



Volume 4, Number 5
Week I, February 2008

INFLATION: THE ECONOMIC AGENTS FEEL THAT THE EXCHANGE CONTROL IS NOT SUSTAINABLE

By:

Alejandro Grisanti
Asdrúbal Oliveros
Michael Penfold

Edited by:
John Holden

Reproduction and/or
distribution prohibited

During the last few weeks, the opinion that Chávez's Government is in serious fiscal trouble has gathered momentum. The reason being, a series of news items, like: 1.- The interpretation that the reduction from 30 to 8 days in the recovery of the oil bill by PDVSA is associated with cash-flow problems, 2.- the release of PDVSA's debt figures and CITGO's loan, that, as a matter of fact, coincided with our esteemed, 3.- the Tax reform being planned within the framework of the Special Powers Law in order to increase Tax collection, 4.- the announcement that the Government doesn't have money for the education missions, among other things, etc.

BCV improves inflation calculation method

The Central Bank of Venezuela (BCV) has made methodological and operational improvements in the way inflation will be calculated. These improvements will go into effect for the publication of the January inflation figures and include the following: 1.- Updating the index base, setting the month of December 2007 as the base instead of the year 1997. From now on, 100, corresponds to the month of December 2007. 2.- The number of items included in the basket are increased from 287 to 351, for Caracas, and from 287 to 343 for Maracaibo. The

Weekly Report

more items that are measured, the more exact price increase estimates are. 3- The weighting structure for the items included in the basket is updated. It will be based on the results of the III National Survey of Family Budgets carried out during 2005. In other words, this new consumer basket will more accurately reflect the current average Venezuelan consumer. 4.- The number of stores included in the sample are increased from 2,000 to 2,800 in Caracas, and from 1,325 to 2,225 in Maracaibo. As will be explained further on in this report, these changes introduced by the BCV were made following strict technical criteria, without political considerations.

Plus, these are just partial changes, since the BCV looks to create a National Consumer Price Index (NCPI) which will include the 10 most important cities in the country and its first results will begin to be published starting in the month of April of this year.

The inflation published is not comparable to previous months

The Consumer Price Integrated Index (CPII) for the metropolitan areas of Caracas and Maracaibo reflected a variation of 3.0% for the month of January 2008. This integrated variation is a result of a 3.4% price increase in the capital city region and a 1.8% price increase for the city of Maracaibo. This variation reflects the price increase recorded for the following items: Alcoholic beverages and tobacco (5.4%), Health (5.1%), Restaurants and hotels (4.9%), Foods and non-alcoholic beverages (4.4%), and Miscellaneous goods and services (3.3%); and also lower rate increases reflected by other items: Transportation (2.7%), Education (2.0%), Recreation and culture (1.8%), Clothing and footwear (1.4%), Household equipment (1.2%), Rent (0.6%), Housing services (0.1%), and Communication (0.1%).

	1997 Weights	2007 Weights	Inflation	Inflation with 1997 base	Inflation with 2007 base
Food and non-alcoholic drinks	22,9%	25,6%	4,8%	1,1%	1,2%
Alcoholic drinks and snuff	1,5%	2,3%	6,4%	0,1%	0,1%
Clothing and footwear	6,5%	5,2%	1,7%	0,1%	0,1%
Rental housing	15,1%	12,1%	0,6%	0,1%	0,1%
Service housing except phone	3,5%	2,7%	0,3%	0,0%	0,0%
Equipment from home	5,6%	5,4%	1,1%	0,1%	0,1%
Health	4,2%	6,5%	5,9%	0,2%	0,4%
Transport	13,3%	11,2%	4,0%	0,5%	0,4%
Communications	5,2%	4,9%	0,0%	0,0%	0,0%
Recreation and culture	5,1%	4,0%	2,2%	0,1%	0,1%
Education services	4,8%	4,5%	2,5%	0,1%	0,1%
Restaurants and hotels	6,1%	9,4%	5,6%	0,3%	0,5%
Miscellaneous goods and services	6,2%	6,2%	3,7%	0,2%	0,2%
General Index	100%	100%		3,0514%	3,4%

Sources: BCV and Ecoanalítica

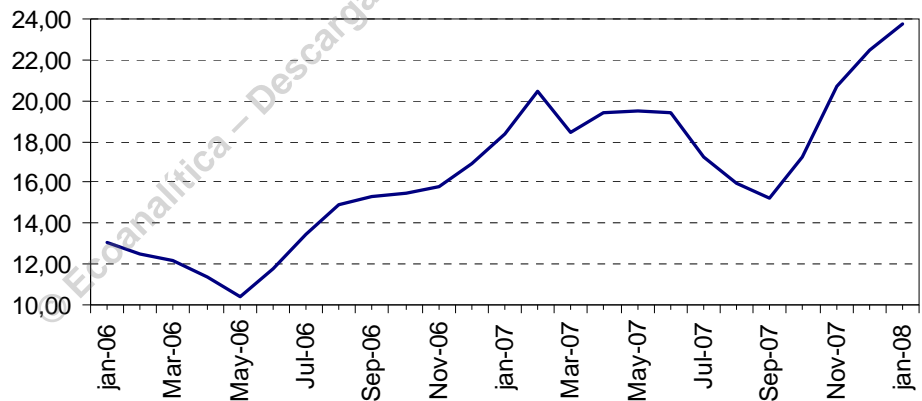
Weekly Report

In order to make a temporal comparison of inflation we'd have to use the same methodology which would make it necessary to make the same weighting as before and multiply them by the change in price of each item group. These changes are shown in the previous table and reflect an inflation rate of 3.1% for the month of January 2008. This calculation was done using the year 1997 as a baseline. Having obtained a lower inflation rate by using the new methodology, this allows us to conclude that no political criteria were used to design it.

Inflation has been increasing during the last three months

With the new inflation calculation we can state that the 3.1% inflation rate for January 2008 is slightly lower than the month of December (3.3%) and higher than January 2007 (2.0%). The accumulated inflation for the last 12 months is 23.8%, higher than the 18.4% inflation rate posted for the previous 12 months before January 2007. It's important to point out that during the last three months prices have increased by 11.2%, which would give us an annualized rate of 52.8%.

Annual inflation



Sources: BCV and Ecoanalítica

There are three additional factors that help to explain the increase in inflation during the last quarter: 1.- The international increase in the price of food. 2.- Having implemented the financial transaction tax. 3.- The feeling that the exchange rate is not sustainable or that "my company isn't going to continue receiving foreign currency at the preferential exchange rate."

The increase in inflation has international causes: The international increase in food prices

Given the high and sustained growth of very populated areas of the world like China and India, international food prices have been increasing at an unprecedented rate. International market food prices have increased by an average of 24% in December, with some items increasing in price by more than 200% over the last three years. Of course, this increase in price has had an impact on domestic prices, and it makes trying to control the prices of certain items impossible with such an adverse international scene. Our own calculations indicate that this factor is responsible for a 4.2 percentage point increase in inflation. In other words, if international market food prices would have increased at their historic average rate, then the inflation in Venezuela would have been at 19.6% instead of 23.8%. For 2008, given lower growth levels in China and India and the possible recession in the United States, we expect the pressure on international food prices to ease up.

Inflation increasing is due to a tax being implemented: The financial transaction tax.

The financial transaction tax had a significant impact on the whole commercialization chain, forcing wholesalers to pass on the costs to consumers. The wholesale price index increased by six points less (17.8%) than the consumer price index (23.8%) during the last 12 months up until January. In fact, if we want to isolate the effect a fixed control exchange is having, the domestic wholesale price index was at 18.9%, almost 4 points less than the consumer price index. It's important that the SENIAT carry out a reform in order to adjust the distortions created by this tax and that Government spokespeople stop saying that this is a tax on companies and that it doesn't affect the people. The people are paying for it through a drop in their salaries purchasing power.

Exchange control fatigue is also a cause of inflation

And lastly, *Ecoanalítica* is of an opinion that the private sector has increased its awareness of the risks involved with the exchange rate. An increase in the risks associated with the exchange rate can be attributed to a feeling that the exchange control is reaching its end and will be dismantled in the short term and that the State won't be able to fulfill its foreign currency obligations. (We don't share this point of view.) Or, if a number of "non-priority" sector companies simply receive notification informing them that their sector will not continue to be authorized preferential rate foreign currency. This has already happened in a number of sectors like alcoholic beverages, vehicles, candy, etc.

Weekly Report

In this scenario, and even if the official exchange rate doesn't depreciate, the companies have suffered a very significant de facto devaluation and they must adjust their prices to the new exchange rate. Despite the fact that companies have not yet received the aforementioned notification (and they may never receive it), since they've seen what has happened to other sectors that have been left without access to preferential rate foreign currency, they may just adjust their prices to the unofficial exchange rate as a way of covering their interests. On a number of occasions we have mentioned this fact: the exchange control is not sustainable in Venezuela. As it begins to show signs of vulnerability, the private sector will adjust its prices to the value of the unofficial market foreign currency rate, independent of the fact that it continues to receive preferential rate foreign currency from the State.

Unfortunately, we are not optimistic

Despite more favorable price conditions in the international markets and having during the last four months carried out fiscal and monetary contractive policies, we are not optimistic about inflation. All the surveys show that the President has dropped significantly in popularity and that there is a real chance that he will lose important political seats in the upcoming regional election.

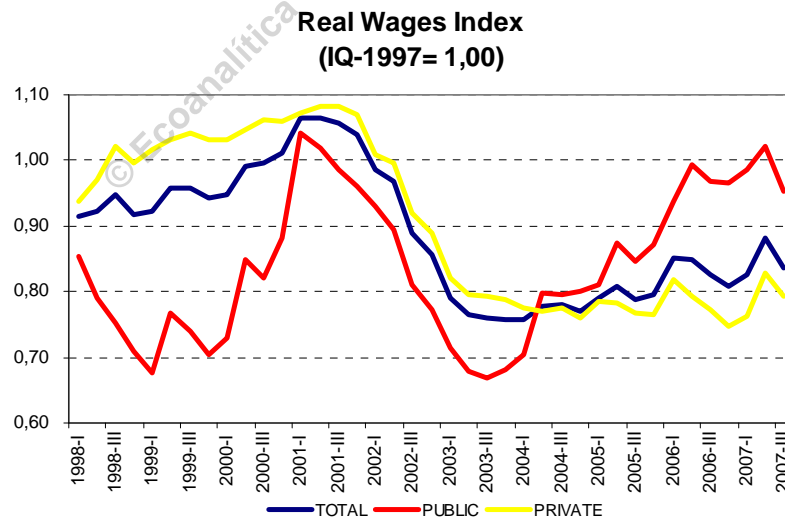
With this political scene on the horizon, we at **Ecoanalítica** have no doubts that during the second quarter of the year the Government will not be able to avoid the temptation of substantially increasing public spending in order to better safeguard political seats that may be threatened. The Government would say: "In the end, all these resources that the State has saved up, without the reelection possibility, what are they all for then? Well, they're to be spent in these moments of need." This significant increase in public spending will increase inflation's spiral effect and make the shortage problem worse. Of course, the party will continue in 2008. But, the atmosphere will have deteriorated. And the new ministers, after a month in office, are still not able to come up with an idea of their own.

Economic Tips

Increased debt service. The total payments that the Government and PDVSA have to make to service the debt during this fiscal year are at US\$8.03 billion. Of this amount, US\$3.90 billion correspond to the domestic debt, specifically Vebonos. Foreign debt payments are at US\$2.12 billion, and according to the Ministry of Finance the bulk of these obligations correspond to euro-bonds which payments add up to US\$1.30 billion. The oil industry has to make payments in this fiscal year for US\$2.87 billion.

Food basket increased by 4.1%. According to CENDA, the Worker's Food Basket cost VEF1,187 in January, up 4.1% compared to December 2007. According to this, the current minimum wage (VEF614.79) covers 51.8% of the food basket.

Salaries registered an increase of 6.8%. The Salary index registered an increase of 6.8% in the fourth quarter of 2007. This was mainly due to new Government measures which adjusted the pay scale of workers that are members of the teacher's and doctor's union, starting from November 1, 2007. This increase in salaries itemized by sectors highlights that Government worker salaries increased by 17.4%, while private sector worker salaries increased by 2%.



PDVSA finances most of out-of-budget spending. Since 2005, PDVSA has transferred more than US\$97.00 billion to the State, excluding what it transfers

through direct financing from its own budget to Missions like Ribas, Robinson, Barrio Adentro, Vuelvan Caras, Milagro, Guaicaipuro, Sucre e Identidad, and Mercal.

Studying salary increase. The Minister of Planning and Development, Haiman El Troudi, announced that the Administration is contemplating a revision of the public sector worker pay scale. El Troudi continued to say that this year there would be an increase in the minimum salary, though he didn't specify exactly how much the adjustment would be for since it is still being evaluated.

A new interest rate policy could be on its way. The Superintendent of Banks, Trino Alcides Díaz, confirmed that the BCV, the organism in charge of regulating interest rates, should fix a ceiling for each sector like it has already done for agriculture where banks aren't allowed to set agriculture loan interest rates above 15%.

International reserves. According to the latest figures released by the BCV, international reserves were at US\$33.70 billion, up 1.0% compared to the previous week.

Interest rates. The average loan interest rate during the course of the week for the six main banks in the country was at 24.05%, down 0.62 percentage points from the previous week. Term deposit interest rates were up by 2.39 percentage points compared to last week and settled at 13.59%. This is the highest it's been in the last three years when in January 2005 it was at 13.55%.

OIL TIPS

Oil prices bounce back. The price of Venezuelan crude oil bounced back last week, up US\$3.08 thereby reflecting a 3.8% variation compared to the previous week to settle at US\$84.38 per barrel. This puts the average price of the Venezuelan oil basket for the year at US\$84.63 per barrel.

PDVSA agreement. PDVSA agreed to pay US\$1.10 billion to Statoil and Total for the nationalization of the strategic association Sincor, on the Orinoco Oil Belt. Payment will be made through a combination of cash and oil shipments. Norwegian Statoil and French Total will reduce the percentage of their shareholdings in Petrocedefo to 9.67% and 30.32%, respectively. This agreement could serve as a negotiation base for PDVSA's pending settlement with Conoco and ExxonMobil.

PDVSA, unusual business deal. PDVSA finalized an offer to sell eight VLCC (very large crude carrier) shipments of fuel oil with 3% sulfur, which total around 16 million barrels. The close date for the offer is February 6th, with the odd condition that the shipments, which have a minimum sales price of US\$1.0 billion, must be paid for without delay on February 7th. In other words, it's basically a "cash in hand operation," something that is quite unusual among operators that deal with this product.

PDVSA committed 29.7% of its equity last year. While the debt balance increased 449%, equity increases didn't reach 2%. The US\$13.12 billion in new debt that Petróleos de Venezuela and its foreign subsidiaries took last year increased the debt/equity rate of the holding to 29.7%. PDVSA's consolidated equity increased to US\$106.99 billion, while company equity closed 2007 at a total of US\$53.85 billion.

PDVSA and Shell sign joint development agreement. PDVSA signed a memorandum of understanding with Shell to exploit a field in Zulia state through a mixed company. In it will be defined the project's feasibility, the technical analysis of the deposits, the evaluation of the existing and future infrastructure, costs and investment, and estimated production.

Energy issues treaty. The National Assembly gave its sign of approval regard the Approval Law of the Secure Energy Treaty, much like the Petrocaribe agreement, between Venezuela and Uruguay, and between Venezuela and Argentina. Its aim is to develop a broad and sustainable integration process that contributes with secure energy, promoting technology exchange to search for new energy sources, developing an energy chain while achieving its industrialization, and promoting its rational use.

OPEC not to increase production. The OPEC decided not to increase the supply of crude oil last week despite high oil prices. This decision was motivated by fears of possible economic recession that would spark a significant drop in worldwide oil demand.

BUSINESS SECTOR TIPS

Not even close to full capacity. At the close of the third quarter last year, the industries average production capacity rate was at 59.6%, which means that a little over 40% of production capacity was idle during that period compared to the same

quarter in 2006. So reflects a State of Industry survey prepared quarterly by Conindustria. After peaking at 62.22% production capacity during the last quarter of 2006, industry production capacity has dropped to 59.69% between January and March 2007, bouncing back to 61.43% during the second quarter, only to slide down below 60% in the third quarter.

Slight increase in the future. When industrialists were asked if they would be able to increase production capacity in the short term, most big as well as medium sized and small industrialists, answered that they would be able to reactivate between 0 and 20% of their currently idle production capacity, but big industrialists would be more willing to reactivate between 41% and 60% of idle production capacity. Along these lines, they pointed out that during the last quarter of 2007, they almost exclusive made operative investments. Very few (especially the big industrialists) said they had any plans to make any more investments this term.

Consumer loans increased by 984% in a period of four years. Statistics released by the Superintendent of Banks Office indicate that between December 2003 and December 2007, total consumer loans, which include credit card financing and car loans registered an increase of 984% going from US\$1.03 billion to US\$11.14 billion. The increase measured in bolivars is of 1,387%.

Extension for the bank. Superintendent of Banks Office decided to extend the date when the new accounting manual will go into effect until April 2008. The manual will force the financial system to have all its information appropriately adjust in a way to comply with the monetary conversion.

Good showing by the insurance sector. Venezuelan insurance companies grew by more than 50% in 2007, according to a report from *Softline Consultores* based on the 50 companies that make up the insurance sector in the country.

Restrictions to ALADI agreement. The Foreign Currency Administration Commission increased the range of the Administration's power regard allocation access to exchange controls. In Administrative Provision 085, published in the *Gaceta Oficial* N° 359.317, it is established that for imports related to those that are made through the Latin American Integration Association Agreement (ALADI), that they would receive foreign currency authorization as long as what's being imported is a good that is made in any one of its member countries, independently of what kind of good it is.

More controls. Published in the *Gaceta Oficial* number 38.862, corresponding to January 31, is the increase of maximum price levels allowed for public sale of

carao (black beans) and white cheese, that were already regulated, and included the regulation of the price of yellow cheese and pork chops.

And more repression. Cilia Flores, president of the National Assembly, announced that the Law against Hoarding, Boycott, and Price Gouging aimed at avoiding any disruption in the consumption of first necessity goods or those goods subject to regulation is in the *Gaceta*. She pointed out that an article has been added which deals with the “destruction” of first necessity goods, an act that will be punished by 5 to 10 years in prison.

Food sales in Táchira state. Last week, the second regulated food sale took place in Táchira which included items like rice, sugar, oil, and pasta, all within the “*Patria Soberana*” plan.

Transportation of food control along the border. The Administration has come up with a plan to allow the mobilization of food transportation vehicles along the border areas in order to avoid these items going out of the country.

What’s happened with Cooperativas? The 2006 Cooperative Census results released by the National Statistics Institute (INE) indicates that 54% of the Vuelvan Caras Mission cooperatives are in operation (and from Vuelvan Caras II Mission only 22% are active) which doesn’t reflect this as being a very effective means of spurring on the productive sector or diversifying national production with the aim of generating products for possible export. Furthermore, 75% of these units which are operational are in the service sector and more than 66% are dedicated to the production of non-tradable goods (insurance, construction, and transportation).

Good outlook for metallurgy. The president of the Metallurgy Industrialists and Mining Association (AIMM), Eduardo Garmendia, announced that it’s expected that the sector could grow by up to 11% this year if PDVSA carries out the projects that were fixed in the Oil Seeding Plan, mainly the Paraguaná Refining Center maintenance plan and the fuel re-conversion plan that the El Palito and Puerto La Cruz refineries have to undergo.

SIDOR with losses. Recent strikes at Sidor’s Industrial Complex disrupted steel production dropping the yield by 32,000 tons which caused financial losses calculated at US\$21 million, according to industry sources. A failure to reach an agreement with the economic clauses of the collective bargaining agreement led the Steel and Iron and Related area Workers Union to call for a general strike which stopped all activities for two weeks.

Weekly Report

Rent increases. In 2003, of the housing units being offered on the market, 70% were up for sale and 30% to rent. At the close of 2007, of the housing units being offered on the market, 90% were up for sale and 10% to rent. The average rent value for a unit at the close of last year was at VEF56.25 per m² while in June 2007 it was at VEF45 per m². In a period of 6 months, rent prices went up 25%, according to real estate sector estimates.

Business between Iran and Venezuela. After the Tehran meeting between Minister of Basic Industry, Rodolfo Sanz, and his Iranian counterpart, Alí-Akbar Mehrabian, they calculated that to date, joint projects between Iran and Venezuela reached US\$350 million, with an import number of projects yet to be initiated calculated at US\$1.0 billion. Most of the agreements are concentrated in areas like oil, gas, automobile manufacture, tractors, and cement.

"Gran Caribe" company created between Cuba and Venezuela. As part of a pact established between Cuba and Venezuela in 2007, the mixed company Gran Caribe was created. Its purpose is to commercialized telecommunication services between countries and everything related to transport capabilities in the Caribbean, which won't only connect Venezuela and Cuba, but also Jamaica, Haiti, Curacao, and Trinidad, thereby taking advantage of the submerged fiber optic rings that currently exist.

Internet purchases. CADIVI is studying the possibility of making the foreign currency quota limit allowed for Internet purchases more flexible. The quota is currently set at US\$400 for anyone making a purchase over the Internet. The new option considers giving special permission to persons who legitimately buy merchandise for business purposes on the internet.

Internet expanding. In Venezuela, Internet use market penetration has reached 18% and has registered an annual increase of 210% compared to last year, according to statements issued by Mercadolibre.com commercial director, José Pinto.

Political Tips

New head at the SENIAT. José David Cabello, who was the former Minister of Infrastructure, will now head the SENIAT, replacing Vielma Mora. The announcement was made at a press conference by the Minister of Finance on Friday, February 1st. The Minister was accompanied by the heads of Infrastructure and the SENIAT. Given

Vielma's efficiency during his time at the SENIAT, it's very probable that President Chávez has plans to appoint him to another high level post and/or nominate him to run for one of the more prominent posts in the regional upcoming election.

Isidro Ubaldo new head of the MINFRA. In *Gaceta Oficial* number 38.863 dated Friday, February 1st, 2007, Isidro Ubaldo Rondón Torres was appointed as new Minister for the People's Power for Infrastructure (Minfra) through decree number 5.852. Isidro Ubaldo Rondón Torres up until his appointment was vice-minister of Management for the Ministry of Infrastructure. Before his time at the Ministry, Rondón was the president of the Pro-Patria 2000 foundation in 2004 and the director of the Board of Directors of the Habitat Mission Foundation in 2007.

Chávez accused of spurring on growing wave of anti-Semitism. The director of the Anti-defamation League in the United States announced that there was a growing wave of anti-Semitism in Venezuela which has become part of a campaign to harass and discredit institutions that have existed for years in the country.

CONATEL vs. Globovisión. CONATEL sent a message to Globovisión last week informing them that: "Globovisión has been broadcasting messages that could be in violation of the Radio and Television Social Responsibility Law, specifically during the "Aló Ciudadano" program and the shorts "Usted lo vio" (You saw it). Globovisión answered the message saying that "it would adhere to its responsibilities, but that it would not tolerate that the content it broadcasts be censored simple because it makes some public officials uncomfortable."

Magistrates before the IACHR. Last Thursday, the Inter-American Court of Human Rights heard the allegations of the three Supreme Court magistrates that were removed from the bench in 2003, and of those responsible for defending the Government's decision.

Centralizing health. The Vice-President of the Republic, Ramón Carrizales, announced that the Administration decided to create a special committee that would be responsible for immediately coordinating all the elements that integrate the national public health system. Minister Carrizales explained that the Metropolitan area was chosen for the pilot plan because that is where the majority of the population is concentrated and all the components that integrate the public health system are present there. In a short term, this system will be extended to the rest of the country.

Now its submarines. Russia has a contract ready to sell to Venezuela three Varshavianka class ships, equipped with 4 torpedo launchers for an approximate cost

of US\$1.0 billion that could be signed during President Hugo Chávez's next trip there, announced a spokesperson for the Russian military industry.

Other Tips

Another cut in rates. The U.S. Federal Reserves (FED) once again decided to cut interest rates yesterday, this time by $\frac{1}{2}$ point which puts the rate at 3%. The cut came as no surprise to anyone, especially after the disappointing news which was released just hours earlier that the U.S. economy had only grown by 0.6% during the fourth quarter of 2007, half of what Wall Street had forecasted. This latest move by the U.S. Central bank comes just eight days after it decided to cut rates by 0.75% during an emergency meeting after the so-called "Black Monday" when half of the world's stock exchanges took a dive. Since September 18th, the FED has cut rates by a total of 2.25% (five consecutive times), something that hadn't occurred since 1990.

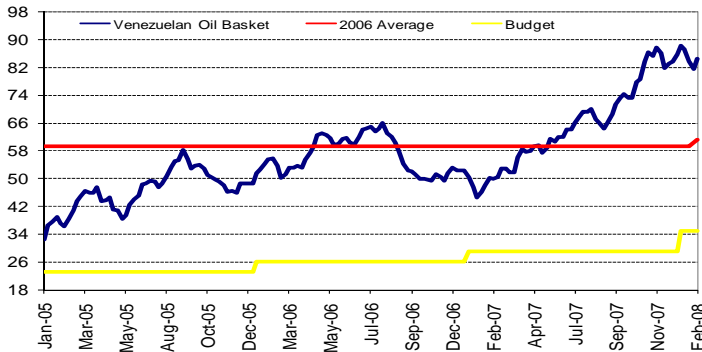
Only 7% of people in the U.S. consider Latin America important. Only 7% of people living in the U.S. consider that Latin America is a region that is important for the country. Most people in the U.S. admit to being bothered by having to send remittances. This is the information reflected by an interactive survey carried out by *Zogby Internacional*, published on Monday. It shows how the anti-immigrant sentiment is also affecting people's perception of Latin American countries. 43% say that the Middle East is the most important region for the U.S., followed by Asia (20%) and in third place Europe with 12%.

Latin America blocks the publication of most IMF reports. Latin American Government's only allowed 48% of the reports prepared by the IMF experts on their economies published last year, which leaves the region in last place in terms of transparency. This is a drastic drop from the previous year when 70% of the reports were made public, according to an analysis released by the IMF this week. Only Bolivia, Chile, Costa Rica, Ecuador, El Salvador, and Mexico approved the publication of all the IMF studies that were presented to their Executive Council between November 1st, 2006 and October 31st, 2007, according to the organism.

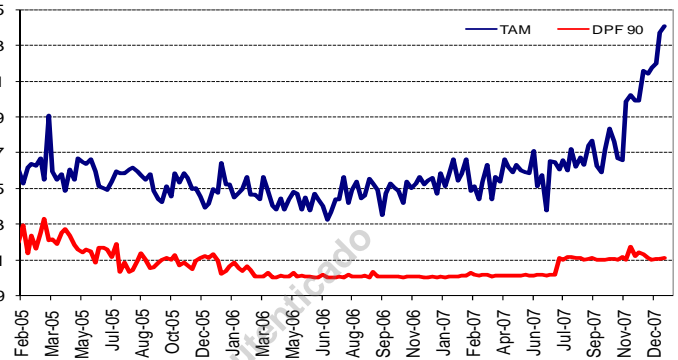
Weekly Report

ECONOMIC OVERVIEW

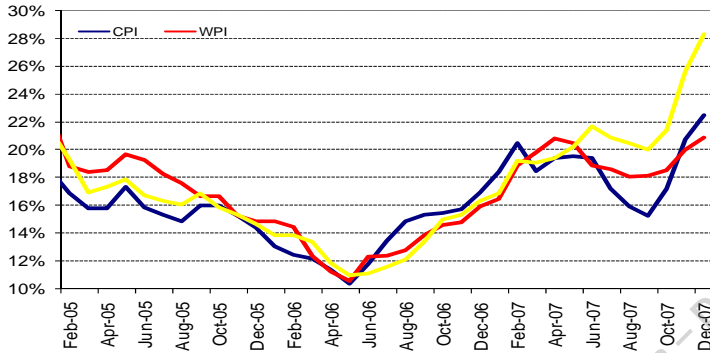
Oil Price
(Venezuelan Basket US\$/pb)



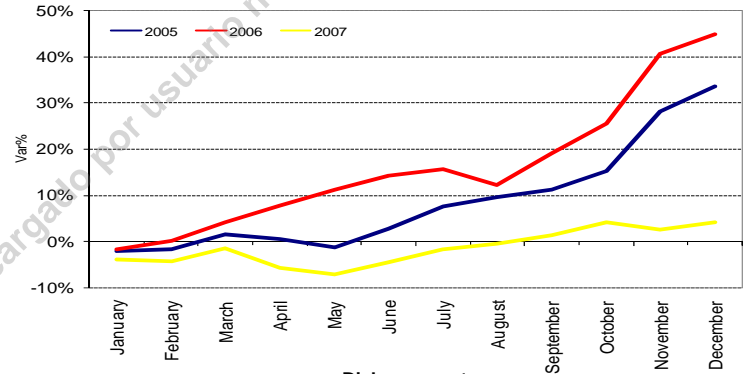
Interest Rate
(Six Principal Banks)



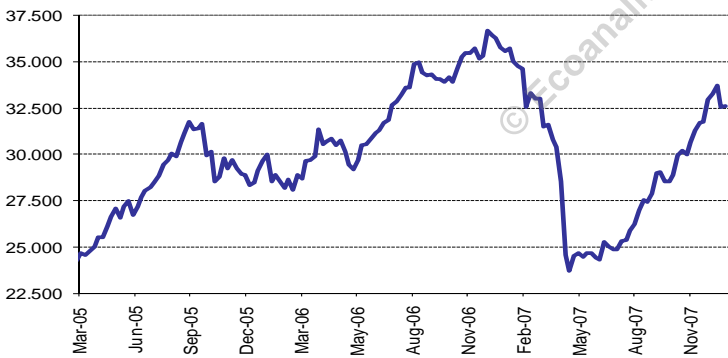
Inflation
(Last 12 Months)



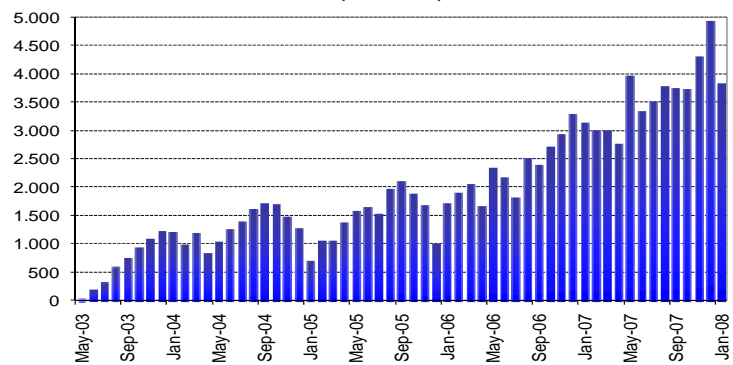
Real Expansion (M2)



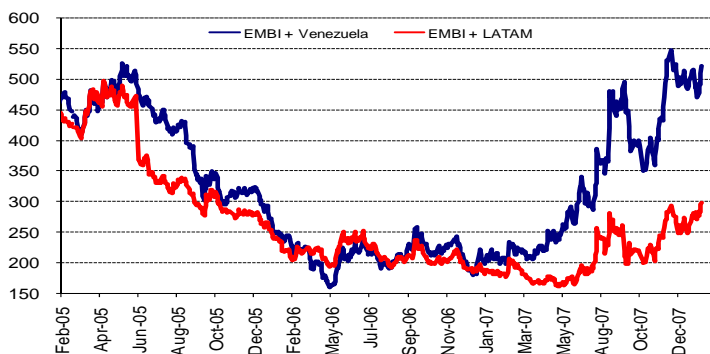
Fx Reserves - BCV
(US\$ Million)



Disbursement
(US\$ Million)



EMBI



Central Government
(VEB Billion)

