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HOW WILL THE ADJUSTMENT THAT IS COMING BE?

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There is no doubt that Venezuela is a changing country. In less than three months, the outlook for the coming year changed radically, with an all encompassing global financial crisis entering into the picture, among other things. So now, 2009 looks like an adjustment year. And no one, much less the Government, likes to use that word. In this report, we offer three possible scenarios which could happen this coming year.

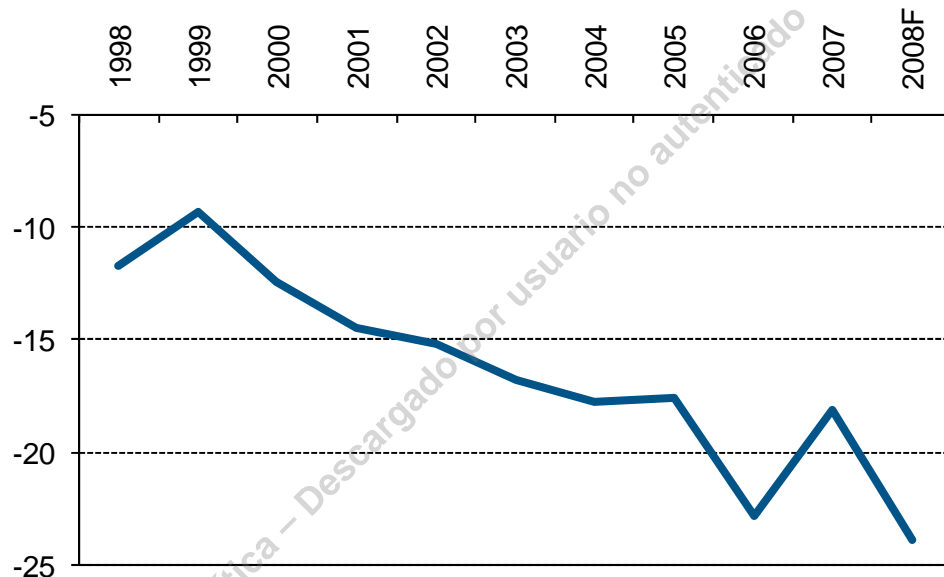
**The crisis is
affecting us...but not
that much**

How did everything change from one day to the next? The answer, in Venezuela's case, can be easily summed up by pointing to two events, global recession and oil prices dropping significantly. Forecasts of oil prices reaching US\$ 200 a barrel are memories of a past which already seems to have happened a long time ago. It's still too early and too difficult to predict the full reach and consequences of this crisis, but it's quite clear and there is no doubt that oil prices will remain at levels much lower than those reached in the last few years.

This is a crucial point for the economic policies of the current Administration, since it has propped itself up on ever increasing public spending which requires oil prices to steadily continue to rise. An indicator

which allows us to explore this fact more accurately is the non-oil fiscal deficit, which shows us how much of public spending has to be covered by oil revenues and acquired debt. In 1998, this indicator was at 11.7 points of GDP. This year, this same indicator could settle at 23.9 points of GDP. In other words, in ten years, this indicator has doubled, which clearly shows more dependency on the ups and downs of the international oil market.

Non-Oil Quasifiscal Deficit



Sources: MEF and Ecoanalítica

How will the Administration react?

In a scenario with oil prices significantly dropping, it is not easy to predict how the Government will react, because we believe that economic policy is subject to the viability of the political project of President Chavez and hence the measures they can take in the economic field are not always based on technical criteria and / or economic rationality. From now on, every decision the Administration makes will be considered in terms of two objectives: first, how will this decision affect the President's approval/popularity levels; and second, how to keep the "revolutionary process" going. These two objectives aren't necessarily affected in the same way by what the Administration chooses to do, and sooner or later, the Government is going to have to prioritize one of them.

Scenario 1: "Nothing new, business as usual"

In this scenario, the Government chooses the path which one could call orthodox. In other words, the main economic adjustments made in 2009 would be: cutting back on public spending, by around 3 or 4 points of GDP,

which would mostly affect infrastructure spending and Government transfers to the regions, as well as new salary benefits for public administration employees.

Furthermore, the Government would also devalue the currency (around 30%) and increase the VAT from 9% to 12% and reintroduce the Bank Debit Tax. These measures would allow the Government to collect an additional 4 or 5. The Government would also take a hard look at and review its oil policies, especially its PETROCARIBE agreements.

The principle palliative measures will include increases to social assistance programs, greater transfers to the so-called Peoples Power organizations (mainly communal councils), and maintaining controls on the exchange rate and prices, with CADIVI being increasingly selective on one side and an increase in policing businesses on the other.

It's not as orthodox as it seems

The problem is that this type of scenario may increase social discontent, despite increases in so-called social spending, because with these measures comes higher inflation and shortages (more controls and less imports), and jobs being lost (drop in economic growth and consumer consumption). At *Ecoanalítica*, we believe that the Administration will not be so orthodox in its fiscal adjustment (IMF guidelines), especially since it knows that it can count on all its out-of-budget resources during the coming year. It's important to point out that even with all the orthodox measures implemented in this scenario, there is still no mention of dismantling the control policies. We believe that before the Government will contemplate such a move, it will explore a whole series of options and possibilities.

Scenario 2: Chávez style or living in dreamland

This scenario corresponds to what Chávez and his different spokespersons have said. For the coming year, there will be greater control of imports, extraordinary resources will be used to palliate the crisis, there will be another transfer of international reserves to FONDEN, greater acquisition of debt, specially domestic debt (remember the 2001-2003 period). Furthermore, public spending cutbacks will be mostly felt by the amount of resources transferred to governorships and mayorships, even more so if one keeps in mind that the current hegemonic control that the Administration enjoys throughout the country's regions, will most likely change, and it will have to deal with new political players from the opposition and dissident chavistas.

This scenario is ideal for Chávez, since it has very little political cost but seriously compromises the validity of the future of his revolutionary project, because with low oil prices it's impossible to sustain the model. This leads us to raise a point which is of vital importance to understand the decisions taken by the Executive in the coming months: Chávez is going to prioritize his political survival, even if in the short term it means suffering a drop in popularity, and that will lead him to introduce some hard measures, which will of course be compensated by other measures to ease the pain. So we can call this scenario, living in dreamland.

Scenario 3: Compete chaos

This scenario has elements included in both the previous scenarios and would try to find the least painful path for the Government. It's a mixture of economic policy decisions which look to minimize negative impacts on government administration and at the same time guarantee its viability. The Government would make a slight adjustment of the exchange rate (maximum 20%), spending cutbacks would also be minimal which could be covered by making adjustments to the National Budget, without falling back on supplementary appropriations. This scenario would also included increased acquisition of domestic debt, reintroducing the Bank Debt Tax, without changes to the VAT.

Social spending will increase and greater transfers will be made to FONDEN¹. In other words, the Government would sell an exchange rate adjustment as if it were not adjustment at all. The point being that it would only be a measure to gain time, because if low oil prices persists and lasts longer than expected, the Administration's margin for maneuverability will be completely gone, and at the same time its out-of-budget resources would be extremely low. We think that this is the scenario which the Government will most probably opt for².

	Scenario 1	Scenario 2	Scenario 3
Economic Growth (%)	0,4	1,3	0,6
Inflation (%)	38,4	34,0	35,3
Official Exchange Rate	2,9	2,2	2,6
Fiscal Deficit (%)	-2,1	6,1	-4,0
Imports (US\$ MMM)	41,0	48,2	45,5
International Reserves (US\$ MMM)	28,1	21,0	25,3

Source: Ecoanalítica

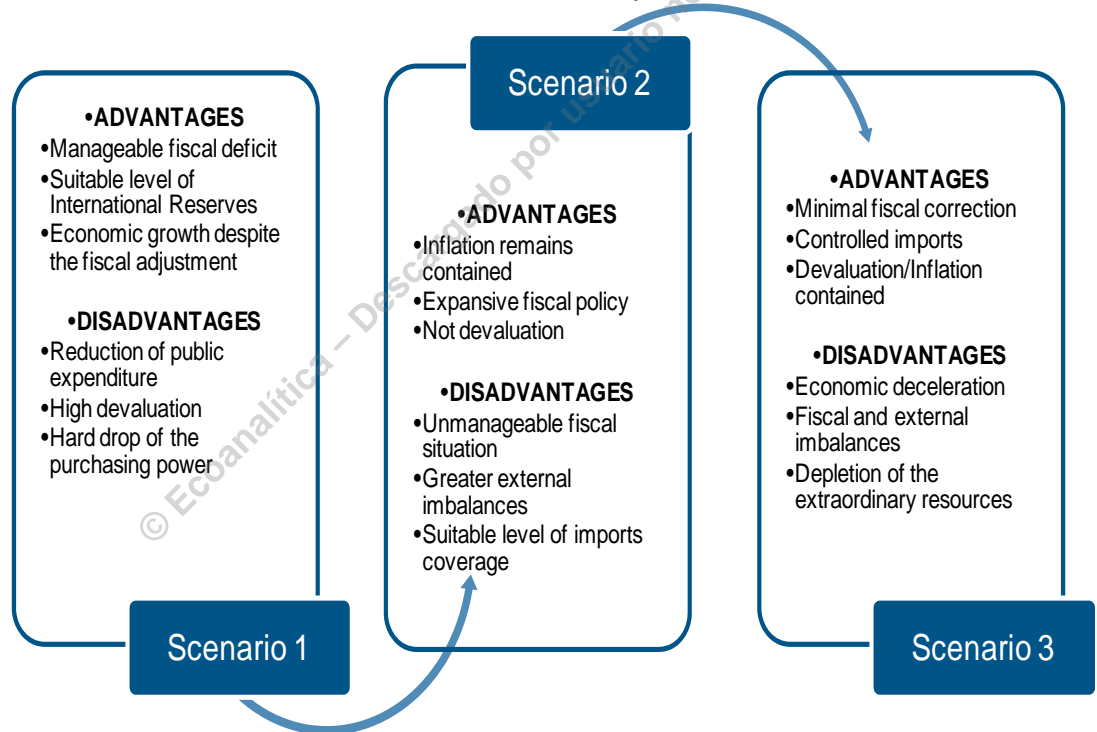
¹ If the BCV would set the new optimum levels of international reserves at US\$ 28.0 billion, transfers to FONDEN would be at around US\$ 11.50 billion at the beginning of next year.

² However, at **Ecoanalítica**, we expect the adjustment to the exchange rate to be greater, closer to 30%.

You can't always win

As you can see, each scenario leads the Government to a serious crossroad and hard decisions. Any decision taken will have significant political costs. At **Ecoanalítica**, we are convinced that the adjustment will not be orthodox, which means that there will not be a significant correction of the macroeconomic imbalances, but just temporary band-aid measures to hold us over and survive the crisis. The Government is always going to act, hoping that oil prices will bounce back, so that it can go back to the unsustainable economic practices it's used to, the only ones that it knows how to follow.

What would Chávez prefer?



Economic Tips

Lehman Brothers notes in FONDEN. The titles issued by Lehman Brothers, the American bank that went into bankruptcy in September, which are held by FONDEN as

part of its structured notes, will be held in the same Fund until maturity, as agreed by the Ministry of Economy and Finance.

It's legal to use FIEM resources. The Ad Hoc Political Administrative Chamber of the Venezuelan Supreme Tribunal declared legal, albeit six years late, that the Government had withdrawn US\$ 300 million from the Macroeconomic Stabilization and Investment Fund (FIEM). This action was denounced by opponents as deputies in violation of the law governing the fund.

Investment spending for 2009 drops. According to the 2009 Budget Bill, investment resources will account for 4.9% of Gross Domestic Product (GDP), down from the 2008 percentage of 5.6% of GDP. Consequently, the amount of VEF 167.4 billion will largely be allocated for current spending and obligations derived from the Special Powers Law.

The new socialist production model down the throat. The 2009 Budget Bill provides for that the Central Government, as well as state governor's and mayor's offices, have to prioritize their resources based on the socialist production model. In fact, 66.7% of the budget appropriations (resources for projects) are earmarked for the development of this scheme, since current legal framework established new budget obligations since last August.

The Government disagrees about the allocation of the revenue sharing requirement. The Executive, through the Constitutional reform, tried to modify the percentage of resources allocated to governor's and mayor's offices through the revenue sharing requirement, according to which they receive 20% of the ordinary revenues and 15% of VAT. The government thinks that it's inconceivable that most of the resources are concentrated on six states: Capital District, Aragua, Carabobo, Miranda, Lara and Zulia.

Contributions for governor's and mayor's offices and communal councils increase. The 2009 Budget Bill establishes that the total resources that will be transferred to governor's and mayor's offices and communal councils will amount to VEF 36.0 billion, which represents an increase of 36.7% with respect to this year's amount (VEF 26.3 billion).

Rodríguez Araque: the fewer the supplementary appropriations the lower the inflation. After submitting the 2009 Budget, Alí Rodríguez Araque, Minister of Finance, declared that the government is determined to fully comply with the next year's budget. The idea is to restrict the common practice of increasing budget through supplementary appropriations. This tighter fiscal discipline is intended to curb inflationary pressures derived from higher public spending.

Deepening controls. According to a press statement of the Ministry of Finance, measures are being considered to tighten control over food prices. The document states that some measures included in the plan implemented by the administration to fight inflation, including eliminating tax on financial transactions and cutting back VAT, didn't have the desired effect due to speculative activities. It's also confirmed that official exchange rate will be maintained at VEF/US\$ 2.15 so that the prices of foodstuffs and medicines that are sensitive to devaluation due to their dependence on imports is not affected.

BCV controls bank fees. The Central Bank of Venezuela issued a resolution fixing ceilings for fees that financial institutions charge their clients for international transactions, such as transfers for students abroad and import payment instruments. Consequently, the maximum fee for operations related to CADIVI is fixed at VEF 32.25. Meanwhile, authorizations to receive foreign currency for special cases, retired persons and students cannot be charged with a fee over VEF 43. The maximum fee for import and export registration will be VEF 77.94.

Standard & Poor's ratifies BB-/B rating for Venezuela. Roberto Sifón Arévalo, expert analyst from Standard & Poor's, ratified Venezuela's public debt rating of BB-/B. According to Sifón Arévalo, this rating was based on the government's net foreign position and "*our expectations that current account will continue to register a surplus at least until 2010.*" They also estimated Venezuela's inflation levels at high levels, 30% in 2008 and 26% in 2009.

Creative Chávez. The President of the Republic, Hugo Chávez, proposed his Ecuadorian counterpart, Rafael Correa, the creation of a new regional currency, Sucre, during his official visit to Ecuador. In Chávez's opinion, the current historic environment that is marked by the global financial crisis is favorable to determine "*the time of creating an international currency.*" Chávez proposed "Sucre" as the name for the new proposed currency, explaining that in this way the "*name of Sucre can be used again for a currency, but an international currency that helps us regulate our trade, control our deficits, surpluses and work by ourselves.*"

Interest Rates. Active Interest rates closed the second week of October with a slight increase of 1.38% over the previous week, closing at 22.76%. On the other side, the increase in the rate of term deposits was negligible, 0.06%, from 17% to 17.1%. The passive rate remained at 15%.

Foreign Exchange Reserves. The international reserves showed an increase of 2.53%, going from US\$ 40,015 million at the close of the second week of October to US\$ 41,026 million at the close of the third week of the month.

Monetary liquidity. At the end of the second week of October, the monetary liquidity recorded an increase of 0.95% over the previous week to close at VEF 171,618 million.

Oil Tips

Venezuelan oil basket plummets. The Venezuelan oil basket registered a steep drop at the end of the third week of October, losing US\$ 6.9/bbl. on the week to close at US\$ 61.09 per barrel, a level that is close to the reference price per barrel that the government used to finance next year's spending.

Cumulative drops. According to data from the Ministry of Energy and Petroleum, oil price averaged US\$73.59 per barrel in October, or a 44% drop with respect to the average in July this year, which was at US\$132/bbl. The year-to-date average amounts to US\$99.09, which ensures US\$64 surpluses for the government.

"The Revolution will not fall". According to President Chávez, oil price volatility will not impact our economy and he stressed that *"if the price falls to US\$7, the Revolution will not fall, but strengthen."* However, he pointed out that it is necessary to fix a price range between US\$70 and US\$90 per barrel.

International prices plunge. Despite the announced OPEC's production cut, oil continued its dropping trend. WTI closed at US\$64.15 per barrel last week, down US\$3.69 from last Thursday's price. Brent lost US\$3.42 per barrel, to US\$62.05, although previously would have reached a minimum of US\$61 per barrel.

OPEC cuts production. At the extraordinary OPEC's meeting in Vienna, a substantial cut of 1.5 million b/d was decided, which will be effective in November. This adjustment means that the Organization will reduce 28.8 million b/d, to 27.3 million b/d to be prepared for a possible drop in demand.

Equitable distribution. The reduction agreed last week implies an equitable distribution among OPEC members based on their production levels. Of the 1.5 million b/d cut, Venezuela will reduce 129.000 b/d, while PDVSA is announcing that it will produce 3.6 million b/d in 2009.

Venezuelan proposal rejected. Minister Rafael Ramírez proposed that a price band between US\$80 and US\$100 be established as a stabilization tool, similar to the one

that was fixed between 2000 and 2005. However, the proposal was not approved by the other members of the Organization.

“We believe a second cut would be possible”. The Venezuela Minister of Energy and Petroleum, Rafael Ramírez, pointed out that if the price of oil barrel continues dropping, a new production cut could be decided in the next OPEC’s meeting, scheduled for December 17th in Oran, Algeria. Arabia Saudi also stated that OPEC could meet more frequently to examine market behavior.

Iran is also anticipating another adjustment. The Iranian representative to OPEC, Mohammad Ali Jatibi, considered that the Organization will have to cut production again if the recent reduction is not enough to stabilize crude oil prices.

PETROCARBE dismisses any change. PDV-Caribe Director-Manager, Luis Rivas, stressed that PETROCARIBE financing policies have not changed as a result of oil crude price fluctuations, because the financing mechanism is variable, meaning that it’s adjusted according to oil price.

Refinery projects postponed. Since refining projects in Venezuela need to be prioritized, PDVSA will decide to postpone some of the refinery construction projects that were planned as part of the PETROCARIBE agreements. The agreements postponed include those with Nicaragua, Dominican Republic and Ecuador, although this latter is not member of PETROCARIBE. However, energy projects with Cuba are maintained.

Russia tries to cooperate. Last Wednesday October 22, the Russian president, Dimitri Medvedev, declared that after meeting with OPEC President, he considers that establishing a cooperation relation with the Organization is a key factor for Russia’s energy policy.

New names for gas stations. The resolution, according to which gas stations and liquid fuel wholesale facilities that will be under PDVSA’s control must change their names, was published in the Official Gazette, as provided for by the Organic Law for the Reordering of Liquid Fuels. Furthermore, a special committee (the Strategic Negotiation Committee) was created to supervise that operations and service will not be interrupted.

New auction round. PDVSA plans to put for auction a part of three oil blocks in the Carabobo field in the Orinoco Oil Belt reserves, which will grant access of new companies to this hydrocarbon reserves. According to internal sources, the auction will take place in Caracas and different international companies may try to become PDVSA’s minority partners at these three blocks. The minister of Energy and

Petroleum, Rafael Ramírez, confirmed this information last week in Vienna. “We will open the bidding round next week with the interested companies,” declared the minister who is also PDVSA’s president.

Business Sector Tips

Stock Market not to be affected. Venezuela has not been affected by the profound global stock market crisis, specifically the Caracas Stock Exchange (BVC), because the Venezuelan capital markets are regulated and supervised by the National Securities Commission (CNV), according to Victor Flores.

It’s happening in November. The Santander Group anticipates announcing in November the closing of the sale of Banco de Venezuela to the government, affirmed the entity’s delegated advisor, Alfredo Saenz. The process “is continuing apace and is very far along,” said Saenz during a presentation to analysts of the quarterly results of the bank. The sale will inject fresh capital into the bank, although he noted that the bank is “very comfortable” with its current situation.

Full food supply guaranteed. The Food minister, Felix Osorio, said that “supply is assured; we have made a calculation based on what remains of 2008, and there won’t be a problem of shortage in any [food] category.”

Supply not that certain. In spite of what has been stated by government authorities, in supermarkets in the capital there is a scarcity of certain food items, such a rice, sugar and coffee. Consumers comment that the supply of these items is neither constant nor absolute, and when they can be found, there isn’t any variety, only a single brand on the shelves.

Consumption and industry lose steam. In comparing consumption growth figures during the first 7 months of the year, a significant deceleration is noted, since from 2006 to 2007 registered growth was 35.33%, while in 2008 it is only 17.65%. With industry, the situation is not much different; if one compares the first 7 months of 2006 with the same period in 2007, growth was 9.36%. But in comparing the same period of 2008 with that of 2007, growth was only 3.45%.

Electricity system overloaded. Edelca’s Labor and Complaints Worker’s Union secretary, Jose Cedeno, denounced that the limits of energy transmission are violated daily, which is why we have suffered such significant blackouts in many of the country’s

cities, principally during peak hours of between 10 a.m. and 2 p.m. This, added to the lack of investment and the obsolescence of equipment, has generated the crisis in the sector.

Law of electricity rationing. The National Assembly is currently putting together a law project whose goal is to maximize the use of energy. The law will have two main features: to obtain savings in national electricity consumption, and to preserve the sources of energy and conservation of the environment.

Claims of deficiencies. The former director of the Energy Ministry, Victor Poleo, claims that the deficiencies of the electricity system are due to the “militarization of the electricity industry, Cuban interference, and the side-tracking of investments.”

SENIAT tax collection surplus to go to Treasury. The national superintendent of taxes, Jose David Cabello, said that the SENIAT estimates that by November it will have collected the total that had been projected for the year, and it expects to turn over to the Treasury the collected total during the month of December.

New accord between Venezuela and Spain. At the end of the last week of October, the countries signed an energy cooperation accord in which the Spanish government will buy Venezuela oil, at a price yet to be determined, in exchange for technology for this country’s development projects.

Cemex negotiations extended. In view of the fact that the Executive has not reached agreement with the cement company, it was decided to extend the time period of negotiations in order to come up with the final decision.

VEF 14.56 million destined for tourist areas. An item is being included in the National Budget Law to invest VEF 14.56 million in a “Touristic Recuperation Plan for Choroní,” and a “Sustainable Development Plan for State Tourism Activity.” With this investment, the Government hopes to promote a socialist productive model in adjoining localities.

Pipeline factory to be of public use. A full house of the National Assembly declared that Helvesa, an industrial manufacturer of large diameter pipelines for the national oil, gas and petrochemical industries, is to be of public utility and social interest. This involves the right to operate, use, and profit from assets, real estate and property improvements that constitute this Industrial Complex, located in Anzoategui. In this manner, PDVSA will end up holding a 20% share in the productive process of this sector.

Political Tips

Voting to take time. The general observation by individuals who participated in a voting simulation of the upcoming Nov.23 elections, was the slowness of the process, due principally to the large number of posts up for election, and the difficulty in spotting the candidates on the electoral card.

Chavez initiates a new operation: “Manuel Rosales, you are going to jail.” The President of the Republic said that one way or another he would put the current governor of Zulia, Manuel Rosales, in jail. He ordered the Supreme Tribunal to investigate all his assets and activities, where the President is sure that they will find something abnormal in order to be able to put him behind bars.

Cuts don't include directors. For the next year, government functionaries will receive salary increases above the average originally set for public administration employees. According to the 2009 National Budget Law Project, the salaries of directors of government entities will rise 42%, to VEF 6,744, for the next year, after having been at VEF 4,769 this year. On the other hand, the incomes of deputies will register an increase of 44% in 2009, according to budgetary accounts, going from VEF 3,735 to VEF 5,378.

World Crisis Tips

Another new FED mechanism. The Federal Reserve (FED) announced the creation of a new financing mechanism (with so many it is difficult to keep count), the Money Market Investor Funding Facility (MMIF), that will complement other commercial paper purchasing mechanisms (CPFF), that go into effect on Monday, and also of commercial paper liquidity of mortgage titles (AMLF) that was introduced Sept. 19. With this MIFF scheme, the Fed will offer financing of ten SPV's (special vehicles) that will buy certificates of deposit or commercial paper with 90-day payment terms, issued by financial institutions with a rating of A-1/P-1/F1 or higher.

Difficult situation. This is another indication that things are worse than what they seemed. In fact, since the downfall of Lehman Brothers, investors have withdrawn US\$342 million in funds invested in company debt.

USA: Foreclosures and unemployment. According to the Federal Housing Finance Agency, in August the index of housing prices fell 5.9% in comparison with the same month of the previous year, the biggest drop in 17 years. The factor that most affected the lowering of housing values was the increase by 71% of the number of home foreclosures, in the 3T08, with respect to the same quarter in 2007, to reach the highest level since the statistic was first recorded. On the other hand, the number of individuals seeking unemployment insurance (that is, who have gone more than two weeks without work) is 46% higher than that of the previous year.

New round of interest lowering. In recent days, the Central Banks of various countries have lowered their official interest rates, in order to counteract the effects of the global recession and credit crisis. Among them is the Bank of Canada, which lowered its rate 25 basis points, to 2.25%; the New Zealand Reserve Bank lowered its rate 100 basis points, to 6.50%; and Sweden's Riksbank lowered its repo rate 50 basis points, to 3.75%. The market now anticipates that the BCE and the Bank of England will adjust their interest rates in the coming months.

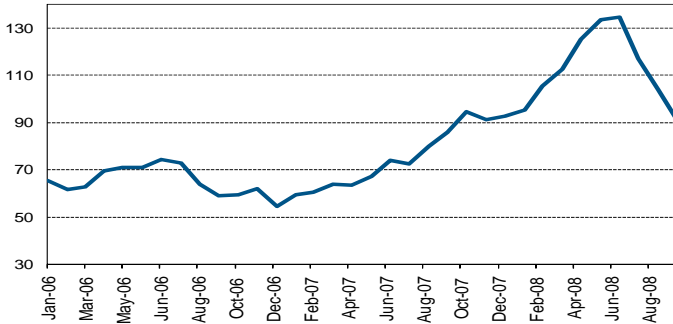
Black credit scenario. The risk rating agency, Fitch Ratings, expects a 50% decrease in the net growth of credit, given that the financial crisis has brought with it higher levels of risk aversion and imbalance in global markets.

To rescue Ukraine and Hungary. The International Monetary Fund (IMF) agreed to lend US\$16,500 to Ukraine, and an amount not yet disclosed to Hungary, to help them out of the financial crisis that has shaken the world. The IMF said it would lend the money to Ukraine to "maintain confidence and economic and financial stability." The global credit crisis has strongly jolted shareholdings, the banks and the currency of this Eastern European country. On the other hand, the IMF said that the "considerable financial packet" for Hungary will be determined in the next few days. Hungary will receive the loan on the condition that it adopts "strong policies" to be prescribed by the IMF, the European Union (EU) and some European governments, "together with regional and multilateral institutions," said the IMF's director, Dominique Strauss-Kahn in a communiqué.

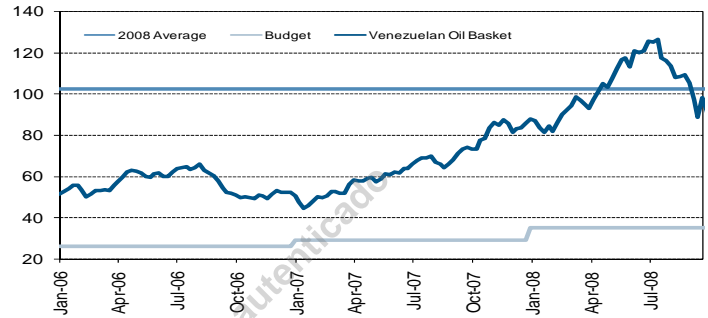
Iceland to seek aid from Nordic neighbors. Iceland's prime minister, Geir Haarde, foresees asking for economic aid from other Nordic leaders in an extraordinary meeting. Haarde explained that Iceland reached an agreement with the IMF to receive a loan of US\$2.1 billion (1.5 billion euros), but that it needs an additional US\$4 billion, an amount that other Nordic countries could place on the table.

ECONOMIC OVERVIEW

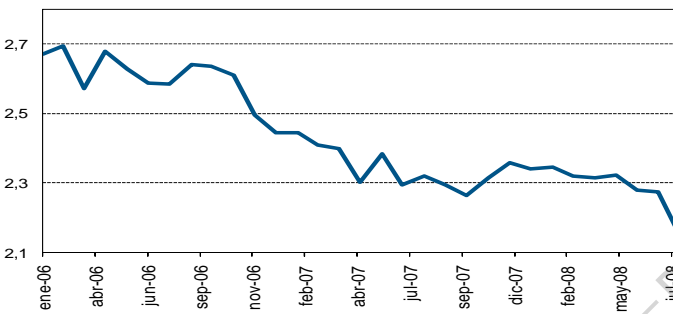
Oil Prices (WTI US\$pb)



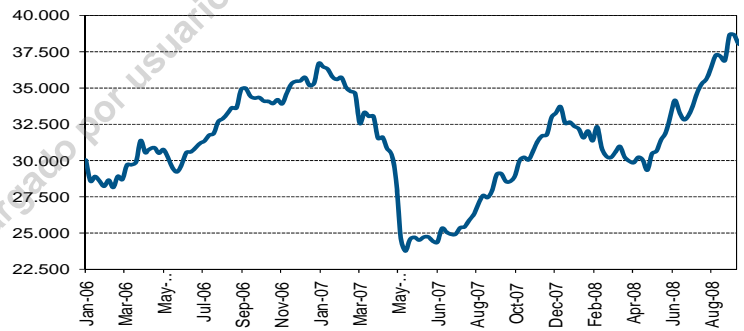
Oil Price (Venezuelan Basket US\$/pb)



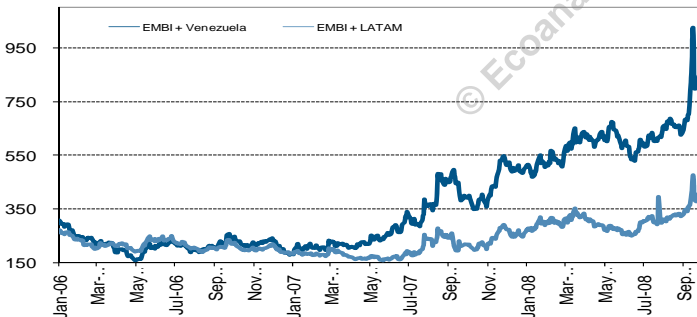
Oil Production MMBB



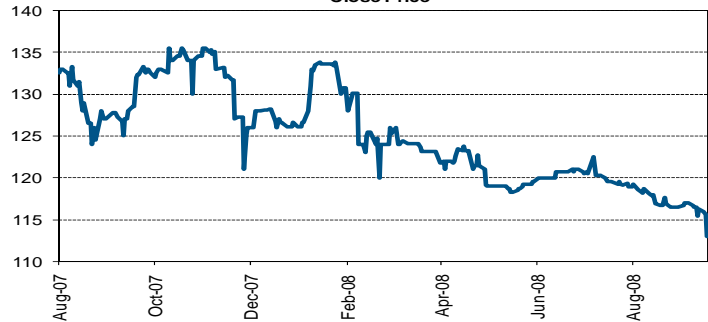
Fx Reserves - BCV (US\$ Million)



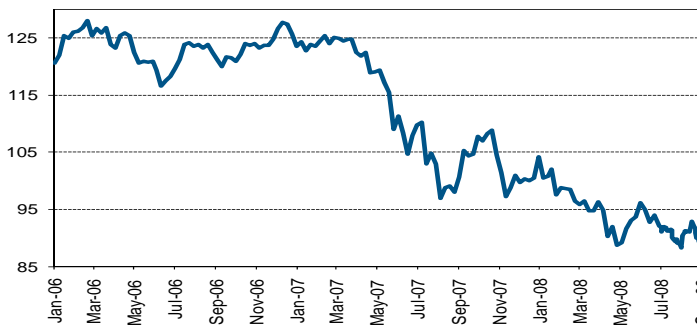
EMBI +



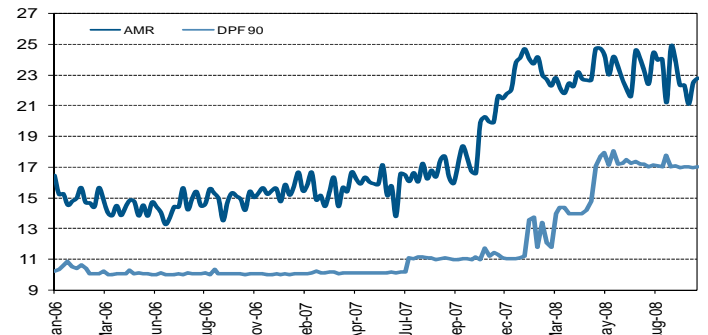
Venezuelan Global 18 Close Price



Venezuelan Global 27 Close Price



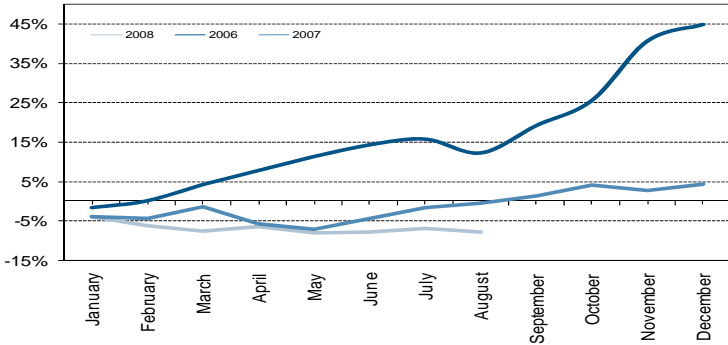
Interest Rate (Six Principal Banks)



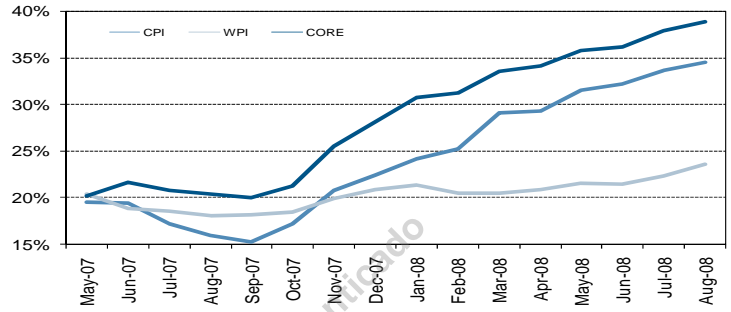
Weekly Report

ECONOMIC OVERVIEW

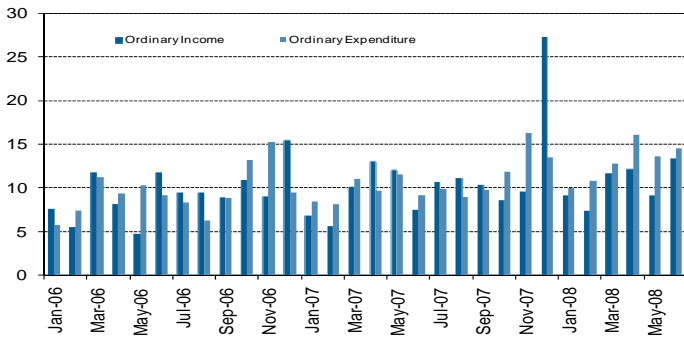
Real Expansion (M2)



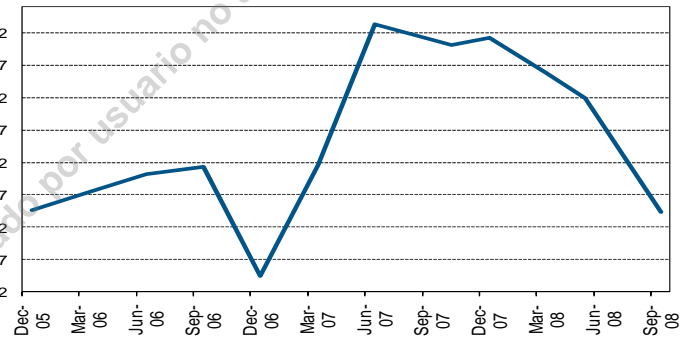
Inflation (Last 12 Months)



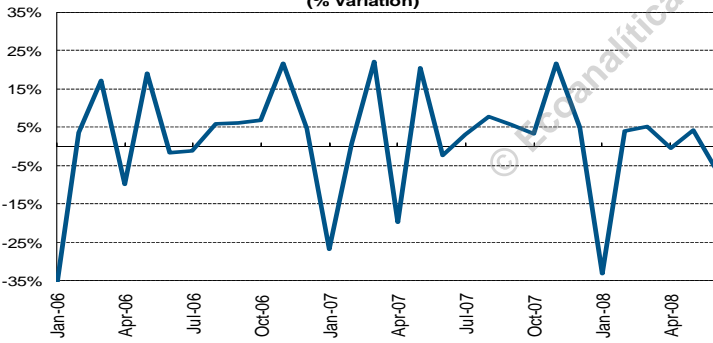
Central Government (VEB Billion)



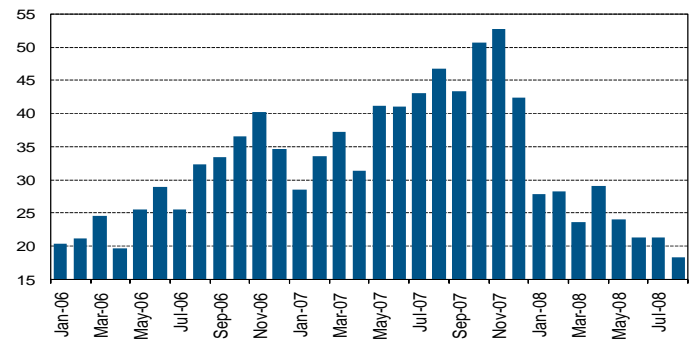
Resources of the State (US \$ MM)



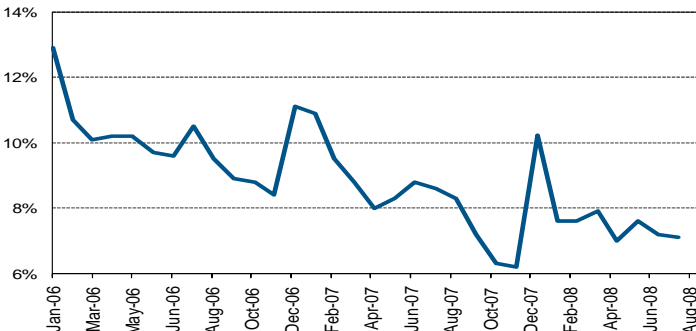
Volume of Sales (% Variation)



Sale of Vehicles (Thousands of Sold Units)



Rate of unemployment (% Variation)



Disbursement (US\$ Million)

