



Volume 3, Number 25
July 13, 2007

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THE BCV FINALLY REACTS TO THE RISE OF INFLATION

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THE CLIENT

During the last 13 months the Board of Directors of the Central Bank of Venezuela (BCV) have stood by and passively watched inflation rise, without taking any action concerning the matter. After more than four years since having launched an expansive monetary policy, despite the increase with regard to the amount of absorption operations, the BCV board decided this week to make a change in the monetary policy and began taking steps to reduce the quantity of circulating bolivars. In our opinion, such measures are clearly not enough and have been introduced way too late. However, these measures should provoke an increase in lending rates, which will reduce the stimulus to consume even though the incentive to save is precarious.

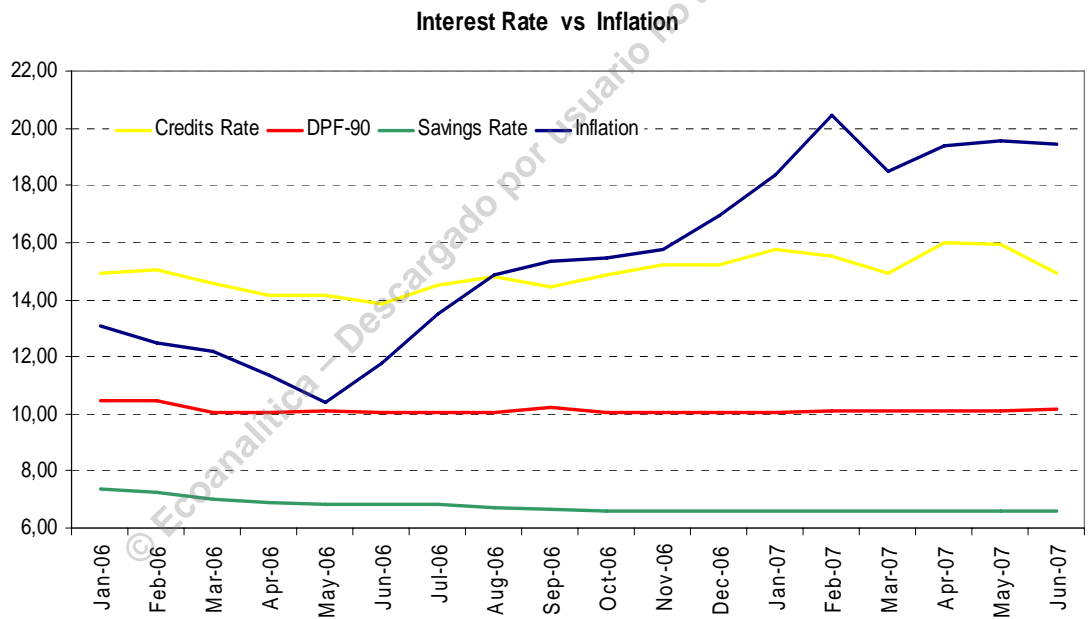
Sustained increase in inflation

In the 12 previous months to May 2006, inflation was at 10.4%. Despite the fact that the Government had been carrying out an expansive fiscal policy and that the BCV reduced the interest rate levels a number of times, the domestic industry's excess installed capacity was able to continue increasing the supply of goods to satisfy the increase of demand. However, since then, inflation has been steadily increasing, and for the last 12 months, it's been around

19.4%, without the BCV taking any measures to control and/or reduce it.

Interest rates stable and under the inflation rate

The lending rate of the six main banks averaged 16.0% during the months of April and May, dropping down to 14.9% for the month of June. This drop in the rate for June is due to seasonal factors, since it's during this month that the financial system tends to be more aggressive with regard to placing loans before the close of the semester. It's important to remember that the BCV set the ceiling for loans at 28.0%. Of course, this ceiling in no way binds the financial system, since the enormous increases in liquidity has allowed the bank to issue loans under that rate.



Sources: BCV and Ecoanalítica

On the other hand, the rate set for savings as well as term deposits, have all year been set at their lowest levels by the BCV. Savings deposit rates averaged 6.6% when the minimum rate allowed was set at 6.5%, and term deposits averaged 10.1% when the minimum level allowed was set at 10.0%. This rate structure clearly reflects that the minimum levels set for savings rates did bind the banking system, and if minimum levels had not been set, savings rates would be even

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lower. In any case, lending rates as well as savings rates closed the first semester at levels below inflation.

The BCV finally reacts

In this scenario, the BCV decided to increase the minimum interest rate levels from 6.5% to 8%, and fixed term deposits from 10% to 11%. At the same time, the BCV adjusts the portion of deposits that a financial institution is not allowed to lend and must keep frozen as a legal reserve requirement, increasing it from 15% to 16%, during a first stage, and from October 1st this year to 17%. Besides adjusting savings rates and the reserve requirement amounts, the BCV decided to offer financial institutions interest rates of 11% if they deposit their resources with them for 56-day periods. It also ordered that of the funds the banks receive from selling bonds, they must place 13.75% in reserve, and this percentage placed in reserve, will progressively increase each week by 0.25% increments until reaching 17%.

All these measures point to an increase of the lending rates

These measures previously mentioned have a double effect on the lending rate. On the one hand they make the cost of the system deposits more expensive, and at the same time, they reduce the percentage of bolivars that the bank can lend. And even though the BCV is offering a new instrument which allows for 56 day term placements at 11.0% interest, it's not enough to compensate the increased costs generated by the increased savings rate. If a financial institution receives a term deposit at 11.0% and it is allowed to lend VEB83.0 of each VEB100 received, it has to place that money at, at least 13.3%, in order not to incur losses due to just the process of intermediation, and this doesn't even include the cost of intermediation itself. Before this measure introduced by the BCV, placement had to be done at, at least 11.8%, since the system could receive term deposits at 10.0%, and place VEB85 out of every VEB100 received. This is why we expect that there will be an increase in the average lending rate of around 150 base points, going from the average reflected during the first week of July of 16.6% to levels around 18.0% by the end of the month or the beginning of the next month.

The lending rate increase will be hardest felt by the corporate sector

Another limitation of the system is that the lending rates can't be increased for the sectors that the Government considers strategic, like agriculture, tourism, micro-businesses, and real estate, since they already have preferential interest rates set. This is why the adjustment required of the lending rate will be most felt by the rest of the products.

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As we mentioned before, the ceiling for loan interest rates is 28% and currently, as of the close of last week, large companies have been paying an average of 13.7%; commercial establishments 21.0%, car loans are at 21.8%, and credit cards are at 25.9%. As can be seen, there is not much room for rate adjustments when it comes to credit cards, which leaves the corporate sector holding the bag when it comes to major adjustments to be made, and this means, big businesses and commercial establishments, which will probably see an average rate increase of around 250 base points, with big business increasing to an average of around 16.2% and the commercial sector to an average of 23.5%.

Another point that is important to mention is that the measures won't all affect the financial system in the same way. For example, those banks which have the majority of their deposits in term instruments, which imply greater costs, will tend to make much more severe lending rate adjustments, specially the corporate ones. On the other hand, those financial institutions with a greater variety of funds will have much more options when it comes time to adjust their interest rates.

As long as inflation is around 20%, you don't create incentives to save

Despite the predictable increase in savings rates, if inflation remains at current levels, people saving won't feel much difference. In fact, for every VEB100 that is placed in a term deposit, a person will lose 9.0% of the purchasing power of the amount deposited if inflation remains at 20.0%. This is why we maintain that the BCV should continue to make an effort to establish positive real interest rates thereby de-stimulating the purchasing of foreign currency and stimulating domestic savings.

The Government has been successful controlling liquidity during the first semester; however, we don't believe that this situation will be able to be maintained in the second semester

The BCV's efforts, with the help of other Government institutions, to control the increase of liquidity have been successful during the first semester. During the first semester, CADVI has increased its foreign currency authorizations by 66%. Additionally, the issue of US\$7.5 billion of PDVSA bonds, plus the *bono del sur II* issue for US\$1.5 billion and very limited fiscal restrictions have led to liquidity in the system only increasing by 1.8%. This figure is very favorable compared to the 23.3% increase in liquidity registered during the same period last year.

However, Venezuelan fiscal policy has a very high seasonal component that on average concentrates around 60% of total National Budget spending during the second semester of the year. This is why,

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despite very limited intervention by the BCV, before a scenario of increasing liquidity during the second semester of the year, we anticipate that inflation will close at levels around 18.0% and 20.0%, much higher than what the Government's revised target for the end of the year of 14.0% is.

Interest rate increases will moderate the consumption boom, but their effects on inflation will be limited

Interest rate increases for loans would help to moderate the consumption boom and to somewhat lessen some of the pressure on inflation. However, Government rhetoric, which is very much in fashion, and is full of words like expropriation, nationalization, confiscation, speculation, etc., and continually echo throughout the halls of Government, has completely killed any initiative there may have been to increase investment, and thereby growth, in the supply necessary to achieve substantial improvements at the rhythm prices keep on increasing.

Economic Tips

Increase in international reserves. The BCV reported that international reserves are at US\$26.03 billion, which represent an increase of US\$668 million with respect to the previous week. Of the total reserves, US\$25.24 billion are in the BCV and US\$790 million are in the Macroeconomic Stabilization Fund.

CADIVI at full speed. During the month of June, CADIVI authorized an average of US\$150 million daily.

Government sells banks structured notes. The Government reported that it sold around US\$455 million in structured notes to ten domestic financial institutions in order to optimize Treasury cash flow and generate resources to finance social investment programs. The Minister of Finance, Rodrigo Cabezas, assured that the Government expects to place around an additional US\$550 million of this kind of instrument, which combine sovereign risk from Argentina, Brazil, Ecuador and Venezuela.

US\$100 million in Bolivian bonds. A press release issued by the Ministry of Finance indicates that this transaction was announced during a CAF board meeting which was attended by the Minister of Finance and the Minister of Planning of the countries

associated to the Corporation. Concerning the matter at hand, Minister of Finance, Cabezas, pointed out that he had taken advantage of the fact that the Bolivian Minister of Finance, Luís Alberto Arce, was present, to finalize the loan for US\$100 million. He assured that “Before the month of July is over, we’ll have to be carrying out the operation for a period of two years.”

Bolivian bonds only for the banking system. According to sources close to brokerage houses in Caracas, the Government’s next Bolivian bond placement will be exclusively earmarked for the banking system, and therefore, the possibility that the papers may be in the form of structured notes is not ruled out.

A *Bonos del Sur III* on the horizon? According to statements issued by the President of Argentina, Néstor Kirchner, to the newspaper *Ámbito Financiero*, Venezuela will issue US\$1.0 billion in Argentinean bonds at the end of July. These will be sold to small investors in Venezuela and will make what will become the *Bono del Sur III*.

Maza Zavala stated. The former director of the BCV criticized the measures recently taken by Government to reduce inflation. In his opinion, he considers that the Government will not be able to fulfill its goal to control inflation, and estimates very conservatively that inflation will reach levels no lower than 15%.

And Cabezas pontificated. Rodrigo Cabezas assured that the bolívar would not be devaluated and that there would not be any cutbacks in public spending. He also predicted a growth of at least 8% in the economy for 2007. He also went on to say that there are sectors of the opposition that are demanding a devaluation of the bolívar, demands which he identified as being “ominous voices echoing old fashioned Monetary-Fund-like strategies.”

The Government won’t devalue the bolívar in the next five years. Cabezas assured that there are no plans being considered to devalue the currency, at least, not for the next four or five years. On the other hand, there are plans to increase subsidies to the agriculture sector and to also extend price control measures to a greater number of sectors and products.

The impact of supplementary appropriations is being studied. According to Ricardo Sanguino, the Permanent Finance Commission has approved 52 supplementary appropriations equaling VEB12.8 trillion so far this year. The National Assembly is looking onto this matter.

The requirements governing the Caracas Stock Exchange bonds transactions are being adjusted with the BCV. The Caracas Stock Exchange, the BCV, and the Ministry of Finance are adjusting the legal requirements in order that Public Debt transactions be allowed and that they have a transparent and single reference price for these instruments, according to Víctor Flores Rojas, president of the BCV.

Credit card interest rates could go up. One of the proposals being studied by the Government aimed at reducing the amount of liquidity circulating and lowering inflation is to raise the interest rates that the banks are charging on credit card balances.

Differential rates an option. Ricardo Sanguino, chairman of the Finance Commission, explained that the measure could be applied by instructing the banks to establish differential rates for each type of credit card. He explained that it's not the same the purchases made with "a basic credit card that can be used to buy medicines compared to a platinum card that can be used to pay for a meal in a restaurant on the Eastside of Caracas." He argued that the idea is to orient consumption, given that the Government recognizes that it is an element that puts pressure on the price of goods and services.

OIL TIPS

Venezuelan barrel of oil increases by US\$1.92. The Venezuelan oil basket increased by US\$1.92 compared to the previous week and settled at US\$65.79; as international prices reach their highest levels in 10 months.

Workers warn that oil operations could pass into the hands of the Reserve. Oil workers fear that some of the industry's medullar functions may be fulfilled by the ranks of the Military Reserve. This alarming news spurred around 700 workers to stop operations on for drills operation in Zulia state, specifically in the areas of Lagunillas and Bachaqueros. Rafael Zambrano, general secretary of the Federation of oil Workers, warned that on top of the damages in terms of refinery operations, production, and infrastructure that handing over these operations to inexperienced personnel would cause, that it would also put the jobs of more than 15,000 people that work in contracting firms or companies that are currently working in the industry.

Ramírez denies. The Minister of Energy and Petroleum and president of PDVSA, Rafael Ramírez denied the fact that Western PDVSA had fired people due to the nationalization of the medullar processes "that were in the hands of private interests."

He said that it was not true that the company had fired 700 drill and general service workers.

Caracas and Teheran invest US\$4.0 billion in the Orinoco Belt. Venezuela and Iran will invest US\$4.0 billion on certifying crude oil reserves in the Orinoco Oil Belt. PDVSA announced that the joint investment will be carried out on Ayacucho-7 block, where it's estimated that there are around 31.0 billion barrels of crude, out of the 1.3 trillion barrels of extra-heavy crude estimated to be found in the little over 55,000 square kilometers that makes up the Orinoco Oil Belt in the Easter-Central part of the country.

Labor demands. Orinoco Oil Belt workers are demanding the payment of VEB50.0 billion in labor back payments that they have pending with the transnational oil companies that were working under the figure of "strategic associations" before activities were nationalized in that area of the country.

Negotiations continue. Venezuela is negotiating in good faith in order to compensate ExxonMobil and ConocoPhillips for their recently nationalized assets and expects to avoid litigation, announced yesterday the ambassador of Venezuela to the United States. Ambassador Bernardo Álvarez, who was on a good will trip to Texas, said that it was possible that his country and the oil companies based in this state end up having good ties despite the unpleasantness that the expropriation of their operation in the Orinoco Belt by the Venezuelan Government caused.

BUSINESS SECTOR TIPS

Greater control over the health sector. The national customs and tax superintendent, José Vielma Mora, stated that the Ministry of Finance has made concrete proposals in order to more efficiently control the hospital sector. He indicated that an effective plan is being carried out and he assured that ways are being explored to include the Public Finance School with the SENIAT, thereby allowing for a thousand more personnel to work in overseeing clinical and medical supply services operations.

Proposals for the regulation of private clinics. The Special Commission analyzing the prices offered by private clinics turned in a report to the Ministry of Light industry and Commerce where it introduced a number of ways by which to reduce service costs. The National Assembly representative and member of this commission, Iroshima Bravo, explained that among the petitions introduced there is a call for the regulation of the price of medicines used by the private clinics in treatment.

The regulation of private medical services is “irreversible.” The chairman of the Special Sub-commission that is investigating private clinics, assigned to the Finance Commission, Tirso Silva, stated that the regulation of medical services is a reality, and there is “no turning back.”

Pure speculation. According to the president of CADIVI, lieutenant-cornel Manuel Barroso, the increase in price with regard to services in the clinics is not logical and it's due to speculation. Barroso pointed out that CADIVI has increased by 60% its authorizations of foreign currency to the pharmaceutical sector compared to last year.

Low level of earnings. Ricardo Alfonso, former president of the Private Clinic Chamber, assured that the private clinic sector didn't have earnings greater than 5% and that it only attends 20% of the population. Furthermore, he insisted that the nationalization of private sector health care would finish the career and the institute of medicine in Venezuela. In Alfonso's opinion, the Government's figures have been manipulated.

Goal not being met. According to a statement by Ramón Carrizalez, Minister of Housing and Habitat, to date, the Government has built 24,000 houses out of a total of 82,000 houses it expects to deliver before the end of this year.

Non-traditional exports will remain at US\$5.0 billion. So said the president of the Venezuelan Association of Exporters (AVEX), Francisco Mendoza. AVEX reported that for 2006, non-traditional exports were at US\$ 5.0 billion. For this year it estimates that imports will increase to US\$ 40.0 billion because CADIVI has become much more efficient.

Banking security advancing in technology. The head of SUDEBAN, Trino Alcides Díaz, pointed out that the national banking system would reinforce its security measures in order to avoid ever increasing cases of fraud through credit cards, ATMs, and more recently banking espionage. According to Alcides, the national banking system will replace current ATM machines with the new 3D machines that are much more invulnerable since it encrypts its information.

And new cards being issued. The banking system is also changing its current cards that have magnetic bands, for cards with a chip. “All cardholders will have their new cards within two years, since agreements have already been made between SUDEBAN and the Venezuelan Banking Association,” assured Alcides.

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Estimated 50% increase in the automobile sector. According to Luis Cárdenas, president of the Venezuelan Automobile Chamber (CAVENEZ), to date, the automobile industry has increased by 51%, which indicates that sales will reach record levels this year. He said that according to conservative estimates by CAVENEZ, around 400,000 cars, of all different brands, will be sold this year.

The Government will invest in mining projects. Vice-Minister of Mines of the Ministry of the People's Power for Basic Industries and Mining, Iván Hernández, informed that the Government will invest a total of US\$38 million in mining projects.

Six companies will participate in the first stage of the transition. Those in charge of planning the development of electric sector have defined two stages to be completed en route to initiating the National Electric Corporation, expected completed by 2010. For the first stage, six companies will be in charge of delivering service, said sources of the sector. The corporation will centralize the sector through internal divisions for each activity: generation, transmission, distribution, and commercialization.

Multinacional de Seguros market share increases by 2.8%. The French insurance company AGF announced the sale of its Venezuelan affiliate *Adriática de Seguros* to *Multinacional de Seguros*, the sixth largest company in the country with a market share of 4.9%. The sale closed on July 2nd, stated the report from AGF, which didn't include the amount of the sale but did remind that *Adriática* had receipts for EUR108 million last year, mostly in automobile and companies insurance, and health activities. With these figures, *Adriática* occupies the 11th place in the Venezuelan market, with a 2.8% market share.

Political Tips

Political Parties back the Catholic Church. After President Chávez's harsh words against the clergy, the spokesperson for *Alianza al Bravo Pueblo*, Richard Blanco, publicly announced his backing of the Church. The president of *Acción Democrática*, said that the language was unacceptable and very sad that the President of the Republic "taking advantage of his Office, would have to stoop so low to using pejorative language and low blows in order to impose his criteria." *Primero Justicia* and UNT also condemned the President's attack on the clergy.

Müller Rojas says he won't recant what he said to Chávez. General Alberto Müller Rojas affirmed that he will not back down to Chávez for having said that the Armed Forces was "politicized" in an interview published by the Brazilian newspaper O

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Estado de Sao Paulo. "President Chávez said that I have to recant. Just like he didn't have to recant before the Brazilian Senate, I am not going to recant either." "Chávez shows what's not true. He says that he isn't stimulating political conduct in the army, but he is doing it. I refuse to participate in deception," insisted Müller.

Baduel smooths over. Raúl Isaías Baduel confirmed that members of the National Armed Forces (FAN) do have ties to politics, but, he added in an attempt to smooth over the fact, said such ties have to do with security and defense.

Investments in weapons reach VEB9.8 trillion. According to a study of the Investigative Unit of *Primero Justicia*, the Venezuelan Government has bought, between 2005 and 2007, US\$4.5 billion in arms from Russia which is equivalent to VEB 9.8 trillion. According to the study, Venezuela has purchased AK 103 rifles, submarines, helicopters, and Sukhoi 30 fighter planes. It has also been announced that a purchase for anti-aircraft defense systems.

National Police Law is on the Special Powers list. The Minister of the Interior, Pedro Carreño, indicated that he is only waiting for Vice-President, Jorge Rodríguez, to call him to go over the National Police Law project put together by his office and that according to sources from both instances had been returned by the Special Powers Law's Cabinet.

Suit against the governmental resolution that ordered the freezing of school tuitions. The suit will be introduced by the president of the Venezuelan Chamber of Private Education, Octavio De Lamo, arguing that the Government can not impede a good education.

The turpial and the Centauro hit the streets. The Minister of Defense, Chief General Raúl Baduel, delivered the first cars assembled by the Venezuela-Iranian company, Veniran, inaugurated in November 2006. The Vice-Minister of Industries, Elio Colmenares, announced that the lot of cars delivered was earmarked for recently graduated cadets from the Military Academy, who will be able to purchase the cars with special loans granted by Banfoandes. Veniran will produce two models, the Turpial valued at VEB17 million and the Centauro that will have a sticker price of around VEB23 million.

Bolivian students receive scholarships to study in Venezuela. 735 Bolivians will go to university in Venezuela, beginning in the next few months, after having been selected by the *Gran Mariscal de Ayacucho* Foundation within the framework of ALBA, announced the president of said institution, Jorge Arreaza. The students were chosen from among 5,600 candidates who sent in their applications hoping to receive one of the scholarships that would allow them to pursue a degree in this country.

A weekend for life. University students are calling for a nationwide activity called “A weekend for life.” The aim of the activity is to raise awareness concerning the serious problem with personal safety that Venezuelans have to live with. Ricardo Sánchez, a student leader from the Universidad central de Venezuela (UCV), announced that on Friday the 20th, Saturday the 21st, and Sunday the 22nd, they will be making a call for peace by calling for everyone to wear a white T-shirt.

Venezuela gets worse. Chile gets better, and Venezuela gets worse, these are the opposing poles with regard to the control of corruption, according to a world governance study between 1996 and 2006 presented by the World Bank in Washington. The study measures governance by considering a citizen’s capacity to make decisions, political stability, the absence of violence, governmental effectiveness, regulatory quality, confidence in laws and institutions, and the control of corruption, based on reports published by 33 different organisms.

RCTV is back. The president of the corporation 1BC, Marcel Granier, announced at a press conference that RCTV will return to the air on July 16th this year through cable, being broadcast by Intercable on channel 13, Directv, on channel 103, Net-Uno, on channel 12, and on Planet. He highlighted that the broadcast will be 24 hours a day, seven days a week, and that it would start at 6 am with the show “La Entrevista”.

Brazilian Congress believes in Venezuelan democracy. The Brazilian Congress asked President Hugo Chávez to renew RCTV’s broadcasting license for the same reasons it opposed the coup in 2002: in defense of Venezuelan democracy, stated senator Aloizio Mercadante, one of the main leaders of the party sympathetic to the Government called the Workers Party, and very close to President Lula.

Trash treatment plant proposal. According to Gustavo Rojas, one of the leaders of *Primero Justicia* in Libertador municipality, in order to solve the collection problem of 4,000 tons of trash a day that occurs in Caracas. Around 33 treatment plants are needed, which will have a cost of approximately VEB25.0 billion.

Recall Referendums initiated. The main rector and president of the Political Participation and Financing of Electoral Power Committee, Vicente Díaz, announced that next October 7th, the 10 Recall Referendums that were approved by the nationwide signature drive will take place.

INDECU will sanction *Delujo Promociones*. Samuel Ruh, president of INDECU, announced yesterday that legal proceedings will be introduced against the company

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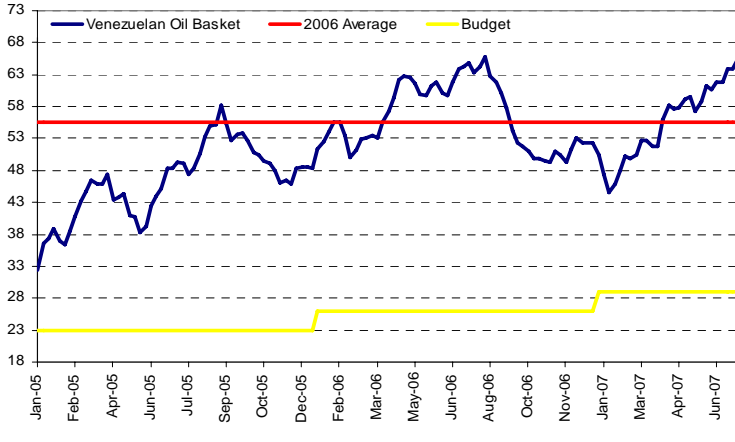
Delujo Promociones which was in charge of selling tickets to all 26 games of the America's Cup.

Starting in August all drivers without their papers will be fined. According to Franklin Pérez, director of the National Transit and Transportation Institution, starting from the first week in August of this year, fines equaling five tributary units will be given to all those who don't have their car's papers in order.

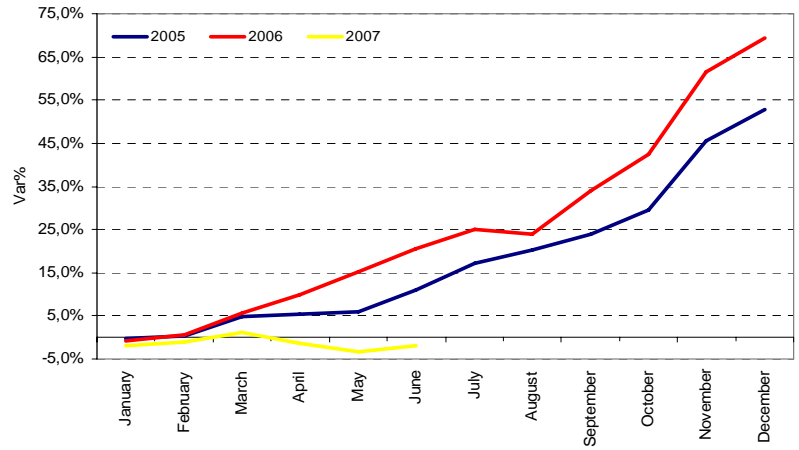
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ECONOMIC OVERVIEW

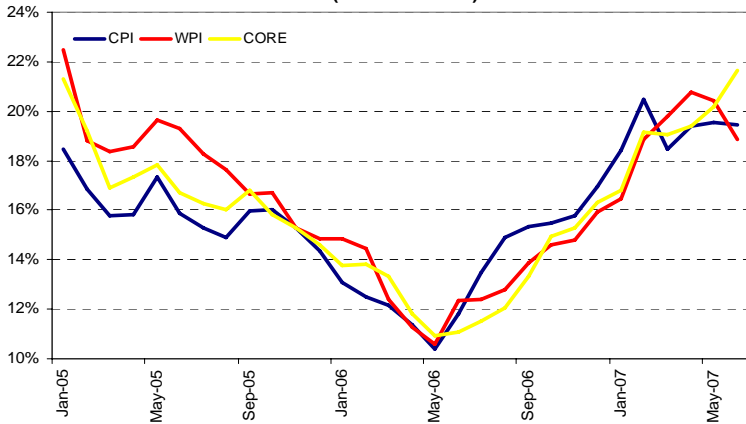
Oil Price
(Venezuelan Basket US\$/pb)



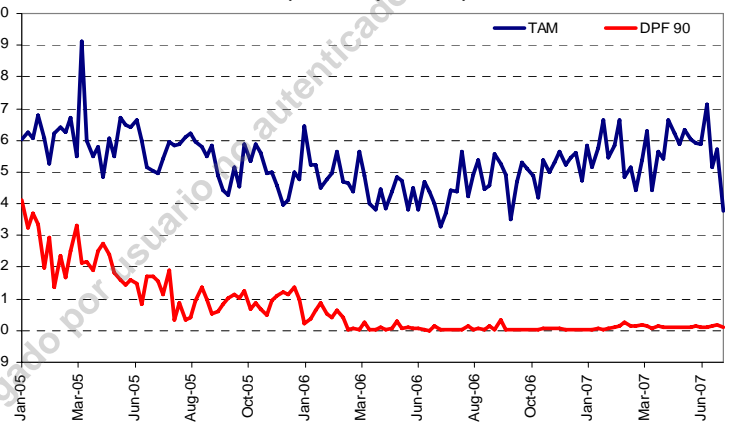
Real Expansion (M2)



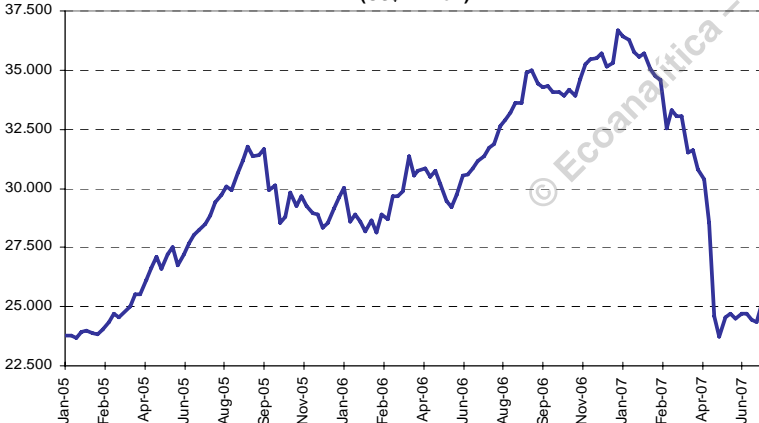
Inflation
(Last 12 Months)



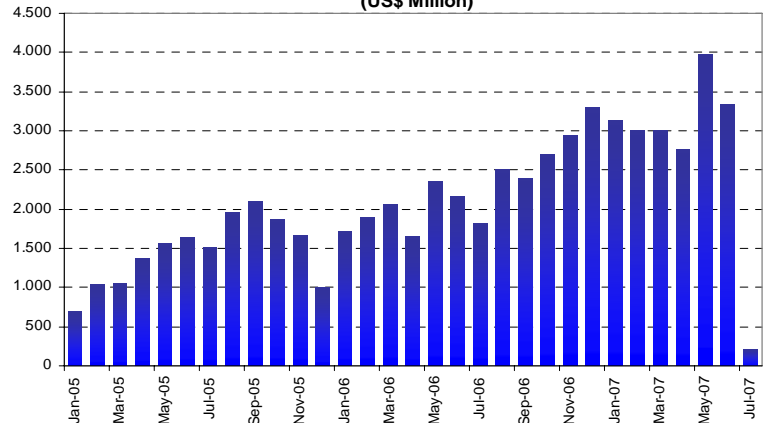
Interest Rate
(Six Principal Banks)



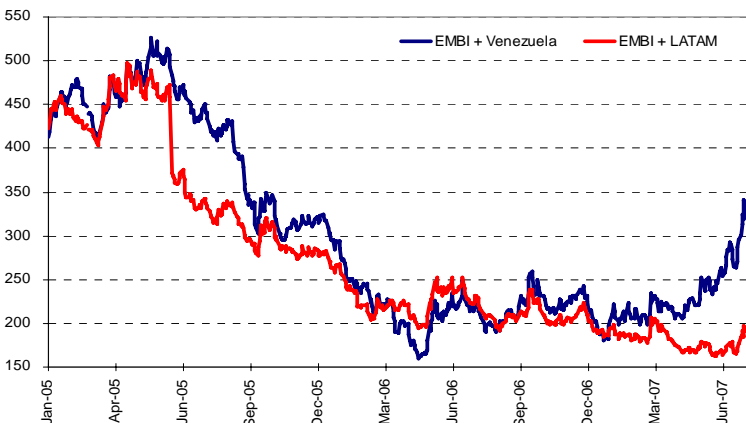
Fx Reserves - BCV
(US\$ Million)



Disbursement
(US\$ Million)



EMBI



Central Government
(VEB Billion)

