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# Financial Reverberations: Latin America's Private Banking System During the Mid-1990s

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## Introduction

The early 1990s witnessed a broad liberalization of the banking sector across Latin America. Structural reform programs led to the liberalization of the capital account and financial system. Privatization programs reduced the role of the state in the provision of financial services. The surge in foreign investment, particularly portfolio investment led to a proliferation of financial institutions and a deepening of financial services. Nevertheless, the new banking institutions were frail, and supervision was weak. The sector was vulnerable to endogenous and exogenous shocks.

This paper examines the different financial systems across the major countries in Latin America and their experiences with economic crises. The focus of this paper is on the private banking system. Therefore, it does not look at the role of the state or public sector banks.[i] The shocks started arriving in late 1993 and peaked during the first quarter of 1995, as the effects of the Mexican devaluation spread to many of the Latin American economies. This paper argues that starting in early 1990s banking sectors experienced a period of sharp unregulated expansion that heightened an already fragile situation. In each case, an exogenous domestic or international shock pushed the sector into a crisis. Unfortunately, the region lacked the economic resources to stem the damage, and the crises led to deteriorated macroeconomic conditions.

## Banking in Latin America

Banks play a key role in economic development by creating credit and helping implement monetary policy (Welch, 1993 and Edwards, 1987). They channel capital from external sources, and mobilize savings and investment. In fact banks have traditionally been the only major vehicles for institutional savings due to historically weak domestic capital markets (Rojas-Suarez and Weisbrod, 1996). Banks also play an important role on the microeconomic level by providing financial services, intermediation, corporate governance, and principle agent monitoring.

In a stable macroeconomic environment, banks fulfill their roles as financial intermediaries through the provision of credit. In other words, this role is optimized in an environment of stable interest rates, currency, and prices. Relatively low real interest rates allow

banks to provide consumer and business sector to generate investment and facilitate consumption. The predominance of foreign currencies in asset management and business transactions means that exchange rate stability facilitates the bank's role. Last of all, price stability allows economic agents to generate expectations about the future, thus paving the way for investment and credit creation. These basic premises suggest that banks maximize their macroeconomic role in an environment of strong institutions, such as central bank independence, judicial responsibility, and fiscal accountability. Unfortunately, political and economic institutions, traditionally, have been in low supply across Latin America. This put the banks at an important disadvantage and provided the seeds for the subsequent crises.

Besides a weak institutional framework, Latin America entered the 1990s with a relatively feeble banking sector. Financial intermediation was low (see Table 1). The primary reason was that the region was exiting a long period of macroeconomic volatility.[ii] Years of fiscal mismanagement, high inflation, and projectionist policies weakened the banking sectors.[iii] Some countries instituted distortions in an attempt to continue with the banks' traditional roles. Other countries transformed the banking sectors as sources of government credit. Some banking sectors survived by lending to the government at very high interest rates.

**Table 1: Financial Intermediation in Latin America in 1994**

(as percentage of GDP)

| | Deposits | Credit |
|---|---|---|
| **Argentina** | 15 | 17.7 |
| **Brazil** | 24 | 33 |
| **Mexico** | 29 | 49 |
| **Chile** | 34 | 51 |

(IMF, 1996)

In addition to macroeconomic problems, Latin America's banking sectors also had endogenous problems. Capital controls during the 1980s excluded the introduction of foreign competition. Insulated behind high walls, the banking sector became bloated and very inefficient.[iv] The banks and the banking regulators also failed to keep up with technological changes and modern banking practices. There were no systematic approaches to manage assets and credit analysis was virtually nonexistent. Most banking relationships were personalized or relationship driven. Furthermore, the sector was highly politicized. Regulation was virtually non-existent and state banks were managed in a way to optimize political objectives instead of

financial objectives. In other words, the banking sector was highly inefficient.[v] Lending practices were suspect, at best, and corrupt, at worst. Hence, it is little surprise that the region was ill-prepared for the banking sector boom of the 1990s.

**The Boom Years: The 1990s**

The 1990s heralded a new era for Latin America. First of all, the macroeconomic situation improved across the region. The introduction of orthodox stabilization plans stabilized prices and exchange rates, while reducing fiscal deficits. At the same time, some of the major industrialized countries were pursuing lax monetary policies, thus facilitating capital flows. The liberalization of domestic controls brought a surge of foreign capital, opening the way to new banking sector activities. Banks surged into consumer lending and new products. The result was an unprecedented expansion of credit. The boom appeared to have no end, but the inherent fragility of the banking sectors soon became evident. One by one of the sectors experienced major crises as their home economies were exposed to exogenous shocks.

**Policy Responses**

Banking crises are always difficult to endure, even when they are well managed. The reply and approach adopted by the government, however, will either help accentuate or mitigate the macroeconomic impact. There are several major actors in the banking sector: depositors, regulators, shareholders, and borrowers. While each of the actors plays an important role, the intervention of a bank affects only two--shareholders and depositors. Governments can adopt several policies to address a banking sector problem. At the extremes, they can design a market-based approach that spreads the brunt of the adjustment on both depositors and shareholders, minimizing macroeconomic costs. Governments can employ a non-market approach that protects these groups, allowing the government to shoulder these costs. The market approach clearly puts the brunt of the adjustment on the banking sector and minimizes the macroeconomic costs. The non-market approach puts the brunt of the adjustment on the government, thus aggravating the macroeconomic problems. Of course, there can also be a mix of the two approaches with results that are somewhere in the middle. The table below illustrates the arrangement.

**Table 2. Government Responses to Banking Sector Crises**

| | Protect Shareholders | Do Not Protect |
|---|---|---|
| **Protect Depositors** | Non-Market Response | Partial Response |
| **Do Not Protect** | Partial Response | Market Response |

Over the years, Latin America has sustained a number of banking crises. Between 1993 and 1995, however, all the major countries in the region underwent banking sector problems. Venezuela was the first to encounter a crisis, followed by Mexico and Argentina, and then, Brazil. Each of the governments adopted a different reply, which roughly fits one of the ideal types. The case material, as depicted in Table 3, reveals that Mexico and Argentina were at the two extremes. Mexico followed a non-market approach, while Argentina followed a market approach. Brazil and Venezuela, however, followed mixed programs. This paper examines each of the four cases to understand the relationship between the government's response to the crisis and macroeconomic impact.

**Table 3. Government Responses to Banking Sector Crises**

| | Protect Shareholders | Do Not Protect |
|---|---|---|
| **Protect Depositors** | Mexico | Venezuela |
| **Not Protect Depositors** | Brazil | Argentina |

**Mexico**

The Mexican banking system witnessed a wave of nationalizations soon after the onset of the Mexican debt crisis in 1982. Although the system was privatized at the end of the decade, the method of privatization was somewhat questionable. First of all, the privatization process led to too much concentration in the banking system, minimizing competition (McComb, Gruben, and Welch, 1994). Fifty-eight financial institutions were merged into 18 commercial banks (Carstens, 1993). Of the 18, only 6 were considered to be national banks, while the rest were classified as regional banks. The government, however, retained control over several development banks that provided loans to the private sector. This allowed the national leadership to exercise political discretion over the provision of credit. In fact, the uncontrolled expansion of credit by the state banks prior to the 1994 national elections debilitated Mexico's macroeconomic stability. The second major criticism was the breakneck speed at which the banks were privatized; indeed, a bank was sold every three weeks. This harried pace prevented the proper analysis of assets and it granted an advantage to investors with insider knowledge. It is not surprising that the winners

consisted mainly of investors with good political connections.[vi] Last of all, the radical deregulation of the Mexican economy and excess international liquidity produced an unprecedented expansion of the banking sector and a dramatic lending boom (Hausmann and Gavin, 1996). This, however, made the banks very vulnerable to internal and external shocks. Unfortunately, these shocks arrived in relatively rapid succession in 1994.

The tightening of U.S. monetary policy in February 1994, provided an unexpected blow to the emerging markets by raising the cost of capital. Subsequent political crises, such as the Chiapas uprising and the assassination Donaldo Colosio and Ruis Masccieu, led to an exodus of capital. Furthermore, fears of a devaluation at the start of the new government and the lack of an appropriate monetary policy to quell market fears, finally resulted in the devaluation of December 1994. A deep recession soon followed.

The deterioration of the Mexican economy delivered a devastating blow to the banking sector. Interest rates soared, economic output plummeted, asset prices evaporated, real wages plummeted, and economic agents found themselves lacking the resources to service their obligations. Faced with a possible meltdown of the financial sector, the government introduced several programs to assist both debtors and creditors.

The government stepped in and directly intervened in several small banks that were approaching insolvency. The government's goal was to prevent a run on the banks. Five institutions (Banpais, Cremi, Union, Obrero, Interestatal, and Inverlat) were intervened through the PROCAPTE program to guarantee deposits. Later, Sureste and Capital were intervened (Grupo Financiero Bancomer, December 1996). Hence, as in the Venezuelan case, liquidity was provided. But unlike the Venezuelan case, the Mexican government took over the banks completely--preventing the perpetuation of bad management or policies. However, as the crisis spread to other institutions, the government decided to provide assistance to both shareholders and depositors through the provision of debt relief. Such a policy, of course, was a non-market approach and it avoided any real adjustment in the value of portfolios. Given that the banks were recently privatized and that key political allies had won the privatizations, the government wanted to minimize the losses to the bank shareholders. Nevertheless, the decline in deposits underscored that there had been damage to the banking system. The National Banking and

Securities Commission (CNVC) reported that total deposits fell 13% in 1995 and 4.3% during the first half of 1996 (CNVC, December 1996).

The government created a series of ad-hoc assistance programs to help debtors and creditors. The first program was FOBAPROA. Banks sold troubled loan portfolios to the government in exchange for 10-year government bonds whose yields were based on Cetes rates. By June 1996, the program had purchased an estimated 12.9% of the total system's loans. The banks were required to monitor and collect the loans, thus if the collection exceeded the amount the government paid for the loan, the bonds amortized. If the recovery was less than the amount of the bond, the bank absorbed only 20% of the loss. FOBAPROA was clearly designed to benefit the owners of the banks. Losses were delayed for 10-years, while the gains were realized immediately. This allowed the banks to keep accruing assets on their books, reduce loan loss provisions by improving asset quality, while freeing capital reserves due to the fact that less risky loans were left on the books. The government hoped to recover some of its losses by repackaging the assets and selling them to the secondary market. The assets, however, will be sold at a high discount and result in a capital loss for the government.

The next program, the UDI, was offered to commercial borrowers to transform short-term floating rate loans into 8-to-30-year long term loans. Borrowers submitting to the program were required to pay the UDI real interest rate plus inflation. Given the spike in interest rates shortly after the devaluation, the program reduced long term interest payments dramatically. The government assumed the differential in rates. A fourth program, ADE, provided assistance to individual debtors. Like the UDI program, it capped interest rate payments to debtors. In return, the commercial bank agreed not to bring legal action against debtors. The government also assumed the interest rate differential.

Since most of the costs for these programs were going to be realized over a long period of time, the government decided to calculate the cost of the rescue on a net present value (NPV) basis. While this mitigates the cost in the short-term, it perpetuated the expense of the crisis into the next century. The initial estimate for the rescue of the banking sector rescue was an NPV equivalent of 5.1% of GDP. In 1996, the government extended the assistance programs to mortgages, farming (FINAPE), and the small and medium sized industry (FOYPE). As a result,

it revised the NPV estimate to 8.4% of GDP (see Table 4). Standard & Poor's, however, estimates the cost at 12% of GDP because it assumes that the government will have to introduce new assistance programs.

**Table 4. NPV Cost of the Mexican Banking Sector Crisis**

| Program | Cost (Ps. Billions) | % of 1996 GDP |
|---|---|---|
| UDIs | 48.7 | 2.0 |
| ADE | 4.3 | 0.2 |
| FOBAPROA | 70.5 | 2.8 |
| PROCAPTE & Capitalization Schemes | 39.0 | 1.6 |
| Toll Roads | 26.0 | 1.0 |
| FINAPE | 14.2 | 0.6 |
| FOYPE | 7.4 | 0.3 |
| **Total** | **210.3** | **8.4** |

(Mexican Central Bank)

While the Mexican rescue programs were crucial to stem a run on the banking system, they created serious problems. One of the major concerns was the large amount of past due loans. In of April 1996, the CNVC reported total past due loan level at 18.3% of total system loans ($20 billion). Even though this level was quite high, it was grossly underestimated. Mexican accounting rules calculated the total past due amount as the portion of the loans that are delinquent. The introduction of U.S. GAAP in 1997, will double the levels. The damage sustained by the banking sector evaporated new credit. Some large Mexican companies circumvented the problem by tapping into the international markets, but many small and medium-sized businesses were dependent on the domestic banking sector. This created a perfect opportunity for foreign banks to increase their market share.

It is clear that the Mexican banking sector crisis and response produced serious macroeconomic damage. First and foremost, the decision to protect depositors, bank shareholders, and debtors created a huge fiscal liability and costs. Second, the decision to spread the cost over a long period time will put an important drag on the Mexican economy well into the next century. From now on, the support to the banking sector will have to be explicitly acknowledged in the fiscal accounts. Third, the Mexican rescue program failed to address the problems of the state-owned banks, particularly Nafinsa and BANOBRA. The deterioration of their balance sheets will sooner or later translate into a capital cost for the government.

## Argentina

Argentina's banking sector suffered from a number of long-standing problems, such as low mobilization of bank deposits, scarcity of credit, and high inefficiency. In the 1980's the country's large public sector deficits, high inflation and the 1984 nationalization of savings accounts, exacerbated the banking sector's deficiencies. Provincial banks provided yet another problem. Up through June 1995, the provincial banks accounted for 42% of total loans and 33% of all bank employees (Carrizosa, Leiziger, and Dhah, Finance and Development March 1996). The provincial governments used their banks to finance state deficits as well as to obtain credit for political allies. Although most of the provincial banks were insolvent by international standards, political needs forced the central bank to keep them afloat through loans and guarantees. The central bank, however, was limited in its supervision and oversight of the provincial institutions since they were protected by provincial law.

Argentina's Convertibility Law of 1991, however, provided a major impetus to reform the financial system. The law fixed the currency to the dollar and established a currency board system. In theory, a currency board removes the central bank as the lender of last result. The monetary base is also restricted by the level of international reserves. The banking sector was forced to undergo radical changes to allow the country to adhere to the new currency arrangement. The central bank also increased its supervision of the banking sector. Unprecedented oversight of capital adequacy requirements and provision requirements were implemented. The central bank doubled its bank supervision department and implemented regulations on reserve requirements, loan classification and minimum loss provisioning requirements. The new staff began to initiate on site examinations and reviews.

The reforms were proceeding at a steady pace, when the system suffered an unexpected external shock in December 1994 due to the so-called Tequila crisis. Investors perceived that the Argentine economy shared many of the symptoms of the Mexican economy, such as an over-valued exchange rate, a growing current account imbalance, a low savings rate, and political instability, and they withdrew their portfolio capital from the country. As a result, international reserves sagged, and the monetary base contracted. One of the first set of institutions to come under pressure were the wholesale, or brokerage, banks. As prices of instruments plummeted and

the value of the collateral diminished, these institutions found themselves cut off from lines of credit. The government had no choice but to force these institutions to close. As a result, the event triggered a system-wide panic, as depositors rushed their money out of smaller institutions and into larger more stable names.

By mid-1995, an estimated $8 billion, nearly 20% of the financial system, had fled the country. The shock endangered the stability of the banking sector and the survivability of the Convertibility Plan. Indeed, about a fourth of the nation's private banks, 40 out of 175, were thought to be in serious trouble. Bank credits shrank by $3.5 billion, roughly 8.8% of the total outstanding credits to the private sector. Ironically, the provincial banks were the recipients of much of the displaced deposits. Unlike most private institutions, the provincial banks insured depositors up to $20,000. This contraction in credit/liquidity raised interest rates, lowered investment and produced a slowdown in economic activity.

The Argentine government had to respond quickly. However, it was limited in its choice of policy responses. First of all, the central bank could take no action that would expand the money supply if the country was going to adhere to the Convertibility Law. Second of all, it could not implement any type of capital or financial controls. Therefore, it responded with a series of market-based solutions that would enhance the public's confidence in the overall banking system. The government's objective was to save the banking system, and not protect Argentine creditors or debtors. The central bank opted to create a deposit insurance scheme, establish two fiduciary funds to consolidate the private sector banking system, and privatize the provincial banks.

The first fiduciary fund was established in January 1995. It was a $250 million Trust Fund empowered to buy the assets of illiquid wholesale banks. The crisis, however, spread to smaller rural banks when the large Buenos Aires institutions refuse to provide additional credit or liquidity, since they were not sure if the central bank was going to use the crisis as an opportunity to consolidate the sector. The central bank was forced to expand out its repo lines to provide these smaller institutions with liquidity. Hence, a second trust fund ($750 million) was set up, with the help of the IDB and the World Bank, to purchase the illiquid assets of the smaller banks.

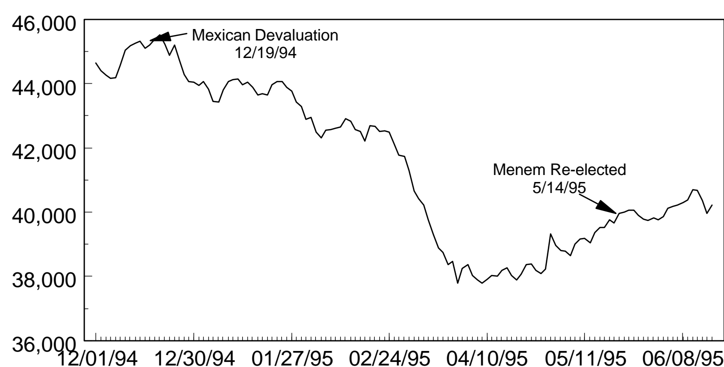
The multilateral funds were also used to restructure and privatize most of the provincial banks. Since the central bank was no longer the lender of last resort, the provincial banks had no

where to run when they got into trouble. Most of the provincial governments begrudgingly ceded control of their banks to the federal government. The central bank proceeded to clean up the balance sheets of the troubled provincial state banks by assuming the liability for non-performing assets. The banks were then sold.

Although a market solution clearly paved the way for the stabilization of the banking sector, political considerations were not too far away. Presidential elections were scheduled for May 14, 1995. Instead of allowing the mechanisms of the currency board to play out, the government needed to jump start the economy. Therefore, in March 1995, the Economy Ministry launched several new policies to stimulate borrowing and demand. For example, the VAT on loans was halved to 10.5%, and provincial banks were prohibited from collecting a Gross Revenues and Stamp Taxes on new loans.

The prompt reaction of the central bank, nevertheless, prevented a further outflow of deposits and a complete meltdown of the banking sector. By December 1995, deposit levels had returned to pre-crisis levels, and by the first quarter of 1996, the economy started showing signs of recovery. Most of the deposits were, at first, dollar denominated, but the distribution began to even out as the risk subsided. The increase in peso deposits reflected the improvement in the level of confidence in the government, as well as the perception that the economic crisis was subsiding. As the risk declined, a virtuous circle emerged, and the relatively high interest rates attracted a repatriation of capital. Deposits surpassed pre-crisis levels by the first quarter of 1996 when they rose to $48.1 billion and they reached $52 billion by the end of 1996. By 1996 end, the crisis had passed (see Graph 1).

**Graph 1.Total Dollar and Peso Deposits**




Sources: M&S Consultores and SBC Warburg.

The Argentine banking sector crisis was prompted by external factors, much like the Venezuelan and Mexican cases. However, the Argentine government, unlike the Venezuelan and Mexican governments, addressed the problem solely with market solutions. The Argentine government also exploited opportunities afforded by the crisis to deepen some of the pending financial sector reforms. The banking sector was consolidated as almost 50 institutions were merged or taken over. By the end of 1995, the top 20 institutions held 73% of total system deposits and 68% of total loans, thus improving efficiency. The government also pushed ahead with the provincial privatization program. Although the Argentine economy sustained a deep recession as a result of the crisis, the financial system emerged stronger.

**Venezuela**

Venezuela's banking sector crisis had its roots in the sharp decline of oil prices. Between 1990 and 1994, real oil prices plunged almost 25%. The adverse terms of trade created a sharp deterioration of the fiscal accounts, as oil tax revenues fell from 19% of GDP in 1990 to below 10% of GDP in 1994. The government was forced to curtail spending, the unemployment rate soared from 6.3% in 1993 to 17.4% in 1994 wages plummeted (IIF, 1995) and the economy entered into a deep recession.

The main internal factor was the radical deregulation of the financial sector in 1989 during the Perez Administration. Deregulation led to an unprecedented expansion of the banking sector and banking sector activities. Bank supervision, however, failed to keep up with the pace of financial liberalization. This was partially due to a lack of resources, but it was also due to a tradition of weak political institutions. Not surprisingly, lax oversight allowed lenders to run rampant. Mismanagement rose as soft loans were extended to bank insiders (The Economist, December 14, 1996). Intergroup lending and weak credit controls exacerbated the deterioration of asset quality across key banks. The weak sector was unable to withstand the deep recession of 1994 and a rapid deterioration of balance sheets, thus leading to the subsequent crisis.

Venezuela's bank failures occurred in three waves between January 1994 and September 1995, and claimed a total of 16 banks and their affiliates (see Table 4). The first wave consisted of only one bank--Banco Latino, Venezuela's second largest bank in terms of deposits. It failed on January 12, 1994, when it was unable to make payments to clients and to meet its clearing house obligations. Rumors about Latino had circulated for at least three months prior to its intervention; yet, the Deposit Guarantee and Bank Protection Fund (FOGADE) quietly provided additional liquidity. Once it intervened in Banco Latino, FOGADE officials thought the problem had been neutralized. Meanwhile, several other Venezuelan financial institutions were just steps away from disaster. FOGADE, however, did not intervene partly because of political considerations and partly because it was afraid that the intervention of additional banks could trigger a run on the bank system. Although there was not much concern about the shareholders of the banks, the government wanted to maximize the protection to the depositors. Therefore, FOGADE again provided additional liquidity support to the troubled institutions. By June 1994, FOGADE had provided 136 billion bolivars in liquidity support to seven banks and one finance company. Finally, it decided that further assistance was futile.

**Table 4. Venezuela**

**Bank Interventions**

| Month | Day | Number | Bank | Method |
|---|---|---|---|---|
| January 94 | 17 | 1 | Banco Latino | Intervened |
| June 94 | 15 | 2 | Banco La Guaira | Intervened |
| | | 3 | Banco Maracaimbo | Intervened |
| | | 4 | Bancor | Intervened |
| | | 5 | Banco Metropolitano | Intervened |
| | | 6 | Banco Amazonas | Intervened |
| | | 7 | Banco Construccion | Intervened |
| | | 8 | Banco Barinas | Intervened |
| | | 9 | Sociedad Financiera Fiveca | Intervened |
| August 94 | 9 | 10 | Banco Venezuela | Nationalized |
| September 94 | 11 | 11 | Banco Consolidado | Nationalized |
| December 94 | 14 | 12 | Banco Progreso | Intervened |
| | | 13 | Banco Republica | Nationalized |
| | | 14 | Banco Andino | Intervened |
| February 95 | | 15 | Banco Italo Venezolano | Intervened |
| | | 16 | Banco Principal | Intervened |
| | | 17 | Banco Profesional | Intervened |
| August 95 | | 18 | Banco Empresarial | Intervened |

FOGADE handled the first two waves of bank failures by pumping liquidity into the intervened institutions instead of looking at the asset side. Yet, this turned out to be a flawed policy. It perpetuated the poor banking policies and it did little to remedy the situation. All in

all, FOGADE, supplied 839 billion bolivars (US$4.9 billion) in liquidity, approximately 10% of GDP, and 40% of M2 to these troubled institutions. Unfortunately, failure to act swiftly and decisively eroded the public's confidence in the troubled institutions. Therefore, much of this added liquidity found itself in the economy as depositors took their money out of the banks.

At first, depositors in the weaker banks withdrew their money and transferred their accounts to what they considered to be the safest banks. The biggest beneficiary of the flight to quality in terms of percentage increases was Banco Venezuelan de Credito - arguably the best-managed bank in the country. Total deposits, in bolivar terms, surged 312% in the first half of 1994. Banco Consolidado's deposits also climbed 167%, and Banco Provincial's rose 127%. Riskier banks saw small increases, such as Banco Mercantil (60%), Banco de Venezuela (+44%), and Banco Union (+13%). The surge in deposits created new problems for the banks since they now had to reckon with the profitable placement of the excess liquidity. Furthermore, the failure of second largest bank in the country meant that there was hardly any safe places to run. Typically, banking sector problems begin with small institutions and spread to larger healthier banks. In Venezuela's case it began with the largest bank and spread to the rest of the system. Left with few alternatives, Venezuelans began to withdraw funds from the banking system, thus creating new macroeconomic problems.

The surge in liquidity destabilized monetary aggregates, pushed up the inflation rate, and pushed down the interest rate. While a part of the rise in liquidity was effectively sterilized when individuals moved out of bolivars into U.S. dollars, the broad money supply, M2, still registered a 43% year-on-year increase through end of June 1994, contributing to additional inflationary pressure and a decline in real interest rates. The government tried to stem the explosive growth of liquidity by stepping up the issuance of 90-day zero-coupon treasury bonds, yet its efforts were not enough. The run on the currency put downward pressure on the bolivar and depleted international reserves. The rapid devaluation of the exchange rate created additional inflationary pressures. By June 1994, the monthly inflation rate had spiked 9%, the bolivar had depreciated nearly 70% ytd, and foreign reserves had plunged $2 billion. Finally, the Venezuelan government was forced to apply financial and capital controls to prevent a complete meltdown of the financial system. It fixed the exchange rate at Bs170/US$, imposed price

controls on basic goods, and introduced a system of import and exchange controls. Realizing that controls breed corruption, the government adopted very strict mechanisms for the allocation of resources, setting prices, and obtaining foreign exchange. The price controls, which were initially imposed on 25 basic products and subsequently expanded to nearly 100 products, squeezed profit margins and led to shortages. The allocation process, furthermore, became highly politicized and bureaucratic leading to a sharp decline in imports, the emergence of a black market, and the deepening of the recession.

The introduction of financial and capital controls induced a third wave of bank failures in September 1994 that brought down another seven banks. This included two of the largest financial institutions in Venezuela— Banco Consolidado and Banco de Venezuela, which together controlled 18% of the system's deposits. FOGADE, however, had learned its lesson this time around. Instead of providing additional liquidity, it intervened as soon as trouble appeared. It then adopted a case-by-case approach to promote the recapitalization of the banks by the existing owners or to achieve their restructuring as a prelude to privatization.

The banking sector crisis and its aftermath sent a powerful shock to the Venezuelan economy. First of all, it helped fuel the recession by debilitating the already feeble fiscal accounts. The bailout of the banking sector cost an estimated Bs. 1.8 trillion, or $12 billion (The Economist, December 14, 1996). The crisis also removed an important source of credit from the economy. by the end of 1996, total bank capitalization had declined to $1.1 billion. Such low capitalization levels constrain consumer lending and depress economic activity. It was not until the government signed a Stand-by Agreement with the IMF in May 1996 that the government finally decided to move ahead with the privatization of the banks.

In retrospect, it is not difficult to identify the sources of the Venezuelan banking sector crisis. Unbridled financial liberalization, along with lax supervision debilitated the financial sector. The drop in global oil prices produced a deep recession pushing the banking sector over the edge. The country's second largest bank was the first to fail, eroding the public's confidence in the banking system. This created an uphill battle for FOGADE. The Caldera administration had been elected on a populist platform; therefore, it did not care much about the shareholders of the banks. However, it was very concerned about the protection of individual deposits. That is

why FOGADE focused the rescue program on the liability side of the banks' balance sheets, or on customer deposits. Yet, this policy aggravated Venezuela's macroeconomic problems by endangering the monetary system and the exchange rate. FOGADE's approach clearly treated the symptoms of the banking sector crisis, but not the causes of the problem.

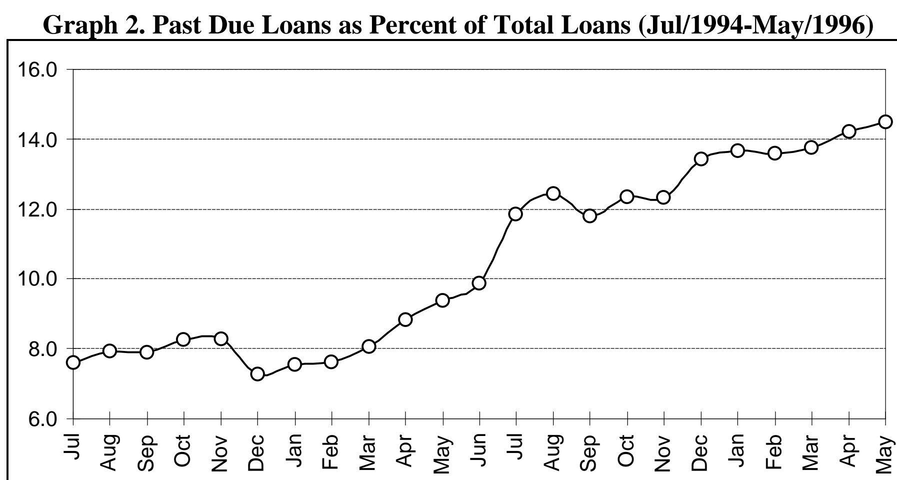
**Brazil**

While Brazil's banking sector, as most of the region's, was characterized by relatively high levels of inefficiency, large state-owned banks and lack of competition it did have economies of scale. Unfortunately, almost five decades of high inflation, at times hyperinflation, and capital controls had addicted the banks to the *float*. This was the highly profitable business realized from inflationary transfers and the real depreciation of demand deposits. It is estimated that the *float* transferred resources to the banks estimated at 2% of GDP per year (Barros and de Almeida, 1996). The situation changed, however, on July 1, 1994, when the government embarked on an exchange rate-based stabilization plan, the Real Plan. The government had to liberalize the capital account and remove most of the financial sector controls in order for the plan to be sustained. As inflation dropped, the banks would be forced to compete and generate earnings from services.

The Real Plan immediately created stronger banks. As monetary aggregates stabilized, lower inflation produced a surge in bank deposits. Demand deposits surged 165% and time deposits rose 40% during the first six months of the plan (Barros and de Almeida, 1996). Moreover, lending rose by 43.7% during the first eight months of the Real Plan: the economy sustained a powerful consumer boom from the elimination of the inflation tax and the simultaneous liberalization of the current account, and the banks responded with a rapid expansion of credit. The central bank attempted to counter the expansion by dictating higher reserve ratios, and still credit surged. This unexpected lending boom as banks were undergoing reform increased the vulnerability of the banking. At the end of 1994, the Mexican devluation created a powerful external shock.

The macroeconomic reverberations caused by the Mexican devaluation forced the central bank to tighten monetary policy during at the end of the first quarter of 1995. The decline in demand pushed up the rate of non-performing loans, and several banks found themselves in government hands (see Graph 2).

**Graph 2. Past Due Loans as Percent of Total Loans (Jul/1994-May/1996)**




Source: Banco Central do Brazil

The first bank to face trouble was Banco Economico in August 1995. The central bank, however, was slow in formulating an appropriate response. The owners of Banco Economico were the Maghalaes family, close allies of Brazil's ruling coalition. Eduardo Luis Maghalaes was the Speaker of the Lower House and a key member of the government. Therefore, the government was very keen to protect the shareholders of the banks. This, however, led to more systemic problems as many smaller institutions faced liquidity constraints. The absence of deposit insurance led to a gradual flight to quality. The government did not respond until November 1995, when it announced the PROER program which provided incentives for the consolidation of the banking system. Banks were given generous tax breaks and access to lines of credit to acquire ailing banks. The central bank also introduced a new deposit insurance arrangement, as well as new powers to intervene. The government realized that preserving the integrity of the banking system was the first priority; therefore, the cost of the adjustment was shared by the bank shareholders. Nevertheless, the crisis put an additional strain on Brazil's fiscal situation. The central bank estimates that the PROER program cost about 1% of GDP. Although it is not as high as the Mexican rescue, it was still an important drag on the government's finances.

**Conclusion**

The banking sectors of Venezuela, Mexico, Argentina, and Mexico all experienced rapid liberalization and deregulation in the early 1990's. The opening of the economies also produced a rush of new activity and new instruments. Banking supervision, however, failed to keep pace. This made the banking sectors susceptible to external shocks. In Venezuela the external shock was induced by the decline in global oil prices and in Mexico it was the abrupt reversal in U.S. Federal Reserve policy. Argentina and Brazil both suffered shocks from the reverberations associated with the Mexican devaluation.

The case studies of policy response to these shocks suggest that the timing of the policy implementation is an important factor in controlling the damage. Yet, the type of approach - market, non-market, or mixed - was a more telling factor.

In Argentina, the Convertibility Plan was a significant constraint on the range of possible policy responses. The central bank had to pursue a market approach. While this type of approach spread the cost of the adjustment among depositors and shareholders, it minimized the macroeconomic damage. Although the Argentine economy entered into a deep recession as a result of the contraction of credit, it did not sustain the degree of fiscal, inflationary, and other macroeconomic damage that were generated in most of the other cases (see the 1995 and 1996 columns in the Appendix). In fact, like the phoenix, the Argentine banking sector emerged stronger from the crisis.

The Mexican government chose to adopt a non-market approach in response to its crisis by providing protection to both shareholders and depositors. The macroeconomic damage, however, was severe since the policy will perpetuate the cost of the adjustment well into the next century (see the 1995 and 1996 columns in the Appendix). The Venezuelan and Brazilian approaches were mixed. Populist concerns forced the Venezuelan government to pursue a policy that protected depositors. This exacerbated the short-term costs (see the 1994 and 1995 columns in the Appendix), but mismanagement in implementing pushed the economy into a deeper recession. Political considerations forced the Brazilian government to protect the shareholders of Banco Economico. Although delays in presenting a comprehensive plan produced some systemic

problems, the exchange rate plan eventually stabilized the situation and minimized the macroeconomic problems (see the 1996 column in the Appendix).

One indicator of the macroeconomic damage created by a banking sector crisis is the fiscal cost of the rescue. Barros and de Almeida (1996) estimated the fiscal cost of some of the banking sector crises.[vii] Using their estimates and other estimates, we have constructed an approximation of the fiscal costs (see Table 5). The data clearly shows that Venezuela was the most expensive, followed by Mexico. The Mexican data, however, may be understated since it is on an NPV basis. Argentina and Brazil were clearly the least expensive.

**Table 5. Fiscal Costs as a Percentage of GDP of Banking Sector Crises**

| | **Shareholders -Protect** | **Not Protect** |
|---|---|---|
| **Depositors-Protect** | Mexico (8-12%) | Venezuela (13%) |
| **Not Protect** | Brazil (1%) | Argentina (0.5%) |

(Barros and de Almeida, 1996).

**Appendix**

**GDP (Real GDP Growth)**

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| Argentina | 8.9 | 8.7 | 6.0 | 7.4 | -4.4 | 4.4 | 8.3 |
| Brazil | 0.2 | -0.8 | 4.2 | 5.7 | 4.2 | 2.9 | 2.6 |
| Mexico | 3.6 | 2.8 | 0.4 | 3.5 | -6.8 | 5.1 | 5.2 |
| Venezuela | 6.6 | 9.7 | 0.3 | -2.8 | 2.2 | -1.6 | 4.2 |

**Fiscal Deficit as % of GDP**

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| Argentina | 1.1 | -0.4 | 0.9 | -0.3 | -0.6 | -2.1 | -1.5 |
| Brazil | 1.4 | -2.2 | 0.3 | 1.3 | -5.0 | -3.9 | -2.5 |
| Mexico | -1.5 | 1.7 | 1.0 | -0.4 | 0.5 | 0.1 | -1.0 |
| Venezuela | -3.3 | -6.3 | -1.3 | -14.0 | -8.3 | 7.3 | -0.6 |

**CPI (Year end % Change.)**

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| Argentina | 84.0 | 17.5 | 7.4 | 3.9 | 1.6 | 0.7 | 0.5 |
| Brazil | 459 | 1129 | 2491 | 1173 | 23 | 10 | 5.7 |
| Mexico | 18.8 | 11.9 | 8.0 | 7.0 | 52.0 | 26.3 | 17.4 |
| Venezuela | 31 | 32 | 46 | 71 | 57 | 103 | 38 |

[i]This paper also does not explores the political dynamics of government-banking relations. Maxfield (1990) examines the formation of banking coalitions.
[ii]Latin America has a relatively recent history of severe banking sector crises. Argentina experienced a severe crisis between 1980 and 1982 that cost about 55% of GDP. Chile had a sevre crsis between 1981 and 1983 that cost 40% of GDP, and Uruguay witnesed a crisis between 1981 and 1984 that cost 30% of GDP.
[iii]There was such a lack of confidence in the Argentine banking sector in 1989, that M2 dropped to 5% of GDP (Rozenwurcel and Bleger, April 1997).
[iv]Edwards and Vegh (1997) argue that inefficient, or expensive, banking sectors can amplify the effects of macroeconomic disturbances.
[v] Gruben and McComb (1997) argue that the lack of competition in the Mexican banking sector led to the high level of inefficiency and the subsequent problems of the 1994/5 crisis.
[vi]Elizondo (1993) argues that Mexican governments since President de la Madrid have made it a point to forge a close alliance with the owners of the banks.
[vii]The fiscal costs are Net Present Value (NPV).