



2002

YEAR-END ADDRESS
PRESIDENT
THE CENTRAL BANK OF VENEZUELA

2002

**YEAR END ADDRESS
PRESIDENT
THE CENTRAL BANK
OF VENEZUELA**



© 2002, Banco Central de Venezuela
Caracas-Venezuela

Source cataloging
Biblioteca Ernesto Peltzer

Banco Central de Venezuela
Mensaje de fin de año del Presidente
del Banco Central de Venezuela, 1994-

Formerly:
Declaración de fin de año del Presidente
del Banco Central de Venezuela/
Banco Central de Venezuela.-
Caracas: BCV, 1976-1993.

Dewey classification: 330.987064
JEL classification: E58, E60
VENEZUELA - CONDICIONES ECONÓMICAS
BANCO CENTRAL DE VENEZUELA

Free distribution

Editorial production:
Gerencia de Comunicaciones
Institucionales
Departamento de Publicaciones
Torre Financiera, Avenida Urdaneta,
Esquina de Las Carmelitas,
Piso 14, ala sur,
Caracas 1010.
Phone: 801.55.14 / 801.52.35
Fax: 801.87.06

Graphic design:
María de Lourdes Cisneros

e-mail:
libreriabcv@bcv.org.ve

Internet:
<http://www.bcv.org.ve>

I	PRESENTATION	5
II	INSTITUTIONAL ACTIVITY FRAMEWORK	7
III	TOWARDS A TRANSITION IN MONETARY POLICY	9
IV	CONTRIBUTION TO THE INTERNATIONAL FINANCIAL ARCHITECTURE	11
V	CONSOLIDATION OF THE INSTITUTIONAL MANAGEMENT MODEL	13
VI	ANNUAL POLICY AGREEMENT AND CHALLENGES FOR 2003	15

2002
YEAR END ADDRESS
PRESIDENT
THE CENTRAL BANK
OF VENEZUELA

It has become customary for the President of Banco Central de Venezuela to present a year-end address on the most significant aspects of the country's economic development and on the most important challenges facing the Venezuelan society in the approaching twelve month period. On this occasion, the message differs from previous years, since current laws require the disclosure of accounts with an institutional scope for the first quarter of the coming year. Therefore, I take the opportunity to address the entire country to inform it about the steps being taken by Banco Central de Venezuela to comply effectively with the mandate it has been assigned.

It is impossible to ignore the limitations imposed by specific events of the past month on the Institution's ability to gather, prepare, and dispose of figures on the most relevant economic indicators, which constitute the indispensable raw material for analysis of economic and social development. However, our own macroeconomic estimates, which are in line with specialized international organizations, would hint at a drop in the Gross Domestic Product during the year.

Given the adverse circumstances facing the country, solutions of an institutional nature dealt with in this address may constitute basic instruments contributing to economic recovery. In this regard, the Annual Economic Policy Agreement, countersigned by the Minister of Finance and the President of Banco Central de Venezuela sets forth objectives targeted at recovering the path towards positive economic growth, price stability, and external balance.

But above all, prioritizing the coordination of monetary, fiscal, and exchange policies requires an institutional framework to be created to develop the stimuli for economic agents to invest, produce and generate employment, deepen the formation of markets to overcome their current imbalances and reduce the transaction costs involved in the formulation of public policies. The Annual Policy Agreement allows us to face the future with greater assurance to the extent that the economic entities involved are committed to developing their organizational capabilities for designing and pursuing their policies.

It is with this vision that we should face the significant and difficult challenges of 2003.

In an international context and specifically within our region, the basic feature is –as demonstrated by the Economic Commission for Latin America and the Caribbean (ECLAC)– that there has been a drop in economic activity estimated at 0.5% of GDP in 2002, which means that Latin America will round off a half-decade of growth loss.

The international economy and its frankly bad economic results are an unfavorable external context for our economies and societies specifically as regards the deteriorating financial conditions that resulted in a minus sign for the net transfer of external resources, added to the notably under par performance of the US economy for the second consecutive year and loss in the terms of trade with noticeable effects on non oil-producing or exporting nations in the region.

Another particularly important feature is the fact that our countries' economic policies have an increasingly diminished response capacity. As such, for most

Considering the adverse circumstances facing the country, solutions of an institutional nature may become fundamental instruments for economic recovery.

The Annual Economic Policy Agreement for 2003 allows us to face the future with greater assurance to the extent that the economic bodies involved are committed to the development of their organizational capabilities for designing and pursuing their policies.

of them, monetary policy had a minus sign to the extent that they had to concentrate on defending their currency in the face of exchange pressures. In this same regard, fiscal policy –for most of the nations– also contracted since the nations’ efforts were geared at public debt and at attempting to find a sustainable path for it. In the area of exchange policy, some countries got results by increasing the exchange rates to increase competition between major sectors.

It is true that there is a widening gap between expectations created by the economic model followed by our countries in the nineties and the prospects of achieving economic growth. The result has been exacerbated inequalities, environmental problems, and worsening conditions and quality of life for millions of Latin Americans as well as cultural deformation, this last having been considerably influenced by imposition of consumption patterns foreign to our idiosyncrasies and traditions.

The close relationship between economic and social affairs suggests a profound reflection in terms of how the meager performance of our countries’ economies can affect achievements in human development. In effect, a look at the figures of the Human Development Report, 2002, published annually by the United Nations Development Program (UNDP) reveals the effort made by most Latin American countries to meet acceptable levels of Human Development Indices (HDI). In the case of Venezuela, the HDI was 0.716 in 1975 and it moved up to 0.770 in 2000 as a result of substantial improvements in the related life expectancy indices, education and even in the Gross Domestic Product.

For the reasons indicated in the first few lines of this address and given the importance that we at Banco Central de Venezuela attribute to institutional affairs, emphasis is placed on the Institution’s activity framework, the transition in monetary policy and contribution to the international financial architecture as well as on acknowledging the work that went into consolidating the management model. In concluding, emphasis is placed on the challenges posed by the Annual Policy Agreement, which by constitutional mandate is signed for the first time between the Central Government represented by the Minister of Finance and Banco Central de Venezuela.

Via approval of the Constitution of the Bolivarian Republic of Venezuela, the Law for Financial Administration of the Public Sector and the Law of Banco Central de Venezuela, a new institutional framework has been created for the conceptualization, design, execution, and control of Venezuelan economic policy based on introducing the principles guiding the actions of policy executors. These include general principles, such as transparency and responsibility as well as the more specific principles that directly concern monetary authority including autonomy and coordination, all set out in a mandate to achieve price stability.

Introduction of these principles by the legislator is interpreted by the monetary authority as the ability granted to the State by a set of tools to promote development and well-being of the society through the entrenchment of macroeconomic policies that generate stability.

During the year, Banco Central de Venezuela has analyzed these legal principles so as to identify their repercussions on the organization's objectives and functions and to identify core issues revolving around the execution of monetary policy and consequently, its management environment.

Transparency relates to the obligation of policy makers to explain fully and clearly to society the purpose of their management as well as the activities directed towards meeting planned objectives. As such, society will be kept informed as to formulation and execution of economic policy and can participate in improvement of these policies.

A much discussed issue in the practice of transparency relates to determining its optimum point or level. Many countries accept different levels of transparency in execution of their policies and as such there does not seem to be a general formula for application. What is certain, is that exercising transparency requires a building process and is subject to deeper consideration of the extent to which institutions reinforce themselves and of consolidation of the learning process between information recipients and producers.

The legislator places responsibility close to the principle of transparency; responsibility is understood to be the obligation of public servants to be accountable to society for economic policy actions adopted in a specific time period whether directly or through their representatives in the National Assembly. On introducing this link between society and public policy managers, the latter's commitment increases according to the functions delegated to them by society.

Overall, transparency and responsibility guide the discussion of economic policy towards its more structural aspects and allow for an evaluation of accompanying situations with a medium-term perspective.

Autonomy or independence of the monetary authority is expressed fundamentally in two ways: by virtue of its responsibility to achieve price stability and in exercising this responsibility, it has autonomy in formulating and putting into practice the policies within its scope and would not therefore, be subordinated to directives of the Central Government.

The first component in the principle of independence tries to create the necessary stimuli so that in execution of monetary policy, the Banco Central authorities

The legislative framework leads to application of new principles in the execution of economic policies under the responsibility of the BCV.

The BCV's autonomy is complemented by the need for macroeconomic coordination and the Annual Policy Agreement is one of the ways to achieve this.

During 2002 the BCV had to adapt its organization, accelerate coordination, and redesign its economic policies.

are capable of facing the *quid pro quo* produced between the inflation rate expected by economic agents and the need to favor increased growth and economic development. The stimuli structure would appear to be created upon a law being established that sets forth a new responsibility in the sphere of its competencies, that is, once the inflation target has been set, the monetary authority would be obliged to account for any deviations that may occur. The second component requires Banco Central to comply with its functions by utilizing mainly the most rigorous criteria in order to ensure rational decisions in line with the functions attributed by law.

As a balance to autonomy, legislation introduces the need for coordination, which indicates that different economic policies and fiscal, monetary, and exchange policies in particular should be executed in a harmonized and consistent fashion. This reduces the possibility of the economic policy managers producing combinations that are not the most desirable from the point of view of social well-being since they respond to varying macroeconomic objectives.

The limitations on applying the remainder of the legal framework congruent with total policy coordination must be recognized, especially as regards the implementation of mechanisms that ensure the sustainability of public finance in the medium-term. The objective of leaning towards sustainable fiscal measures is propitiated by law through the creation of the Pluriannual Budget Framework, which in addition to imposing rules for management of the Central Government of maximum ordinary spending limits, debt and deficit, allow for planning of fiscal management in a medium-term timeframe. However, pursuant to the Law on Financial Administration of the Public Sector, the macro-fiscal rules of the Pluriannual Budget Framework will be indicative for the 2003-2004 period and binding only as from the following year. As such, it sets forth objective limits for the core purposes of the Annual Policy Agreement that will be in effect in 2003.

During the current year, Banco Central de Venezuela set itself significant challenges in different areas of activity that will be examined below.

Firstly, an evaluation was made as to whether its organization is sufficiently flexible to face the new tasks imposed by institutional change. The advances in coordination have been important, specifically as regards interpretation of the legal requirements. New processes were implemented aimed at flexible execution of monetary policy at the root of adopting a system for floating the exchange rate in February 2002.

In addition, communications policy has been transformed to generate a smoother relationship with the markets regarding the rationalizing of monetary policy decisions and the Institution's management model was improved to integrate its core activity processes.

An important area in the scope of macroeconomic policies under the responsibility of Banco Central de Venezuela is assessment of the system of exchange rate bands and the decision to abandon them in favor of the floating system, produced in the presence of a series of macroeconomic conditions that made these conditions unavoidable.

In effect, as of August 2001, the first stages of strong pressure on the exchange market became evident, and were reflected in an increase in the sale of foreign currency by the Bank and losses in the country's international reserves. These exchange rate pressures became increasingly frequent since the middle of December of that year. Also, an increase was observed, albeit small, in the consumption of imported goods and specifically non-perishable goods that caused a short-lived growth in the Gross Domestic Product. Both elements lead to the conclusion that economic agents accelerated the exhaustion of the band system and as such its necessary substitution.

Among the various possible alternatives to the band system, exchange rate flotation was presented as an alternative with the greatest benefits over the medium and long term. This would introduce an exchange system that would allow the Bank to have independence in implementing its monetary policy congruent with the legislative principle of autonomy of the monetary authority proposed in the new institutional framework. In addition, its implementation allowed for immediate correction of the nominal exchange rate within the dimensions required by the market.

The floating exchange rate was implemented through creation of the "highest-bid closed envelope auction" mechanism in order to generate an efficient assignment of foreign currency that the Institution was ready to sell to the market. Assignment efficiency was ensured on granting foreign currency to those agents that were willing to pay a higher price for them. However, despite flotation, distortions may still occur in the process of forming a price for this resource; for example, the currency price may be gathering risk premiums due to the lack of future markets and the little depth of the overall market.

The exchange rate flotation system gave the Institution the option of designing a monetary policy aimed at promoting price stability by setting forth inflation targets. Likewise, uncertainty in the markets whether from external shocks, the short fiscal policy planning horizon or from changes in other policies hampered decisions within the scope of monetary policy. These issues and others arose from the varied handling of information from different markets, which weakened the Bank's capacity for analysis and forecasting of general macroeconomic conditions.

Considering the limitations imposed by the macroeconomic environment, subsequent to exchange rate flotation the Institution announced and put into practice a flexible monetary strategy which, although it incorporates inflation targeting strategy elements on setting forth explicitly inflationary targets, also bases decision-making on a group of wider indicators such as inflation forecasts and monetary, exchange, and real indicators. With this strategy an attempt has been made to maximize the amount of information used to make monetary policy decisions, without outlining strict rules of action, such as for example, a monetary or exchange rule announced, and can respond flexibly to the changes

III / TOWARDS A TRANSITION IN MONETARY POLICY

Adoption of the floating exchange rate system has made market operations more transparent, while at the same time it is being refined.

The flexible monetary strategy allows for greater rationalization of the Institution's actions and is considered a transition towards the setting up of an target inflation system.

that may be produced in the macroeconomic environment, taking into account target inflation.

Therefore, as an important part of the flexible monetary strategy, the Institution's actions in the exchange market have been rationalized to making the basic supply of foreign currency through auctions and minimizing additional intervention. As such, exchange policy ceases to be the center of the Bank's actions and becomes one of various elements on which the flexible monetary strategy is based. Likewise, the operating mechanisms adopted are directed at guaranteeing that exchange rate movements reflect monetary and financial market conditions given that the agents are aware of the Bank's actions.

The flexible monetary strategy utilizes interest rates of absorption instruments and injection of funds, which the Bank uses as an instrumental variable. This variable on being directly under the control of the monetary authority is handled based on its expected effect on intermediate variables and on target inflation. This implies that movement in these interest rates also serves to reflect the purpose of the Institution's monetary policy at each moment, constituting a transparent operating mechanism for the markets.

The operating procedure for implementation of the flexible strategy is based on a Monthly Report on Monetary Policy presented to the corresponding committee and which tries to meet a consensus position on monetary policy options to be followed. Its recommendations are submitted to the Institution's Board of Directors for due approval and their decision is reported through a declaration and a Monetary Policy Act published on the electronic network site.

This practice, which represents a true learning process, has been followed regularly since the middle of the present year and contains essential elements for its own perfecting and qualitative adaptation to the country's characteristics, following the already generalized experience of the other central banks.

The interdependence of the world today determines the need for Banco Central de Venezuela to adapt its actions to the corresponding national and international scenarios. In the latter case, its participation involves contributing to the scope of the country's international objectives in those diverse events where world economic policy decisions may affect performance and efficiency of local institutions and policies.

**IV /
CONTRIBUTION
TO THE
INTERNATIONAL
FINANCIAL
ARCHITECTURE**

It is an opportune moment to reiterate that in this context, the process of economic globalization is still incomplete and, more often than not, its accompanying international policy agenda evidences significant imbalances in international relations. Consequently, it is with preoccupation we observe the frustrating economic growth, loss in productivity and increase in shared tension, a deepening of dissimilar institutional capabilities, efficiency levels, transparency and government with alleged universal rules that do not respond to the reality and priorities of developing nations who find themselves in an environment in which they have been forced to adapt rapidly to the changes brought about by market globalization.

Hence, it becomes necessary to drive reform of the international financial architecture promoting a wider network of regional institutions, in which the countries that have limited participation in international forums can find, in a complementary fashion, better conditions to become active participants with a view to modifying the current international environment.

In this context, the Institution's actions are registered in the constitutional provision which, in the area of the Republic's international relations, sets the standard for maintaining democracy in all international organizations and institutions. As such, the Bank has backed thought and actions linked to the international financial environment of strategic importance to Venezuela.

In line with advancing globalization, the Bank has had to deal with increasingly complex and profound issues such as liberalization of financial services markets, creation of free trade zones, monetary unions, regional monetary funds, macroeconomic stabilization programs, international bank supervision, etc.

The Bank's participation has been directed at strengthening regional organizations and regional integration plans. For example, it has supported the initiatives of the Latin American Reserve Fund (LARF), whose purpose is to provide financial assistance for stabilization programs in the face of disruptions and imbalances in the balance of payments and safeguarding the monetary and financial stability of the economies of its member countries, by virtue of being alternative and complementary to other organizations of a similar nature.

However, this international activity is not divorced from the national reality and implies a search for consensus and synergies that drive common positions between organizations that act together with the Institution in different international meetings. As such, Banco Central de Venezuela aspires to promote deep reflection on the identification of criteria, strengthening of initiatives, use of scale economies, greater focus on negotiation actions and capacity that contribute to a greater benefit both for Venezuela and the developing world.

The activity framework of Banco Central de Venezuela also conditions changes in the international environment.

Coordination between national institutions and organizations should be improved in order to progress with the Republic's integration objectives.

Achieving price stability and monitoring the integrity of the financial system in a new conceptualization of the Venezuelan State and in a scenario characterized predominantly by technology evidences the need to drive and promote a transformation process within the Institution.

In this regard, Banco Central de Venezuela has pursued the consolidation of a management model whose basic premises are explained below.

Firstly, directing the core areas in concentration of their efforts and resources to comply with the mandate of attaining price stability as part of the public policies aimed at favoring ordered development of the economy.

For this purpose, a research agenda has been proposed together with modern and sophisticated analytical, simulation, and forecasting tools. Modernization of payment systems has also been promoted as well as deeper analysis of risk management and establishment of bases to consolidate knowledge networks in matters related to the Bank's policy areas.

Secondly, aligning support areas with core areas contributes via specialization to validation of compliance with proposed objectives.

Consequently, priority is given to increasing productivity, intensive use of technology in process transformation, integration of decision-making systems and management of information and communications as a corporate resource, both within and outside the institution.

Next is coordination in the search for coherence and integrity in the Institution's administration and management. This aspect promotes rational use of resources, constant and continuing improvement of internal capabilities, result-based management evaluation, and transformation of institutional practices based on formal strategic decision-making.

Last is formalization to guarantee institutional functioning, legitimacy, and continuity. Here we can highlight the rules, regulations, and relations that guide the organization's operation, the methods of execution, timing, and mechanisms to make the effort to change a sustainable one and the practices or methods that demand the Bank face fundamental challenges.

Based on these premises, a management model was consolidated with a focus on change, which contemplates conceptual and organizational design criteria. Management supports itself on the construction of a culture centered around learning, adoption of institutional result-based management following clear rules of operation, principles of action, and interaction mechanisms that reinforce the Institution's capacity to maintain its autonomy, guarantee its sustainability and viability, and facilitate transparency and the disclosure of accounts.

In terms of organizational design, management should provide timely, quality answers and face the changes imposed by the environment that requires an organization to be flexible in its administration and functions and be process-designed, supported by exchange networks, high-performance equipment, integrated workstations and a technological platform to transform and make the operation of internal processes more efficient.

Institutional change has driven organizational change at the Bank in which cooperation and learning form an inherent part.

In the management model, priority is given to an increase in productivity, intensive use of technology in process transformation, integration of decision-making systems, and management of information and communications as a corporate tool both within and outside the institution.

Consequently, the combination of benchmarks, values, and individual behavior makes change in an organization not be conceptualized as a prearranged model, but rather as one that emerges, a product of circumstance and also facilitates organizational arrangements for leaders in each area to produce and foster the necessary transformation in a participatory fashion.

Consequently, Banco Central de Venezuela is positioned before Venezuelan society and the rest of the world as an organization of high credibility and prestige, whose actions are coherent and consistent with policies designed within the framework of its mission to ensure and maintain confidence of the citizenry and financial markets.

On referring to the exercising of autonomy by the monetary authority and its necessary link to coordination of economic policies, attention became focused on one of its concrete aspects which is the Annual Policy Agreement. This is conceptualized as a bilateral act between the Central Government and Banco Central de Venezuela, which sets forth the macroeconomic objectives to which each fiscal and monetary policy executor is committed (these are economic growth, inflation, and external balance).

As the Agreement is a new instrument, its preparation involves a learning process, in which there is a progressive adaptation between the capabilities of the authorities that execute economic policy and the competencies required for execution of the constitutional mandate. Note that in this context, other commitments of the Venezuelan state may be included that benefit from a strengthening of national government. These considerations should be present in interpreting the scope of the Agreement signed for 2003.

The Agreement allows for identification of another important set of challenges that Banco Central de Venezuela will have to face over the next few years. These will be directed at finalizing the monetary policy instruments for the basic good of the public, such as price stability for the Venezuelan economy, setting forth bases to increase the level of well-being of the society.

For this purpose, the Institution's efforts are directed at:

1. Securing progress in the area of coordination with other economy policy executors in order to provide consistent and sustainable policy adaptation. However, progress in this area may be limited if the rhythm of transformation in monetary authority is not accompanied by changes in the other institutions involved.
2. Pursuing evaluation of exchange rate market characteristics, specifically those that relate to the interrelationship between agents participating in this market and the way in which they make their decisions, in order to improve efficiency in the price formation process.
3. Promoting development of financial and monetary markets by introducing technological improvements so as to reduce transaction costs of participants and information imbalances and increasing the efficiency of these markets.
4. Finalizing the Bank's mechanisms for communication with the Venezuelan society to contribute to a greater level of transparency that allows dissemination and awareness of decisions adopted and an unruffled disclosure process.
5. Continuing to adapt the organizational structure derived from the new institutional reality to increase efficiency and effectiveness in compliance with the objectives and functions of Banco Central de Venezuela.

Within the above context, it is extremely important to continue working on the design, operation, and consolidation of the institutionalism needed to obtain macroeconomic stability, with the understanding that the institutional structure determines the results of public policies and that its pursuit is human growth and development.

Converting economic stability to a basic public good is a challenge that Banco Central de Venezuela must face in 2003.

One of the challenges of the BCV is to pass on the advances in coordination to the other economic policy executors in order to attain consistency and sustainability of the policies adopted.

It is extremely important to continue working on the design, operation, and consolidation of the institutional areas needed to obtain macroeconomic stability.

In complying with these responsibilities, Banco Central de Venezuela will contribute decisively as an important catalyst for institutional change in the country.

I vote for peace and harmony among all Venezuelans with absolute respect for the values of democracy and liberty enshrined in the Constitution.

Diego Luis Castellanos E.

Caracas, December 27, 2002