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Redaction:
Alejandro Grisanti

Editors:
Gabriel Dobson

The problem is the transfer of reserves, not monetary policy

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THE CLIENT

The policy of transferring reserves which the executive has implemented, violating, as the Central Bank says, the tenth transitory provision of the Central Bank Partial Reform Law, is the real cause of the strong expansion of liquidity and the losses accumulated by the Bank during the first four months of this year. The losses have been swelled by the revenue lost by the decision not to devalue. For **Ecoanalítica** this policy will continue and in the end all Venezuelans will have to pay with a reduction in earnings. The short-term benefit is artificially low interest rates.

Strong expansion of liquidity

A strong expansion of fiscal expenditure, combined with the monetization of the international reserves and exchange controls which make it impossible to sterilize surplus funds with the purchase of the foreign currency, continue to push up liquidity levels. In week ended May 26, 2006, money supply expanded to VEB80.5 trillion, a 13.7% increase this year and 63.0% in the last 12 months.

Central Bank absorption operations skyrocket

The increase in liquidity would have been even greater if the Central Bank had not kept open the window for accepting deposits from the financial system on which the Central Bank pays 9.25% and 10.0% for operations at 14 and 28 days. These deposits, known as absorption operations, totaled on May 26 VEB33.2 trillion, a 9.5% increase so far this year and 300% in the last 12 months.

Decision not to devalue and the interest paid on deposits from the system has fuelled Central Bank losses

In the first four months of the year, the Central Bank accumulated losses of VEB305.09 billion. These losses are produced, first, by the loss of revenue from the decision not to devalue, and second by the higher cost of monetary policy generated by the expansion of absorption operations. For reference, 94.6% or VEB5.3 trillion of the VEB5.7 trillion that the Central Bank reported as total revenue in 2005 was attributable to foreign currency operations. And 65.9% or VEB1.9 trillion of the VEB2.8 trillion of Central Bank expenditure in 2005 was generated by monetary policy.

Finance Ministry help to cut cost of monetary policy is insignificant

The Central Bank reported that the Finance Ministry had paid its pending debts of VEB678.80 billion (US\$316 million). For the president of the monetary authority, the payment of this old claim will help relieve costs and reduce the Central Bank's high rate of losses. The government cleared the debt, which dates from a loan granted to the Republic in 1990, with fixed-interest bonds (TIF) maturing in 2011 and 2012. The funds will be used to absorb money from the market and cut back the placement of certificates of deposit. Despite the statements of intention by the Central Bank president, the amounts are clearly insufficient. The government repayment covers only 2.0% of absorption operations.

The main distortions are the exaggerated central government expenditure and the transfer of international reserves

Amidst this discussion, it is ironic that the published Central Bank balance sheet for the third quarter of 2005 still contains this note: "The balance sheet presents the effect of the tenth transitory provision of the Central Bank Partial Reform Law [...], whereby US\$6.00 billion must be transferred to Fonden once only." At this date, the Central Bank has transferred US\$10.22 billion and President Chávez is certain to ask for more. This policy has caused losses of VEB22.0 trillion to the Central Bank. Regardless of how they are spent, the transfer of reserves increases the bolivars in circulation and so the cost of

absorption operations. In this situation, interest rates will remain at artificially low levels.

Economic Tips

Spending boom. The March fiscal figures published by the Central Bank confirm the thesis of fiscal expansion as engine of growth. In March alone, public expenditure skyrocketed 93% from March 2005 to VEB11.2 trillion. In the first quarter of the year, expenditure expanded 50% in real terms, compared with the same quarter last year. In the same period, revenue increased 22%, discounting inflation.

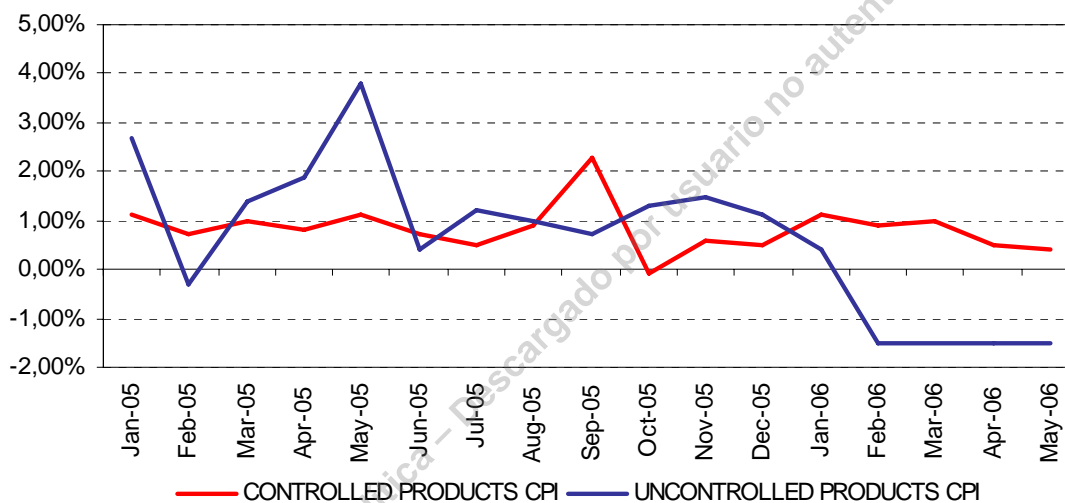
Public finances vulnerable. During the January-March period, the government generated a fiscal surplus of VEB858 billion, down from the surplus of VEB4.0 trillion in the same period last year. The non-oil fiscal deficit, which is the expenditure that oil has to finance, grew to VEB12.0 trillion, up from VEB7.2 trillion a year ago. The increase in the non-oil fiscal deficit simply shows that public finances are more dependent than ever on the international oil market.

| FISCAL BALANCE CENTRAL GOVERNMENT | Ene-Mar 06 | Ene-Mar 05 | Nominal |
|--------------------------------------|--------------|------------|---------|
| | Bs. Billions | | |
| Total Revenue | 25.039 | 18.274 | 37,0% |
| Non-Oil Revenue | 12.212 | 7.127 | 71,3% |
| Oil Revenue | 12.203 | 7.565 | 61,3% |
| Centrl Bank Earnings | 624 | 3.582 | -82,6% |
| Total Expenditure | 24.181 | 14.278 | 69,4% |
| Primary Expenditure | 22.915 | 12.505 | 83,3% |
| Interest Payments | 1.265 | 1.773 | |
| Domestic Debt | 858 | 1.327 | |
| Foreing Debt | 407 | 446 | |
| Quasifiscal Expenditure | - | - | |
| Fiscal Balance | 858 | 3.997 | |
| Primary Balance | 2.123 | 5.770 | |
| Non Oil Balance | (11.968) | (7.150) | |
| Debt Amortization | 3.251 | 1.103 | |
| Financing Requirements | 2.393 | (2.894) | |
| Foreing Debt | 100 | 28 | |
| Domestic Debt | - | 3.366 | |
| Tresury Bonds | - | 3.011 | |
| Tresury Debt | - | 355 | |
| Others | 2.292 | (6.289) | |

Source: BCV y Ecoanalítica

Inflation surge. The Consumer Price Index (CPI) jumped 1.6% in May, higher than in April (0.6%) but lower than in May 2005 (2.5%). The year-on-year inflation to May was 10.4% and in the January to May period 3.6%, lower than the same period last year (7.4%). According to the Central Bank, the inflation spurt is mainly due to hikes in the food and non-alcoholic beverages group, which gained 4.7%. For *Ecoanalítica*, the surge in inflation is associated with higher labor costs following the increase in the minimum wage, changes in labor regulations, and the entry into force of the labor clearance certificate.

CONTROLLED-UNCONTROLLED PRODUCTS CPI



Source: BCV and Ecoanalítica

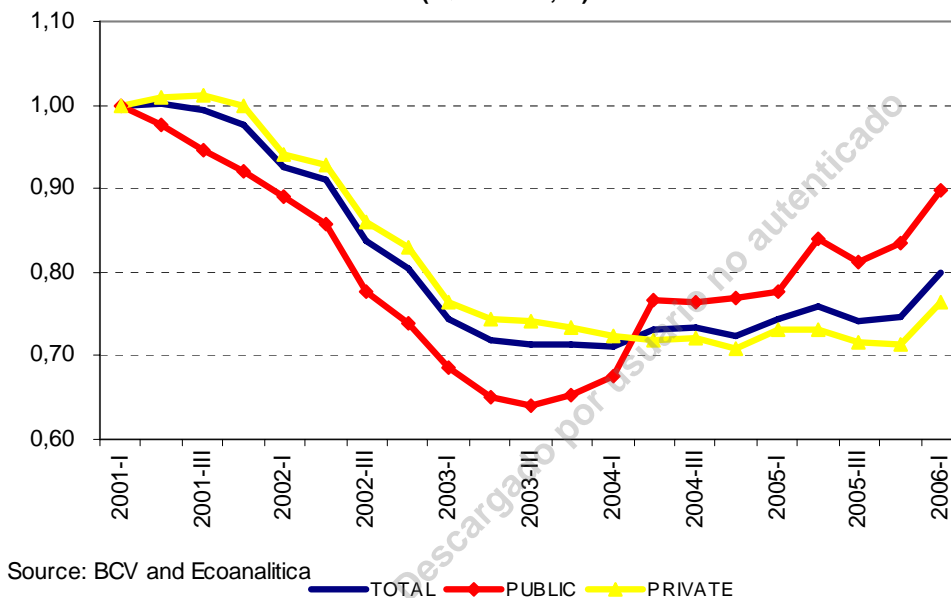
Non-controlled prices leap. The goods and services outside price controls leaped 2.8% while controlled products grew only 0.4%. Analysis by group reveals that, in addition to food and non-alcoholic beverages, prices in three more groups rose: household equipment (from 0.3% to 2.2%); clothing and footwear (4.4% to 1.0%); and transport (0.3% to 0.7%). These items are strongly correlated to private consumption which was affected by the seasonal impact of Mother's Day in May.

Wholesale price index follows trend. The wholesale price index gained 1.5% in May. The domestic component increased 1.8% compared with only 0.5% for imports. In the first five months of the year, WPI increased 5.3% and 10.0% in the last 12 months.

Public sector leads in pay. According to the Central Bank, the Wage-Earner Pay Index (IRE) gained 8.6% in the first quarter of 2006, higher than in the previous quarter (3.2%) and also above the same period of 2005 (6.1%). The gain stems from the

adjustment in public sector pay decreed on February 1, the 15% hike in the minimum wage, the 14.3% increase in the value of food tickets, and the adjustment of the tax unit. Public sector pay rose 9.1%, while the private sector grew slightly less at 8.3%.

Real Wages Index
(IQ-2001 = 1,00)



Real wages still below 2001. Evaluating the trend in the IRE compared with the CPI, the relative price between the two indicators shows that IRE has recovered 6.8 percentage points. However, this recovery has not offset past falls. In the last five years, real wages have lost 20% of their purchasing power.

Oil Tips

Venezuela loses. As expected, the extraordinary OPEC meeting in Caracas decided not to change the production quotas which have been at 28 million barrels a day since last July. Venezuela had insisted that a cut was necessary in current market conditions. This position was taken because Venezuelan oil production in recent years has fallen well below the OPEC quota. The real decision-maker on production is Saudi Arabia which produces 34% of OPEC supply.

Venezuela as long-term producer. Venezuela's oil reserves - the largest on the continent - are estimated at 77 billion barrels (MMMB) of conventional crude, almost 48% of the reserves of the Americas, and 6.5% of world reserves. This figure does not include the reserves of extra-heavy crude and bitumen of 236 MMMB in the Orinoco Belt. Adding these figures together, Venezuela possesses 22% of world reserves, sufficient to maintain current production for 317 years. On this basis, the strategy of the Venezuelan oil market should be a long-term effort to maintain stable and moderate prices so as not to create incentives for new sources of alternative energy; otherwise the country will be left with a good part of its oil in the subsoil.

OPEC could expand. According to sources in OPEC, three countries could be interesting interested in joining: Angola, Ecuador and Sudan.

Venezuelan oil price climbs. The Ministry of Energy and Oil reported that the Venezuelan oil basket rose US\$1.56 in the week to average US\$61.23 per barrel.

Productive associations. According to the Corporación Venezolana de Petróleo President Eulogio Del Pino, the four Orinoco belt strategic associations will pay US\$2.00 billion in dividends to Petróleos de Venezuela.

Joint venture budget ready. After outlining the business plans of the joint ventures, Del Pino said that the partners had agreed on an US\$800-million investment budget for the 21 companies formed on April 1, plus over US\$600 million of expenditure already in execution. PDVSA will contribute 63% (US\$882 million) of the total investment of US\$1.40 billion, and the private companies the rest.

How much do they produce? Del Pino, who is also a PDVSA director, said that production of the joint ventures averaged between 350,000 and 360,000 barrels a day. The seven fields that were returned to PDVSA (including Dación and Jusepin) were producing approximately 120,000 barrels which is added to PDVSA's own production. PDVSA forecasts that production from the joint ventures could increase by about 100,000 barrels in one year.

Tax claim issued to Statoil. Seniat issued a tax deficiency assessment for VEB3.50 billion (US\$1.6 million) to the Norwegian state oil company Statoil in relation to the income tax audit for the 2002 fiscal year. At this date tax deficiency notices have been issued to 19 companies for a total of VEB1.6 trillion (US\$744 million). By the end of April, operators had paid over VEB500 billion (US\$233 million) in partial payments.

Sectoral Tips

Commercial sector performs well. The Central Bank reports that sales increased 33% in the first two months of the year in relation to the same period last year. Wholesale sales climbed 26.9% and retail sales 35.9%.

Machinery and equipment lead the way. The sectors that grew most in the first two months were machinery and equipment with 62%, followed by household equipment 29%, and construction materials 25%.

Manufacturing picks up. In the first quarter of the year, private manufacturing industry grew 14.3% from the first quarter of last year. The sectors that performed best were: metal products with 77%, machinery and equipment 41%, plastic products 29%. The wood sector was the only one that shrank falling 27%. According to the Central Bank, these figures are under review since they relate to a sample of only 82.8%.

Food sector expanding. According to Food Minister Erika Farías, the government has earmarked this year VEB2.8 trillion for purchase of basic food products for distribution by the Mercal network. Farías added that 32% of the food distributed by Mercal is imported. The target is to distribute 6,000 tons of food a day.

CANTV negotiates with cable TV providers. CANTV is negotiating agreements with 11 cable TV companies which are interested in delivering their services to subscribers through the phone company's posts and underground ducts. Since 2001, nine operators have finalized agreements with the telephone company.

Insurance sector booming. In the first quarter of the year, the insurance sector grew 28.5% in real terms, according to the latest report from the Insurance Superintendency (SUDESEG). These very preliminary results reveal that total production of net premiums charged by the Venezuelan insurance market to March 2006 increased to VEB2.2 trillion, a 44% nominal growth rate since the same period last year.

New calculation for dollar home loans. The instructions for recalculating dollar loans granted for purchase of principal residence, which now have to be repaid in bolivars, is ready after a year and a half. The calculation must be based on the dollar rate at the date of the signing of the purchase option and not the date of the sale deed.

Weekly Report

Gaming tax ready. According to the Betting and Gaming Tax Bill, gambling activities will pay tax at rates between 20% and 40% on net monthly revenue. Lottery and horseracing will be taxed at 20%, and other gaming activities at 40%.

New INTI president. President Chávez named Juan Carlos Loya as president of the National Land Institute (INTI), attached to the Ministry of Agriculture and Land to replace Richard Vivas. Loya was vice minister of Popular Training in the Ministry of Popular Economy, and national coordinator of the Vuelvan Caras (unemployment subsidy) Mission.

Political Tips

Chavez safe. According to the latest Datanalisis poll, President Chávez continues to lead voter preferences for the presidential election next December with 58.2%. The opposition candidates together total 21.2% and undecided voters 19.9%. Since October last year, President Chávez has increased his voter intention by 11 percentage points. The poll based on 1,300 household interviews with a 2.7% sampling error was taken in the first week of April.

Candidates sign key agreement. The three main opposition candidates signed an historic agreement to present a unified option in the presidential elections. The agreement covers four aspects:

1. Registering a single candidate with the CNE. If this candidate is chosen by consensus should be selected before July 31, 2006. Primary elections, if held, would be between July 30 and August 6, 2006.
2. A national project for the short, medium and long term which transcends the December elections, including areas for urgent action: job creation, effective combating of crime, emergency home building program, improvement of medical services and quality of education, and crack down on corruption.
3. A joint position on the bottom line for participating in the presidential election in December this year, which includes elimination of fingerprint machines and electronic voter rolls, opening of boxes and counting of ballot papers, reliable professional audit of the voter roll and its clean up in a reasonable period, and publication of the voter roll with all the information established by the law.

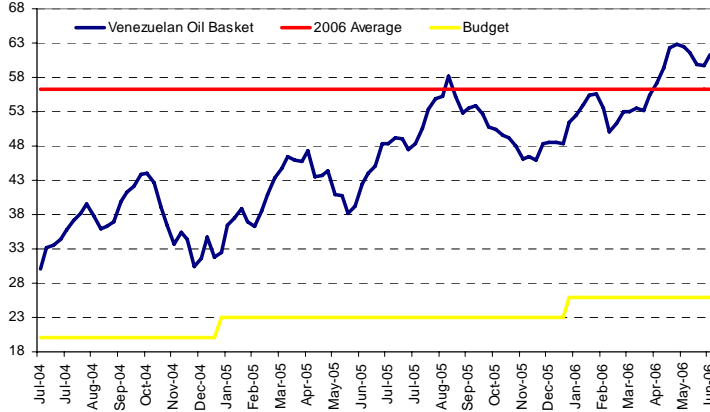
4. Formation of a single campaign team.

Voter roll audit further off than ever. So far it is unlikely that the audit of the voter roll will take place, at least on the original terms proposed by the country's three leading universities UCV, USB and UCAB, promoters of the project. The universities said that their proposal was technically incompatible with the proposal from the seven official educational institutions and IVIC. The UCV, USB and UCAB also suggested an audit in parallel with the one managed by the CNE. In the opinion of Ecoanalítica, the CNE is unlikely to accept this proposal and an audit without the presence of the three most prestigious universities would not be credible.

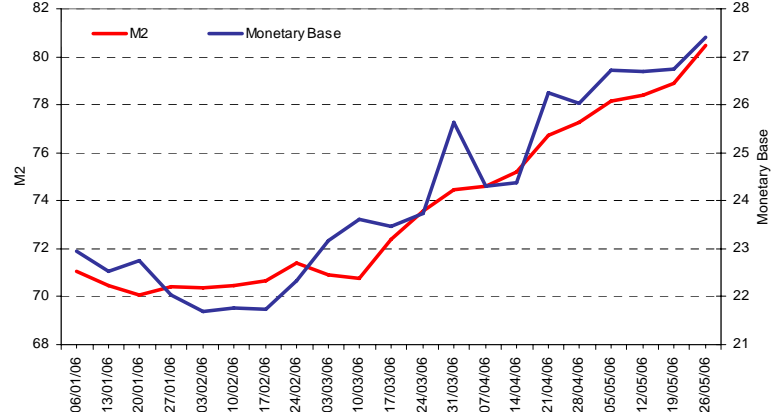
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ECONOMIC OVERVIEW

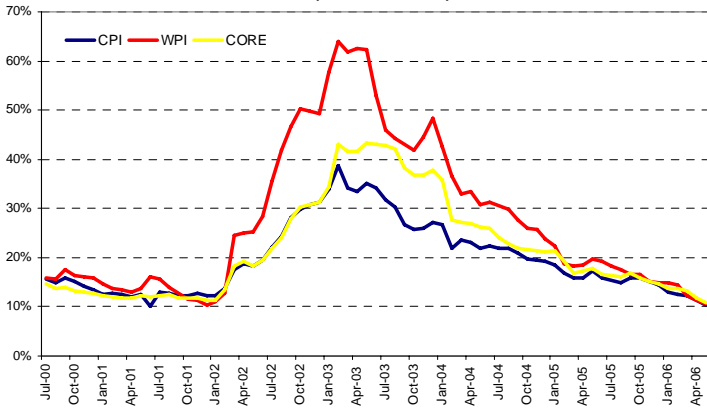
Oil Price
(Venezuelan Basket US\$/pb)



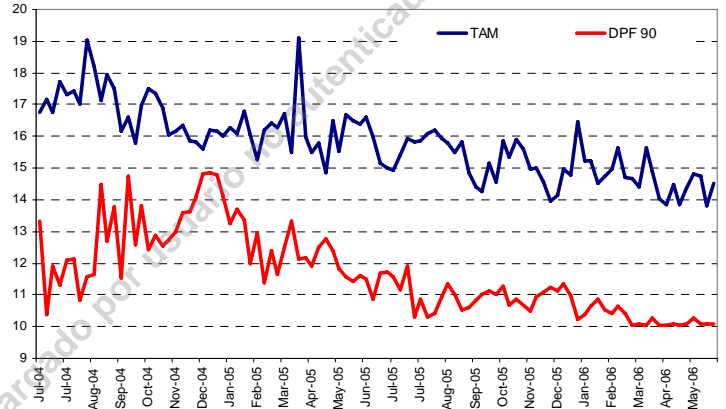
Monetary Base & M2
(VEB Billions)



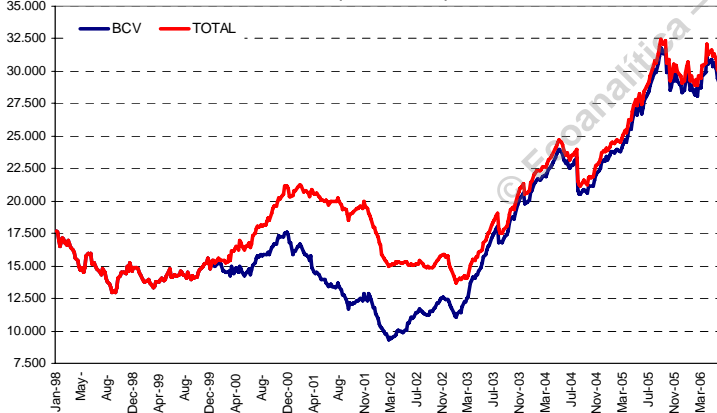
Inflation
(Last 12 Months)



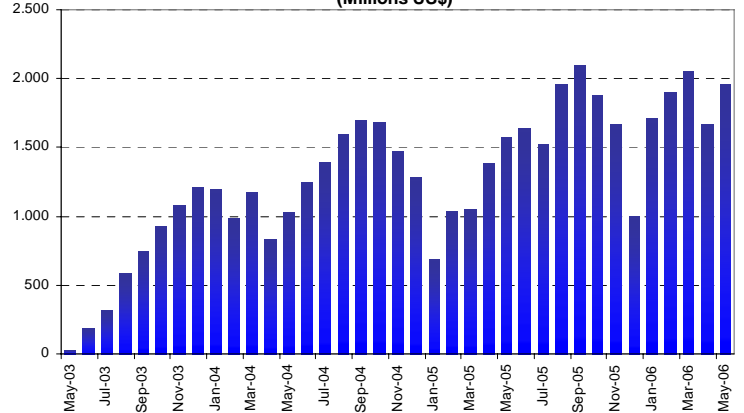
Interest Rate
(Six Principal Banks)



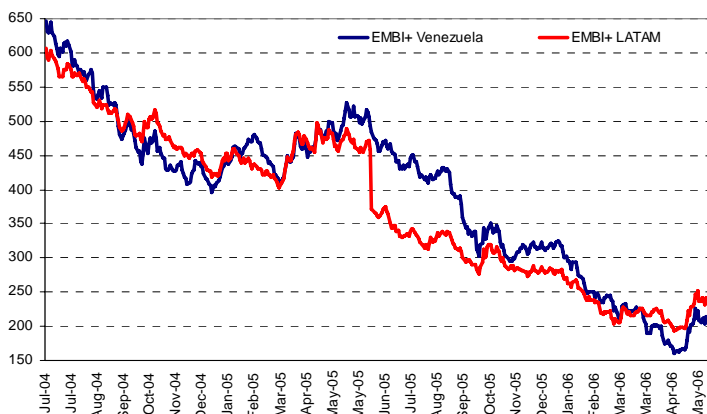
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(VEB Billions)

