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## ***ECONOMIC ACTIVITY INDICATORS SUGGEST HIGH LEVELS OF GROWTH FOR Q206***

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**THE CLIENT**

**The Venezuelan economy will grow for the tenth consecutive semester**

The BCV will be publishing second quarter economic growth figures within a few weeks, and with them the results for the first half of 2006. At **Ecoanalítica** we are sure that the Venezuelan economy will show a strong rate of economic growth, driven by the non-oil sectors, whilst oil-related activities will continue their tendency to stagnate.

**10% growth is forecast**

We calculate that the Venezuelan economy will grow at a year-on-year rate of 9.8% during the second quarter of 2006. By sectors, the non-oil-related activities sector will grow 12.2% year-on-year and the **non**-oil-related sector will show zero growth when compared with the second quarter of 2005.

**Public consumption and expenditure**

Q206 growth will come as no surprise to anyone, since it will continue to be buoyed by a fiscal expansionist policy and a boom in private consumption, resulting from an increase in the demand for credit, lower interest rates and CADIVI's efficient performance delivering foreign currency.

**Sustainable, thanks to the blessing of “black gold”**

The main factor behind all this has been the stellar performance of oil prices on international markets, which has allowed the Government on the one hand to use public expenditure as a political instrument to boost growth and internal added value, and on the other hand to keep the exchange control system in place.

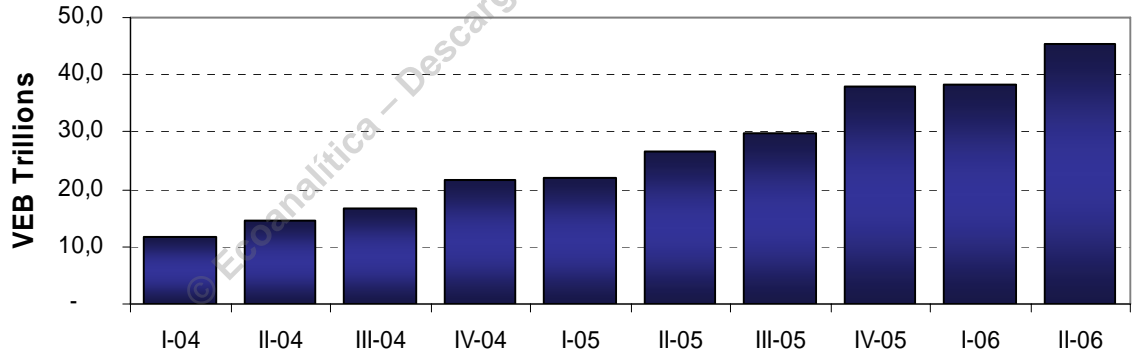
**Economic activity data ratify high growth**

Our economic growth projection is ratified by the economic activity numbers being generated by the different sectors, which are generally in line with an expansion in non-oil-related economic activity of upwards of 10%.

**Demand for credit explodes**

Net credit portfolios grew at a year-on-year pace of 70.5% when compared with 2005. Most growth is to be found in the areas of home mortgages, credit cards, micro-credits and vehicles. Thus the credit expansion has fuelled an expansion in construction, as well as an increase in retail volume (through credit card purchases) and car sales.

**Credit Portafolio**



Sources: SUDEBAN and Ecoanalítica

The increase in credit portfolios is not only tied to the expansion in internal demand but also to the drop in interest rates, with interest rate (TAM) falling 142 basic points between June 2005 and June this year.

**Most credit is short-term, however**

Credit growth is a good sign of energy in economic circles, given its multiplying factor. Nevertheless, most of the debt is short-term, which would indicate that the economic agents in the country perceive the

current bonanza as being somewhat vulnerable, ratifying the thesis that private investment is not as dynamic as consumption.

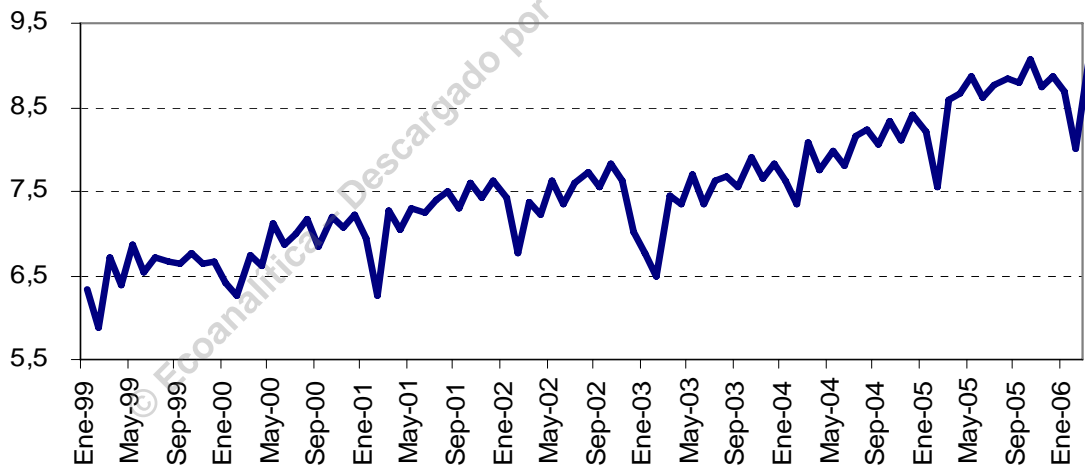
**Insurance sector also growing strongly**

At the close of May, insurance policy sales had grown 39.1% year-on-year, driven by car insurance policies.

**Electricity demand expands**

The behaviour of electricity generation and demand is another good indicator, due to its importance not only in the home but also in the industrial and commercial sectors. OPSIS figures show that accumulated electricity generation grew 6% for the January - May period, compared with the same period of 2005. Moreover, energy demand grew 7% in the same period. The Government estimates that electricity generation demand will grow 8% in 2006.

**Electricity Demand  
GWh**



Sources: OPSIS and Ecoanalítica

According to CAVENEIL statistics, national electricity consumption for the first five months of the year is 37.65% above that of the same 1999 period, brought about mainly by the development of infrastructure projects such as the construction of Line 4 of the Caracas Metro, which will connect the stations of Capuchinos and Zona Rental (Plaza Venezuela); construction of the Metro linking Caracas and Los Teques; construction of the Metros of Valencia and Maracaibo, and construction of the railway line linking Caracas and Valles del Tuy.

All these public works projects have pushed up demand for the electricity needed to drive the heavy machinery used in their development. Another factor that explains the increase in demand for electricity in Venezuela is the demographic expansion over the last 7 years, which has led to an increase in demand for electricity to power the different electrical appliances in the home, together with the technological and telecommunications expansion seen during the last 5 years.

It is important to highlight that this upswing in the electricity energy indicators is unusual, since Venezuela's electricity generation and demand figures have typically grown at rates no higher than 4%, even during periods of strong economic growth.

## Construction grows 25%

According to the President of the Venezuelan Construction Chamber (-CVC), Irwin PerretGentil, preliminary figures show that the industry grew at a 25% rate during the first half of 2006, compared with the same period for 2005. Note that construction grew 21% in the first quarter, against the same 2005 period. According to the CVC, the sector is investing amounts similar to those of 2001, i.e., around 5% of GDP. However, the Chamber points out that investments equivalent to 8% of GDP are needed to cover demand in this area.

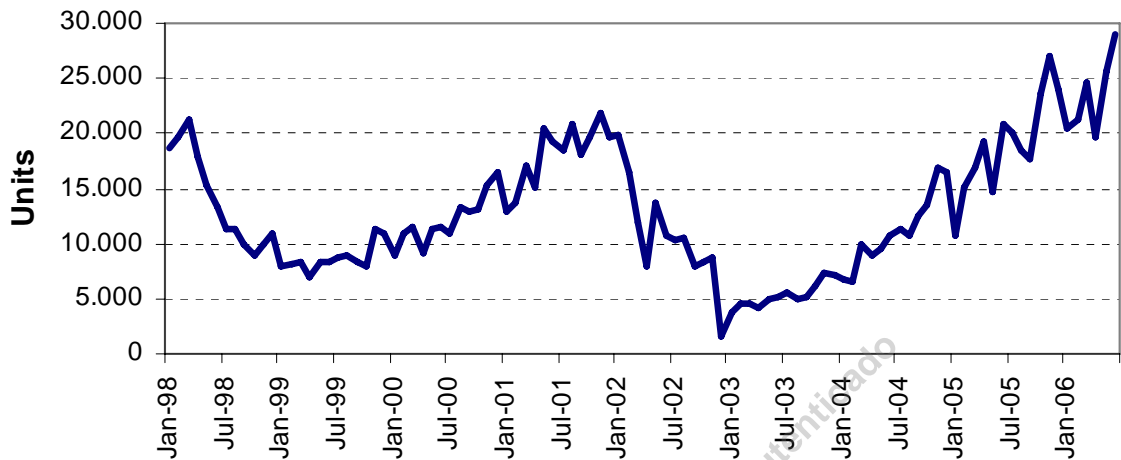
**Ecoanalítica** thinks that the construction industry will grow at an accelerated rate during the second half of the year, boosted by public works projects ahead of the election campaign, with the Government promising the initiation of 150 such projects.

## Cars for everyone

In Venezuela, the most significant sign of consumption growth and increase of purchasing power are the private sector new car sales. CAVENEZ data show that vehicle sales rose 44% during the first half, with 144,000 new cars leaving the showrooms. CAVENEZ projects 250,000 new car sales for 2006, but at **Ecoanalítica** we believe this is a conservative estimate, and that sales will in fact be closer to 280,000 vehicles, an increase of 23% over the 2005 total.

# Weekly Report

## Car Sales



Sources: Bloomberg and Ecoanalítica

### Consumption also grows in the home

Datanálisis reports that first half food consumption grew 10%, with an increase in practically all items. Apart from this, Venezuelans are not big savers and according to studies carried out, 63 out of every 100 Venezuelans are not prepared to put off their gratifications.

### Consumption growth impacts sales

The BCV reports that first quarter commercial sales were up 34.3% on the same period last year. Wholesale and retail businesses were, respectively, 35.9% and 33.6% up on 2005 for the same period. The BVC has not yet published figures for the second quarter, but **Ecoanalítica's** estimates indicate that sales grew 35% in the second quarter, with the leading areas being machinery and equipment, construction and hardware, food and beverage and textiles and footwear.

According to the Shopping Malls Chamb, department stores and large-format stores reported an overall 27% growth in sales during the second quarter of the year, compared with the same period of 2005.

### Telecommunications sector booming

CONATEL's preliminary figures indicate that the sector generated first quarter operating income in the order of US\$ 1.391 billion and private investment of US\$ 138 million, reflecting an increase of 72% with respect to the same period last year.

We expect that among telecommunications services, the mobile telephone area will show greatest growth in terms of subscribers, reaching a penetration for cell phones of 55%. Internet and subscription TV will be other areas of promising growth.

**Manufacturing is also growing but at a slower rate**

As opposed to the commercial sector, the BCV reports that growth in private sector manufacturing was only 8.2% in the first quarter, compared with the same period of 2005. Manufacturing is seriously affected by the real appreciation of the exchange rate. Best-performing sectors were: metallurgy (51%), machinery and equipment (41%) and clothing (24%). The only three sectors in decline were: the wood industry (-24%), chemicals (-2%) and vehicles (-2%). This dynamic will have continued during the second quarter.

The Planning and Development Minister, Jorge Giordani, also points out that growing economic activity levels have brought spare capacity levels of certain industries down to less than 10%. Moreover, he adds that according to INE statistics, overall capacity levels are up at around 88%, with 58% of companies working at full capacity.

**Taking seasonal factors into consideration, the economy will contract by 3.1% in Q206, compared with Q106**

The seasonal growth of economic activity allows us to have a more complete perspective of its evolution. Taking seasonal factors into account, our analysis shows that the Venezuelan economy will experience a slow-down in its growth rate in the second quarter, a conclusion drawn by comparing the economic activity performance of the second quarter with that of the first quarter of this same year. Using this methodology, we conclude that the overall economy will have declined by 3.1%, against a growth of 1.2% in the first quarter and of 3.7% in the fourth quarter of 2005. These numbers lead us to believe that it is becoming ever more difficult for the Government to use public expenditure to boost growth, considering also the limited capacity of oil prices.

If the Government wants to maintain high levels of growth, it must include the private sector and operate within a transparent legal framework where the rules of the game are respected, since it has been clearly demonstrated that the Government cannot, on its own, maintain the growth of an economy. If this dynamic is pursued, a moment will arrive when public expenditure is insufficient to maintain the whole State structure (old and new), whereupon, in order to attempt to respond to the ever greater demands of the population, the

excellent macroeconomic performance will collapse like a house of cards and Venezuela will not have achieved the much-desired path of stable and sustainable economic growth.

## Economic Tips

**Yet another regulation.** The BCV has decided to establish a 30% legal reserve over the increase in resources raised, as of the Banks' balances at July 14. It should be noted that deposits prior to such date are subject to a reserve withholding of 15%. The BCV pointed out that with this measure "the Institute seeks to avoid potential increases in the levels of liquidity over the rest of the year that would affect efforts to control inflation."

**The BCV cannot act alone.** In light of the current economic scenario, it was foreseeable that the BVC increase reserve levels. However, the control of liquidity and consequently, of inflation, has to be coordinated with the Executive in order to establish a better synchronized fiscal policy. If this does not begin to occur, it will be ever more difficult for the Monetary Authorities to establish mechanisms to control inflation.

**Rates unchanged.** Although the BCV communiqué leaves open the possibility of taking additional measures to control inflation, we do not envisage a short-term monetary policy measure to reduce benchmark rates that is tied to inflation's tendency to increase over the last few months.

**The party continues.** The Government will probably acquire a further US\$ 400 million of Argentine debt. Since Argentina has to cover important debt repayments this coming August 2, the Kirchner administration is counting on Venezuela to attend to part of their requirements. Moreover, according to the Argentine press, Venezuela is expected to acquire a further US\$ 2 billion in Argentine bonds. At **Ecoanalítica** we think that a proportion of this sum will be executed through the so-called "Southern Bonds" ("*Bonos del Sur*"). Since May 2005, Venezuela has purchased US\$ 3.3 billion in 2012 Bonds and 2015 Bonds.

**Bonanza or no bonanza, poverty seems to be unbeatable.** According to Matias Riutort, a UCAB investigator, poverty has grown and sometimes declined over the last ten years, showing clear signs of variation. If this behaviour continues during 2006, we can expect levels slightly lower than those of 1998. The poverty percentage at the

individual level for 2005 was 57% against the 65.7% registered for 2003. For families, the 2005 poverty level was 48%, against 60% in 2003.

**Without investment and employment there will be no reduction in poverty levels.** Riutort stated that the Government's expansive fiscal policy has not produced a significant effect either on employment or investment, mainly due to the uncertainty and instability of the political environment during recent years. The behaviour of variables such as inflation and unemployment may explain the growth of inequality in Venezuela over the last few years.

**The minimum salary is never enough.** Even though the minimum salary has increased in real terms, the percentage of workers receiving a salary that is lower than the minimum has been growing since 1999. Moreover, GDP *per capita* has not overcome, in real terms, the levels registered in 1998.

**Tax on matches eliminated.** The National Assembly announced in the Official Gazette that "the duty on the manufacture of matches is hereby eliminated." In a report recently submitted to Parliament, the SENIAT established that the tax had been eliminated because of the low levels of tax contributions and the fact the tax falls on national production.

**Estate tax too.** The SENIAT also decided to no longer charge estate tax, after determining that the tax is harmful and produces negligible income for the institution.

## Oil Tips

**Four weeks of rising prices.** The basket of Venezuelan crudes and derivatives finished up for the fourth week in a row at US\$64.83 per barrel, 47 cents higher than the previous week. The July average was US\$64.39 per barrel, the highest level so far this year, and the average so far in 2006 is US\$57.82 per barrel.

**New issue of PDVSA bonds.** According to its financial director, Eudomario Carruyo, PDVSA is looking into the possibility of issuing debt bonds in the European market, as part of its global financing strategy, both abroad and in the local market. As Carruyo explains, it is precisely the definition of this strategy which is holding up the issuing of about US\$ 3.5 billion in PDVSA bonds.

**Not only in the internal market.** At *Ecoanalítica* we think that PDVSA's debt issue will probably take two forms: one portion for the local market, using a scheme similar to the

Bolivar-Dollar bonds, and another portion through international banks (bilateral debt). We do not think that bonds will be issued on international markets, in view of PDVSA's situation before the SEC.

**Five down.** The CVP and US firm Chevron last week signed the conversion agreements for the joint-venture companies (*empresas mixtas*) Petroboscán and Petroindependiente. Petroboscán, in charge of production at the Boscán field in Zulia State, thus became the joint-venture with the highest production volume, with an average extraction of 115,000 barrels per day. Participation is divided as follows: CVP with a 60% shareholding; Chevron with 39.2% and the remaining 0.8% in the hands of the Venezuelan company Ineboscán. At Petroindependiente, production is 8,000 barrels of crude per day, with CVP's shareholding standing at 74.8% and the remainder in the hands of Chevron.

**PDVSA in Bolivia.** PDVSA is gearing up for exploration in the northern part of the department of La Paz, hoping to discover large quantities of oil and gas. Investment is put at US\$ 1.2 billion, which would represent one third of PDVSA's estimated investment in exploration and production in Venezuela this year.

**Argentina and Uruguay in the Orinoco Oil Belt.** PDVSA, Enarsa (Argentina) and Ancap (Uruguay) have signed an agreement to begin to quantify and certify crude reserves in the Ayacucho 6 Block of the Orinoco Oil Belt. PDVSA will have a 51% shareholding in the exploratory work, with the other companies dividing up the remainder.

## Sectoral Tips

**Another public offering.** As predicted by *Ecoanalítica*, La Electricidad de Caracas (EDC) launched a new public share offering on the local stock Exchange, following the success of the previous program, when the company managed to place all the 80,781,982 shares it was offering to investors. On this present occasion, it is offering 62,854,655 new shares, opening up an opportunity to a greater number of investors. The share price will be VEB 503.43, which was the price resulting from the previous program. Minimum investment is pegged at VEB 250,000. These shares may be subscribed to by the general public, whether individuals or companies, and whether or not they are domiciled in Venezuela. We view this as an attractive offer and therefore recommend it to our clients.

**Financial system results.** According to SUDEBAN, first half results for the banking system were very promising, when compared with the closing figures for 2005: an earnings increase of 23.23% and a growth in the credit portfolio of 18.97%.

**Regulations have negatively affected home rentals.** According to numbers provided by the Venezuelan Real Estate Chamber, rental operations have declined by 60% since tariff regulation began. For the year 2003, 30% of all contracts were for leasing and the remaining 70% were sales/purchase agreements, whereas only 10% of all current contracts are leasing agreements.

**Sony's prospects are excellent.** Sony calculates that its video camera sales will grow by 150% during the 2005-2006 period. The company has about 60% of the video camera market and 40% of the digital camera market.

## Political Tips

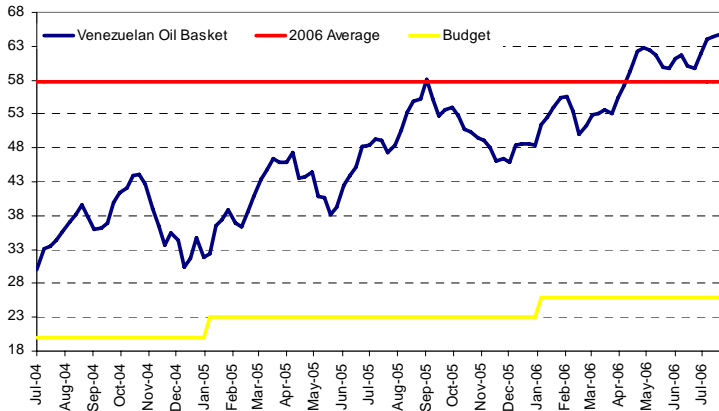
**A surprising discovery.** After digitally auditing the Electoral Role (the data taken from the CNE website up to May), technicians from USB, UCV and UCAB (universities), have certified that there are 170 municipalities in Venezuela with an excess of voting population (i.e., more voters than inhabitants), but were quick to point out that these inconsistencies do not appear to be related to the intention to vote in the upcoming presidential elections.

**Nevertheless, the errors increase.** The study also indicates that when comparing the defects of the 1998 Electoral Role with those detected in 2006, inconsistencies have multiplied in municipalities where errors had already existed. When analyzing the incidence of newly registered voters on the roles, they conclude that the errors are extreme in the majority of the municipalities of Zulia, Miranda, Lara and Portuguesa.

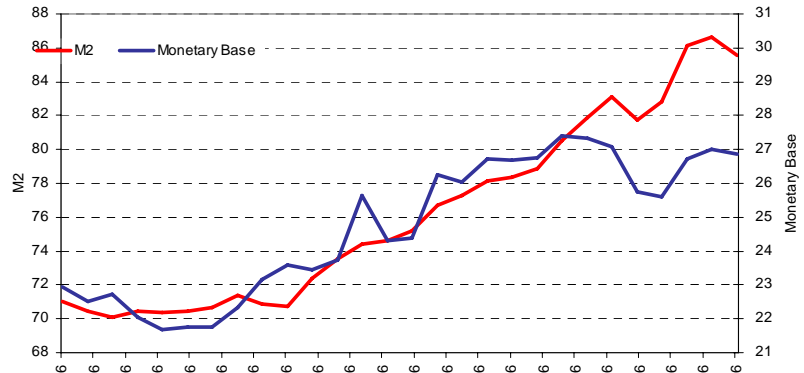
**No restrictions.** A ruling that is aimed at regulating the behaviour of the candidates ahead of the December 3 presidential elections, was distributed to the campaign headquarters of the candidates. The Project does not include specific restrictions over the "Aló, Presidente" program, nor does it impede the presence of the President at the inauguration of public works projects. Tibisay Lucena, President of the CNE, hopes that the candidates' suggestions will serve to perfect the regulations and is prepared to listen to and receive any pertinent observations. The regulations are expected to be approved at the end of this month or the beginning of August.

# ECONOMIC OVERVIEW

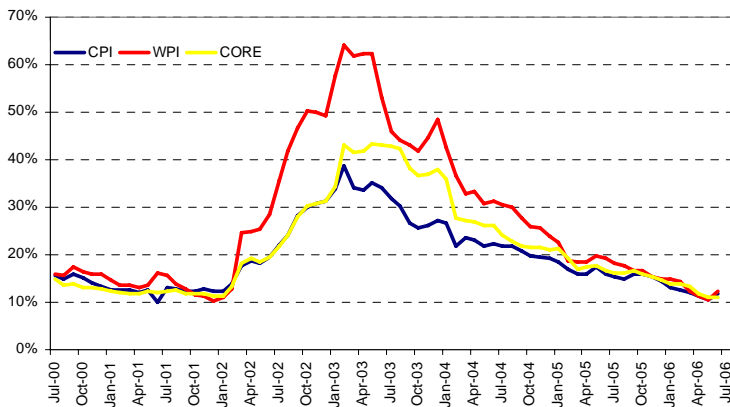
**Oil Price**  
(Venezuelan Basket US\$/pb)



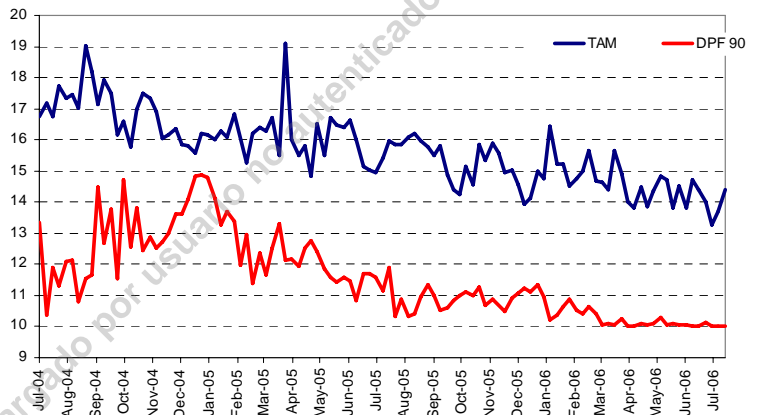
**Monetary Base & M2**  
(VEB Billions)



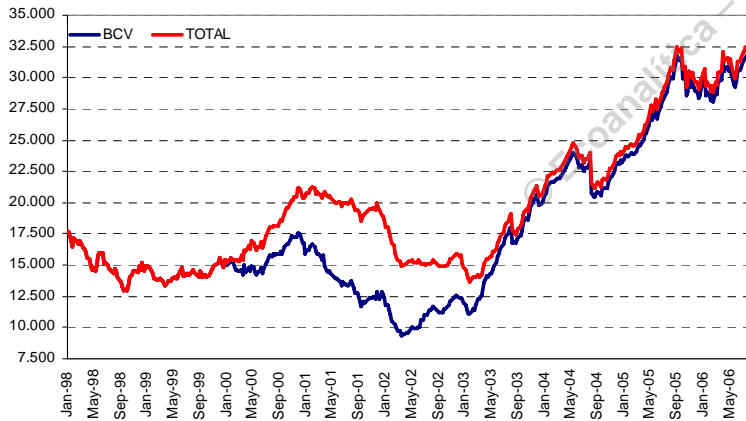
**Inflation**  
(Last 12 Months)



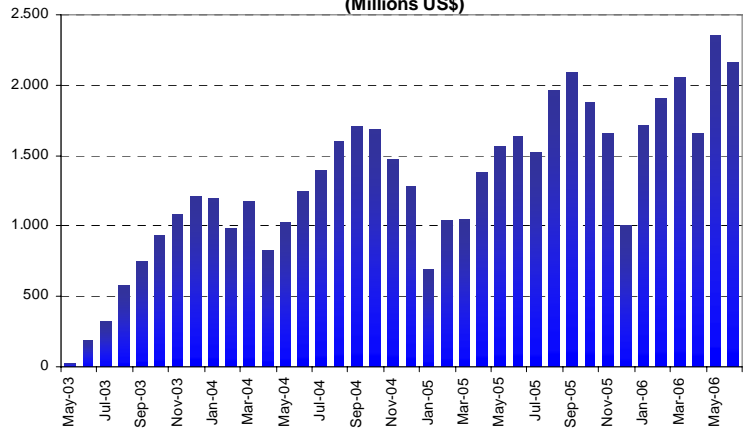
**Interest Rate**  
(Six Principal Banks)



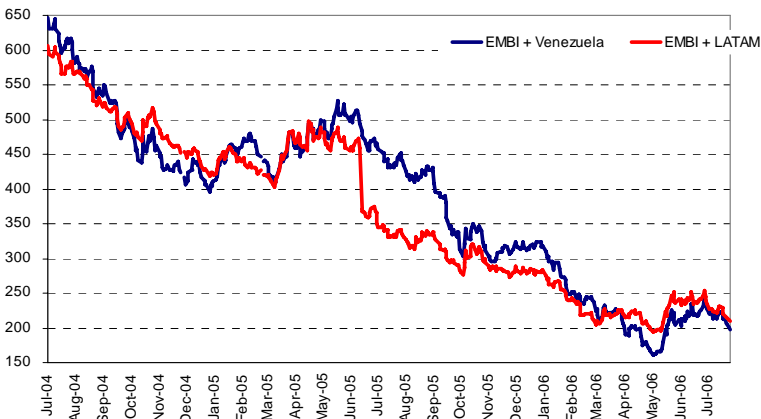
**Fx Reserves**  
(Millions US\$)



**Disbursement**  
(Millions US\$)



**EMBI**



**Central Government**  
(VEB Billions)

