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WHY DOESN'T INFLATION GO DOWN?

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THE CLIENT

The inflation rate registered for the month of June confirms what we have been saying concerning the Government's failure to implement truly anti-inflationary policies; a failure that still continues. Venezuela's high inflation rate is explained by a number of factors of which to date, the Government has only begun to address one of them: the high level of public spending. Reducing inflation will become structural when the Government designs a far reaching economic strategy that includes the analysis of elements such as: controls, the anchored exchange rate and the role of private investment, among other things.

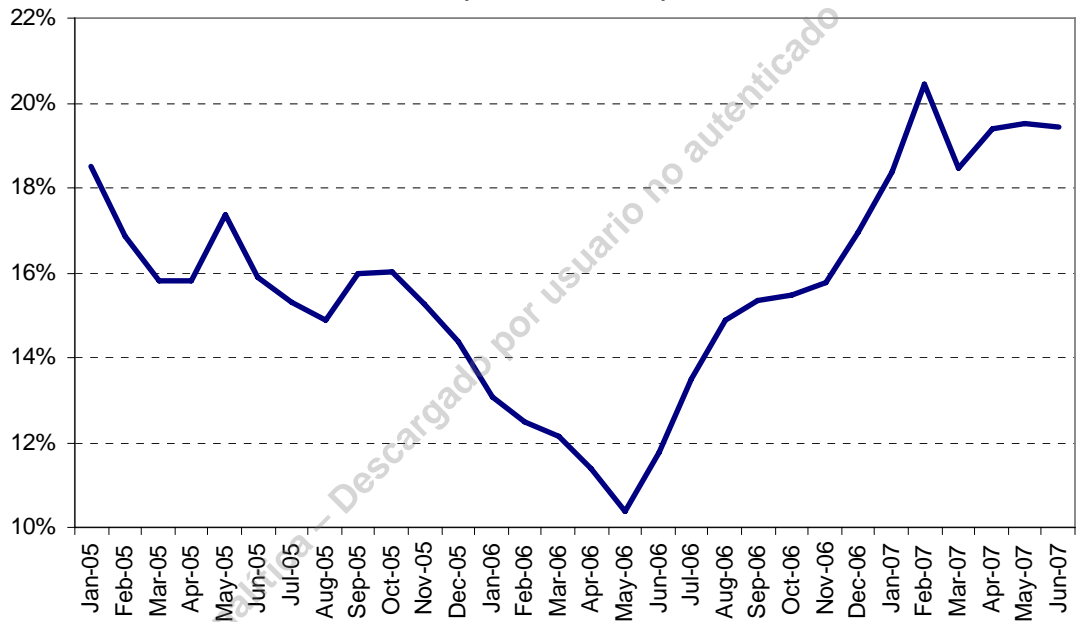
June's inflation proves the failure of MF and BCV policies

According to the report issued by the Central Bank of Venezuela (BCV), the Consumer Price Index (CPI) increased 1.8% in June 2007, much like the previous month's increase of 1.7% and the increase registered in June 2006 of 1.9%. With this final figure for the month of June, the accumulated CPI variation for the close of the first semester is at 7.8%, topping the 5.5% that was reported for the same period in 2006. The annual variation of the CPI is at 19.4%, similar to the month of May which was at 19.5% and greater than the 11.8% that was registered in June 2006.

Weekly Report

With these results we can infer that the measures announced by the National Government during the first two months of the year haven't had much positive effect and it is becoming increasingly more difficult for the Government to meet its established inflationary goals (12%) for 2007. At **Ecoanalítica**, we continue to stand behind our estimate that annual inflation for 2007 will reach 20.7%.

Inflation
(Last 12 Months)



Sources: BCV and Ecoanalítica

The Government has only applied temporary measures

At the beginning of the year the Government announced a series of additional economic measures aimed at controlling inflation. In fact, in one of the first "Alo, Presidente" programs of 2007, the President recognized that the only macroeconomic indicator that had him really worried was the current inflation rate.

The following are some of the measures introduced at the beginning of the year:

- Implementing monetary reform in order to lop three zeros off the national currency (bolívar) starting in 2008.

- Approving a special law against hoarding, price gouging, boycott, and any other behavior that may affect the consumption of food items or products subject to price control.
- Reducing the Value Added Tax (VAT) rate.
- Allowing the National Treasury to maintain US\$ accounts within the BCV.

The inflation problem has three variants

The inflation issue is very complex and its refusal to come down has to do with three factors that have yet to be dealt with simultaneously by the economic cabinet:

- **The fiscal issue:** Without a significant cutback in monthly public spending, it will be difficult to achieve a structural drop in inflation. However, it is important to mention that in the last few months, the Executive has begun to cutback on public spending in an attempt to control price increases. But, this measure is not enough if the other two fronts are not addressed. The road to controlling inflation has to go through a fiscal policy adjustment which includes greater control of public spending, taking into account seasonal factors, and that adjusts the increase in said spending to the inflation goal set by the Government.
- **Control policies:** After more than four years of having been applied, exchange controls and well as price controls are starting to show their vulnerability, especially the second ones. The only things that price controls have achieved are shortages and making prices go up, precisely what they were supposed to correct. A well thought out anti-inflationary policy has to include a redesign of the control mechanism, which although doesn't call for the complete elimination of controls (this government will never completely eliminate them), includes their constant revision, and with regard to exchange controls, making them more flexible.
- **The role of expectations:** This is the most difficult point, since it has ramifications that go beyond economic policies. We've pointed out that we are in the middle of a period of economic expansion that is significantly fueling demand, alongside the fact that most Venezuelans have experienced an increase in

their purchasing power. But this recovery of demand has not been compensated for with a significant increase in supply, since the private sector has not substantially increased its levels of investment. The situation isn't worse thanks to imports, which can only be sustained at these levels due to the enormous flow of petrodollars.

Of these three factors, the Government is finally starting to adjust one of them

At *Ecoanalítica* we have been observing that the Central Government (CG) has been reducing its spending. These observations are backed by the Central Government's fiscal management figures for the first quarter 2007 released by the BCV. This being said, it's important to point out that the CG doesn't represent the whole Public Sector, but it is its most important component, in terms of spending, making up 76% of SPR.

During the first quarter of the year, total spending dropped in real terms by 5.4%. During the first three months of the year, the Government spent VEB27.4 trillion, which is to say, a monthly average of VEB9.1 trillion.

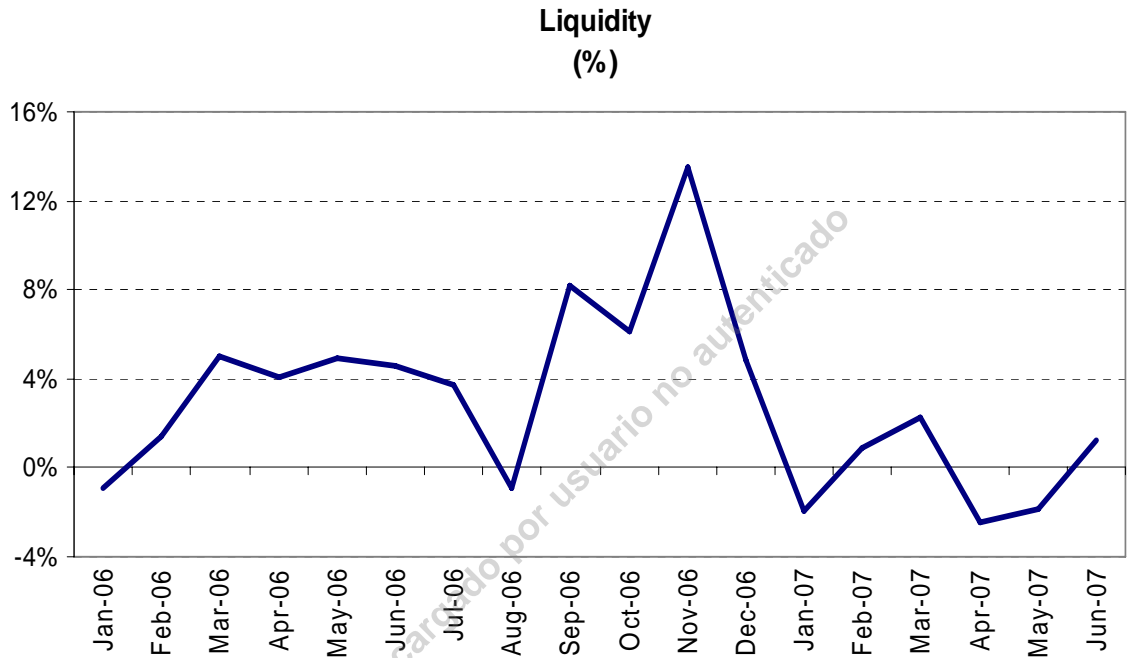
Upon analyzing the evolution of liquidity, one finds that these observations are substantiated. It's important to point out that the growth of M2 during the first quarter of 2007 has been significantly lower than during the same period in 2006. While during the first quarter in 2006 M2 grew 20.6% in nominal terms (7.8% in real terms) compared to the close of 2005; during the first quarter of 2007, M2 dropped by 2.0% which translated to a drop in real terms of 17.8% compared to the close of 2006. This is the main reason we have for stating that the CG, since March, has been starting to moderate the growth of current spending within the framework of a far reaching anti-inflationary policy.

A point that must be mentioned is the fact that part of this cutback in public spending, that the statistics of the BCV reflect, is due to the fact that part of current Government spending is in dollars. However, according to Ministry of Finance (MF) sources, the amount of spending in dollars doesn't surpass 10% of the global amount.

It's still too soon to tell if the Government really has a plan to reduce public spending. If the polices of the first quarter continue, we are

Weekly Report

convinced that they will have positive consequences on the Government's efforts to control inflation.



Sources: BCV and Ecoanalítica

Reducing inflation requires structural measures

The problem with inflation has become much more serious in the last few years. Fiscal policy management is the factor that generates the most pressure with regard to the increase of prices, although the other two factors that we mentioned before can not be left unchecked. If controls are changed and the Government doesn't create incentives for private investment, reducing inflation won't be structural. In the past, it was enough to peg the exchange rate in order to have a significant lowering effect on inflation, as it happened during the period within 1996-2001. In the current situation the country finds itself, anchoring the exchange and announcing a monetary conversion policy is not enough.

Economic Tips

SENIAT collected VEB 36.7 trillion during the first quarter of 2007. The tax collection agency reported that non-oil revenue registered an increase of 43.5% compared to the same period last year, when it was at VEB 25.6 trillion. VAT collected registered an increase of 23.3%, despite the drop in the tax percentage from 14% to 11% during this period.

The 9% VAT rate entered into effect. The big commercial establishments all complied with the Executive Office decree which lowered the VAT from 11% to 9% starting on July 1st. This Saturday, Minister of Finance, Rodrigo Cabezas, indicated that government policies were focused on moderating the VAT with the ultimate aim of disappearing it all together because “a tax like this is what directly affects a worker’s salary and a family’s income.”

INDECU monitors VAT modification. INDECU noticed some mistakes in the cash registers of a few establishments when it came time to adjust the VAT change.

People belonging to the third age group are exonerated from real estate tax (principal house). This benefit will be enjoyed by people that are retired or pensioned by the national, state, and municipal public administration and that are 65 or more years old.

Vargas will continue to be exempted from paying VAT and income tax for 2007; so reported the National Tributary Superintendent, José Vielma Mora.

40% of the National Budget has been executed. By the close of June, the National Budget for the year has been executed by more than 40%, reported the director of the National Budget Office, Alfredo Pardo. The approved National Budget for 2007 was of VEB115 trillion, an amount that has increased by VEB10 trillion due to supplementary appropriations approved by the National Assembly (AN). Therefore, the true National Budget is VEB125 trillion.

AN approved supplementary appropriations for VEB207.00 billion. The supplementary appropriations were approved for the Ministries of the Office of the Presidency of the Republic and Higher Education, with the aim that they be transferred to the Gran Mariscal de Ayacucho Foundation.

Venezuela is among the most expensive South American countries to work and live in. According to a study by the Economic Commission for Latin America and the Caribbean (ECLAC) people's purchasing power is affected by the increase in cost of goods and services. The report points to Chile as being the most expensive country, followed by Brazil, Venezuela, and Uruguay, while Paraguay and Bolivia are the cheapest countries to work and live in.

TSJ orders the BCV to set credit card interest rates. The Constitutional Chamber of the TSJ ordered the BCV to set the maximum and minimum interest rates on credit cards. The court's decision came about due to a defense action on behalf of cardholders regarding their collective and diffuse interests.

OIL TIPS

The price of Venezuelan crude closes at US\$63.87. MENPET announced today that the price per barrel of Venezuelan oil closed the week at US\$63.87; down US\$0.12 from the previous week's price.

PDVSA extends EPS registration. PDVSA extended the deadline to signup in the Social Production Company Registry (EPS) for the Petroleum and Gas sector, until December 31st, of this year. The oil company explained that the extension was aimed at guaranteeing the participation of all economic entities dedicated to producing goods, works, and services which wish to enter into contracts with PDVSA.

ExxonMobil doesn't expect that pulling out of Venezuela will affect its financial situation. The US oil company, ExxonMobil, said that it didn't expect that the nationalization of its interest in the Cerro Negro project in Venezuela will have any material effect on its operations or financial situation. Exxon said that the net investment in productive assets in Cerro Negro was US\$750 million, less than 0.7% of its assets. The company said that it was negotiating the compensation for its participation with Venezuela.

CITGO refineries could be expropriated to makeup for Orinoco belt compensation. The Houston Chronicle reported yesterday that a United State's judge could rule to confiscate Venezuelan government properties in the US and award them to ConocoPhillips and ExxonMobil, in compensation for their assets in the Orinoco Oil Belt that were taken over by the Venezuelan government after the oil companies refused to migrate their projects to the new operational scheme which gives PDVSA majority stakes in operations. The confiscation of Venezuelan property would happen

if the case were to enter into international arbitration, the ruling be against Venezuela, and Venezuela refuse to pay whatever the ruling stipulate.

CITGO declared innocent. The company was accused of errors in the quantity of benzene reported in the streams of the Corpus Christi effluents treatment plant during 2001-2002.

Venezuela will require investments of US\$120 billion over the next ten years. In Asdrúbal Baptista's opinion, this quantity can only be covered by national or foreign private investment.

SINOPEC searches for more business in the Orinoco Belt. The Chinese petrochemical corporation (SINOPEC), the second largest of its kind in China, is holding talks with Venezuela in order to initiate further exploration of the Belt. SINOPEC will be in charge of 32% of the POSA exploration project located on the eastern part of the Paria Gulf, and PDVSA will control 60% of this mixed company with INELECTRA controlling 8%.

17 agreements between Venezuela and Iran. Among the most noteworthy are the construction of a petrochemical mixed company at the petrochemical complex Pars del sur, located in Assaluyeh, and the sale of gasoline by Venezuela to this Islamic Republic.

BUSINESS SECTOR TIPS

The competition will be about prices. CANTV announced a new promotion for domestic and international calls, and for calls to cell phones that are made from any public phone. Domestic long distance calls will have a discount of 20%; while calls to cell phones will have a discount of between 17% and 20%.

Bank capital contributions will have to be accounted for. SUDEBAN authorities will require banking entities to provide all information concerning capital contributions made by owners, or shareholders between the year 2000 and up to the present time, with the aim to continue studying the factors that have led to the drop of the system's index of equity solvency. It's worth mentioning that the MF, along with the BCV, and the supervising organism, are carrying out the respective studies in order to determine the viability of a new drop in the minimum equity index required, which was set last year at 8% after a drop of two points.

SUDEBAN evaluates the creation of six development banks. According to the calculations of SUDEBAN, in Venezuela there exist around 2,000,000 micro-companies that need loans in order to carry out their projects. Of these only 200,000 have had access to the national banking system. The entities that are waiting for the authorization to come from the BCV and the SUDEBAN are Prosperar, Integral, Bantodos, Banco Popular, Bampymi, and Medibanco.

Crisis due to price control effects. Beef price regulations imposed by the Government continue to worry sector workers and merchants. The lack of profits is forcing a number of merchants to search for alternatives in order not to have to close their establishments and/or to fire personnel.

Authorizations are issued to import 90 million units of eggs and 45 tons of chicken. Rafael Oropeza, Minister of Food, authorized the private sector to carry out complementary imports of chicken and eggs with the aim to address the shortages in the markets.

Construction sector grows. According to the Construction Chamber, the construction sector of Nueva Esparta state registered an 80% growth in the first quarter of 2007 compared to the same period in 2006.

The National Assembly approved the gambling tax. On July 1st, the new Gambling Tax law was published in the *Gaceta Oficial*. From that date, all games of chance such as lotteries, betting on horses and sports events, slot machines, and bingos and casinos, will be taxed.

Car sales increase by 51.6% in the first semester of 2007. Car sales in Venezuela reached 213,056 units during the first semester of the year according to the Venezuelan Automobile Chamber. Of the cars sold between January and June 2007, 72,964 (34.2%) were assembled in Venezuela and 140,092 (65.8%) were imported.

AN will propose a reform of the Mortgagor Protection Law. The reform looks to solve the problem of the real estate debts in dollars, according to the president of the Subcommittee for Finance Policies, Banking, and Insurance, Rafic Souki.

SIDOR still fenced in. The Integral Social Development Commission of the National Assembly will hear the case of the Ternium SIDOR workers, in order to settle the issue concerning industrial security and pension back payments of that company.

Informal trade increases. The president of FEDEAGRO, Gustavo Moreno, once again announced his concern for price controls that lead to shortages. He insists that

the trade of Venezuelan products through “back road channels” towards Colombia continues to increase.

Food consumption increased by 30% to 40%. This announcement came from the Minister of Food, Rafael Oropeza. The Mercal chain is selling 110,000 tons of food a month that “although it is covering consumption, the goal is to sell 150,000 tons a month before the year’s end.”

Carlos Slim overtook Bill Gates. The Mexican telecommunication mogul, Carlos Slim, is now the world’s richest man, according to “Sentido Común” web page.

Political Tips

PSUV’s next step will be to debate its organizational structure. The *Partido Socialista Unido de Venezuela* (United Socialist Party of Venezuela) is getting ready to create its assemblies of socialist battalions where the party’s organizational structure and ideological concept will be debated in order to decide how the new revolutionary organization will be ruled.

The purging of the PSUV will be done by regions. The purging of the list of those registered in the PSUV will be done by regions and not in a centralized manner. The promoting commission will only receive a report concerning the process and will not directly participate in the purging of the aspiring candidates which supposedly total 5,862,000 people.

Russia and Venezuela signed a sales contract for 5 submarines before the end of the year. According to Russian sources, the Venezuelan government has plans to purchase another four submarines and at least a hundred surface vessels.

Presidente Chávez signed off on 3,324 promotions of the Venezuelan Armed Forces. The ceremony was presided over by the Minister of Defense, Raúl Baduel. Among those receiving promotions were: the Director of Civil Protection, Antonio Rivero, promoted to General, Carmen de Maniglia, promoted to the rank of Rear-Admiral of the Navy.

The National Assembly Comptroller’s Commission recognizes the shortage of personnel. After having been appointed Minister of Interior and Justice, Pedro Carreño, former president of this Commission, took with him to his office around 11 employees to work for the Ministry on special assignment, of which only two have been replaced.

Sub-commission of the National Assembly proposes the elimination of passwords for medical emergencies. The elimination of authorization passwords for emergencies, the setting up of a single fee, and the setting of maximum and minimum fees for doctors' services are just some of the proposals put forward by the National Assembly Sub-commission in charge of studying the high costs of medical surgical services.

Constitutional Reform slanting dangerously to the Left. The archbishop of Coro and first vice-president of the Venezuelan Episcopal Conference (CEV), Roberto Lückert, considers that in order to reform the Constitution, a new National Electoral Council (CNE) has to be appointed and that a Constituent Assembly should be convened.

MERCOSUR. President Chávez gave the congress of Brazil and Paraguay three months to approve Venezuela's membership to MERCOSUR. The President's ultimatum makes it almost a certainty that both congresses will approve Venezuela's entry. However, the President's of Brazil, Argentina, and Uruguay, are trying to bring the relevant parties together so that the Venezuela's petition will be accepted.

Are the Armed Forces becoming politicized? There has been an on-going debate concerning this issue between General (r) Alberto Müller Rojas, and the President of the Republic. Müller maintains that the Armed Forces are politicized, just like they were in the past. The President strenuously denied the General's comments, saying that it was not true.

Foreign experience will nurture the Civil Registry. The following 18th, 19th, and 20th of this month, Venezuela will be host to the international encounter on Civil Registry, which will be organized by the CNE.

Problems on the border due to toll collection. Public transport drivers clashed with Colombian police which tried to clear one of the border roads connecting with Venezuela, near the city of Cucuta, which was closed in protest of a toll being charged to use said road.

UCV professors insist in having a dialogue with the Government in order to discuss university autonomy. Víctor Márquez, teacher representative before the University Council and president elect of the Teacher's Association of the UCV, announced that they would ask the Executive to open talks to discuss university autonomy.

Weekly Report

Schools will demand the nullity of the resolution freezing tuition. During an assembly held yesterday, and to which more than 120 members nationwide came to attend, the Venezuelan Chamber of Private Education decided to request the nullity of the ministerial decision published in last week's *Gaceta Oficial*.

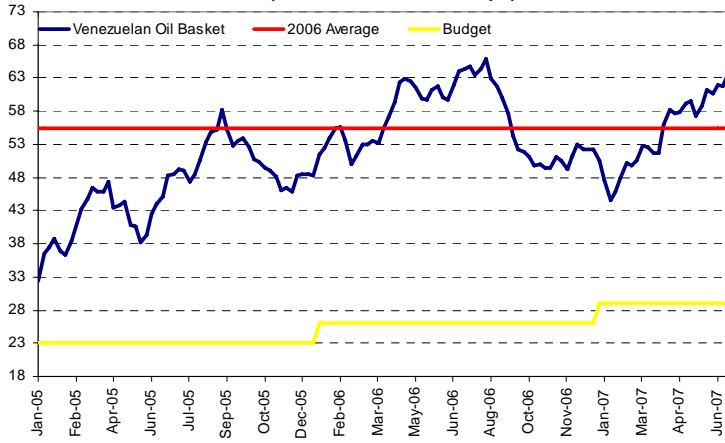
RCTV will begin broadcasting this month on cable and satellite TV. According to the vice-president of marketing, Julián Isaac, the signal will be broadcast by pay-television companies INTER, DIRECTV, and NET UNO.

Published in the *Gaceta Oficial* decree about the creation of the Colombeia Foundation. The objective of said foundation is to produce educational content audiovisual material, its broadcast, and dissemination through public and private social communication means.

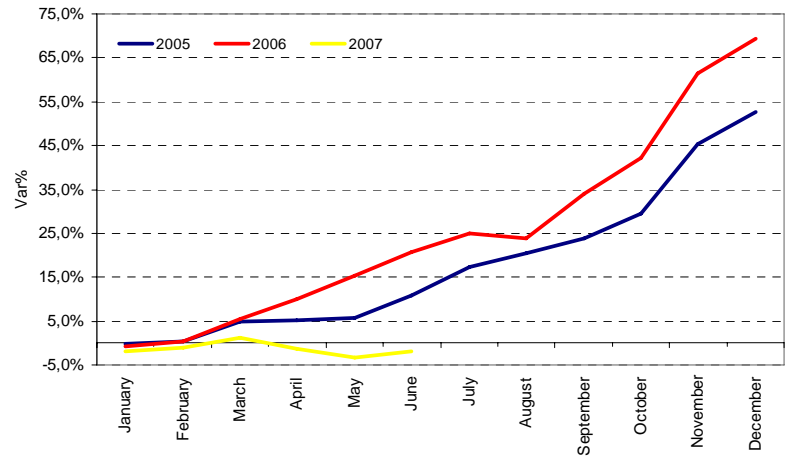
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ECONOMIC OVERVIEW

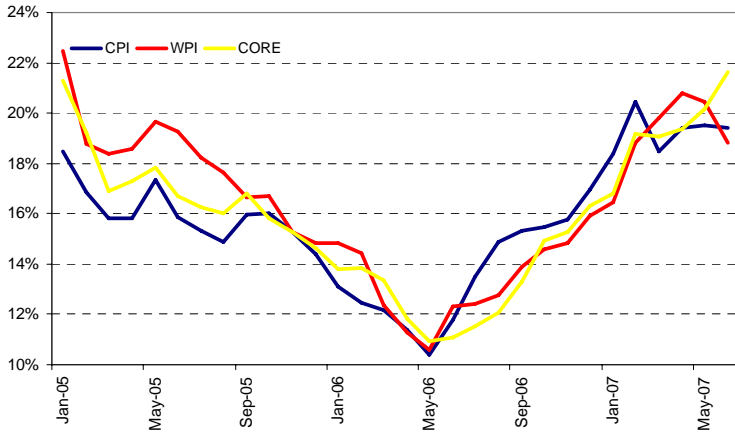
Oil Price
(Venezuelan Basket US\$/pb)



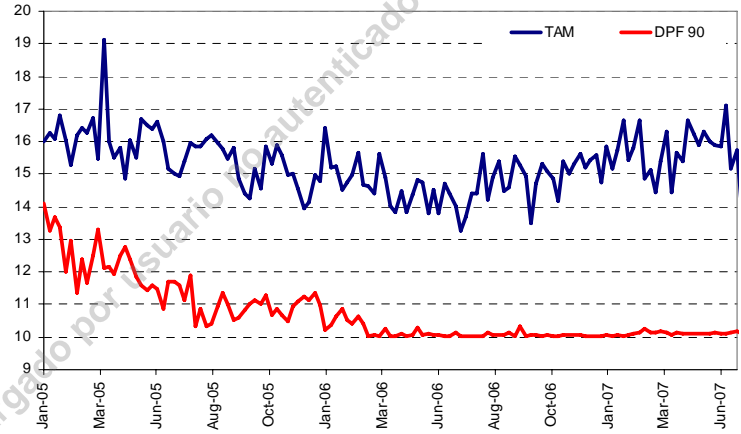
Real Expansion (M2)



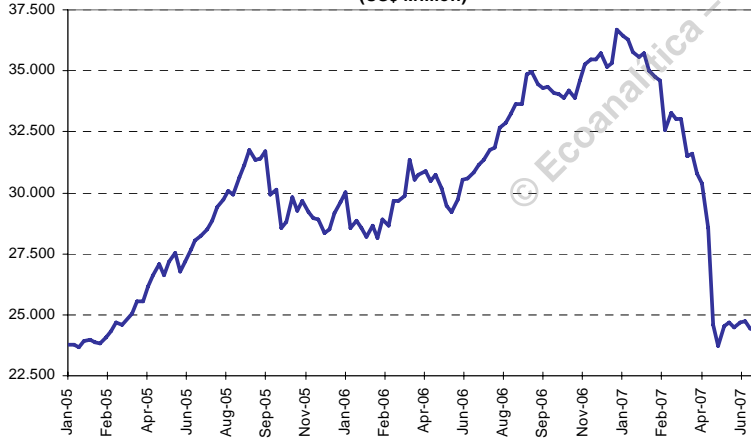
Inflation
(Last 12 Months)



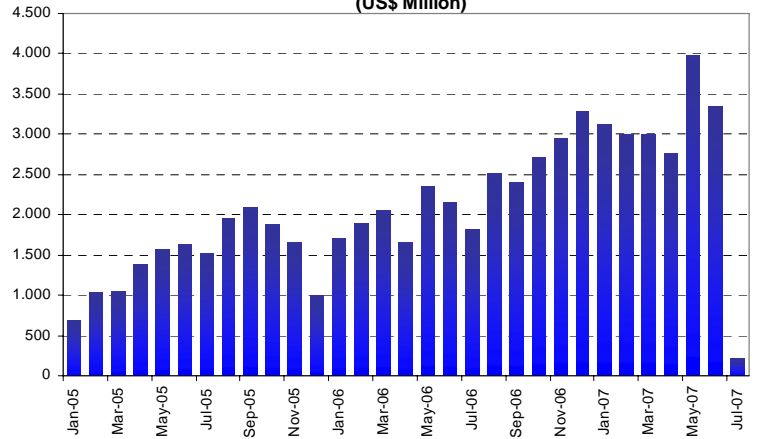
Interest Rate
(Six Principal Banks)



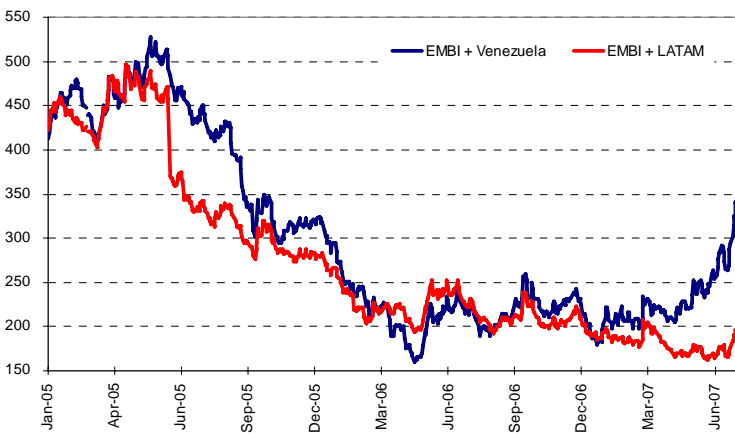
Fx Reserves - BCV
(US\$ Million)



Disbursement
(US\$ Million)



EMBI



Central Government
(VEB Billion)

