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CHÁVEZ ANNOUNCES MEASURES TO CONTAIN INFLATION, BUT DOESN'T GET TO THE ROOT OF THE PROBLEM

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THE CLIENT

President Chávez returned to air in his program “*Alo Presidente*” and announced a series of additional economic measures to those already announced by Vice President Jorge Rodríguez and the Finance Minister Rodrigo Cabezas aimed at controlling inflation. One point worth highlighting is that the president admits that the current inflation rate is the only macroeconomic indicator that is really worrying him.

Beyond the Anti-Inflationary Pact

The measures in question were:

- Reducing the Value Added Tax (VAT) by 5 points in two stages: 3 points starting in March and then 2 points in July.
- Increasing the efficiency with which income tax is collected in an attempt to partially compensate for the anticipated fiscal loss resulting from lowering the VAT rate.
- Introducing the monetary reform or conversion measures aimed at eliminating three zeros from the bolívar starting from February 4th, 2008.

- Approving a special Law against hoarding, price speculation, boycotts, and any other conduct that affects the consumption of foods or products subject to price controls. According to this law, any action that can be construed as hoarding, price speculation, boycotts, and any other conduct that affects the consumption of food or products subject to price control will be considered as not in the best interest of social peace, the right to life, and public health.

Reducing the VAT should be accompanied by other measures

It's worth making a few comments concerning the lowering of the VAT. At *Ecoanalítica* we have always maintained that the VAT rate was fairly high, as well as including a great number of exemptions and exceptions that distort the nature of a consumption tax. What would be ideal is if the Government not only lower the VAT rate, but also eliminate the exemptions and exceptions.

Lowering the VAT should be compensated by taxing the non-oil sector

Another point that must be made is that it makes no sense to lower the VAT, if the revenue lost here is going to be compensated by the surplus collected from the oil sector, which seems to be what the Government is planning according to recent statements made by Minister Cabezas. The ideal strategy would be if the fiscal loss suffered by lowering the VAT be made up by increased tax collection of other non-oil sector taxes. If this were to prove insufficient, then the Government would have to take a look at and possibly revise their current spending policies. But given the current scenario, this doesn't seem very plausible, being that reducing the VAT with a policy to increase spending is part of a very dangerous fiscal formula unsustainable in the mid term, because it's not enough to increase other taxes (income tax, taxes on personal assets, selective consumption tax, land taxes, etc.) in order to compensate for significant increases in public spending.

The SENIAT overestimates the fiscal sacrifice

According to SENIAT, these measures will add up to a fiscal sacrifice of more than VEB 12 trillion. Of this amount, VEB 3.7 trillion comes from the decision to not levy taxes on 10 products and more than VEB 8 trillion is the cost that will reflect the lowering of the VAT rate from 14% to 9% in four months.

However, at *Ecoanalítica* we estimate that said measures will lead to substantially less fiscal sacrifice than what is reported by the tax authority. It's very important to be aware that it's common practice for

the SENIAT to underestimate the taxes collected from the non-oil sector (official goals) and therefore, in this case, they would overestimate the sacrifice. According to our calculations, the global cost of the measures considered would be between VEB 6.5 and VEB 7 trillion, where the exemption increases would be around VEB 1.1 trillion and the rest would be due to the VAT rate reduction.

The impact on inflation is limited

The lowering of the VAT is announced not as part of an integral reform package, but as a measure to reduce inflation. Though it's true that by lowering the VAT rate the global cost of products will drop, it's also true that lowering the rate doesn't guarantee that prices won't rise in the future, which is why this measure has a very limited impact over time.

Monetary reform is back

Now that the Central Bank of Venezuela (BCV) is under control, President Chávez has defined the schedule to be followed so that Venezuela will have a new currency in February 2008. According to Chávez, this will make the payment system more efficient, rally confidence in the currency, and produce positive psychological effects among the people. According to the schedule the preliminary studies will be ready by the end of March so that the law may be approved during the second semester and the people be informed as to its significance and implications.

A monetary reform that eliminates the zeros from the currency should be the final step of a series of reforms

In order for monetary reform to be real effective it's necessary to go through a series of profound fiscal reforms in order to reduce the vulnerability of fiscal accounts before oil revenues. However, the non-oil sector deficit, which means the part of spending that has to be financed with oil revenues, has gone from 10.1 points of the GDP, or US\$ 10.4 billion in 1999, to 26.3 points, or US\$ 43.71 billion in 2006. Furthermore, reserve transfers and the "supposed exchange profits" don't favor the stability of our national currency. It's clear that with this kind of fiscal policy it's impossible to introduce a monetary reform that will stabilize our currency.

Even though we consider that the monetary reform won't be efficient, we don't oppose it since we believe it to be harmless from an economical point of view

Monetary reform could have benefits in terms of simplifying accounting, managing quantities, and lowering the average number of bills in possession of the public, just like the president has pointed out. Within the costs incurred are the adjustments to the new currency symbol, the "rounding off" effect, and the cost of printing new bills. There is a so-called "psychological" effect, which to tell you the truth we have no idea which way it will go. In **Ecoanalítica's** opinion, none of these benefits or costs are significant, which leads us to believe that monetary reform will come without making much of a difference one way or another.

The other issue: The Treasury account in dollars

In the middle of all these measures taking place, Minister Cabezas announced a modification to the PDVSA foreign currency sales plan in order to regulate the liquidity levels and thereby have an impact on prices. The Government decided that PDVSA would now deposit the dollars it received into two National Treasury accounts. According to the Ministry of Finance, this measure is upheld by provisions found in the Hydrocarbons Organic Law.

According to the new plan, in one account, PDVSA will deposit all the resources budgeted for the year's spending, and in the other account, all excess resources, i.e. resources resulting from selling oil at a price over US\$ 29 per barrel, which is the base price that is used to calculate the budget, are deposited. With this new plan, it's the Treasury that will now sell foreign currency to the Central Bank when total spending requires attention (transfers to entities and regions).

It doesn't imply a cutback in spending

According to Cabezas, this way "the impact that generates liquidity in the prices indicator is reduced... Some VEB 11 trillion won't have to be circulating in the financial system." However, this will only be a short-term impact since the Government doesn't have any plans to make any change concerning fiscal policy or public spending growth; and therefore, this measure won't have any significant impact in reducing prices.

But the measure limits the BCV's freedom

Therefore, since the Government and PDVSA are free to do business in dollars, they could conduct foreign exchange operations by any of the current popular means available. In this case, the BCV loses a lot of its freedoms with regard to its monetary policy to control inflation, since it has no control over the country's main company.

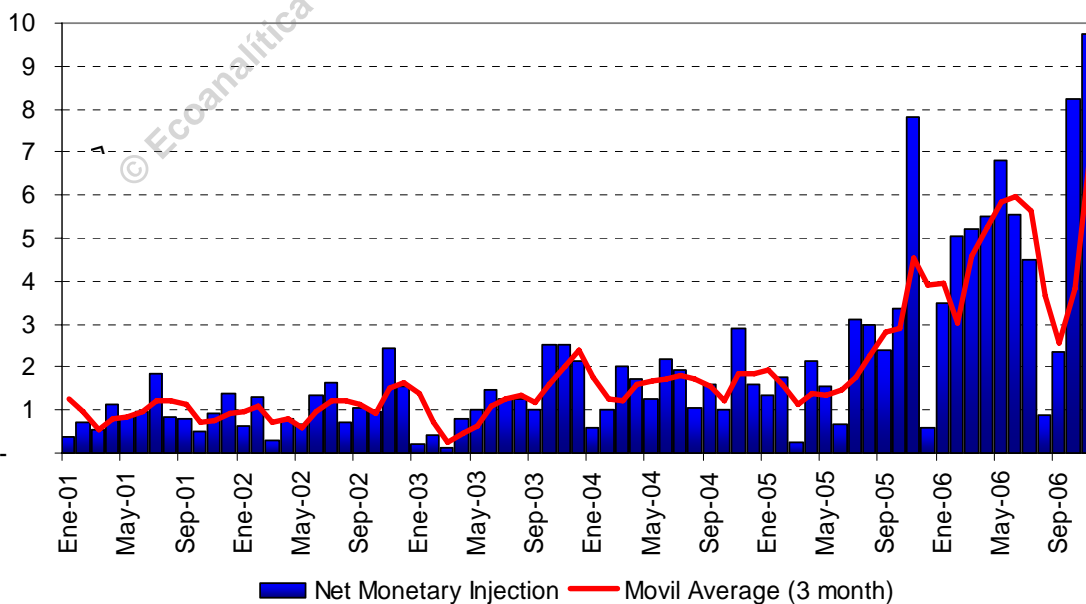
Weekly Report

Without getting to the root of the matter, inflation will continue to rise

Inflation control requires an adjustment of fiscal policy that includes greater control over public spending taking into account seasonal factors, as well as adjusting its increase to the Government's anticipated inflation. On the other hand, the Government should control the flow of quasi-fiscal spending into the economy. Cutting spending is just as important as improving the quality of spending by earmarking a greater portion of resources towards productive investments and social development and less towards current spending.

However, since 2006, the Government has done just the opposite since fiscal origin net monetary injection (an indicator that is generated when you add non-oil fiscal results, not including external interest payments, and net amortization) settled at VEB 57.3 trillion (US\$ 26.64 billion) for the period January-November, while for the same period during the previous year this indicator was at VEB 27.4 trillion (US\$ 12.76 billion). In other words, in inter-annual terms, fiscal origin monetary injection increased by 109%, which is the same as, an increase of 84% in real terms.

**NET MONETARY INJECTION
(VEB MILLIONS)**



Sources: BCV and Ecoanalítica

At **Ecoanalítica**, we believe that the tendency to increase public spending will continue during 2007. This dynamic will generate a situation that will keep inflation, which is a monetary phenomenon, pressured to continue to rise as it has done so since May 2005. As long as fiscal policy doesn't become more moderate, inflation will continue to be this Administration's Achilles heel, because it will close at around 23%.

Economic Tips

Bono del Sur II ready. According to information coming from the presidents of Venezuela and Argentina, Hugo Chávez and Néstor kirchner, respectively, next week the "*Bono del Sur*" will be placed on the market for an amount equivalent to US\$ 1.5 billion. This will be the second time that Venezuela and Argentina place an instrument on the market that combines debt from both nations and is sold jointly.

Encourage small investors. President Chávez explained that the offer will be open for sale to the public on Monday, February 26th and close on Thursday, March 1st, with a minimum investment of US\$ 1,000 (VEB 2,150,000), that looks to encourage the participation of small investors. Chávez additionally pointed out that both governments guaranteed this bond issue that is divided in half, 50% for each country (US\$ 750 million each). For this new issue of the *Bono del Sur*, Venezuela has already bought US\$ 750 million in bonds from Argentina that mature in 2015.

Very attractive. We believe at **Ecoanalítica** that this new issue of *Bono del Sur* will be very attractive for acquiring foreign currency earmarked for capital outflows; and therefore we highly recommend it. However, it's very important to wait for the final notice in order to know the financial terms. Furthermore, we expect to see more of these types of operations during 2007, since the Argentinean government faces a number of debts which are about to mature totaling around US\$ 13.5 billion this year, and there is an issue of bonds by PDVSA that is also pending.

FONDEN final figures. According to the Ministry of Finance figures, up until the close of last year, FONDEN had resources totaling US\$ 18.3 billion, of which US\$ 16.6 billion had been tied up in programs and a total of US\$ 9.3 billion had been outlaid.

Weekly Report

Income Tax reform approved. The National Assembly plenary session authorized the change in the Income Tax Law. Said change affects transnational companies, especially oil companies. One of the provisions modified states that, earnings or losses resulting from loans or savings in foreign currencies or with readjustment clauses based on exchange rate variations, be considered realized at the moment they are collectable, collected, or paid.

Also affects related companies. Besides the adjustment set forth in that provision, it was decided that another article was to be incorporated in the text which states that interest paid to and debt resulting from a related party shall be deductible only to the extent that the taxpayer's total debt does not exceed its equity. According to the National Assembly members, the new tax plan will be in place for the coming fiscal year.

New implementation schedule. According to Minister Cabezas, from now on, revenue sharing payments will be made on a quarterly basis. Those funds that will be in the Treasury will be kept in dollars and will be sold as soon as the orders are issued. Besides these quarterly payments, the MF has plans to review the management of trusts that public entities have in banks, through the setting up of a legal framework that allows for a monitoring of the resources that are already retained.

Law against hoarding is approved. The Government approved the "Special Law in Defense of the People against hoarding, price speculation, Boycotts, and any other conduct that affects the consumption of foods or products subject to price control." The crimes (hoarding, price speculation, price change, contraband, and boycott) will be punished by 2 to 6 years prison time and fines between VEB 4.9 million to VEB 752.6 million, depending on the value of the Tax Unit.

OIL TIPS

Dropped again. Last week, the Venezuelan crude and by-products basket dropped US\$ 0.29, settling at US\$ 49.86 per barrel. January closed with an average price of US\$ 46.83, and so far in February the average price is up to US\$ 49.85 per barrel. To date, the Venezuelan basket cumulative average is at US\$ 47.85 per barrel.

Total expects long negotiations. The French oil company Total doesn't believe it will be able to complete its negotiations with the State before the end of the year concerning the latter's plans to take control of the strategic association Sincor. Total has 47% stake in Sincor one of the heavy crude upgraders in the Orinoco Oil Belt,

PDVSA has 38% stake in the company, and the Norwegian company Statoil has the remaining 15%.

BUSINESS SECTOR TIPS

Food consumption is up. The Venezuelan Chamber of the Food Industry (CAVIDEA) reported that during 2006 there was a 9.2% increase in demand for food with respect to 2005.

Banco del Tesoro figures out. The *Banco del Tesoro* (BNT) figures corresponding to the month of January indicate that its trusts total VEB30.2 trillion. These trusts include the resources deposited in FONDEN, as well as the deposits from entities like PDVSA, among others. On the other hand, the bank's loan portfolio reaches VEB 45.6 billion. The bank used to grant housing loans, but in the last few weeks it began to grant car loans. The balance highlights that during the first month of the year, public deposits reached VEB 265 billion.

2006 a good year for telecommunications. CONATEL released the 2006 figures for the TELECOM sector, highlighting a strong increase in market share in mobile phones, 69%. The same indicator for 2005 settled at 47%. Another point that was highlighted was the technical tie between MOVISTAR and MOVILNET, both reaching 42%, while digital reached 15% of the market share.

Internet continues to grow. The other sector that showed substantial growth was the Internet, increasing its market share by 15%, in other words, a 3 percentage point increase with respect to 2005, while the so-called telecommunication centers increased by 16.4%. On the other hand, fixed-line phones increased by 15%, barely 2 percentage points over the close of 2005. CANTV is the leader in this sector with 79.1%.

CANTV also releases its year-end results. CANTV made public its financial tallies for 2006 last week. Revenues increased by 33.6% with respect to 2005. A positive indicator was the 137.1% increase of the EBITDA (Earnings Before Interests, Taxes, Depreciation, and Amortization) during the same period.

Significant cut in debt. The company's profits in 2006 reached US\$ 526 million, compared to US\$ 100 million in 2005. Working capital increased by 25.2% compared to 2005, settling at US\$ 558 million. The company closed 2006 with US\$ 319 million in

Weekly Report

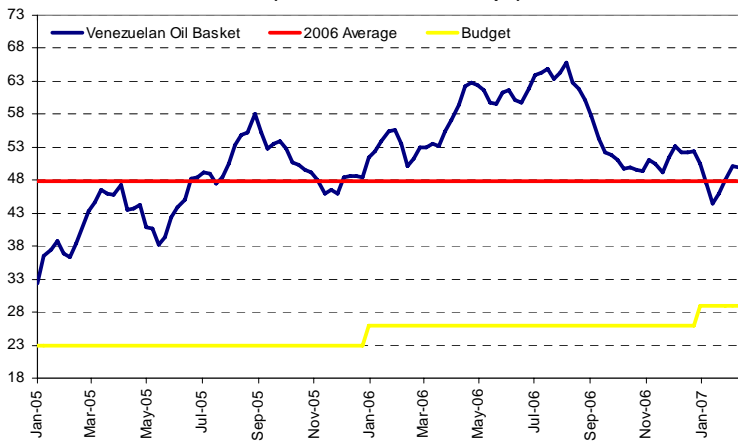
free cash flow. Debt payments were cut significantly going from US\$ 113 million in 2005 to US\$ 24 million in 2006.

EDC also closed with positive figures. EDC also released its 2006 balance sheet highlighting a 1.9% drop in operational income with respect to 2005. The main reason for this drop is the lag in rates in relation to the accumulated inflation for the period. In other areas, operational spending increased by 6.7% compared to 2005 due to the salary increases agreed to in the collective bargaining agreement as well as the maintenance of the network. The accumulated EBITDA for the year was US\$ 327 million. EDC booked a net income of US\$ 118 million in 2006, which represents an increase of 27.7% compared to the close of 2005.

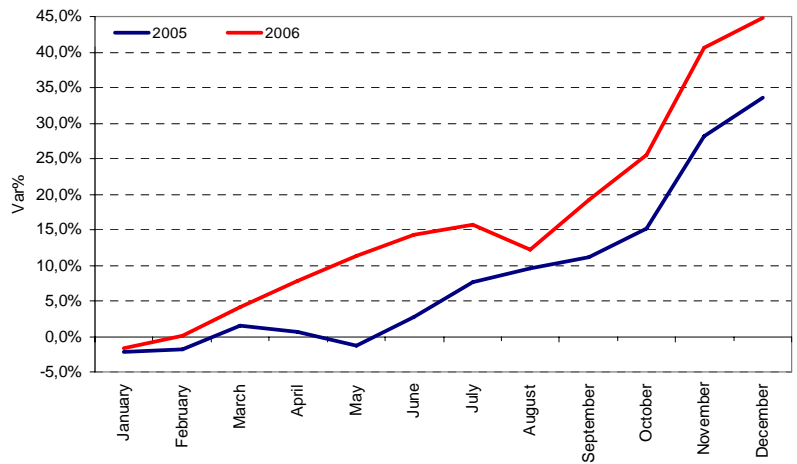
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ECONOMIC OVERVIEW

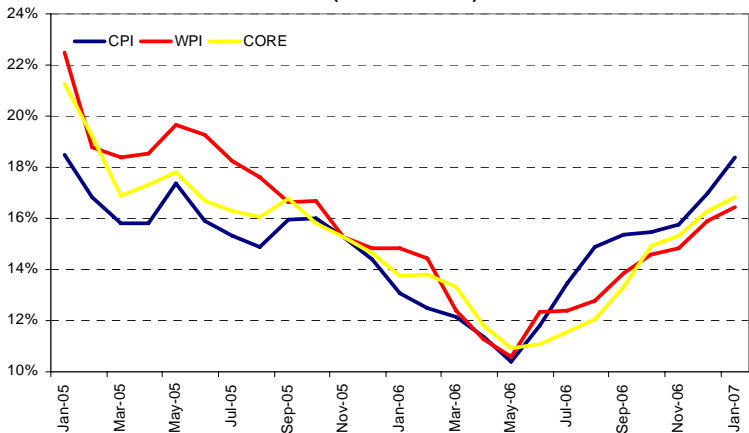
Oil Price
(Venezuelan Basket US\$/pb)



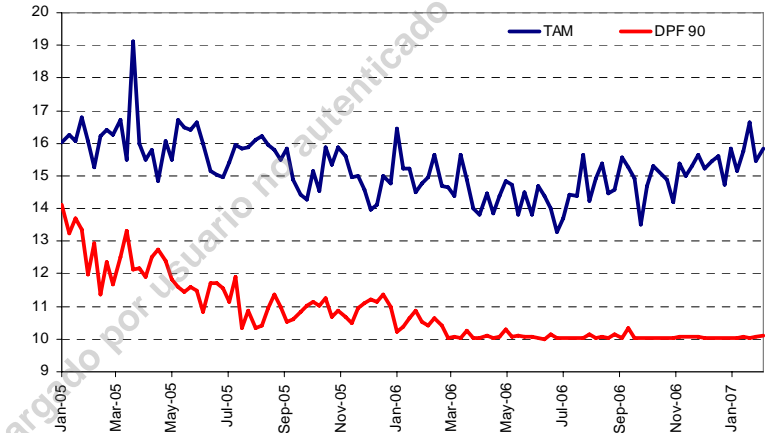
Real Expansion (M2)



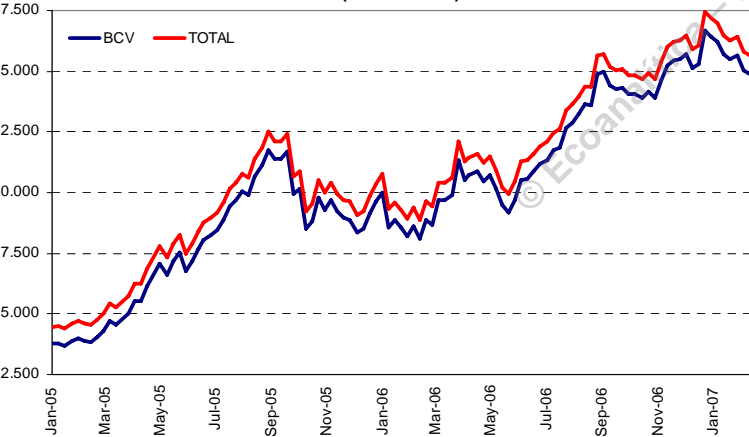
Inflation
(Last 12 Months)



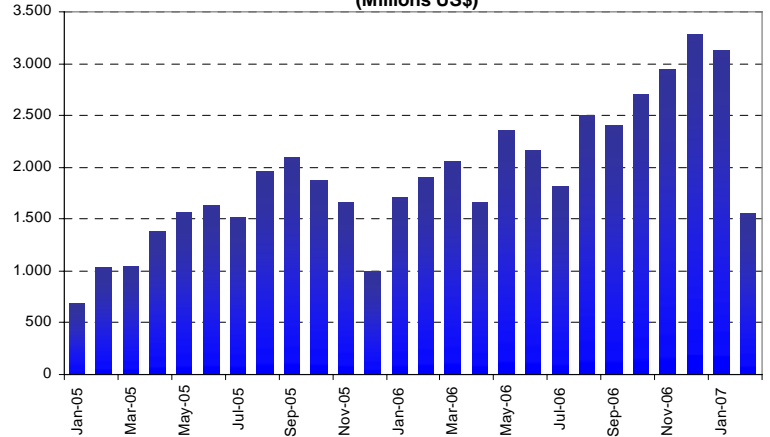
Interest Rate
(Six Principal Banks)



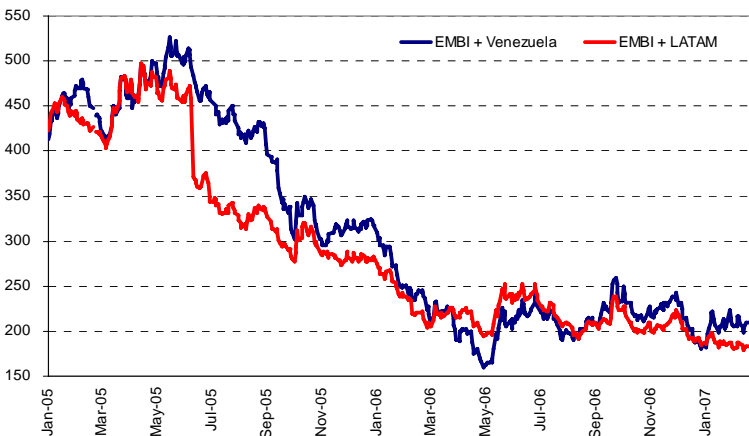
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(VEB Billions)

