal rules that keep banks uncompetitive and burden them unnecessarily.

Banks must be able to compete fairly in the global markets, and both legislators and government should dismantle anti-competitive rules that make them unable to do so. As was our experience in Venezuela, banks in emerging market economies are often less competitive because of numerous government regulations that force them to lend to specific sectors, or restrict their business opportunities.

Impose strict licensing requirements, and allow regulators to carefully screen bank owners and managers. Licensing is the first step in the regulatory process, and must be rigorous. It acts as a filter, screening out bad banks and imprudent or dishonest people. Venezuela’s banking problems were partly caused by lax licensing; the same could be said of Russia’s mid-1990s banking crisis. Licensing rules should also force new banks to be well-capitalized by shareholders who are putting their own capital at risk, and must ensure that banks are managed by people with the requisite ethics, skills, and prudence. If a corporation buys or establishes a new bank, true ownership must be disclosed, as only individuals are ultimately accountable for an institution. The same criteria should be applied when a bank is re-licensed or when controlling ownership changes.

Some countries, such as the United Kingdom, screen and approve applicants in order to determine whether they are “fit and proper” for banking. Many other countries’ legal and political systems make screening regimes much harder to establish, but this is worth the effort. Give supervisors legal authority to disqualify applicants for any of the following reasons: a criminal record, a history of financial wrongdoing, improperly-sourced funds, inadequate personal funds, insufficient professional experience, or a track record of imprudent management of banks or other financial institutions.

Make the licensing process transparent. Publishing and uniformly applying the laws, regulations and requirements for getting a license, and publishing a register of licensed banks, their shareholders and the types of business they are allowed to conduct, are actions that will strengthen the banking system. Carefully craft the rules of disclosure to include checks and balances that will protect citizens from abuse by bureaucrats. While supervisors must have the power to demand all pertinent information, they must also be responsible for maintaining confidentiality and should be subject to strict penalties for any breaches. The law must also punish applicants who provide false information.
Apply meaningful and consistently enforced sanctions. Supervisors must be vested with the authority and obligation to sanction a bank if it fails to comply with regulatory requirements, and be empowered to turn over a case to the authorities if criminal activity is suspected. If sanctions are inconsequential or inconsistently enforced, they don't serve to deter wrongdoing, and the bank supervisor will not be respected. The U.S. thrift crisis in the 1980s, and certainly the Venezuelan banking crisis, demonstrate how the cost to the taxpayer rises when regulators are unwilling to force institutions to reorganize, or to let them fail once their value is depleted.

Favor early regulatory intervention. This keeps the banking system healthier, and reduces the potential cost of a banking failure. But such powers require clear rules for the imposition of sanctions. Such rules generally specify that a bank's capital may not decline below a specified percentage of total assets. Yet closing a bank while its net worth is still positive—i.e., before it reaches the point of technical insolvency—is a tough decision that might make supervisors the target of political attacks and lawsuits.

Preventive measures and sanctions should be graduated, increasing from least to most severe, beginning with cease-and-desist orders, fines, termination or suspension of deposit insurance; then moving to holding measures and civil or criminal penalties; and finally allowing government takeover and revocation of a bank's license. The power to promote early mergers should also be part of a regulator's arsenal of resolution instruments.

Develop clear and rigorous rules for bank closure, resale or government takeover in the event of bankruptcy. If so-called "exit rules"—procedures to move a bank out of business when it goes bankrupt—are lax and ambiguous, governments will tend to postpone tough measures until carrying them out is politically expedient. By then, the bank's capital is likely to be gone, and the public will be forced to foot the bill. The Venezuelan experience demonstrates that, over decades, vague exit rules for problem banks left excessive room for political maneuvering, weakened the regulators and contaminated banking supervision with politics.

Establish consolidated supervision. This is the only effective means of ensuring prudential supervision and giving supervisors the ability to monitor a bank's entire business, including its international operations. Conglomerates love regulatory complexity for tax reasons, or as a means of regulatory arbitrage. Supervisors must be able to look after bank operations on a global basis. Venezuelan regulations did not allow for consolidated supervision until 1994. As the crisis emerged, insider lending, off balance sheet liabilities and offshore operations proved to be the silent cancer killing the banks.

Take a broad view of financial sector regulation and supervision. As boundaries between different types of financial intermediaries blur, closer cooperation between different regulatory authorities is needed to assure solvency of all components of a business conglomerate. In Venezuela, insur-
ance companies, securities firms and banks often collaborated in a variety of speculative ventures, taking advantage of regulatory loopholes. This spread insolvency throughout the financial system. Meanwhile, the regulatory framework was trailing far behind, treating these institutions as if they were unrelated to one another.

Lawmakers must decide which is the best regulatory architecture for their country, without losing sight of broad supervisory goals. In any case, the central bank must play a key role in banking regulation, no matter what arrangement the country chooses.

**Ensure that corporate income tax law establishes a neutral and stable tax system for banks.** Tax treatment of loan losses should be geared toward assuring that permissible tax deductions match the accrued deterioration of the bank’s loan portfolio. Getting that right is a tricky business. If loan loss tax deductions are allowed in anticipation of losses, that will encourage risky investment. But if such tax deductions are deferred for too long, losses will be larger when a troubled borrower defaults.

In Venezuela, a loan loss write-off was more financially advantageous for a bank than a provision against a loss because provisions were not deductible. Therefore—as long as the supervisor allowed it—banks would underprovision loan losses in order to show higher profits and distribute dividends, and would write off losses as a matter of tax planning.

The lesson: legislators should establish tax rules consistent with the regulatory loan losses. Such a system will be reasonably close to tax neutrality and will yield substantial benefits.

**Avoid aiding problem banks with tax concessions.** Supporting problem banks with tax concessions is not a sound bank resolution strategy. It does not provide the ailing banks with enough funds, is expensive for government, and interferes with market incentives. The tax system should, however, allow banks to write off losses incurred as a result of mergers and acquisitions of ailing banks.

**Make deposit insurance an incentive for prudent risk-taking.** Reinforce market discipline by limiting the official safety net and making depositors assume part of the risk. Full, implicit protection of uninsured depositors is not advisable; governments fool themselves into believing that they are not liable to depositors and fail to allocate funds, only to find themselves unable to meet their commitments when a crisis arrives. Deposit insurance without credibility deepens the cost of a crisis, as happened in Venezuela. Generally meant to protect small and unsophisticated depositors, public deposit insurance serves to prevent bank runs, too, but can also end up encouraging reckless behavior by depositors and bankers. Meanwhile, other bank creditors are encouraged to be less vigilant in their monitoring of banks. I believe blanket coverage should be used, if at all, only in times of systemic crisis.
History and culture shape deposit insurance programs. As a result, this is a politically sensitive issue. Some countries, such as Australia, New Zealand and several republics of the former Soviet Union, have chosen not to offer deposit insurance at all. But certain European countries that did not have deposit insurance in the past are now developing it, to comply with an E.C. directive adopted in 1994 "to ensure a harmonized minimum level of deposit protection wherever deposits are located in the Community." The U.K. has a minimalist approach, covering 75 percent of the first £20,000 in deposits made with an "authorized institution." The U.S. approach applies $100,000 of coverage generously to numerous separately-insured accounts.

The Argentine experience offers interesting lessons on how countries can simultaneously limit deposit insurance and address the needs of depositors.

Before 1991, the Argentine banking system operated under a regime of optional, explicit deposit insurance, coupled with extensive implicit deposit insurance in the form of Central Bank assistance to failing banks. In 1991, the Central Bank drastically limited the scope of the deposit insurance guarantee. Legislative action in 1992 further barred the Central Bank from providing any sort of insurance for bank deposits, either implicit (by assisting troubled banks) or explicit (by paying off depositors after failure).

Though opposed by most influential interest groups, the repeal of deposit insurance did not pose major political risks at the time. Once deposit insurance was repealed, the government and the Central Bank endeavored to convince financial markets that they would not under any circumstances rescue a failing bank. The market responded by attempting to develop private arrangements to help banks cope in the event of a crisis. In 1995, however, in the face of an impending election and a severe financial crisis sparked by the December 1994 devaluation of the Mexican peso, the Argentine government re-instituted a form of deposit insurance in an effort to stave off an all-out panic in the banking system. The new program is compulsory and entirely funded by banks. Coverage for depositors is limited, with short-term deposits insured up to $10,000, and deposits of 90-days or more up to $20,000. To guard against moral hazard, the Central Bank has the power to impose higher insurance premiums on riskier banks.

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506 Directive 94/19/EC on Deposit Guarantee Schemes.
507 In fact, U.S. depositors can obtain effectively infinite protection by splitting accounts among institutions or using different types of accounts within a single institution (e.g., joint accounts, trust accounts, individual retirement accounts). Furthermore, brokered deposits give rise to de facto protection of uninsured deposits and “pass-through” insurance allows institutional investors to take advantage of increasingly larger amounts of deposit insurance coverage.
and deposits bearing an interest rate 2 percent higher than the annual deposit rate of Banco de la Nación (a state-owned bank) are not insured. Capital markets and depositors reacted positively to the program.298

Ensure that shareholders are never protected by deposit insurance schemes. Furthermore, if regulators make controlling owners liable for double or even triple the amount of capital they’ve invested in their banks, incentives for prudent management will be much stronger.

When drafting a deposit insurance system:

- Don’t subsidize sophisticated players out to profit from banks’ distress. Coverage should ideally be geared to the small and unsophisticated depositor earning a market, or below-market, interest rate.
- Don’t subsidize undercapitalized banks. Establish fair burden sharing between weaker, riskier banks and sounder, better-capitalized ones, by using risk-adjusted insurance premiums instead of flat rates.
- Focus on protecting the payment system. Make funds available to insured depositors as soon as a bank is taken over by the government. Don’t make them wait until the bank is liquidated.
- Establish firewalls to prevent the government from subsidizing trading activity by insured banks.
- Make sure the deposit insurance program is adequately funded, and safely invests its money. Unless it demonstrably has appropriate funds, a deposit insurance program has no credibility and will be useless.
- Educate depositors, making them aware of the exact insurance coverage they can expect in the event that their banks should fail.

TO BANK REGULATORS AND SUPERVISORS

Bank supervision is usually a thankless job. When the job is well done, it goes largely unnoticed; success is measured by the absence of problems. Regulators have to carry the heavy burden of making banks follow the law, sometimes without much budget or staff. They’re often ignored until things fall apart. Then, they’re blamed.

Outdated laws hamper them, too. Even so, regulators can make the most of their powers.

Know as much as the bankers do about bank business, financial techniques, risk management and market trends. Give up the

traditional auditor’s approach of financial analysis and examination of financial statements; move away from the desks and get closer to the banks. Financial innovation is unleashing new risks, but it is often unclear what kind of regulations (if any) these new risks warrant. Regulators and banks, in more frequent contact, can come up with the answers before the health of banking systems is put at risk.

**Emphasize on-site inspections.** Supervisors can’t tell if a bank is solvent just by looking at paperwork. Bank reporting can be biased, and vested interests can disguise problems. To be effective, on-site inspections must be conducted regularly, by skilled people following rigorous procedures. As former Spanish bank supervisor Aristóbulo De Juan sharply advises, inspectors should focus on quality rather than compliance, pay special attention to the loan portfolio and look into good loans, which might just look good because of practices bankers use to conceal insolvency. Don’t waste time looking into the bad loans, he cautions; those have already been taken care of.\(^{269}\)

**Educate your staff in modern banking techniques.** The industry is changing dramatically. Banks are moving away from traditional deposit-taking and lending, entering into the securities business, and often merging with non-bank financial intermediaries that offer services very similar to those of banks. Mergers and acquisitions are also creating fewer and bigger banks. Regulators must be able to assess how these events might impact banks’ markets, learn what regulatory peers in other countries are doing, and share information and experience. If regulators across borders trust each other, they can do much more for the banking systems of their respective countries.

**Use external auditors to supplement your resources, but make them accountable to you.** Information provided by external auditors in Venezuela since 1985 proved inconsequential—sometimes verging on the misleading—because bank auditors and bank shareholders perceived that the supervisor was weak. External auditors must be accountable to strict rules and strong sanctions in the event of non-compliance. Fortunately, bank auditors in Venezuela now understand that they may be liable for bank failures.

**Set up a reliable information system that includes adequate disclosure.** Accurate and timely information is the basis for effective supervision. Make sure uniform banking accounting rules are in place, and bring them into line with international standards. Banks should not be left to choose among different accounting options.

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Require the timely disclosure of relevant bank financial data, so markets will be able to help monitor the banks. But keep in mind that markets, like supervisors, don't need more information; they just need good information—objective, accurate, complete, relevant, timely and comparable. Beware, however, that disclosure may also end up encouraging imprudent banking and unsound accounting practices. In Venezuela, the obligation to publish financial statements in the press every month led the banks into a perpetual race to show a nice face, with a stable or growing market share.

Adopt Basle capital adequacy rules, and adapt them to your country's situation. Regulators should strive for rules easy to comply with and enforce. Risk-weighted capital adequacy ratios should take into account country-specific circumstances. In developed countries, it might be appropriate to identify as many risk categories as possible and to fine-tune the risk-weighting criteria in order to prevent regulations from interfering with the market, though this admittedly makes the system more difficult to enforce. Having fewer risk-weighting categories makes the system easier to implement and supervise.

Evaluate assets conservatively. "Marking to market" might not be prudent in an unstable economy and may increase a bank's risk by bloating its balance sheet. An asset's value, at a time of reform and transition, is unstable; prices rise sharply in a boom and quickly collapse with a shock. Marking to market should come along with rules that take into account the possibility of sharp downturns. Illiquid assets should also be valued conservatively, in case a crisis should make disposing of them impossible.

Avoid using risk-weighting criteria to influence credit allocation. Direct loan portfolio regulations are fortunately no longer fashionable. Risk-weighting coefficients should reflect the risk of the asset, not the political priorities of the government.

Monitor bank investments in government bonds. Although the Basle Accord considers government bonds to be riskless, in developing countries they carry market and credit risk. Help set up criteria linking government bond risk to market indicators, such as secondary market price volatility or debt service arrears.

Monitor liquidity. In developing markets, liquidity is often a primary proof of solvency. Use liquidity, rather than solvency, as an early warning system. Make a detailed analysis of a bank's short-term assets, including the concentration of refinancing dates and the cash flow needs of the issuers of the securities held by the bank.

Announce increases in capital requirements well in advance. Bank shareholders are right to argue that bank capital cannot be increased overnight, especially in times of crisis. Surveillance must be constant, in order to avoid surprises. Regulators should announce
increases in capital requirements well in advance and, if possible, to coincide with expectations of good banking sector earnings. Be aware of national economic cycles, too; it may be easier to raise requirements when the economy is growing. Getting shareholders to recapitalize their banks when the economy is souring is much more difficult, as the Venezuelan experience demonstrates.

Err on the side of licensing fewer banks. In many emerging market economies, as in Venezuela, too many banks are competing for limited business. Consolidations are underway, either driven by the market or by bank restructuring programs. Consider that it might be better to license fewer banks, particularly if they are all strong and competitive. But don't use licensing policies to restrict competition in the banking industry, or to discourage the participation of foreign banks.

Act when you see danger signs. Systemic risk might be brewing if banks are masking low profitability with the sale or transfer of assets to affiliated parties, offshore operations or trusts they manage. Signs of that kind are not trivial, especially when they come from banks that have grown very rapidly. That is a time to act. Look for information on large loans, equity and real estate investments, trust funds, proprietary funds, and loans to affiliates and offshore operations.

Monitor the economy. Business cycles, macroeconomic shocks and changing economic policies affect both banks and borrowers, and regulators must be able to anticipate the consequences.

Build up your credibility. Convince bankers to trust you. Bankers must know they will be fairly treated, and that confidential information will not be misused. The government must also be certain that it will receive timely information. Congress should have no doubt that it will get expert and unbiased reports. Regulators must also win the trust of their peers in other countries. Regulators who are not trusted and respected will be unable to carry out their mission.

Resist political pressure. The job of a bank supervisor is to regulate banks, not to uphold a reigning administration's policies or solidify its political influence.

Take early action. Banking problems don't go away on their own: if the regulator doesn't intervene in a timely and effective manner, things can only get worse.
TO ECONOMIC POLICYMAKERS

Economic policymakers have a tough job. They must juggle the demands of various sectors of the economy, where there is usually something out of balance: inflation, unemployment, interest rates or the exchange rate. But the Venezuelan banking crisis has led me to believe that four measures are key to securing low-inflation growth and a simultaneously benign environment for banking:

**Build powerful macroeconomic stabilization mechanisms.** If, like Venezuela, a country earns most of its national income from a single commodity, it is crucial to save for a rainy day. Careless spending of windfall profits handicaps a country in its quest for healthy economic growth and healthy banks. It creates financial euphoria and speculative bubbles, and can end in financial crisis. Banks start lending imprudently, entering into new businesses without adequately assessing risks. Citizens easily give in to the temptation of speculative investments in securities or real estate. The fall inevitably arrives.

**Stress continuity when building a free-market reform program.** Continuity in reforms is key to creating a strong economy with healthy banks. This is not easy, especially during transition, because reforms often bring hardship until they take root and improve people's living standards. However, it is even tougher on business and the public when policies constantly shift. Risk management in an uncertain policy environment becomes extremely difficult. A borrower that looks fine today might soon fail to pay, because business is hurt by unexpected changes in tariffs, trade regulations, price controls or foreign exchange restrictions. Venezuela has a long history of trial and error with economic controls. The lesson is that economic policy cannot be forever managed by considering only political goals and ignoring market dictates. All Venezuelan controls have been costly, have quickly lost effectiveness, and have ended in painful adjustment programs. And the banks weakened along the way.

**Monitor potentially destabilizing cross-border capital flows.** In a global economy with open capital markets and free financial flows, there is less room than ever for unsound economic policies. Dealing with large and volatile cross-border capital flows is a never-ending project. In no time, financial stability can be at risk, particularly in countries with weak banks, thin capital markets and limited investment opportunities. Governments must establish their credibility with the investing community, or risk speculative attacks on the currency.

**Avoid exchange controls.** Debates about whether and how to control capital flows have resurfaced, as countries seek ways of dealing with the dangerous economic disruption that fast-moving money brings. I side firmly with those who oppose direct exchange controls. Experience has proven
that these lead to economic distortion and corruption. Venezuela is not an exception. Governments should instead avoid controls by maintaining an appropriate level of foreign reserves and taking early action to deal with macroeconomic imbalances and potential banking problems.

TO THE INTERNATIONAL FINANCIAL COMMUNITY

With financial institutions moving freely from one national market to the next and the volume of cross-border activity growing, few industries have a more powerful impact on the world today than the banking business. Countries are thus increasingly interdependent, and must cooperate to avert bank failures. International banking regulation is a relatively recent phenomenon and must catch up with the marketplace. Though international ties are increasing, regulation still remains nationally-based, largely limited to domestic jurisdictions.

The work of the Basle Committee is worth remarking upon. The Central Bank governors of the Group of 10 countries established the Basle Committee in 1975.270 It is an informal, independent body that aims to set international banking standards and help build trust among bank supervisors. The Committee meets regularly in Basle under the auspices of the Bank for International Settlements.

The Basle Committee set up regional groups of banking supervisors, to make it easier for countries to deal with their problems and to stop rogue bankers from profiting from regulatory arbitrage.

For regulators and supervisors in the developing world, the Basle Committee is a source of empowerment.

Updating the regulatory framework is important, but the real challenge is in enforcing it. I would therefore recommend focusing international cooperation between regulators and supervisors on the wide array of practical matters that will enhance the enforcement capabilities of national supervisors. Progress will come faster with support from the IMF, the World Bank, the BIS, the regional development banks and other key international financial institutions.

The IFIs should play a more active role in helping countries create the right supervisory frameworks. Safe and sound banking is already a top priority; let us make it more effective by helping national governments focus on the essentials: independent bank supervision, effective enforcement of banking

270 Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States, plus Luxembourg and Switzerland. The Basle Committee has become a permanent forum to develop international guidelines for prudential banking supervision. Non G-10 countries from Latin America, Asia and Eastern Europe also participate.
regulations, and as much disclosure as possible.

Offshore banking centers should also play their part, by refusing to allow rogue bankers to use their jurisdictions to unload bad assets and hide the truth from their home country’s supervisors. Consolidated home country supervision in many developing countries is still at an early stage. Offshore banking centers should help enhance supervisory effectiveness by strictly enforcing accounting and disclosure rules, and demanding full compliance by external auditors. Non G-10 supervisors also face obstacles when trying to obtain information from large money center banks. We need to enhance the incentives for large money center banks to cooperate.

TO LATIN AMERICA

The causes of banking sector weaknesses in Latin America differ, and each country’s banking experience has been unique. Yet there is a common general pattern. Most Latin American economies are fragile and volatile. Dependence on a few commodity exports, low rates of domestic saving, and frequent policy changes leave them extremely vulnerable to economic and political changes. When economic reforms in the late 1980s and early 1990s opened the region to large and volatile cross-border capital flows, the potential for loan portfolio expansion grew and encouraged banks to take imprudent risks.

Macroeconomic shocks are to blame for most Latin American banking crises of the 1980s and 1990s. But microeconomic factors contributed. Ineffective banking regulation and supervision, poor corporate governance and almost nonexistent market surveillance conspired to leave banks weak, undercapitalized and with low-quality assets. Banks faced frequent legal difficulties or political pressures when trying to get loans serviced. Foreclosing on loans was often extremely difficult. Many of these problems still exist.

But the economies of most Latin American countries have grown more resilient over the past decade, as modern economic reforms have slowly taken root. In the turmoil of the 1998 Asian economic crisis, Latin American economies and banks have been put to a test and—though the problems have not ended—there is widespread recognition of their strength. This is the result of a sea change. Governments, banks and supervisory authorities in an increasing number of countries have recognized the need for more stringency and transparency in their oversight of banking systems. Prudential supervision provisions are increasingly embedded in many Latin American banking laws. Enforcement is the real challenge now.

**Harmonize banking regulations regionally.** Latin American commercial banks, investment banks, pension funds, and insurers are expanding
across Latin America, while also seeking to do business in G-10 countries. That has created new risks and new challenges. Via the banks, volatility might spread from less stable Latin American countries into more stable ones. At a time when global competition has lowered profit margins, even the region's strongest banks could suffer if loan expansion is not adequately overseen.

**Establish common accounting standards in line with international standards, and implement comprehensive home country supervision.** Until recently, only a few Latin American supervisors had been exposed to this issue, mostly as home country supervisors dealing with G-10 authorities. The new phenomenon of intra-Latin American bank expansion is forcing supervisors to play the role of both host and home country supervisor. Regulators are meeting more frequently to exchange ideas and information, and returning to their governments with recommendations. This will help assure a level playing field in Latin America. But banks must also do their part, and many are not well-prepared for these new challenges.

**Protect banking systems from insider lending.** As in Venezuela, many Latin American countries must deal with the problems that come from links between banks and other businesses. Banks' corporate governance is weak. Closely-held ownership, loose regulations on insider and affiliated-party lending, and lax accounting rules have led to questionable asset quality. A big wealth gap between rich and poor, and small capital markets, explains how we got there and why it is difficult to change the situation overnight. Expanding bank ownership is one solution, but it is often hard to accomplish. To avoid the risks of closed ownership, higher capital requirements must be imposed, along with strict disclosure rules on ownership and on loans to shareholders, board members, management and affiliates. Better disclosure will help develop market surveillance, a much-needed supplement to official supervision. Specific regulations on bank holding companies are also advisable, so companies aren't used to channel low-quality capital into affiliated banks.

**Set rules that build trust.** Many Latin American countries are building strong and effective regulatory frameworks to ensure prudent risk-taking by banks and other financial institutions. Laws might need to change, but the most important challenge is to enforce incentives for safe and sound banking, and to overcome the barriers of distrust, conflict and vested interest that conspire to make institutions weak and banking supervision meaningless.
TO VENEZUELA

Bank failures are a fact of life. No society will ever have an absolutely safe banking system. That would be too expensive to achieve.

Since the 1994 banking crisis, we Venezuelans have learned a few lessons, and we have made some comforting improvements. But much still must be accomplished if we are to decrease our risk of blundering into another financial crisis.

We should stop blaming the 1994 banking crisis on bad luck and bad people. As I have argued, the Venezuelan banking crisis was less the result of bad luck than of years of putting up with bad policy and bad banking. Without the latter two elements, the bad luck of an imperfectly-implemented economic reform program and a financial downturn would have been far less damaging.

We experienced a rare confluence of negative conditions, with all of the chief contributors to banking crises present: a weak economy, with a fragile financial system and weak institutions; a poorly-sequenced economic reform program; weak banks burdened by bad assets (accumulated over many years of insider lending financed with depositor money); and a dearth of investment opportunities outside the banking system.

Even though the burst of a two-year financial bubble triggered weak banks’ spiral into bankruptcy, these other problems were responsible for the severity of the crisis. As has been observed of other crises, this was a case of “bad policies, bad banking and bad luck.”

Likewise, we can’t lay all the blame on rogue bankers who abused their licenses or supervisors who failed to carry out their duties. We Venezuelans are collectively responsible: we have for too long treated banks as instruments for partisan and individual gain.

The calls for action in this book are fundamentally addressed to all of my fellow citizens. They emerged from the lessons of our crisis and should help us build strength and prevent such a painful experience from striking us again.

We must abandon our quick-fix policymaking habits, and prioritize policies that stress economic stability. Our oil cushion lulled us into years of short-term, quick-fix economic and monetary policies, often built with an eye to waiting for oil price rises to bail us out. We must put that policymaking style to rest and recognize that there’s no quick fix for an ailing economy. Our track record speaks to our lack of success: since the 1970s, we have had higher, more volatile inflation, financial instability and very modest growth. Short-term thinking killed off our prospects for vigor-

ous investment-led growth and led to a rush into short-term, high-stakes investment. Our currency lost value and credibility, and domestic savings plummeted. We developed a casino economy.

The weakness of the banking sector in the 1990s, combined with these problems, led us into a complex banking crisis. Even though we were by then undertaking appropriate free-market reforms—freeing controlled interest rates, for example—those proved insufficient, even damaging, since the weakly-supervised banking system sent money offshore and jacked up real rates so high that private investors couldn’t borrow to invest in the economy. So, private investment in Venezuela just kept plummeting.

Venezuela still needs to create a pattern of stability, aimed at sustainable growth, low inflation and positive real interest rates. To do that, we need fiscal discipline, monetary prudence and powerful stabilization mechanisms to shield us from the ups and downs of oil prices.

Building a strong financial system is key to our development.

The 1994 banking crisis cleaned up our banking system. Now is the time to move steadily toward building a strong financial system. A strong financial system will foster savings, finance investment, build competitiveness, and decrease the risk of another banking crisis. The commitment to safe and sound banking must bind bankers and policymakers alike. Banks may falter, and some might even fail, but they should not take the wealth of the country with them.

We also need to diversify the financial system more, to reduce our dependence on commercial bank credit, most of which is short-term. This dependence hurts our development prospects, since short-term credit must serve both the short- and long-term financing needs of the government and the private sector.

Excessive dependence on commercial banks and short-term credit also weakens our prospects for monetary stability, for several reasons.

First, businesses’ extreme dependence on short-term loans means they are quickly hurt by increases in short-term interest rates, which are in turn sensitive to monetary policy: they are, in fact, the transmission channel for monetary policy. Venezuelan borrowers react quickly to interest rate hikes, and vested interest pressure on the Central Bank builds up fast, especially when the economy has been in a protracted recession.

Second, dependence on short-term credit explains why Venezuelan governments have relied so much on rules requiring subsidized lending to certain sectors. Vested interests naturally turn to the Central Bank for relief, for either seasonal or long-term financing needs. Monetary relaxation has always seemed politically costless.

Third, the weakness of commercial banks and the lack of developed financial markets builds up payment system risk and places constraints on monetary policy.
We need a four-pronged cure. We need better banking, better rules, better bank supervision and a stronger economy. Our crisis came from all four sources, and so we need to address them all.

Bad banking was at the root of our crisis. Inadequate law and supervision let it happen, but it originated fundamentally from the combined effects of closed ownership, inordinate bank links to commerce and industry, and weak corporate governance. We cannot change this situation abruptly. We can, however, mitigate some negative consequences by raising capital, and thus force shareholders to be more committed to their banks. We can also improve the disclosure of relevant information. Let depositors and investors know who owns banks, what portion of loans and investments have gone to shareholders or affiliates, and what portion is past due, non-performing or restructured.

Supervisors need to make sure that the information banks provide is truthful and reliable. The market will help do the policing.

Supervision should focus on risk management—making sure that risks are properly assessed and accounted for, and that directors and management are really on top of things. Let bankers run their banks, but make sure they know what they are doing, and be prepared to stop them from venturing too far down the wrong path.

The 1994 Banking Law is a step in the right direction. It has brought more competition and more opportunity for capital to enter the system. It has restricted affiliated-party lending, and imposed serious penalties for bank directors and managers who fail to comply. Venezuelans are also much more sensitive to the need for safe and sound banks and want to do away with some past errors. Let us now make sure that bank supervisors enforce the new law effectively.

Venezuelan banking supervisors still don’t get enough resources to do their jobs well, don’t have proper legal protection, and are not shielded from political influence, despite the provisions of the new banking law. Crisis-period emergency bank legislation still in force must give way to normal rules, to restore the powers of bank regulators and enhance their independence.

Corporate governance is slowly improving. But risk management has a long way to go. New rules have not yet succeeded in making the Venezuelan banking system less prone to lending booms and to financing risky operations with depositor money.

Disclosure has improved, too. Yet many regulatory decisions and procedures remain hidden from public scrutiny. Information provided by banks still lacks the depth needed to assess the quality of bank assets, the structure of ownership and the impact of relationships with affiliates. Many banks still put more emphasis on showing a nice face than on trying to be truly healthy.
The Venezuelan banking industry also faces new risks. Foreign banks comprise a large share of the market now, but this doesn’t mean that regulators in other countries will take care of our problems. The role of a host country supervisor vis-à-vis the international banking community and supervisors in other countries is new to us, and is as crucial and demanding as looking after our own banks. Allowing universal banking is a big improvement over pushing financial institutions to narrowly specialize. But it also poses new risks that must be better understood and monitored by bankers, supervisors and the markets. Banks are taking up sophisticated new financial products, and there is a distinct possibility that they might be unprepared to deal with and contain the new risks they bring.

Between 1996 and 1998, with the memory of the banking crisis still lingering, Venezuela went through another boom-bust economic cycle. Concerns over the fragility of both the economy and the banks quickly resurfaced, proving that much more must be done to make the economy more resilient, and to ensure safe and sound banking.

Our dependence on oil is as high as ever. Oil wealth allowed us to mask problems more readily apparent in other countries. But it is time to remove the mask. Venezuelans should no longer count on oil to cover up mistakes and provide painless solutions. Governments must learn to be disciplined, and citizens must demand that they be—and build the institutions that will help us achieve our goal. This is what makes the independence of the Central Bank so important to our future.

Vested interests in Venezuela continue to seek solutions to their problems through manipulation of monetary policy and favorable legislation, demanding interest rate caps, special lending programs and directed lending rules for banks. The Venezuelan Central Bank has long been called upon to step in and substitute for the lack of sound development policies. Politicians too readily turn to the Central Bank for easy money. That will continue to happen if we elude facing up to the need to build competitiveness.

The 1992 reform of Central Bank law created the building blocks for Central Bank independence. The idea has been gaining support, but will only happen if we all make it happen. We need to learn to have confidence in a process of empowering and living with not only an independent Central Bank, but with laws that are enforced, regulation that is strong, and institutions that have the capacity to function credibly from one Presidential administration to the next. We have not yet taken these ideas to heart. The means are there; the issue is fundamentally that if there is a will, there is a way.
LETTER TO FINANCE MINISTER PEDRO ROSAS,
MAY 19, 1993

Dear Mr. Minister:

The second vice president of the Central Bank has informed me of the meeting held in your office on May 5, 1993, for the purpose of presenting to you and the superintendent of banks the detailed results of the Central Bank's study on the Venezuelan banking system's solvency and profitability. The presentation essentially covered the following matters:

a) methodology used in the study;
b) condition of the banking system at the end of the first half of 1992;
c) new quantitative, qualitative and methodological factors considered in the second half of 1992;
d) evaluation of the 1992 year-end results, classification of financial groups by risk, and the relationship between bank strategies and the banking system's risk level;
e) trend of the return on equity of the banking system, subsystems, financial groups and individual institutions;
f) preliminary analysis as of March 31, 1993, based on factors previously cited;
g) conclusions and outlook;
h) implications of the condition discovered.

As both you and the superintendent will have realized, this study demonstrates that part of the banking industry continued to deteriorate throughout 1992. The facts discovered raise the risk level for depositors and also impair the banking industry's capacity to finance the country's productive activities.

In accordance with the aforementioned study, although unequally distributed over the sector, the main weaknesses include:

a) low bank capital ratios;
b) high level of dependence on extraordinary revenue items for internal capital creation;
c) major increases in operating costs, which have progressively canceled out the profits derived from traditional intermediation and led to operational losses;
d) a rather generalized problem of high credit concentration, placing capital at risk;
e) unclear information and unreliable financial statements.

With this letter and the detailed presentation made in your office, the Central Bank of Venezuela discharges its duty to inform the government of the findings of this study. The Central Bank wishes to advise you of its readiness to provide the fullest cooperation in the drafting and implementation of the appropriate policies, aimed at developing a coordinated action of all institutions involved, within the framework of each body's specific authority. We suggest that you consider the following policies:

1. Designing and implementing a program of corrective measures, adapted to the particular condition of each of the financial groups and intermediaries confronting structural problems.

2. Crafting preventive and corrective measures applicable to situations that have arisen or that may arise within our banking system as a result of acquisitions, business agreements and integration of services which are allowing banks to expand into non-traditional operations and increasing the system's risks and distortions.

3. Progressively implementing consolidated supervision and broadening preventive regulations in pursuit of a healthier banking system.

In view of the situation described above, the Central Bank deems it appropriate to urge the government to renew its efforts, at the appropriate levels of jurisdiction, to emphasize the need for prompt approval of the new General Law of Banks and Other Financial Institutions.

This is essential to facilitate the modernization, competitiveness and efficiency of the banking sector. In addition, it will: a) allow current preventive regulations to be broadened; b) implement consolidated supervision; c) deal more effectively with possible banking crises; and d) give the Office of the Superintendent of Banks the resources it needs to fully carry out its duties.

In view of the matters discussed above, and considering the need to prevent potential fallout from the general weakness of economic activity and the loss of confidence in the banks, the Central Bank reiterates its intention to fully cooperate and awaits with great interest your advice regarding the action plans that the government deems appropriate.

Yours truly,
Ruth de Krivoy
President
LETTER TO PRESIDENT RAMÓN J. VELÁSQUEZ,  
DECEMBER 1, 1993

Dear President Velásquez:

I am writing to bring to your attention several matters in connection with the condition of the banking industry. These are urgent matters that must be attended to as soon as possible, to minimize potential economic and social costs as well as direct charges against the Treasury.

In spite of the difficult economic and financial climate over the past two years, the operations of the majority of banking institutions have been satisfactory. However, some institutions have weaknesses that affect their normal functioning and, by extension, that of the financial system. This problem has been raised with the national government on many occasions by this Bank; the recent intensification of the problem impels us to call it to your attention, inasmuch as it requires effective and timely solutions.

In the third week of November 1992, the Central Bank of Venezuela made available to the national government the results of its studies on the banking system’s solvency and profitability, in which banking groups were classified according to their risk level. A detailed presentation was made to the minister of finance and the superintendent of banks on the subject. This presentation was also made to the board of directors of the Central Bank, which included three members of the Cabinet at the time.

In late April 1993, these studies were updated, incorporating new information. Since there had been further impairment to the condition of the banks, the board of directors of the Central Bank agreed that the results should be presented again in detail to the minister of finance and the superintendent of banks. This presentation in fact took place on May 5, 1993. Our conclusions were further ratified in a letter to the minister of finance dated May 19, 1993.

We brought up the need to immediately implement a properly coordinated corrective policy, within a framework of joint actions, that clearly defined the duties and responsibilities of the minister of finance, the Office of the Superintendent of Banks, Fogade and the Central Bank of Venezuela.

Likewise, once the current minister of finance took office, in meetings undertaken to address matters of common interest to the Finance Ministry and this Bank, I took it upon myself to inform him about the condition of the banking industry and the need for the Office of the Superintendent of Banks to adopt appropriate preventive measures.
Since then, a year that could have been put to better advantage has elapsed, a year in which measures could have been introduced, under a joint action, to effect a progressive adjustment in each of the affected institutions without major damage.

II

During the past two weeks, the banking system has faced liquidity problems originating from seasonal factors, aggravated by the high level of capital outflow, in an environment affected by the current political climate. Under these circumstances, the condition of most of the weaker banks has significantly worsened.

To date, the acute liquidity crisis has mainly been concentrated in a group of seven commercial banks that have been recording serious losses in the daily clearing of checks, with debit balances systematically growing since November 15. For this group of banks as a whole, today’s negative clearing balance was Bs. 17.7 billion.

Consequently, by November 30, 1993, three of these banks had shortfalls in their cash reserve requirements totaling Bs. 8.8 billion, and five banks needed credit assistance from the Central Bank, with a total debit balance of Bs. 24.9 billion as of the same date.

As a temporary measure, the use of the financial assistance of the Central Bank as lender of last resort is a normal transaction within the activities of a commercial bank, and, therefore, it does not necessarily have negative connotations. However, it is another story when a bank has weaknesses and its debit balance at the Central Bank grows very rapidly, with no indication that sufficient efforts are being made to strengthen its capacity to pay.

Considering the difficult circumstances during the month of November, the Central Bank provided financial assistance to the banking system, based on a program designed to guarantee the normal functioning of the banks and the payment system, which is a responsibility expressly stipulated in its law. The Central Bank provided this assistance without compromising its monetary policy program. However, it must be pointed out that the law itself limits the sphere of the Bank’s lending activities to covering temporary liquidity needs and prevents it from granting loans to resolve structural problems, which must be handled by Fogade.

III

In view of the foregoing conclusions, the Central Bank deems it appropriate to reiterate to the government the urgent need to draft and implement coordinated plans aimed at correcting the existing weaknesses and reducing these banks’ vulnerability to liquidity crises, as well as guaranteeing the stability of the financial system and protecting people’s savings. This pre-
ventive policy must prevent current problems from worsening and ending up being much more costly and damaging, both for the people and for the government. Such plans must include a specific assignment of the duties to be carried out by every government body involved, especially by the Ministry of Finance, the Office of the Superintendent of Banks and Fogade.

We would like to take this opportunity to state the Bank’s intention to provide its full cooperation in drafting and implementing the aforementioned plans:

Yours truly,
Ruth de Krivoy
President

cc: Minister of Finance
LETTER TO PRESIDENT RAMÓN J. VELÁSQUEZ.
JANUARY 4, 1994

Dear President Velásquez:

As a result of the evaluation made today by the board of directors of the Central Bank regarding the condition of Banco Latino, S.A.C.A., and by resolution of the board, I am writing to bring the following to your attention:

1. The most recent records show a severe worsening of the condition of the treasury of Banco Latino, which is reflected in its large debit clearing balances on January 3 and 4, as well as in the use of almost all of its ordinary legal cash reserves on these dates. In addition, this bank is having increasing difficulty accessing the resources of the interbank market. Furthermore, it has been undergoing intense public pressure at the teller windows during these two days, as has been reported to you in person today by its acting president.

2. A condition as fragile as that described above could potentially bring Banco Latino under the provisions of Article 12 of the Clearing System Regulation and, as a result, the bank would be excluded from said mechanism. In that event, the Central Bank would immediately send notice to the Office of the Superintendent of Banks for said office to adopt the measures needed to address the roots of the problem.

3. Should Banco Latino fall under the provisions of Article 12, the financial system would be at immediate risk of instability, given the size of the bank. This could have adverse consequences on the operation of the country’s payment system and result in the loss of depositor confidence.

4. The impairment of Banco Latino points to the immediate need to take proactive steps and to draft a plan that adequately deals with the bank’s problems. Under this plan, each of the appropriate government bodies—the Ministry of Finance, the Office of the Superintendent of Banks, Fogade and the Central Bank of Venezuela—should carry out its legal responsibilities, protecting the stability of the financial system and people’s savings.

The facts described above and the potential risks involved obligate the government to take urgent action. The Central Bank of Venezuela is ready to provide its assistance within the framework of its own law and the newly-enacted General Law of Banks and Other Financial Institutions.

The foregoing statements reiterate the assertions contained in the Central Bank’s letter to you dated December 1, 1993.

Yours truly,
Omar Bello Rodríguez
Acting President
LETTER TO RAMÓN J. VELÁSQUEZ,
JANUARY 14, 1994

Dear President Velásquez:

The board of directors of the Central Bank of Venezuela deems it necessary to inform you that Banco Latino was excluded from the clearing system as of January 12, pursuant to Article 12 of the Clearing System Regulation.

I

Banco Latino faced acute liquidity problems for the last 70 days, as we reported to you verbally on several occasions, and in writing, in the Central Bank's letter to you dated January 4, 1994. The bank's worsening condition led to a very delicate situation, more so in view of the structural weaknesses detected by the Office of the Superintendent of Banks in the last two inspections carried out in end-1992 and mid-1993. The Central Bank's opinion on this problem was raised with the national government in letter to you dated December 1, 1993, with copy sent to the minister of finance. The superintendent of banks was also informed about it.

Banco Latino's prolonged illiquidity became especially pressing early this year, when its daily debit clearing balances reached levels above Bs. 7.0 billion and the bank operated without fully complying with the legal cash reserve requirements. At the beginning of January 12, its cash reserve shortfall was Bs. 12.4 billion. The Office of the Superintendent of Banks and Fogade were duly informed about this by us.

Throughout this 70-day period, the loans extended to Banco Latino by the Central Bank as lender of last resort rose, reaching Bs. 23.3 billion on the day the bank was excluded from the clearing system. Securities legally acceptable as collateral for this type of operations were pledged by the bank. Unfortunately, as its difficulties deepened, it became increasingly difficult for the bank to provide assets acceptable as guarantees by the Central Bank, in accordance with the conditions set forth in the law.

II

The Central Bank of Venezuela made intense efforts in seeking a timely and appropriate solution to the aforementioned liquidity problem, in order to avoid harmful situations that would affect the bank's depositors and thus turn this specific problem into a confidence crisis affecting the stability of the Venezuelan financial system.

In addition to providing substantial financial assistance to the bank, the Central Bank actively explored two options:
1. In order to avoid the harmful consequences that Banco Latino's intervention would have for the Venezuelan economy and the financial system, the Central Bank recommended initiatives to set up an effective adjustment and reorganization program that would rationalize, redimension and strengthen the bank and allow it to continue operating normally. Such a program would be jointly undertaken by the bank's shareholders, private sector banks and Fogade.

The Central Bank encouraged conversations to this end among a group of the bank's majority shareholders, banking sector representatives, Fogade and the Office of the Superintendent of Banks. These conversations took place on January 11-13, and a program was gradually shaping up, in spite of the fact that the shareholders claimed to be unable to make meaningful contributions to the recapitalization plan geared to coping with the bank's severe difficulties and laying the foundations for its recovery within a reasonable time frame.

2. When faced with Banco Latino's inability to settle its debit clearing balance on January 12, the board of the Central Bank agreed to postpone the closing of the aforementioned clearing in order to allow the bank to raise funds with other banks, and also to receive the government bonds that would settle the bank's claims against Centro Simón Bolívar. These bonds were the only option available to Banco Latino in order to gain access to loans from the Central Bank and cover the clearing balance outstanding at that time.

However, in spite of intense efforts, it was materially impossible to complete the transfer of these bonds to Banco Latino in a timely fashion. The bank had thus to be excluded from the clearing system. Extending any longer the January 12 closing of the check clearing operation would have paralyzed the country's payment system.

The aforementioned measure may affect the financial system, and the situation requires proper, timely and coordinated actions by the Ministry of Finance, the Office of the Superintendent of Banks, Fogade and other relevant authorities.

To this end, the Office of the Superintendent of Banks must immediately assess the options available to either maintain Banco Latino under normal operation, or to intervene in it and subsequently decide whether the bank will be rehabilitated or liquidated. The latter will require the opinion of the Central Bank of Venezuela and the approval of the Superior Council of the Office of the Superintendent of Banks. This is a decision of great signifi-
cance, and must be geared to honor in the safest possible way the bank's liabilities with depositors, in accordance with the law.

If the Office of the Superintendent of Banks decides that the bank should be rehabilitated, it will be Fogade's duty to recapitalize the bank and to provide the means to keep it functioning. Otherwise, it will be Fogade's responsibility to honor the legal deposit insurance coverage. The latter will result in direct losses to numerous people and will have a long and profound impact on confidence in our banking system.

The impact of this situation might spread beyond the financial system. In order to avoid undesirable side effects, it is necessary to inform the community in a clear and truthful manner.

The Central Bank is ready to cooperate with the national government in the search for the best possible solutions within the legal framework.

Yours truly,
Ruth de Krivoy
President
LETTER TO PRESIDENT-ELECT RAFAEL CALDERA,
JANUARY 29, 1994

Dear Mr. President:

I am pleased to advise you, as directed by the board of directors of the Central Bank in fulfillment of the stipulations of articles 43 and 116 of the Law of the Central Bank of Venezuela, with respect to recent monetary, financial and exchange rate trends, to recommend actions that, in the judgment of the Central Bank, would allow the country to deal with the difficult situation described.

In January, the financial and foreign exchange markets were seriously affected by the Banco Latino crisis and the resulting general loss of confidence in the Venezuelan financial system, in an environment shaped by expectations about the impact on economic policy of the upcoming change of government. In this context, Venezuelan society was fertile ground for spreading rumors about the condition of the banks and possible financial and exchange rate measures, all of which contributed to increasing the uncertainty.

I. FOREIGN EXCHANGE MARKET

Within a period of several days in January, there were unprecedented capital outflows that prompted the Central Bank to massively intervene in the foreign exchange market. This capital flight reflected a vast loss of confidence in the bolivar, for reasons neither related to economic fundamentals nor to the current condition of the exchange rate, but more to the generalized perception of weakness of the Venezuelan financial system and the uncertainty surrounding basic economic and fiscal policy issues.

In fact, the high levels of demand for foreign exchange over the past few weeks can mainly be attributed to the following factors:

a) a crisis of confidence in the financial system as a result of the collapse of Banco Latino and the developments in the days since the bank was taken over;

b) expectations regarding macroeconomic policy, the fiscal crisis, strong inflationary expectations and a decline in oil revenues;

c) the evident fragility of the political and social situation.

The purpose of the Central Bank’s substantial intervention in the foreign exchange market was to keep the exchange rate on track, with the understanding that, at such times, this is the best option for strengthening confidence in the bolivar and to gain time to reestablish stability. Our decision was based on the reasonable prospect that this crisis can be overcome inso-
far as the condition of the banks is addressed properly and in a timely manner, and your government's program sets the economic, fiscal and financial goals for the country.

Under such circumstances, restricting the supply of foreign exchange in the market or amending the foreign exchange rules would undoubtedly have worsened the crisis, increased capital flight and created a more difficult environment for the economic stabilization measures called for in this situation.

Yet to stanch capital outflows and minimize the effects of this crisis we must attack its roots, and quickly reestablish confidence both in the financial system and in the fiscal and anti-inflation policies.

II. CONDITION OF THE BANKS

The collapse of Banco Latino has had very negative effects on Venezuela's banking and payment system, resulting in serious damage to depositor confidence in the banking system and, therefore, in bolivar-denominated financial assets in general.

If this situation should continue, Central Bank performance would be seriously hindered, since monetary policy operates through the banks. A sound and competitive banking system is thus required to enable the Central Bank to carry out its stabilizing role, at the lowest possible cost to society.

Corrective measures must aim at reestablishing people’s confidence in the banking system as soon as possible. To this end, actions must be taken in the following directions:

a) developing rapid and effective solutions for Banco Latino;
b) continuing to guarantee an adequate liquidity level for the financial institutions affected by massive withdrawals of deposits;
c) designing and implementing an adjustment and recovery program for the Venezuelan banking system;
d) taking the necessary measures to clarify the facts and apply sanctions established by law, as appropriate.

BANCO LATINO

A swift and appropriate solution of the Banco Latino problem is key to stabilize the financial situation of the country and to do away with social unrest. This is necessary not only to deal with the difficult and complex situation that has arisen regarding the bank, but also to contribute to rebuilding general confidence in the system and avoiding knock-on effects on other financial institutions and Venezuela’s economy, both domestically and internationally.
To these ends, a full gamut of activity must be deployed immediately, as detailed in the document attached to this letter. This action plan calls for measures by the government, the Office of the Superintendent of Banks, Fogade, the board of conservators of Banco Latino, and the Central Bank. A political statement from the government must precede the action plan.

The board of conservators is called upon to carry out an important role in this process. However, if it is to perform effectively, the board needs the full support of the government. In addition, it must have access to experts in several strategic areas, such as legal, administrative and operational. Otherwise, members of the board will be quickly worn down and will be faced with growing pressures from disgruntled depositors and other affected sectors.

The urgency of our proposal is based upon the notion that the passage of time will erode the value of the bank’s business units, diminish the chances for an effective recovery of assets and exacerbate the distress and irritation of the people affected.

LIQUIDITY SUPPORT

In order to stop the waves of the banking crisis from engulfing and contaminating the entire system, and to maintain the normal functioning of the payment system, the Central Bank made timely decisions that expedited the banks’ access to liquidity.

First, the Central Bank reactivated the credit facility supporting the overnight interbank market and granted short-term loans to several institutions. Subsequently, it reduced the legal cash reserve requirements from 15 percent to 12 percent, freeing funds that allowed banks to get around liquidity problems in the first stage of the crisis. In the third phase, as a supplementary measure, it set up a mechanism to free cash reserves on a selective, conditional and temporary basis. This enabled a group of banks with adequate solvency to work with banks affected by significant outflows of deposits, with proper safety measures in place.

This selective freeing of cash reserves gave banks with problems time to apply to Fogade for financial assistance that would allow them to meet their current obligations. Once Fogade began to provide financial assistance to the banks, it imposed a set of holding measures on them aimed at strengthening their liquidity and solvency levels and thus rehabilitating them.

The Committee of Presidents of Commercial Banks participated in the design of the aforementioned mechanism. Members have contributed their cooperative efforts, given the systemic danger involved.

Fogade has repeatedly required loans from the Central Bank as its funds have turned out to be insufficient by any measure, given the magnitude of the problems that broke out. The amount of loans granted to date, added to
the requests that will probably be submitted shortly, reach significant proportions. Above all, this has given rise to a situation that will soon exceed the action framework established in the Law of the Central Bank and the General Law of Banks and Other Financial Institutions.

It is worth noting that current conditions demand from Fogade great dynamism and ample capacity to deal with problems that are well beyond the institution's organizational and financial capability. Therefore, there is an immediate need to adopt measures that allow expedited action and broaden Fogade's financial base.

In order to assure that the great effort currently being made will lead to favorable results, there is the need to enhance Fogade's management capabilities to design the necessary strategies and enhance its ability to monitor the banks receiving financial assistance. A major injection of capital into Fogade by the government is also needed. The role of the Central Bank should be limited to helping to meet liquidity requirements, as stipulated in the Law, and to lending to Fogade with its eligible assets and future bank contributions as collateral, in the event of bank rehabilitation.

ADJUSTMENT PLAN FOR THE VENEZUELAN BANKING SYSTEM

While the most critical aspects of the current situation are dealt with, it is also necessary to implement effective measures for the restructuring and recovery of the banking sector, based on the provisions of the new Banking Law.

Step by step, we must rebuild banking industry activity based on a frame of reference very different from that of the past. It must be based on more competition. Greater discipline must come from prudential regulations to be promptly established and enforced by the Office of the Superintendent of Banks. It must be better capitalized and honor, without fail, the obligation to furnish complete, truthful and timely information to the supervisory bodies and to the general public.

The Office of the Superintendent of Banks and Fogade must concur to this task. It involves complex factors, and requires strong leadership and effective management to lead us into a new banking system, quite different in terms of its form, structure, and performance from the traditional one.

If the public perceives that this action has been initiated with clarity of purpose and strength, the confidence of both Venezuelans and foreigners in the financial system will return. Weak and delayed initiatives, on the contrary, will worsen the lack of confidence.

PROGRAM TO REESTABLISH FINANCIAL STABILITY IN INDIVIDUAL AFFECTED BANKS

The banks affected by the crisis must submit to strict reorganization and rehabilitation plans agreed upon jointly by the Office of the Superintendent
of Banks and Fogade. The plans must be carried out with teller windows kept open; that is, the banks must allow depositors free access and safeguard the integrity of the deposits.

This implies sweeping action in terms of management, administration and finance, which will have different nuances in each bank affected. This action must not be postponed. In fact, there are already several banks that have received financial assistance from Fogade and, if the necessary measures are not taken, we will run the risk of losing the funds earmarked for this purpose.

The aforementioned considerations once again focus attention on the immediate need for the government to take measures to facilitate:

a) reorganization and strengthening of the Office of the Superintendent of Banks and Fogade because of the complex responsibilities they have in the current situation; and,

b) applying the necessary funds, in adequate amounts and within the timeframe required, to manage this crisis as well as to rehabilitate and strengthen the banking system.

RESPONSIBILITIES

The incalculable cost of this banking crisis will fall upon the people of Venezuela. Its adverse consequences are inevitable. Government and Congress will have to evaluate the issue and decide who will bear the major brunt of the crisis: shareholders and administrators, depositors and creditors, or taxpayers. This difficult matter must be cleared up in the very near future.

There are also other responsibilities that cannot be overlooked. The responsibilities of management or other individuals, and the related financial and physical penalties, must be meted out as determined by the proper administration of justice. Penalties must be applied efficiently, objectively and for the purpose of setting an example. In this direction also lies a route to minimizing the cost of the crisis to the state.

The extent of this crisis may still not be determined with precision, but, in any event, it is clear that it has compromised public policy in all its various forms, generated profound ethical questions, and, of course, has had an impact on every aspect of the Venezuelan economy. Prompt attention to the crisis will speed the recovery of the people's confidence in their institutions.

III. THE SENSE OF URGENCY

Mr. President, the Central Bank's perception of the speed and extent of the circumstances discussed in the letter lead us to respectfully suggest that you consider these proposals, taking advantage of your assumption to the office of Chief of State to announce the measures designed to deal with this diffi-
cult situation, and that you immediately put into effect all the appropriate initiatives.

The Central Bank of Venezuela reiterates its complete readiness to work with you to solve the problems set forth, within the sphere of its jurisdiction.

Yours truly,
Ruth de Krivoy
President

cc : Dr. Ramón J. Velásquez, President of the Republic
BANCO LATINO

PREMISES

1. To begin with, a decision to rehabilitate or liquidate Banco Latino must be made.

2. If, for political reasons, it is decided that Banco Latino must be rehabilitated, under the assumption that immediate liquidation would be more costly in terms of its consequences to the society, the economy and the financial system, the route to be followed may be found in Article 231 of the General Banking Law.

3. Notwithstanding the fact that the referenced law assigns the above-mentioned decision to the Office of the Superintendent of Banks, the board of conservators of Banco Latino and Fogade, the magnitude and implications of the problem call for a policy statement issued at the highest level of government.

4. The Banco Latino crisis affects Fogade's capital. Therefore, the government and financial institutions must make the appropriate contributions, in accordance with the law.

ACTIONS

1. DECISION TO REHABILITATE

Government statement of its assessment whereby immediate liquidation of Banco Latino would have serious social repercussions and would affect the stability of the banking system.

ACTION: Official letter of the President of the Republic to the government bodies involved.

ENTITY RESPONSIBLE: Government (Executive Branch)

2. COMPLIANCE WITH THE PROVISIONS OF THE BANKING LAW Article 231

ACTION: Determine the operational viability of Banco Latino (within a set of assumptions).

ENTITIES RESPONSIBLE: Office of the Superintendent of Banks and Fogade

ACTION: Determine that financial assistance is necessary to safeguard the stability of the banking system.

ENTITIES RESPONSIBLE: Office of the Superintendent of Banks and Fogade
ACTION: Acquisition of controlling interest in Banco Latino
ENTITY RESPONSIBLE: Fogade

Article 256

ACTION: Reduction of Banco Latino's equity capital.
ENTITY RESPONSIBLE: The board of conservators
ACTION: Subscription of new capital (also stipulated in Article 231)
ENTITY RESPONSIBLE: Fogade
ACTION: Appointment of a board of directors
ENTITY RESPONSIBLE: Office of the Superintendent of Banks and Fogade
ACTION: Suspending government intervention and beginning the rehabilitation program, including the sale of Banco Latino stock to third parties.
ENTITY RESPONSIBLE: The board of directors and Fogade

Article 229

ACTION: Granting financial assistance to deal with severe liquidity problems (withdrawal of deposits)
ENTITY RESPONSIBLE: Fogade

Article 225

ACTION: Requesting advance from the Central Bank. The amount will be determined on the basis of the structure of the deposit base and methods of repayment.
ENTITY RESPONSIBLE: Fogade
ACTION: Approval of advance to Fogade and the terms and conditions under which it is granted.
ENTITY RESPONSIBLE: Central Bank of Venezuela

3. CAPITAL CONTRIBUTIONS

ACTION: Organic Public Credit Law, Article 3: Request for Congressional authorization to issue public debt bonds
ENTITY RESPONSIBLE: Government (executive branch)
ACTION: Approval of Special Public Credit Law
ENTITY RESPONSIBLE: Congress of the Republic
ACTION: Banking Law, Article 223: Amendment of the percentage of bank contributions to Fogade.
ENTITY RESPONSIBLE: Government (executive branch)
BENEFITS OF THE STRATEGY

1. Minimizes the social and political cost of the banking failure.
2. Guarantees a collective contribution of all agents involved, both in the lending operations and in recapitalization.
LETTER TO FINANCE MINISTER JULIO SOSA RODRÍGUEZ,
FEBRUARY 18, 1994

Dear Mr. Minister:

I am pleased to write to you, as directed by the board of directors of the
Central Bank, to convey to the government, through your offices, the Bank’s
proposals with respect to the banking system.

1. The board of directors has reviewed the repercussions from the take-
over of Banco Latino and its closure for a period that now exceeds one
month.

As a result of this event, the Venezuelan banking system has undergone
one of the most difficult periods of turmoil in recorded Venezuelan history.
In this regard, we must call your attention to the situation verging on panic
in the foreign exchange market, which reached its most dangerous level on
Friday, January 21, 1994. This was only reversed some days after the new
government took office, when a change in expectations took place.

This significant outflow of capital, along with the spread of concerns
regarding the viability of some banking institutions, allows us to state that
the contagion effect is affecting several banks. In some cases it stems from
the banks’ preexisting ownership or operational relationships with Banco
Latino. In others, it is due to their structural weaknesses, which made them
especially vulnerable to the combined effect of severe capital outflows and
runs on deposits which have yet to be brought under control.

An additional complication arises from the pervasive idea of the weak-
ness of a group of banks. Depositors are increasingly sensitive about the
health of the banks. This has translated into an unusual volatility of deposits.
Several banks have experienced waves of withdrawals attributable to uncer-
tainty focused specifically on those banks, to rumors, or simply to the fear of
a takeover that would cause clients the same kinds of problems that Banco
Latino depositors have gone through recently.

2. A group of banks has lost a large portion of its deposits through various routes:

a) withdrawals of deposits by individuals, through the teller window or
through the clearing system;

b) withdrawals of interbank deposits in response to the lack of liquidity
caused by Banco Latino’s closure, capital flight, and the withdrawal of
Fogade’s trust funds at several banks in order to meet its commitments of
advances to Banco Latino;
c) withdrawals of deposits by government bodies, including the oil industry, based on their lack of confidence resulting from the freezing of Banco Latino funds; and,

d) substantial withdrawals of deposits from offshore units of Venezuelan banks.

3. A situation such as that described—illiquidity in the banking system as a whole and critical illiquidity in a group of banks that virtually exhausted their secondary reserves, and even their legal cash reserves—would inevitably have led to the exclusion of several banks from the clearing system and therefore, to their virtual takeover.

Most likely, this would have led to the repetition of the unfortunate chain of events that occurred in the case of Banco Latino. Undoubtedly it would have spread lack of confidence throughout the entire Venezuelan banking system, which could have led to a collapse of the payment system and a foreign exchange crisis that would have seriously compromised the viability of the new government’s economic policy.

In view of this situation, the Central Bank adopted highly unusual emergency measures aimed at safeguarding the financial system. For this reason, the Central Bank granted special advances to Fogade, as stipulated in articles 314 and 225 of the General Law of Banks and Other Financial Institutions. The purpose was to allow Fogade, in turn, to assist ailing financial institutions, in accordance with the law. This action of the Central Bank through Fogade was absolutely necessary for the aforementioned purposes, since, at that time, the problem banks had exhausted their secondary reserves for dealing with withdrawals of deposits, and lacked securities eligible for Central Bank advances.

The financial institutions that have received financial assistance from Fogade have been subject to preventive measures. The primary purpose has been to assure that all funds obtained (both from Fogade and other sources) be applied to serving depositors.

4. The method of financial assistance assumed by Fogade, with liquidity support of the Central Bank, although necessary and urgent, is not free of cost:

a) The amount of funds furnished has been considerable, practically equivalent to the amounts of the deposit loss. Its expansive effect on money supply has only been partially offset through the issuance of Central Bank liabilities.

b) The quality of the assets submitted to Fogade, as collateral tends to lose value, is likely to decline as runs continue and Fogade’s financial assistance goes on.
c) In addition, the banks receiving assistance have capital insufficiencies that have not been adequately specified; reports from the Office of the Superintendent of Banks on all of them are both incomplete and untimely.

In spite of all these considerations, such costs, to date, are presumably less than those that would result from the takeover and closing of these institutions, or their liquidation.

For a breakdown of funds provided to Fogade by the Central Bank and the assistance given by Fogade to the banks during this period of the banking crisis to date, please see the attached table.

5. The phenomenon that has occurred may be understood as a simultaneous loss of liquidity and solvency for a group of banks, derived from runs on their deposits (still not over) and an indeterminate loss of capital, which has been made even more critical by the increase of their non-performing loan portfolio.

Through Fogade, the government has been replenishing the banks’ liquidity (i.e., subrogation of deposits); in addition, it has probably already begun to assume a portion of their capital losses. This depends on the quality of the collateral that Fogade has received from the banks, including assets contributed by the respective financial groups as well as the assets and/or personal guarantees of their current shareholders.

6. The situation described above calls for significant corrective measures. There is no doubt by now that the condition of the banks receiving assistance will not be turned around through injections of liquidity alone.

Concrete strategies must be implemented as soon as possible. They must be designed to change the management of said banks and deal with their solvency and profitability problems in a consistent way. The purpose of these strategies must be to improve the banks’ standing and refloat them. In this way, the foundation will be laid for recovery of the financial assistance already granted.

Fogade and the Office of the Superintendent of Banks must thus urgently commit themselves to a series of actions, in order to:

- determine the capital inadequacies of the banks and/or financial groups in question;
- recapitalize the banks as necessary and conclude agreements to that end with the current shareholders, Fogade and with possible new investors in the banks; and
- formulate and implement a rehabilitation plan for each of the banks and/or financial groups affected.
They would thus be able to proceed to replace the current management, provide the banks with new capital and management, and make the relevant public announcements.

In addition to these measures, there is a need for a suitable program of government deposits in the financial system in support of the plan.

Furthermore, it is reasonable to assume that Fogade's support will continue to be necessary for some time, both through financial assistance and/or through capital contributions.

7. With respect to the group of banks receiving financial assistance from Fogade, data available as of this date indicates that, in at least three cases, the size and persistence of deposit losses and the weakening of the collateral posted to Fogade, make immediate, effective action advisable in order to reverse the current trend and contribute to stabilizing the markets.

8. It should be emphasized that, in addition to the aforementioned group of banks, the case of Banco Latino is pending action. This too calls for a swift determination of an action plan that will, most certainly, require significant financial support from Fogade and also, to some extent, liquidity to be provided by the Central Bank.

9. Strengthening of Fogade's capital is a key element in the overall banking crisis plan. This process has already been started with the increase in contributions from banks and other financial institutions decreed by the government on February 16, 1994. However, as we advised in our memorandum on that date, the Central Bank estimates that the referenced contributions from financial institutions must be supplemented with additional government contributions to ensure that Fogade has the capital resources required for its needs and has the capacity to repay the debts it is contracting with the Central Bank.

To this end, the Office of the Superintendent of Banks and Fogade must quickly determine the financing plan for the bank rehabilitation process in progress, setting amounts and target dates. This will make it possible to move swiftly toward getting legislative approval of contributions that the government must make, and the most suitable financial instruments for this purpose.

10. The board of directors of the Central Bank of Venezuela estimates that, if the current conditions of Fogade’s financial assistance program remain unchanged, in the near future, the Central Bank could exhaust its option to continue granting Fogade the financial assistance stipulated in articles 314 and 225 of the General Law of Banks and Other Financial Institutions.
11. Amendments to the current legal system may be required to resolve some aspects of this banking crisis in a comprehensive manner. The Central Bank is analyzing these matters and offers its cooperation to the government and Congress in order that the regulations to be implemented may achieve the best results.

To conclude, I would like to advise you of the emphasis placed by the board of directors of the Central Bank on the urgent need to implement measures that will effectively address the problem of solvency and management of the affected banks, and allow for the resolution of the current banking crisis.

Yours truly,
Ruth de Krivoy
President
LETTER TO FINANCE MINISTER JULIO SOSA RODRÍGUEZ,
APRIL 21, 1994

Dear Mr. Minister:

The Board of Directors of the Central Bank of Venezuela deems it appropriate to advise you of the difficult situation arising from advances granted by the Central Bank to the Deposit Guarantee and Bank Protection Fund (Fogade) starting January 28, 1994. These advances were earmarked for providing financial assistance to several banking institutions within the framework of the regulations governing this matter.

As of April 15, the outstanding balance of advances granted reached Bs. 509.69 billion. This figure does not include interest accrued for January, February and March on the order of Bs. 21.07 billion. Projections effected by the Central Bank indicate that, by the end of this year, Fogade's total debt for these advances, including principal and interest, could exceed Bs. 700 billion, even if no new advances were granted. By way of illustration, this last figure represents more than 10 percent of GDP forecasted for 1994, one-third of the remaining assets of the Central Bank and almost twice the monetary base as of the close of February.

Advances already granted commit Fogade's future flow of revenues from bank contributions, by way of collateral, for the next 15 six-month periods. This estimate is based on the assumption that financial system deposits will grow at the same rate experienced in 1993 and that the aforementioned contribution is maintained at its current level (1 percent). This period would be extended to 18 six-month periods if we were to consider the total estimated debt as of year-end 1994.

The above-mentioned ratios make it foreseeable that assistance provided to Fogade by the Central Bank is reaching its limit. It is therefore necessary to explore new avenues to meet Fogade's present and future financing needs and to ensure recovery of advances granted by the Central Bank. This calls for a review of the administration's policy vis-à-vis the banking crisis.

In addition, there is some concern about the collateral Fogade is receiving on account of the financial assistance it is granting. In this regard, data on hand at the Central Bank indicates that, as of March 15, 1994, the six institutions receiving assistance from Fogade (not taken over as of that date) had delivered assets to Fogade—primarily loans, property and stock—in amounts that would suggest that as of that time, their capacity to post additional collateral was exhausted. One outstanding fact is that the amount of the loans ceded to Fogade represented 83 percent of the total loan portfolio of the group of commercial banks receiving assistance as well as of the investment banks and mortgage banks of the respective groups. With re-
spect to property and stock, this percentage reached 483 percent and 181 percent respectively, calculated on balances from balance sheets of the financial institutions of the groups under financial assistance.

Given the limitations on an increase in financial assistance granted to it by the Central Bank, Fogade must: 1) take effective steps to recover its banking assets, 2) turn to issuing its own bonds, and 3) undertake a complete restructuring of its organization.

Fogade will only be able to move toward its proper long-term financial stability—without being an excessive burden on the Treasury—if it recovers the banking assets it has received, including selling the stock of the assisted banks. To this end, Fogade will have to delegate the asset sale to a specialized institution, either an existing one or one to be created for this purpose.

Launching a program to issue its own securities, in significant amounts, is the most plausible way for Fogade to meet its new financial needs and repay its debt to the Central Bank of Venezuela. Fogade’s bond issues might have varied characteristics, adapted to each case. This would bring advantages both to Fogade, by restructuring its liabilities and reducing its financial costs, as well as to the Central Bank, which could use these bonds for its open market operations. These could replace Central Bank bonds, with a resulting saving in the cost of monetary policy. In addition, these bonds could be delivered to banks receiving assistance to replace low-quality assets, thus enabling Fogade’s financial assistance to support the true rehabilitation of these institutions and not, as has occurred up to now, create a burden that hurts their financial viability.

In order to achieve the two aforementioned objectives, Fogade must undertake an immediate overall restructuring that would ensure the technical capacity needed for the efficient management of its bond issues, liquid assets and operating costs as well as monitoring the banks receiving financial assistance. Otherwise, Fogade will not have the capacity to manage the banking crisis.

On the immediate horizon, it is imperative to correct the current lag both on the definitive treatment of the banks receiving assistance and on the structural solutions to the problems raised in this letter.

In advising you of the aforementioned proposals, the board of directors of the Central Bank wishes to inform you about a situation that must be reviewed by the competent authorities as soon as possible. The Central Bank is prepared to provide the cooperation needed in this regard.

Yours truly,
Ruth de Krivoy
President
LETTER TO PRESIDENT RAFAEL CALDERA,  
APRIL 26, 1994

Dear Mr. President:

I accepted the position of president of the Central Bank of Venezuela in April 1992 under very difficult circumstances. I did it because I believed that I could make a contribution to my country.

Throughout my professional life, I have held the conviction that central bank autonomy is essential for monetary stability, economic development and the well-being of the people. After two years as head of this bank, I can only confirm my belief.

From the very beginning of my tenure, I set myself the goal to achieve for the Central Bank the institutional autonomy needed to fully carry out its mission, which is of the highest national interest: to promote monetary stability and maintain the country’s international reserves. In December 1992, this was accomplished with the reform of the Law of the Central Bank of Venezuela.

I was fully dedicated to enforcing the new law, focusing the bank’s actions on its sphere of jurisdiction, while dealing with the tremendous problems Venezuela was facing at that time. My goal was to carry out the mission of the Central Bank.

The decisions we had to make at the Central Bank over the past two years were neither easy nor without cost. But the results cannot be dismissed.

In spite of political upheaval, enormous fiscal problems and the well-known deficiencies of other government bodies whose action is required if this bank is to perform effectively, we managed to maintain foreign reserves, avoided aggravating the problem of inflation, and gained time in which to implement, under the best conditions possible, the fiscal and economic policy measures needed to set the country on the road to healthy development.

I have been guided at all times by my desire to contribute to the solution of the serious problems facing the Venezuelan economy. I can therefore say, in good conscience, that I spared no effort or sacrifice, and that I always sought to constructively support the four governments with which I worked throughout my tenure. All of this is well documented. My contribution however, does have one limit: my personal beliefs.

I do not wish to impede the progress of the policies that your government plans to implement nor the processes now being initiated. I wish you success in all these efforts, since your success will be shared by all Venezu-
elans. But neither can I participate in actions that go against the basic principle which, to me, justifies my serving as head of the Central Bank.

Therefore, Mr. President, I hereby submit my irrevocable resignation from the presidency of the Central Bank of Venezuela.

Yours truly,
Ruth de Krivoy
Table 1
Dependence on Oil

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<th>Oil price</th>
<th>Oil exports</th>
<th>Government oil revenues/total ordinary revenues</th>
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<th>Terms of trade</th>
<th>Balance of payments</th>
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n.a. not available

1/ Venezuelan oil basket annual average
2/ Oil export price index / Import price index, 1990 = 100
Source: Central Bank of Venezuela and IMF
Table 2.1
Macroeconomic Performance Indicators

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<tr>
<th>Year</th>
<th>Total GDP % change</th>
<th>Non-oil GDP % change</th>
<th>National income per capita US $</th>
<th>Unemployment 1) %</th>
<th>Informal sector employment 2) %</th>
<th>Income Distribution 3) %</th>
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1) Percent of total labor force
2) Percent of total employment
4) Source: Central Bank of Venezuela and Venezuelan Bureau of Statistics (OCEI)
Table 2.b
Macroeconomic Performance Indicators

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<th>Savings % GDP</th>
<th>Total % GDP</th>
<th>Public % GDP</th>
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\* Adjusted by inflation, 1984 = 100.
\* Consumer price index

Source: Central Bank of Venezuela and Venezuelan Bureau of Statistics (OCII)
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Source: Central Bank of Venezuela
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Source: Central Bank of Venezuela
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1/ (deposit rate minus inflation rate) / (1 + inflation rate)
2/ deposit rate minus exchange rate depreciation
Source: Central Bank of Venezuela
### Table 6.a
Commercial Banks
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Source: published financial statements
### Table 6.h
Commercial Banks
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Source: published financial statements
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Source: Central Bank of Venezuela
Table 8
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% Change

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Source: Central Bank of Venezuela

* Adjusted by CPI 1984=100
### Table 9
**Balance of Payments**

*Billions of US $*

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1/ includes errors and omissions
2/ foreign reserves expressed as months of imports

Source: Central Bank of Venezuela
### Table 10
Cross Border Capital Flows

**Billions US$**

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Source: Central Bank of Venezuela
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*(*) Annual average
(**) Purchasing power parity calculated vis-a-vis US
Source: Central Bank of Venezuela
### Table 12.a
Public Finance
(% GDP)

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*Public Sector includes: Central Government, PDVSA, FIV, IVSS and other nonfinancial enterprises.*

*Source: Central Bank of Venezuela and Ministry of Finance.*
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(*) Public Sector includes: Central Government, PDVSA, FIV, IVSS and other nonfinancial enterprises.
Source: Central Bank of Venezuela and Ministry of Finance.
### Table 13
Public Debt

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Source: Ministry of Finance
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Letter to President Ramón J. Velásquez, January 14, 1994.

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Financial Supervisory Authority (Sweden), Experiences from the Swedish financial crisis from a supervisory perspective, March 1966.


ROSEN, Gustavo, Bases para un compromiso de solidaridad, April 25, 1994.

"A blow by blow account of the collapse of a banking system from one on the firing line."
Paul A. Volcker

"The story is one of the short-sightedness of the domestic bankers seeking to preserve their privileged status, the stubborn refusal of government to face up to a banking problem...the tragic underfunding of domestic financial supervisory activities, the lack of political will on the part of entrenched political interests which chose to ignore the problem...all compounded by spectacularly unfortunate timing."
John G. Heimann