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INFLATION IN THE EYE OF THE STORM

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THE CLIENT

Faced by the inflationary surge of the last three months, the Chavez administration has announced a set of measures to control inflation and possibly reduce it by the end of the year. However, the measures do not include any changes in fiscal and exchange policy, which are, in our opinion, the causes of the inflationary burst. In the short and medium term, inflation will stay on its upward course.

The government through its fiscal execution is the chief culprit

So far this year, the government has executed a clearly expansionary fiscal policy. Although public expenditure has soared since 1999, average monthly spending has risen significantly in 2006. Quasi-fiscal expenditure has also been rising, especially due to the execution of FUNDEN which is fed by surplus resources from PDVSA and transfers from international reserves.

Fiscal accounts highly vulnerable

The Ministry of Finance has just published the fiscal figures for the first half of the year which contain some relevant information for understanding the rise in the inflation rate over the last three months. First, the non-oil fiscal deficit, which is the main source of the monetary injection of public origin, rose from VEB13.4 trillion in the first half of 2005 to VEB28.3 trillion in the first half of this year. This indicator

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measures the proportion of expenditure financed by revenue of non-domestic (non-oil) origin, not forgetting that domestic revenue does not have a monetary effect.

Net monetary injection of fiscal origin is behind the inflationary surge

An analysis of the finance ministry figures shows that the net monetary injection of fiscal origin by the central government (non-oil fiscal result, excluding payment of external interest, plus net amortization) totaled VEB24.2 trillion in 1H06, while for the same period of last year, this indicator was only VEB15.5 trillion. Year-on-year, monetary injection of fiscal origin grew 56%, or 39% in real terms.

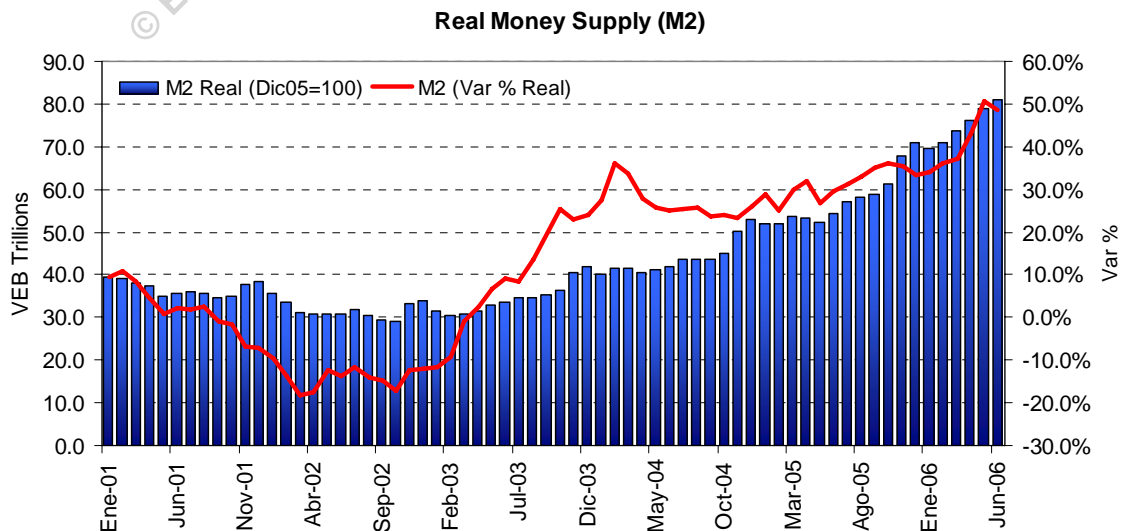
A clearly expansive fiscal policy will not help to dampen inflation

The upward trend in public expenditure will continue in the second half given the presidential elections in December. Following this trend, total expenditure could expand to VEB130 trillion in 2006.

Inflation, which is a monetary particular event, will be pressured up as has been happening since May. If fiscal policy does not moderate, rising prices will continue to be the administration's Achilles heel, ending the year at around 15%.

The other culprit is capital control

Money supply (M2) on August 18, 2006 had grown to VEB88.7 trillion, an 27.0% increase this year or 60.2% since the same date last year. Following the trend, high-powered money or monetary base expanded to VEB28.5 trillion, a 23.2% increase this year and 52.4% in the last 12 months.



Sources: BCV and Ecoanalítica

The causes of this expansion of money supply are, first, the impossibility of sterilizing surplus resources through the foreign exchange market because of exchange controls; second, the strong fiscal expansion; and third, the monetization of the international reserves.

Inflation is essentially a monetary particular event

The Central Bank has a limited degree of freedom for controlling inflation. Its absorption operations totaled over VEB40 trillion in early August and the reserve policy has not had the desired effect.

Now would be the best time to scrap capital controls. Considering the high cost of dismantling controls after they have become unsustainable, the government should act now

High oil prices, the strong position of the international reserves, the liquidity surpluses repressed in the Central Bank, low expectations of devaluation, and the spread between the parallel and official rates, which fluctuates between 18% and 25%, create optimal conditions for removing exchange controls with minimum negative effects. The Government has all the variables in its favor for dismantling exchange controls at a lower level even than the current parallel rate with no great impact on interest rates.

If fiscal indiscipline is not attacked, measures to control inflation will not work

However, to maintain a free exchange system in Venezuela, and a credible anti-inflation policy, strict fiscal discipline is fundamental. Unfortunately this is exactly what the government lacks.

Government on alert announces measures

In view of the spiraling inflation rate in the last quarter, the National Assembly Finance Committee has recommended a package of measures to control inflation and meet the new 12% official target (up from 10%).

Star role for CADIVI

First, they recommend that CADIVI again increase its levels of liquidation of foreign currency which fell in the last three months after the changes at the head of the agency, the entry into force of the labor clearance certificate, and restrictions on what are considered luxury imports. However, since the exchange subsidy is one of the most efficient mechanisms for controlling inflation, we expect CADIVI to liquidate an average of US\$85 million daily over the next few months. The FX agency is also expected to raise the dollar quota on credit cards from US\$4,000 to US\$6,000 annually.

The rise in imports is not sustainable

The spread between the official and parallel exchange rates acts as a subsidy for the import sector. Currently in Venezuela the parallel rate is around VEB2,700 per dollar. If an importer, as an economic agent, perceives that this is the market exchange rate but is able to purchase dollars at the official rate of VEB 2,150, he considers that the State has granted a subsidy of VEB550 per dollar. This "implicit subsidy" increases imports year after year until exchange controls become unsustainable.

VAT cut with null effect

Second, the government cut the value added tax rate by one percentage point, effective from October. We share the opinion of Central Bank director Domingo Maza Zavala: the expectations created by the decision to cut VAT must be viewed with caution, avoiding the error of thinking that it will drastically bring down inflation. In the best case, according to Maza, it could produce a 1% fall in the CPI which would end the year at 13%, minimum.

Additional measures

Third, the administration wants to regulate the flow of dollars between Treasury and state bodies by limiting the flow of funds so as not to generate great pressure on liquidity. A temporary reserve for public-sector deposits in the banking system has also been suggested.

Last week the Central Bank took two new monetary policy decisions. First, it increased the minimum rate for time deposits and savings accounts, and changed the rates paid on open-market operations. Maza said that these measures would contribute to reducing liquidity in the market, cut absorption costs and decrease inflationary pressure. However, he added that this would not solve the Bank's losses on absorption operations.

Why not go to the root of the problem. The recent announcements are only half measures

Control of inflation inevitably requires a change in fiscal policy that includes more control over execution of public expenditure, taking into account seasonal factors. The government also needs to control the flow of quasi-fiscal expenditure into the economy. Expenditure would not necessarily have to be cut but its quality has to improve by allocating a higher proportion of resources to productive investment and social development, and less to current spending.

Surplus funds can be used to reduce the debt even more

A proportion of the surplus funds could be used in a more aggressive foreign debt repurchase program, which would limit their monetary impact.

Excessive regulation of the financial system does not help

Controlling inflation is not only the Central Bank's responsibility but also involves the executive. It would be unfair if the anti-inflation measures fell exclusively on the financial system. We don't think it is prudent to increase the legal reserve. This measure has harmful effects on the system in general, and on small- and medium-sized banks in particular.

Controlling inflation or vote catching?

Lastly, some recommended measures, such as the increase in the dollar quota on credit cards and the VAT cut, have little impact on inflation, but could have an impact on the election.

Economic Tips

New monetary policy measures. The Central Bank took two new actions in the monetary area. First, it expanded the margin of application of interest on time deposits, fixing at 10% the minimum rate that banks pay on time deposits and ceded investments for all terms. The minimum rate for savings deposits and money market funds was set at 6.5%. As a result, "the minimum rates have now been delinked from the rate the Central Bank uses for its absorption operations."

Changes in absorption operations. The Central Bank held the rates of 10% and 9.25% for 28 and 14 day terms, respectively, for operations not exceeding the balance on September 7 this year, and fixed the rate for 28-day absorption operations at 6.5% on the portion of these operations that exceed each institution's balance on the date mentioned. The rate for 14-day terms is 6%. For absorption operations by State financial institutions, the rate will be 6.5% for 28 and 6.0% for 14 day terms, respectively, regardless of the balance on September 7.

Rates set to slide. The measures announced by the Central Bank mark a downward trend in interest rates, as well as discouraging time placements. For each marginal Bolivar that the banks place at 10%, they will have to assume a cost that could be up to seven percentage points (which would include the differential on absorption operations and the cost of transformation and reserve).

More flexible reserves. The Central Bank decided not to apply the marginal reserve established last July on institutions whose operations subject to reserve are less than VEB90 billion. The marginal reserve requires the banks to hold funds in the Central Bank equivalent to 30% of the change in their deposits since September 14 this year.

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This decision should benefit the new development banks and small- and medium-sized financial institutions.

New debt refinancing. The National Assembly Finance Committee approved the financial conditions for restructuring operations of (domestic and foreign) debt for VEB1.7 trillion (US \$791 million). The plan offers two options: first, refinancing the debt using the mechanism of restitution of investments through the Andean Development Corporation (CAF), or a bond issue.

It seems better to do this with CAF. At *Ecoanalítica* we believe that the Republic should opt for the CAF loan because the cost is on average less than the loans previously granted by that organization and the operation would not have a monetary impact at domestic level.

High level of foreign currency liquidation. The Foreign Currency Administration Commission (CADIVI) reports that the Central Bank liquidated US\$15.51 billion in the first eight months, bringing average daily liquidation to US \$93.4 million. However, in July and August the liquidation levels fell below the average at US\$81 million a day and US\$87 million a day, respectively.

Job freeze extended. Labor Minister Ricardo Dorado announced that the job freeze would continue for the coming months, although he did not specify for how long the measure would be extended. The current decree, which expires on September 30, had duration of six months. The government has extended the freeze without interruption since 2002.

Oil Tips

Lowest level for five months. The Venezuelan oil basket fell US\$2.43 last week to US\$57.75 per barrel, the lowest level for five months. This year the Venezuelan basket has averaged US\$58.71 per barrel.

Prices could go on falling. According to former PDVSA President Luis Giusti, a fall in oil prices is on the horizon because of the situation on the world market where global inventories are at their highest level for the last eight years - for example, in the United States, product inventories are 10% above normal for this period the year, along with slack demand. According to Giusti, the market should prepare for slightly lower prices in the medium term.

OPEC maintains supply. As expected, OPEC will maintain its crude production at 20 million b/d despite the 16% fall in crude prices since mid-July. The organization could decide in the near future on a production cut if prices continue to fall. OPEC last cut production in April 2004.

New back tax claims on oil companies. SENIAT continued its inspection of the income tax returns of oil companies. In a statement, SENIAT said that a total of five companies were notified of unpaid back tax totaling over VBO33 billion (US\$15.3 million). The companies involved are CNPC America, Teikoku Oil de Sanviguere and Perenco for income tax differences in 2005, and Statoil, Sincor and PDVSA for the 2001 return.

Sectoral Tips

Economic freedom on the decline. Venezuela has fallen far behind in its economic freedom score (down 23 places from the last report), according to the Economic Freedom of the World: 2006 Annual Report published by the US Cato Institute and the Canadian Fraser Institute. The report analyzes 130 countries and compares their current performance with 2004. Venezuela is rated at 126, above the Democratic Republic of the Congo, Republic of the Congo, Myanmar and Zimbabwe. The study analyzes variables such as personal freedom, voluntary trade, freedom of competition, and security of private property.

Not easy to do business in Venezuela. According to the Doing Business 2007 Report prepared by the World Bank and the International Financial Corporation, Venezuela is at the tail end of the countries of the region with respect to facilities for business development. According to the study, between 2005 and 2006, paperwork for doing business in Latin America has been simplified; however Venezuela and Bolivia were at the bottom of the list of nations in the region that cut the time, cost and bureaucratic red tape for companies. Venezuela, at position 164, is ranked even lower than Libya at 131, out of the 175 economies analyzed.

Bank of the Treasury expands. According to official sources, a plan to expand and strengthen the Bank of the Treasury includes 70 new agencies by the end of 2007, 30 of which will be opened before the end of this year.

CAF places bond issue. CAF placed a US\$250-million issue on the US market. The placement matures in 2070.

Weekly Report

Vehicle sales rising. Automobile sales in August grew 74.4% from August 2005, the highest monthly sales volume this year. During the month 32,336 units were sold. So far this year, vehicle sale have increased 45.7% from the same period last year.

Mortgage portfolio to be expanded. The government is studying the possibility of securitizing the 3% of the fixed mortgage portfolio, which has been used for long-term finance, so that banks without mortgage business will have the instruments needed to meet the obligation, and those that have more experience in this field will have more resources for loans. Changes in the percentages of the compulsory credit quota (gavetas) were ruled out. These remain at 7% for loans to construction companies and 3% for individuals.

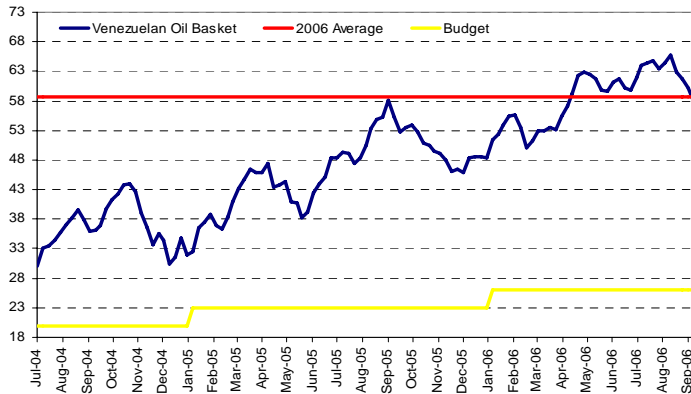
Political Tips

Fingerprint machines to be audited. The National Electoral Council (CNE) will allow an audit of the fingerprint machines and an exhaustive analysis of the biometric comparison of the voter platform. However, it is not yet known if the audit will reveal details of the place where the fingerprint machines transmit the information collected.

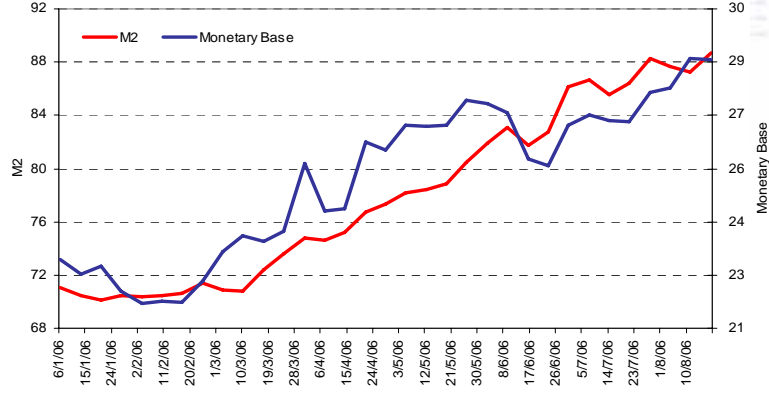
More audits. In addition to the audit of the fingerprint machines, the CNE also plans to validate and certify the data contained in the equipment manufactured by Smartmatic (voting machines), check the source code, follow-up and control the listing of the machines, and verify the program signature. The CNE also agreed with the election experts of the presidential candidates to allow a study of the software of the voter authentication system and the data on voter distribution by voting center).

ECONOMIC OVERVIEW

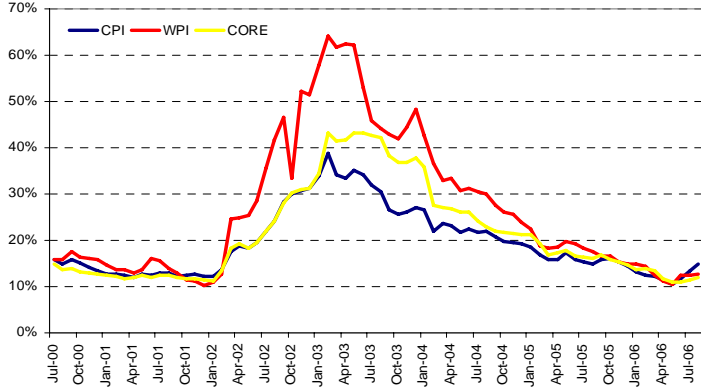
Oil Price
(Venezuelan Basket US\$/pb)



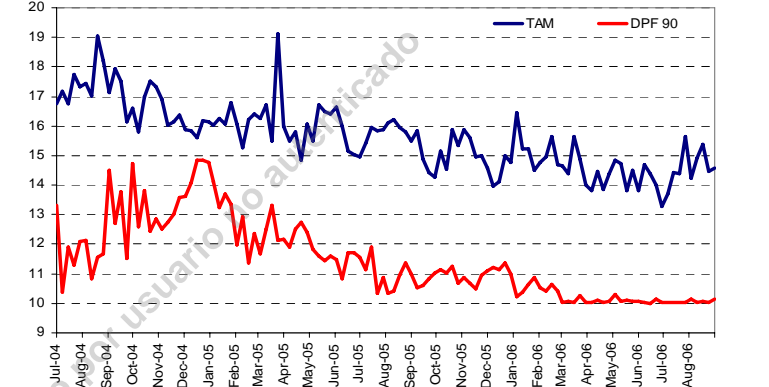
Monetary Base & M2
(VEB Billions)



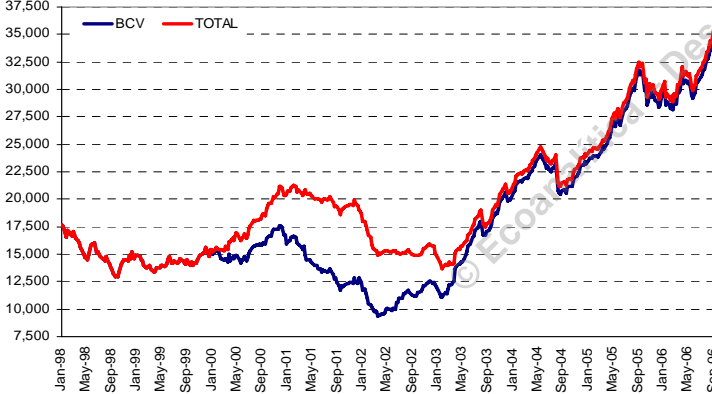
Inflation
(Last 12 Months)



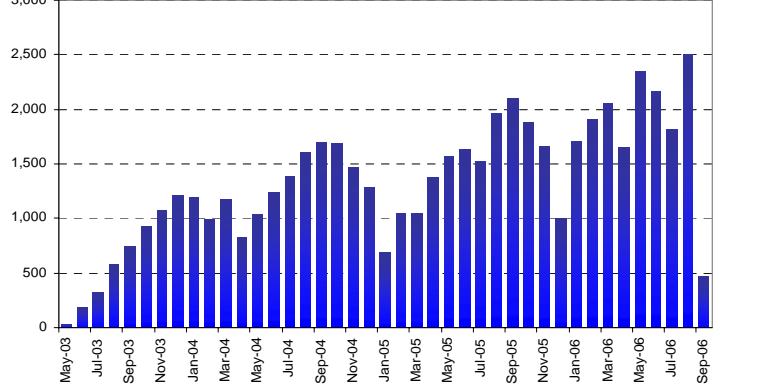
Interest Rate
(Six Principal Banks)



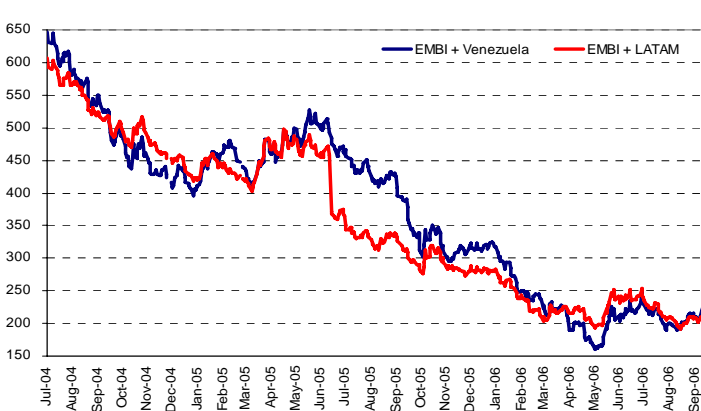
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(VEB Billions)

