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## ***EXPANSIVE FISCAL POLICY TO CONTINUE THROUGHOUT 2007***

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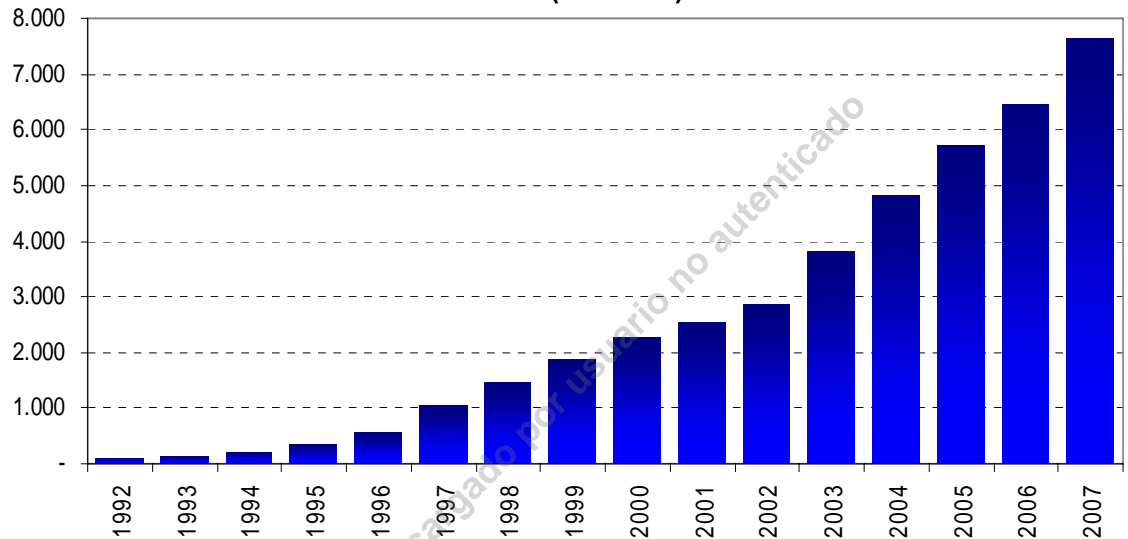
The Central Bank of Venezuela (BCV) recently published the Central Government's fiscal figures for January of this year. Two things stand out: firstly, a strong growth in public expenditure and secondly, a sharp drop in oil income. These January numbers are a clear indication that the Government is not thinking of modifying the expansive trend of the fiscal policy it has been applying over the last three years.

### **Expenditure up considerably in January**

According to the BCV, the Government's fiscal expenditure in January was VEB 8.4 trillion (US\$ 3.921 billion), an increase of 48.1% over January 2006. In real terms, the variation was 25%. It should be noted that budgeted expenditure is seasonally low for the first quarter of the year in Venezuela, since there is a high level of expenditure in the last quarter of the year (particularly because of the closing of contracts and payment of bonuses to Public Administration employees), and there is a corresponding reduction of public expenditure in the first quarter of the following year.

This rule has been broken during the last three years of the present administration. In fact, according to the BCV figures, January 2007 expenditure was the highest ever in real terms, taking 1992 as base year.

**Index of Real Expenditure of January  
(1992=100)**



Sources: BCV and Ecoanalítica

According to our calculations, January primary expenditure rose by 30% in real terms, indicating that net monetary injection was VEB 6.6 trillion (US\$ 3.070 billion), for a real growth figure of 47%.

**Oil income falls – cause for concern**

Total income suffered a nominal fall of 5.2% in the first month of the year, which translates into a 58.7% drop in oil income, especially in royalties, which fell by 66.6% in real terms. This surprisingly sharp fall hides the reality of the modifications that the Government has been making to the way it administers oil income. It has to be remembered that PDVSA is not handing all the foreign currency it receives over to the BCV, and that a significant surplus is accumulating in its currency accounts at the Treasury.

**Things turn murky**

This mechanism was thought up by the Government to take on the problem of inflation, although its effects are limited, since it implies no change at all in the direction and execution of its fiscal policy. However, both the Finance Ministry and the BCV should report how

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these foreign currency funds are being administered and how exactly they are being spent. Nevertheless, in view of the way in which the FIEM, FONDESPA and FONDEN funds are being managed; there is little hope of our receiving clear accountability of these mechanisms now being used by the Government at the Treasury.

Moreover, this exclusion of a part of the oil income generates distortions in the Central Government's fiscal activities, since if the Government is not going to be receiving an important part of the oil income which is repressed in Treasury accounts, the logical effect should be a slowing down in public expenditure. This has obviously not happened and the fiscal administration results for the month of January this year are ample evidence to this effect.

**We are already faced with a significant deficit for the first month of the year**

According to the BCV, the Government ended January this year with a deficit of VEB 1.7 trillion (US\$ 787 million). This contrasts with a fiscal surplus for January 2006 of VEB 1.4 trillion (US\$ 659 million).

FISCAL BALANCE CENTRAL GOVERNMENT (VEB Billions)					
	January 2007	January 2006	Nominal Variation	Nominal Variation	Real Variation
Total Revenue	6.738	7.109	-5,2%	-5,2%	-19,9%
Non-Oil Revenue	4.805	3.154	52,3%	52,3%	28,7%
Oil Revenue	1.932	3.955	-51,1%	-51,1%	-58,7%
Central Bank Earnings	-	-		0,0%	0,0%
Total Expenditure	8.429	5.692	48,1%	48,1%	25,1%
Primary Expenditure	7.947	5.172	53,6%	53,6%	29,8%
Interest Payments	482	520	-7,3%	-7,3%	-21,7%
Domestic Debt	286	297	-3,8%	-3,8%	-18,7%
Foreing Debt	196	223	-11,9%	-11,9%	-25,6%
Quasifiscal Expenditure	-	-			
Fiscal Balance	(1.692)	1.417			
Primary Balance	(1.209)	1.936			
Non Oil Balance	(3.624)	(2.538)			
Debt Amortization	3.173	1.468			
Net Monetary Inyection	6.600	3.783	74,5%	74,5%	47,4%
Financing Requirements	4.864	51			
Foreing Debt	2	28			
Domestic Debt	-	-			
Tresury Bonds	-	-			
Tresury Debt	-	-			
Others	4.863	23			

Sources: BCV and Ecoanalítica

Moreover, January amortization of public debt reached significant levels (VEB 3.2 trillion), upping financing requirements to VEB 4.8 trillion (US\$ 2.262 billion). On the other hand, according to calculations made by **Ecoanalítica**, interest payments on public debt fell by 22%.

## Nothing new under the sun for 2007

Although to date only the January figures have been reported, it is already clear that the Government's tendency towards increasing public expenditure will be maintained throughout 2007. This is in spite of the fact that the Government is supposedly worried about controlling inflation. Average total expenditure will stand for the year at around VEB 140 trillion, meaning an average monthly expenditure for the February to December period of VEB 12 trillion (US\$ 5.581 billion).

In fact, in a recent interview, the Finance Minister, Rodrigo Cabezas, indicated that during this stage of the Government's administration, maintaining growth and controlling inflation are the areas that will receive most attention. He also said that no economic policy will be implemented that would cause a recession as a result of bringing down inflation, since "the reduction of expenditure forms part of diabolical world scheme."

According to Cabezas, the Government prefers to grow with moderate inflation, rather than to detain sustainable economic growth in order to beat inflation. The Finance Ministry estimates that public expenditure for the year 2007 will be equivalent to 27% of GDP, and that it will be manageable and shock-free, just as it was in 2006. At **Ecoanalítica** we are of the opinion that the public expenditure of the Central Government during 2007 will be equivalent to 32.7 points of the GDP, *i.e.* 5.7 points above the Government's estimate.

The increased expenditure will be largely paid for with surplus oil income, even in a scenario where SENIAT tax collections decline. This is a bad sign, because it makes the fiscal accounts even more vulnerable than they already are.

## Urgently required: integrated tax reform and a redesigned fiscal policy

We believe that Venezuela has to implement an integrated tax reform, which will necessarily mean making changes to the legal framework - the tax laws - and that this also must include profound judicial changes. Likewise, a fundamental change to the composition, stabilization and inherent rigidity of public expenditure is long overdue in order to improve its efficiency and flexibility, with a view to

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encouraging investment in human capital and physical infrastructure. In other words, a State-instituted reform that is so far nowhere in sight.

We must emphasize that the Government has to revamp its current fiscal policy strategy and, as a first step, establish credible stabilization mechanisms and reduction of its liabilities (rather than increase them). We must bear in mind that the fiscal policy has had a decisive role in transferring external shocks to the rest of the economy, which has acted as a sort of echo chamber for propagating them, rather than being an instrument that contains or limits the distortional effects arising from the external vulnerability of Venezuela's economy.

For all of the above reasons, what we see in current circumstances is a very low capacity of public finances to adjust to such shocks. Over the longer term this could well lead to chronic fiscal problems that over time will prevent sustainable growth within a stable and low-inflation environment.

At ***Ecoanalítica*** we are convinced that the stability of public expenditure is always a valid objective, not only to achieve macroeconomic balance, but also for reasons of efficiency and welfare, since in order to meet any goals in the areas of public health, education, infrastructure and reduction of poverty (themes that are held by the Government to be the prime concerns of its public policies), expenditure has to be stabilized over a relatively long period of time. If the aim is to achieve sustainable economic growth that will permit a better distribution of income, it is very important to reduce the volatility of prices and/or fiscal income.

## Economic Tips

**Budgeted expenditure continues to rise.** In a period of just four months, the National Assembly has approved VEB 6.7 trillion in additional credits. Thanks to these authorizations, the expenditure covered by the budget has grown by 6%, putting it now at VEB 121.8 trillion.

**PDVSA bonds declared tax-free.** The Government issued a new decree granting all companies and investors, both those residing in the country as well as abroad, tax-free status to earnings on PDVSA bonds. In the original decree, the exoneration only applied to country residents, which meant that the issues were less attractive. Tax experts point out that although the new decree does not specify the extension of the grace period, it should be interpreted as five years, since this is the maximum term allowed under the Organic Tax Code. Nevertheless, the Executive is empowered to extend the exoneration every five years.

**Government pays down foreign debt.** President Hugo Chávez announced that the last part of the country's debt with the World Bank, equivalent to US\$ 52 million, had been paid. Last year the Finance Ministry cancelled certain projects, worth US\$ 150 million, it had with the World Bank. This early cancellation of obligations led to State savings of US\$ 8 million.

**A low figure.** The balance of the Republic's foreign debt stood at US\$ 26.883 billion at the close of December 2006, of which 11.6% corresponded to obligations registered with multilateral organizations (US\$ 3.105 billion). The bulk of this debt is to the BID and the CAF. The amount owed to the World Bank was less than 1% of the total debt.

**A political decision.** At *Ecoanalítica* we are of the opinion that any reduction of foreign debt is positive, but we believe that this should start with the debt that is most expensive for the Republic. This is not the case of the debt to the multinationals, which is the least costly and is associated with projects to improve the quality of the country's public policies. The Government ought to concentrate on reducing the most costly debt, especially that which it has contracted with commercial banks.

**Transfers of funds continue.** The BCV made another transfer of international reserves to FONDEN. BCV numbers indicate that US\$ 1.3 billion was handed over on April 13, making a total of US\$ 5 billion transferred in just two months. Thus only US\$

1 billion remains to be transferred from the BCV, since the amount requested was US\$ 6 billion.

## OIL TIPS

**Slight drop in the oil basket price.** The Venezuelan oil basket price fell by US\$ 0.60 to US\$ 57.69 per barrel. So far this month of April, the average price of Venezuelan oil stands at US\$ 57.99, which is considerably higher than the averages registered for January (US\$ 46.83), February (US\$ 50.41) and March (US\$ 53.03). So far this year the average stands at US\$ 51.08 per barrel.

**Oil production rises...** According to the EIA, Venezuela increased its crude extraction in the month of March by 60,000 barrels per day to a total of 2.4 barrels per day. OPEC members that are adhering to the quota system (all except Iraq and Angola) jointly raised their March production by 90,000 bpd, mainly thanks to increases by Venezuela and the United Arab Emirates, to a total of 26.57 million bpd.

**... While others say it has dropped.** In its monthly report, the International Energy Agency (IEA) reported a crude production of 2.42 million bpd for Venezuela, a figure that indicates a drop of 10,000 bpd with regard to the month of February. As may be seen, these numbers contradict those of the EIA. According to the IEA, national production for the last quarter of 2006 averaged 2.5 million bpd, and then went down to 2.44 million bpd in the first quarter of 2007.

**Crude prices to stay high...** The EIA expects WTI crude to average US\$ 65 per barrel throughout the summer (compared with US\$ 70 for 2006) and will stand at an average yearly price of US\$ 64 for this year and next year.

**Not going to happen.** Mario Isea, President of the Hydrocarbons Sub-Commission of the National Assembly, has stated that in view of the fact that the increase in gas prices announced by President Chávez in January would be accompanied by other measures, the increase is therefore not planned for the short term. According to the Deputy, the Parliament's Permanent Commission of Energy and Mines has yet to receive the price increase scenarios prepared by the Ministry of Energy and Petroleum (MENPET) that had been requested by the President.

## BUSINESS SECTOR TIPS

**Awful results.** The Government plans to build 110,877 over a two-year period - an investment of VEB 11.6 trillion. According to the schedule it has presented, 79,108 homes are to be finished in 2007. Of these units, 69,583 would correspond to the termination of prior housing developments and 9,525 would be new housing solutions. 31,769 homes are supposed to be built in 2008, with an investment of VEB 1.9 trillion. What most calls one's attention is that the Government recognizes that there are still housing developments that were planned for the years 2001 and 2002 that are as yet unfinished.

**Car sales continue to rise.** According to CAVENEZ, 37,277 vehicles were sold in March this year, 11% up on February sales. 99,489 units were sold in the first quarter, 50.1% more than during the same period of 2006.

**EDC says yes.** The Board of Directors of La Electricidad de Caracas (EDC) unanimously recommended accepting PDVSA's offer to purchase the company. In February, the National Government had agreed with AES on a price of US\$ 739 million for 82.14% of EDC, and on Monday it launched a Public Offer of Acquisition (POA) for the electricity company in the local market of VEB 587.81 per share.

**CANTV abstains.** CANTV's Board of Directors did not issue a decisive opinion as to the POA initiated by the Government. It did, however, exhort the Government to resolve the economic imbalances existing between Venezuelan shareholders and holders of ADSs in the USA. The CANTV directors asked the Government to modify the exchange control regulations in order to allow shareholders the possibility of converting the price paid by the State in US dollars at the official exchange rate.

**CANTV workers at a disadvantage.** The telephone company's Board of Directors considers, moreover, that Class "C" shareholders are at a disadvantage in respect of the other classes of shareholders, but declined to make any recommendations in this regard. "The alternative of not accepting the offer and continuing as shareholder of the company requires an analysis of the future scenarios for the company," stated the communiqué.

**State seeks to lower rates.** Jesse Chacón, Communications Minister, has indicated that once the acquisition of CANTV is completed, a "fair rate" system will be implemented to stimulate competition. In the Government's opinion, cell phone rates

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have grown far faster than inflation. It is worth mentioning that Chacón ruled out price controls over the cell phone sector.

**Internet use continues to grow.** According to estimates made by Tendencias Digitales, Internet penetration in Venezuela at the close of 2006 was 15.3%, a figure equivalent to 4.1 million users, meaning an increase of 35.5% over the year 2005.

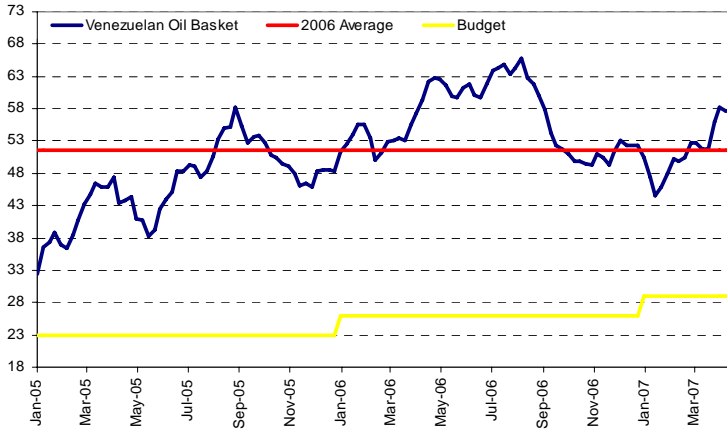
**Better financing conditions sought.** The Banking Superintendency is seeking to improve access to micro financing through more favorable, appropriate and special conditions. The review of the conditions is being made with the intention of reforming the General Law of Banks and Financial Institutions under the Enabling Law (*Ley Habilitante*). Details of such modifications to credit conditions were not published, however.

**Government looking to regulate the private health sector.** The Finance Commission of the National Assembly has assigned a sub-commission to study the cost of private sector medical and surgery services. The sub-commission, headed by Tirso Molina, will review the private sector marketing chain. On his side, Ricardo Alfonzo, President of the Venezuelan Chamber of Private Clinics, stated that costs rose by 12.3% last year. He stated categorically that the profits of Class A and B private clinics operating in the country are between 1% and 3.5% per year.

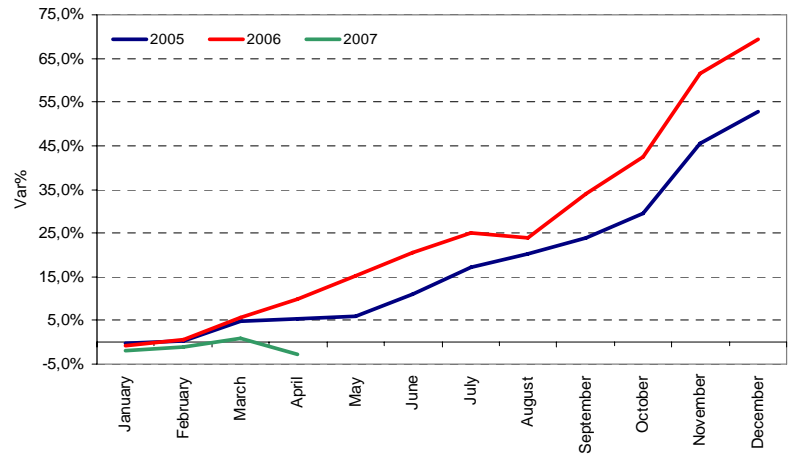
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# ECONOMIC OVERVIEW

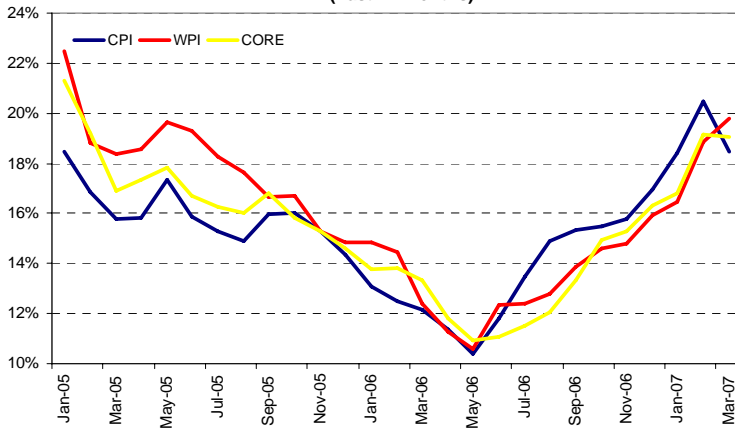
**Oil Price**  
(Venezuelan Basket US\$/pb)



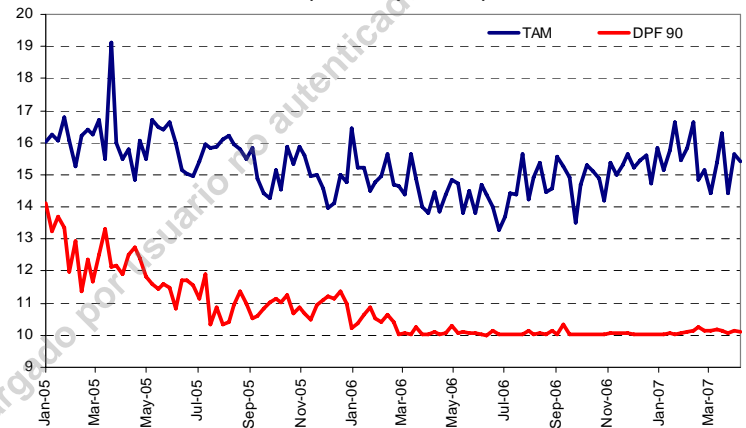
**Real Expansion (M2)**



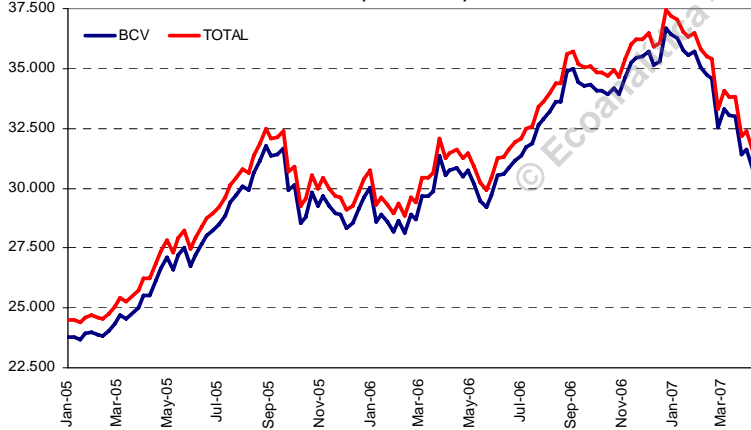
**Inflation**  
(Last 12 Months)



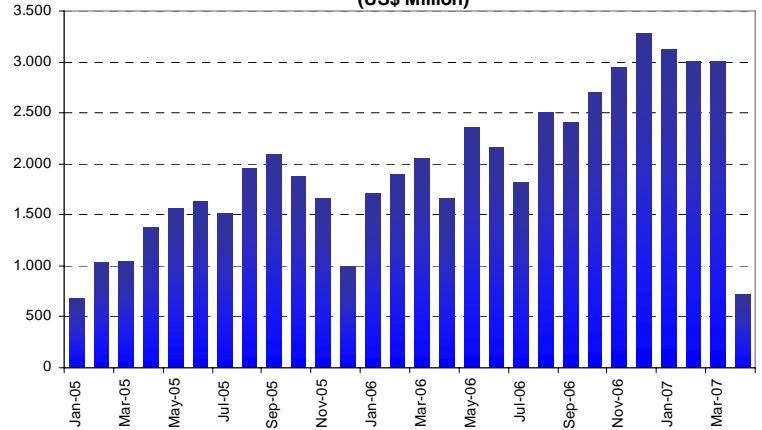
**Interest Rate**  
(Six Principal Banks)



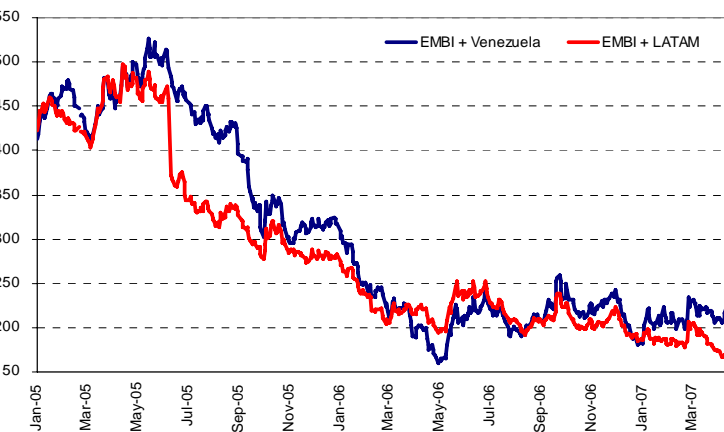
**Fx Reserves**  
(US\$ Million)



**Disbursement**  
(US\$ Million)



**EMBI**



**Central Government**  
(VEB Billion)

