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INCREASED MONEY SUPPLY PRESSURES INFLATION. THE DOWNSIDE OF THE SPENDING BINGE

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THE CLIENT

Explosive fiscal expansion, fueled by the Government ahead of elections, and financed partly by additional oil income, partly by the transfer of international reserves, and partly by exchange control earnings, is producing a significant increase in the money supply at source. So inflation, which is essentially a monetary phenomenon, will tend to rise over the next few months to close the year above the Government's 10% goal.

Public spending, year-on-year, rose a significant 104% in May

The Central Bank has published the May 2006 performance figures for the Central Government's administration of the public coffers. There are three salient points:

1. Total spending was up 104% on May last year, reaching VEB 10.1 trillion, with an increase in primary expenditure (i.e., not including debt servicing) of 118% for the same period.

Weekly Report

- Oil income actually went down 49% year-on-year, a surprising fact, given higher oil prices and relatively stable production.
- A sustained increase in non-oil revenue (reported by the tax agency SENIAT), with May this year up 40% on May 2005. Non-oil income is now almost double oil income.

The Government is spending more than it receives, in spite of the unprecedented oil bonanza

The Government's administration of its finances during the January - May period provides clear evidence for explaining the inflation rate increase over the last 3 months. Whilst its revenue rose year-on-year by 10% in real terms, its spending grew a hefty 58% in real terms.

Thus the fiscal deficit now stands at VEB 5.3 trillion, while last year at the same time the Republic was reporting a VEB 6.4 trillion surplus, and while the public finance figures have worsened, the Venezuelan oil basket has risen 37%.

FISCAL BALANCE							
(Billions of Bs)							
	May-06	May-05	Nominal	Jan-May 06	Jan-May 05	Nominal	Real
Total Revenue	5.235	5.727	-8,6%	38.312	31.167	22,9%	9,9%
Non-Oil Revenue	3.623	2.596	39,6%	19.952	12.934	54,3%	37,9%
Oil Revenue	1.612	3.131	-48,5%	17.736	14.652	21,1%	8,2%
Central Bank Earnings	-	-		624	3.582	-82,6%	-84,4%
Total Expenditure	10.146	4.982	103,7%	43.658	24.751	76,4%	57,7%
Primary Expenditure	9.712	4.466	117,5%	41.217	21.645	90,4%	70,2%
Interest Payments	434	516	-15,9%	2.441	3.106	-21,4%	-29,8%
Domestic Debt	298	303		1.536	2.045		
Foreing Debt	135	213		905	1.061		
Quasifiscal Expenditure	-	-		-	-		
Fiscal Balance	(4.911)	745		(5.346)	6.416		
Primary Balance	(4.477)	1.261		(2.905)	9.522		
Non Oil Balance	(6.522)	(2.386)		(23.705)	(11.817)		
Debt Amortization	414	348		4.657	2.221		
Net Monetary Injection	6.936	2.997		28.362	14.953		
Financing Requirements	5.325	(397)		10.002	(4.195)		
Foreing Debt	1	7		131	55		
Domestic Debt	-	959		-	4.835		
Tresury Bonds	-	886		-	4.407		
Tresury Debt	-	73		-	428		
Others	5.323	(1.363)		9.871	(9.085)		

Source: BCV and Ecoanalítica

Revenue accounts are becoming more vulnerable

We have now reached a situation where results for the non-oil account, which is the Government's main source for injecting money into the system, has passed from VEB 11.8 trillion to VEB 23.7 trillion. It is important to emphasize that this indicator measures the proportion of expenditure that is financed with revenue other than internal sources (non-oil), taking into account that internal revenue has no monetary effect.

Net amount of money injected into the system soars over the first 5 months

When analyzing the net injection of revenue - an indicator that is calculated by adding non-oil revenue to net amortization¹ - we see that in the first 5 months of this year it rose to VEB 28.4 trillion, against the VEB 15.0 trillion that was injected by the Central Government during the same period last year.

Expenditure grows over the last 3 months

However, the real fiscal growth has been felt since the month of March. In the first two months of this year, net monetary injection stood at an average of VEB 4.5 trillion, whilst the March - May average was VEB 6.4 trillion, an increase of 42%.

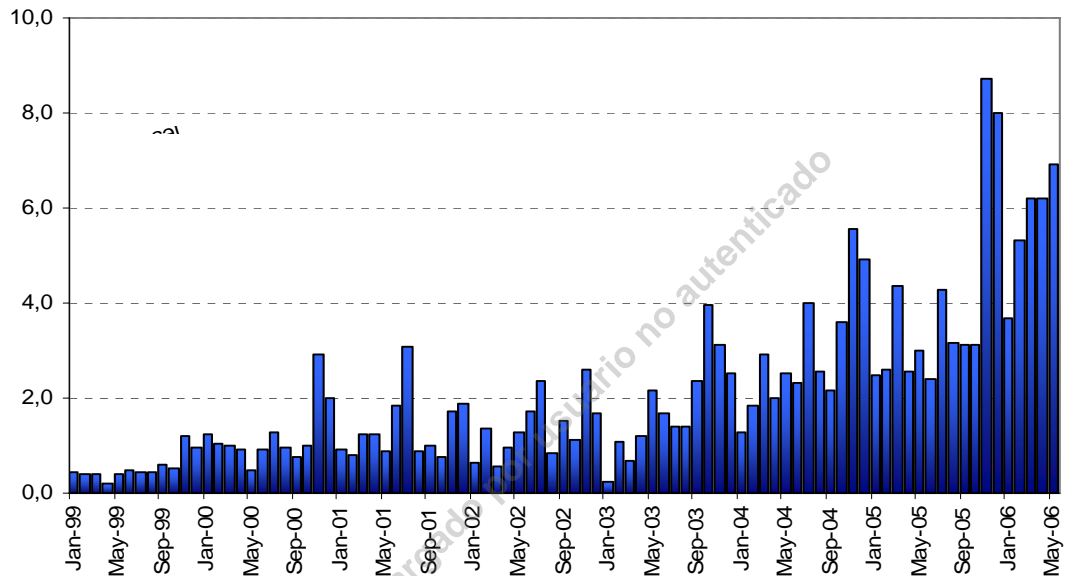
Government's 2006 force-feeding of the economy has tripled that of previous years

For the 1999 - 2005 period the average amount of money injected into the system each month was VEB 1.9 trillion. The average for the first 5 months of 2006 was VEB 5.6 trillion. Thus monetary injection for the year 2006 is three times greater than the average for the last 6 years.

Another striking fact is that as time passes, net monetary injection has been increasing. For the 1999 - 2002 period, average net monthly monetary injection was VEB 1.1 trillion. But the figure for the next period, 2003 - 2005, rose to a monthly average of VEB 2.9 trillion.

¹ Net amortization is defined as the differential between amortization and placement of public debt. If it is a positive number, it is defined as a public monetary injection.

**Net Monetary Injection
(Billions VEB)**



This panorama will continue to year's end

The BCV only has statistics available up to May. At **Ecoanalítica**, however, we estimate that the fiscal expenditure for June - July will average VEB 10 trillion per month. This upward tendency of public expenditure will continue throughout the second half of the year, given that Presidential elections are to take place at the end of the year. In fact, Government spending could move even higher still, to an average VEB 12 trillion per month. This way, total expenditure by the Central Government could reach VEB 130 trillion in 2006.

Inflation will likely close 2006 at 13.9%

Therefore inflation, which, as we mentioned above, is a monetary phenomenon, will be under growing pressure, as has in fact occurred already as of May this year. If there is no moderation of fiscal policies, inflation will continue to be the Achilles heel of the current administration, closing above the Government's estimate of 10%. At **Ecoanalítica** we have upped our estimate for inflation this year to 13.9% from an original figure of 9.8%.

Economic Tips

A BIG bond. According to sources at the Argentine Finance Ministry, the “Southern Bond” issue will be for a record US\$ 5 billion, that is, US\$ 3 billion more than was originally estimated. We believe this is a high number and that it does not correspond to the two countries’ financial needs. Nevertheless, the Government is probably already preparing several issues for the rest of 2006 and next year.

Maybe in 2008. The Finance Committee of the National Assembly (AN) is intent on introducing monetary reforms as early as the beginning of 2008, and has already submitted its position regarding changes in the system to the BCV. However, the Bank’s President, Gastón Parra, has indicated that the institution will take the time necessary to analyze the proposal and conclude the studies of the monetary reforms being carried out by BCV experts. In fact, the people at the Central Bank would like monetary reform to be debated next year, not this, which has an upcoming electoral campaign.

An innocent proposal. The Finance Commission is proposing that a law be passed to regulate “rounding off” (*redondeo*), and an instrument to regulate surpluses. The proposal is that excess oil revenue generated by royalties and Income Tax (ISLR) only be converted to legal tender at the BCV, when the Executive makes an expenditure through additional credits, or incorporates them into next year’s budget. What is not explained, however, is how the Government is to handle the public expenditure, nor how the funds are spent or distributed.

Oil Tips

A week on the rise. The Venezuelan oil basket closed last week at US\$ 64.37 per barrel. So far in August the national oil basket is at an accumulated average of US\$ 64,68 per barrel, which puts it at its highest level this year.

Agreements and more agreements. The latest Presidential trip netted 15 cooperation agreements in the energy sector. Most of them were with Russia, where 4 energy deals were signed to develop the Venezuelan gas and petrochemical sectors, as well as import agreements for potassium chloride, and the construction of 2 or 3 fertilizer plants.

The results for Iran were also notable, and 5 agreements were signed as follows: exploratory studies, training and coaching in oil and gas, technical evaluation of areas of the Orinoco oil belt (*Faja*) and incorporation of two joint-venture companies.

Now the S&P. The rating agency Standard & Poor's withdrew the B+ rating it had given the debt (both CP and LP), issued by the Petrozuata Strategic Association, which operates in the Faja. It should be noted that US\$ 287.2 million of the company's debt matures in 2009, US\$ 625 million in 2017 and US\$ 75 million in 2022. The agency has put the debt under observation with negative implications.

The regulatory framework weighs heavily. The justification for the above decision rests in the fact that the Government intends to apply higher taxes on excess production of crude and the unauthorized use of associated gas at Petrozuata, as well as an increase from 34% to 50% in the Income Tax rate; a raise in the royalty aliquot, and the fact that PDVSA is seeking a higher shareholding participation in the project.

Average US\$ 10.20 discount. An analysis carried out by ex-finance managers of PDVSA reveals that an average 262,000 barrels of oil and derivatives per day are being supplied this year to neighboring countries, at an implicit discount of US\$ 10.20 per barrel. They arrive at the discount by calculating the long-term financing cost and flexible conditions imposed on the beneficiary countries. The member-countries of Petro-Caribe are those most favored.

Sectoral Tips

EDC results for the second quarter. Electricidad de Caracas' Q206 operating income fell 0.8% year-on-year, mainly affected by the rate-hike delay. On the other hand, operating costs for the period were down 12.7% and EBITDA increased 11.5%. Net income for the second quarter was VEB 76 billion (US\$ 35.3 million), 16.7% above the figure for the same quarter last year. We believe the EDC's second-quarter results are positive and that this tendency will continue throughout the second half.

Significant debt reduction. At the close of June, EDC's financial debt stood at US\$ 359 million, a reduction of US\$ 183 million (33.8%) on the debt for June 2005. Average debt life is 6.3 years and has an average cost of 9.3% in foreign currency and 12.5% in local currency. The debt/equity relationship is now 22.6%.

Telecommunications penetration growing. *Tendencias Digitales* estimates that telecommunications penetration will have risen to between 65 and 70% by year's end, mainly thanks to a growth in the participation of lower social strata. It is calculated that 42% of the users of telecommunications services are from Class D, and more than 70% of users are under 34. According to studies, almost 2/3 of the users access internet through cybercafés and the latter's costs are only 37% of the world average, which is currently the equivalent of Bs. 3,255 per hour online.

Tax credit for CANTV. Gustavo Roosen, President of CANTV, has announced that tax credits for VEB 210 billion (US\$ 97.7 million) have been granted to the company. Roosen explained that the SENIAT extended the decree lowering taxes in new investments that were not quantified last year, and promised that the company's net income will increase, thanks to the lower tax burden over the remainder of the year, and that this will translate into better results for the third and fourth quarters of this year.

Pensioners protest. A group of CANTV retirees and pensioners has demanded that the Constitutional Chamber of the Supreme Tribunal of Justice (STJ) order the telephone company to immediately pay them the minimum salary. The ex-employees of CANTV allege that more than 70% of the retirees collect pensions that are below the minimum salary. It should be remembered that in recent months CANTV offered its ex-employees to abide by an agreement to receive the minimum salary, but the retirees warn that acceptance of the agreement is unnecessary since the company is obliged to homologate the pensions, due to the provisions of a court sentence handed down against it.

A strange twist. A group of retirees is not happy with the calculations made by the BCV of the amount to be paid by CANTV, and there are rumours afoot that the National Assembly is going to ask the Ministry of Finance and the SENIAT to take charge of once more determining the retroactive amounts. This would, in our opinion, be a negative step, since the BCV study was seen as being strictly technical.

Car sales head skywards. CAVENEZ reports that new car sales grew by 27.6% in July to 25,626 units. So far this year 166,142 cars have been sold, an increase of 41.21% on last year's similar period.

GM to invest US\$ 20 million. As part of its investment plan, GM Venezuela is to upgrade its plant by the tune of US\$ 20 million, according to Ronaldo Znidarsis, its CEO. This investment is part of an integrated plan that includes a third production shift at the assembly plant in the industrial zone of the capital of Carabobo State. The upgrade will translate into an additional daily capacity of 376 vehicles.

Weekly Report

Growth in the insurance sector. The Venezuelan insurance market grew by 43.7% in the first half of the year, recording net premium collections of VEB 4.5 trillion, according to data provided by the Insurance Superintendency (SUDESEG).

Hotel occupation rises. According to hotel and tourism sector spokespersons, hotel occupation has risen to its highest level since 1995. On average, hotel occupation at the most popular tourist destinations is around 80 - 82%, an increase of between 10 and 12% in respect of the 2005 holiday season.

Political Tips

Enabling an agreement. Presidential candidat Teodoro Petkoff withdrew his candidacy for the Presidency of the Republic, thus easing the way towards a sole candidature, and in light of the fact that he had not achieved significant popular support. The candidate had indicated that if the opposition presents itself divided for the December elections, not only would it be defeated but it would also encourage the tendency to abstain from voting, as well as general public apathy

Rosales is the candidat. Finally the majority groups of the opposition achieve an unitary agreement and Manuel Rosales reached; he will be the candidat opponent. This result was produced then that the CNE was deciding that Rosales does not need to resign to his position of Governor of Zulia (though a manager will have to stop). Additional, the appointment of Rosales leaves without effect the Sumate to primary elections. A positive fact is that a widely majority sector of the opposition (included other precandidates to primary) showed his support to this offer. It is probable that Julio Borges is the candidate for vice-president.

Let's see if it happens. The Vice President of the Electoral Commission (CNE), Janeth Hernández, guaranteed that before the beginning of the postulation period of candidates for the presidential elections, the rules governing the race would be clear. However, the CNE had previously promised the opposition candidates that such rules would be clarified by the end of July. So far still pending are the results of the audit, the postulation rules and the use of fingerprint reading.

No limits. The CNE approved the financing rules for the upcoming presidential elections. Although it did not cap campaign expenses, it established an "on-the-spot" audit mechanism that will allow technicians from the Political Participation and Finance Commission to carry out surprise audits of the candidates' accounts at any time during the campaign and as often as they deem necessary.

Weekly Report

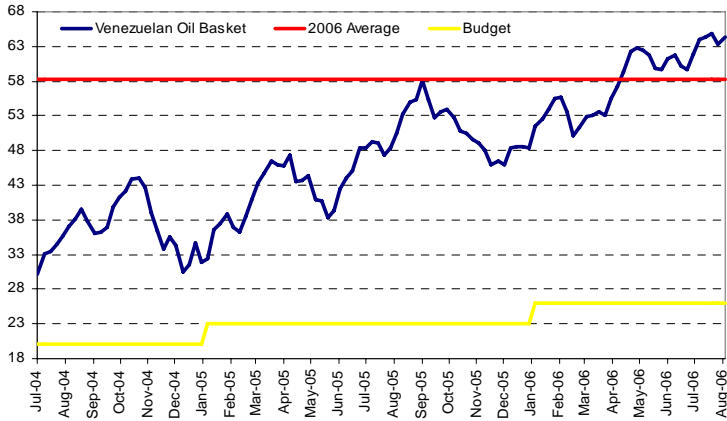
Changes in the Cabinet. Adán Chávez will no longer hold the post of Ambassador to Cuba, having taking over as Minister of the Presidency in place of Delcy Rodríguez. It is still not known who will be designated Ambassador to Cuba. Also, Nicolás Maduro was named like Chancellor, replacing Alí Rodríguez and Jose Khan like Minister of Basic Industries and Mining in substitution of Victor Alvarez. Probably the President makes changes in other ministries like Interior and Justice, Education, Labor and Food.

Nothing positive. In our opinion these changes are not positive, most of the appointments and the possible candidates have little experience in ministerial positions, in addition that reflect the most radical sector of the Government.

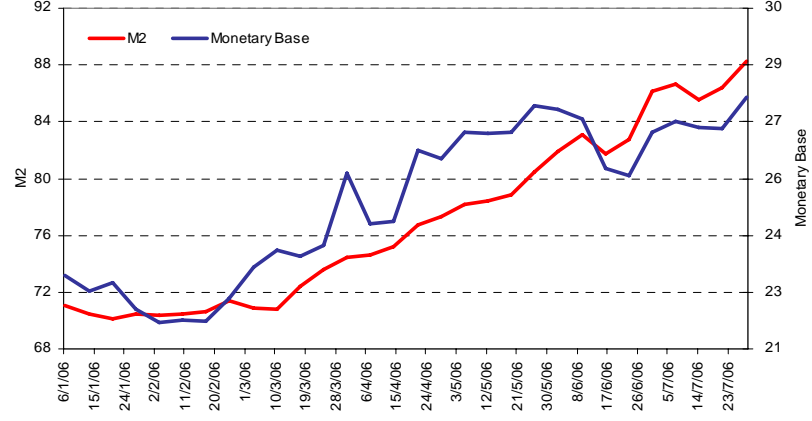
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ECONOMIC OVERVIEW

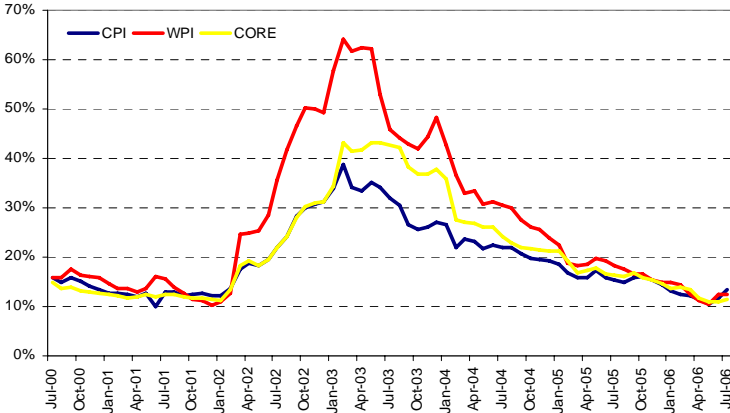
Oil Price
(Venezuelan Basket US\$/pb)



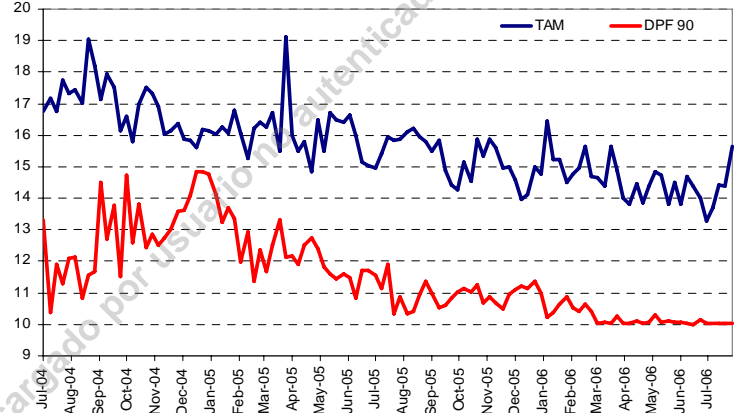
Monetary Base & M2
(VEB Billions)



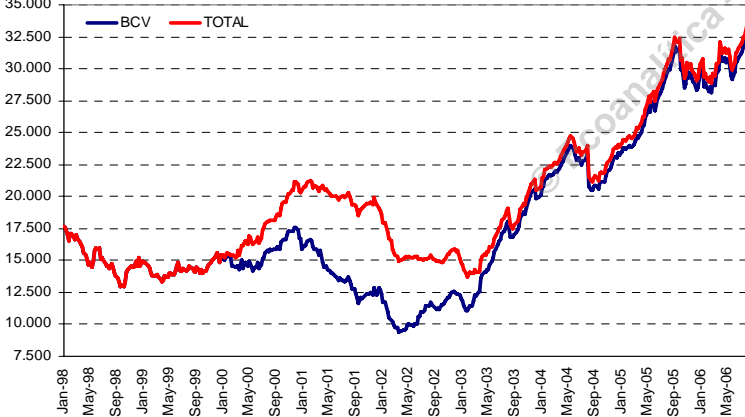
Inflation
(Last 12 Months)



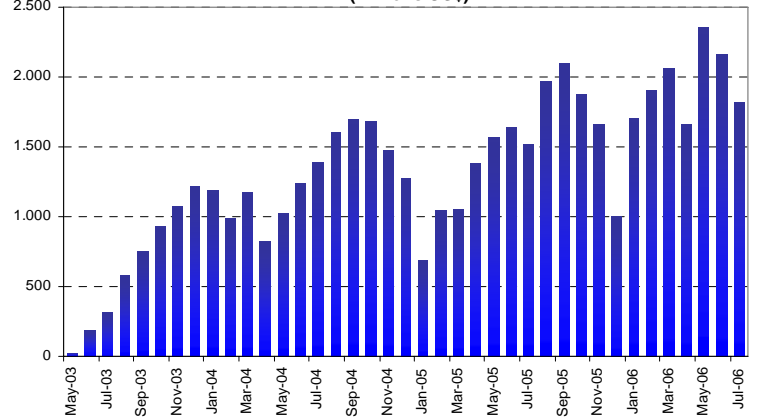
Interest Rate
(Six Principal Banks)



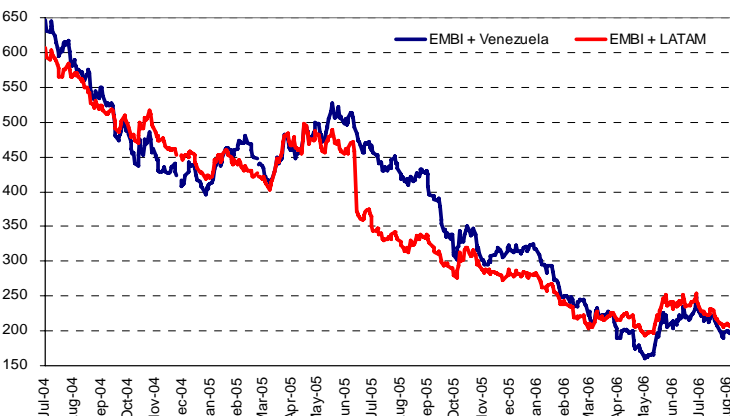
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(VEB Billions)

