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**2008 BUDGET: CABEZA IN
WONDERLAND**

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A few weeks ago, the Minister of Finance, Rodrigo Cabeza, submitted the new 2008 Budget and Indebtedness (*Umbrella*) Draft Law for next year to the National Assembly. At **Ecoanalítica**, we believe that this act is a mere formality. This Draft Law, according to the Minister, is completely novel, since it is expressed in *bolívares fuertes* and contains a few elements of the new institutional reorganization found in President Chávez's constitutional reform proposal. However, the Budget doesn't present anything new compared to the previous years, since the Government is continuing its "boom" policies taking advantage of the current high oil prices and using macroeconomic premises that are clearly underestimated and far from being realistic. Public spending will continue to increase in 2008, focusing on the "social," especially on the new structures of the so-called people's power: the communal councils, and the socialist companies.

**Reality on one side and
the Government on the
other**

Now that the Minister has submitted the 2008 Budget, at **Ecoanalítica**, we would like to make some comments with regard to it and contrast a number of macroeconomic assumptions that are included in it with certain events that we expect will happen in the coming year.

However, as far as we are concerned, the preparation and submission of the Yearly Budget Law and Indebtedness Law carry very little weight when it comes to determining what the Government's fiscal policies will be for the coming year, in the specific case of Venezuela.

The first lie: The level of spending budgeted

In our country, fiscal policies mainly follow the current trend in oil prices, which allows the Government, when prices are high, to be able to count on significant amounts of surplus resources that spur increases in spending that was already budgeted.

In fact, 2006 and 2007 are good examples of such an event. Last year's original Budget for fiscal spending was set at VEB87 trillion, but ended up almost reaching VEB129 trillion, in other words, VEB42 trillion over the original budget. This was due to the fact that the Venezuelan oil basket averaged US\$56.4 per barrel, while the Budget estimated that the average price of the Venezuelan oil basket would be around US\$26 per barrel.

In 2007, the scenario repeats itself. The Budget set fiscal spending at VEB115 trillion. However, with all the supplementary appropriations that have been added on it is already at around VEB139 trillion. At this rate, spending could close out the year at VEB145 trillion. In other words, 26% over what was originally budgeted.

So, it's very naïve to think that the Government will only spend VEB137.5 trillion in 2008. Even more so when you take into account that next year the Government will probably have extra constitutional obligations to take care of and that it is an election year for governors and mayors.

"Boom" policies with a touch of voracious fiscal management continue.

It's no surprise to any of the analysts that for the past seven years the Administration has been applying "boom" policies. If oil prices are high, you take advantage of the earnings and splurge. If oil prices are low, an inefficient fiscal adjustment is put into place which is based simply on delaying National Treasury payment orders, where transfers to regional and local governments, investment spending on infrastructure, and the payment of State labor liabilities.

Added to this "boom" policy, during the last two years, fiscal management has become ever more voracious: the Government has been increasing public spending on all fronts, and therefore, in the

middle of an unprecedented oil bonanza, with a crude oil basket hovering around US\$80 per barrel, the Government is decreeing new taxes and increasing others that already exist.

The Government is not very revolutionary but rather conservative

The 2008 Budget draft law includes a number of assumptions that deal with key macroeconomic variables like oil prices, GDP, exchange rate, and inflation among others. It's a common practice of the previous Governments, and especially of this one, to underestimate some of these variables and to present a very conservative scenario in order to have greater freedom to manage budget policies throughout the year, especially when it is with regard to fiscal and oil revenue surpluses.

A double lie with regard to the oil sector

With regard to the oil sector, there are significant discrepancies in the Budget, with regard to production as well as the price of oil. The Government continues to insist that oil production will reach an average of 3.6 million b/d and that the average price of the Venezuelan basket will be around US\$35 per barrel. With regard to production, the figures are very misleading with regard to real production because it lumps together oil production, liquid gas production, and the production of other oil by-products, which due to their characteristics were not included in oil production. All the international agencies that deal with the subject of oil (PIW, IEA, OPEC, Bloomberg, IMF, among others) set Venezuelan oil production at around 2.4 million b/d and with the possibility of slightly increasing next year to a maximum of 2.6 million b/d.

With regard to the price of oil, at **Ecoanalítica** we expect it to average around 69% over the price estimated in the Budget (US\$59.1 per barrel).

A big responsibility for the SENIAT

With regard to non-oil revenues (through the SENIAT), the Government estimates that it will collect 59% of the resources budgeted in the 2008 National Budget. 59% of the Budget is equal to VEB75.9 trillion. We estimate that non-oil tax revenues next year will reach around VEB 83.6 trillion.

It's important to keep in mind what Minister Cabeza has said as well as the superintendent of the SENIAT, José Vielma, that the Bolivarian Government is working to implement a new tax system that aims to progressively eliminate direct taxes and concentrate on income taxes, taxes on earnings, consumer taxes and taxes on luxury imports.

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However, ever year it's become more difficult for the SENIAT to meet its goals, since this Government's voracious tendencies continue to put more pressure on collecting more revenue, not only from the oil sector but from the non-oil sector too.

We agree on growth

We do agree with one of the Ministry of Finance figures included in the Budget and that has to do with growth. The Government is estimating growth at 6%. Our estimates are at 6.7%. Given that the Government's fiscal expansion policies will continue, the non-oil sector will grow by about 7.3% (spurred on by fiscal spending) and the oil sector will reflect moderate growth, especially petrochemical and refining activities, of around 2.2%.

Minister Cabeza lives with Alice in Wonderland

This economic growth spurred on by public spending scenario will lead us to higher inflation. In fact, our estimated inflation rate for the close of 2008 is 11 percentage points higher than the Government's estimate of 9%.

Spending could be even higher

Within this macroeconomic scenario, the 2008 Budget Draft Law amounts to VEB137 trillion, which represents 27.3% of the expected GDP (VEB 502.6 trillion) for the year. An important fact is that Minister Cabeza pointed out that spending could increase to 30% of GDP, in other words, it would reach VEB150.8 trillion. So, the Administration's budgeted spending will most certainly be surpassed through supplementary appropriations, which is why we estimate total spending at 28.3 points of GDP and a quasi-fiscal spending (carried out mainly by PDVSA) at 6.0 points of GDP, while it is almost non-existent in this Budget.

Fiscal Balance Central Government (%PIB)		
	MF 2008	Ecoanalítica 2008
GDP Nominal (VEB Trillions)	503,0	588,5
Oil Price (VEB per US\$)	35,0	51,9
Economic Growth (%)	0,1	0,1
Inflation (%)	0,1	0,2
Exchange rate (VEB per US\$)	2150	2150
Total Revenue	25,4	29,0
Non-oil Revenue	15,1	14,2
Income Tax	4,4	3,6
Customs	1,8	1,5
Tax	5,4	5,0
Others	3,5	4,1
Oil Revenue	10,3	14,8
Oil Tax	3,0	5,1
Oil Royalty	5,7	8,0
PDVSA Earnings	0,9	0,5
Others	0,7	1,2
Central Bank Earnings	0,0	0,0
Total Expenditure	27,4	28,3
Primary Expenditure	25,3	26,2
Interests	2,1	2,1
Domestic Debt	0,8	0,7
Foreing Debt	1,3	1,4
Quasifiscal Expenditure	0,0	6,0
Fiscal Balance	-2,0	0,7
Primary Fiscal Balance	0,1	2,8
Non Oil Balance	-12,3	-14,1
Amortization	1,1	2,3
Financing Requirements	3,1	1,6
Foreign Debt	0,5	0,2
Domestic Debt	1,5	1,4
Others	1,1	0,0

Sources: MF and Ecoanalítica.

Increased spending for debt service

Domestic and foreign public debt will mostly be serviced by ordinary revenues according to what is proposed in the 2008 Budget Law Project. 2008 domestic and foreign debt payments will be at VEB16 trillion and according to the proposal submitted to the National Assembly, 12% of the Budget will be earmarked to service the debt,

which would represent an increase with respect to this year, when the amount for debt payment was 9%.

It's indicated in the allocation that foreign debt service is expected to be at VEB12.1 trillion (US\$5.63 billion), corresponding VEB5.4 trillion (US\$2.51 billion) to principal payment and VEB6.6 trillion (US\$3.12 billion) to the payment of interests. Domestic debt payments are estimated at VEB3.9 trillion. Payment for next fiscal year is only expected to cover the interest due.

The 2008 Budget Draft Law indicates that for this fiscal year, 53% of the total debt service, VEB8.5 trillion, will be covered with ordinary revenue and funds coming from other financing sources. 47% of the service, VEB7.5 trillion, will be handled with borrowing.

Though less in terms of GDP

According to next year's Budget Law, debt payments will represent 3.2% of the GDP, compared to this year's 3.6%, so there is a slight drop in 2008.

Debt repurchase must continue

It's expected that the Administration will carry out debt refinancing or restructuring operations for around VEB8.6 trillion. The Budget Law mentions that "the national public debt profile will continue to be optimized, and therefore refinancing operations are being considered. This will achieve the objectives proposed of reducing interest rates, the expected payment term extension, the conversion of foreign debt into domestic debt, and the reduction of the projected flow." At **Ecoanalítica**, we are convinced that the Government should set aside a significant part of the extraordinary resources in order to carry out debt repurchase programs, for domestic as well as foreign debt, and to reduce the Republic's liabilities. The Government has already carried out these types of programs in the past; we hope they will continue with more of the same.

More transfers

According to Minister Cabeza, the tendency to increase National Budget resources earmarked for social spending will continue in 2008. The Minister mentioned that in 2006, this area represented 40% of the country's budget, in 2007 it was 41%, and in 2008 it will reach 46% of the Budget.

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However, this amount isn't all necessarily direct social spending, since an important percentage (around 60%) is earmarked for the payment of wages and salaries, as well as labor liabilities. So, the so-called "social investment" is approximately at VEB25 trillion, in other words, 18% of the total budget. In 2007, according to our estimates, social spending represented 16% of the total, so the increase is of 2 percentage points.

With greater opaqueness Last year, the Government decided to include the budget of the Missions in the National Budget. However, the so-called Missions have been allotted a budget of VEB5.5 trillion, an extremely low figure if you take into consideration that spending this year on Missions could reach VEB20 trillion. Resources have mainly come from PDVSA and FONDEN.

At ***Ecoanalítica***, we have always considered that the way the Missions are managed is not very efficient and not easy to control. We are not very optimistic for the future of this issue. The Administration, backed by the BCV and the National Assembly, has taken a series of measures to ensure a degree of opaqueness concerning the management of these resources. This is one of the reasons that FONDEN, *Banco del Tesoro*, and other financial institutions by the public sector were created, along with the elimination of PDVSA's obligation to sell its foreign currency to the BCV (Exchange Agreement No.9), the establishment of the National Treasury's US-dollar account, all of which makes it much more difficult to control the Administration.

Economic Tips

Record levels. Venezuela's GDP in 2007 will for the first time in the country's history reach US\$200.00 billion, according to announcements made by the Minister of Planning, Jorge Giordani.

Let's hope it's true. The Administration expects to lower the foreign public debt to 12.7% of GDP for 2008, according to the 2008 Budget Draft Law that the Minister of Finance, Rodrigo Cabeza, submitted to the National Assembly this month.

Slight increase in the lending rate. The average lending interest rate from January to October was 16.47%, showing a slight increase of 1.15% compared to the average registered during the same period last year. During the last three months that rate on average surpassed 17%.

ITF will have a very negative impact on businesses. The president of the Banking Association announced that if the stipulated 1.5% tax on financial transactions isn't modified, costs for businesses would increase dramatically, the banks profitability will approach zero, and the growth of loan portfolios will stop.

Only two articles. The superintendent of the SENIAT, José Vielma Mora, confirmed that the Government decided to modify some of this legal instrument's articles on request of the private bank. He explained that only two articles were modified: one concerning exemptions and the other concerning the ranges susceptible to canceling this tax. In the chapter concerning exonerations the following was added: this tax will not be paid by operations derived from negotiations of titles on the Caracas Stock exchange and the Venezuelan Agriculture Stock Exchange. While in article 3 of this Law, which establishes the operations that must pay the tax, it was accepted that inter-bank operations (loans between banks) will pay the ITF starting from the second working day. These changes will prevent credit card operations and the issuing of registered bank checks from having to pay the tax more than once.

BCV, without autonomy, can't be guarantor of the public debt. Members of the BCV Board of Directors are in talks with different levels of the Administration and the National Assembly warning that if the constitutional reform suppressing the autonomy of the Bank is approved the sovereignty of new public debt issues to be placed on the financial market would be jeopardized.

IDB doesn't agree with the idea of eliminating the BCV's autonomy. According to the chief economist at the Inter-American Development Bank, the idea of eliminating the BCV's autonomy, as it appears in the constitutional reform proposal, can have serious consequences for the country. He pointed out that there is no evidence in the world that indicates that autonomy of central banks is detrimental, but rather that it is indispensable for medium-term development.

The priorities are education and poverty. A panel of nine recognized economists concluded that Latin America's efforts should be focused on finding solutions for

issues regarding education, poverty, health, fiscal situation, infrastructure, democracy, and employment.

The signing of the foundation of the *Banco del Sur* will be on December 5. The Minister of Finance, Rodrigo Cabeza, announced in a press release that the signing of the foundation of the *Banco del Sur* will be held on December 5th this year, as was agreed upon unanimously by all the Ministers of Finance and Economy of the member countries. Originally there was talk of setting the date for November 3rd.

Maza doesn't have any confidence in the monetary conversion. In the former Central Bank of Venezuela director, Domingo Maza Zavala's opinion, the monetary conversion will not reduce inflation like proponents say it will.

Monetary conversion implied very high costs for the financial sector. The monetary conversion process which will give way to the strong bolivar starting on January 1st has cost the financial system around US\$100 million. Víctor Vargas, president of the Banking Association, explains that each bank has had to deal with costs of up to US\$12 million.

New bills introduced. The new strong bolivar currency, made up of six bills and seven coins which will begin to circulate on January 1st, 2008, was introduced to the public by the president of BCV, Gastón Parra Luzardo, along with the Minister of Planning and Development, Jorge Giordani, and the board of directors of the BCV. The bills have an innovative vertical design on their front side, and for the "first time in monetary history" have the image of a woman printed on them. On the reverse side of the bill "the BCV wished to pay homage to the geographic richness of our country. Furthermore, it selected the image of endangered animals, native to the region, in an effort to create awareness among the people with regard to conservation and respecting the country's biodiversity," said Parra.

Bolívar devalued before the Colombian peso. Exchange rate operators explain that Venezuelans pay VEB2,631.50 for each COP1,000 on the Venezuela-Colombia border, in other words, an exchange rate of VEB2.6:COP. According to the BCV, during the first quarter of this year, each Colombian peso had a cost of VEB0.9 and on October 24th, VEB1.06.

Electoral Christmas bonus. Rodrigo Cabeza announced that most public administration employees will be receiving two months' salary in Christmas bonus pay in November and an additional one month bonus in December.

Rise in prices. The consumer price index suffered a variation of 2.4% during the month of October, the largest reported so far this year. Thus, the cumulative inflation is located at 13.62%, which exceeded the target of inflation scheduled for 2007. In October of the previous year inflation was 0.74%

OIL TIPS

Historic. The average price of a barrel of Venezuelan oil was up US\$0.91 and reached US\$78.55. Recent high prices are mainly due to a very intense and speculative futures market activity as well as the news announcing the drop in U.S. hydrocarbon and product commercial inventories and the US-dollar weakening before other currencies.

High prices in 2008. Oil prices will average more than US\$70 per barrel in 2008, higher than what was previously estimated, due to limited supply, geopolitical tensions, and cash flow by the funds, revealed a survey taken by Reuters.

Production up in September. Once again, Venezuela increased its crude oil production in September, averaging 2.38 million b/d, according to a monthly report by the International Energy Agency (IEA). In August, the Agency reported a slight increase of 20 thousand b/d in local production which was repeated in September. However, despite these increases, third quarter average was at 2.36 million b/d, down from the 2.37 million b/d posted in the second quarter, and the 2.44 million b/d registered in the first quarter.

Chávez reaffirms oil price increase. After signing seven memorandums of intent between Algeria and Venezuela, President Hugo Chávez reiterated that the price of oil would reach US\$100 per barrel, due mainly to the imperialist pressures of the U.S. government.

PDVSA invests in Gas. PDVSA will invest a total of US\$785 million in order to lease the drilling ship Neptune Discoverer for four years. It will be in charge of the off-shore drilling of 21 non-associated gas wells in the eastern part of the country.

To export gasoline to Colombia. Within the framework of an agreement between PDVSA and ECOPETROL, Venezuela will begin to export 8 million liters of gasoline every month to the north of Santander, Colombia. This measure will satisfy part of the region's demand and prices will be competitive to that of gasoline brought in by contraband.

Conoco to ask for arbitration in dispute with Venezuela. The executive president of ConocoPhillips said yesterday that his company would probably request arbitration in the "next few weeks" in order to end the dispute with the Venezuelan government concerning the compensation of the operations it left behind in the Orinoco Oil Belt.

BUSINESS SECTOR TIPS

Venezuela next to least attractive business region. The Economist Intelligence Unit (study group division of The Economist), revealed that for the period of the next 12 years, starting in 2008, Venezuela is next to the last place that is considered "attractive" for business, just in front of Angola. Iran even placed higher than Venezuela. The United States came in ninth place.

Authorized increases. The resolution which fixes the Maximum Consumer Sale Price for some products is published in the *Gaceta Oficial* No. 38.796, dated Thursday, October 25, 2007. Increases for a number of cooking oils were established. Also increased was the price for bread, pasta, wheat flour, and black beans. It's expected that the Government will also adjust the price of some other regulated products.

Street vendors speculating with milk. Given the milk shortage suffered by all Venezuelans, the street vendors are taking advantage of this to sell milk at outrageous prices. The newspaper *El Universal* made a survey in the Baralt avenue area where they found that all the street vendors have significant quantities of milk, and they are selling it for VEB25,000 when the regulated price is VEB12,551.

Protests at the Ministry of Agriculture and Land. The Ministry of Agriculture and Land was the stage for a protest carried out by around 400 sugarcane producers and workers and another 300 from the coffee industry, who are demanding that the Government increase the price of coffee and sugar at the production level.

International wheat prices hit the roof. The price of a ton of wheat has generated much concern among domestic industries given that the combination of these international wheat prices and local price controls of finished goods like pasta have made it impossible to maintain adequate commercialization margins. Industry sources report that companies will stop importing this raw material while they ask the Government to take measures to adjust the price or deregulate certain items, or subsidize at least 40% of production.

Corn, sorghum, and rice continue to be subsidized. In an attempt to stimulate agriculture development, the Government announced an extension of the subsidy period for the production of corn, sorghum, and rice, in the *Gaceta Oficial*.

PEQUIVEN looks to expand. PEQUIVEN attended the International Plastic Fair held in Germany, aiming to promote investment, and meet new partners interested in the developing of 54 resin transformation projects introduced in their business plan.

CADAFE to invest US\$1.5 billion. CADAFE expects to invest more than US\$1.5 billion during 2008. The investment is aimed at improving the domestic electric system in the areas of power generation, transmission and distribution.

CADIVI and the Insurance Superintendence sign a provision. CADIVI and the Insurance Superintendence signed the joint provision N° 082 which establishes the requirements and procedures for the foreign currency authorization request to be used for insurance companies' operations. This new regulation is a result of the modification made to provision N° 049, which established the administration and control of foreign currency destined for insurance, re-insurance, retrocession, export insurance credits and health claim management abroad.

Strengthening ties to Russia. US\$8.0 billion exchanged between Venezuela and Russia could result in 12 agreements being signed that were established during the IV Top-Level Inter-Governmental Commission between both nations.

Colombia and Venezuela cooperating in telecommunication issues. Within the framework of the 2007 World Conference on Radio Broadcasting, both countries created a technical commission to study to the feasibility of developing projects to increase the fiber optic connection between both countries.

Political Tips

Weekly Report

Reform approved in third discussion. The National Assembly approved in its third discussion the constitutional reform proposal which contemplates the modification of a total of 69 articles: 33 proposed by the President, Hugo Chávez, and 36 by the Parliament. The document will be submitted by the National Assembly board to the National Electoral Council (CNE) once the Secretariat makes the appropriate corrections and it is read one last time during a plenary session.

Referendum regulation. The CNE approved the regulations which will govern the constitutional referendum that will be held at the end of this year. The CNE will be in charge of contracting the publicity spots, which it will then evenly distribute among the opposing groups. Proselytism is prohibited for those natural or legal persons not registered in any of the groups. This does not apply to the President or the members of the Parliament, because they are the reform proposal proponents. The CNE will be in charge of the televised debates.

Moral Power will be renewed. The second vice-president of the National Assembly, Roberto Hernández, announced the creation of the evaluation committee that will review and choose the credentials of those candidates to be nominated for the Moral Power.

President Chávez received the credentials of four new ambassadors. Chávez received the credentials of the new diplomatic representatives from the Republic of Italy, Chile, United States of America, and the Socialist Republic of Vietnam.

ECONOMIC OVERVIEW

