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**By:**  
Alejandro Grisanti  
Asdrúbal Oliveros

**Edited by:**  
Ronald Karj

## ***THE BOLIVAR DOESN'T GET STRONGER BY TAKING ZEROS OFF OF IT***

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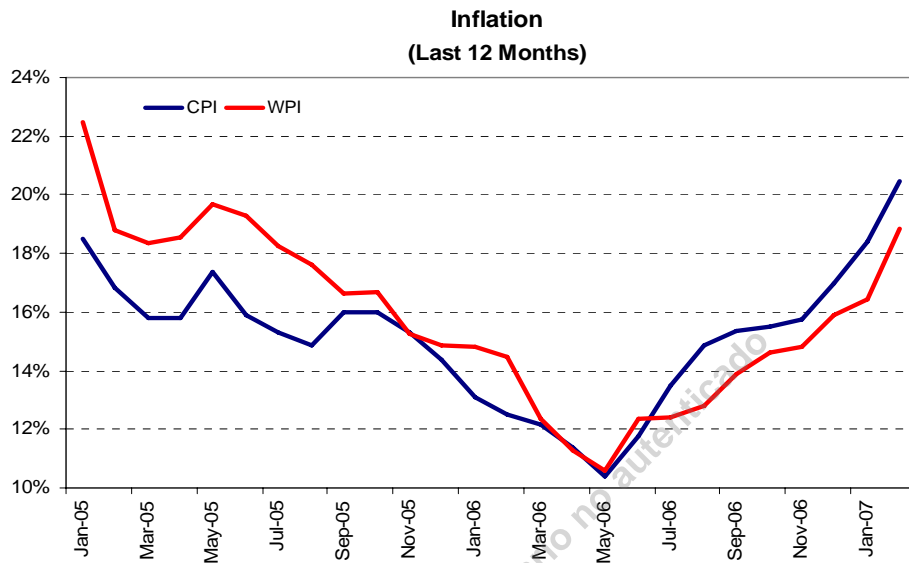
**THE CLIENT**

Currently, Venezuela is one of the countries with the highest level of inflation in the world, and it's the Government's main economic problem. The recently announced monetary conversion plan is not a solution to strengthen the currency.

### **Since May 2006, the CPI has been steadily rising**

Since last May, the consumer price index (CPI) has been gradually rising. In February, yearly inflation was pegged at slightly over 20%. None of the measures taken by the Government to date have tackled the root of the inflationary problem: the magnitude of the non-oil sector fiscal deficit.

The non-oil sector fiscal deficit, which is to say, the portion of spending financed through oil revenues went from 9;1% points of the GDP, in 1999, to 19,2% points of GDP last year. Today, more than ever, Venezuela is dependent on its oil revenues, and the significant increases in public spending are sustained only thanks to high oil prices.



Sources: BCV and Ecoanalítica

**Venezuela, with the highest inflation of emergent economies**

Any serious inflationary policy that is to have any chance of being successful in Venezuela will have to start by redesigning its fiscal policy, and in so doing, will have to focus on achieving an inter-temporal cutback of the non-oil fiscal deficit.

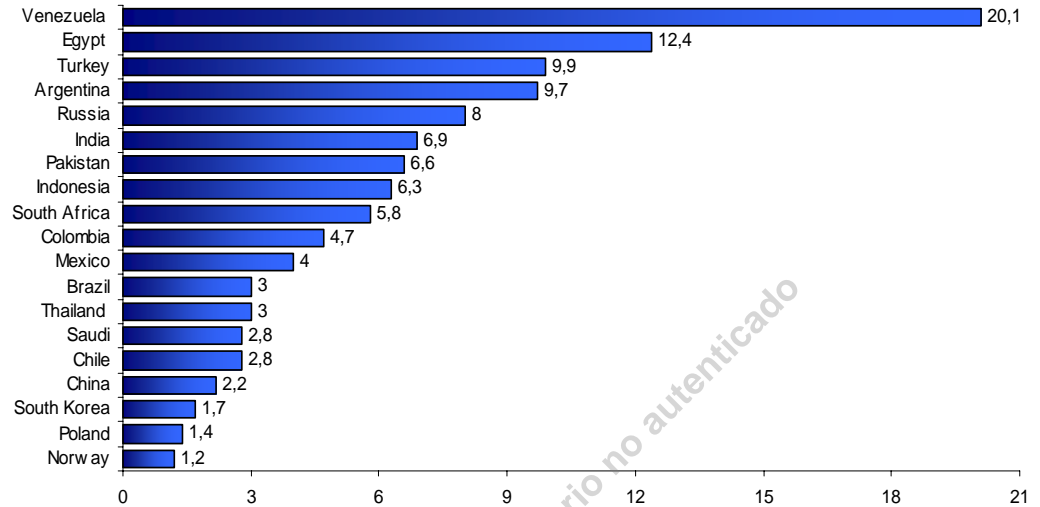
Some government officials have pointed out that the high levels of inflation are due to the high levels of economic growth that the economy is experiencing. However, China, the second largest economy on the planet, has been posting sustained levels of growth (<10%) for the past 20 years, and a 2.2% inflation rate.

Another excuse that the Government uses is that since the country is going through an unprecedented oil boom, additional pressures are put on prices. Saudi Arabia, which has oil revenues much higher than Venezuela, has an inflation rate of 2.8%.

Furthermore, Venezuela closed 2006 with the highest inflation rate among the main emergent economies, higher than Chile (2.8%), Brazil (3.0%), Mexico (4.7%), and Argentina (9.7%).

# Weekly Report

## Inflation (Emergent Economies)

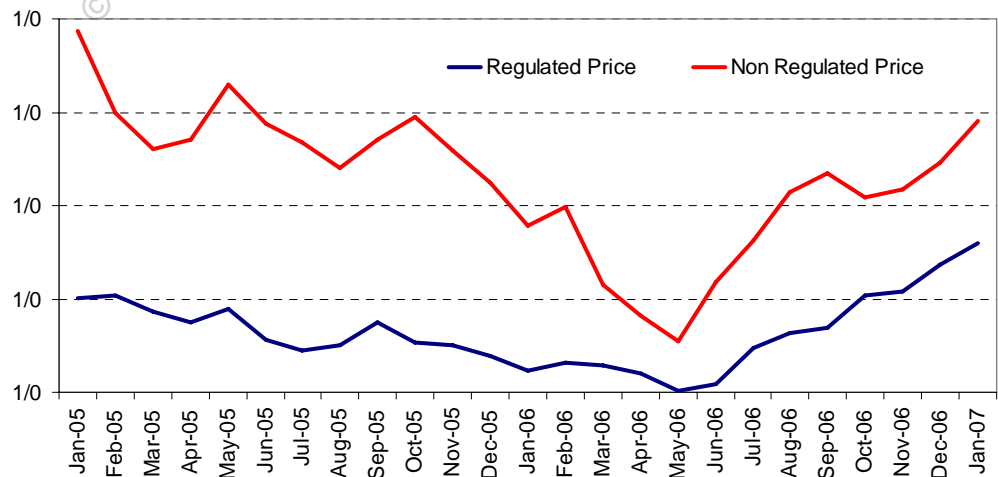


Source: Ecoanalítica

**The price controls are not enough...**

A fact that stands out is that this high inflation phenomenon is happening within the context of price controls that have been in place since February 2003. Around 40% of the items found in the goods and services basket, that is used to calculate inflation, are price controlled. The effect that MERCAL has, selling highly subsidized items, and able to count on a number of centers and affiliates with a substantial market presence nationwide, should also be considered.

## Inflation ( Annual Var% )



Sources: BCV and Ecoanalítica

## ***Weekly Report***

The effect that price controls have had on the overall situation hasn't surprised anyone. It hasn't prevented inflation from falling, and it has generated shortages and created a black market with higher prices and with an ever growing lack of complying with the price control measures as time goes by.

According to a BCV internal report, the indicator that measures the number of items that aren't found on the shelves or in stock for January this year, is equal to 26.1% of the basket of specific products that BCV pollsters measure every month. This reflects a 2.6 percentage increase with respect to last December. The shortage indicator (when the consumer can't count on substitute goods) for the same month was at 13.4% of products, over 9.2% from December.

The same report highlights that Venezuelans pay, on average, over 66% of the price allowed by regulation for price controlled goods. With regard to food items, this value reaches 67.8%.

### **...the same as the exchange rate control**

The exchange control has gotten in the way of efficient monetary management mechanisms working by not allowing economic agents to freely exchange their assets in bolivars into dollars. This has generated a significant increase in monetary aggregates. On top of this, there is a strong fiscal expansion and the monetization of the international reserves through transfers to the National Development Fund (FONDEN). In this context, the BCV's margin of play to control inflation is limited. The absorption operations by the end of February totaled more than VEB 34,8 trillion and the bank reserve requirement policies haven't had the desired effect.

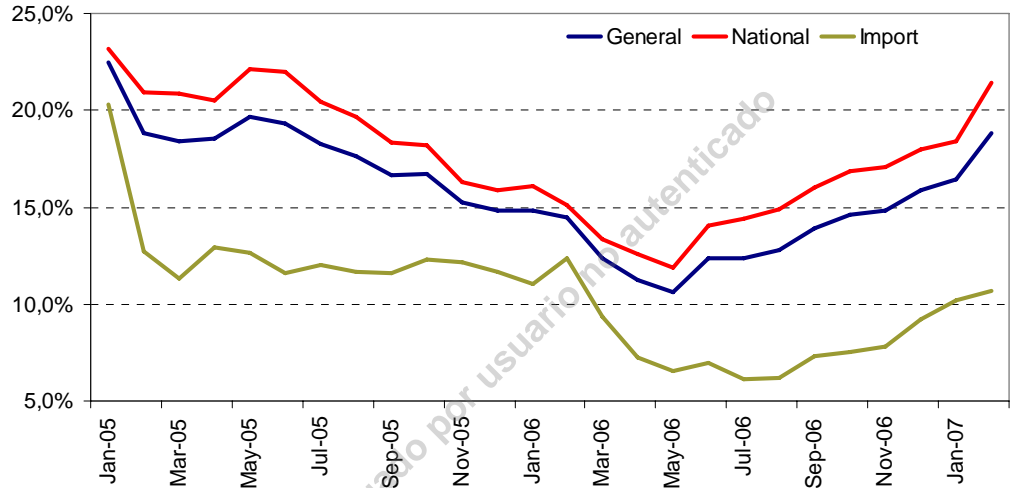
According to the economic policies of the economic cabinet head, the Minister of Planning, Jorge Giordani, a fixed exchange rate is the main strategy in play to control inflation. This strategy has worked well in the past, especially during the 1996-2001 period, when inflation was cut by more than 100% to settle at 12%. However, this exchange control was accompanied by coherent monetary and fiscal policies aimed at lowering the inflation rate.

This is not the case with what's happening now, as we have witnessed, monetary policies are subordinate to the expansive fiscal policy and the use of public spending as a mechanism to spur

# Weekly Report

economic growth and reduce social inequalities. To date, the Government has preferred a high inflation rate (two digits) rather than having to lower and adjust the levels of public spending; and all this while being confined to a draconian exchange control.

**WHOLE SALE PRICE INDEX  
( Annual Var%)**

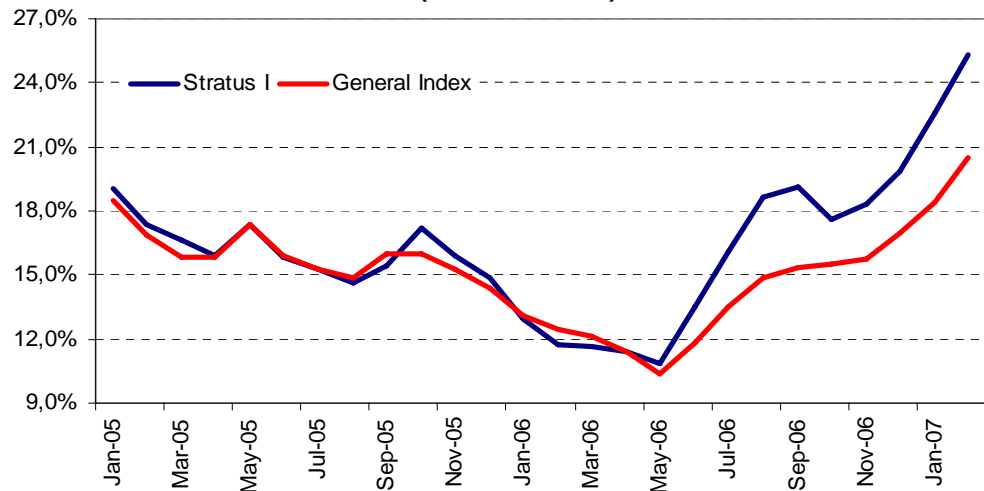


Sources: BCV and Ecoanalítica

## Inflation hurting the poorest

President Chávez has used the political slogan that in his government the people rule. However, the jump in the price index has been most significant in social stratus I (lowest income bracket). For February, while yearly inflation was pegged at 20,5%, in the social stratus I it reached 25,3%.

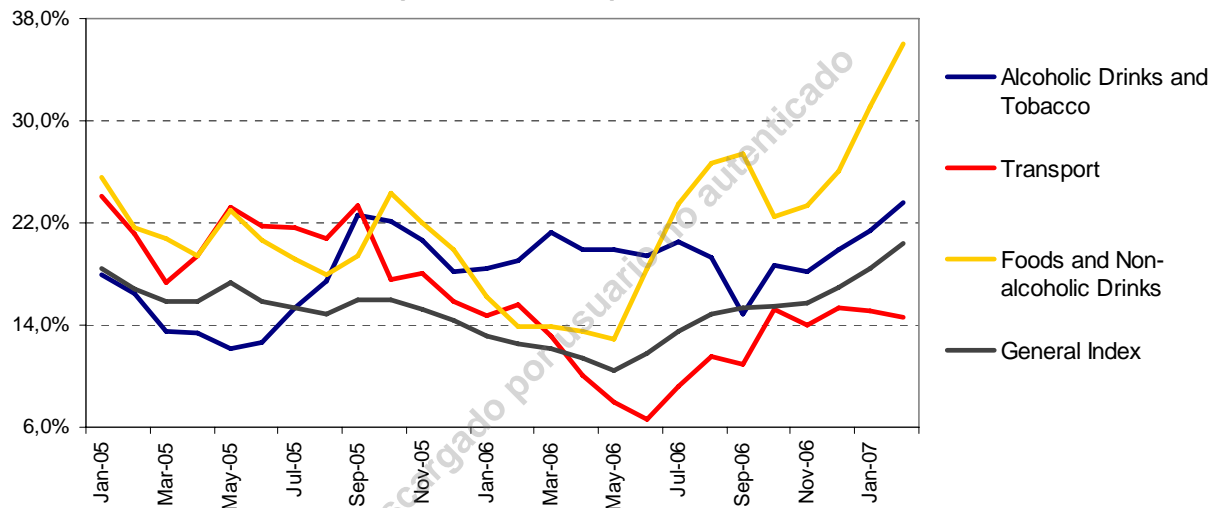
**Social Stratus Inflation  
(Annual Var%)**



Sources: BCV and Ecoanalítica

This is explained by the fact that households belonging to the lower income classes allocate a higher proportion of the family budget to buy food and non alcoholic beverages, both items belonging to the group of goods that reflect the highest increase in inflation, according to the results for the month of February.

**Inflation  
(Annual Var%)**



Sources: BCV and Ecoanalítica

### **Inflation is synonymous to a weak bolivar**

Inflation is nothing more than currency losing its purchasing power. So we have a currency that day by day is able to buy less in the shops and supermarkets. In other words, inflation is synonymous to a weak bolivar. So, if we were the country in the world with the highest inflation rate, we'd also be the country with the weakest currency.

### **A stronger bolivar won't come from monetary reform, but from an economic plan to control inflation**

Concerning the elimination of three zeros from the currency, the BCV pointed out in a statement that "within the framework of the price stabilization policies that the Central Bank of Venezuela is introducing along with the Executive, **the monetary reform plan represents a commitment towards regaining the currency's purchasing power and to reaffirm the objective of attaining economic stability...**"

At **Ecoanalítica**, we don't understand what the elimination of zeros has to do with strengthening the currency. A stronger bolivar will only be achieved if the Government embarks on a serious plan to reduce inflation, which by definition has to reduce the increase in public

spending. The monetary reform plan only generates advantages in terms of accounting, as well as optimizing the payment system, but it in no way strengthens the bolivar, since the currency's purchasing power remains the same.

## Economic Tips

**Revenues expanded by 20% in 2006.** The BCV released its fiscal figures for 2006. Total revenues reached VEB112.6 trillion, which reflects a 20% increase in real terms. By sector, oil revenues had a 33% increase in real terms, while non-oil revenues increased by 20% not counting inflation.

**But spending increases even more.** With regard to spending, the figures show that it reached VEB113.9 trillion, which represents an increase of 31% in real terms. So, public spending had a more pronounced increase than fiscal revenues. Average monthly public spending in 2006 reached VEB9.5 trillion.

FISCAL BALANCE CENTRAL GOVERNMENT (VEB Billions)	December	December	Nominal	January-December	January-December	Nominal	Real
	2006	2005	Variation	2006	2005	Variation	Variation
Total Revenue	15.313	8.611	77,8%	112.551	82.453	36,5%	20,1%
Non-Oil Revenue	4.557	3.571	27,6%	48.409	35.571	36,1%	19,7%
Oil Revenue	10.757	5.039	113,5%	63.145	41.661	51,6%	33,4%
Central Bank Earnings	-	-		997	5.220	-80,9%	-83,2%
Total Expenditure	9.422	8.110	16,2%	113.854	76.638	48,6%	30,7%
Primary Expenditure	8.628	7.572	13,9%	105.438	67.697	55,7%	37,0%
Interest Payments	794	538	47,6%	8.416	8.941	-5,9%	-17,2%
Domestic Debt	298	384	-22,3%	3.201	4.228	-24,3%	-33,4%
Foreing Debt	496	154	221,5%	5.215	4.713	10,7%	-2,6%
Quasifiscal Expenditure	-	-		-	-		
Fiscal Balance	5.892	501		(1.303)	5.814		
Primary Balance	6.686	1.039		7.114	14.756		
Non Oil Balance	(4.865)	(4.538)		(65.445)	(41.067)		
Debt Amortization	811	107		6.600	4.515		
Net Monetary Injection	3.940	751	424,8%	61.217	28.190	117,2%	91,1%
Financing Requirements	(5.080)	(394)		7.902	(1.300)		
Foreing Debt	11	24		267	182		
Domestic Debt	1.240	3.740		5.611	12.678		
Tresury Bonds	1.237	3.740		5.596	11.361		
Tresury Debt	3	-		16	1.317		
Others	(6.332)	(4.159)		2.023	(14.160)		

Sources: BCV and Ecoanalítica

**The Government closed with a slight deficit.** Taking all these results into account, the figures reflect that the Government closed the year with a VEB1.3 trillion deficit, compared to the surplus of VEB5.8 trillion with which it closed 2005. Additionally, the non-oil sector fiscal deficit inflated from VEB41.1 trillion in 2005 to VEB65.4 trillion in 2006. These figures support our theory that currently, fiscal accounts are more dependent on oil revenues than ever before. Financing needs reached VEB7.9 trillion, and they were mainly covered by domestic debt (VEB5.6 trillion). It's important to point out that between 2005 and 2006, gross domestic debt dropped 56%, going from VEB12.7 trillion in 2005 to VEB5.6 trillion in 2006.

**Public sector labor obligations increase.** According to the Ministry of Finance, during 2006, the Executive paid out more than VEB1.1 trillion in severance payments to former public administration employees, which only represents 5% of the total of this debt owed by the State. According to Ministry of Finance preliminary estimates, these obligations amount to VEB20 trillion and debt increased by VEB4 trillion during last year, given that the number of people retired in the sector increased.

## OIL TIPS

**The basket closes going down.** Venezuela's average export price closed with a weekly average of US\$52.70, down US\$0.9 from last week average. Including this price, the yearly average so far is at US\$48.68 per barrel.

**PDVSA's rating is up.** Standard & Poor's raised PDVSA's long-term foreign currency rating to 'BB-' from 'B+' and removed the classification from creditwatch, where it had been placed since February 8<sup>th</sup>. S&P also assigned PDVSA a BB- long-term local currency corporate credit rating and added that the perspective for all ratings is "stable". This S&P decision paves the way for the issue of the so-called PDV-Bono.

**Everything ready for the PDVSA bond.** After the successful placement of the Bono del Sur II, the market now awaits to receive the issue of the PDVSA bond for an amount that could reach US\$3.5 billion. Though it's been speculated that the issue will be in bonds denominated in dollars to be paid in bolivars, it's not totally out of the question that they could use a formula similar to the Bono del Sur, which is to say, 50% of the bonds will be a bolivar-dollar paper and the other half a TICC. In any case, we believe that the issue will be another excellent investment opportunity and we recommend our clients to be on the lookout for the announcement defining the conditions.

## Weekly Report

**Some oil taxes didn't fill the bill.** The Government didn't meet their expected goals on the collection of 6 oil taxes. The tax on sulfur royalties applied to projects to upgrade heavy crude that have or use this by-product, was the item with the highest percentage of unpaid taxes, VEB156.28 billion was the target, and only 1.2% of that amount was collected, which is to say, VEB1.85 billion. Another taxes which didn't bring in what was expected was the tax on gasoline consumption, only bringing in VEB137.78 billion, while the target figure was VEB1.21 trillion; and the tax on the consumption of other hydrocarbon by-products, which together had a collection target figure of VEB 2.07 trillion, and only 28% was collected.

**Natural gas also caused a problem.** Of the three taxes left, two of them have to do with gas production, where taxes collected fluctuated between 50% and 85% of the target figures.

**New tax gets off to a bad start.** The recently created extraction tax collected VEB2.34 trillion, which is to say, 89% of the target (VEB2.64 trillion). The total of what was not collected by the Government concerning these six taxes equals VEB8.3 trillion. However, these setbacks were amply made up for by the crude tax surplus collected from the public as well as the private sector.

**Production cutbacks continue.** According to the monthly figures published by the International Energy Agency (IEA), Venezuela cutback production by 65,000 barrels in February. According to IEA, December production was at 2.55 million barrels, January was at 2.49 million barrels, and February was at 2.43 million barrels. The Agency pointed out that most of the decline in production came from the Orinoco Belt that had dropped its production average from 580,000 barrels to 525,000 barrels.

### BUSINESS SECTOR TIPS

**Consumption boom among the poor.** According to a recent study by Datanálisis, it's the poor who are spending more money in Venezuela, due to the fact that for the last eight years, the purchasing power for Class E families (around 45.7% of Venezuelans) has increased by 14%, while Class A, B, and C family incomes have gone down by 23%, and Class D doesn't register any increase at all.

**Excessively optimistic.** Currently, the volume of purchases made by the lower income levels surpasses those made by upper levels due to the perception that these sectors have concerning the country and their personal economic situation. While

## Weekly Report

70.6% Class A-B households consider that the situation that the country is in is completely negative, a fact that affects spending and investment, 67.5% of lower income families think that everything is just fine and dandy. Furthermore, 81.6% of this group considers that their situation will improve in the mid term, while only 50% of Class A-B families are optimistic about their economic and social future.

**Poor people with money.** Datanálisis points out that the increase in purchasing power has turned poor people into compulsive buyers, and even though Venezuelans are just as poor as ever, now they have more money in their pockets to spend. This sector of the population doesn't believe that savings is a priority, because the money they have today, they won't have tomorrow, so they decides to spend to protect themselves from high prices and the shortage of products.

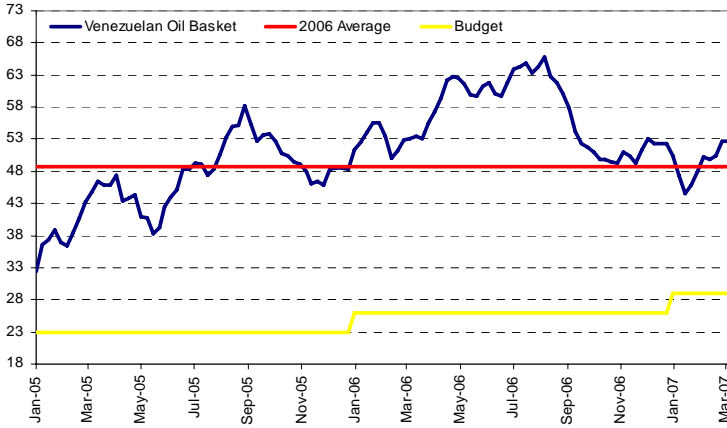
**The consumption of energy rises.** In January, a 6.14% increase in the consumption of energy from the National Electrical System was registered compared to the amount consumed for the same period last year. The maximum power demand of the system, during that period, reported an increase of 4.18% with respect to January 2006.

**Stronger State.** According to the Minister of Labor, José Rivero, the State will take over companies in the process co-management if they follow the lines established by the National Strategic Plan. For those companies that aren't a part of the Plan, alternatives will be established for their participation.

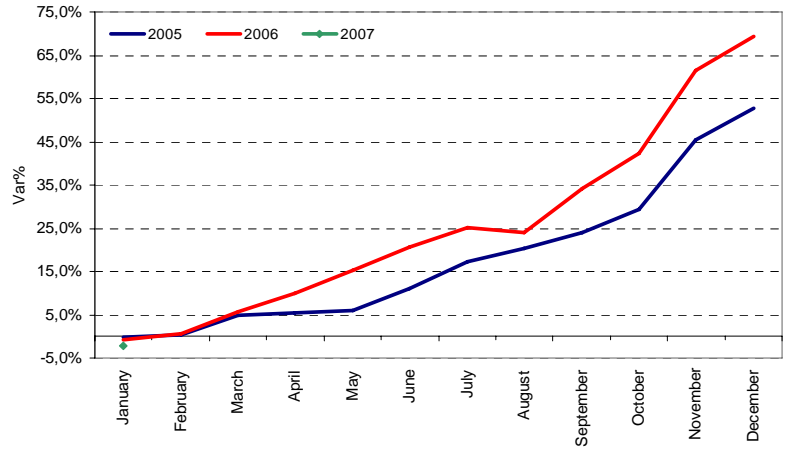
**A reform that affects the banks.** According to the SENIAT, within the framework of the Special Powers Law, the Government proposes to tax bank earnings through a reform of the Income Tax Law, according to which earnings that are generated by public bonds will be taxed by 34%.

# ECONOMIC OVERVIEW

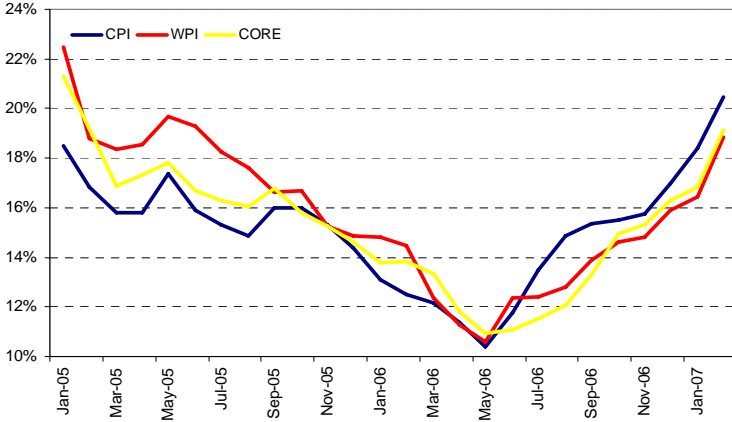
**Oil Price**  
(Venezuelan Basket US\$/pb)



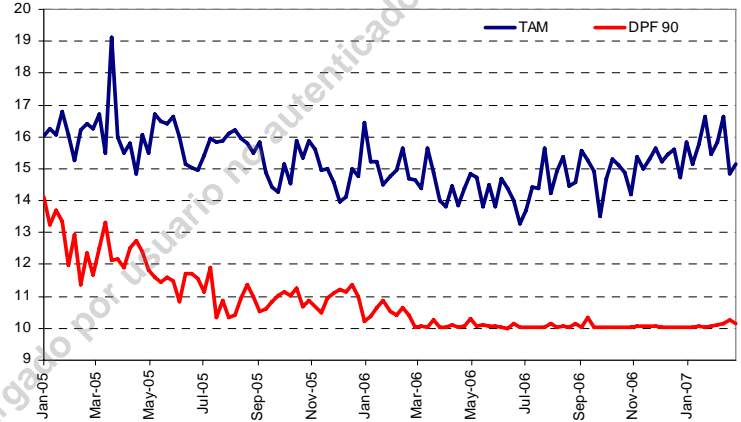
**Real Expansion (M2)**



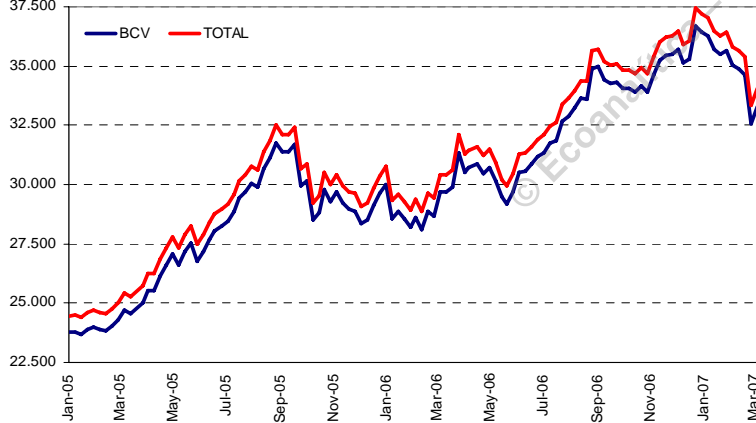
**Inflation**  
(Last 12 Months)



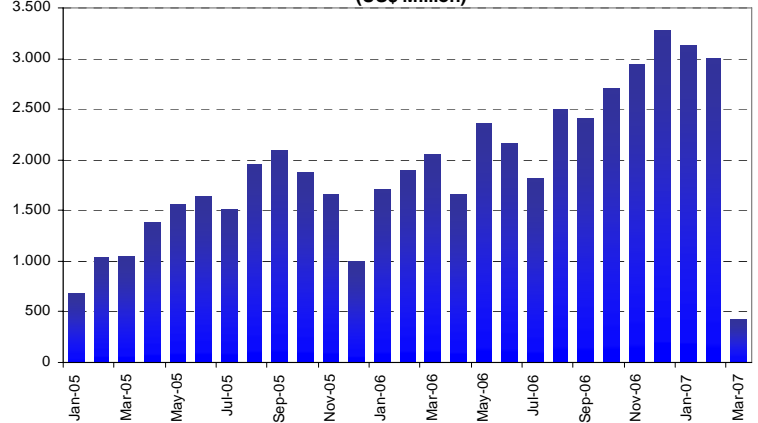
**Interest Rate**  
(Six Principal Banks)



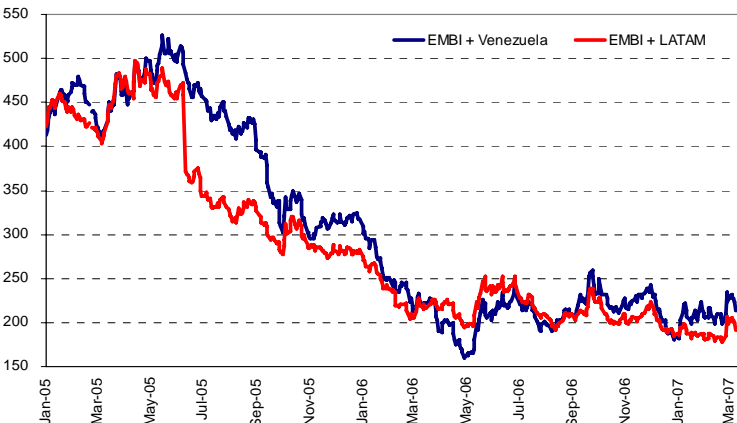
**Fx Reserves**  
(US\$ Million)



**Disbursement**  
(US\$ Million)



**EMBI**



**Central Government**  
(VEB Billion)

