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HOW VENEZUELA GROWS?

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In 1998, a new economic development model took root in Venezuela. It looked to be different as well as more successful than the failed experiences of the so-called "IV Republic." However, the model is not sustainable. It's being sustained by a fiscal bonanza and expanding consumption, while countries which have experienced true success in growth have developed their foreign sector and focused on investment levels.

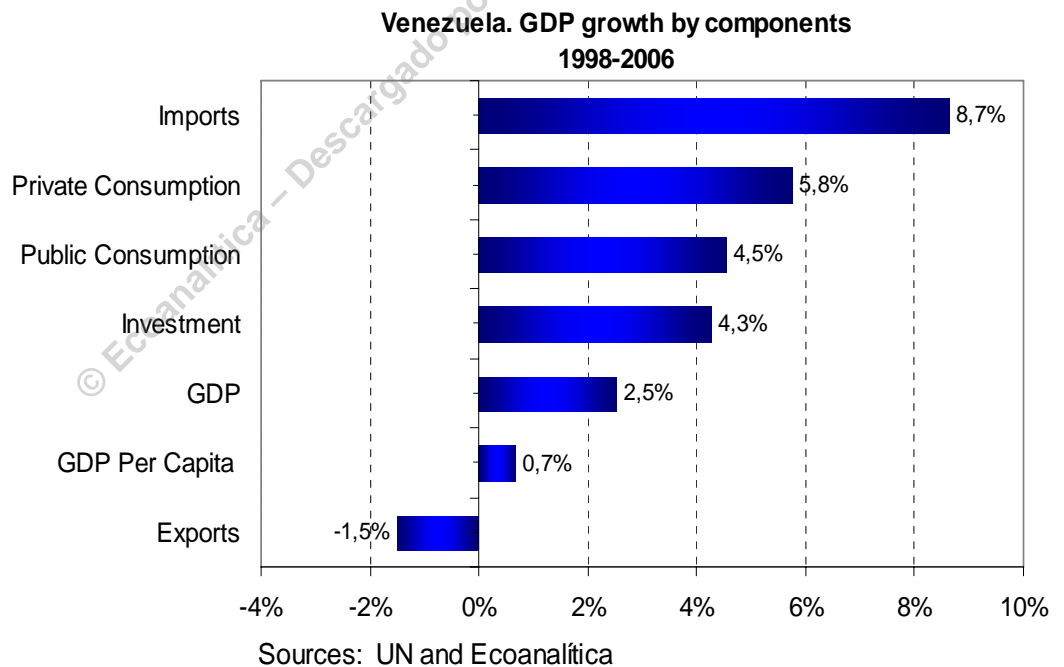
Venezuela is living its communist party

Even though important official spokespersons, including President Chávez, have pointed out that the constitutional reform project does not violate the concept of private property, legal experts consulted by **Ecoanalítica** point out that what article 115 of the constitutional reform project establishes is ambiguous and leaves many things open to interpretation. It would be good if the president of the National Assembly would follow through with what she said a few days ago that

The current Administration has 15 consecutive quarters of economic expansion under its belt, mostly spurred on by high oil prices and increased public spending. However, this expansion has led to

increased private consumption levels that have reached heights never before experienced in the last 20 years.

This idea is reinforced if we study the behavior of the Venezuelan economy through components of the Gross Domestic product (GDP) during the period of 1998 – 2006. As can be seen, economic expansion (supply) during this period was only 2.5%. In contrast, private consumption increased by 5.8% and the public sector increased by 4.5% during the same period. In other words, the private consumption of our economy increased more than two times more than the supply did. So even though the Venezuelan economy has been developing at a good pace during the last three and a half years, which has led most of the different economic sectors to post acceptable growth figures, this boom involves more those sectors that have to do directly with services and consumption, like the financial system, telecommunications, and commerce.



The increase in consumption is sustained by the intensification of imports

Another important point is related to the mechanism used in order to solve the gap that exists between demand and supply, which would have required a significant adjustment in price. However, given that the Venezuelan oil boom has allowed for a significant amount of

foreign currency to come into the country, along with the exchange rate control put in place in 2003, imports have consistently increased. In fact, imports are the component that have grown the most in the period in question (8.7%) and have compensated for the imbalance between supply and demand.

Not enough investment

During the period being analyzed, investment has grown by 4.3%. However, and even though the Central Bank of Venezuela (BCV) doesn't point it out, this growth rate is mostly due to the public sector. According to figures released by the International Development Bank (IDB) in 2006, private investment in Venezuela represented 7.3 points of GDP, while the Latin American region average was at 14.8%; this, despite the fact that Venezuela is posting an economic growth rate average of 12% for the last three and a half years.

The case of exports is even more dramatic

In this environment of economic expansion, exports are the GDP component that has shown a drop. And, what is so sad about this is that, exports, along with investment are the two components that most contribute to sustaining and stabilizing growth over a period of time.

In fact, during the period in question (1998-2006), the GDP per capita only increased 0.7%. Despite methodological and measurement problems, this indicator is used as a measurement of the people's well-being.

Venezuela's economic growth is not sustainable over time

According to the different economic Cabinet members, and especially the Minister of Planning, Jorge Giordani, Venezuela's economic growth is guaranteed. At **Ecoanalítica** we disagree with this statement. Growth will be maintained for a few years more, probably until 2009, mainly spurred on by high oil prices, increased public spending, exchange rate controls, and the consumption boom. When the exchange rate controls finally become unsustainable, which is to say, when not enough foreign currency is being generated in order to finance the extremely high levels of imports, then the economic adjustment will come with all the usual signs that we are all sick of, and very familiar with: devaluation, high inflation, fiscal spending shrinks, and economic recession.

What's the key to growth?

The generalized opinion in economic circles tends to revolve around three types of answers concerning what causes economic growth: the

first one says that economic growth comes about because workers have increasing more tools and machinery by which to fulfill their labor, which is to say that they have more capital. To those who defend this idea, the key to economic growth is investment. The second answer says that as workers become more skilled and well trained they become more productive, thereby obtaining increased levels of production by using the same amount of resources as before. So, this answer suggests that the key to economic growth is education, which increases the value of human capital or labor becomes more effective. The third answer says that increased economic growth comes from developing better combination of items, superior machinery, and more advanced knowledge. This train of thought believes that the key to economic growth is found in technological advances.

Oil is important too

Therefore, economic growth in Venezuela can only come about by strengthening the foreign sector, which is to say, by becoming more competitive and increasing investment, including investment in human capital. Since we are an oil-producing country, any strategy concerning economic growth must part from this sector and consider it its center. From here, production levels must be spurred on, products and markets diversified, as well as costs reduced. Unfortunately, PDVSA's current management doesn't seem to be taking these aspects into consideration. The presence of exchange rate controls also doesn't contribute to increasing our competitiveness, which is why any potential for long-term economic growth is doomed to fail.

The State isn't helping any

Specialists in the matter of economic growth have dedicated most of their efforts to studying and evaluating what causes economic growth; with special interest paid to inventions, research and development, and innovative techniques, which make us more competitive in foreign markets. The State's role in this matter is to create incentives to promote these activities. However, the institutional changes that have occurred, and those that have yet to occur, in Venezuela seem to only generate obstacles that get in the way of growth, especially due to:

- Price distortion. People should be able to perceive real costs in order to be able to lower them. Price distortions make it impossible to perceive real costs. Inflation is the most harmful type of price distortion.

- Excessive controls with regard to prices and interventions in the credit market make it so prices send mixed and mistaken signals with regard to market conditions.
- Poorly conceived regulations and bureaucratic obstacles that inhibit investment.
- Obstacles to international commerce, of which exchange rate controls is one of the major culprits.
- Absence of a legal framework and institutions to protect economic rights like private property.

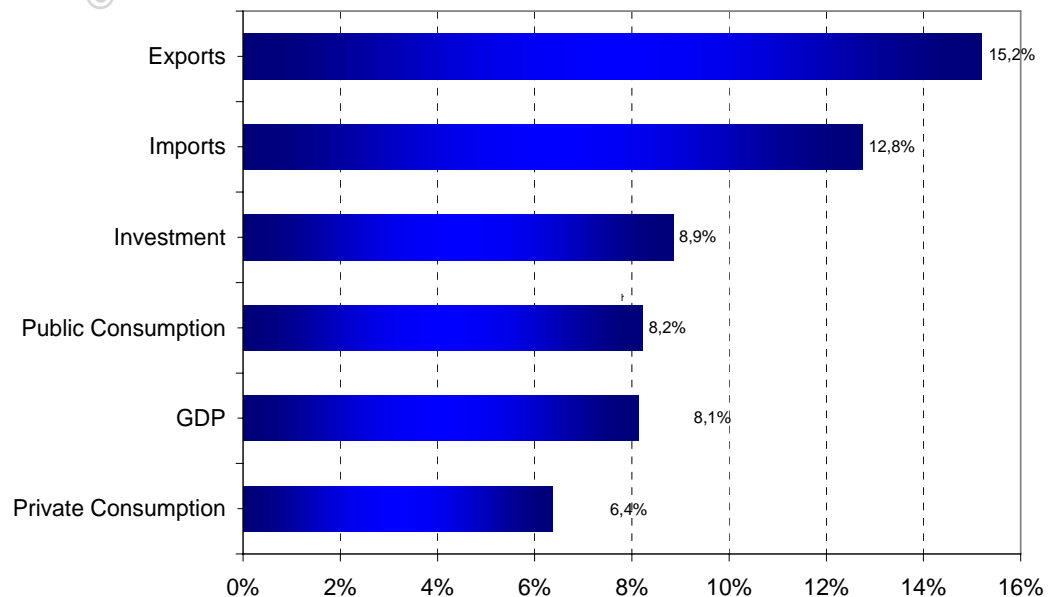
Two examples to compare ourselves to

At *Ecoanalítica*, we have studied two countries that during the last few years have done quite well in terms of economic growth. We are referring to China, which is on the verge of becoming the world's largest economy, and Chile, to use an example a bit closer to home, is a country that for the past few years has been referred to as the "new Switzerland of Latin America."

China: Competitiveness and foreign investment

According to UN figures, China's leading growth GDP components were the foreign sector (exports and imports) and investment. During the last few years, the growth of imports has almost doubled economic growth. Imports have increased significantly, especially capital imports, since private consumption is the component which reflects the least amount of growth. Due to the socialist nature of the country, China's public sector plays a dominating role in the country's development, growing at almost the same rate as its economy.

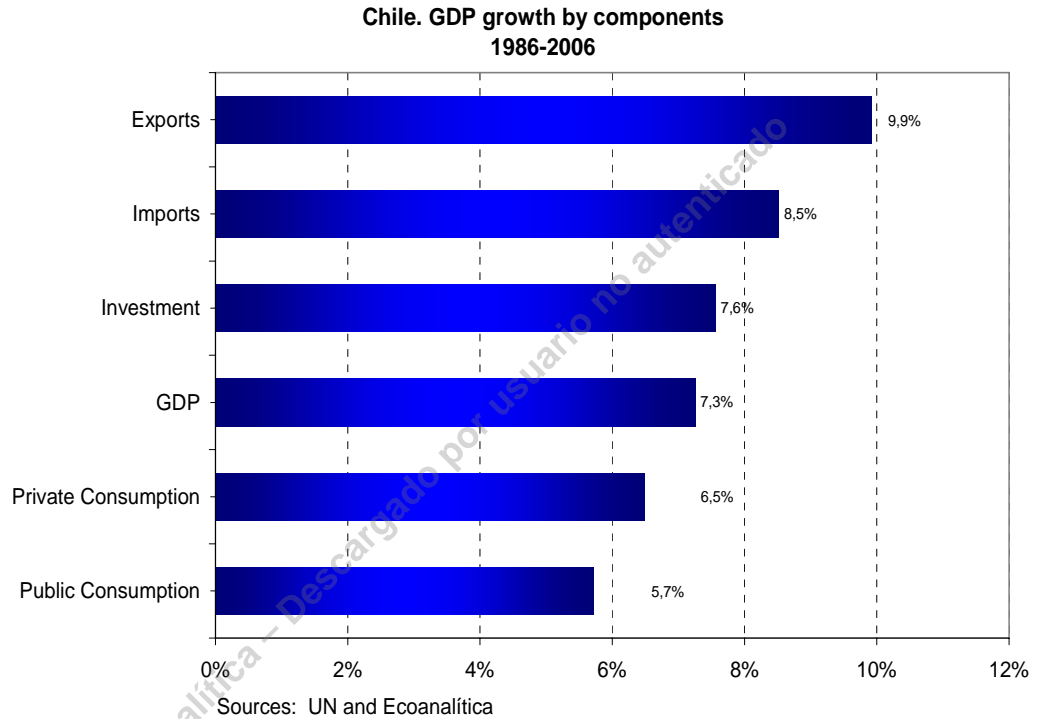
China. GDP growth by components 1986-2006



Sources: UN and Ecoanalítica

Chile: More of the same

It's surprising that in the case of Chile's economy things are working pretty much in the same manner. The most dynamic sectors continue to be the foreign one and investment, while the components related to consumption (public and private) have growth rates that are less than what the economy is expanding.



The world on one side and we are on the other

Using the figures made available by the UN, we find that for a significant number of countries, the foreign sector is the most dynamic, through exports. Countries like Argentina, Saudi Arabia, Iran, Ecuador, and Norway show that their leading economic growth component is exports. An oil-producing country like Qatar has exports as its second leading growth component, with investment being its first one. None of these countries shows private consumption among the first two places with regard to growth components. Venezuela does.

Economic Tips

Finance Ministry reacts to parallel exchange rate spike. The *Bono del Sur III* didn't improve the parallel exchange rate any, to the contrary, it spiked to levels between VEB5,570 and VEB5,600 to the US\$. Faced with this situation, the Finance Ministry is getting ready to intervene. The Ministry's intention is to once again begin to issue structured notes and wait for the Central Bank of Venezuela (BCV) to authorize the modification to the 4th exchange rate agreement so that Covered Interest and Capital Titles (papers protected from devaluation) can be placed on the Stock Exchange.

More restrictions concerning official US-dollars. The Minister of Finance, Rodrigo Cabeza announced that the list of goods considered to be "priority goods" are currently being reviewed. The goods on this list are those eligible to receive official US-dollars from CADIVI for their production and/or import. It's expected that priority will be given to food items, capital goods, and other items necessary for domestic production, and limit funds being issued for luxury goods like whisky and Hummers.

Public spending continues to shrink. According to the BCV, during the period January-July 2007, public spending was at VEB67.4 trillion, which represents a nominal increase of 10% compared to the same period last year and a drop in real terms of 8%. Total revenues dropped by 6% in real terms. The Government has a cumulative deficit of VEB2.3 trillion and financing needs were at VEB10.5 trillion.

FISCAL BALANCE CENTRAL GOVERNMENT (VEB Billions)	July 2007	July 2006	Nominal Variation	January-July 2007	January-July 2006	Real Variation	Nominal Variation
Total Revenue	10.520	9.429	12%	65.160	58.320	12%	-6%
Non-Oil Revenue	4.667	3.489	34%	34.964	26.656	31%	10%
Oil Revenue	5.853	5.940	-1%	30.125	31.041	-3%	-19%
Central Bank Earnings	0	0	-	71	624	-89%	-90%
Total Expenditure	9.805	8.307	18%	67.422	61.456	10%	-8%
Primary Expenditure	9.263	7.761	19%	62.996	56.553	11%	-7%
Interest Payments	542	545	-1%	4.425	4.903	-10%	-24%
Domestic Debt	218	225	-3%	1.863	1.916	-3%	-18%
Foreing Debt	324	320	1%	2.563	2.987	-14%	-28%
Fiscal Balance	715	1.122		-2.262	-3.136	-28%	
Primary Balance	1.257	1.667		2.163	1.767	22%	
Non Oil Balance	-5.138	-4.818		-32.458	-34.800	-7%	
Debt Amortization	702	1		8.264	5.395	53%	
Net Monetary Injection	5.516	4.494	23%	36.535	37.204	-2%	-18%
Financing Requirements	-13	-1.121		10.526	8.531	23%	
Foreing Debt	0	6		22	160	-87%	
Domestic Debt	0	4		1.624	4	100%	
Treasury Bonds	0	0		1.624	0	100%	
Treasury Debt	0	4		0	4	100%	
Others	-13	-1.132		8.880	8.367	0	

Sources: BCV and Ecoanalítica

Taxes increased. For more than a year now, the Administration has been working on tax reform which is now being included in the framework of the Economic and Social Development Plan for 2007-2013. The program contemplates a restructuring of the tax system which includes implementing a real estate revaluation tax due to public works. This means that real estate that is close to subway or train stations among others would have to be taxed.

The first ones are here. The Administration has modified the tax to be applied on liquor. The change means that the tax on beer and natural wine goes from 8.5% to 15% and for all other alcoholic beverages it goes from 10% to 20%. Producer and importer taxes remained the same. Besides revising the amounts taxed, the conditions to authorize liquor sales were also adjusted, so business must now have a permit to sell alcohol issued from the mayor's office and the community councils.

Cigarettes too. Along with the tax modifications for alcoholic beverages that were published in the *Gaceta Extraordinaria* dated October 5, were also published the tax modifications for cigarettes. Starting from October 15, the new tax on cigarettes will be 70% of the public sale price. The rate used to be 50%.

Bank Debit Tax again. The Government also established a Financial Transaction Tax (ITF) which companies and banks will pay for inter-account operations (withdrawals and/or transfers). Natural persons are exempted from this new tax. According to the SENIAT, this new tax will be in effect for two months and it is looking to make up for revenue lost due to the lowering of the VAT. The new tax rate is of 1.5%. The SENIAT hopes to collect around VEB1.4 trillion through these new taxes: VEB930.00 billion by the ITF and VEB500.00 billion by the adjustment of liquor and cigarette taxes.

Makes no sense. At *Ecoanalítica* we don't understand why the Government is creating these new and higher taxes, especially the ITF, when the fiscal situation is so comfortable. It seems excessive and it will simply increase a business' operational costs which will adversely impact the inflation rate.

Giordani admits. The monetary conversion from the current bolivars to the *bolívars fuertes* (strong bolivars) which will go into effect on January 1st, 2008 will have a "neutral effect" on inflation because it "doesn't effect it directly," explained the Minister for Planning and Development, Jorge Giordani. According to Giordani's estimates, the economy will close out the year with a GDP growth rate of no less than between 8.5% and 9%.

Oil revenue contingency fund is considered. In the new Constitution the Macroeconomic Stabilization Fund is eliminated but a similar scheme is considered.

The program establishes that in order to promote public spending stability and sustainability a number of financial systems will be created, and one of them will be the contingency fund for fiscal revenues coming from oil interests. Once again the Administration will have another source of income that comes from crude oil sales.

Work will legitimize the right to property. In the Nation's Economic and Social Development Plan for 2007-2013, the idea to define work, not only as the source of all wealth, but that it would also legitimize the right to property was established. The main thing among a number of aspects is "to recognize work as the only activity that generates value, and therefore, legitimizes the right to property.

Foreign agreements will be modified. The parameters that cover foreign investment and the trade of services with other countries will be modified as soon as the Economic and Social Development Plan for 2007-2013 is approved. These foreign agreements must be reviewed in order to establish if they are in line with the country's endogenous development.

Integration banks wait until next week. President Hugo Chávez plans to launch the *Banco del Sur* and the *Banco del ALBA* next week. As one of the points to be discussed during his visit to Brazil, the finishing touches to the banks constitution will be wrapped up. Countries participating in this endeavor are Venezuela, Argentina, Paraguay, Uruguay, Bolivia, Ecuador, and Brazil, the banks initial capital will be of US\$7.0 billion.

Basket increasing. According to figures published by the Documentation and Analysis Center for Workers (CENDA), the cost of the basic basket of food, goods, and services for the month of September increased by 0.7% compared to August settling at VEB2,158,720. So far this year the food basket accumulates an increase of 12%. According to CENDA estimates, an average family income covers 57% of the cost of the basket.

More supplementary appropriations. The National Assembly approved VEB815.00 billion in supplementary appropriations which are mostly earmarked for the Ministry of Food to subsidize the purchase of food by FUNDAPROAL, CASA, and MERCAL (VEB769.00 billion). The rest of the resources will be assigned to the presidential guard and Ministry of Agriculture and Lands.

Venezuela absolves Guyanese debt. The Venezuelan government decided to write off US\$12.5 million owed by Guyana from a debt stemming from 1974. Furthermore, Venezuela will donate the country US\$2.0 million to build a refuge center for indigents.

OIL TIPS

Oil price drop. The Venezuelan crude oil and oil by-products basket dropped 87 cents to the US-dollar this week after five consecutive weeks of increases. The price is at US\$73.16, taking the yearly cumulative average to US\$59.88 per barrel.

PDVSA will be in the hands of *Empresas de Producción Social* (Social Production Companies). PDVSA will delegate part of its productive activities to the new Social Production Companies with the aim of lightening their load and strengthening the new property model. This is established in the Nation's Economic and Social Development Plan for 2007-2013 which is waiting to be approved by the National Assembly.

Continue with activities at *El Palito*. Activities resumed last week at *El Palito*. They had been stopped due to preventive measures since last Tuesday.

Slight increase in oil exports to the United States. Venezuelan crude oil and oil by-products shipments increased slightly by 22,000 b/d in July, going from 1.36 to 1.38 million b/d, reported the Energy Information Administration (EIA).

Mixed companies will export individually. The National Assembly approved the mixed company constitutional agreements resulting from the elimination of the previous strategic associations on the Orinoco Oil Belt and the Shared Risk agreements. According to the agreements, the following mixed companies: Petromonagas, Petrocedeño, and Petropiar (taking the place of Cerro Negro, Sincor, and Ameriven, respectively) will be able to directly export the crude oil they produce. But, Golfo de Paria Este, Oeste, and Central must sell all their production to PDVSA. The aforementioned agreements also establish measures that guarantee PDVSA will receive between royalties, income tax, extraction tax, and other measures at least 50% of the value of each barrel produced by these companies.

Proven reserves increase. Venezuelan proven reserves reached 100,000 million barrels, after having certified 12,400 million barrels in the Orinoco Oil Belt. These new reserve estimates bring the total in the Orinoco Oil Belt up to 25,900 million barrels and 6.4 trillion cubic feet of gas.

BUSINESS SECTOR TIPS

CONVIASA receives extra loans. The state-run airline received from BANCOEX, also a state-run bank, the sum of US\$20 million in order to purchase two new planes and substantially increase their inventory of spare parts in order to support operations.

Banco del Tesoro expands. The *Banco del Tesoro* expects to have 32 offices operational by the end of the year, announced the bank's president, Gustavo Augusto Giral. The president also announced that the bank was currently working on unifying the public financing system.

Venezuela among the countries with the least positive environment for micro-financing. A report by the Inter-American Development Bank indicates that the country has a very low return rate concerning micro-financing matters or with regard to micro-business loans or loans awarded to low income people. The report called *Microscopio*, which evaluates 15 countries in the region, indicates that Venezuela along with Argentina are in the last place with 27.4 points, and the Latin American country with most points at 79.4 is Bolivia. The report studies the investment environment, the development of public institutions, and the regulating framework for micro-finances.

Feeling the impact of the parallel rate. Electric appliance stores are starting to feel the effects of the parallel exchange rate that is around VEB5,600/US\$. Consequently, they have increased their prices by between 5% and 10%.

Electric problem affects Sucre and Anzoátegui state. Approximately 60% of the population of these two states was affected by a blackout during the beginning of this week.

Energy Revolution. By replacing normal light bulbs with energy saving bulbs, carried out by the Energy Revolution campaign, you drop the total demand of energy by 176 Mw. This translates to a savings of VEB27,875 a month, according to figures released by the Mission.

The Land Law is back. Almost seven years after having been approved, the Land Law is being reintroduced by the Economic and Social Development Plan for 2007-2013, to support the development of agriculture activities. The recently submitted Plan establishes as one of its goals for the next seven years "to continue the official register of non-urban land, to conclude the specific location of large estates by transparent means, and to systematically rescue identified tracts of land."

Problem with the wheat industry. Juan Crespo, president of the National Federation of Flour Workers (Fetraharina), announced that the stock situation concerning the wheat industry was in critical conditions. The stock that currently exists is expected to hold out until the first week of December.

Shortage of liquid milk. The import subsidy that was announced in order to alleviate the milk shortage will not be enough to cover demand, explained the Minister of Food, Rafael Oropeza; he continued to say that medium-term solutions look to reinforce production.

Cheaper calls. A fiber optic connection between Venezuela, Colombia, and Ecuador which will be ready by December will make calling these countries cheaper.

A Mixed cell phone company. Falcón state will be the headquarters for *Venezolana de Telecomunicaciones C.A.* (Ventelca) one of the two companies in Venezuela that will be assembling cell phones. Both companies have mixed capital (Venezuela and China). In the case of Ventelca, 84.3% is in the hands of the *Corporación de Industrias Intermedias de Venezuela* (Corpivensa), while 15.7% is in hands of the Asian cell phone manufacture ZTE Limited. ZTE's goal for 2008 is to have at least made one million phones according to the plans laid out by the company and the Government.

The three that pre-qualified. The National Commission for Telecommunications announced yesterday that the operators Digitel, Movilnet, and Movistar all pre-qualified to receive a new portion of the radio-electric spectrum in order to be able to offer third generation service. On October 22nd the decision will be made to select the companies that will operate the 1800 and 1900 MHz bands.

Luxury car demand in up. According to figures from the Venezuelan Automobile Chamber (Cavenez), the sale of luxury cars considered "premium" increased by 83% during the first eight months of the year (20,026 units), compared to 2006 (11,068 units).

Colombia won't give in. Colombian President, Álvaro Uribe, reiterated that his Government would not eliminate the toll installed on the border with Venezuela last July and that this decision should not be seen by those that have been protesting the toll as being "defiant."

Political Tips

Socialist Plan will be approved in December. The president of the National Assembly, Cilia Flores, announced that before December 15th the Assembly would approve the First Socialist Plan for the period 2007-2013, written by President Hugo Chávez.

The 15th of this month starts the third discussion. According to the president of the National Assembly, Cilia Flores, on the 15th of this month a plenary session of the Assembly will begin the third discussion regarding the constitutional reform project. She continued to say that during the last two weeks of the month articles included in the reform will be approved so that, as the CNE has already informed, on December 2nd the referendum can be held.

Opposition demands of the CNE that it sanction “Chávez’s unfair advantages”. Representatives from the different political parties met with CNE members to request that they put a stop to, and if need be, sanction, the unfair advantages that the Administration is enjoying.

Another survey. 61.1% of Venezuelans would vote against the constitutional reform if it means allowing Chávez to continue in power indefinitely, limiting private property, eliminating states and municipalities, and transferring the responsibility of children’s education to the Government; only 38.9% would vote in favor of the reform. This same survey shows that abstentions would favor the President, since questions regarding this issue reveal that 46% of those planning to abstain would have voted No and only 16% Yes.

And yet another one. According to Datos, 60% of those surveyed prefer a democratic system and 1% prefer communism. Joseph Saade, executive president of Datos, during the forum “*Lo bueno, lo malo y peor de 2008*” (The Good, the Bad, and the Worst of 2008) organized by **Ecoanalítica**, explained that a survey was carried out with regard to what could be expected of 21st Century Socialism and two options were presented to those surveyed: social democracy or communism. Faced with these two options, the majority opted for social democracy, but Saade points out that 24% of those surveyed accept socialism and 4% capitalism with 11% undecided.

New U.S. Ambassador presents his credentials. After having to wait more than a month since his arrival in Venezuela, the U.S. Ambassador to Venezuela, Patrick Duddy, was able to present his credentials to the Venezuelan Minister of Foreign Affairs, Nicolás Maduro, which officially allows him to commence fulfilling his

appointed duties. Also presenting their documents yesterday at the *Casa Amarilla* were the ambassadors from Mexico, Mario Chacón; Spain, Dámaso de Lario Ramírez; Vietnam, Tran Thanh Huan; Switzerland, Armin Ritz; and Japan, Shuji Shimokoji.

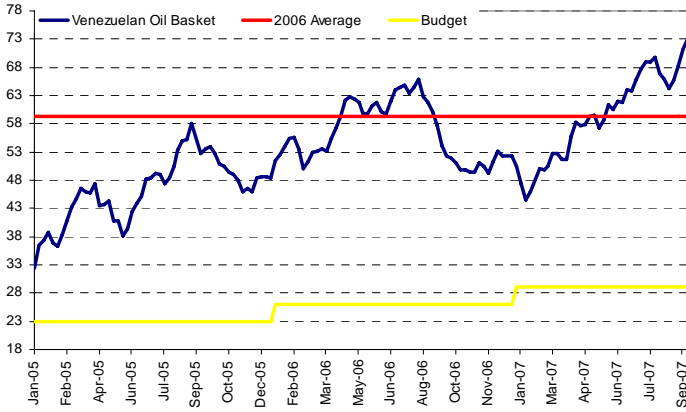
Other Tips

Ecuadorian Government reduces extraordinary revenue participation to 1% for oil companies. On October 4th, Ecuadorian President, Rafael Correa, signed a decree establishing that 99% of extraordinary revenues generated by high oil prices shall go to the State and 1% to the oil companies. Up to now, profits had been divided up in equal parts (50% - 50%). The Government expects to receive additional income around US\$840 million a year due to this reform.

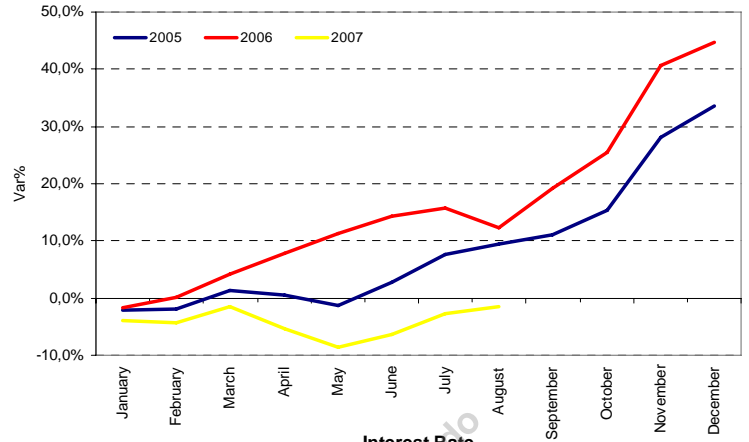
Unsatisfied. According to a report "*Barómetro Cesta Ticket*" (Food Stamp Barometer) carried out by the consultant firm Ipsos, on behalf of Accor Services, 60% of workers often feel that they are proud of their job, while 53% are happy with their jobs. But almost 1 out of every 2 workers is unsatisfied with their salary. Many of them are seriously considering changing jobs. According to the Barometer, 53% of private sector workers consider this option quite often, and would consider almost any offer presented, or that they have already decided to quit and are looking for a job. In the public sector, the percentage of those thinking about quitting was at 35%.

ECONOMIC OVERVIEW

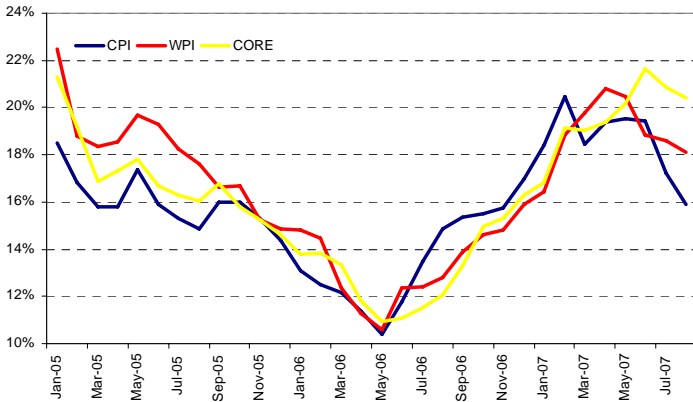
Oil Price
(Venezuelan Basket US\$/pb)



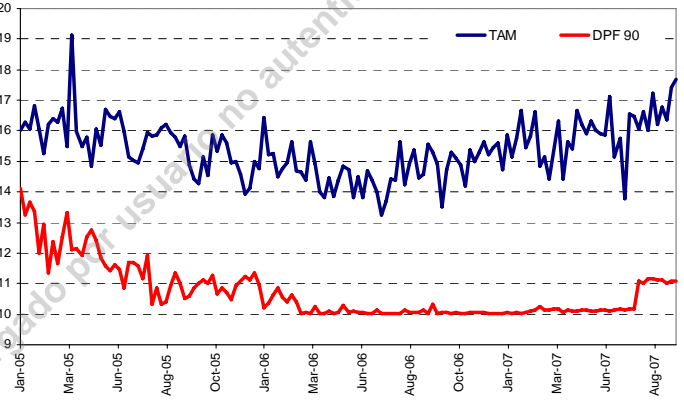
Real Expansion (M2)



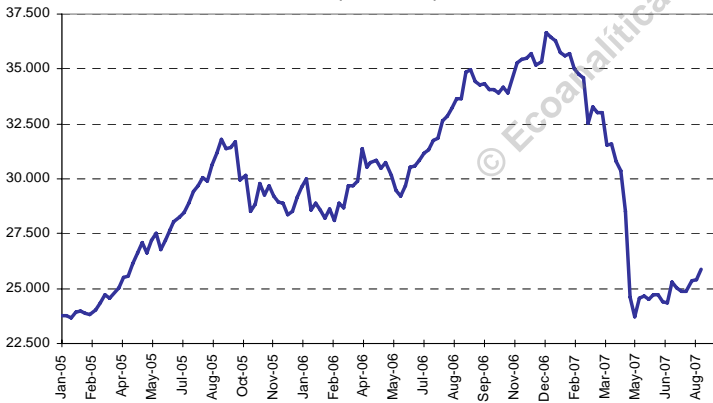
Inflation
(Last 12 Months)



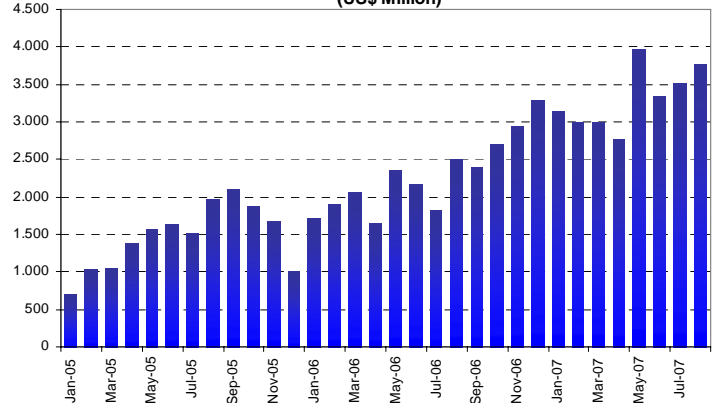
Interest Rate
(Six Principal Banks)



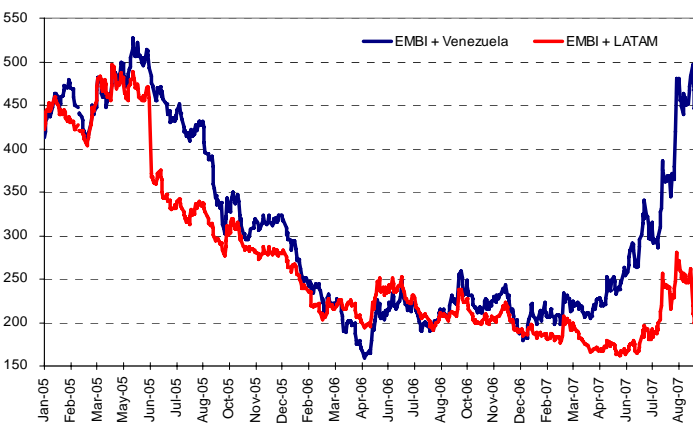
Fx Reserves - BCV
(US\$ Million)



Disbursement
(US\$ Million)



EMBI



Central Government
(VEB Billion)

