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Report No. 13961

PROJECT COMPLETION REPORT

VENEZUELA

FINANCIAL SECTOR ADJUSTMENT LOAN
(LOAN 3224-VE)

FEBRUARY 13, 1995

Country Operations Division
Country Department I
Latin America and the Caribbean Region

CURRENCY EQUIVALENTS

Currency Unit = Bolivar (Bs)

US$1 = Bs 117.50

FISCAL YEAR

January 1 - December 31

GLOSSARY OF ACRONYMS

BANDAGRO	Agricultural Development Bank
BCV	Central Bank
BIV	Venezuela Industrial Bank
COPEI	Christian Democrats' Political Party
CORPOINDUSTRIA	Institution for Artisans and for Small and Medium Industry
CPI	Consumer Price Index
DFIs	Development Finance Institutions
EFF	Extended Fund Facility
FCA	Agricultural Credit Fund
FIV	Investment Fund of Venezuela
FOGADE	Deposit Insurance Fund
FONCREI	Industrial Credit Fund
FSAL	Financial Sector Adjustment Loan
GDP	Gross Domestic Product
ICAP	Credit Institute for Small Farmers
IDB	Inter-American Development Bank
IMF	International Monetary Fund
PCR	Project Completion Report
S&Ls	Savings and Loans
SAL	Structural Adjustment Loan
SBIF	Superintendency of Banks
SDR	Special Drawing Rights

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THE WORLD BANK
Washington, D.C. 20433
U. S. A.

Office of Director-General
Operations Evaluation

February 13, 1995

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Project Completion Report on Venezuela
Financial Sector Adjustment Loan (L3224-VE)

Attached is the Project Completion Report on Venezuela - Financial Sector Adjustment Loan (FSAL), prepared by the Latin America and the Caribbean Regional Office. This PCR does not contain Part II.

The loan in the amount of US$300 million was approved on June 12, 1990 and closed on June 30, 1993. Its main objectives were to liberalize the financial policy environment, reduce the Government's direct role in financial intermediation, strengthening the regulatory and institutional framework and improving the financial strength of intermediaries. The FSAL was one of a package of seven operations through which the Bank committed $1.7 billion in support of a comprehensive program of structural adjustment.

The PCR discusses the results of the FSAL not only on the basis of the degree of compliance with loan objectives and conditionality, but also taking into account the broader framework of Venezuela's overall adjustment efforts, and the extent to which macroeconomic and other factors affected the achievement of its objectives. FSAL conditionality was related to sectoral policy decisions and to the need for maintaining an adequate macroeconomic framework. All sector conditionality was met and was complemented subsequently by legislation adopted after completion of the FSAL's disbursements. Macroeconomic policy, however, deteriorated substantially in the second half of 1992 and 1993. This led to a major financial sector crisis in early 1994. The PCR states that the delay in approving legislation by Congress led to insufficient preparation by the Superintendency of Banks and the Deposit Insurance Fund (SBIF), but that, even if the regulatory functions had been properly performed, this would not have been sufficient to prevent the financial crisis brought about by mistaken macroeconomic policies. It also argues, however, that had the SBIF been able to perform its functions as defined in the new laws, its actions would have been effective in reducing the proportions of the financial crisis, and would have provided timely signals that might have led to earlier monetary and exchange rate action.

Based on the above, the project outcome is rated as unsatisfactory and the institutional development as modest. Sustainability, however, is rated as likely because the thrust of the financial reform is expected to continue to be supported by the country in the foreseeable future.

An audit is planned. The audit will focus on the diagnosis of the financial sector problems at the time of appraisal, the design of the project and of its conditionality, the sequencing of financial liberalization measures, their consistency with macroeconomic conditions, and the rationale for disbursing the loan before the approval of legislation.

Attachment

PROJECT COMPLETION REPORT

VENEZUELA

FINANCIAL SECTOR ADJUSTMENT LOAN
(3224-VE)

PROJECT COMPLETION REPORT

VENEZUELA

FINANCIAL SECTOR ADJUSTMENT LOAN (LOAN 3224-VE)

PREFACE

This is the Project Completion Report (PCR) for the Financial Sector Adjustment Loan in Venezuela, for which Loan 3224-VE in the amount of US$300 million was approved on June 12, 1990. The loan was closed on June 30, 1993. It was fully disbursed on December 29, 1992, 18 months behind schedule.

The PCR was prepared by the Country Operations Division, Department I, of the Latin America and the Caribbean Regional Office (Preface, Evaluation Summary, Parts I and III). On February 9, 1994, the Bank sent the Borrower Parts I and III with the request to prepare Part II by March 2, 1994, but no reply was received.

Preparation of this PCR was started during the Bank's final supervision mission of the project in October 1993, and is based, inter alia, on the Staff Appraisal Report; the Loan; supervision reports; correspondence between the Bank and the Borrower; and internal Bank memoranda.

PROJECT COMPLETION REPORT

VENEZUELA

FINANCIAL SECTOR ADJUSTMENT LOAN
(LOAN 3224-VE)

EVALUATION SUMMARY

Background

i. Venezuela's economic history until the late 1980s had been characterized by wide swings in performance as a result of inappropriate policies, which had been influenced by the country's heavy dependence on oil exports. By the end of 1988, the overall economic situation had become untenable: inflation was accelerating to record levels, foreign exchange reserves were depleted, growth prospects were negative, and poverty was affecting a rapidly increasing proportion of the country's population. To achieve efficient and sustainable growth, there was a need to eliminate the many distortions which had been created during past decades, including inter alia, widespread subsidies, the high levels of protection of non-oil production, an excessive participation of the state in economic activity, and also an excessive and inefficient regulation of the economy.

ii. To deal with the above situation, the new government which took office in February 1989 adopted a structural adjustment program which initially included the unification of the exchange rate, the reduction of the fiscal deficit, a substantial trade policy reform, a substantial liberalization of interest rates as well as the preparation of a comprehensive financial sector reform, and the formulation of a plan to replace most indirect subsides by focused social programs. The Bank supported this structural adjustment effort through a Structural Adjustment Loan (3091-VE), a Trade Policy Reform Loan (3092-VE), a Public Enterprise Reform Loan (3223-VE), a Technical Assistance Loan (3225-VE), an Interest Support Loan (3279-VE) and the Financial Sector Adjustment Loan (FSAL), (3224-VE), which is analyzed in this PCR.

iii. In 1989-90, when the FSAL was being prepared, the main issues faced by the financial sector included the existence of preferential interest rates for agriculture, and for loans provided by Government-owned development banks, mandatory agricultural credit requirements for commercial banks, excessive public sector participation in the financial system, distortions caused by Central Bank financial operations, substantial weaknesses in the institutional and regulatory structure and in the competitive environment for the financial system, and a large number of financial intermediaries in a weak financial condition.

Objectives

iv. The FSAL was designed to support the first phase of the program, focusing on: (a) liberalizing and rationalizing interest rates and credit allocation; (b) reducing public sector participation in the commercial banking system and redefining the role of the public sector in development finance; (c) rationalizing the credit operations of the Central Bank (BCV), with a view to enhancing their transparency and minimizing their disruptive effects in the financial system; (d) strengthening the regulatory and institutional framework; (e) improving the financial strength of financial intermediaries and upgrading mechanisms for dealing with problem banks;

and (f) enhancing the competitive environment for financial intermediaries. In addition, the FSAL included two components aimed respectively at supporting the reduction of Venezuela's external debt and at providing technical assistance to the financial sector for, inter alia, providing the basis for further strengthening the financial system after completion of the first stage of its reform.

Implementation and Results

v. The FSAL conditionality was related to the sectoral policy decisions required to achieve the objectives referred to in para. iv of this Summary, as well as to the need for maintaining an adequate macroeconomic framework. As analyzed in para. 33-51, the sectoral conditionality for effectiveness and for the release of the second and third tranches was satisfactorily met, and was complemented subsequently by additional important progress made after completion of FSAL's disbursements. Macroeconomic performance was also moderately satisfactory in 1990-91, but deteriorated substantially in the second half of 1992.

vi. An important fact that facilitated FSAL implementation was the ownership of the financial sector reform by the Government's economic team. The Bank played a meaningful supportive role but it was just that. The Bank did not have to use the "leverage" of its FSAL to ensure the adoption of the required basic decisions by the government's economic team, because the government's economic team had already decided to do so. The Bank's support, however, was important because of three reasons: a) its technical work on the financial sector provided the basis for key aspects of the needed reform, thus facilitating and accelerating policy decision-making; b) the financing supplied by the FSAL strengthened the position of the economic team vis-a-vis the rest of the Executive Branch and the private financial institutions, concerning the need for quick action in the financial sector; and c) Bank support also strengthened the position of the Executive Branch vis-a-vis Congress.

vii. The FSAL design and implementation had to be handled by the Bank taking into account that many of the needed reforms required Congressional approval of the corresponding legislation. This posed a dilemma for the Bank: either to program the disbursing of the loan based upon the adoption of the measures which did not require Congressional actions and the submission to Congress of law proposals for all other reforms, or to postpone the availability of all or part of the proposed loan resources (by postponing the whole loan or by dividing it into two) until the needed laws were finally approved. The Bank decided to choose the first option, and to go ahead with the entire $300 million loan. In doing so the Bank accepted the substantial risk of not achieving some of the FSAL key objectives if Congress failed to approve the required legislation.

viii. Government actions before and after completion of FSAL disbursements proved the Bank right in accepting the risk noted above. Congress approved in 1992 the new BCV Law, strengthening BCV and increasing its autonomy substantially. In 1993, Congress also delegated to the Executive Branch the consideration of the proposed Banking, Superintendency of Banks (SBIF) and Deposit Insurance Corporation (FOGADE) laws. With these three proposals, consolidated into a broad Banking Law, approved in November 1993, all the legal objectives of the reforms supported by the FSAL were achieved.

ix. FSAL disbursements, however, were completed 18 months behind schedule. While macroeconomic problems contributed to this delay, particularly in 1992, most of the slippage was related to the underestimation by the Government and the Bank of the time required to prepare the studies and to process the legal measures envisaged in the FSAL conditionality.

x. The delay in approving the Banking Law with the new legal framework for the SBIF and FOGADE meant that these institutions were not prepared to perform their functions properly during 1993 and 1994 when increasing monetary instability ultimately led to a severe systemic financial crisis. It would be naive to think that a good banking supervision is a safeguard against systemic financial crisis. The FSAL conditionality properly identified a sound macroeconomic framework as a necessary, if not sufficient, condition to prevent financial crises of a systemic nature. Had the SBIF, however, been able to perform its functions as defined in the new laws, its actions would have been very effective in reducing the proportions of the financial crisis. Moreover, a proper supervision would have provided timely signals that, most likely, would have led to change monetary and exchange rate policies as required to make the macroeconomic framework consistent with stability in the financial sector.

Sustainability

xi. In view of the consensus that has been reached by the Government's Executive Branch, Congress and the financial community on the basic objectives of financial reform, it can be reasonably expected that such objectives will continue to be supported by the country as a whole in the foreseeable future. There is still the unavoidable risk of new policies reversing some reform decisions, but the strengthening of BCV autonomy by the recent BCV Law,[1/] other aspects of the BCV and Banking Laws, and the prevailing national consensus in support of most of the reform objectives, make it unlikely for a full counter-reform of this sector to succeed. Most likely, the present financial and foreign exchange crisis will force the authorities to adopt macroeconomic policies consistent with the objectives of the financial sector reform and to accelerate the reform process in general and the strengthening of SBIF and FOGADE in particular.

Main Findings and Lessons Learned

xii. The main findings and lessons learned can be summarized as follows:

a) Whenever important economic reforms are well designed and fully owned by the Government, it may be justified for the Bank to accept substantial risks in order to support such reforms, as it did through the FSAL analyzed in this PCR.

b) In order to minimize such risks, it is also important to involve all interested parties at a very early stage of preparation of the reform. In the case of Venezuela's financial sector reform, substantial progress was made by expanding the sense of ownership at the early stages to include Congress and the private financial community. The 1992-93 political crisis, however, posed substantial obstacles to the working relationship between the Executive and Legislative Branches of Government

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1/ Official Gazette number 35106, December 4, 1992.

and delayed both approval of basic laws and the development of an effective system of bank supervision.

c) Support of a comprehensive structural adjustment program through a package of global and sectoral Bank loans, and the allocation of conditionality among them, can yield very positive overall results. In the case of Venezuela, the success achieved in the deregulation of interest rates and in other important sectoral reforms supported by the FSAL, enabled BCV to utilize monetary policy in a very effective way.

d) On the other hand, the FSAL experience also shows that to achieve the desired long-term effects of an important financial sector reform, it is essential to have a consistent approach in all related economic policy areas and to strengthen the institutions that have to enforce the regulatory system. To ensure consistent economic policies, it would have been advisable to include in each loan conditionality the decisions in related policy areas that would have maintained a sound macroeconomic framework as a safeguard against systemic financial crises. The institutional strengthening planned for the SBIF and FOGADE should not have been delayed until Congress approved the new Banking Law. The low priority that the borrower gave to the implementation of the technical assistance component of the FSAL left the financial system without a proper supervision when this was most needed to reduce the risks of financial crisis.

Part I: PROGRAM REVIEW FROM THE BANK'S PERSPECTIVE

PROGRAM IDENTITY

Name	:	Financial Sector Adjustment Loan
Loan Number	:	3224-VE
Region	:	Latin America and the Caribbean
Country	:	Venezuela
Sector	:	Non-Project Lending

I. INTRODUCTION

1. To assist the Venezuelan Government in addressing the serious economic and social problems emerging mainly from the structural deficiencies and distortions caused over the last four decades by the subsidization by the oil sector of the rest of the country's economy, the Bank supported the government adjustment and development policies with substantial technical and financial support. Such support included 14 loans approved between June 1989 and December 1992 for a total amount of $2412 million. About two thirds of this amount was aimed directly at supporting the government's adjustment program, through six operations:

a) Loan 3091-VE, a Structural Adjustment Loan, which was approved on June 15, 1989, aimed at supporting the initial stage of the Structural Adjustment Program adopted by the government which took office in February 1989. The program included, inter alia, measures directed at deregulating the economy, eliminating subsidies and encouraging private investment;

b) Loan 3092-VE, a Trade Policy Reform Loan, which was approved on June 15, 1989, aimed at reducing excessive and uneven protection, and at encouraging exports and domestic competition;

c) Loan 3223-VE, a Public Enterprise Reform Loan, approved on June 12, 1990, aimed at reducing the dominance of the public sector in the economy; improving the competitive environment for the private sector; increasing the efficiency and rationalizing the price structure of public enterprises; promoting clarity, transparency and accountability in the relationship between the Government and public enterprises; and promoting, over the medium term, the strengthening of public finances;

d) Loan 3224-VE, a Financial Sector Adjustment Loan, also approved on June 12, 1990, which was aimed at liberalizing the financial policy environment, reducing the Government's direct role in financial intermediation; and strengthening the competitiveness and financial condition of intermediaries;

e) Loan 3225-VE, a Technical Assistance Loan, also approved on June 12, 1990, aimed at providing technical support for Venezuela's structural adjustment effort; and

f) Loan 3279-VE, an Interest Support Loan, approved on December 13, 1990, which was designed to support -- jointly with debt reduction components included in Loans 3091, 3092, 3223 and 3224 -- Venezuela's Debt Reduction program.

In addition, several other Bank loans were related to specific aspects of the adjustment process, including, inter alia, the November 1990 Social Development Loan (3270-VE); the December 1991 Agricultural Sector Investment Loan (3420-VE); and the August 1992 Judicial Infrastructure Reform Loan (3514-VE).

2. The results of the Financial Sector Adjustment Loan to which this Project Completion Report (PCR) refers, are analyzed herewith not only on the basis of the degree of compliance with loan objectives and conditionality, but also taking into account the broader framework of Venezuela's overall adjustment efforts and of the Bank's support for such efforts. The Report thus starts by analyzing briefly the macroeconomic and sectoral conditions prevailing at the time of loan approval. It deals, subsequently, with loan objectives, conditions and other features; the country's compliance with the loan conditionality; the relations between this loan and other external financing; and the overall macroeconomic and sectoral effects of the loan. This PCR aims also at identifying the extent to which macroeconomic and other factors not explicitly related to the loan have affected the achievement of its objectives. This report, however, is not intended to present an overall evaluation of Venezuela's structural adjustment process. This evaluation would be better undertaken in the near future in the framework of the Country Portfolio Performance Reviews that -- as indicated in the recent report "Portfolio Management: Next Steps - A Program of Actions" (R-93-125, June 16, 1993).

II. MACROECONOMIC BACKGROUND

A. THE MACROECONOMIC FRAMEWORK

3. Venezuela's recent economic history has been characterized by wide swings in performance as a result of inappropriate policies, which have been influenced by the country's heavy dependence on oil exports. The oil boom of the 1970's led to a short period of rapid growth when the government started large investment programs to diversify the economy. During this time, the government undertook major policy and administrative reforms, and introduced important programs to improve social services. However, when oil prices stabilized, this demand-led growth caused a steadily deteriorating external trade balance, and, eventually, a sudden shift toward contractionary macroeconomic policies. This stop-go pattern continued until the mid-1980s reflecting the fluctuations in the world oil markets. By 1985, Venezuela had a distorted economy which lacked the foundations for sustainable growth, with a large external debt and prospects of increasing inflation. Although oil prices doubled in real terms between 1973 and 1986, real income per capita fell by one-fifth. By the end of 1988, Venezuela's economic situation was untenable: foreign exchange reserves were depleted (they were equal to 3 months of imports), imports were accelerating due to an expected devaluation, the Central Bank was building up internal arrears on foreign exchange, and domestic inflation was accelerating to previously unheard-of levels. Perhaps more

disturbing was the rapid spread of poverty to a point where in 1987 it affected about 44 percent of the population, compared with 33 percent in 1982.

4. Four significant factors had handicapped the economy. First, Venezuela had not pursued a coherent, viable development strategy. A series of disjointed, contradictory policies had been characterized by increases in the extent and complexity of government controls. Regulations and subsidies, which affected virtually all economic activities, had led to structural rigidities, declining private investment, and reduced real per capita output. Producers, accustomed to high protection, were ill-equipped to compete internationally or to utilize resources efficiently. Owing inter alia to over-regulation, excessive public sector participation in financial activities, and the distortions caused by frequently used interest rate subsidies, the financial sector had not provided an overall environment conducive to the efficient mobilization of savings towards productive investment, and to optimizing the allocation of financial resources. Second, Venezuela had remained highly dependent on petroleum which, until the 1986 collapse in prices, provided 95 percent of export earnings. The economy beyond the petroleum sector was unevenly developed and provided limited employment. Third, Venezuela addressed the problems of poverty through unsustainable controls of exchange rates and prices. It had not developed modern, focused programs of income redistribution. Social indicators in Venezuela were poor for a country at its level of income, with major urban slums and high rates of infant mortality, malnutrition, illiteracy and population increase. And fourth, despite numerous programs, Venezuela's governmental institutions and public administration remained weak and lacked the basis for the modernization of government operations that would be required to support a sustainable economic development strategy.

B. THE ADJUSTMENT PROGRAM: KEY OBJECTIVES

5. The new Government which took office in February 1989, sought to redefine the role of the state through economic reform and restructuring. The aim was to reduce the regulatory framework and the complex, costly subsidies which pervaded the economy; and to encourage private investment and production through trade and financial reforms. The measures included a reform of the exchange and trade systems, reduction in price controls, deregulation of financial and industrial markets, and improved government operations. The Government also planned to improve social programs to alleviate poverty. There were five main elements in the initial Government adjustment program. First, the Government unified the exchange rate. The unified market-determined exchange rate for the bolivar began on March 14, 1989 when exchange controls were abolished, and the value of the currency was determined in an expanded interbank market. Second, the Government planned to reduce the fiscal deficit from 7 percent of GDP in 1988 to 3 to 4 percent in 1989 by increasing petroleum product prices, power and telecommunication rates and the prices of goods produced by public enterprises, and by controls on spending. In the medium and longer term, the deficit was to be reduced by eliminating subsidies on exchange rate guarantees, carrying out a planned privatization program, making further price increases, reforming income taxes and introducing a value added tax. Third, the Government undertook a substantial trade policy reform aimed at reducing protection, encouraging competition in domestic markets, and promoting export growth. Fourth, as a first step in financial sector reform, commercial interest rates were to be determined flexibly to reflect market factors and the Government planned to study legislation to rationalize regulation and supervision of financial institutions. Fifth, the Government planned to convert most indirect subsidies into focused social programs. The remaining indirect subsidies would be for a reduced list of goods of special

concern to the poor and would be funded through direct budgetary transfers. Focused programs, such as school-feeding programs and those operating through neighborhood clinics were to be developed.

III. THE FINANCIAL SECTOR IN 1990

A. OVERVIEW

6. The Venezuelan financial system had been conceptually based on a system of specialized banking whereby different types of institutions had different functions. Commercial banks were conceived to borrow and lend short-term for working capital and other short-term needs. Finance companies were to lend for fixed assets and consumer goods as well as support the development of commercial companies. Mortgage banks were to borrow using long-term instruments and lend for construction, home improvement and expansion, and home and commercial property purchases. Savings and loans (S&Ls) were to also borrow long-term and lend for consumer purchases of homes. In practice, there was a de facto universal banking system since financial institutions had formed financial groups whereby a group offered clients a full array of financial services and diversification options.

7. Table 1 depicts the structure of the financial system as of end-1989. There were 41 commercial banks, 16 mortgage banks, 29 finance companies, and 20 S&Ls. There were, in

TABLE 1: STRUCTURE OF THE FINANCIAL SYSTEM
(Billions of Bolívares, as of 12/31/89)

	No. of Institutions	In % of the System Totals					
		Assets		Deposits		Equity	
		Totals	%	Totals	%	Total	%
Commercial Banks:	41	549.3	73	385.8	71	31.7	78
Private Domestic	31	454.4	61	355.4	66	26.4	65
Private Foreign	2	4.8	1	2.3	0	0.5	1
Public	8	90.0	12	28.0	5	4.7	12
Mortgage Banks	16	69.9	9	58.9	11	3.2	8
Finance Companies	29	84.4	11	64.3	12	5.9	14
Savings and Loans	20	45.2	6	32.6	6	-	-
System Totals	106	748.8	100	541.6	100	40.8	100

Source: BCV

addition, 31 leasing companies, 3 pension funds, and about 27 liquid asset funds, brokerage houses, and foreign exchange offices.[2/] As the table shows, commercial banks were the most important financial institutions, accounting for 73% of the assets of the financial system. From 1987 through 1989, commercial banks and finance companies increased their share of assets, funds attracted and credits, while mortgage banks and S&Ls decreased theirs. The system's six largest commercial banks accounted for 57% of the total assets of the system and 63% of total bank deposits. These commercial banks were part of the six largest financial groups which were dominant in the financial sector. Below this group were 15 medium-sized commercial banks with between 1% and 4.9% of deposits each (29% of the total), and 20 small banks with less than 1% of deposits each (8% of the total).

TABLE 2: REAL INTEREST RATES AND FINANCIAL DEPTH, 1987-93

	Real Interest Rates[a/]		Ratios to GDP(%)[b/]		Real Money Indices[c/]	
	Lending	Deposit	M_1	M_2	M_1	M_2
1981	-1.8	-0.4	16.6	38.4	100.9	85.6
1982	5.2	7.5	16.5	42.7	93.4	88.8
1983	7.6	10.7	18.7	49.3	98.9	96.1
1984	1.0	3.2	14.6	39.6	100.0	100.0
1985	0.0	3.2	14.8	39.1	101.1	98.2
1986	-1.6	2.1	16.9	42.1	108.6	99.6
1987	-14.4	-11.2	14.8	35.1	106.1	92.4
1988	-11.8	-8.5	15.2	33.5	105.3	85.3
1989	3.0	0.0	9.8	24.7	63.4	59.0

Source: BCV

a/ Yearly averages deflated by consumer price increase (CPI) over the year; for 1989 end-of-year interest rate is deflated by the annual average increase in CPI for the second semester only.

b/ Average money stock over the year.

c/ Average money stock over the year deflated by CPI annual averages. Index 1984 = 100.

8. Over the 1980 - 89 period, the stock of money broadly defined (M2), fluctuated widely (see Table 2). M2 rose over the early 1980s, reaching a peak of 49% of GDP in 1983. It declined steadily afterwards, to less than 25% of GDP in 1989, the lowest figure in the decade. The drop in monetization coincided with the period of negative real interest rates. In 1987 and 1988, lending

2/ These later institutions are not included in the percentages indicated in this section.

interest rates were negative in real terms by, respectively, 14 and 11 percentage points. It was expected in 1990 that the shift to market-determined interest rates planned then by the Government would facilitate a remonetization of the economy.

9. The Central Bank of Venezuela (BCV) had traditionally played a pervasive role in the financing of activities in most sectors of the economy. In particular, the BCV expanded credit by: (i) financing government deficits through the purchase of domestic public debt; (ii) subsidizing public and private enterprises through foreign exchange guarantees at rates that heavily overvalued the domestic currency; (iii) providing liquidity to the banking system through a liberal rediscount program, and (iv) supporting special sectoral incentive programs and channelling them through the financial system.

10. Monetary policy, subordinated to the achievement of these objectives, was made even more precarious by the virtual absence of flexible instruments of monetary control. The result was that the BCV had only a loose grip over money supply. Many activities (like the complex array of sectoral incentive programs) were premised on obtaining loans at interest rates well below market-clearing levels. Reserve requirements failed to have a disciplinary effect on money supply as these requirements were frequently transgressed and their highly differential nature meant that money supply was vulnerable to portfolio shifts across different types of deposits and institutions. Monetary control was exercised in a rudimentary fashion by ad-hoc policies restricting BCV credit to banks or inducing additional bank deposits at the BCV's money desk. However, the flexibility of the BCV's money desk facility as an instrument of monetary contraction had been lost due to the fact that the rate paid was only infrequently adjusted according to the monetary objectives of the BCV. Moreover, the direct nature of these instruments had other lasting side-effects: (i) it increased the BCV's responsibility for the losses of financial institutions; (ii) it made monetary policy more vulnerable to political pressures; and (iii) it resulted in the bureaucratization of monetary policy-making.

B. MAIN FINANCIAL SECTOR ISSUES

11. Since early 1989, the Venezuelan Government had started to address some of the main problems affecting the operation of the financial sector. By mid-1990, however, key sectoral issues still had to be dealt with. As identified then by the Government and Bank staff, the main ones were as follows:

a) Interest rates. Although the overall interest rate ceilings established periodically by the Central Bank were intended since early 1989 to follow market conditions, there were doubts in the financial markets about whether that market-oriented policy would be maintained over the long-term. There were, moreover, sectoral distortions caused by the preferential rates utilized by various development funds, as well as the preferential rate (7 percentage points below other sectors) that financial institutions had to charge in their loans to the agricultural sector.

b) Agricultural Credit Requirements for Commercial Banks. Commercial banks had the legal obligation to allocate at least 22.5% of their portfolio for agriculture and

agroindustry -- a restriction which caused severe distortions in the operation of the financial system.

c) Excessive Public Sector Participation in the Financial System. The Government and the Central Bank owned 9 commercial banks, all of which had poor asset quality. In addition, there were 23 state-owned Development Finance Institutions (DFIs). One of them -- the Fondo de Inversiones de Venezuela (FIV) -- had been created in 1974 to manage the windfall emerging from the 1973-74 oil price increases, and its main function was to finance state enterprises, although it also acted as a second-tier lender through commercial banks and other financial institutions. The other 22 DFIs were controlled by sectoral ministries and obtained their funding through government transfers, government-guaranteed external financing, and loans from FIV. These DFIs did not have properly defined roles, and their operations contributed substantially to the overall distortions and inefficiencies prevailing in the financial system.

d) Distortions Caused by Central Bank Financial Operations. There was a substantial quasi-fiscal drain on Central Bank resources caused by its credit to the public sector (mainly through unremunerated Treasury bills and low-interest Treasury bonds) and by its subsidies to financial institutions.

e) Weaknesses of the Institutional and Regulatory Structure. These included: (i) Lack of clarity on the functions of the main regulators: the Central Bank, the Finance Ministry, the Superintendency of Banks, and the Deposit Insurance Corporation; (ii) Lack of autonomy and powers of the Superintendency of Banks; (iii) inadequate mechanisms for managing and solving bank crisis; and (iv) weak prudential regulations.

f) Weak Financial Condition of Financial Intermediaries. Many commercial banks were affected by poor asset quality, lending concentration, foreign exchange risk exposure, inadequate capital, vulnerability to liquidity shortfalls and poor profitability. Twelve of the 38 banks not subject to intervention, which accounted for 22% of the total assets of the system, had non-performing portfolios which exceeded their total estimated capital base in August 1989. Mortgage Banks and Savings and Loan Associations were also facing major financial problems largely owing to the mismatch between the maturity and rate structure of their assets and liabilities, as well as to an inadequate capital base.

g) Weak Competitive Environment for Financial Intermediaries. Short-term money markets lacked depth and long-term capital markets were under-developed and mobilized very little equity capital. These weaknesses were mainly due to the prevailing subsidized interest rates; weak regulatory structures and authorities; excessive economic concentration; excessive state intervention; and legal restrictions on the activities of commercial banks and to foreign ownership of financial intermediaries, which were inconsistent with the requirements of a fully competitive and efficient financial system.

IV. THE PREPARATION AND THE KEY OBJECTIVES OF THE GOVERNMENT'S FINANCIAL SECTOR REFORM PROGRAM AND OF THE FSAL

A. MAIN OBJECTIVES

12. The main objectives of the Government's financial sector reform program were: (i) liberalizing the financial policy environment (interest rates, allocation of credit, foreign ownership, universal banking, etc.); (ii) reducing the Government's direct role in financial intermediation (by privatizing and liquidating public banks, consolidating the DFIs, rationalizing housing finance policy, and limiting the BCV's role in the financial support of institutions to bank liquidity and monetary management needs); and (iii) strengthening the competitiveness and financial condition of intermediaries (through adequate prudential regulations and supervision, capital standards, and mechanisms for handling problem banks).

B. PREPARATION AND PROCESSING OF THE FINANCIAL SECTOR ADJUSTMENT LOAN

13. The FSAL was designed to support the first phase of the program, focusing on: (a) liberalizing and rationalizing interest rates and credit allocation; (b) reducing public sector participation in the commercial banking system and redefining the role of the public sector in development finance; (c) rationalizing the BCV's credit operations with a view to enhancing their transparency and minimizing their disruptive effects in the financial system; (d) strengthening the regulatory and institutional framework; (e) improving the financial strength of financial intermediaries and upgrading mechanisms for dealing with problem banks; and (f) enhancing the competitive environment for financial intermediaries.

14. A second phase of the Government program, which the Bank said it might consider supporting through subsequent loans, would include: (i) the full liberalization of interest rates and credit controls following the strengthening of the regulatory and supervisory framework; (ii) completion of the restructuring of the development finance system; and (iii) a full program for reform of the housing finance system. In addition, the Government would pursue reforms in the areas of capital markets and insurance which were largely outside the scope of the first phase.

15. To support the Government's efforts to deal with the above issues, Bank staff started to work in early 1989 with the Central Bank and the Finance and Planning Ministries to prepare the FSAL, in close coordination with the processing then under way of the 1989 SAL and Trade Policy Reform Loans. A comprehensive Financial Sector Report was completed in October 1989, providing the analytical basis for the FSAL. After additional work by Bank staff, the Central Bank and other Government agencies, the FSAL Initiating Memorandum was submitted by the LAC Region to Senior Management in February 1990; the Appraisal Mission visited Venezuela in March; and the loan was negotiated in May and approved on June 12, 1990.

16. While loan preparation required substantial technical work, it was facilitated by the fact that the Venezuelan authorities and the Bank regional staff had similar views on what needed to be done and were, therefore, able to work closely throughout this period. The FSAL objectives and

conditions were extensively discussed inside the Bank, to ensure consistency in the approach followed by this loan with that of other policy-based operations including, in particular, the SAL, Public Enterprise Reform and Trade Policy loans. In comments made at various processing stages, Bank staff raised questions on the degree to which the FSAL conditionality was sufficient and adequately focused, and on issues such as the advisability of promoting the immediate approval of universal banking. Frequent consultations were also held during this period with the IMF (on the macroeconomic situation and on technical issues such as the Central Bank open market operations), and with the IDB, which cofinanced the FSAL. According to the information available in the project files, the decisions made on the questions raised during all these discussions did not introduce any major modifications in the loan proposal made by the regional staff.

17. The key issue which emerged during the preparation/appraisal/negotiations process was the fact that many of the needed reforms required Congressional approval of the corresponding legislation. This posed a dilemma for the Bank: either to program the disbursing of the loan based upon the adoption of the measures which did not require Congressional actions and the submission to Congress of Draft Laws for all other reforms, or to postpone the availability of all or part of the proposed loan resources (by postponing the whole loan or by dividing it into two) until the needed laws were finally approved. The Bank, decided to choose the first option, and to go ahead with the entire US$300 million loan. This course of action may have been fully justified in view of the full commitment of the Government's Executive Branch to the proposed reforms, and of the urgent need for foreign exchange then facing the country. In doing so, however, the Bank accepted the substantial risk of not achieving some of the FSAL key objectives if Congress failed to approve the required legislation.

18. The FSAL supported Venezuela's structural adjustment program in general, and its financial reform program in particular, with US$300 million allocated as follows:

a) US$218 million to finance imported goods, and whose disbursement would take place in three tranches of, respectively, US$71 million, US$71 million, and US$76 million, the first of which would be disbursed upon loan effectiveness. Release of tranches would be subject to Venezuela's compliance with the specific policy conditions referred to below;

b) US$75 million earmarked for a debt reduction plan, linked to the renegotiation of Venezuela's debt with commercial banks. If no agreement was reached on such a plan by February 28, 1991 (or a later date approved by the Bank), this US$75 million could be added, in equal amounts, to the three tranches referred to in (a) above; and

c) US$7 million for a technical assistance component aimed at supporting Venezuela's reform of its financial system through the financing of consulting services and training activities, and related equipment.

C. ACTIONS TAKEN BEFORE BOARD PRESENTATION

19. The overall structural adjustment program prepared in 1989-90 by the Venezuelan Government, with Bank technical support, included, from the very beginning, the reform of the financial sector as a key component. The public statements and policy decisions made during this period by the Government's economic team made it clear that the financial sector reform was owned by them. The Bank played a meaningful supportive role but it was just that. The Bank did not have to use the "leverage" of its FSAL to ensure the adoption of the required basic decisions by the government's economic team, because the government's economic team had already decided to do so. The Bank's support, however, was important because of three reasons: a) its technical work on the financial sector provided the basis for key aspects of the needed reform, thus facilitating and accelerating policy decision-making; b) the financing supplied by the FSAL strengthened the position of the economic team vis-a-vis the rest of the Executive Bank and the private financial institutions, concerning the need for quick action in the financial sector; and c) it also strengthened the position of the Executive Branch vis-a-vis Congress.

20. The decisions taken by the Government Executive Branch and the Central Bank on the financial sector before Board presentation of the FSAL reflect the position referred to above of the government's economic team. In assessing them, however, account has to be taken of the constraint posed by the need to enact the legislation required by some of the most important aspects of the needed reform. While the Executive Branch and the Central Bank did as much as possible within the constitutional limits of their power, those affected by the reform -- particularly the beneficiaries of subsidized credit and some private financial institutions which objected to strengthening the regulatory framework -- were able to delay Congressional action on important aspects of the reform until 1993.

21. The most important single decision adopted before Board presentation was the deregulation of interest rates. The Central Bank decided initially to let interest rates be freely determined by the market, except for the preferential rates benefitting agriculture and the borrowers of Government-owned development finance institutions. Subsequently, the Supreme Court decided that the Central Bank had the legal obligation to maintain interest rate limits. In view of this, the Central Bank decided in April 1990, to set up limits that would allow the rates to be market-determined, by establishing minimum deposit rates and maximum lending rates of, respectively, 10% and 60%, both of which were far from the then prevailing inflation rate. The Central Bank also decided to link to the market the preferential rates for agriculture and some other activities; to limit such preferences to, respectively, 15% and 10% of free market rates; and to reduce the mandatory allocation of commercial banks' credit to agriculture.

22. The Government and the Central Bank also took actions before Board presentation of the FSAL to start the process of privatizing commercial banks owned by the Central Bank, reduce the credit subsidies provided through Central Bank operations, and begin eliminating the management by the Central Bank of external portfolios. In addition, a number of other important decisions by the government, the Central Bank and the Superintendency of Banks (SBIF) were either adopted or announced in commitments included in the Policy Statement sent to the Bank in connection with the FSAL. All these decisions, as well as the conditions for the release of the FSAL second and third

tranches, are listed in the Policy Matrix attached to the FSAL President Report and, also, to this PCR.

V. COMPLIANCE WITH THE FSAL POLICY CONDITIONALITY

23. The FSAL policy conditionality comprised two main categories: a) the country's macroeconomic performance; and (b) the sectoral reform program, including specific conditions for the release of each tranche. This PCR section will deal first with performance at the macroeconomic level; secondly with compliance with specific conditions for effectiveness and for the release of the FSAL's second and third tranches; and thirdly, with actions taken after the FSAL was fully disbursed. At the end of the section for each tranche, the Bank's overall sectoral judgement of compliance with the financial sector reform program objectives will also be examined in the framework of Venezuela's structural adjustment objectives and of their support by the Bank.

A. THE MACROECONOMIC FRAMEWORK

24. It was envisaged in the Loan Agreement that, before releasing the second and third tranches, the Bank would have to be satisfied that the Borrower's macroeconomic framework was consistent with the objectives of the Program. The main aspects of the macroeconomic evolution in 1990-92 is summarized in paras. 25-31, while para. 32 presents an overview of the situation at the end of 1992.

25. Main Macroeconomic Program Components: The Government's adjustment program supported by the IMF and the Bank consisted of four elements: a foreign exchange program establishing a unified market-determined exchange rate; a fiscal reform plan to reduce the deficit by adjusting prices of goods produced by state enterprises, spending controls, tariff reform, privatization and tax reform; a financial reform to adjust interest rates to market levels, and to rationalize regulation and supervision of financial institutions; and a social sector plan to convert most indirect subsidies into focused social programs.

26. Economic Growth: The economic program substantially reduced major internal and external imbalances, although at the cost of a steep recession in 1989. (See graph 1). GDP declined by 8 percent in 1989 and investment by 6 percent of GDP as private sector investment fell and public investment was curtailed, in part due to delays in obtaining legislative approval of the public investment program. However, after 1989, although investment remained below its pre-adjustment level, its efficiency improved significantly. GDP growth resumed in 1990 increasing by 7 percent in that year and by 10 percent in 1991, owing, in part, to windfalls from the 1990-91 Gulf crisis. Despite increasing political instability reflected in two failed coup attempts the growth rate in 1992 was 7 percent, with growth driven entirely by the non-oil sector which had increased its growth rate vis-a-vis the oil sector since the adjustment program began. GDP declined by about 1 percent during 1993, a year when elections took place at the end of a political crisis that forced the president Carlos Andres Perez to resign. (See Table 3.)

GRAPH 1
GDP GROWTH RATE

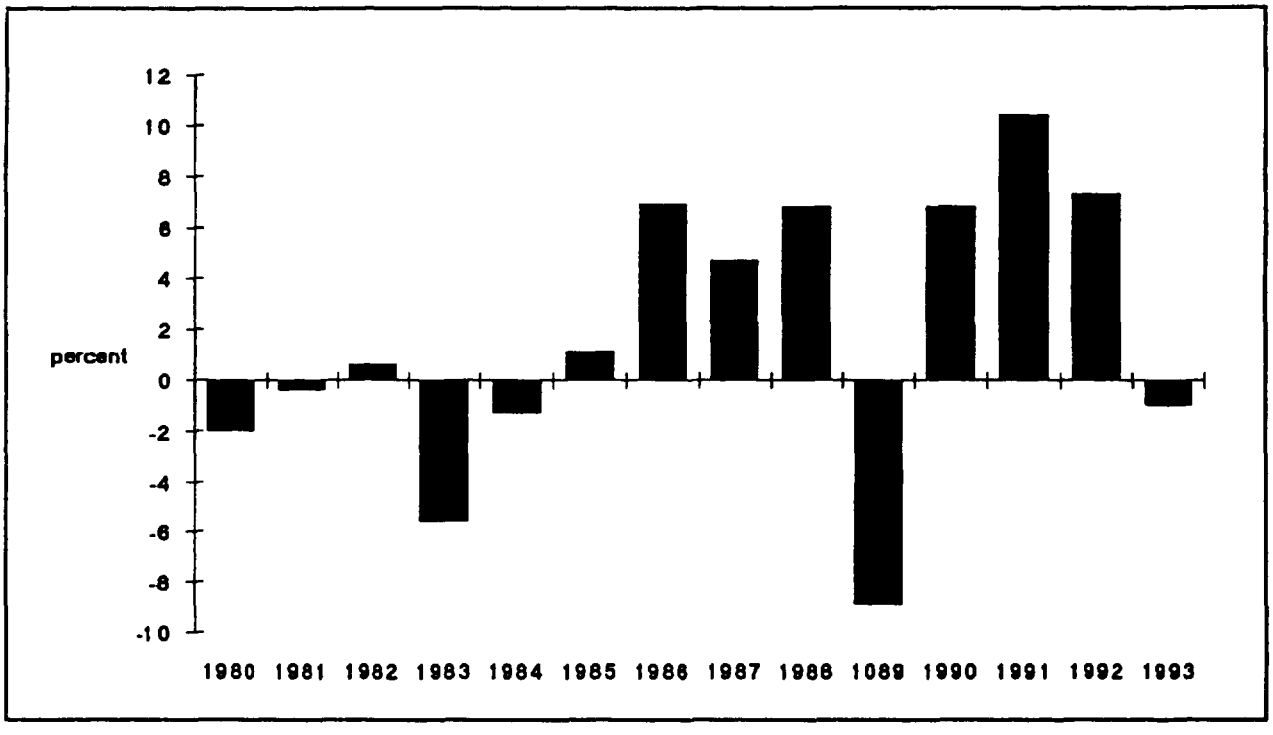


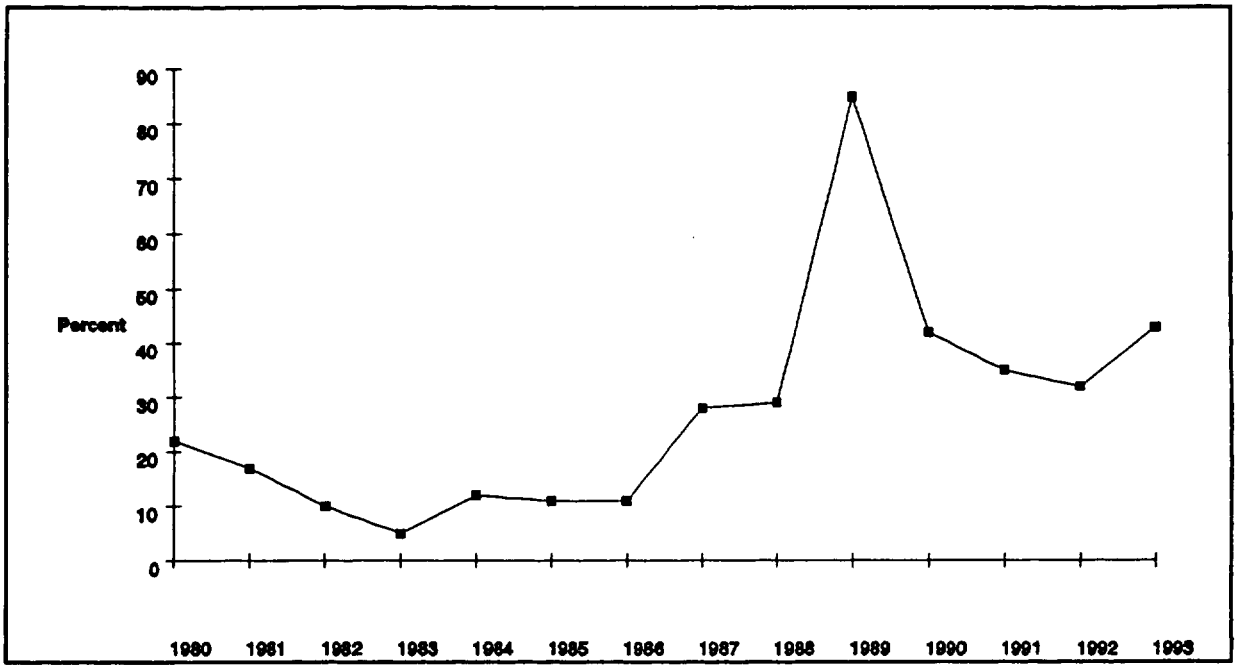
TABLE 3: Gross Domestic Product Growth Rate#					
	1989	1990	1991	1992	1993
OIL SECTOR	-0.4	13.9	10.4	-0.3	3.3
NON OIL SECTOR	-10.9	5.2	10.3	8.1	-2.1
TOTAL	-8.9	6.8	10.4	7.3	-1.0

Notes: # Real GDP at 1984 prices

Source: (B.C.V.)

27. Inflation: Between 1988 and 1989, inflation increased from 30 percent to 85 percent as a result of the exchange rate depreciation, the adjustments in prices of public goods and services and the liberalization of most domestic prices. Inflation declined to 41 percent in 1990 and stabilized at around 32 percent in 1991 and in 1992 (see graph 2). In 1993, however, inflation accelerated to reach 45 percent during the year.

GRAPH 2
INFLATION RATE

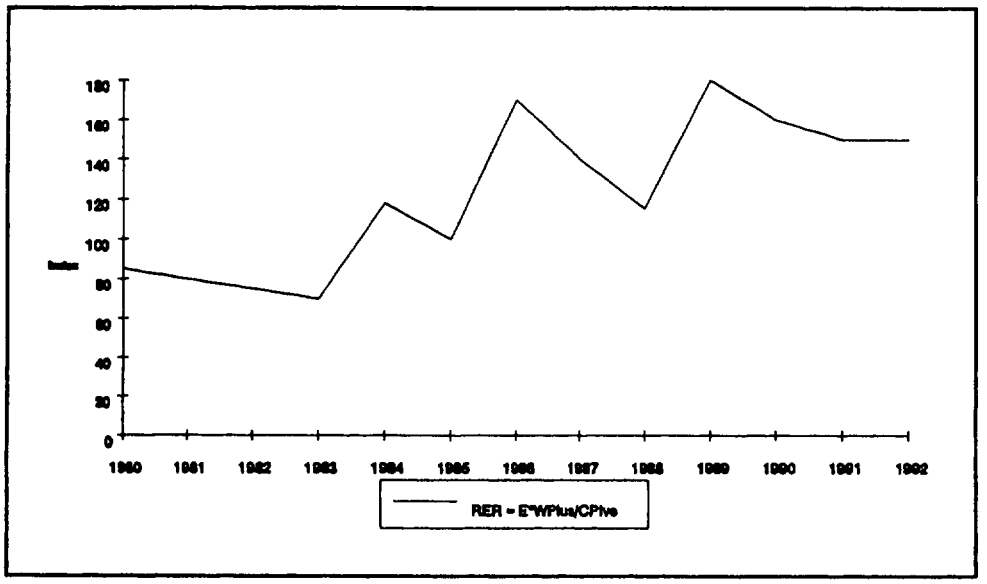


28. Interest Rates: As a result of interest rate liberalization under the adjustment program, the real deposit rate increased from significantly negative levels to -5.6 percent in 1990 and to positive levels thereafter. Real interest rates have been high and rising during most of 1993 as a result of the Central Bank's monetary and exchange rate policies. (See Table 5).

29. Fiscal Policy: For three of the four years preceding the adjustment program the consolidated public sector ran a large deficit which reached 9.9 percent of GDP in 1988. In 1989 the deficit was reduced to 1 percent of GDP, largely because of higher international oil prices and the devaluation, which increased oil revenues in local currency terms. The fiscal situation improved further in 1990 and 1991 due to windfalls from the Gulf crisis and privatization. The Government, however, did not take adequate advantage of the elbow room provided by such windfalls to promote longer-term fiscal stability, and the overall fiscal situation worsened again in 1992 and 1993 when Congress delayed approval of new taxes.

30. Exchange Rate: Between 1986 and 1988, the bolivar appreciated by 36 percent. In 1989, as part of the reform program, the bolivar was devalued some 69 percent in real terms. However, during the subsequent two years the bolivar appreciated by 26 percent (see graph 3). At the end of 1992 the real exchange rate was allowed to recover almost the same level as twelve months earlier but the authorities tried to contain inflation by allowing a further appreciation during 1993. The appreciation that occurred since 1989 ultimately led to a foreign exchange crisis. In May 1994 the Central Bank had to limit the amount of foreign exchange sold every day allowing a rapid devaluation of the domestic currency.

GRAPH 3
REAL EXCHANGE RATE INDEX
Base 1985 = 100



Note: The index measures the value of foreign exchange in domestic currency units.

31. Financial Support: The success of the reform program depended on receiving adequate external finance and, given the strength of the early policy reforms, the international financial institutions provided support quickly. In addition to a First Credit Tranche of SDR 343 million in March 1989, the IMF approved a three-year EFF of SDR 3.7 billion (about US$4.8 billion) in June 1989. Based on the performance on economic policy, the IMF approved releases of EFF tranches as programmed during 1989 and 1990. In these two years, the Bank approved the adjustment loans listed in para. 1 above, for a total amount exceeding US$1.6 billion. In December 1990, agreement was reached between the Government of Venezuela and its commercial bank creditors on a financing plan. Under the plan, Venezuela exchanged US$19.7 billion in original claims by commercial bank creditors (representing 73 percent of Venezuela's outstanding medium- and long-term, public and publicly guaranteed debt) for five new instruments involving debt and debt service reduction. It was estimated that the rescheduling would save Venezuela an estimated US$500 million a year in 1991-1995 and US$800 million a year in 1996-2006.

32. The Situation at the End of 1992: an Overview. The overall economic situation improved substantially between 1989 and 1992, owing to the economic reforms introduced by the government and to additional foreign exchange earnings and fiscal revenues emerging from the 1990-91 Gulf crisis. Annual GDP growth had averaged over 8% in 1990-92, while inflation remained in the 30-35% annual range, well below the 85% level of 1989. By December 1992, when FSAL disbursements were completed, however, economic prospects were less positive. The overall balance of payments situation and prospects were affected negatively by declining oil prices and by an

exchange rate which overvalued the domestic currency. This was also having an important negative impact on public finances. There was a need for immediate decisions to deal with the fiscal deficit, which was contributing substantially to the likelihood of increased inflation. Market interest rates were at high real levels (about 15% in December) under the influence of Central Bank open market operations designed to counter-balance the exchange rate and fiscal problems, and to avoid a substantive increase in the rate of inflation. This was also contributing to depressing credit demand and to slowing down economic activity. These economic trends, and the difficult political situation then prevailing, made it unlikely for Venezuela to achieve substantial GDP growth in 1993.

B. RELEASE OF THE FIRST TRANCHE

33. The conditions for FSAL effectiveness, and, therefore, for the release of its first tranche, were as follows:

a) The Bank had to be satisfied that the macroeconomic policy framework was consistent with the objectives of the financial sector adjustment program.

b) Studies of the financial condition of commercial banks and selected mortgage banks and finance companies would have been commissioned.

c) SBIF would have issued all the changes required to tighten regulations on: provisioning, loan classification, rollover of credits and accrual of interest, chargeoffs, evaluation of investment portfolios, and evaluation of property received as collateral.

d) SBIF would have issued instructions to banks to: (i) establish a general loan-loss provision of at least 2% of loans by June 1991 (with specific provisions counted against the general provision); (ii) write off loans past due by more than 36 months by June 1991; and (iii) require their auditors to include an assessment of loan classification and concentration in audits.

e) Government would have issued a resolution forbidding BIV and BANDAGRO from engaging in lending operations by requiring that any new deposits and all loan recoveries be invested in securities of the Treasury or the BCV. BIV's operations would resume once its restructuring is substantially under way.

34. A Bank supervision mission concluded in November 1990, that Venezuela had met all the above conditions, with the exception of the macroeconomic policy framework, which was then under discussion with the IMF. After the government and the IMF agreed on the macroeconomic policy framework, the loan was declared effective, and the first tranche was released on December 7, 1990, several months after what was expected at the time of Board approval.

C. RELEASE OF THE SECOND TRANCHE

35. The conditions for release of the second tranche of the FSAL were as follows:

a) That the macroeconomic policy framework was consistent with the objectives of the financial sector adjustment program.

b) That satisfactory progress had been made in implementing the financial sector reform program.

c) That the SBIF: (i) had issued changes satisfactory to the Bank, to the regulations applicable to any bank or financial institution within SBIF's jurisdiction (SBIF Institution) on exchange risk valuation, loan concentration limits, and controls for transactions amongst any given group of SBIF Institutions inter-related through equity ownership or control, including requirements for consolidation of accounts of, and uniform criteria for preparation of financial statements for, each such group; and (ii) had completed studies on portfolio review, fixed asset valuation, loan concentration and foreign exchange losses of SBIF institutions.

d) That the Borrower's Executive Branch had submitted to the Borrower's Congress a proposed law for the modification of laws currently governing SBIF as presented by the Borrower under the Program, satisfactory to the Bank, which, inter alia, would aim at (i) tightening norms on capital requirements and lending concentration, and widening the scope of sanctions, including fines, that SBIF is authorized to impose on any SBIF Institution that has not abide by SBIF's regulations; (ii) reorganizing SBIF as an autonomous entity with its own revenues and with a budget subject only to Central Bank's Board approval; (iii) granting full executive powers to the Superintendent subject, in respect of certain specific matters, to approval of a Consultative Committee; and (iv) ensuring that the Superintendent will be supported by experienced and qualified management who shall report exclusively to said Superintendent.

e) That the Borrower's Executive Branch had submitted to the Borrower's Congress a proposed law for the modification of the laws currently governing FOGADE satisfactory to the Bank, aiming at: (i) defining clearly the role of FOGADE in the management of banking crises; (ii) strengthening the mechanisms available to FOGADE for the resolution of said crises; (iii) strengthening FOGADE's financial position; (iv) enabling FOGADE to manage its own funds; and (v) enabling FOGADE, through changes in its accounting and financial statements preparation methods, to reveal accurately its operations and financial condition.

f) That the Borrower's Executive Branch had submitted to the Borrower's Congress a proposal for modification of the Central Bank Law satisfactory to the Bank, which: (i) would grant to Central Bank the power to regulate interest rates charged and paid by all financial intermediaries, including savings and loans and development funds; (ii) would eliminate the Central Bank's obligation to exercise the power referred to in (i) above, thus allowing Central Bank to let interest rates to be determined by the market; (iii) would allow Central Bank to purchase Treasury bills, subject to the credit limit referred to in (iv) below, provided, however that any such purchase should take place after an auction, on a residual basis and at an average price of such auction; (d) would enable Central Bank to include, as part of the overall limit of credit from Central Bank to the Borrower that will be maintained at its current level, the nominal value of Central Bank holdings of, or rights to the, Borrower's debt (including but not limited to, holdings or rights originated in Borrower's debt-equity swaps or in the Borrower's debt denominated in foreign currency with the exception, on a transitory basis, of holdings

or rights originated in ongoing reduction or restructuring of external public debt); (v) would allow Central Bank to enter into discounting, rediscounting, advancing or repurchase contractual (or otherwise evidenced) arrangements with SBIF Institutions, to the extent said transactions are limited to a 30-day maximum duration; and (vi) would eliminate the current obligation of Central Bank of limiting its purchases of Treasury bills to those redeemable within the execution period corresponding to the Fiscal Year in which such bills are purchased.

g) That the Central Bank had, in respect of each of the commercial banks it owns, completed the valuation of such bank's net worth and made available to prospective purchasers the bidding or tender documents for the sale thereof, all to the satisfaction of the Borrower and the Bank.

h) That a program had been submitted to the Bank, whereby Central Bank will disengage, on terms presented by the Borrower under the Program and satisfactory to the Bank, all portfolios which, as of March 15, 1990, were held in trust by Central Bank, with the exception of Fideicomiso Cambiario.

i) That the Borrower's Executive Branch had submitted to the Borrower's Congress one or more proposed laws as presented by the Borrower under the Program on terms and conditions satisfactory to the Bank, for the creation of: (i) a second-tier agricultural credit institution which would absorb all assets and liabilities of, among other agricultural funds, the Fondo de Credito Agropecuario, of the Fondo del Cafe and of the Fondo Fruticola and (ii) a second-tier industrial credit institution which would absorb the assets and liabilities of, among other industrial funds, each of Fondo de Credito Industrial and Fondo de Industria y Tecnologia and of the second-tier intermediation operations of FIV.

j) The Borrower's Executive Branch had submitted to the Borrower's Congress one or more proposed laws as presented by the Borrower under the Program, on terms and conditions satisfactory to the Bank, providing for modifications to Ley de Credito so as to (i) permit (a) issuance by the Borrower's Treasury of fixed term negotiable short-term Treasury bills not mandatorily redeemable within the execution period corresponding to the Fiscal Year in which such bills were issued and (b) market determination of the price of said bills, and to (ii) prevent the maintenance or establishment of any system or mandatory ranking of purchasers requiring, or leading to, the preferential placement of Treasury bills issued in accordance with (i) above amongst one or more pre-determined types of agents or purchasers.

k) The Borrower had commissioned services, including, if so required, the services of consultants, or shall have caused said services to be commissioned, for purposes of completing, under terms of reference satisfactory to the Borrower, Central Bank and the Bank, a plan of prompt action for the financial recovery, staff rationalization, administrative reorganization or restructuring of BIV and the four regional banks owned by BIV. Such plan had to contain a schedule for the resumption of BIV's lending activities.

36. On December 27, 1991, one year behind schedule, the Bank released the FSAL Second Tranche, after concluding that:

a) The macroeconomic framework was consistent with the objectives of the reform program; the President's memorandum to the Bank EDs noted in this respect the positive economic performance in 1989-91, as well as Venezuela's compliance with the IMF's EFF arrangement; and

b) The financial sector reform program was being implemented satisfactorily, and even two important third tranche conditions (the privatization of three Banks and the submission to Congress of a BCV Law proposal) had already been fulfilled. The progress made in the main aspects of the sector reform program is analyzed in the following paragraphs. This progress fulfilled all the sectoral conditions for the release of the Second Tranche, except as noted in para. 40 below.

37. Liberalization of Interest Rates and Rationalization of Credit Allocation. The new Banking Law submitted by the Executive Branch to Congress and approved in 1993 eliminates the BCV obligation to establish interest rate limits, and centralizes the setting of all preferential and other administrative rates in BCV. While this proposed law was being considered, BCV was setting the minimum deposit rate and the maximum lending rate at levels that were far from inflation rates; and preferential rates for agriculture at 85% of the average lending rate of the six largest commercial banks. All lending by Government-owned DFIs for agricultural and non-agricultural activities had been set at not less than, respectively, 85% and 90% of the same average lending rate of the six largest commercial Banks. The agricultural portfolio requirement for commercial banks had been reduced from 22.5% to 17.5%.

38. Reduction of Public Sector Participation in the Financial System. The Government had privatized ahead of schedule three BCV-owned commercial banks (which had been a third-tranche release condition); had decided to liquidate the Agricultural Development Bank (BANDAGRO); had prepared a plan for the restructuring of Venezuela Industrial Bank (BIV); and had submitted legislation to Congress aimed at streamlining the network of Government-owned development banks, drastically reducing their number through consolidation or closing.

39. Rationalization of BCV'S Credit Operations. The proposed new BCV law would be aimed at: (a) pricing BCV credit according to market conditions; (b) reducing the BCV intermediation role by developing money markets and allowing other public entities to invest their funds directly in capital markets instead of placing them in BCV-administered funds; and (c) tightening Treasury access to BCV financing. Through administrative resolutions, the BCV had already: (a) decided that all rediscounts would be offered at a rate determined by the yield on auctioned Treasury bills; (b) terminated direct transactions of Government securities at face value for portfolio managed in trust; and (c) prepared a plan, acceptable to the Bank, for BCV's disengagement from administered portfolios (with the exception of the *fideicomiso cambiario.*)

40. Reform of the Regulatory Framework and Improvements in Bank Supervision. As envisaged in the second tranche conditionality, the Superintendency of Banks (SBIF) had issued new regulations, acceptable to the Bank, applicable to the financial institutions within its jurisdiction, and the government Executive Branch had submitted to Congress a new SBIF law. In addition, the new

Banking Law had also been submitted to Congress ahead of schedule (it was a third tranche condition). The proposed Banking Law introduced the concepts of group and universal banking, and the proposed SBIF Law included, inter alia, revised norms on lending concentration. The Government and the Bank agreed that for SBIF to issue then, in advance of Congressional action, norms related to groups, universal banking and loan concentration, would be likely to cause substantial problems for the approval by Congress of those two laws, and could reduce the probability of such approval. In view of this, it was agreed to postpone the issuance of such SBIF revised norms until after the approval of the laws.[3/]

41. Strengthening Financial Intermediaries and Upgrading the Mechanisms for Dealing with Problem Banks. SBIF had completed several studies required by FSAL conditions, and had instructed banks to set-up a not-less-than 2% provision on all outstanding loans; write off loans more than 36 months past due; and require auditors to assess loan classification and concentration. A law proposal submitted to Congress would strengthen the Deposit Insurance Corporation (FOGADE) and the Banking Law, also submitted as a proposal, would set up appropriate procedures to deal with problem banks.

42. Enhancing the Competitive Environment for Financial Intermediaries. The Government had already met a third tranche condition by submitting to Congress a Banking Law proposal which would enhance competition among financial intermediaries, and substantially liberalize banking activities and foreign ownership of banks.

43. Summary Evaluation. By December 1991, the macroeconomic framework was consistent with the reform program objectives, and the sectoral adjustment program was on track including compliance with all specific actions envisaged in the loan agreement for this stage, except for the revision of regulatory norms referred to in para. 39. At the same time, some important third tranche conditions, including the privatization of banks noted in para. 37, had been met. On the whole, Venezuela's performance fully justified the release of the Second Tranche. At that time, however, it was still too early to ascertain whether the long-term impact of the sectoral reform program would fulfill expectations.

D. RELEASE OF THE THIRD TRANCHE

44. The conditions for the release of the third tranche were as follows:

a) That the Borrower had submitted to the Bank a program satisfactory to the Bank for the capitalization of FOGADE, with contributions therefore starting not later than January 1991.

b) That the Borrower had made contributions to capitalize FOGADE, which would have covered not less than 50% of FOGADE's losses.

c) That the Borrower's Executive Branch had submitted to the Borrower's Congress a proposed law, satisfactory to the Bank, modifying the Borrower's Banking Law so as

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3/ Some of these norms were issued by SBIF in 1993, after Congress delegated to the Executive Branch the final approval of the Banking, SBIF and FOGADE Laws (see paras. 56-58 below).

to: (i) indicate the procedures and the role of the various Borrower's agencies and administrative sub-divisions, involved in solving banking crises; (ii) increase minimum capital requirements for entry into the system of a new SBIF Institution which will supply commercial or mortgage banking services, to not less than the equivalent of US$6,000,000; (iii) allow universal banking and introduce procedures to facilitate mergers and consolidations; (iv) set as 1 to 20 the minimum permissible ratio between equity and total assets for commercial banks, mortgage banks and finance companies, while allowing the future introduction of a risk-weighted system for the computation of the asset base (including some contingencies); (v) allow (a) up to 20% foreign ownership of commercial banks, upon enactment of the revised law, and up to 30% in the future with prior authorization of the Borrower's Executive Branch and (b) Executive Branch authorization as the sole step required to enable foreigners to acquire up to 100% of any financial intermediary operating in Venezuela other than a commercial bank subject to the prior issuance of general operative criteria therefor; and (vi) to eliminate the possibility of computing the value of Treasury bills held by a bank as part of its reserve requirements.

d) That the Borrower, including all of the Borrower's agencies, had taken all such measures necessary to ensure that Central Bank and each other agency of the Borrower which directly or indirectly owned or controlled, as of April 30, 1990, an equitable interest in any commercial bank had divested of such interest by selling it to private purchasers or by otherwise disposing of such interest in form and substance satisfactory to the Borrower and the Bank.

e) That the Borrower had taken all actions necessary to restructure CORPOINDUSTRIA according to "Plans"; meaning (A) the strategic plan indicating the role of CORPOINDUSTRIA and ICAP as first-tier credit institutions, (B) the action plan for their restructuring.

f) That the Central Bank and FOGADE had taken all the action required on their part to disengage FOGADE's portfolio from Central Bank's trusteeship and to enable FOGADE to exercise an effective control of decisions on the management thereof, or to obtain an equivalent result.

g) That the Borrower had issued a Decree reducing agricultural lending requirement on commercial banks to 12% of each bank's total portfolio.

45. On December 29, 1992, one year after the second tranche release and 18 months behind schedule, the Bank released the FSAL third tranche. This was done since Venezuela had met all specific sectoral FSAL conditions, as indicated in the following paragraphs, but in spite of Venezuela not being at that time in compliance with the IMF arrangement and of the doubts that could have been raised then about macroeconomic prospects. (See para 52 below.)

46. Liberalization of Interest Rates and Rationalization of Credit Allocation. After second tranche release, BCV had reduced the agricultural portfolio requirement of commercial banks to 12%. Moreover, the already approved BCV Law centralized in BCV the setting of all preferential and other administered rates. While this law, as approved by Congress, had maintained the obligation

for BCV to establish interest rate limits, BCV had continued setting such limits at levels far from the inflation rate, thus allowing deposit and lending rates to be determined by the market.

47. Reduction of Public Sector Participation in the Financial System. As indicated in para. 38, three BCV-owned commercial banks had been privatized prior to second tranche release. Subsequently, as envisaged in the loan agreement, the number of public development banks had been reduced to two second-tier institutions -- the Industrial Credit Fund (FONCREI) and the Agricultural Credit Fund (FCA) -- and two first-tier entities -- a credit institute for small farmers (ICAP) and a lending institution for artisans and for small and medium industry (CORPOINDUSTRIA).

48. Rationalization of BCV's Credit Operations. The new BCV law included all the reforms proposed by the Executive Branch (see para. 39). After second tranche release, BCV continued to make satisfactory progress in disengaging from administered portfolios.

49. Reform of the Regulatory Framework and Improvements in Bank Supervision. The Banking and SBIF Laws had not been approved yet by Congress, but this did not contradict the FSAL conditionality since approval of those laws was not required by such conditionality. The SBIF, however, had started the process of reaching consensus with the banking community on the required regulatory reforms, thus enabling it to issue some of the needed regulations prior to the approval of the law, without a high risk of legal or political problems.

50. Improving the Strength of Financial Intermediaries and Upgrading the Mechanisms for Dealing with Problem Banks. While important decisions had to wait for the still pending Congressional approval of the proposed FOGADE and Banking Laws, the Government had taken administrative action to meet FSAL conditions in this respect, including the preparation of a program satisfactory to the Bank for the capitalization of FOGADE, and the contribution to FOGADE of the amount required to cover not less than 50% of FOGADE losses (actual contributions covered more than 100% of such loses). Actions had also been taken to disengage FOGADE's assets from BCV and to enable FOGADE to exercise effective control over the management of all its assets.

51. Enhancing the Competitive Environment for Financial Intermediaries. No further substantial progress had been achieved in this respect after second tranche release owing to lack of Congressional action on the proposed Banking Law. Such additional progress, however, was not a condition for third tranche release.

52. Macroeconomic Framework. While the sectoral reform program was on track, and all specific sectoral conditions for the release of the second tranche had been met, the overall macroeconomic situation, which was also part of the third tranche conditionality, was quite worrisome, because of the reasons stated in para. 32 above. Because of the fiscal situation, moreover, Venezuela was not in compliance with its agreement with the IMF. Within a framework such as this, the Bank usually does not release a tranche of a policy-based loan. However, in view of Venezuela's compliance with all sectoral conditions and, also, of the overall progress being made in the structural adjustment process supported by several Bank loans, the Bank Management decided to deal with the macroeconomic situation by seeking and obtaining -- through a December 12, 1992 letter from the Planning Minister -- Government agreement that, prior to the release of the third tranche of the Public Enterprise Reform Loan: a) a macroeconomic assessment by Bank staff would take place; b) the proposed sales and minimum gross assets taxes should be implemented, or, if such taxes were

not approved by Congress, other permanent sources of revenue would be provided by measures such as tariff and price increases of publicly-supplied goods and services; and c) expenditure reductions and accelerated privatization could also be undertaken to ensure that a viable 1993 budget was achieved. On this basis, the Bank decided that all required conditions were met and released the FSAL third tranche.

53. Overall Evaluation. Given the good compliance by Venezuela with virtually all financial sector conditions, the decision to release the third tranche of the FSAL seems, on balance, justified. It was clear, however, that the full benefits of the financial sector reform would not be obtained until the Government could deal adequately with some aspects of the economic situation and prospects, particularly concerning policy areas intimately linked to financial sector performance such as public finances and exchange rates. The Bank Management, by requesting from the Planning Ministry the letter described above, was sending a warning that the Government had to take effective action to correct a worrisome macroeconomic trend. Unfortunately, the political developments that ultimately forced the President to resign did not allow a timely implementation of the measures that should have restored macroeconomic stability before the present administration took office in 1994 after elections.

E. IMPLEMENTATION OF THE DEBT REDUCTION COMPONENT

54. The Bank support of Venezuela's debt reduction program was originally estimated at US$500 million, to be provided through an Interest Support Loan (US$150 million) and debt reduction components in the SAL (US$100 million), Trade Policy Loan (US$87.5 million), FSAL (US$75 million), and Public Enterprise Reform Loan. (US$87.5 million). The FSAL portion of the scheme was released at loan effectiveness, in December 1990. It was subsequently decided, in November 1991, to reduce the total amount of Bank support for the debt reduction program to US$312.5 million, shifting the debt reduction components of the SAL and the Trade Policy Loan to the financing of imports.

F. IMPLEMENTATION OF THE TECHNICAL ASSISTANCE COMPONENT

55. The FSAL's Technical Assistance component was not approved by the Venezuelan Congress as an item for whose financing external loan resources could be utilized. As a result, this loan component was not implemented, and its amount (US$7 million) was canceled. The main studies envisaged in the FSAL, however, were carried out with domestic financing. Meanwhile, most of the items directed towards modernizing SBIF, including, in particular, equipment and training, had not been implemented. In the event, this omission became particularly serious when the absence of an adequate system to enforce the prudential regulations defined in the new Banking Law (approved just before the elections) increased the likelihood and the cost of a systemic financial crisis.

G. ACTIONS TAKEN AFTER COMPLETION OF DISBURSEMENTS

56. As indicated above, the achievement of key FSAL objectives depended upon approval of legislation by Congress, and such approval was not included in the loan conditionality. The substantial risk accepted by the Bank in approving the FSAL under these conditions proved to be worth taking. As also noted before, one key piece of legislation, the Central Bank Law, was approved in 1992, substantially increasing the Central Bank autonomy and its ability to formulate and

implement an effective monetary policy. In addition, after the release of the third tranche in December 1992, some important administrative and legislative actions have taken place.

57. Concerning regulatory reform, SBIF has continued and intensified in 1993 the process of achieving consensus with the financial community on the most important actions envisaged in the FSAL, and of issuing the corresponding new regulations without waiting for the reform of the SBIF law. Until October 1993, these SBIF regulations dealt with classification, restructuring, reserves and concentration of banking credit; collateral guarantees; classification of investments; risks in foreign exchange; extraordinary income; off-shore banking; auditing norms; and capitalization requirements for banks. The most important aspects of the required regulatory reform, therefore, were already being implemented before the enactment of the new law governing SBIF activities.

58. Even more important is the approval of the legislation governing the banking system, SBIF and FOGADE. In the framework of the difficult political and economic problems faced by Venezuela, Congress decided, after the replacement of President Perez, to grant emergency powers to the new President, enabling the Executive Branch to enact some specified high-priority pending legislation, including the three laws referred to above. The government decided subsequently to consolidate those three law proposals into a comprehensive Banking Law, which has been approved in November 1993 by the President and the Cabinet. This new law consolidates all key elements of the three original proposals including, inter alia, the authorization of universal banking; the unification of rules governing equity capital requirements of commercial and mortgage banks and finance companies; the authorization of ownership by foreign capital of all types of private financial institutions, including commercial banks; and a substantial strengthening of the institutional structure, operational capabilities and financial resources of FOGADE and SBIF. Unfortunately the same political events that led to the late approval of this fundamental law also explain the absence of the institutional development required for the SBIF and FOGADE to perform their functions properly. The high costs of this shortcoming of the financial sector reform process became obvious when the financial crisis developed in January 1994 shortly after the new administration took office.

VI. RELATIONSHIP WITH OTHER EXTERNAL FINANCING OPERATIONS

59. As indicated in para. 1, the FSAL was part of a package of six loans designed to support Venezuela's structural adjustment program. This was a well integrated overall effort, aimed at supporting and promoting the general adjustment effort, with particular emphasis on several of its key components -- trade, financial and public enterprise reforms, as well as the reduction of Venezuela's external debt. The close relationship among these operations involved a coordinated allocation of conditionality among them, as well as between them and the IMF arrangements. On balance, this coordinated approach worked quite well.

60. During the implementation of the FSAL and of the other adjustment operations the Bank maintained close contacts with the IMF. Such consultations were particularly intensive on macroeconomic policy in connection with Board presentation and tranches release. During loan preparation, moreover, Bank staff also consulted often with IMF staff about technical aspects of the financial system, such as those related to open market operations of the Central Bank. These close contacts notwithstanding, the Bank maintained an independent position, having decided, as already

indicated in para. 50, to release the FSAL third tranche at a time in which Venezuela was not in compliance with the IMF arrangement.

61. The Bank also worked closely during loan preparation and implementation with the IDB, which cofinanced the FSAL operation. There was also an important relationship with the renegotiation of Venezuela's debt with foreign commercial banks, mainly related to the support provided by the FSAL and other policy-based loans to the Debt Reduction Program.

VII. EVALUATION OF THE GOVERNMENT'S FINANCIAL SECTOR REFORM PROGRAM AND OF ITS SUPPORT BY THE BANK

A. OVERALL DESIGN

62. The FSAL was aimed at supporting the first and most difficult stage of a comprehensive and well-designed reform of the entire financial sector, avoiding most of the pitfalls frequently associated with the piecemeal support of partial reforms. Its overall impact, however, was negatively affected, as already indicated in this report, by the less-than-satisfactory performance of fiscal and exchange rate policies that ultimately led to a systemic financial crisis. As also referred to in prior sections, since key parts of the reform program required Congressional approval, the Bank accepted a substantial risk, with ultimate results that were quite positive but not fully satisfactory. The delay in the institutional development required to implement the regulatory framework defined in the new Banking Law represents a serious flaw in the timing of the reforms that has both contributed to the financial crisis and made its cost very high.

B. MAJOR COMPONENTS

63. As described in more detail through this PCR, the reform program supported by the FSAL was aimed at liberalizing the financial environment (interest rates, allocation of credit, foreign ownership, and universal banking, among other aspects); reducing the government participation in the sector (by closing, privatizing or consolidating government-owned financial institutions, and focusing the BCV support of financial institutions on liquidity and monetary management needs); strengthening the regulatory and supervisory framework; and strengthening the financial condition and competitiveness of financial intermediaries.

64. Two separate FSAL components were aimed at supporting the government's Debt Reduction Program and at providing the technical assistance required by the financial sector. The debt reduction component was satisfactorily implemented, but unfortunately, the technical assistance component had to be cancelled because of lack of Congressional approval.

C. MACROECONOMIC AND SECTORAL PERFORMANCE

65. As described in Section V.A. of this PCR, Venezuela's overall macroeconomic performance in 1990-92 was, on balance, quite positive with strong GDP growth and with inflation, while still too high in the 30-35% range, remaining well below the 1989 level. Two weak aspects of that performance in 1992-93 -- fiscal and exchange rate policies -- combined with declining oil prices and

with the effects of President Perez's political crisis in determining a substantial worsening of the economic situation. GDP declined by about 1 percent in 1993 while inflation accelerated. The annual inflation rate, as measured by the Caracas Consumer Price Index, increased from 32% in December 1992 to an accumulated 45.9% prior to December of 1993. The exchange rate, meanwhile, has been allowed to increasingly overvalue the bolivar. These macroeconomic imbalances led in 1994 to a financial and a foreign exchange crisis.

TABLE 4: STRUCTURE OF THE FINANCIAL SYSTEM
(12/31/89 and 06/30/93)

	No. of Institutions		In % of the System Totals					
			Assets		Deposits		Equity	
	12/31/89	06/30/93	12/31/89	06/30/93	12/31/89	06/30/93	12/31/89	06/30/93
Commercial Banks:	41	45	73	77	71	78	78	72
Private National	31	36	61	71	66	75	65	65
Private Foreign	2	5	1	1	0	0	1	1
Public	8	4	12	5	5	3	12	6
Mortgage Banks	16	16	9	6	11	6	8	5
Finance Companies	29	37	11	12	12	12	14	20
Savings and Loans	–	–	6	5	6	4	–	3
Totals	86	98	100	100	100	100	100	100

Sources and Notes:

Data: For 12/31/89: BCV (from Table 1 of this PCR)
For 06/30/93: For Commercial and Mortgage Banks: SBIF ("Boletin", April - June 1993)
For Savings and Loans: BCV ("Boletin", June 1993)

66. Tables 4 and 5 summarize some interesting characteristics of the impact of the financial sector reform and of its relationship with the overall economic situation. The change in the structure of the system between 1989 and 1993 shown in Table 4 reflects the results of privatization, which caused a substantial increase in the share of private national banks and a corresponding decline in that of public banks. It also shows a substantial increase in the number and equity capital of finance companies. The November 1993 Banking Law, and some recent SBIF regulations, are likely to cause further important changes, including a probable increase in the share in the system of foreign-owned banks, as well as some effects of the more uniform approach now being followed concerning the regulation and supervision of all types of financial institutions.

67. Table 5 clearly shows the relations between Venezuela's persistent (and now accelerating) inflation and the behavior of the financial system. The money supply declined substantially in 1988-89, recovered in 1990-92, and dropped again in 1993. The lack of fully appropriate fiscal and foreign exchange policies has left only one feasible option: to utilize open market policy, in the framework of deregulated interest rates, to compensate for the shortcomings of the other economic policies. As a result, annual real lending interest rates shot up in 1993. The Government took some measures in 1993, including the enactment of a value added tax, to improve the fiscal situation but this was not enough to reverse the adverse macroeconomic trend.

TABLE 5: REAL INTEREST RATES AND FINANCIAL DEPTH, 1987-93

	Real Interest Rates[a/]		Ratios to GDP(%)[b/]		Real Money Indices[c/]	
	Lending	Deposit	M_1	M_2	M_1	M_2
1987	-14.4	-11.2	14.8	35.1	106.1	92.4
1988	-11.8	-8.5	15.2	33.5	105.3	85.3
1989	3.0	0.0	9.8	24.7	63.4	59.0
1990	-1.1	-5.6	8.3	25.2	57.9	64.7
1991	5.1	0.5	9.6	29.7	66.2	75.7
1992	7.5	2.8	8.8	27.9	63.8	74.2
June-1992	6.9	2.7	---	---	64.3	73.0
Dec-1992	15.2	11.6	---	---	60.4	74.1
June-1993	17.2	13.7	---	---	44.8	66.1

Source: BCV and Bank Staff

a/ Yearly averages for 1987-92, deflated by consumer price index (CPI) over the year. For 1989, the end of year interest rate is deflated by the annual increase in CPI for the second semester of 1989. The monthly figures for June and December 1992 are deflated by the CPI over that year, while the June 1993 interest rate is deflated by the annual increase in CPI for the first semester of 1993.

b/ Average money stock over the year.

c/ Average money stock over the year deflated by CPI annual averages. The monthly figures for June and December, 1992, and June 1993 are deflated by the CPI level for those months. Annual and monthly indices are based on 100.0 annual averages for M_1, M_2 and CPI in 1984.

68. Looking at the overall economic situation in mid-1993, two facts become clear: First, financial sector reform, particularly concerning deregulation of interest rates, made it possible to avoid a further substantial acceleration of inflation, and a worsening of the existing internal and external financial disequilibria. Second, in the absence of more appropriate fiscal and exchange rate policies, the demonetization of the economy had reached a point at which further reductions in the

nominal growth of the money supply through open market operations would become economically inadvisable and politically unfeasible. The macroeconomic situation, in short, became inconsistent with financial stability. Even if the regulatory functions had been properly performed, this would not have been enough as a safeguard against a financial crisis of a systemic nature brought about by mistaken macroeconomic policies. On the other hand the absence of proper bank supervision made the financial crisis much more likely and increased its cost. The financial crisis of 1994 has revealed both the mistaken macroeconomic policies followed and the weakness of the bank supervision system.

D. GOVERNMENT OWNERSHIP

69. The financial sector adjustment program was rapidly implemented and its legal reform objectives attained when this reform was fully owned by the government's economic team in the Perez Administration. The Bank played an important and, in some aspects, catalytic role, but the early reform success was mainly due to the full support of the Government's Executive Branch. The only question that could be raised in this respect is whether it would have been feasible to move faster in expanding the sense of ownership to Congress and to the private financial community, through appropriate and timely consultations and, also, through a more forceful exercise of Presidential leadership. This could have facilitated an earlier approval of the required legislative measures before the political crisis that would affect later the Venezuela's Presidency. This would have reduced the risks of financial crisis by allowing a timely development of the capacity to enforce the new legal and regulatory system.

E. OVERALL PERFORMANCE OF THE GOVERNMENT AND THE BANK

70. As described in prior sections of this PCR, the overall performance of the Government's Executive Branch in handling and promoting the financial sector reform has been unusually consistent and effective, in the face of a serious national political crisis. It should be noted, moreover, that Congress, while initially delaying the required decisions, has shown that it also supports the reform objectives by approving the Central Bank Law, and by delegating to the Executive Branch the final decisions on the Banking, SBIF and FOGADE draft laws, now merged into an overall Banking Law.

71. The Bank acted quickly, and also consistently, in helping to complete the final design of the financial reform and in supporting its implementation. It took a substantial risk in supporting a reform largely dependent on Congressional actions, which were not included in the FSAL conditionality. The decision to accept that risk, however, proved to be a correct one from the standpoint of the actions taken by Congress before and after the completion of FSAL disbursements.

72. Two main issues should be raised concerning Bank performance. The first is that experience in the implementation of the Venezuelan FSAL, as well as in economic policy elsewhere, has shown that financial sector reform, particularly concerning aspects like the deregulation of interest rates and credit allocation, cannot succeed fully in the face of serious problems affecting related policy areas, such as fiscal and exchange rate policies. A question can therefore be legitimately asked about whether the FSAL should not have included explicit conditions related to the performance of such policies, with due consideration for the institutional responsibilities of the IMF concerning them. The second issue is that the competitive environment that the reform creates demands proper institutions to carry out the bank supervision functions. The lack of implementation of the technical

assistance component that the reform properly devised for this purpose was a serious omission of the reform implementation process. The FSAL should have given much higher priority to an early implementation of this component of the program.

73. One additional question needs also to be answered concerning the overall performance of both the government and the Bank: why it took 18 months more than expected at Board approval to complete FSAL disbursements?. This delay can be allocated in almost equal proportions to each tranche release; the release of the first tranche, upon effectiveness, was almost 6 months late, while those of the second and third tranches were, respectively, about 12 and 18 months behind schedule. The only policy issue which seems to have contributed to this delay because of less than satisfactory results, particularly at the time of the third tranche release, was the country's overall macroeconomic performance. This issue, however, can explain only a minor part of the 18-month delay. The lack of evidence in the project files on other policy issues that might have contributed to the slippages, appears to indicate that the main reasons for them were: a) the underestimation, by both the Government and the Bank, of the time that would be required to prepare and approve the needed studies and policy measures; and b) the lack of implementation of the FSAL Technical Assistance component.

F. SUSTAINABILITY

74. It is always risky to predict whether the thrust of economic reforms can be sustained over the long term. In the case of Venezuela, however, in view of the consensus reached before the 1993 elections by Congress and the financial community reflected in the approval of the new Banking Law, it can be reasonably expected that such objectives will continue to be supported by the country as a whole in the foreseeable future. There is still the unavoidable risk of new policies reversing some reform decisions, but the strengthening of BCV autonomy, by the recent BCV Law; other aspects of the BCV and Banking Laws; and the prevailing national consensus in support of the reform objectives, make it unlikely for a full counter-reform of this sector to succeed. Most likely, the present financial and foreign exchange crisis will force the authorities to adopt macroeconomic policies consistent with the objectives of the financial sector reform and to accelerate the reform process in general and the strengthening of SBIF and FOGADE in particular.

G. MAIN FINDINGS AND LESSONS LEARNED

75. The main findings and lessons learned can be summarized as follows:

a) Whenever important economic reforms are well designed and fully owned by the government, it is worthwhile for the Bank to accept substantial risks in order to support such reforms, as it did through the FSAL analyzed in this PCR.

b) In order to minimize such risks, it is also worthwhile to involve all interested parties at a very early stage of preparation of the reform. In the case of Venezuela's financial sector reform, substantial progress was made by expanding early the sense of ownership to include Congress and the private financial community. However, a political crisis in 1992-93 posed substantial obstacles to the working relationship between the Executive and Legislative Branches of Government and delayed both approval of basic laws and the development of an effective system of bank supervision.

c) Support of a comprehensive structural adjustment program through a package of global and sectoral Bank loans, and the allocation of conditionality among them, can yield very positive overall results. In the case of Venezuela, the success achieved in the deregulation of interest rates and other important sectoral reforms supported by the FSAL, enabled the BCV to utilize monetary policy in a very effective way. The macroeconomic situation, undoubtedly, would have been far worse in the absence of financial sector reform.

d) The FSAL experience also shows that to achieve the desired long-term effects of an important financial sector reform, it is essential to both have a consistent approach in all related economic policy areas and to strengthen institutions that have to enforce the regulatory system. To ensure consistent economic policies, it would have been advisable to include in each loan conditionality the decisions in related policy areas that would have maintained a sound macroeconomic framework as a safeguard against systemic financial crisis. The institutional strengthening planned for the SBIF and FOGADE should not have been delayed until Congress approved the new Banking Law. The low priority that the borrower gave to the implementation of the technical assistance component of the FSAL left the financial sector without a proper supervision when this was most needed to reduce the risks of financial crisis.

PART II. PROJECT REVIEW FROM BORROWER'S PERSPECTIVE

PART III: STATISTICAL INFORMATION

PROJECT TIMETABLE	
Initial Executive Project Summary	November 15, 1989
Letter of Sectoral Policy	May 16, 1990
Negotiations	May 11, 1990
Board Approval	June 12, 1990
Loan Agreement	Octover 15, 1990
Effectiveness	December 7, 1990
Original Loan Closing	June 30, 1993
Actual Loan Closing	June 30, 1993

CUMULATIVE LOAN DISBURSEMENT
Amount (US$ million)

	FY91	FY92	FY93
Planned	293	7	
Actual	146	71.23	76.04
Cumulative Amount	146	217.23	293.27

MISSION DATA

	Month/Year	# of Weeks	# of Person	Staff Weeks
Preparation I	June 1989	2	1	2
Preparation II	October 1989	3	4	12
Appraisal	March 1990	2	6	11.2
Supervision I	November 1990	1	1	1
Supervision II	March 1991	1	3	3
Supervision III	July 1991	1/2	2	1
Supervision IV	June 1992	3	2	5 1/2
PCR	October 1993	1	2	2

STAFF INPUTS

Staff Weeks

	FY89	FY90	FY91	FY92	FY93	FY94	GRAND TOTAL
LENP	15.5	77.9					93.4
LENA		11.2					11.2
LENN		12.5					12.5
SPN			22.7	12.6	10.6	1.8	47.7
PCR						4.9	4.9
TOTAL	15.5	101.6	22.7	12.6	10.6	6.7	169.7

LIST OF RELATED LOANS

Project Name	Approval Date Agreement Date Effective Date	Number	Amount (In US$ millions)
Interest Support Loan	12/13/90 12/14/90 12/14/90	3279	150
Technical Assistance	06/12/90 10/15/90 06/27/91	3225	30
Financial Sector Adjustment	06/12/90 10/15/90 12/07/90	3224	300
Public Enterprise Loan	06/12/90 10/15/90 12/07/90	3223	350
Trade Policy Loan	06/15/89 10/16/89 11/03/89	3092	353
Structural Adjustment Loan	06/15/89 10/16/89 11/03/89	3091	402

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

POLICY MATRIX

Issues and objectives	Actions taken to date	By Board presentation[a/]	By Second Tranche	By Third Tranche
1. Liberalize & rationalize interest rates & credit allocation.				
1.1 Allow market determination of commercial interest rates.		a)• Policy Statement indicates that, as long as setting interest rate limits is required in the BCV Law, minimum deposit (maximum lending) rates will be reduced (increased) if the limit becomes binding. b)• BCV Board has issued resolution setting the minimum deposit rate & maximum lending rate at 10% & 60%, respectively, which are not binding by a wide margin.	• Modifications to BCV Law submitted to Congress will allow full market determination of interest rates.	
• 1.2 Reduce & rationalize preferential interest rates.		a)• Policy Statement indicates that the Government's medium-term objective is full liberalization of interest rates. Meanwhile, subsidized rates on direct lending by government-owned financial intermediaries & other preferential credits will be reduced. Rates will be based on the average non-preferential lending rate of the six largest commercial banks. Preferential interest rate on agricultural credits by commercial banks will be 85% of this reference rate, while direct preferential credits by DFIs will not bear interest lower than 85% & 90% of this reference rate for agricultural & other activities, respectively. b)• Policy Statement indicates that government-owned		

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

POLICY MATRIX

Issues and objectives	Actions taken to date	By Board presentation[2/]	By Second Tranche	By Third Tranche
		financial intermediaries (including BANAP) will on-lend to first-tier financial intermediaries at no less than the average cost of remunerated deposits of the banking system. First-tier institutions will absorb the entire credit risk of the final borrowers.		
1.3 Ascribe to BCV the prerogative to set interest rate determination mechanisms for all operations of financial intermediaries.			• Modifications to BCV Law submitted to Congress will grant full & exclusive prerogative to BCV to set interest rates of government-owned financial intermediaries.	
1.4 Public disclosure of interest rate structure.		BCV Board has issued Resolution requiring daily publication by the BCV of the average & range of interest rates observed in the market (rates offered to the public, interbanks, & on BCV paper), as well as the rediscount rate.	BCV Board will issue a directive to financial intermediaries requiring them to announce & post their rates on all deposit & credit services, specifying the mechanism for their calculation.	BCV will publish in its monthly bulletin interest rates offered by a range of financial institutions.
1.5 Reduce restrictions on banks' discretionary allocation of credit.		a)• Policy Statement indicates Government's medium-term policy of eliminating all directed credit. b)• Government has issued a Presidential Decree reducing agricultural lending requirement on commercial banks from 22.5% to 17.5% of total portfolio.		• Government will issue decree reducing agricultural lending requirement on commercial banks to 12% of total portfolio.

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

POLICY MATRIX

Issues and objectives	Actions taken to date	By Board presentation[a/]	By Second Tranche	By Third Tranche
2. Rationalize public sector participation in the financial system.				
2.1 Commercial banking system	BCV has issued resolution starting the privatization of the 3 commercial banks it owns.		a)• The 3 banks owned by the BCV will have been brought to point of sale. All valuation & tender or bidding documents will have been completed to the satisfaction of the Bank & issued to prospective purchasers.	• All 3 banks will have been divested from the public sector.
		a)• Policy Statement indicates intention to restructure BIV & its 4 regional banks & to liquidate BANDAGRO.	b)• Government will specify an action plan to restructure BIV & its 4 regional banks, including specification of its new role.	Plan being carried out in accordance with its time frame.
		b)• Government will issue a resolution forbidding BIV & BANDAGRO to engage in lending operations until they are either restructured or liquidated.	c) Submission to Congress of Law to liquidate BANDAGRO.	
2.2 Development banking system.		• Policy Statement outlines the formation of two second-tier credit institutions (for industry & agriculture, respectively) which will absorb the largest funds. It also indicated the main steps to be taken to create them.	a)• Submission to Congress of proposed law for the creation of an agricultural second-tier credit institution which would absorb at least 3 funds.	
			b) Action plan to close BANDAGRO & form the agricultural credit institution will be presented to the Bank.	Plan being carried out in accordance with its time frame.
			c)• Submission to Congress of proposed law for the creation of an industrial second-tier credit institution, which would absorb at least 2 funds.	
			d) Action plan to create an industrial second-tier	Plan being carried out in accordance with its time

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

POLICY MATRIX

Issues and objectives	Actions taken to date	By Board presentation[a/]	By Second Tranche	By Third Tranche
			credit institution will be presented to the Bank.	frame.
			e) Submission to Bank of strategic plan indicating role of CORPOINDUSTRIA & ICAP as first-tier institutions & an action plan for their restructuring.	• Plan being carried out in accordance with its time frame.
2.3 Housing finance system.			Submission to Bank of action plan to restructure & promote the financial independence of BANAP, including phasing out of all new government, BCV or external sources of funding & new policies in support of S&Ls.	Plan being carried out in accordance with its time frame.
3. Enhance the transparency of BCV's credit operations.				
3.1 BCV credit to the Government should be subject to an all-encompassing ceiling. BCV should be free to invest in Government debt of any maturity subject only to this overall credit ceiling.		• BCV Board has issued resolution stating that no zero-yield T-bills will be purchased at any time after the date of Board presentation.	a)• Modifications to Public Credit Law submitted to Congress to permit issuance of fixed-term negotiable short-term T-bills; Law should permit market determination of their price, & should not specify preferential order of placement of such bills among different types of economic agents.	• Modifications to Bank Law submitted to Congress will eliminate use of T-bills as instruments for reserve requirements.
			b)• Modifications to BCV Law submitted to Congress will: (i) allow the BCV to purchase fixed-term T-bills not necessarily redeemable in the fiscal year in which they are issued, at the average clearing price of primary issue auctions or in the secondary market; & (ii) include BCV holdings of, or rights to, government debt obtained through debt equity swaps & any	

VENEZUELA - FINANCIAL SECTOR ADJUSTMENT LOAN

POLICY MATRIX

Issues and objectives	Actions taken to date	By Board presentation[a/]	By Second Tranche	By Third Tranche
			kind of foreign currency denominated debt in the overall credit limit to the Government. The limit will not be raised from the level contained in the current law. On a transitory basis, purchase of government debt obtained through ongoing debt reduction & restructuring programs will not be included in the ceiling.	
3.2 All subsidy programs should flow through the national budget, & should not originate in BCV's operations.	Volume of rediscounts has been cut significantly, with only one bank receiving funds. Rediscount rate has been brought up to close to average market lending rate.	a) Policy Statement outlines Government's intention to turn the rediscount window into a facility for temporary liquidity support once open-market capabilities are fully developed. b) BCV Board has issued resolution linking rediscount rate to yield on BCV bills auctioned. The general rediscount rate will be reviewed at least weekly, will not be set below the yield on BCV bills, & will apply to all financial intermediaries (including BANAP & FOGADE). A special rediscount rate, equal to 85% of the general rediscount rate, will be applied to rediscounting of agricultural documents. The Policy Statement indicates that the special rediscount rate will be phased out in step with agricultural preferential lending rates. c)• BCV Board has issued instructions to Vice-president of Monetary Operations establishing	a) BCV Board will issue resolution switching to market valuation of collateral on rediscounts, advances & repurchase contracts. b) BCV Board will issue resolution barring any new purchases of bank credit portfolios. c) BCV Board will issue resolution requiring purchase of all private debt instruments by the BCV from any source at market value. In no case will such instruments be bought at a yield less than that offered on BCV bills in the secondary market at the time of purchase of the instruments. d)• Modifications to BCV Law submitted to Congress will restrict discounting, rediscounting, advancing or repurchase contracts with financial institutions to a maximum duration of 30 days.	

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Issues and objectives	Actions taken to date	By Board presentation[a/]	By Second Tranche	By Third Tranche
		the procedure for automatic referral of large borrowers (e.g., those with outstanding BCV credit in excess of 25% of their equity) to SBIF for review. d) Policy Statement indicates that the Government will not finance any housing or related subsidies with BCV contributions or profits.		
3.3 BCV should not manage external portfolios; these portfolios should not be used to finance budget deficits.		a)• BCV Board has issued a Resolution mandating that all direct transactions of securities between the BCV & its managed portfolios take place at market value. The only exception will be the sale of securities previously purchased at face value which can be sold to the BCV at face value.	a)• Submission of program acceptable to the Bank to disengage all portfolios from BCV (except FICAM). b)• Modifications of FOGADE Law submitted to Congress will allow it to manage its own funds.	• FOGADE portfolio to be disengaged from BCV.
	PDVSA's portfolio at the BCV has been drawn down entirely.	b) Submission of notice by BCV to PDVSA of non-renewal of management contract at end-1990.		
4. Reform the Regulatory Structure.				
4.1 Redefine the regulatory role & strengthen the financial autonomy of: the Central Bank (BCV), Ministry of Finance (MH), the Superintendency of Banks (SBIF), & the deposit insurance corporation (FOGADE).		Policy Statement describes the division of labor between institutions.	• Submission to Congress of proposed new Law of SBIF to inter alia: (i) reorganize SBIF as an autonomous entity with its own sources of revenue; & (ii) eliminate MH's formal executive & decision-making functions in the operations of SBIF.	

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Issues and objectives	Actions taken to date	By Board presentation[a]	By Second Tranche	By Third Tranche
4.2 Strengthen prudential regulations, auditing, & information disclosure.		a)• SBIF will issue all the changes required to tighten regulations on: provisioning, loan classifications, roll-over of credits & accrual of interest, charge-offs, evaluation of investment portfolios, & evaluation of property received as collateral. b)• SBIF will issue instructions to banks to ask auditors to include assessment of loan classification & concentration in audits.	a)• SBIF will issue & implement all the changes required to regulate the valuation of exchange risk, loan concentration limits & controls of intra-group transactions, consolidation of accounts of financial groups, & uniform publication criteria of financial statements. b)• Submission to Congress of proposed new Law of SBIF to tighten norms on capital requirements & lending concentration, & widen the scope of sanctions & fines.	a) SBIF will issue a new chart of accounts which will facilitate full disclosure of the financial condition of banks. b) SBIF will issue audit guidelines in accordance with the new chart of accounts. c) SBIF will start issuing a monthly bulletin disclosing the financial condition of banks & the overall condition of the financial system. d) Modifications to Bank Law submitted to Congress will be proposed to ensure consistency with the new proposed SBIF Law and to eliminate any remaining redundancies.
5. Improving the Financial Strength of Intermediaries & Upgrading the Mechanism for Dealing with Problem Banks.				
5.1 Review financial condition of banks.		• SBIF will undertake studies of the financial condition of all private commercial banks & selected mortgage banks & finance companies. The studies will focus on: portfolio review, fixed asset valuation, loan concentration, & foreign exchange losses.	• Completion of all studies undertaken by the SBIF to the Bank's satisfaction.	
5.2 Increase provisions for loan-losses, foreign		a)• SBIF will issue directive to banks to establish a general loan loss provi-	a) Review banks' compliance with loan-loss provision. Establish additional pro-	Review banks' compliance with loan-loss provision & write-off requirements.

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Issues and objectives	Actions taken to date	By Board presentation[a/]	By second tranche	By third tranche
exchange losses & charge-off bad assets.		sion of at least 1.5% of loans by December 1990 & 2% of loans by June 1991. Specific provisions will be counted against the general provision.	visioning or write-off requirements for institutions that are in vulnerable positions according to the studies performed under 5.1.	
		b)• SBIF will issue directive to banks to write off loans past due by more than 36 months by June 1991.	b) SBIF will prepare & submit to the Bank a program for the amortization by intermediaries of foreign exchange losses assessed under 5.1.	
5.3 Establish sounder requirements for entry.		• Policy Statement indicates that the MH will stop issuing licenses for opening new banks until the SBIF is strengthened.		• Modifications to Bank Law submitted to Congress will increase minimum capital requirements for entry to at least the equivalent of US$6 million for commercial & mortgage banks.
5.4 Improve the existing mechanisms for managing & solving banking crises.		• Policy Statement defines the policy & procedures with regard to managing bank crises. FOGADE will be provided with greater capacity to handle crises. Policy Statement outlines program of technical, legal, institutional & financial upgrading of FOGADE.	a)• Modification to FOGADE's Law will be submitted to Congress to: (i) more clearly define its role in the management of banking crises; (ii) strengthen its mechanisms for resolution of crises; (iii) strengthen its financial position; & (iv) enhance the transparency of its operations & financial condition. b) FOGADE will commission study to determine market value of its assets under management/sale. c) FOGADE will have undertaken campaign to publicize the types of accounts & institutions that are covered, & its maximum coverage limit.	a) Revise FOGADE's Reglamento Interno in accordance with principles established in Annexes VII & VIII. b)• Monthly capital contributions to FOGADE will have been made by the Treasury after January 1990. By third tranche, total contributions should amount to at least 50% of estimated losses of FOGADE. c)• Presentation to Bank of program to complete the recapitalization of FOGADE. Program will take into account losses uncovered in the study & will contain timing of capital replenishment by the Treasury.

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Issues and objectives	Actions taken to date	By Board presentation[a/]	By Second Tranche	By Third Tranche
				d)• Modifications to Bank Law submitted to Congress will establish the procedures & the role of the various government agencies in solving bank crises, as outlined in Annex VII.
6. Enhance the competitive nature & financial strength of financial intermediaries.				
6.1 Permit universal banking & promote consolidation of financial intermediaries.				• Modifications to Bank Law submitted to Congress will allow universal banking & introduce procedures to facilitate mergers & consolidation (e.g., of specialized banks into universal banks).
6.2 Unify capital requirements of commercial banks, mortgage banks, & finance companies.				• Modifications to Bank Law submitted to Congress will establish the same minimum 5% equity:total assets ratio for commercial banks, mortgage banks & finance companies. The Law should permit the future introduction of a risk-weighted system (including some contingencies) for the computation of the asset base.
6.3 Liberalize foreign ownership of financial institutions.				• Modifications to Bank Law submitted to Congress will: (i) allow up to 20% foreign ownership of commercial banks (or 30% with the Executive's approval); (ii) allow Executive to authorize foreign institutions to