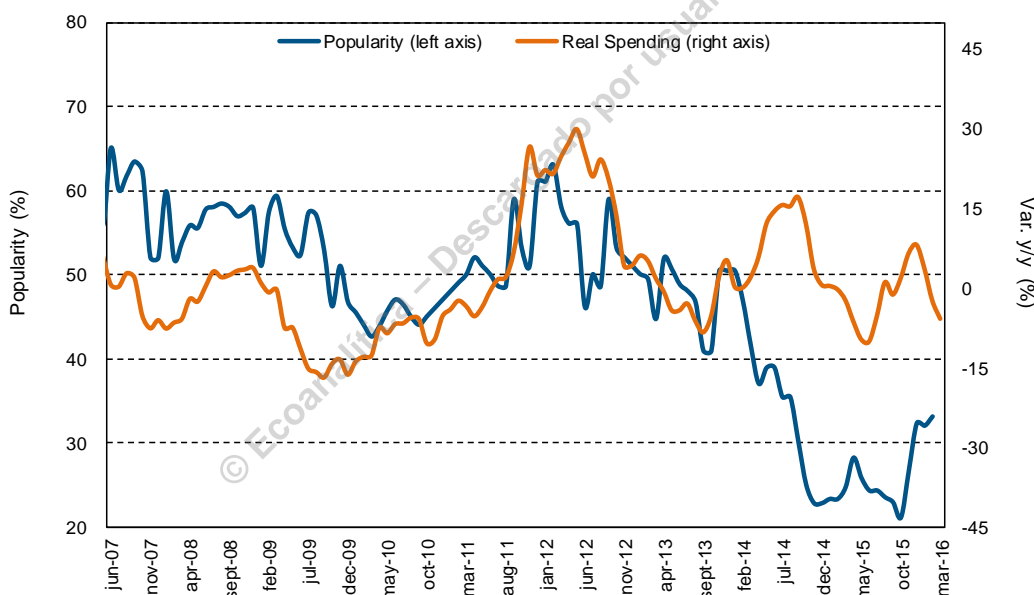


The Inflation Tax: A shattered pillar

From the start, fiscal policy has been the main tool available to the government for achieving its manifold political objectives. By adapting it to the political agenda, the way the economic policy has been implemented seems to have been subordinated to what, at least initially, was a “revolutionary” narrative based on the role of the Government as a tool to achieve greater levels of well-being.

Real Growth of Central Government's Spending vs. Popularity



Sources: ONT, BCV, Datanálisis and Ecoanalítica
Because of restrictions on data availability, the serie limits to March 2016.

Following this line of thought, fiscal policy and the dynamics of government spending and its restrictions on financing came to dominate almost completely other aspects of economic policy, mainly monetary policy.

In this regard, in economies with a weak institutional framework where fiscal policy dominates and with persistent high inflation, both seigniorage and the inflation tax are usually important revenue sources to finance public spending.

Despite not being an explicit tax, its importance on fiscal dynamics has grown exponentially in the past few years and, in the context of a profound contraction in the Government's real revenues, it has achieved a leading role in sustaining the fiscal structure.

How does it work?

In the first place, it should be noted that, both the inflation tax and seigniorage, despite being concepts that are closely linked, are different from one another. Put briefly when the government resorts to printing money to finance its expenditures, two things happen simultaneously.

On the one hand, what is known as pure seigniorage occurs. It stems mainly from the revenues the government receives due to the existence of a demand for real monetary funds from agents, who need a means of payment to meet their liquidity requirements to engage both in transactions (acquisition of goods and services) and in speculation.

So, in broad terms, pure seigniorage is the benefit (or privilege) the monetary authority (in this case the Central Bank of Venezuela) obtains (or enjoys) as the issuer of money and the first beneficiary of the money issued.

Let us take the following example. Let us suppose that we issue a kind of asset (at relatively no cost). Now, with this in mind, let us assume that we put it into the market and we find that there is a favorable demand for that asset; in other words, people, either because of the situation or as a matter of personal preference, assign it a given value. If we, as issuers, can turn to another market and acquire other goods and services using such asset, we will benefit from being the first buyers who used it. That asset is money and the gain in question is what we call *pure seigniorage*¹.

Meanwhile, on the other hand, the so-called inflation tax emerges. Broadly speaking, this refers to the capital losses incurred by the nonfinancial private sector because of the inflationary spiral to which holders of positive monetary balances are subjected.

In other words, let us suppose that, like any other economic agent, we had VEF 100 in our savings account. Now, one month later, if inflation was close to 10.0%, the real value of those bolivars today is VEF 90, and the loss of VEF 10.0 is known as the inflation tax. This means that the inflation tax implies a redistribution of wealth from the holders of money to its issuers, as inflation will benefit those who register banknotes and coins in their liabilities account, such as the Central Bank of Venezuela, for example.

¹ By analogy, the dynamic can also operate the other way round. If we continue issuing the asset and we encounter a favorable level of demand, we cannot talk of revenue from pure seigniorage.

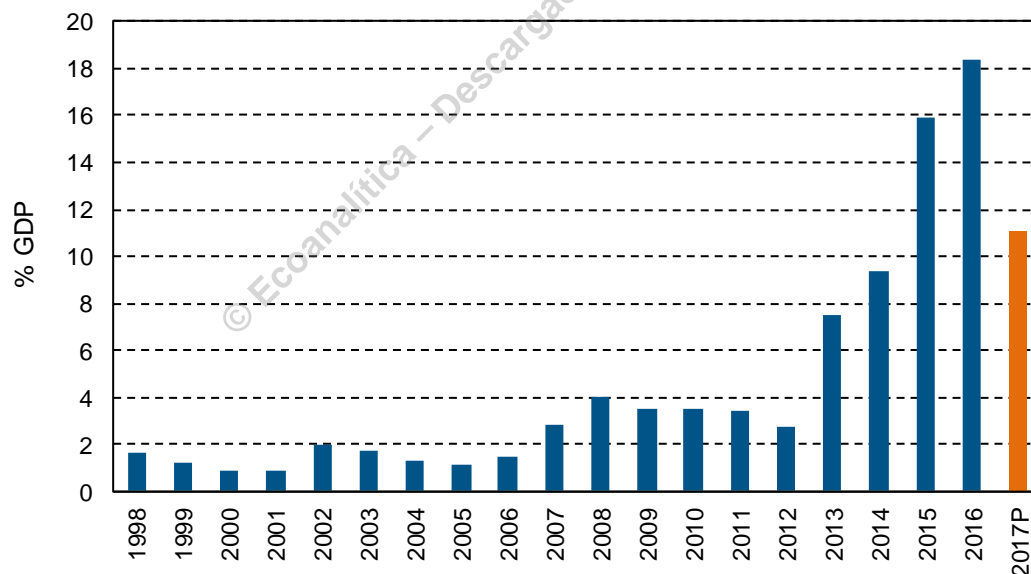
Now then, if we add the revenues obtained via both mechanisms, we obtain what is formally known as seigniorage, which, in a nutshell, represents the different revenues the government obtains as a result of exercising the monopoly of printing and issuing money.

It is worth noting that, even though, from the strictly fiscal point of view, both of these mechanisms provide a series of benefits², they are usually highly distorting sources of financing and have a regressive component from the distributive standpoint.

The mainstay of the revolution

Broadly speaking, in an environment marked by a drop in oil revenues and a contraction in the State's real revenues, the inflation tax has come to fulfill a leading role as the mainstay of the fiscal dynamic in Venezuela.

Revenues Percieved through the Inflation Tax



Sources: BCV and Ecoanalítica.

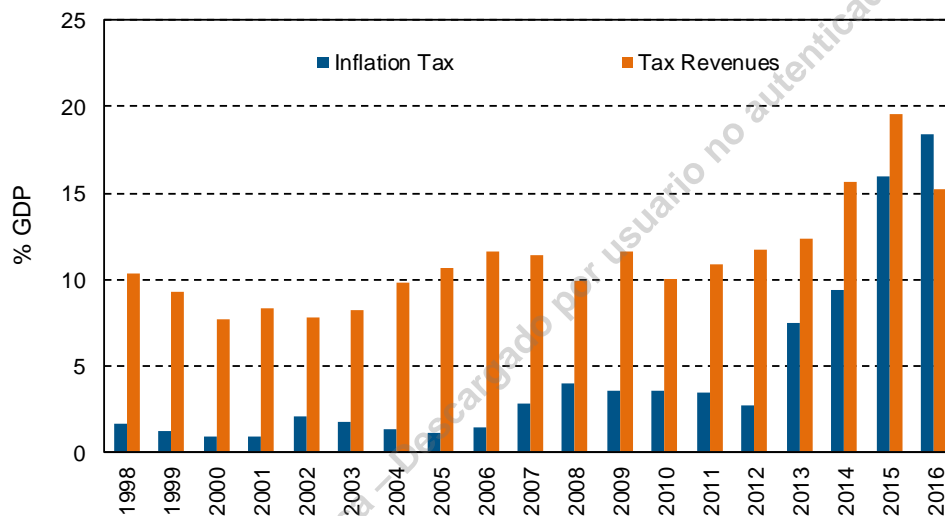
Over the period 2008-2011, average receipts from the inflation tax came to close to 3.6% of GDP, whereas during the period 2012-2016, it jumped to 10.8% of GDP, posting its

² Some of those benefits are that these are revenues that are not subject to relatively formal mechanisms of rendition of accounts (National Assembly), collecting the tax is quick and has a low cost, and, last of all, it is difficult for taxpayers to avoid paying this tax.

highest figure in 2016 (18.4% of GDP). Looked at from another point of view, receipts from the inflation tax are more than receipts from the different taxes levied by the National Integrated Customs and Tax Administration Service (Seniat).

Calculated as a percentage of nonoil tax revenues, the inflation tax went from 17% in 2009 to 97% in 2014, 110% in 2015, and nearly 120% in 2016.

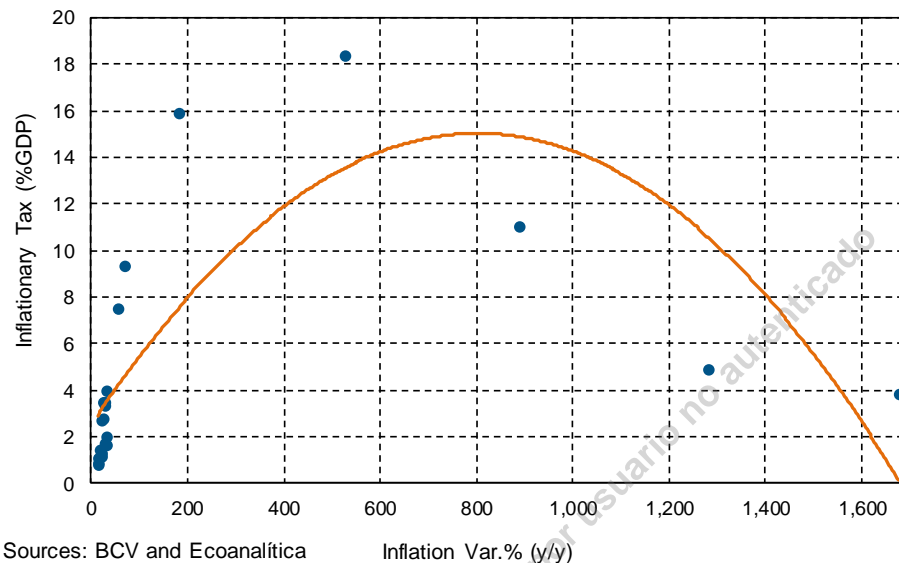
Inflation Tax vs. Tax Revenues



Sources: BCV and Ecoanalítica.

However, receipts from the inflation tax, like any other tax, are subject to the dynamic of the taxable base.

Inflation Tax vs. Inflation



As inflation continues to escalate, the taxable base tends to erode given a steady drop in the demand for real monetary balances (loss of confidence in the underlying asset that feeds the tax), a situation that pushes receipts down, putting us on the “negative” side of the Laffer curve, where increases in inflation tend to reduce the real amount obtained by the government in tax receipts (Zambrano 2013).

This means that, if this trend is maintained, with inflation of close to 900% in 2017, the inflation tax would post a drop year-on-year of 42.5% to nearly 11% of GDP by year-end, 7.4 percentage points lower than in 2016.

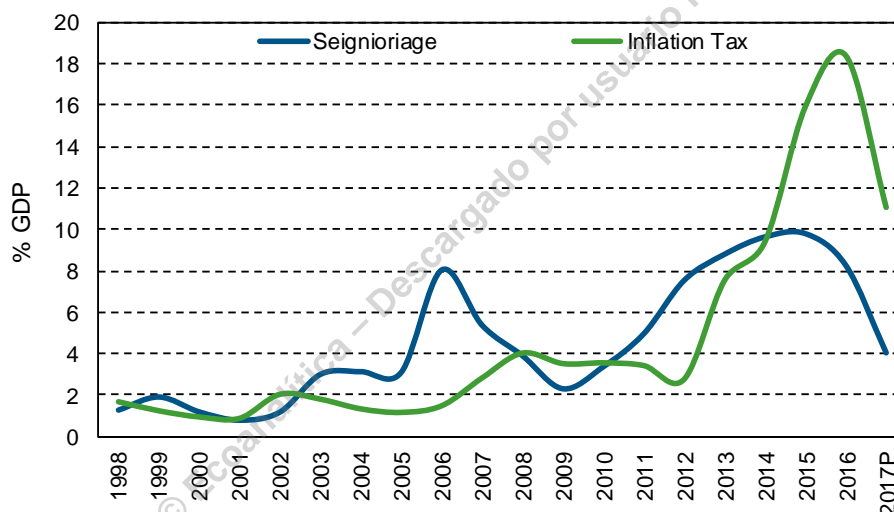
Moreover, it is worth pointing out that, when inflation steps up, the fiscal revenues obtained by the government are eroded in real terms due to the delay between the time the taxes are incurred and the time they are actually received (Olivera-Tanzi effect). Bearing this in mind, it is to be expected that the effectiveness of the inflation tax will tend to shrink in the coming fiscal years, thus imposing further restrictions on government spending, both now and in the medium term.

And what about seigniorage?

Now then, focusing solely on the inflation tax would restrict the analysis to just one component of the financing obtained by the government as a result of expanding the monetary base.

Here we have to add what the government obtains through pure seigniorage, which, in short, depends on what the government obtains from variations in the demand for real monetary balances, in other words the demand for money.

Revenues perceived through Seigniorage and Inflation Tax



Sources: BCV and Ecoanalítica.

So, as shown in the previous chart, since 2015 the inflationary dynamic, as well as the widespread drop in the demand for money, has shrunk the aggregate of revenues obtained by the government, which went from averaging close to 5.0 points of GDP between 2006 and 2012³ to 9.4 points between 2013 and 2015 to close, based on the same assumptions for inflation, to 4.1 points of GDP in 2017⁴.

³ It is worth noting that, in the case of the estimates for 2016, the effect of the contraction in GDP is by no means small, even though the inflation tax continues to go up.

⁴ The calculations given here include the sum of what is obtained from the inflation tax and the revenues obtained exclusively from pure seigniorage. For more information, see Zambrano, 2013.

A Minotaur for the transition

The evidence shows that there is no tax reform that will allow the State to close the fiscal deficit on its own and immediately. Consequently, the fiscal situation poses several policy dilemmas. As has happened with the drastic cut in imports, the loss of wages' purchasing power cannot be considered a factor of equilibrium. Monetary emissions that cover the deficit have caused the loss of control of monetary policy and a spiraling of inflation unprecedented in Venezuela and the only case in a world of low inflation.

Moreover, eliminating monetary financing would be equivalent to cutting public spending by between 30% and 40%, which means that, in the short term, it is necessary to find alternative noninflationary financing mechanisms while the task of trimming public spending is undertaken.

Gorka Lalaguna

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Year 13. Number 21 Week II
 June 2017

WEEKLY INDICATORS

Weekly Economic Indicators			
	2nd Week June	Weekly var. (%)	Depre/Apre (pp) ¹
FX Dicom (VEF/USD)	2161.0	7.5	7.0
	4th Week May	Weekly var. (pp)	Annual var. (pp)
Lending Interest Rate (%)	21.8	-0.2	0.7
	1st Week June	Weekly var. (pp)	Annual var. (pp)
Overnight Interest Rate (%)	0.0	0.0	-6.8
	1st Week June	Weekly var. (%)	Annual var. (%)
International Reserves (USD Bn)	10.6	0.0	-14.1
	4th Week May	Weekly var. (%)	Annual var. (%)
Monetary Liquidity (VEF Bn)	17,781	6.0	259.4
Price of International Oil Baskets (USD/bl)			
	1st Week June	Weekly var. (%)	Annual var. (%)
WTI	49.2	-2.9	0.0
Brent	51.5	-3.5	3.6
Price of the Venezuelan oil basket (USD/bl)			
	1st Week June	Weekly var. (%)	Annual var. (%)
Weekly Average	43.4	1.0	16.5
Annual Average	44.2	0.1	48.4

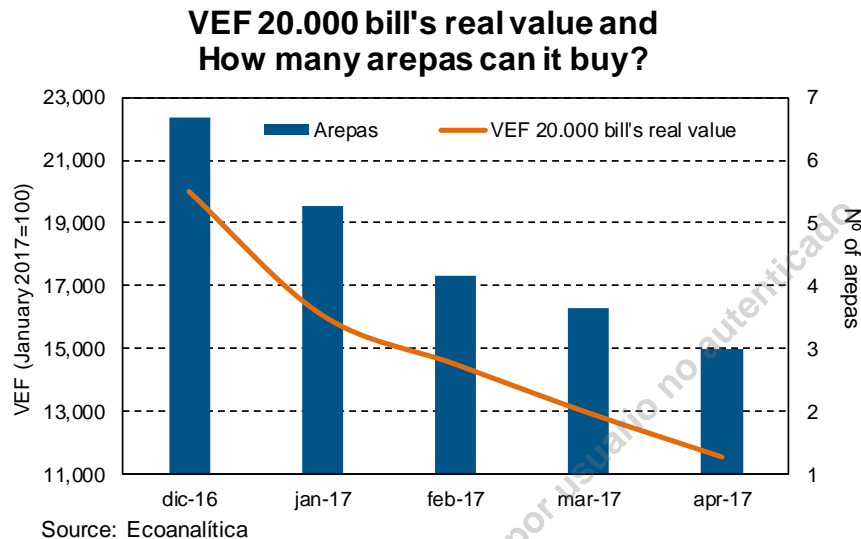
Sources: BCV, MENPET, ONT and Ecoanalítica

* Annual variation of accumulated expenditure.

¹ Depreciation (+)/Appreciation (-)

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CHART OF THE WEEK: “HOW MANY AREPAS CAN IT BUY?”


The volatility of prices in the Venezuelan economy is transforming the needs of the population. The basic properties of money as a means of exchange require the issuing of coins and banknotes to keep pace with the constant increases in prices.

At the start of the year, banknotes of a higher denomination than those existing up until then went into circulation. In January, the debate focused on whether the denominations established by the Central Bank were capable of coping with anticipated inflation or whether, on the contrary, the real value of the new monetary cone would evaporate before it completely replaced the old one.

Today, five months after the first of the new banknotes were introduced, we find that the banknote with the highest denomination (VEF 20,000) has lost 42.2% of its value in real terms, when the presence of the new banknotes is still not total and when they represent only 1.2% of all the banknotes in the economy, according to the figures for April. Purchasing power has shrunk. If we take the arepa, a typical item of consumption for the man in the street, back in January a VEF 20,000 banknote bought seven arepas, whereas today it is only enough to buy three.

The new monetary cone is falling behind the constantly spiraling prices. The replacement of the old cone announced back in December 2016 has still not been completed, nor will it be as long as the VEF 100 banknotes account for 48.5% of all the banknotes in circulation. The value of the “biggest” banknotes is evaporating even before most people are getting a chance to spend them. Whichever way we look at it, improvisation continues to reign in the economy.

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ECONOMIC TIPS

Results of the second round. Pedro Maldonado, a director of the Central Bank of Venezuela, announced that USD 23 million was allocated at the second DICOM auction. The resulting exchange rate was VEF 2,161/USD for a devaluation of 7%.

Who got what. USD 3.1 million was awarded to 8,384 private individuals and USD 20.7 to 607 companies.

Trends. According to the firm Control Risks, the trend indicates that the strategy the Venezuelan Government will adopt, given that money is tight, will be to open the doors to fresh investment; continue selling off assets, with bigger discounts; and offer benefits to those who help to raise oil production.

Anything except default. In the first two years, the government will be capable of giving way on ideological issues to avoid, at all costs, nonpayment of the debt. In its search for liquidity in any form, the Venezuelan Government will be prepared to do business deals with US multinational corporations, and companies will also be prepared to continue investing in Venezuela, according to the forecast by Control Risks.

Unchanged. The international reserves continue to fall. They closed the week of June 2 at USD 10.56 billion for a drop of 0.04% compared to the previous week.

April inflation. According to the firm Torino Capital, inflation in April closed at 18.5%. In its weekly report, Torino Capital specifies that inflation for the past 12 months was 517%. Despite the slight speeding up of inflation, it forecasts that it will close the year at 400%, given the contraction in Central Government spending, which is estimated at around 40%.

Tax collection for December. According to the figures released by the National Integrated Service for Tax Administration (SENIAT), VEF 769.3 billion were collected in taxes for the month of May. Of this amount, VEF 98.3 billion came from Income Tax, and VEF 395.3 billion from the VAT. The agency raised VEF 3,764.2 billion during 2017, of which VEF 1,089,011 billion came from Income Tax, and VEF 1,680.1 billion from Value Added Tax (VAT).

In real terms. Total revenue in May of 2017 compared with the same period last year decreased by 53.3%. The VAT decreased 55.7% in real terms and customs revenues also decreased 80.8%. Meanwhile, income tax revenues decreased 50.1% in real terms over the same period of 2016.

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Year 13. Number 21 Week II
June 2017

Worker's Food Basket reaches VEF 670,891. According to the last report by the CENDA, the Worker's Food Basket (CAT for its Spanish acronym) reached VEF 670,891 on April 2017. This represents an increase of 10.8% compared to the previous month and of 480.0% compared to April 2016.

Family income only covers 6.1% of the basket. According to the report by CENDA, the minimum wage of VEF 40,638.15, effective in April, 2017 had a purchasing power of 6.1%. Which means that, a family requires 16 times the minimum wage just to cover their basic expenses on food.

Let's eat gold. Minister of Ecological Mining Development Jorge Arreaza announced that, on Friday, June 2, 407 kg of gold entered the vaults of the Central Bank of Venezuela from the Orinoco Mining Arc. A total of 1.4 tons of gold have been delivered to the Central Bank since April.

A bigger base means higher inflation. The Central Bank published data on the monetary base as at May 26, which closed at VEF 10.22 trillion for an increase of 438.9% compared to the same week last year. The Central Bank only published the uses of the monetary base; it has not published the total disaggregated figure since April 21 last year.

Without going into details. Last Sunday, President Nicolás Maduro announced the approval of VEF 113.8 billion for state governments and mayoralties.

Engaging in the same practice. The Japanese investment bank Nomura purchased Venezuelan debt bonds with a face value of USD 100 million for around USD 30 million, which represents a discount of 70%, in a similar procedure to the one performed with Goldman Sachs.

OIL TIPS

We'll pay in kind! Minister of Oil Nelson Martínez stated that the loan of nearly USD 1.5 billion that PDVSA obtained from Rosneft will be paid in part with crude obtained by the joint ventures in which Rosneft takes part. It should be mentioned that 49% of the shares in Citgo Petroleum, PDVSA's refining affiliate in the United States, has been put up as collateral for this loan.

How much are we talking about? According to Martínez, these payments in kind will be made using a similar scheme to the one that is currently in place with China, but on the basis of nearly 70,000 barrels a day (70 kb/d).

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Brotherly business. On another front, Minister Martínez, together with Minister for Foreign Trade and Foreign Investment Jesús Faría, held a meeting with the first vice president of the Russian bank Gazprombank and the director of GPB Global Resources to go over the oil and gas projects these companies are executing in Venezuela.

Stepping up the pressure. According to an exclusive published by the news agency Reuters, the Donald Trump administration is considering imposing a series of sanctions on Venezuela's energy sector, mainly on PDVSA, which could mean a significant escalation in the efforts made by the US Government to put pressure on the Venezuelan Government and other Venezuelan government officials.

Are they imminent? Despite the intensification of the conflict in Venezuela, Reuter stresses that the proposed sanctions are still being debated and their implementation is not imminent. Reuters reports that the US authorities are proceeding somewhat cautiously because of fears that the sanctions might significantly worsen the living conditions of Venezuelans and intensify the conflict.

Conflict of interests. Reuters highlights that the role crude imports from Venezuela plays in the United States' energy dynamic has been a key issue in the debates. It is worth noting that, as at March, crude imports from Venezuela accounted for nearly 8% of total crude imports, making Venezuela the United States' third largest supplier of crude after Saudi Arabia and Canada.

What form could the sanctions take? Last of all, according to Reuters, the sanctions could take two forms: more rigid sanctions involving an express ban on US companies importing crude from Venezuela and less severe sanctions where the ban is restricted to contracts with the US Government only, similar to those imposed on Iran by the Barack Obama administration in 2011.

Diverse opinions. However, not all the analysts are on the same page as Reuters on the sanctions issue. As the firm Control Risks sees it, it is unlikely that the Trump administration will impose sanctions that will complicated the operations of oil companies and financial institutions with the Nicolás Maduro administration. In Control Risks' opinion, the sanctions will have more to do with freezing assets acquired as a result of corruption and on account of the violation of human rights in Venezuela.

Sanctions on the local level as well. According to different sources, the team of US public prosecutors and federal agents that is currently investigating PDVSA is also working on some 23 cases of corruption orchestrated from the state-owned oil company's affiliate located in Houston.

Year 13. Number 21 Week II
June 2017

Concern over the Gulf. Following the decision by Saudi Arabia and its allies to break off diplomatic relations with Qatar, the world's leading supplier of liquefied natural gas (LNG), there is concern that interruptions in the dispatches of gas to neighboring countries will have a direct impact on the world supply of LNG.

Low prices on the horizon. The president of Rosneft, Igor Sechin, is of the opinion that crude prices will remain low over the next few years, even if the Organization of Petroleum Exporting Countries (OPEC) decides to extend the production cut agreement indefinitely.

Shale is king. In Sechin's opinion, the positive result of the agreement implemented by OPEC will be completely cancelled out by the shale oil produced in the United States. Moreover, the leader of Royal Dutch Shell, Ben van Beurden, agreed that prices will be in the region of USD 50 a barrel (bl.), at least this year.

BUSINESS SECTOR TIPS

First it was gasoline, now it's cattle. The president of the National Cattlemen's Federation of Venezuela (Fedenaga) said that smuggling of cattle over the border to Colombia is one of the main problems affecting cattle ranchers. He said that cattle in Venezuela are three times cheaper than in Colombia, which provides an incentive for cattle smuggling.

Cash for the CLAPs. A total of USD 650 has been approved for 256 short-cycle crop planting and animal husbandry projects to be undertaken by the Local Production and Supply Committees (CLAPs) in Anzoátegui state.

Reelected as president. Juan Pablo Olalquiaga was reelected as the president of the Venezuelan Confederation of Industrialists (Conindustria) for the term 2017-2019 at the organization's assembly held on Monday, July 5.

At least they've got the label. Forty-three Venezuelan coffee producers received their gourmet coffee certification at a ceremony conducted by Minister for Productive Agriculture Wilmar Castro Soteldo as part of a policy aimed at giving coffee production a fresh boost.

Socialist private contractors. Approximately VEF 144 billion has been allocated to companies that are members of the Bolivarian Construction Chamber (CBC) for the

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Year 13. Number 21 Week II
June 2017

construction of 12,000 housing units intended for the middle class under the Great Venezuela Housing Mission.

Planting socialist crops. More than 75,000 hectares of rice and corn have been sown in Portuguesa as part of the National Venezuela Crop Plan 2017 out of a total of 351,663 hectares in the Llanos region. According to official figures, 100% of white corn seeds and 57% of yellow corn seeds have already been dispatched and 50% of the agrochemical requirements in the area have been met.

Good bye Houston. United Airlines has decided to suspend operations on its Caracas-Houston route due to low demand. Demand for this route came mainly from executives in the oil industry.

Shortage of tires. The manufacturer of Pirelli tires announced that it is to stop operations at its plant located in Guacara on June 16 due to the lack of raw materials. The company stated that it was confident that the plant would be able to overcome the impasse in the short term.

And detergent. This announcement comes after a similar announcement made by Colgate-Palmolive advising that operations at its clothing detergent and washing-up detergent plants would be suspended. The company is waiting for the arrival of a shipment of ammonium sulfate from Mexico to continue operations.

WORLD ECONOMY TIPS

It can't drop any further. According to data from the US Department of Commerce, 138,000 jobs were created in May, way below forecasts that indicated growth of 185,000 jobs. Despite this, unemployment fell by 0.1 of a percentage point to 4.3%, the lowest rate since May 2001.

Inconsistent figures. This result contrasts with the generation of 253,000 jobs, according to the firm ADP, a figure that surpasses by far the expectations of analysts. This difference adds uncertainty regarding the state of the US economy in the middle of the Trump phenomenon.

The euro zone continues to grow. The Purchasing Managers' Index (PMI) for the euro zone was 56.8 points in May, which indicates an expansion in economic activity, in line with the results for April and May.

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Year 13. Number 21 Week II
June 2017

Down during the “strike.” Spain managed to reduce the total number of unemployed by 111,908 in May to 3.5 million. Although a total of 223,192 jobs were created, a large number of people entered the job market, given the improvement of job generation, which meant that the total number of unemployed persons dropped by less.

An historic drop. So Spain has managed to generate more than 110,000 jobs a month for more than four months running and to reduce the total number of unemployed to 3,461,128, the lowest figure since 2009.

Japan up, but less so. The PIM for the services sector in Japan was 53.0 points in May, up from the 52.2 points scored in April. This is the best result for this indicator since August 2015.

An unexpected contraction. Manufacturing activity in China contracted in May for the first time in 11 months. The PMI for the manufacturing sector, calculated by the consulting firm Markit, closed at 49.6 points, where a score of less than 50 points indicates a contraction.

Corn for everyone. The corn harvest in Brazil came to 102.2 million tons this year, 10 million tons more than in 2016. This is Brazil's biggest corn harvest since records started to be kept.

How expensive everything is! Inflation in Mexico reached its highest level in more than eight years in May, posting an increase of 6.9% year-on-year, compared to 5.8% in April. The Bank of Mexico established a target of 3% inflation for the two months.

Bands of growth. The Central Bank of Chile cut its growth forecast for the Chilean economy to between 1.8% and 1% from the range set in March of between 2% and 1%. The cut is even bigger if compared to the range set in December last year of between 2.5% and 1.5%.

POLITICAL TIPS

According to Tibisay Lucena, a director of the National Electoral Council (CNE), 19,786 people signed up as candidates to the Constituent National Assembly. The state where the largest number of candidates has registered is Miranda with 4186, followed by Aragua with 2050, according to Lucena.

More fishermen than businessmen. In the sector category there are 35,438 candidates registered, broken down as follows: workers, 13,880; communes, 9045; pensioners,

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5073; students 2778; farmers and fishermen, 2008; the disabled, 1458; and businessmen 1196.

And what about the independence of the branches of government? Prosecutor General Luisa Ortega Díaz denounced that a ruling is being prepared by the Supreme Tribunal of Justice to take the responsibility for conducting criminal investigations away from the Public Prosecutor's Office.

A witch hunt. Ortega Díaz said that these measures are reprisals against her for doing her job and added, *"It can't be that they pretend to destroy the State. If you have differences with a government official who is in charge of an institution, you can't attack the institution."*

We demand justice! The secretary general of the Organization of American States (OAS), Luis Almagro, condemned the murder of Justice Nelson Moncada. "We demand an objective investigation," he said.

Taking the law into their own hands. Moncada was intercepted by a group of people who were manning a barricade; they shot him and stole his belongings. Nelson Moncada is the judge who ratified Leopoldo López' sentence in 2016.

A respectful conversation. The founder of the political party *Voluntad Popular* (VP), Leopoldo López, had a meeting with former President José Luis Rodríguez Zapatero in Ramo Verde Prison, where López is serving a prison sentence. The conversation was respectful, according to the opposition leader.

A firm refusal. At the meeting, the mayor of Libertador Municipality, Jorge Rodríguez, and the minister of foreign affairs, Delcy Rodríguez, offered López the option of home arrest. The opposition leader's response to the offer was "no." López' wife, Lilian Tintori, who reported the offer, said, *"Leopoldo will never negotiate his freedom. The freedom of an entire country comes first. It's not a matter of the freedom of one man; it's a matter of the freedom of Venezuela all."*

Strength and faith. López posted a video in Twitter, in which he stressed the call to the people to stay on the streets. *"It's necessary to remain on the streets with steadfastness, with determination; always peacefully, but permanently, everywhere, in every locality, at all times. That is the only way will we manage to conquer freedom and democracy,"* was his reminder.

All eyes on Venezuela. Through its deputy research director for the Americas, Carolina Jiménez, Amnesty International expressed its concern over the stepping up of repression

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Year 13. Number 21 Week II
June 2017

in Venezuela. Jiménez said that Venezuela is going through a “*severe human rights crisis*.” She called on people to keep up hope and said that many political actors in international circles had their eyes on Venezuela.

Back to the dialog. Ombudsman Tarek William Saab called on both sides to reconsider dialog to avoid an escalation of violence. Saab added that it was necessary to “*reactivate legal and humanitarian measures for detainees*.”

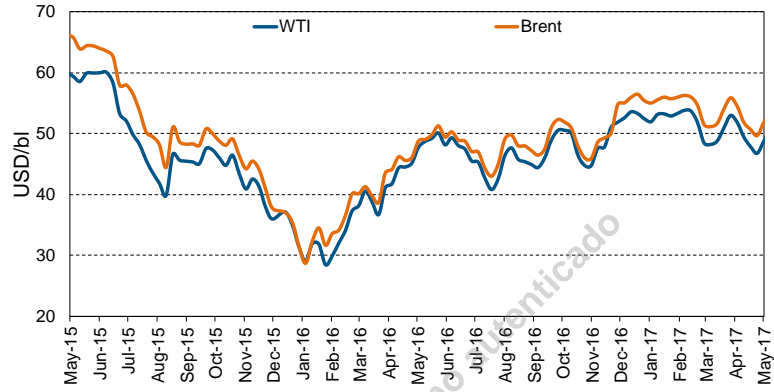
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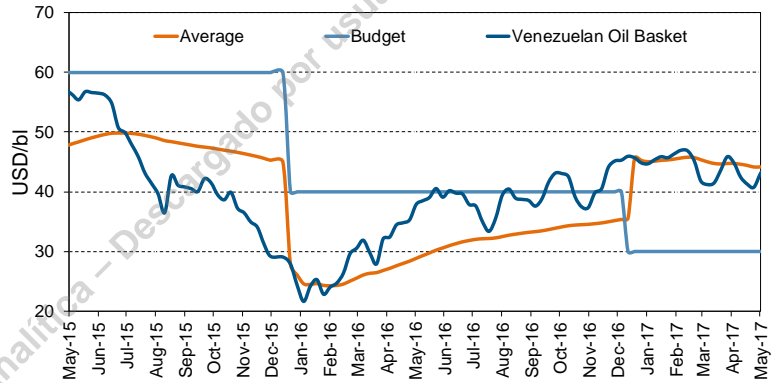
ECONOMIC INDICATORS

Oil Prices (WTI and Brent)



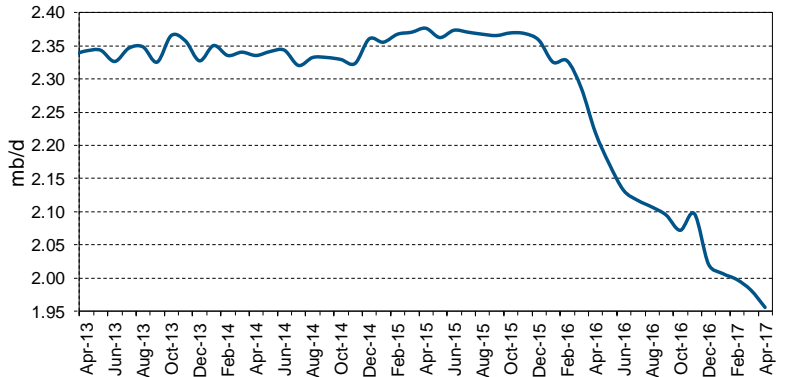
Sources: Menpet and Ecoanalítica

Oil Price (Venezuelan Basket)



Sources: Menpet and Ecoanalítica

Oil Production (Secondary sources)

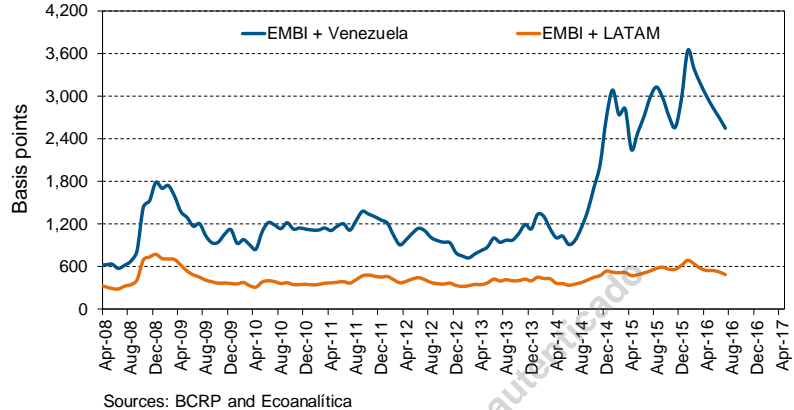


Sources: OPEC and Ecoanalítica

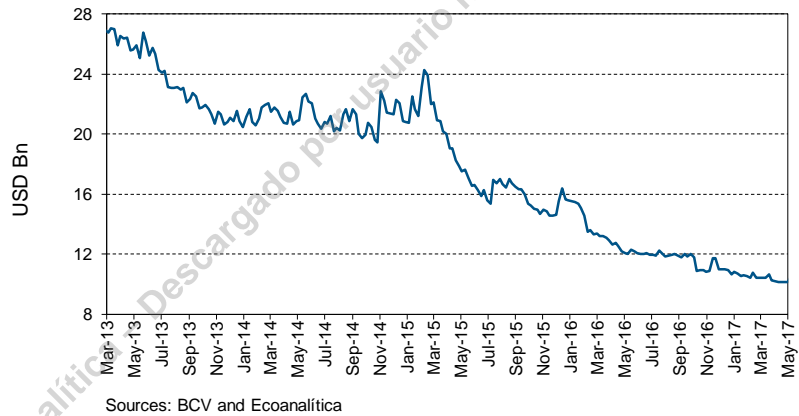
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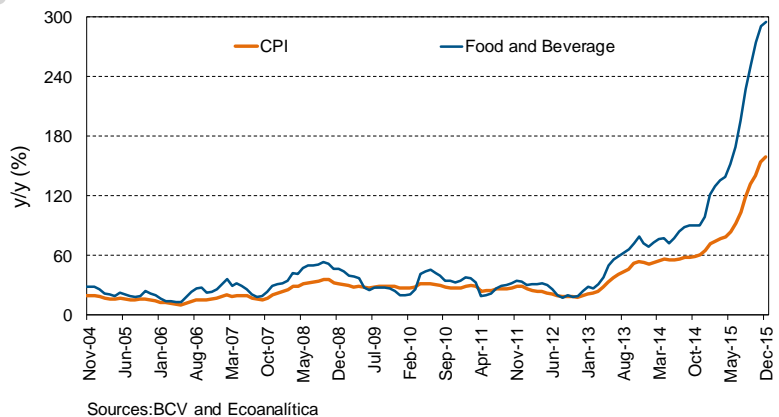
EMBI



FX Reserves (BCV)



Inflation (BCV)

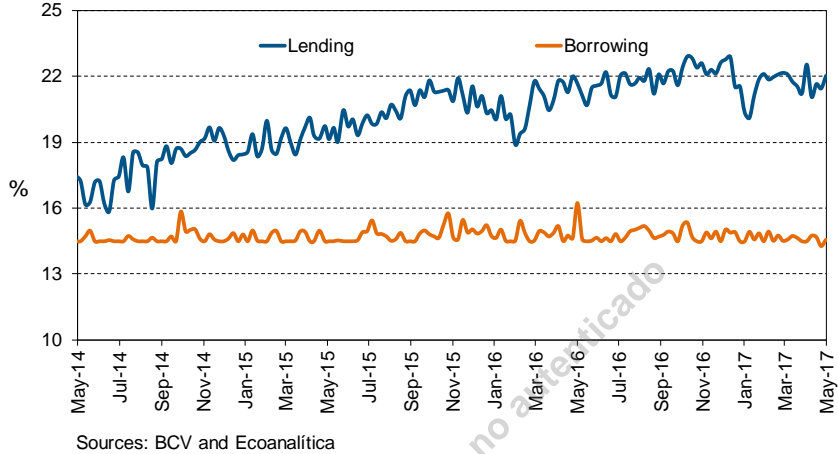


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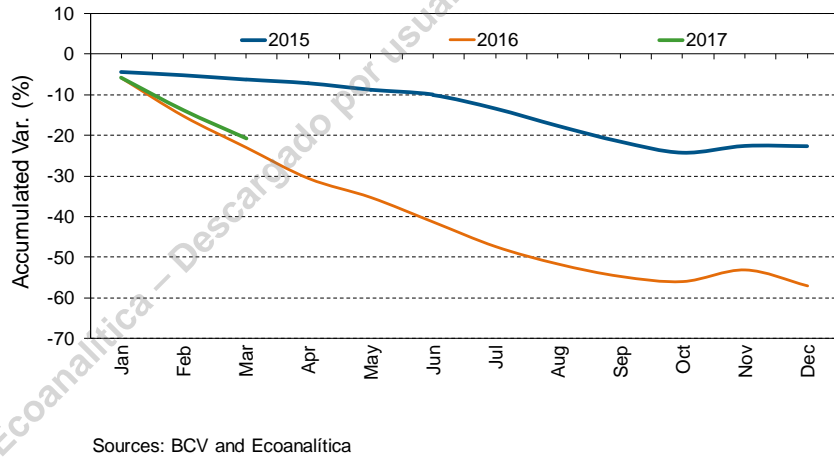
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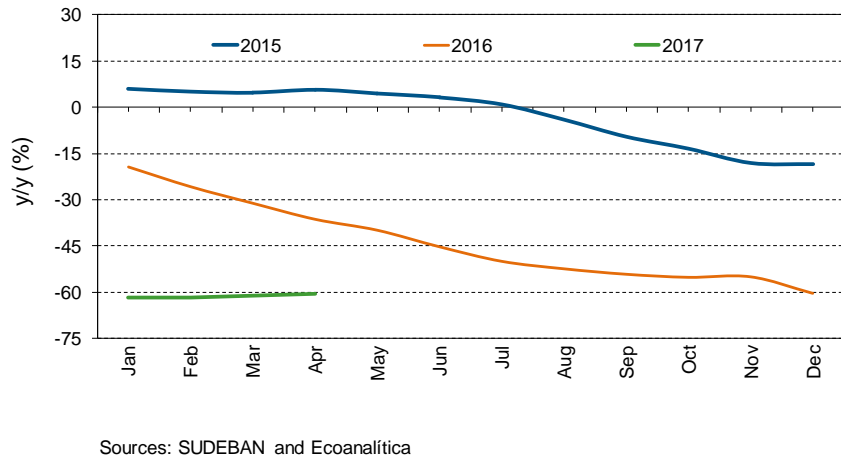
**Interest Rate
(Six major banks)**



**M2 Expansion
(Real)**



**Loan Portfolio
(Real)**

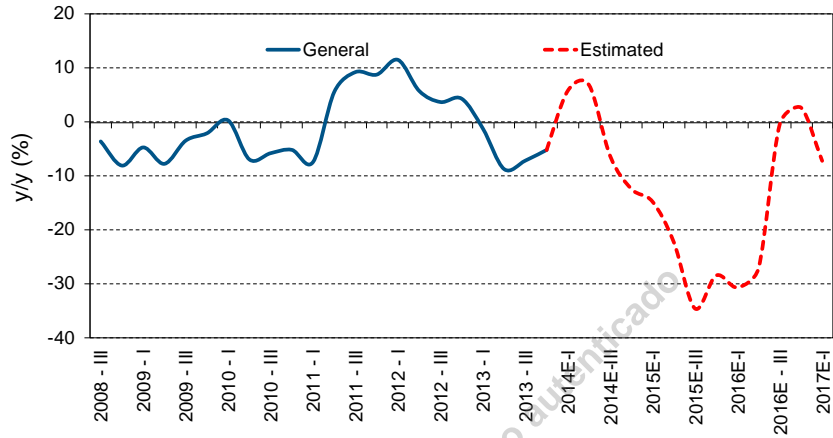


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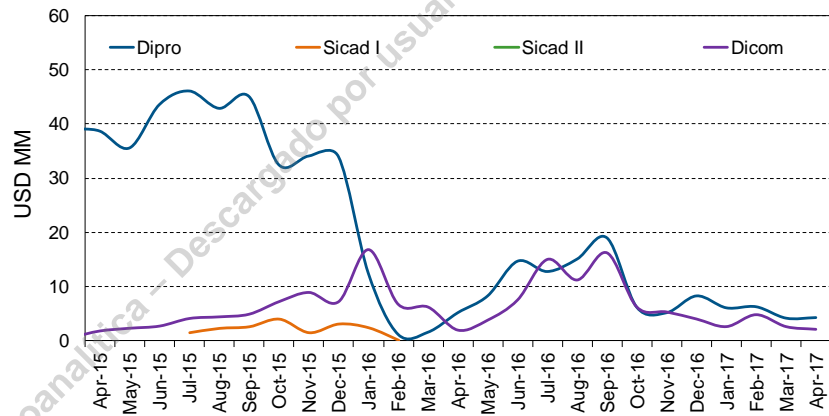
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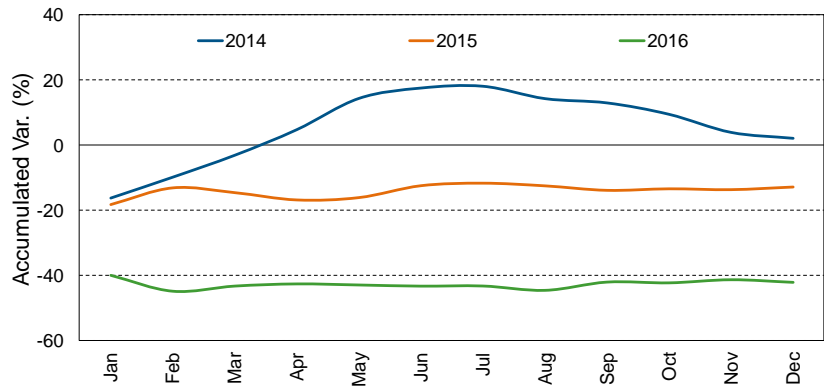
Real Wage Index



Disbursements to the Private Sector (Daily Average)



Primary Spending NTO (Real - Central Government)

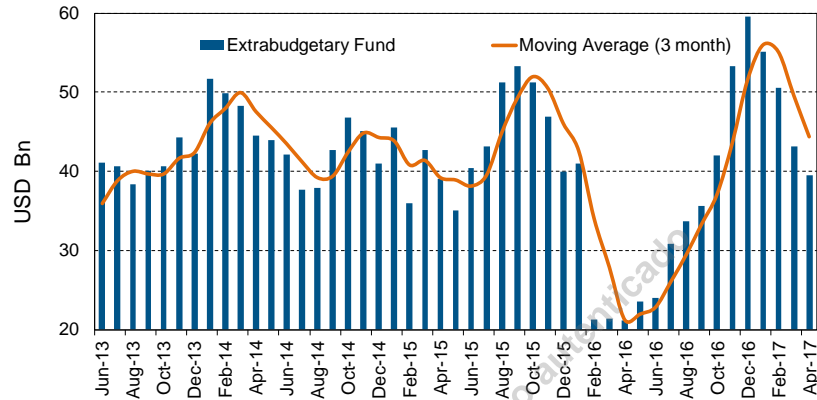


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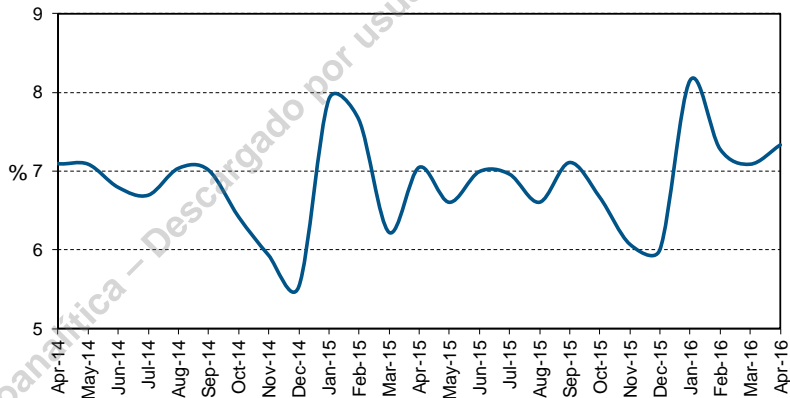
ECONOMIC INDICATORS

State Extrabudgetary Resources



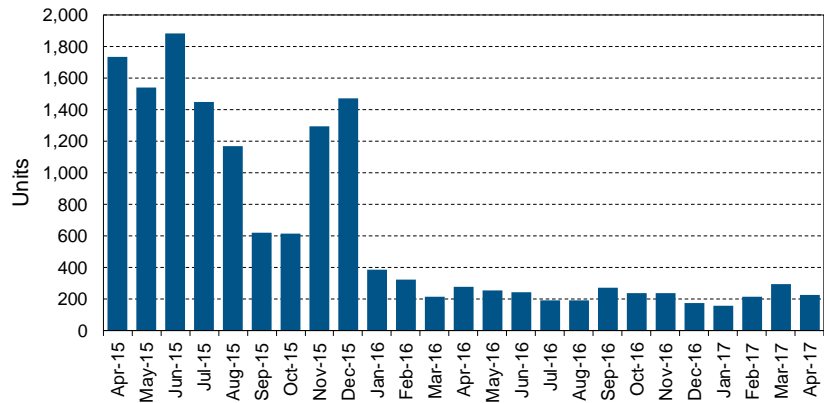
Source: Ecoanalítica

Unemployment Rate



Sources: INE and Ecoanalítica

Vehicle Sales



Sources: CAVENEZ and Ecoanalítica

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