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***Public finances, The
Neverending Story:
higher income, higher
spending and vice versa.***

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Chaos in the fiscal figures

Before commenting on the fiscal figures, we would like to urge the Ministry of Finance and the Central Bank of Venezuela to reflect on the recent publications in which they attempt to clarify the fiscal figures. The numbers do not always agree between the two institutions or even internally. The recent publication of the Ministry's Annual Report reveals a poor capacity of analysis and offers different figures for the same items. Moreover, since the 2004 figures are not disclosed, no time comparison can be made. Worse still, the Central Bank figures contained in the report submitted to the National Assembly do not agree in value or methodology with those published in its latest weekly report.

The recent publications of the Central Bank and the Ministry are a simple reflection of the loss of budgetary institutions.

The main characteristics of the budgetary institutions in Venezuela are lack of transparency, confusion, inclusion of extraordinary sources of financing such as exchange gains and transfers from the international reserves, and the increase in quasi-fiscal expenditure. A series of funds have been created which weaken transparency, and several institutions execute expenditure in the same area. For example, instead of education

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expenditure being centralized in the ministry of the sector, it is dispersed between the central government, PDVSA, Fondespa, Fonden and Banded. Obviously with public finances managed in this way, it is much more difficult to maintain control and present accurate figures, which creates incentives for corruption. Despite these flaws, we are going to attempt to analyze the figures recently published by the Ministry.

Dramatic increase in oil and non-oil revenue

One of the most outstanding aspects of the 2005 figures is a surge in revenue. Stimulated by the oil price, oil revenue grew 3.7 points of GDP from 11.4 in 2004 to 15.1 in 2005. We have often commented that this revenue is not recurrent but depends on a variable that is outside the control of the Venezuelan authorities so expenditure should not be increased on the basis of this "windfall" revenue.

FISCAL BALANCE	% GDP		
	2005	2004	2003
Total Revenues	28,3%	22,7%	21,6%
Non-Oil Revenues	13,2%	11,3%	10,0%
Tax	7,2%	6,3%	4,8%
Income Tax	2,7%	2,1%	2,0%
Customs	1,5%	1,1%	0,8%
Debit Tax	1,0%	0,9%	1,5%
Others	0,8%	0,9%	1,0%
Oil Revenues	15,1%	11,4%	11,6%
Royalties	10,0%	8,4%	7,4%
Income Tax	4,1%	1,8%	1,5%
Dividend	1,0%	1,2%	2,8%
Total Expenditures	30,6%	26,3%	27,8%
Primary Expenditures	27,3%	22,8%	23,0%
Interest Payment	3,3%	3,5%	4,8%
Internal	1,4%	1,8%	2,8%
External	1,9%	1,7%	2,0%
Deficit (-) Surplus (+)	-2,2%	-3,6%	-6,2%
Primary Balance	1,1%	-0,1%	-1,4%
Non-Oil Balance	-17,3%	-15,0%	-17,8%
Total Amortization	4,4%	7,1%	12,8%
Amortization - Internal Debt	2,2%	3,3%	6,0%
Amortization - External Debt	2,2%	3,8%	6,9%
Financing Needs	6,6%	10,7%	19,0%
Extraordinary Income and Debts	10,9%	12,9%	21,9%
Net Treasury Bills	0,2%	0,1%	0,9%
Internal Debt	3,3%	6,3%	11,6%
External Debt	5,4%	5,4%	7,8%
Foreing Exchange Profits	1,9%	1,2%	1,7%
Assets Variations	4,3%	2,2%	2,9%

Source: BCV and MF

As a positive aspect, we have emphasized the rise in non-oil revenue.

Non-oil revenue, which has risen 1.9 points of GDP from 11.3 to 13.2 points, is more stable and recurrent than oil revenue so it is possible to base an expansionary expenditure policy on this. However, despite the spectacular increase, non-oil revenue only represents 46.7% of recurrent revenue.

The Neverending Story: more revenue, more spending

In Venezuela we seem condemned to fiscal indiscipline. In all the positive oil price shocks, we spend the windfall revenue and we even get into debt. Last year was no exception. The governments' primary spending increased 4.6 points of GDP from 22.8 points in 2004 to 27.2 points in 2005. If we add interest payments, total central government expenditure rises to 30.6 points of GDP.

Despite the highest oil revenue in Venezuelan history, the central government generated a deficit of 2.2 points of GDP in 2005.

Despite the higher oil prices, total revenue less total expenditure results in a government deficit of 2.2 points of GDP. The non-oil deficit, that is the fraction of expenditure that has to be financed by oil and borrowing, is even more troubling. In 2004, the non-oil deficit was 15.0 points of GDP or US\$16.50 billion. In 2005 this increased to 17.3 points of GDP or US\$21.26 billion.

The regime is loaded. Debt issues were 4.3 points of GDP higher than borrowing requirements.

One question that the Ministry has to answer is why the overborrowing? Why is the Republic borrowing above its requirements. In 2005 financing needs represented 6.6 points of GDP but debt was issued for 10.8 points of GDP, leaving the central government with 4.4 points of GDP of deposits in its account, earning interest at lower rates than the interest paid on the loans.

In conclusion, in times of high oil prices governments should be conservative and generate a surplus for times of low prices. In fiscal policy, the government is no different from any of its predecessors during the last 30 years.

Economic Tips

Based on the interpretation of the new Central Bank Law, the issuing authority will transfer an additional US\$4.20 billion to Fonden. The Central Bank defined the transfer timetable in three equal parts. The first handover will be in March, the second in April, and the last in May, all for US\$1.40 billion. *Ecoanalítica* totally disagrees with the use of the international reserves. We are concerned by the expansionary trend of money supply and the decline in the international reserves.

Unemployment in February. According to INE, the unemployment rate in February was 10.7%, a fall of 3.4 percentage points from the same period of 2005. The number of employed grew from 10.3 million in February 2004 to 10.7 million in February this year, a rise of 403,063 workers.

The labor force participation rate continues to fall. Last year, the economically active population (EPA) grew only 2,429. Given the population growth, the participation rate, defined as EPA, in the 15+ age group fell again, this time from 66.7% in February 2005 to 64.8% a year later. This unusual downward trend in the rate was due to the reclassification of members of the missions as inactive.

What would the figures be if the labor force participation rate had not fallen? An interesting exercise is to calculate what would have happened to the unemployment rate and the number of unemployed if the participation rate had remained constant. The results make us realize that the EPA should have grown 357,510 generating 720,416 new jobs. That is, the number of unemployed would increase by 317,353 and the unemployment rate would remain at the same level as February last year. *Ecoanalítica* is concerned by high economic growth without creation of jobs. In 2005, the economy grew 9.3%, but the number of employed increased a paltry 0.3%.

BANDES balance sheet. According to the information published by BANDES, assets held in trust totaled VEB15.2 trillion, down over VEB7.0 trillion. Most of the assets were transferred to the National Treasury Bank. The securities portfolio held by BANDES totaled VEB6.9 trillion with a loan portfolio of VEB1.7 trillion.

New tax. The Housing Ministry is planning a series of measures to regulate real estate prices, including a tax on unoccupied dwellings, according to the government, in a bid to stimulate the supply of property on the secondary market. So far, the ministry has not defined the rates or method of application.

Ecoanalítica believes the measure will be counterproductive because of its negative effect on investment in the sector.

Uruguay rewarded. The president of Uruguay visits Venezuela. During the visit, the government arranged to purchase a Uruguayan savings and loans cooperative, shares in the subsidiary of the Uruguayan oil company in Argentina, and the Pluna airline. Venezuela has invested over US\$37 million in Uruguay.

Oil Tips

Oil income tax changes go ahead. Energy and Oil Ministry Rafael Ramirez confirmed that the government would raise the income tax rate paid by the Orinoco Belt strategic associations from 34% to 50%. The increase will come into effect after the National Assembly passes the bill recently introduced by SENIAT. The change could affect production of around 600,000 barrels a day from the Orinoco Belt by Exxon Mobil, Chevron, Conoco Phillips, Total and Statoil together with PDVSA.

No decision yet on gas. On the plan to raise the income tax rate on natural gas producers, which currently pay 34%, Ramirez said that no decision had yet been taken. *Ecoanalítica* sources in PDVSA tell us that the rate will probably stay unchanged at 34%.

SENIAT returns to the attack. Last week SENIAT closed the Total and Eni oil companies for 48 hours on the grounds that the company's VAT records had not complied with some minor legal formalities. According to SENIAT, these measures have no relation to the tax deficiency assessment process.

Total and Eni reluctant. The French oil company Total has shown its displeasure at the 50% increase in the income tax rate. Seniat Special Taxpayer Manager José Joaquín Cedillo said: "The company has not accepted the application of the rate. We are giving them until next week to accept, otherwise precautionary measures and attachment could be applied." The tax deficiency totals VEB231 billion (US\$107.4 million). Cedillo said that Eni was in a similar situation.

Oil companies in tax arrears. Tax deficiency assessments total VEB1.4 trillion although Seniat has not yet issued the notices. The companies involved are BP and Suelopetrol. Chevron has already been notified that it owes VEB92.74 billion (US\$43 million) in back tax. The oil companies have to pay their debts to the tax administration before they can migrate to the joint ventures.

Smaller operating agreements. The report submitted by the Ministry of Energy and Oil to the National Assembly states that the areas originally granted "will be drastically reduced to the limits that are being effectively exploited or explored." According to the document, the average area granted under the agreements is 1,398 km² per block, whereas the Hydrocarbon Organic Law permits maximum lots of only 100 kilometers.

No to arbitration. Another important point in the report is that national courts have exclusive jurisdiction in dispute settlements, ruling out international arbitration. Also for reasons of sovereignty, joint ventures cannot compromise the State's right to regulate the rate of exploitation of the resource.

All power to PDVSA. As majority shareholder, PDVSA can approve all the work programs and annual budgets, as long as they are in accordance with the originally agreed business plan. In general, PDVSA will make all decisions whose approval does not specifically require a two-thirds majority. The minority shareholders may only participate in the decisions that require a two-thirds majority, such as amendments to the Articles or the initial business plan, mergers, liquidations or asset transfers, changes in dividend policy, amendment to the sales agreement, selection of external auditors, and waivers of substantive rights.

Changes to the royalty mechanism. The administration plans to amend Article 44 of the Hydrocarbon Organic Law, which establishes that the royalty rate can be lowered to 16.66% for certain types of exploitation. The idea is to raise the minimum rate to 20% and restrict its application to production of extra-heavy oil in the Orinoco Belt. The Executive has the power to restore this rate to 30%, which applies to the rest of production, if it is demonstrated that the productivity of the field can be maintained.

Sectoral Tips

Financial system results. In February bank lending expanded 1.1% from January to VEB37.3 trillion. Deposits in the system totaled VEB71.4 trillion, up 1.6%. One important aspect is the sharp 12.2% drop in the net result from the month before. In the month, the loan-to-deposit ratio of the financial system, including ceded investments, fell to 37.9%, down 0.6 percentage points from January.

EDC results. Electricidad de Caracas (EDC) reported a net profit of VEB168.18 billion (US\$78.2 million) in 2005 following a drastic cut in financing costs. In 2004, EDC's net profit was VEB13.23 billion (US\$7 million). This positive result was possible even though EDC has had to contend with out-of-date electricity tariffs, higher fuel prices and a new collective bargaining agreement.

Good financial management. EDC cut its net comprehensive financing cost by 97% compared with 2004 after early repayment of its foreign loans and application of lower rates to the bolivar-denominated debt. Financial debt fell to US\$399 million after repaying US\$84 million in loans from local banks, US\$285 million to bilaterals and commercial banks, and US\$12 million in commercial paper and unsecured debt instruments. EBITDA was VEB677.11 billion (US\$315 million), 9.0% lower than in 2004.

More money for co-management. In 2005 the national government granted finance of VEB113 billion to companies under co-management schemes, as detailed in the 2005 report of the Ministry for Popular Economy (MINEP). The main companies to benefit were Industria Venezolana Endógena Textil (Invetex) and Industria Venezolana Endógena de Válvulas (Inveval). The State holds 51% of the capital of these companies with the remaining 49% in the hands of workers and former owners.

More State. A court awarded the State 39.6% of the equity of Cement Andino and 60.4% to the former owners. The shares that the State now holds were held by the Argos company which acquired the interest in 1998. Cemento Andino supplies the Andean states (Táchira, Mérida and Trujillo) and Barinas. The Colombian Argos cement group, the fifth in Latin America, said it would appeal the decision.

Easy solutions. In an effort to open communication channels with the private construction sector to facilitate home building, the government declared another emergency in the national housing system to allow imports of inputs and expropriate land for building. This is a repeat of the measure taken in November 2005, only four months ago.

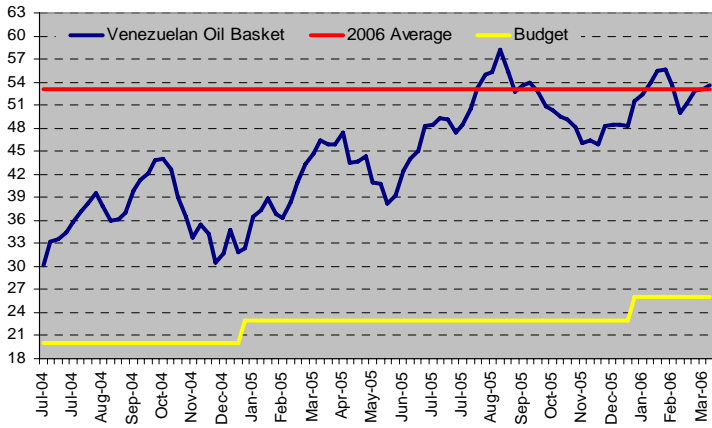
Food consumption rising. According to CAVIDEA, food consumption in January increased 7.5% from the same month last year. The reason is the improvement in purchasing power of Venezuelans. CAVIDEA said that sales of other items had also improved thanks to the higher share of private enterprise in Mercal.

Another Venezuelan bank in Florida. With an investment of US\$20 million BBU Bank began operations in Florida. The shareholders of the new financial institution (Juan Carlos Escotet, Luis Xavier Luján and Jorge Caraballo) opened their office in Coral Gables yesterday. The new bank will concentrate on mortgage, construction and consumer business.

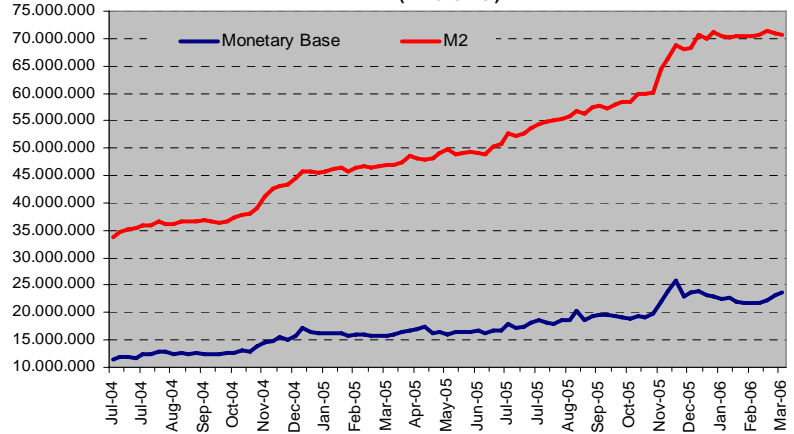
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ECONOMIC OVERVIEW

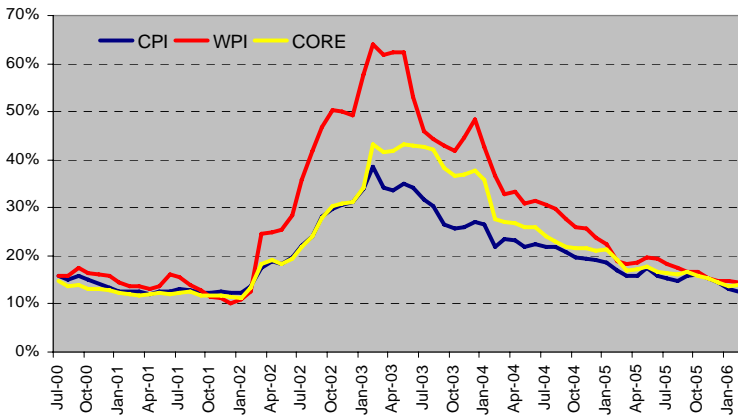
Oil Price
(Venezuelan Basket US\$pb)



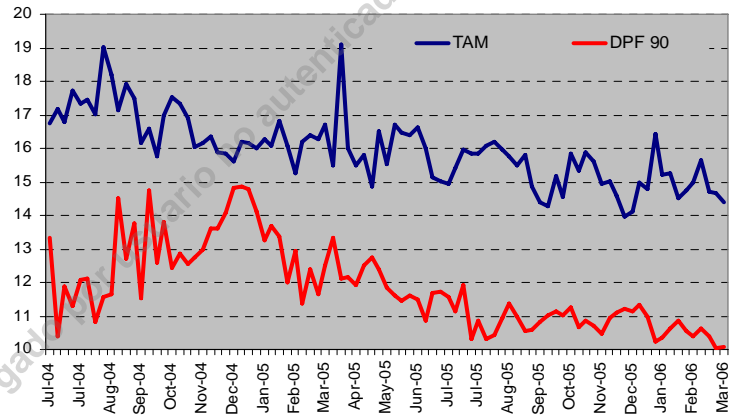
Monetary Base & M2
(Millions Bs.)



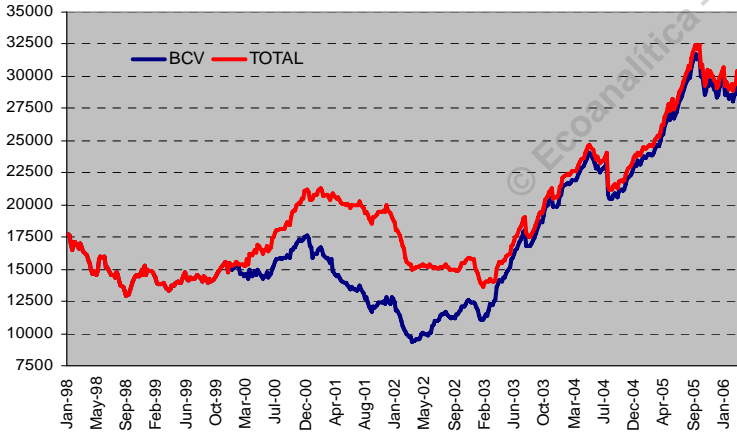
Inflation
(last 12 months)



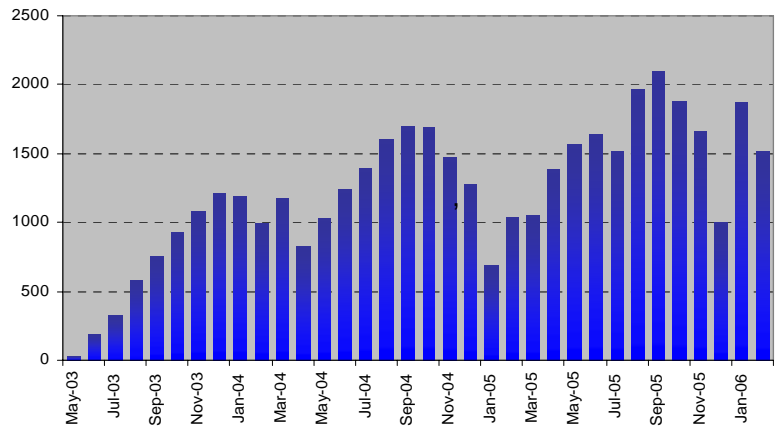
Interest Rate
(Six principal Banks)



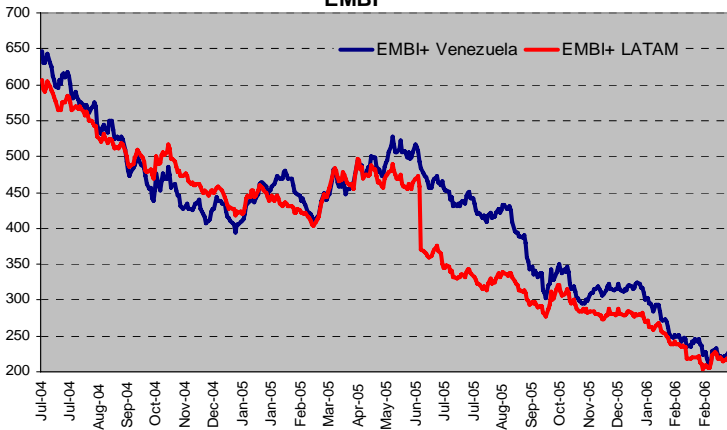
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(Billions US\$)

