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## **2007 BUDGET: A MANUAL OF "GOOD INTENTIONS"**

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**THE CLIENT**

Finance Minister Nelson Merentes presented the National Budget with nothing new in relation to previous years. The government continues to apply a "corner store" economic policy, overspending revenue from high oil prices and using clearly underestimated and unreal macroeconomic premises. In 2007, public expenditure will continue its upward trend, emphasizing the "social" aspect.

### **The Venezuelan budget is a "dead letter"**

This week the Finance minister presented the budget for 2007. We will comment on this, evaluating a series of macroeconomic assumptions about what will happen next year. However, for **Ecoanalítica** the preparation and presentation of the annual budget bill is largely irrelevant in judging what the government's fiscal policy might be next year, in the specific case of Venezuela.

In our country, fiscal policy is geared to the trend in oil prices. When they are high the national government has a large quantity of surplus resources which push the initially budgeted expenditure up.

## Weekly Report

This year is a good example: the original budget estimate for expenditure was VEB87 trillion. This figure has now risen to almost VEB115 trillion, up VEB28 trillion from the original budget estimates. The reason for this is that the Venezuelan oil basket currently averages US\$58 a barrel while the budget estimate was only US\$26 per barrel.

It is no secret for any Venezuelan analyst that the administration has been applying a "corner store" economic policy for the last seven years; if oil prices are high, it take the windfall revenue and squanders it. When oil prices are low, it executes an inefficient fiscal adjustment based simply on delaying payment orders in the National Treasury, which mainly affects expenditure for transfers to state and local governments and infrastructure investments, as well as the State's labor liabilities.

### The budget assumptions are unrealistic

The 2007 budget bill contains a series of estimates of the key macroeconomic variables, including oil price, GDP, exchange rate, and inflation. It is the common practice of Venezuelan governments - especially this one - to underestimate some of these variables and present a very conservative scenario. This sleight of hand gives the government more freedom of action on budget policy during the year; particularly in relation to the surplus fiscal revenue mostly from oil.

### No one believes the oil price in the budget

In the oil sector, the budget contains deep discrepancies in relation to production and the oil price. For political reasons the Chávez administration claims that average oil production will be 3.5 million barrels a day in 2007 and that the average value of the Venezuelan basket will be only US\$29 per barrel. The production figure is intended to sow confusion about Venezuelan production by including figures for liquified gas and other oil products which, because of their characteristics, have never been included in oil production. All the international agencies that analyze the oil area (PIW, AIE, OPEC, Bloomberg, IMF, and others) place Venezuelan production around 2.6 million b/d with the probability of a slight increase next year to a peak of 2.7 million b/d.

**Ecoanalítica** forecasts an average oil price that is 74% above the budgeted price (US\$50.4 per barrel). For non-oil revenue (via SENIAT), the government estimates receipts of 16.1 points of GDP, a very similar figure to ours (16.6). However, it should be borne in mind

# Weekly Report

that the GDP used by the government for next year is much lower than ours because of the official forecast of low growth, low inflation and zero devaluation. So, in fact, the revenue received by SENIAT next year will still be significantly higher than the budgetary target.

Fiscal Balance Central Government (%PIB)		
	MF 2007	Ecoanalítica 2007
GDP Nominal (VEB Trillions)	352,2	440
Oil Price (VEB per US\$)	29	50,4
Economic Growth (%)	5	7,8
Inflation (%)	12	17,0
Exchange Rate (VEB per US\$)	2.150	2.300
<b>Total Revenue</b>	<b>29,9</b>	<b>33,4</b>
<b>Non-Oil Revenue</b>	<b>16,1</b>	<b>16,6</b>
Income Tax	5,8	5,9
Customs	2	2,1
Tax	8,0	8,2
Others	0,4	0,4
<b>Oil Revenue</b>	<b>13,8</b>	<b>16,8</b>
Oil Tax	5,4	6,6
Oil Royalty	7,4	9,0
PDVSA Earnings	0,8	0,8
Others	0,2	0,4
<b>Central Bank Earnings</b>	<b>-</b>	<b>1,2</b>
<b>Total Expenditure</b>	<b>31,9</b>	<b>35,7</b>
<b>Primary Expenditure</b>	<b>29,0</b>	<b>33,8</b>
Interest	2,9	1,9
Domestic Debt	1,1	0,7
Foreing Debt	1,7	1,2
Quasifiscal Expenditure	0,1	8,7
<b>Fiscal Balance</b>	<b>(2,0)</b>	<b>(2,4)</b>
<b>Primary Fiscal Balance</b>	<b>0,8</b>	<b>(0,5)</b>
<b>Non Oil Balance</b>	<b>(15,8)</b>	<b>(19,1)</b>
<b>Amortization</b>	<b>0,8</b>	<b>4,8</b>
<b>Financing Requirements</b>	<b>2,8</b>	<b>7,2</b>
Foreing Debt	-	0,8
Domestic Debt	(0,5)	0,9
Others	3,3	5,5

Sources: MF and Ecoanalítica

## **The economy will grow faster**

Economic growth is another budget figure that differs considerably from our estimates. The government is forecasting 5% growth. Our estimates are much more optimistic given the strong increase in fiscal expenditure. *Ecoanalítica* forecasts 7.8% overall growth, driven by strong growth in the non-oil sector of around 8.0% (fiscal stimulus) and moderate 3.4% growth in the oil sector, especially petrochemical and refining activities.

This higher growth scenario, mainly fuelled by fiscal expenditure, will lead to higher inflation and the possibility of a minor adjustment in the exchange rate in the first quarter of next year. As a result, *Ecoanalítica* forecasts inflation of five percentage points above the government estimate (12%).

## **Strong expansion of public expenditure continues**

As part of this macroeconomic scenario, the budget bill for 2007 totals VEB115.2 trillion, which is 32.7% of expected GDP (VEB352 trillion) for the year, up 32.4% in nominal terms or 14.7% in real terms relative to the original 2006 budget.

The level of total expenditure (not including debt amortization) is 31.9 points of GDP. We have no doubt that central government expenditure next year will overrun the amount budgeted through the use of additional credits. We forecast total expenditure of 35.7 points of GDP and quasi-fiscal expenditure (mainly executed by PDVSA) of 8.7 points of GDP, which is almost non-existent in the budget.

One striking aspect of the budget is that the government is planning a very low amortization of public debt, only 0.8 points of GDP. According to our estimates and the maturity profile, total amortization should be almost five points in GDP.

## **"Social investment" is not as high as it seems**

According to Minister Merentes, 45% of the national budget will be destined to social expenditure (VEB51.4 trillion) compared with the 2006 budget when the allocation was 40% (VEB35 trillion). However, not all this is direct social expenditure, a large percentage (about 65%) goes to pay wages and salaries, as well as labor liabilities. So the so-called "social investment" could be around VEB18.0 trillion, only 16% of the total budget.

## **Budget underestimates cost of the missions**

Last year, the government made a commitment to include the social missions in the national budget. Yet the so-called "missions" have a

budgetary allocation of only VEB3.5 trillion, an extremely low figure taking into account that this year expenditure on missions probably totaled VEB16 trillion, mainly financed by PDVSA and FONDEN. In fact Merentes himself has guaranteed "that next year the missions will not have less money than in 2006."

**Ecoanalítica** has always considered that this murky practice means that there is no way to control the missions or know if they are effective. With little data to go on, we are not optimistic about the missions. The administration, backed by the Central Bank and National Assembly, has taken a series of measures to disguise how these resources are managed. For example, the creation of FONDEN, Bank of the Treasury and other financial institutions in the public sector, combined with the ending of PDVSA's obligation to sell its foreign currency to the Central Bank (Exchange Agreement No. 9), weaken control over the executive.

## Economic Tips

**The Bond of the South now in November.** According to the Finance Ministry, Venezuela and Argentina will launch the Bond of the South in the first half of November with an initial offering of US\$1.00 billion in equal parts. The Venezuelan government has been announcing the launch of the Bond of the South since August, but each time it has been postponed. Argentina is reluctant to issue more debt since its financial needs are covered for the next six months. According to sources consulted by **Ecoanalítica**, Venezuela and Argentina have still not agreed on the financial structure of the bond so the issue is still on standby.

**SENIAT receipts.** In September SENIAT collections edged up to VEB4.2 trillion, only 0.9% more in real year-on-year terms. This year, non-oil tax collections totaled VEB37.9 trillion. Income tax collection was the best performer increasing 56% in real terms.

**Tax reform postponed.** The tax reform currently under study will come into force in 2008, SENIAT Superintendent José Vielma said. The reform includes the introduction of the ecology, selective consumption, electronic commerce taxes and a tax on the assets of natural persons. The idea of the ecology tax is that companies whose

# Weekly Report

activities generate pollution pay for the damage they do to the environment. The selective consumption tax will be paid on purchases of goods that are not in the basic category, such as cigarettes, alcohol, energizing drinks, and imported luxury products.

NATIONAL TAX COLLECTION		SEPTEMBER		
(Bs. Billions)	2006	2005	Var %	Var % Real
<b>TOTAL</b>	4.262	3.661	16,4%	0,9%
<b>Income TAX</b>	1.310	925	41,5%	22,7%
<b>Tax</b>	1.565	1.336	17,1%	1,5%
<b>Customs</b>	1.248	1.012	23,3%	6,9%
<b>Others Incomes</b>	139	123	13,2%	-1,9%
<b>Debit Tax</b>	0	265	-100,0%	-100,0%

NATIONAL TAX COLLECTION		JANUARY-SEPTEMBER		
(Bs. Billions)	2006	2005	Var %	Var % Real
<b>TOTAL</b>	37.885	27.799	36,3%	20,8%
<b>Income TAX</b>	14.563	8.288	75,7%	55,8%
<b>Tax</b>	12.049	9.402	28,2%	13,6%
<b>Customs</b>	9.827	7.346	33,8%	18,6%
<b>Others Incomes</b>	1.122	910	23,4%	9,4%
<b>Debit Tax</b>	324	1.854	-82,5%	-84,5%

Sources: SENIAT and Ecoanalítica

**Two more.** The objective of the tax on electronic commerce is to normalize the VAT, income tax and other tax returns. At present, there is no clear definition of which country generates the tax. In other announcements, the tax chief said the assets (*patrimonio*) tax on natural persons would replace the current inheritance and gift tax, the land tax would not be applied next year, and there was no plan to bring back the bank debit tax in 2007.

**Bolivarian indexes.** The Central Bank said it was considering deepening the family budget survey, introducing an agricultural survey and incorporating social components into the indicators to measure the economic and social impact of subsidies. The announcement follows the recent statement by Food Minister Erika Farías on the need to create "revolutionary" indexes. **Ecoanalítica** considers that any methodological changes made by the Central Bank and INE should be explained to public opinion.

## Oil Tips

**Nine weeks in a row.** For the ninth week running the price of the Venezuelan oil basket fell ending the week at US\$49.80 per barrel. The average for this year is US\$57.89 per barrel.

**Maza confirms.** According to Central Bank director Domingo Maza Zavala, Venezuela produces around 2.6 million b/d, based on information from the Ministry of Energy and Oil and PDVSA itself. This figure agrees with the estimates of the oil analysis agencies, OPEC and the IEA.

**PDVSA continues restructuring.** PDVSA President Rafael Ramírez said that the company would continue to review its international business, beginning with the sale of the assets of CITGO Asphalt. He added that the revenue earned from overseas business in 2005 was US\$3.00 billion. He denied that CITGO would be sold in its entirety.

**PDVSA to launch local bond.** According to national government sources, PDVSA may be considering the issue of US\$3.50 billion in debt through local-currency bonds, with fixed coupons and an indexation clause that covers the risk of devaluation but not exchange risk because the bonds will not be in dollars. Given the current shortage of assets for investment, this paper could be attractive to the local market. The advantage for PDVSA is that it can borrow more cheaply at home than on international markets.

## Sectoral Tips

**SENIAT goes after the banks.** The tax authorities are checking the tax payments of banks to determine if they are complying with the dividend tax. SENIAT said that the financial institutions adjust their assets for inflation which, according to the income tax law, generates a difference between taxable and accounting income, and gives rise to the dividend tax. The intention is to determine if the banks are effectively complying with this procedure. The banks will be audited selectively on fiscal years 2004 to 2006.

**New bill supports SMEs.** President Chávez announced the imminent approval of the Law on Bank Preferences for Credits to the Industrial Sector which will oblige banks to grant financing to small and medium-sized enterprises. The legislation will be similar to

that enjoyed by the agriculture sector. The president also announced that imports of capital goods not produced in Venezuela will be exempted from payment of tariffs and VAT.

**New state company.** President Chávez announced the creation of the company Suministros Venezolanos Industriales C.A. with an initial capital of around US\$50 million. The new state company will "develop a national system of industrial supplies for intermediation, storage, transport, quality control, financing and technical assistance for inputs and industrial supplies."

**New opportunity for SMEs.** A new type of capitalization fund to finance small- and medium-sized enterprises (SMEs) in MERCOSUR and the Latin American region was proposed as a financing option by Integration and Foreign Trade Minister Gustavo Márquez. The fund would be fed by quotas from each country's international reserves along with domestic savings (private and public). An OPEC-type commodities market will also be created for industry and agriculture.

**Labor clearance certificates more for doing business with the State than for dollars** The Labor and Social Security Ministry processed 156,223 labor clearance certificates between May and September. Most companies applied for the certificate to participate in state bidding process processes, accounting for 56.3% of total certificates issued. Processes for state purchases and business rounds came second with 12.6%. The reason for these figures could be the presence of a large number of small enterprises and cooperatives which are doing business with the State under the new economic model.

**A curious fact.** Applications to access foreign currency through CADIVI at the official exchange rate came third with 8.6%. Next were applications for technical assistance, renegotiation of debts with the State, and obtaining loans from official financial institutions. The fact that CADIVI is in third place is surprising because one of the main reasons given to justify the low level of delivery of foreign currency between June and August was delay in the issue of the labor certificate.

**Insurance market grows.** The insurance market grew 27% in real terms in August on a year-on-year basis. According to figures issued by the Insurance Superintendency (SUDESEG), a breakdown of the volume of premiums shows that the top 10 companies in the ranking accounted for 67.8% of the total net premiums charged.

**National mobiles are coming.** CVG Telecom, jointly with the Chinese company Huawei, plans to set up a mobile telephone plant in the country. In its initial phase, the

## ***Weekly Report***

facility will produce a million phones a year. The plant is scheduled for completion before the end of next year when the first Venezuela mobiles will go on sale.

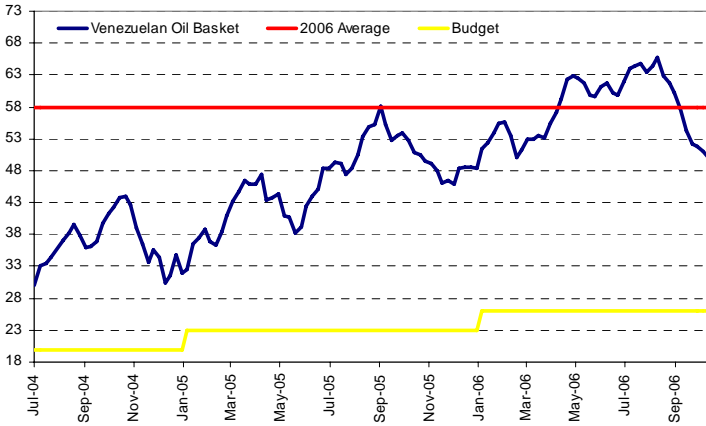
### ***Political Tips***

**New poll.** The Venezuelan Data Analysis Institute (IVAD) published its latest poll taken between October 1 and 9 with a 2.37% margin of error. President Chávez leads spontaneous voting intention (open) with 51.5%, followed by Manuel Rosales with 22.7% and lastly Rausseo with 0.8%. In the closed question, Chávez obtains 54.4%, Rosales 24.8% and Rausseo 2.7%. The don't know/no answer option received 18.1%. An interesting point is that 66.4% of respondents said they would definitely vote while only 6.8% said they would definitely not.

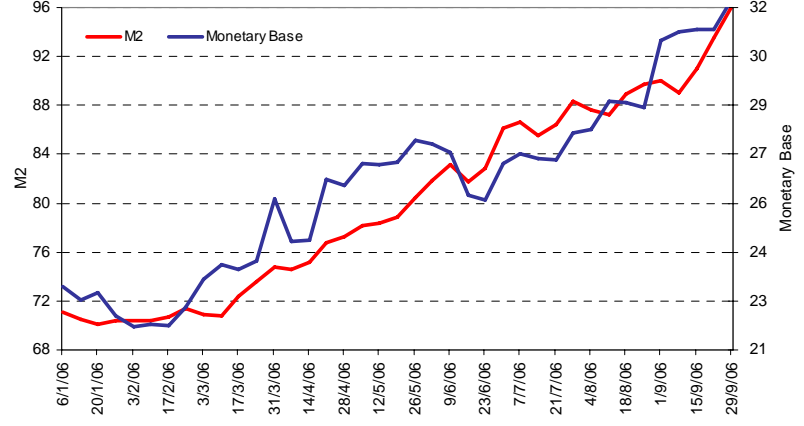
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# ECONOMIC OVERVIEW

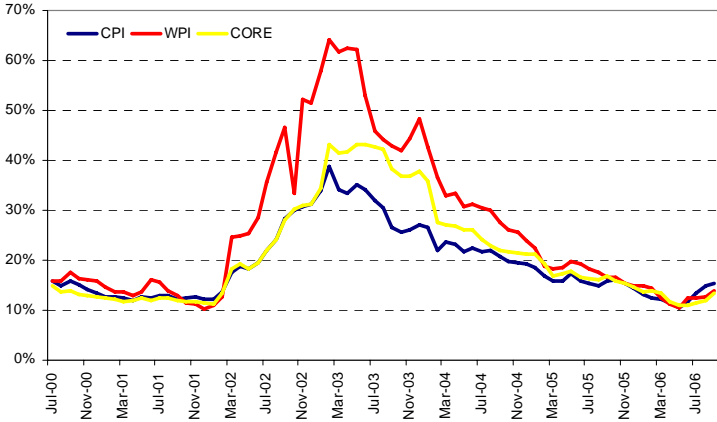
**Oil Price**  
(Venezuelan Basket US\$/pb)



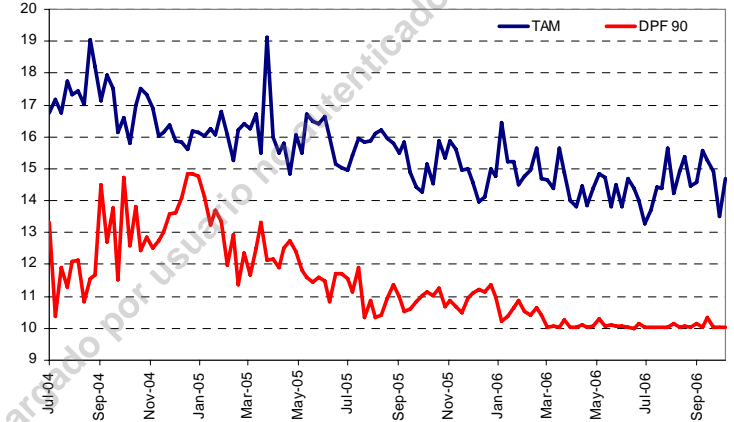
**Monetary Base & M2**  
(VEB Billions)



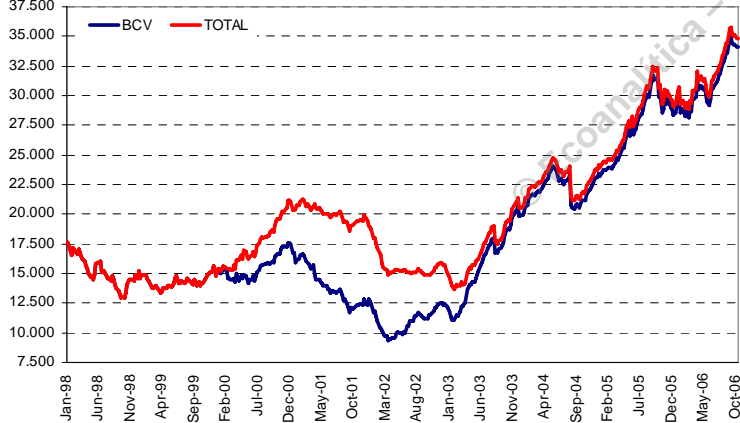
**Inflation**  
(Last 12 Months)



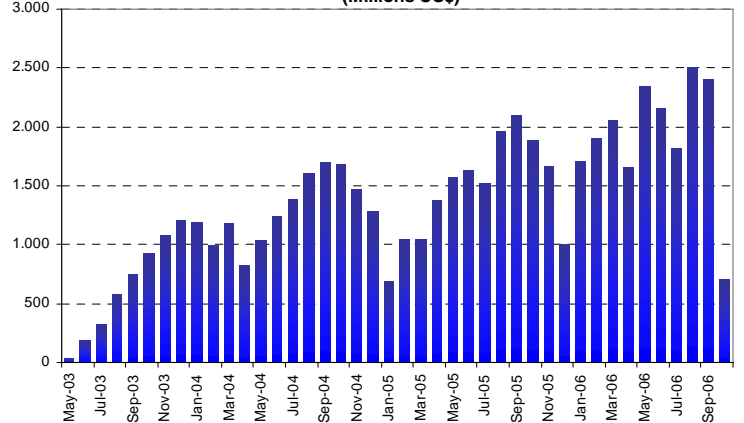
**Interest Rate**  
(Six Principal Banks)



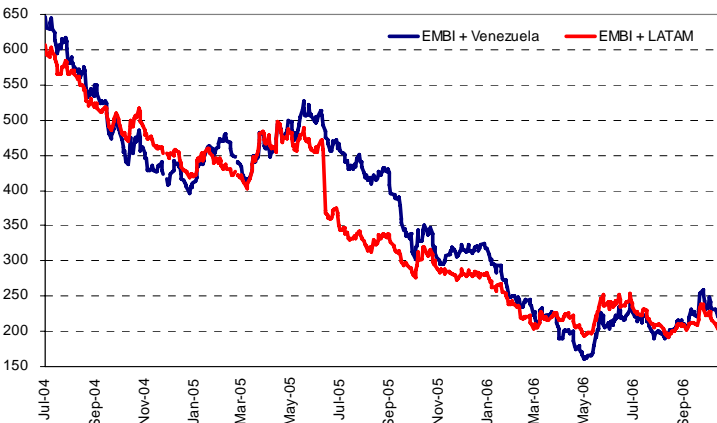
**Fx Reserves**  
(Millions US\$)



**Disbursement**  
(Millions US\$)



**EMBI**



**Central Government**  
(VEB Billions)

