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THE COST OF THE WORD "NATIONALIZE"

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THE CLIENT

Last week President Chávez took a quantum leap when he announced plans to nationalize various service companies. **Ecoanalítica** believes that this measure has important political and economic costs and risks for the government. We do not understand the reason for the change of strategy, so we recommend companies to take a "wait and see" attitude until more information is available. The cost of the measure has already resulted in 19.5% depreciation of the unofficial exchange rate and destruction of US\$3,573 millions in the value of companies listed on stock exchange.

What 21st Century Socialism means

Ecoanalítica believed that 21st Century Socialism was a set of regulations for private enterprise especially related to profits, combined with the entry of new actors and strengthening of state capitalism. The statements by official spokesmen seemed to be simply a continuation of the processes begun eight years ago. For example National Assembly Deputy Carlos Escarrá, member of the presidential commission for constitutional reform, commented that the reforms would take place within respect for private property, while creating new

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forms of properties such as social, collective and public. Rodrigo Cabezas, the new finance minister, told *El Nacional* newspaper that the Chavez administration wanted the private sector to contribute more to the State which was behind the idea of regulating company profits. Cabezas went further saying that "the regulatory mechanisms of these profits will be through taxes ..."

Before making a deeper analysis, we comment on the costs of the method

If the government's objective is to control the companies that provide "strategic" services, why didn't the president announce a simple takeover instead of nationalization. For example, it is no secret that Verizon wants to reduce its exposure in Latin America and that CANTV was for sale. Announcing a takeover bid would not have had negative effects on private sector confidence and perception. In the short term these effects were reflected in a 19.5% depreciation of the unofficial exchange rate from VEB 3,475.6/US\$ to VEB 4,153.1/US\$.

In the short term, the destruction of value of the companies listed on the stock exchange was VEB 7.7 trillion

Another way of measuring the cost associated with the new measure is the market capitalization of the companies affected and the leading companies listed on the Caracas Stock Exchange (BVC). Market capitalization is simply multiplication of total number of shares by the price of each share. Before the announcement, CANTV was capitalized at VEB 7.7 trillion and VEB 6.1 trillion after the announcement. EDC's market capitalization dropped from VEB 2.4 trillion to VEB 1.5 trillion. The capitalization of the companies with most volume on the stock exchange slid from VEB 30 trillion before to VEB 22.3 trillion after. If this destruction of value is converted into dollars at the official exchange rate, the loss totals US\$3,573 million. In other words, the universe of economic agents that had confidence in Venezuela and transferred their savings into investment in the country lost VEB7.7 trillion with the nationalization announcement. **Ecoanalítica** believes that government leaders did not expect this reaction from the market.

In the long term, the measure leads to less investment, lower growth, more inflation, more unemployment, and lower real wages.

Clearly in countries where private property is not respected, investment will be much scarcer than in countries - socialist or otherwise - where the legal framework is stable and respected. Private investment is a source of growth, creation of employment and higher productivity. Real wages simply reflect a country's productivity levels. Investment increases the supply of goods which moderates inflation. Countries with less investment suffer from higher unemployment rates, higher inflation, and wages with lower real purchasing power.

This nationalization leap brings no political or economic benefits for the government; the only explanation is ideological

The Chávez administration's quantum leap makes no political or economic sense. The only possible explanation is that ideology is dominating decision-making regardless of the economic and political cost of the measures. The official sector obtained a positive political benefit from the freeze on electricity and telephone tariffs, which in an environment of high inflation led to a rapid fall in real terms. The government benefited from the efficiency of the private sector in guaranteeing the quality of service and survival of the utility, without having to use funds that could be spent in other sectors. Basically, this is what it has done for the last eight years and which, given the political results of the presidential election last December, has been very successful.

What can be done?

We believe that it is necessary to find out why the strategy has changed as a first step to understanding, negotiating and adopting future strategies. So far, ***Ecoanalítica*** has not found any rationally satisfactory answers to this question. If the conclusion is simply that the ideological factor is dominant, and that the government announced the nationalization of these companies irrespective of their economic and political costs, then they will continue with nationalization of other companies which they consider "strategic."

The key is the price

However, something important must be present. The intensity and depth of the called "radicalization of the process" can be seen in the price that the government is willing to pay for CANTV and EDC. In other words, if Chavez' government pays a price away from the market (in the case of CANTV, there is a price fixed by Slim's offer), we can be seeing one profound radicalization of the called Socialism of the 21st century. In the contrary, if the actual administration pays an appropriate price as in the market ("fair" has been said by Minister Cabezas) then, the Bolivarian project will continue with its actual rhythm.

In this way, we recommend to keep a "wait and see" position, until we have more information.

Economic Tips

Economic results 2006. In his annual message, the Central Bank president gave the preliminary results of the Venezuelan economy in 2006. The Venezuelan economy

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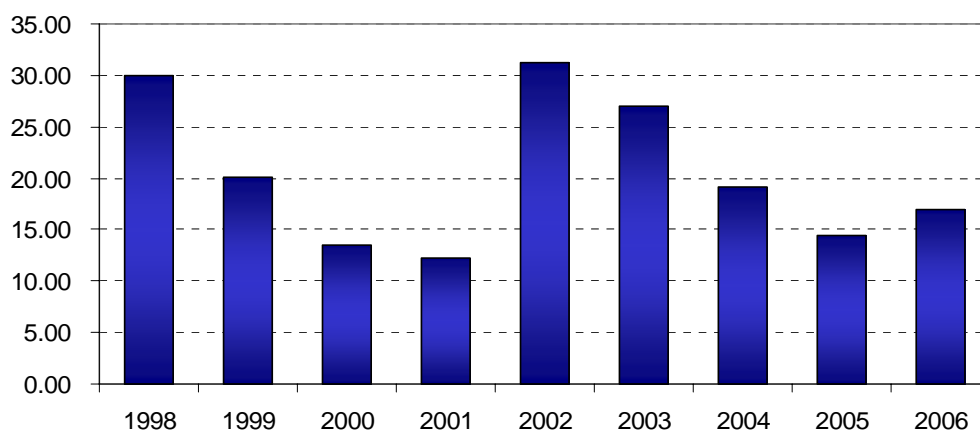
grew 10.3% in relation to 2005. The non-oil economy expanded 11.4% while oil activity fell 0.3%. The fall in oil activity is mainly due to declining investment in the industry by PDVSA and private oil companies, given the migration process of the operating agreements to joint ventures.

Inward growth. The Central Bank president also said that non-tradable activities (mainly services) expanded 15.3% in 2006 while the tradable sector (which covers export activities) grew only 8.1%. Domestic aggregate demand rose 18.8% from 2005, attributable to the 18.4% expansion of private consumption. Imports as component of GDP grew 26.8% during the year while exports fell 4.3%.

Strong expansion and investment. Gross capital investment was the GDP component that expanded most, growing 31.5% compared with 2005. Unfortunately, unlike consumption, the Central Bank does not discriminate between the public and private components of investment. In the opinion of *Ecoanalítica*, expansion of investment is driven mainly by the public sector. This trend will continue in 2007 because building a new institutional framework generates uncertainty among economic agents which inhibits investment.

Inflation: Achilles heel. Strong growth of the economy was not accompanied by an easing of the inflation rate. According to the Central Bank, inflation in 2006 was 17.0%, higher than the 14.4% reported in 2005 and also higher than the 12% official target. In the last month of the year, inflation was 1.8%, higher than November (1.3%) and the same period of 2005 (0.8%). Since coordination between fiscal and monetary policies is inadequate, inflation will remain high with little margin for reduction. Regrettably, after the recent announcement on elimination of the independence of the Central Bank, we believe that reduction of inflation is an impossible goal.

**Inflation
(Last 12 Months)**



Sources: BCV and Ecoanalítica

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Balance of payments falls. The balance of payments in 2006 dropped to US\$4.59 billion, down 16% from the year before. This reduction is explained by a 17% increase on capital account. An interesting fact is that direct investment moved from a positive US\$1.40 billion in 2005 to disinvestment of US\$2.91 billion.

Fiscal accounts to October. At this date, the finance ministry has still not published information on government fiscal accounts to the end of 2006. The latest information available is for October. In the January-October period, although fiscal revenue expanded 17.7% in real terms, expenditure grew 39.4% in the same period. According to *Ecoanalítica's* calculations, execution of expenditure was 86% with respect to total expenditure approved (budget + additional credits). In the first ten months of the year, the government accumulated a small deficit of VEB950 billion which contrasts with a VEB9.7 trillion surplus in the same period of 2005.

FISCAL BALANCE CENTRAL GOVERNMENT (VEB Billions)							
	October 2006	October 2005	Nominal Variation	January-October 2006	January-October 2005	Nominal Variation	Real Variation
Total Revenue	11,147	6,670	67.1%	88,286	66,320	33.1%	17.7%
Non-Oil Revenue	3,935	3,081	27.7%	39,017	28,477	37.0%	21.2%
Oil Revenue	6,838	3,589	90.5%	48,272	32,622	48.0%	30.9%
Central Bank Earnings	373	-		997	5,220	-80.9%	-83.1%
Total Expenditure	13,181	6,802	93.8%	89,236	56,619	57.6%	39.4%
Primary Expenditure	12,605	5,731	119.9%	82,142	48,814	68.3%	48.8%
Interest Payments	576	1,070	-46.2%	7,094	7,805	-9.1%	-19.6%
Domestic Debt	232	336	-31.1%	2,671	3,469	-23.0%	-31.9%
Foreing Debt	344	734	-53.2%	4,423	4,335	2.0%	-9.8%
Quasifiscal Expenditure		-		-	-		
Fiscal Balance	(2,034)	(132)		(950)	9,701		
Primary Balance	(1,459)	939		6,144	17,506		
Non Oil Balance	(9,245)	(3,720)		(50,219)	(28,141)		
Debt Amortization	262	800		5,663	4,289		
Net Monetary Inyection	8,234	3,366	144.6%	47,522	19,607	142.4%	114.3%
Financing Requirements	2,296	932		6,614	(5,412)		
Foreing Debt	28	30		256	130		
Domestic Debt	930	420		3,938	8,488		
Tresury Bonds	930	420		3,934	7,171		
Tresury Debt	-	-		4	1,317		
Others	1,339	482		2,420	(14,030)		

Sources: BCV and Ecoanalítica

Record non-oil tax receipts. Tax collected by Seniat totaled VEB52.1 trillion (US\$24.25 billion) in 2006, a real increase of 19.8%. The highest increase was income tax which grew 57.1% after inflation. Customs receipts took second place with 24.0% while VAT grew 11.7%.

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NATIONAL TAX COLLECTION (VEB Billions)		DECEMBER		
	2006	2005	Var %	Var % Real
TOTAL	5,268	3,801	38.6%	18.5%
Income TAX	1,497	621	141.2%	106.3%
Tax	2,048	1,622	26.3%	8.0%
Customs	1,442	959	50.4%	28.6%
Others Incomes	281	255	9.9%	-6.0%
Debit Tax	0	344	-100.0%	-100.0%

NATIONAL TAX COLLECTION (VEB Billions)		JANUARY-DECEMBER		
	2006	2005	Var %	Var % Real
TOTAL	52,141	38,298	36.1%	19.8%
Income TAX	18,415	10,314	78.5%	57.1%
Tax	17,205	13,547	27.0%	11.7%
Customs	14,504	10,287	41.0%	24.0%
Others Incomes	1,694	1,407	20.4%	6.0%
Debit Tax	324	2,743	-88.2%	-89.6%

Sources: SENIAT and Ecoanalitica

Tax reform planned for 2007. Under the special powers granted to President Chávez by the Enabling Law, Seniat set up a work team to draw up new customs and tax rules. The laws to be considered for inclusion in the Enabling Law include Net Worth (Patrimonio) Tax, Selective Consumption Tax, Value-Added Tax (VAT), Gambling and Betting Tax, Organic Tax Code, and Oil Sector Income Tax.

More transfers to Fonden. In the next few days, the executive and the Central Bank will decide the timetable for transferring US\$7.00 billion from the international reserves to Fonden as requested by President Chávez. The Central Bank has not yet made public any study on the *optimum level* of international reserves which is the prior step to establishing the amount of the so-called surplus reserves to be transferred to Fonden. From October 2005 to December 2006 the Central Bank transferred US\$10.20 billion to Fonden.

Zero independence for Central Bank. President Chávez said "the Central Bank should not be independent; that is a neo-liberal thesis." He added that "the Bank decided that the reserves could not be touched because it is independent, but that is one of the things that I want to change in the Constitution. It was left in the 99 Constitution and it is a disaster." **Ecoanalítica** considers that since the changes to the

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Central Bank Law put through in 2004 and 2005, the monetary authority has enjoyed very little independence so President Chávez's announcement would institutionalize something that is already in operation.

Moves on the Central Bank board. Chávez appointed former finance minister Nelson Merentes as Central Bank director to represent the executive in replacement of Planning Minister Jorge Giordani. In the coming weeks, the National Assembly will choose two more directors for the Bank. The committee to make this selection will be named this week.

Stabilization fund to be scrapped. In 2007, the government should have begun to make the transfers of savings to the Macroeconomic Stabilization Fund (FEM) but this procedure has been aborted. According to National Assembly Finance Committee Chairman Ricardo Sanguino, the FEM will be eliminated in the constitutional reform because Fonden now fulfills its function.

they are not the same. In our opinion, Deputy Sanguino is wrong to compare Fonden with FEM. Fonden is not a mechanism for saving but a para-fiscal expenditure fund. Its resources are used discretionally by the executive for spending on different projects. In contrast, a FEM-type fund is a mechanism that has a savings-expenditure role clearly defined in line with the trend in the oil market.

Oil Tips

Crude down again. Last week, the crude basket was priced at US\$46.87 per barrel, 16.9% below the US\$56.46 average for all last year. The January average so far is US\$48.47, just over US\$4 below the average of US\$52.86 recorded in December. This is the first monthly average below US\$50 since the last quarter of 2005. Overall, the Venezuelan basket has lost a total of US\$6.67 (12.45%) in the last three weeks.

Forced migration. According to PDVSA President Rafael Ramírez, negotiations with the private multinationals in the Orinoco Belt (strategic associations) have ended and nationalization will take place under a law that is being drafted which includes a timetable for adapting the strategic associations to the existing law. Ramírez added that the private companies that participate in the business will be able to maintain a minority percentage of the shares that today give them control.

Total control. With the primary intention of exercising control over a strategic activity, the upgraders that process the crude produced in the Orinoco Belt will come under PDVSA control through CVP. This change was not considered in the negotiations with

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the private companies. As Ramírez explained, the idea is to administratively unify the operations of the four independent upgraders operating in the Belt in an effort to establish synergies and avoid interfering with the execution of decisions of State, such as implementation of the OPEC cuts. In addition, PDVSA will take over all the marketing of the upgraded crudes from the Belt, as already happens with the operating agreements.

Debt restructuring planned. Ramírez put the strategic associations' debt at US\$4.00 billion and said the restructuring would go ahead without any default whatsoever.

PDVSA numbers. PDVSA published its financial results for 2006. The highlights are:

- Revenue increased 20.5% from 2005 to US\$55.07 billion, of which 69% was transferred to the State as tax and social contributions.
- PDVSA paid a total tax bill of US\$27.94 billion, made up of US\$17.51 billion as royalties, US\$794 million for a recently created a production tax, US\$1.32 billion as dividends, and US\$8.32 billion as income and other taxes.
- The state oil company also handed over US\$3.07 billion to the executive to finance missions and other social projects, and transferred US\$229 million to Fondespa, and US\$6.86 million to Fonden. The total contribution to the State was US\$38.10 billion.
- On the financial side, operating costs totaled US\$8.01 billion while other costs and expenses were US\$6.20 billion. Lastly, investments (in exploration, production, gas and refining) totaled US\$5.94 billion. Investment represented 58% of the amount contributed by PDVSA to Fonden and the social programs.

Sectoral Tips

Vehicle sales rise. Cumulative sales of automobiles in 2006 totaled 344,351 units, up 50.3%. This increase outstripped the industry forecast of 320,000 units.

Macro expands. The shareholders of Makro Comercializadora, after opening 26 hypermarkets in the country, are planning to launch a new chain of stores to be known as Mikro, targeted at low-income sectors of the population.

Many sectors affected. The special powers that Parliament will grant President Chávez include changes to many laws affecting the economy, especially the Income Tax Law. These include adjustments to corporate taxation which will increase the tax on profits, and creation of an oil chapter in the Law. The government is expected to prepare nationalization laws by sector in addition to the reform of the Electricity

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Service Law. After announcing the nationalization of the telecommunications, electricity and oil sectors, the government has not yet made any formal announcement about other areas of the economy.

Banking sector also affected. Another sector sure to be affected will be banking. The General Banking Law and the Insurance Law will be subject to new changes; however, no details have been given as to what these will be. The Bank Preferences Law will also be included in the reform process.

More current transfers. Changes will also be made to the Financial Administration Organic Law, as well as the FIDES Law and the Special Allocations Law, to free up more funds for the communal councils, in addition to the creation of the Inter-Territorial Compensation Fund Law.

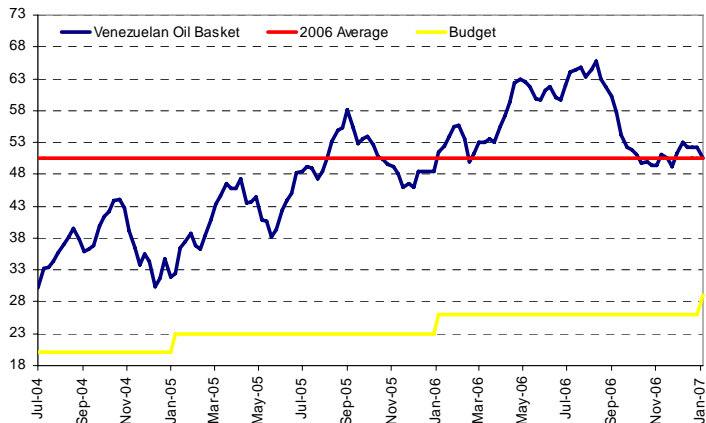
Political Tips

Chávez all powerful. The National Assembly has received the Enabling Bill which will authorize President Chávez to legislate in ten areas for 18 months. In only three articles, the legislative branch will authorize Chávez to issue decree-laws in the areas of transformation of state institutions, popular participation, essential values of the civil service, economic and social areas, financial and tax area, citizen security, legal security, science and technology, land planning, security and defense, and infrastructure, transport and services. In other words, Chávez will have the power to issue decrees with force of law in almost all areas. So the obvious question is: What role will the National Assembly play in the future? The bill is expected to be passed by Tuesday at the latest.

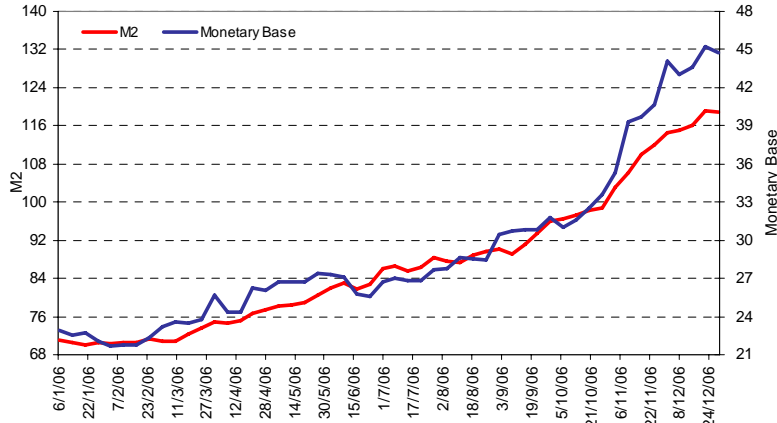
Only the executive knows. The Enabling Bill does not specify the specific laws to be decreed by the executive. The parliament and Venezuelan society will only hear about the new decrees when they appear in the Official Gazette. This is the third Enabling Law to be granted to President Chávez. The first was passed in 1999 by the then National Congress and the second in late 2000.

ECONOMIC OVERVIEW

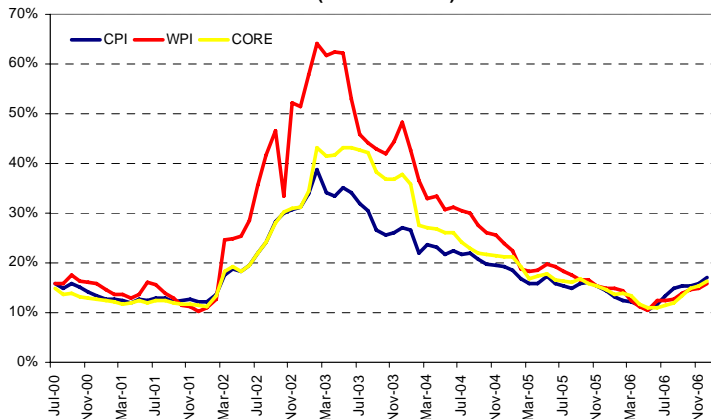
Oil Price
(Venezuelan Basket US\$/pb)



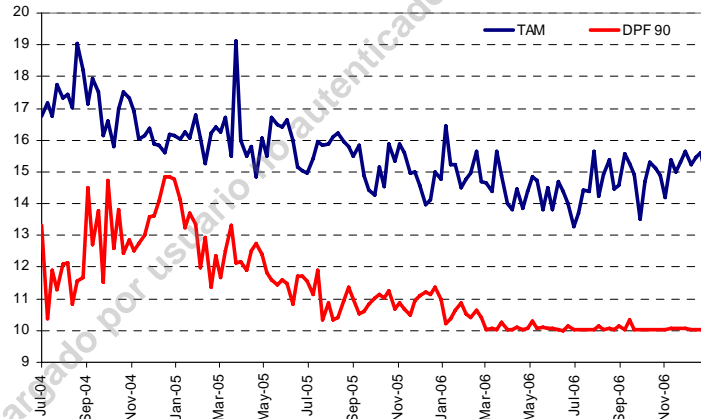
Monetary Base & M2
(VEB Billions)



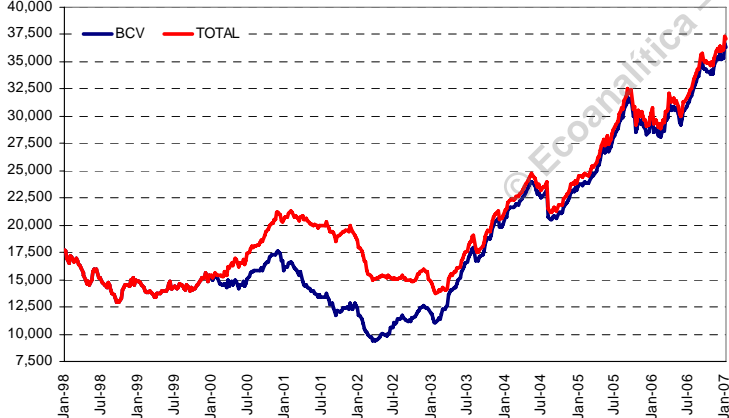
Inflation
(Last 12 Months)



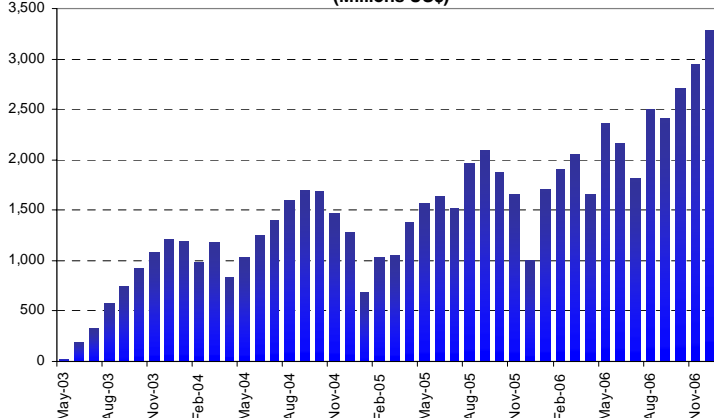
Interest Rate
(Six Principal Banks)



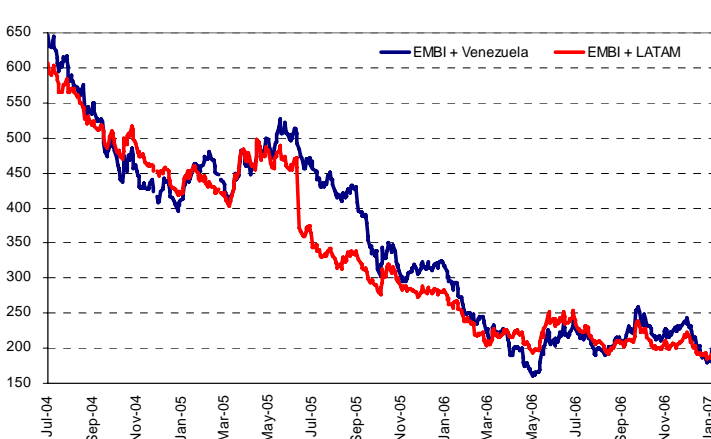
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(VEB Billions)

