Prospective Report

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IS THERE ANY GOOD NEWS FOR 2010?

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2009 – 2013 Economic Outlook Update and introducing 2014

This Outlook Report is written after the 2009 first semester economic figures were released by the Central Bank of Venezuela (BCV), the Administration announced its 54 economic measures, and ***Ecoanalitica*** having held its 7th Interactive Forum on Economic Outlook. The economic figures released by the BCV show the economy shrinking by 2.4% during the second quarter, and at ***Ecoanalítica*** we are quite sure that third quarter figures will also be negative, continuing the shrinking trend.

With respect to the Administration's new 54 economic measures, for all the hype and expectation created, they can be summed up as being: more public spending, a very weak stimulus package for the private sector, and more control over the exchange differential. No substantial changes were announced. And if you think about it, nothing more could be expected from an Administration that only knows how to implement one economic model, that which places the State as the main player, where economic policies and the development of the country take a back seat to political viability and agenda.

At the Forum held by ***Ecoanalítica***, we not only got to hear the opinions of our associates regarding key economic variables, but we also heard from Alejandro Grisanti, Research Director for Latin America and the Caribbean for Barclays Capital, as he presented the region's outlook for the coming months. His main conclusions were:

1. The global recession is over and China is leading the recovery.
2. A cyclical recovery is beginning in the U.S. and Barclays expects a sustained recovery by 2010.
3. With the end of the asset purchasing program, it's expected that U.S. Government bond rates to increase and the US-dollar to begin to appreciate.
4. Oil prices next year are expected to hover around US$85 per barrel and in the medium term top US$ 100 per barrel.
5. Emergent markets, including Latin America, have passed the test.

Based on this, one of the most important implications for Venezuela is that oil prices will be higher in the coming year than they have been in 2009. The implications are quite obvious, and especially with 2010 being an election year. But the Venezuelan

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economy is beginning to face some serious structural problems that are going to require more than just an increase in public spending to revitalize it.

What novelties can we expect on the horizon? Well, for one thing, there is the ever worsening impact of the deterioration of electric power and water services, and how the Administration is planning to face them. To this, you can add on how the Administration is planning on controlling the exchange rate. Will Merentes continue with his aggressive issuance plan? What impact will the BCV Law reform have? And there are a lot more questions, such as: Will PDVSA be able to manage its rising costs of operations which are in bolivars without the official exchange rate being adjusted? Will an alternative mechanism be created to allow it to solve this situation? Will crude oil production continue to be stagnant?

These are the questions that we will try to answer in this Report. Of course, there are other vital issues affecting the economy, for example, inflation. It has become one of the Government's most difficult problems to handle, and to bring down. Another problem associated with this, is how purchasing power is dropping, made worse by the economy slowing down. And last, but not least, the problems with CADIVI which is now being managed by Jesse Chacón has his famous foreign currency budget.

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This latest outlook update includes some minor changes. With regard to oil prices, given the international context, we've increased our projections, but not drastically. On average, the projections for 2010-2013 increased by 2.8%, for example:

- **Gross Domestic Product:** We've increased the amount by which economic activity will drop in 2009 from 0.5% to 1.1%; and we've estimated a slightly higher level of economic growth in 2010 due mainly to aggressive public spending.

- **Inflation and exchange rate:** We've lowered our estimate of yearly inflation for 2009 and 2010 by one percentage point to 27.5% and 34.6% respectively. However, this adjustment does not reflect any structural change and is a lot higher than the official Government estimates. With regard to the exchange rate, we continue to say that the Administration will devalue the currency during the first semester of 2010, though we have lowered the percentage of the adjustment.

- **Interest rates and liquidity:** We haven't changed our stance on negative real interest rates for the next few years. However, we have increased our projections with regard to the increase in liquidity.

- **Fiscal management:** We've increased our projections with regard to Government public spending, which in turn increases our projections for the fiscal deficit. It's important to mention here that the Administrations aggressive borrowing policy will have a significant impact on debt service which is increasing on an average of 1.1 points of GDP per year.

- **Balance of Payments:** Improvements in the Current Account due to increasing oil export revenues and to a limited increase in imports. The Capital Account deficit will be dropping during the next few years.

According to our calculations, the Venezuelan economy will recover slightly in 2010, but it is not likely that it will see the kind of growth it showed during the "boom" in the coming years. As long as the Administration is not will to work together with the private sector, our growth levels will remain below potential growth levels, which will adversely affect the general population. If the plan is that the State is going to be the main player in the economy, then our economy will not showing much better results.

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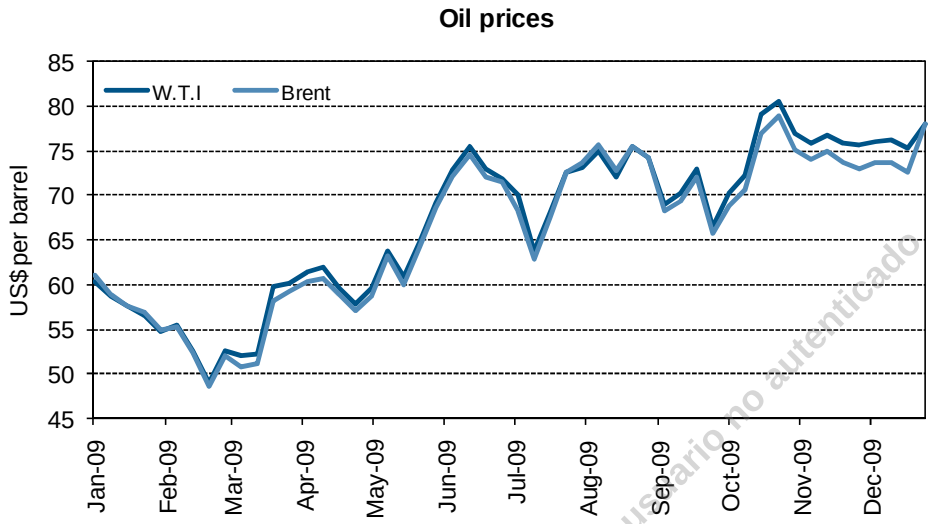
Oil scene. Back to the boom?

With the third quarter closed, it's a good time to look at what oil prices will be doing for the rest of the year and 2010. It's important to take into account how international oil prices have been recovering during the third quarter with Brent averaging around US$69.00 a barrel and WTI at US$70.60, with prices fluctuating during the whole third quarter at between US$65-US$75 per barrel.

Looking at oil prices starting in the second quarter, with special emphasis on third quarter performance, at ***Ecoanalítica,*** we expect the average price for oil for the last three months of the year to be at around US$74.00 per barrel and for 2010 at around US$83.00 per barrel. On the international scene we see oil prices hovering around the US$70.00-US$80.00 per barrel range for the rest of the year and between US$80.00-US$90.00 a barrel in 2010.



Sources: Bloomberg and Ecoanalítica

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With oil prices recovering on the international market and the subsequent increase of the average price for the Venezuelan oil basket for what's left of the year and next year, leads us to point out four key points:

1. First, the possible short term effect on the U.S. commodities market as a result of new regulations on the U.S. financial system which will be announced soon by President Obama. But, we expect these measures will be based on the capital market as a whole and not on this market specifically. Therefore, we only expect a slight effect on the market, at the moment the announcement is made, without any real changes in the volatility of prices.

2. Second, the point of view expressed by some of the main members of the OPEC, such as the Minister of Petroleum and Natural Resources of Saudi Arabia who mentioned that the necessary price range for oil prices in order to maintain investment and keep the market balanced in the long term was US$70.00 per barrel. He continued to say that cutbacks on production were not anticipated in 2010.

3. Another important point, related to the previous point, is the positive expectations surrounding the world economy. As these positive expectations are accompanied by real recovery and an increase in economic activity, the demand for energy will increase. OPEC estimates that the worldwide demand

for energy will increase by 0.7 million barrels a day in 2010 compared to 2009, spearheaded by the demands from the industrial, transportation, and petrochemical sectors.

Another factor which supports the OPEC's estimates is the increase in demand for energy coming from non-OECD countries, mainly China, India, the Middle East and Latin America.

It's important to see how the cartel's predictions measure up with other industry sources. The International Energy Agency outlook for 2010 is much more optimistic, with worldwide energy demand increasing by 1.5 million barrels a day (mb/d). The U.S. Energy Information Agency increased its outlook to 1.1 mb/d; Barclays Capital estimates it will be around 0.7 mb/d.

So, with the International Energy Agency adjusting worldwide energy demand by the close of 2009 from 83.2 mb/d in June to 84.6 mb/d in October, worldwide energy demand seems to be looking up for 2010. At ***Ecoanalítica***, we expect world energy demand to be at around 0.9 mb/d.

4. And lastly, but not least, there is the geopolitical aspect. Politics and oil go hand in hand. In an environment full of regulations, there is the risk that big energy consumers such as China insure their long term oil reserves through political means rather than through the market. One can assume that other players may chose to do the same.

The implications that this could have on the Venezuelan oil basket in 2010 (estimated at around US$70/bl) are tied, in principle, to OPEC's outlook. For PDVSA, the ideal price to sell oil is at between US$70-US$80 per barrel in order to be able to guarantee investment for exploration and extraction, as well as to give investors a healthy return in order to continue to develop the Orinoco Oil Belt, which will allow oil production to increase by approximately 0.4 mb/d in the next five years. Export oil production in 2010 will be at around the same levels that they were in 2008, around 2.3 mb/d.

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Gross Domestic Product. Growing below our potential

In the next few days the BCV will publish its third quarter results, which will continue with the negative trend of the second quarter. In this period, GDP contracted 2.4%, but if we look at individual sectors, some results are much worse.

Some of the most dynamic sectors of the economy during the period 2004-2008, such as financial institutions and insurance, which grew at an average rate of 26.8%, show negative growth in the second quarter. The mining sector suffered the worst contraction, as its productivity has been falling for some years due to a lack of investment and labor problems; also because of the global economic crisis which has reduced demand.

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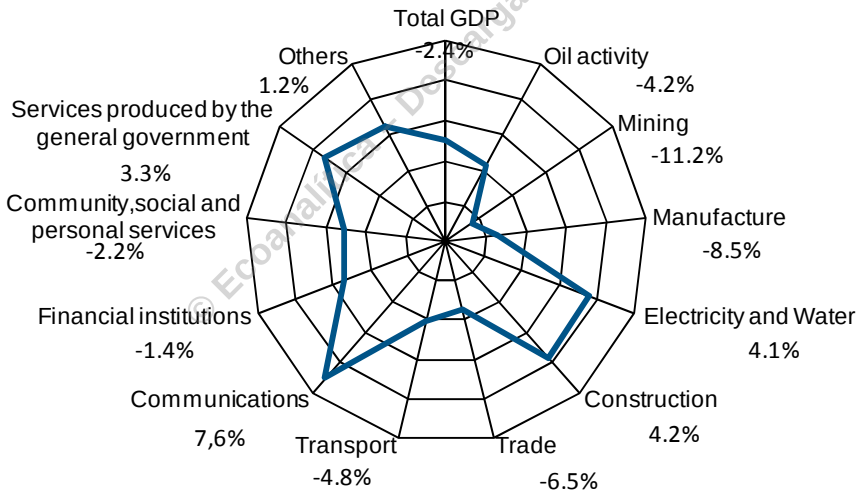
Economic Growth II quarter 2009



Sources: BCV and Ecoanalítica

The manufacturing sector is an extreme case, contracting by 8.5%, making this the third consecutive quarter that domestic manufacturing production has fallen, affected not only by the crisis that reduces external demand and the availability of foreign currency to import supplies, but also by loss of competitiveness of the exchange rate.

The construction industry is an exception to these negative results. Its 4% growth in the second quarter of the year is the result the impetus it received from the public sector, thanks to extraordinary resources received from FONDEN and the China-Venezuela Fund, as opposed to private sector construction which was adversely affected.

In this regard, one must refer to the measures adopted by the Administration. The press conferences held by various ministers of the economy, that in principle were to announce 54 economic measures which President Chavez had talked about on various occasions, were nothing more than the setting forth of various strategies, and not an economic plan as such. The principle measure that the Government will apply to stimulate the economy will be more of the same: to increase public spending. A growth in public spending.

Afterwards, the Minister of Science, Technology and Intermediate Industries, Jesse Chacón, announced that a series of special subsidies will be granted to strategic sectors, the efficiency of granting loan will be increased, and national production will be stimulated. He also pointed out that one of the Administration's new plans was to reinstate capital goods exoneration, to stimulate construction, and to repair infrastructure.

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In effect, no definitive measure was announced. In the near future, it is not expected that steps with a high political cost will be taken, such as currency devaluation, an increase in the price of gasoline, or the lifting of price controls on foodstuffs; in general terms changes in economic policy that the Administration has pursued are not expected. Or as Minister Giordani said: "The measures will be released very gradually and on a day-to-day basis."

We estimate that in 2009 the economy will decrease 1.1%, with the non-oil sector falling by 0.2% and the oil sector 7.8%. In 2010, with an estimated increase of US$16 of the Venezuelan oil basket, GDP will grow 1.4%. After 2010, growth of the Venezuelan economy will stagnate at around 2%. The reason for this is that the private sector will continue to be held back without any concrete stimulus to increase investment.

In this respect, in the medium term one would see that: first, companies are not investing to increase productive capacity, but only to extend their coverage and deepen their understanding of the consumer. Second, that dependency on imports will increase, given the overvaluation of the currency and less internal production; third, CADIVI will

grant less foreign currency, which will mean that many imported products will cease to be competitive.

Lastly, public sector participation in some sectors of the economy will continue to grow (those denominated as "strategic"). However, in other sectors public-private interdependence will increase, since the private sector has a greater understanding of the domestic market. All of this with negative impacts on investment and employment. What's left is an economy running just on public spending and growing well below its potential (3.8% yearly average).

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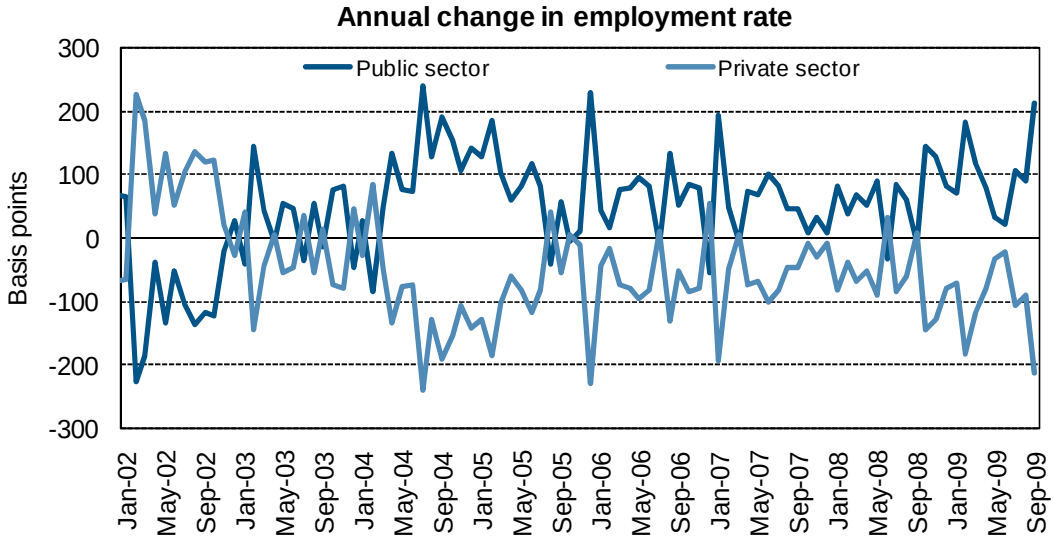
Jobs and salaries. The shrinking economy weighs heavy.

During the last few years, the labour market has been characterized by various special features. First, the growth in the number of ministries and other public institutions has translated into a significant increase in the public sector payroll, in addition to the government's fondness for nationalizing a large part of the productive sector. According to the INE's monthly report, in September the number of public sector employees was 2.29 million, or 19.2% of the working population; employment by the sector grew 58.4% since September 1999, when public sector employment was 15.1% of the total. On the other hand, private sector employment increased at a lesser rate 36.4% in the last ten years; it stood at 9.62 million in September, or 80.08 % of total employment.



Sources: INE and Ecoanalítica

Additionally, the greater increase in public sector employment only demonstrates that hiring in that sector is not related to real employment needs or its level of productivity, something which has contributed to government employee salaries being much higher than those of the private sector. However, the anticipated increase in prices in the economy will play an important role in lowering real salaries, both public and private, which at the same time could raise the level of public discontent and increase labour strife. This is an important element to consider for next year.

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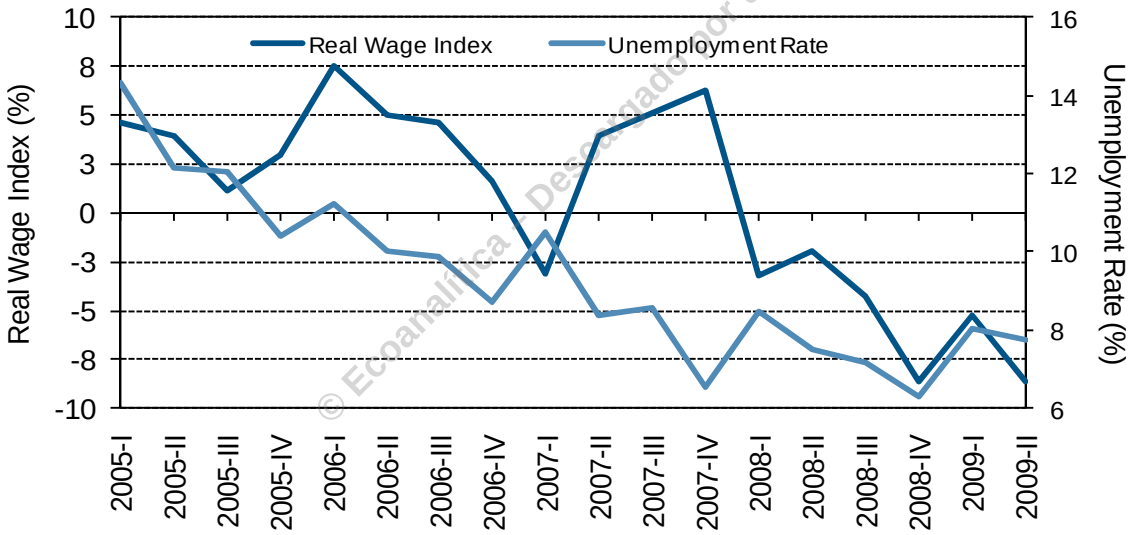
Real Wages Index (IQ-1997=1,00) and Unemployment Rate



Sources: BCV and Ecoanalítica

On the other hand, the slowing of economic activity has meant that unemployment has gone back up as of May of this year, with respect to the same month last year. In this respect, in September 2009 the unemployment rate was 8.4%, whereas in the same period a year before it was 7.2%, for a total of 1,098.554 people out of work, according to the figures of the National Research Institute (INE).

Nevertheless, seen from another view, the second feature of the labour market is the decided lowering of the unemployment rate in the last few years. Up to a certain point, this is an obvious consequence of the growth in the economy until at least 2008.

However, it is also the result of an under-estimation of the figures made possible by changes in the method of calculation by the INE. These changes principally have to do with placing participants in the educational missions and other government social programs in the category of "inactives," that is, taking them out of the "unemployed" category, thus provoking a fictitious reduction in unemployment.

It is clear to us that despite the underestimated figures, the creation of productive employment should have been much greater during the economic bonanza that Venezuela experienced. One must bear in mind that the non-oil sector is the principal generator of employment in the country. ***Ecoanalítica*** established, through a simple equation, and using data from 1968 through 2008, that for every percentage point increase in the growth of the non-oil sector, that on average 77,000 new jobs should be created.

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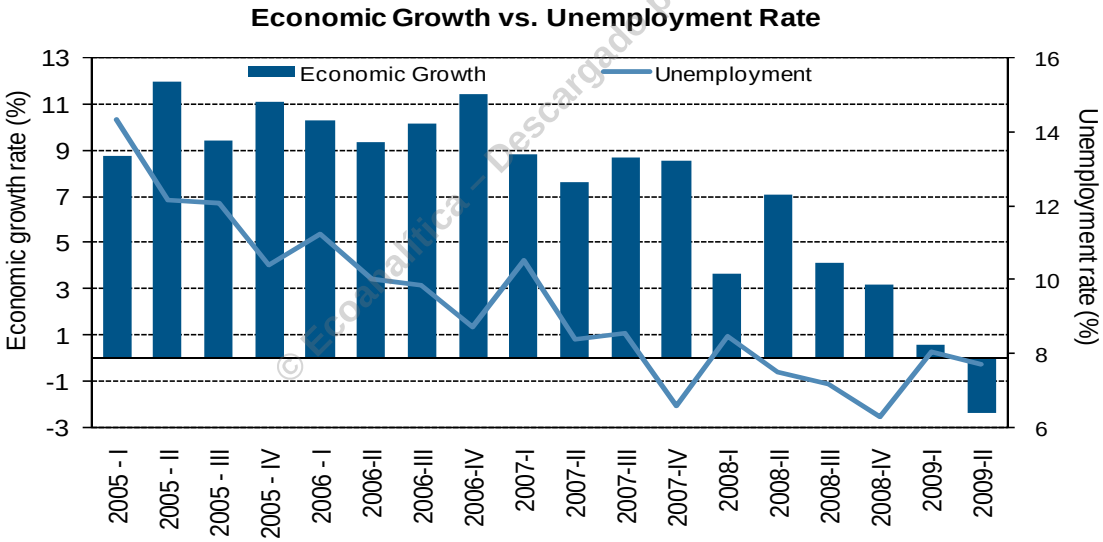

Sources: BCV, INE and Ecoanalítica

At ***Ecoanalitica***, we project that unemployment, which could close the year at 7.9%, could go up again in 2009 as a result of the economic scenario described. For that reason, we estimate that the percentage of unemployed will be around 9.0% in 2010, and will average 8.7% thereafter. In the coming years we anticipate an improvement in the Venezuelan labour market, as the difficulties in this environment are due to various factors such as: the weakness of institutions, political uncertainty, the threat felt by the private sector regarding property rights, the sense that growth is not sustainable, and

that the exchange control that stimulates imports increases production and the creation of employment among our commercial partners.

Inflation. Its not coming down soon.

The Central Bank of Venezuela (BCV) has published the national and Caracas Metropolitan Area inflation figures for October. According to the entity, the Consumer Price Index (INPC) rose 1.9% as compared to the month before, while the accumulated ten-month rate increased 20.7%, and the year-on-year rate was up 26.7%.

As for the different components of the INPC, those categories showing the greatest monthly price increases were: educational services (2.7%) goods and diverse services (3.6%), food and non-alcoholic beverages (3.3%), and alcoholic beverages and tobacco (3.2%).

The results by city show that the highest monthly increases were found in Valencia (3.0%), Barquisimeto (2.2%), and Caracas and Maracay (2.1% for each). **(IDEM)**

The Consumer Price Index (IPC) for the Caracas Metropolitan Area showed accumulated inflation of 23.0% since December 2008, and year-on-year inflation of 28.9%. **(IDEM)**

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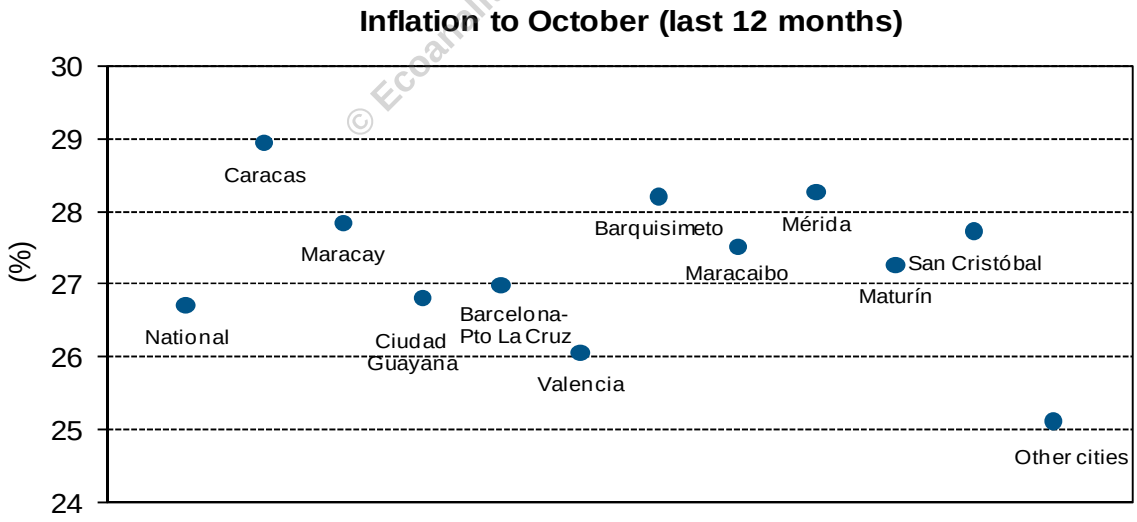
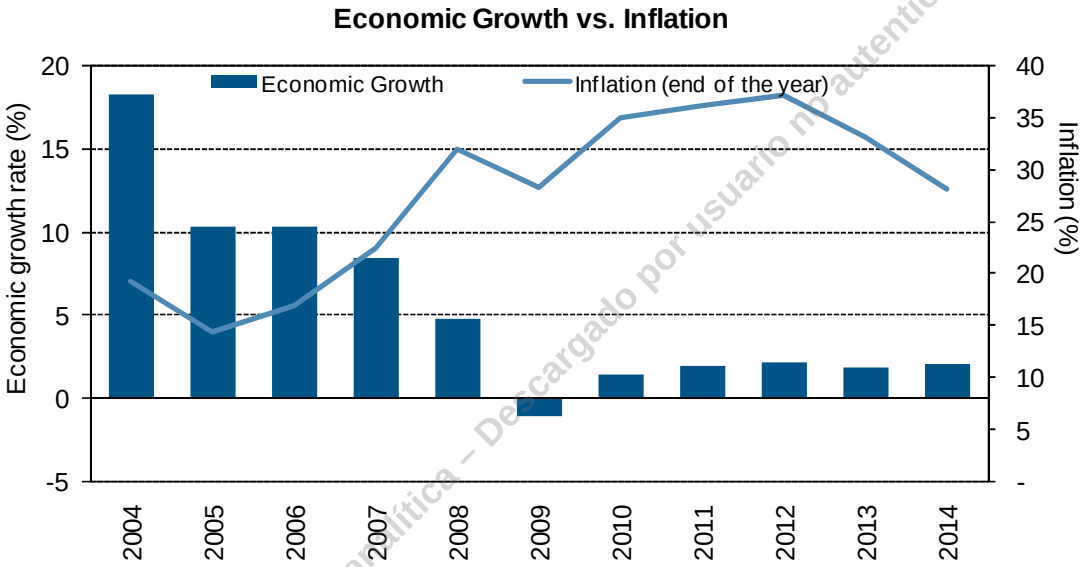


Sources: BCV and Ecoanalítica

Despite the results showing an acceleration of inflation, we estimate this year's rate to be lower that last year's, because the parallel dollar rate has gone down in the last

months, due to, among other factors, the issuing of bonds 2019 & 2014, and the latest PDVSA bond offering. Additionally, a foreign currency budget is being prepared in order to maintain greater fiscal control and to facilitate foreign currency payments to companies. This is why, for the end of the year, we estimate a domestic inflation rate of 27.5% and a slightly higher rate of 28.3% for Caracas. Of course, this is all in the context of an economy that is in frank deceleration.



Sources: BCV and Ecoanalítica

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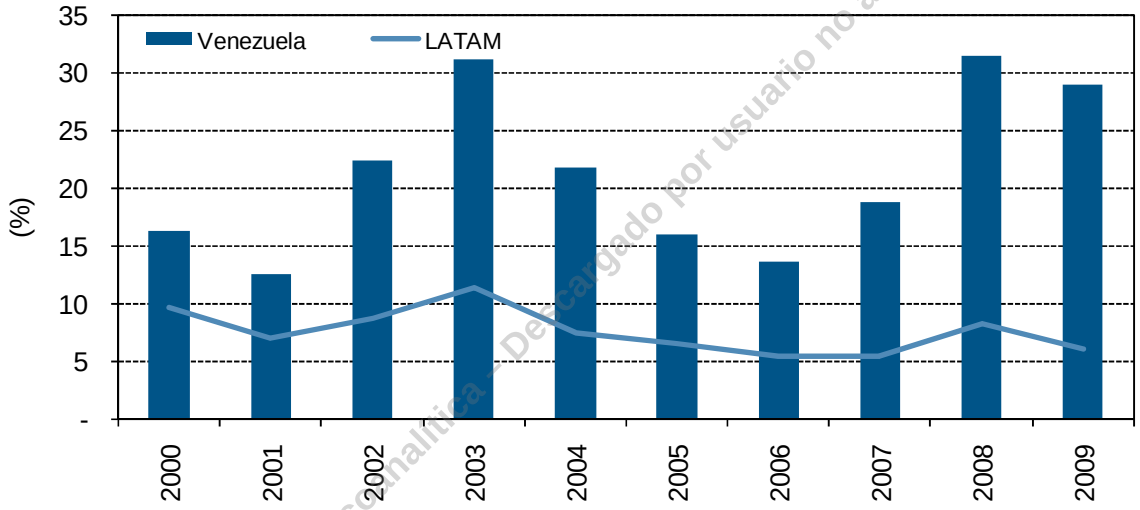
For 2010, Ecoanalitica expects the inflation rate to rise to 34.6% on a national basis. This estimate is based on the expectation that in the next few months there will be an accentuation of price increases. The major factor to consider is the readjustment in the exchange market: if the exchange rate is maintained to subsidize food and medicines, the parallel market would be financing at least 40% of imports. On this point, various government officials have admitted that the parallel market has a significantly negative affect on inflation. Meanwhile, the prices of foodstuffs provided by MERCAL have been moderated, without taking into account that the substitution of Colombian imports by those from Argentina could imply higher costs.

Lastly, the Administration will continue to increase spending through greater oil revenues, and given the multiplier effect of public spending on the rest of the components of demand and limited production of goods, we expect to see higher

prices in the next year. This thesis is bolstered by the recent reform of the Central Bank Law, which in essence creates mechanisms to finance the fiscal deficit.

Attendees of the Forum hold a similar view with respect to inflation. Thirty-eight percent predict that inflation will close at 30%, while 34% said it will be around 35%, and 12% see a 40% end-of-year rate. Only 4% believe in the Administration`s estimate incorporated in the Budget Law (20-22%).

Venezuela vs. Latin American inflation



Sources: BCV, ECLAC and Ecoanalítica

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In the last few years the inflation problem has gotten worse. Fiscal management, if it is the element which exercises the greatest pressure on the rise in prices, cannot overlook factors such as exchange policy and the lack of private investment. If the Administration does not modify the controls and provide incentives for private investment, the reduction in inflation will not be structural. In the past, an anchored exchange rate was enough to reduce inflation significantly in the 1996-2001 period. Nowadays, an anchored exchange and the announcement of measures are insufficient.

Interest Rates and Monetary Policy

As mentioned before, the State's strategy for the first half of the year consisted of counteracting economic deceleration derived from the fall in oil prices and drop in demand as a result of the global crisis. Concerning monetary policy, expansive is the term that best describes the decisions made by the Central Bank of Venezuela (BCV).

One of the first decisions was lowering the marginal bank legal reserve from 30% to 27% in January with a further decrease to 25% in March, which had the aim of releasing enough resources so that the financial system could absorb the public debt issues that started to be launched at the end of the first quarter.

Furthermore, and in line with the above, in April the BCV began to progressively decrease interest rates: the top (ceiling) lending rate was lowered from 28% to 26% and then to 24% in June, and the minimum (base) savings rate was reduced from 15% to 14%, later to 13.75%, and finally to 12.5%. This, together with a relaxed monetary policy by the BCV through the decrease in interest rates of Open Market Operations (OMAs), had an expansive effect on liquidity during these months of the year.

For the second half of 2009, the BCV did not modify interest rates or bank legal reserve, although the balance of the titles issued by the Bank continuously decreased from February to September (last data available) as a consequence of interest rate cuts intended to have an expansive effect on liquidity; this balance dropped 23.3% between June and September 2009. One of the arguments employed to justify the interest rate cuts was that the goal was stimulating the economic activation through a larger number of bank loans; however, in the practice, these resources have been used to purchase domestic debt issued by the Administration. An example of this is the fact that financial institutions have increased their investment in securities by 19.8% in real terms between September 2008 and 2009, whereas, the loan portfolio year-to-year real variation has been 7.28%.

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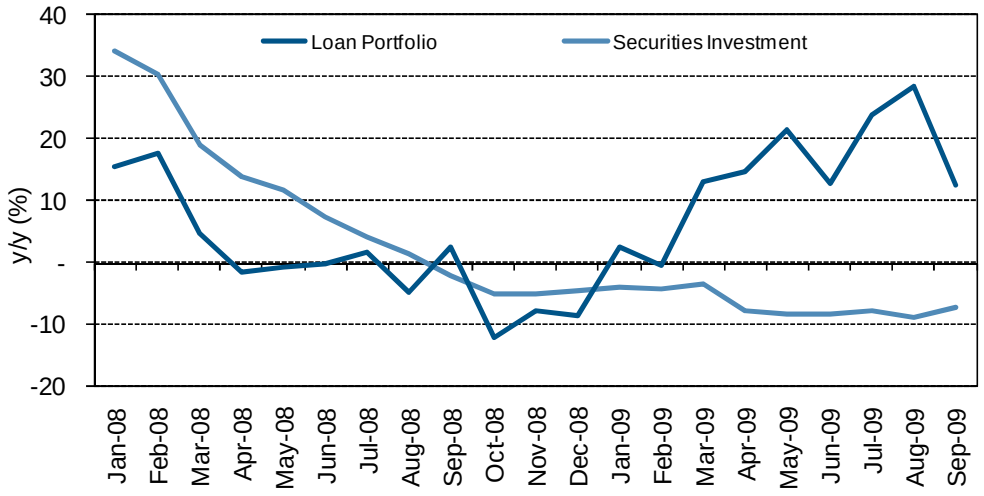
Loan Portfolio Growing Rate vs. Securities Investment



Sources: BCV, SUDEBAN and Ecoanalítica

The real contraction of loan portfolio is due, among other things, to the risk associated with loan granting (amidst an economic recession), which is higher than that implied by the purchase of public papers, which has brought about a lower liquidity growth.

Until a few months ago, a further reduction of bank legal reserve was considered likely, in order to make resources available for the financial system to purchase domestic debt issues that were finally launched, as well as the planned foreign debt issues (like the sovereign bonds for US$ 4.93 billion and PDVSA's for US$ 3.26 billion), which helped the general public to access foreign currency. However, the amount of bolivars absorbed will be re-injected through public spending and PDVSA debt payment to local suppliers; therefore, the purpose is not reducing liquidity, but covering financing needs. Finally our perspective for the end of the year is that liquidity will reach VEF 250.0 billion, which shows that the moneys absorbed by the debt issues will be re-injected, thereby stimulating liquidity growth for the remaining 2009 and boosting the increase that is traditional for the last quarter of the year.

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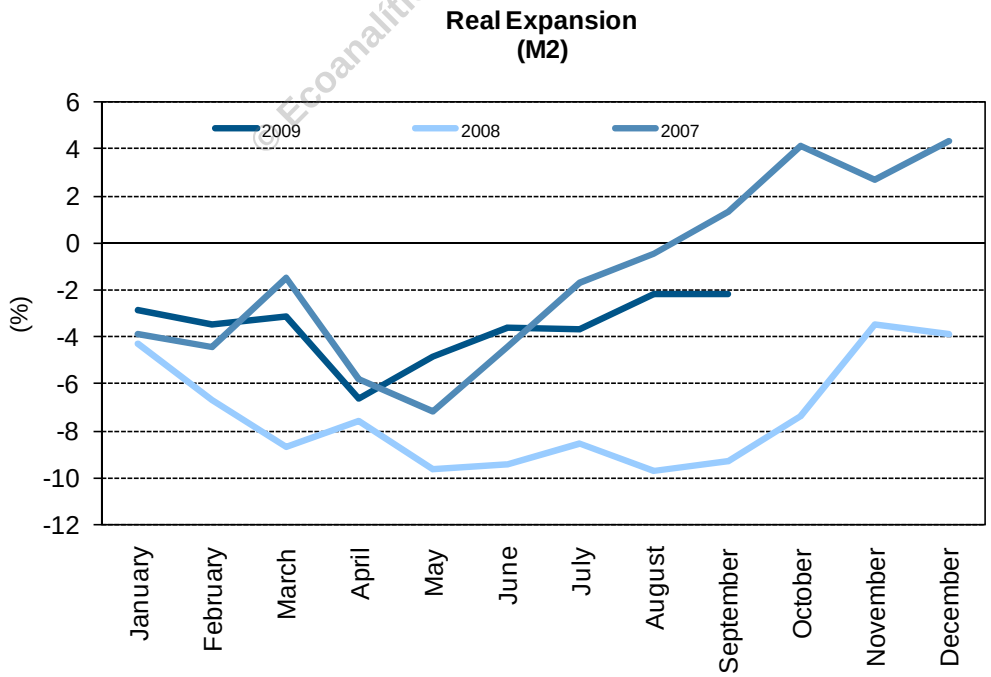
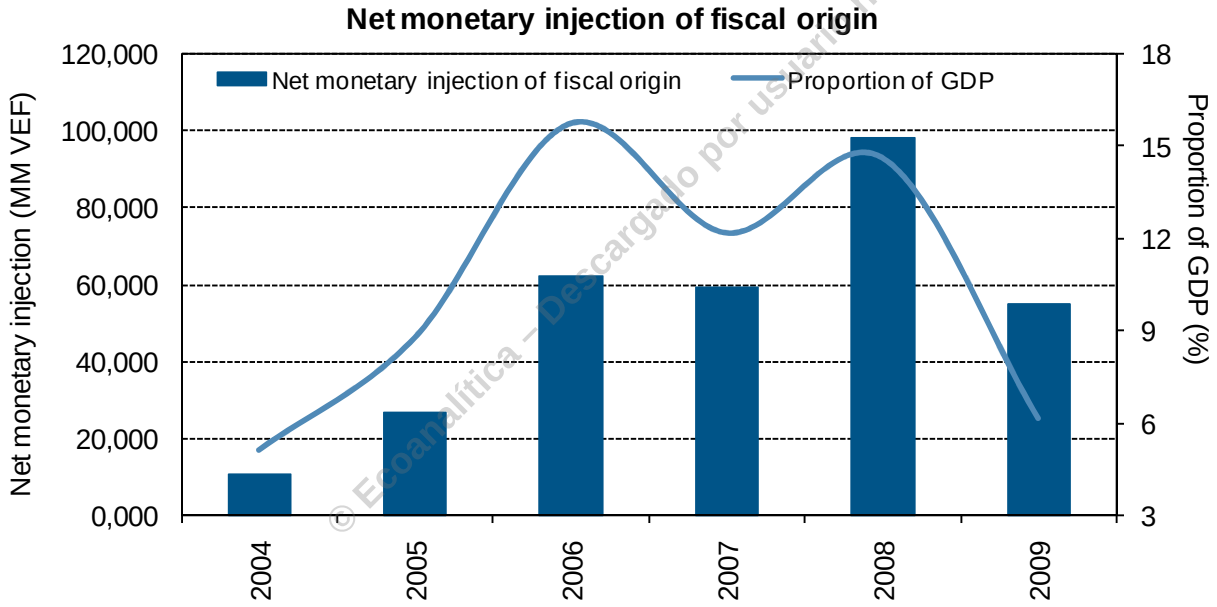


Sources: BCV and Ecoanalítica

At ***Ecoanalítica***, we estimate that liquidity is going to increase 36% in nominal terms for 2010, meaning that levels of up to VEF 340.0 billion will be reached. This perception is derived from the fact that the Administration is going to strongly increase spending since 2010 is an election year; however, we believe that several public debt issues (domestic and foreign) are going to be made. These placements are intended to control the dollar swap rate, but not to curb liquidity growth, which reveals a strategy aimed at reactivating economic growth in the short term by releasing resources to the financial system and the general public, with the cost of higher inflation in an economy like Venezuela's, which already has the highest inflation rate in Latin America.



Sources: BCV and Ecoanalítica

Concerning interest rates, we at ***Ecoanalítica*** do not believe that the maximum lending rate or the minimum savings rate will be further modified, because the Administration intention is to continue to apply the strategy of creating the conditions for an economic reactivation. Therefore, we believe that lending interest rate will close 2009 at around 19.2%, reflecting its downward trend, with the average rate closing at 21.7%.

In 2010, although we believe that rates are going to remain low, our projection states that lending rate will close the year at 22.5%, but with an average lower than the one recorded this year (close to 20.9%). Low levels are also forecast for savings interest rate (close to 14%), which is a bit lower than the 12.6% level expected for the end of this year. We can see that both rates will tend to remain over the current levels; however,

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they are expected to close 2010 at levels higher than those expected for the end of 2009, far below the expected inflation rate.

Balance of Payments. All depends on oil

During the third quarter of 2009, the International Monetary Fund surprised us with the allocation of Special Drawing Rights to all its member countries for a total of SDR 182.7 billion, equivalent to US$ 285.0 billion, of which Venezuela was granted US$ 3.48 billion; therefore, at early September, foreign reserves increased by more than 11%, up to US$ 34.52 billion. However, our projections for the balance of payments continue to be the same, because the foreign reserve increase was counteracted by other opposite forces.

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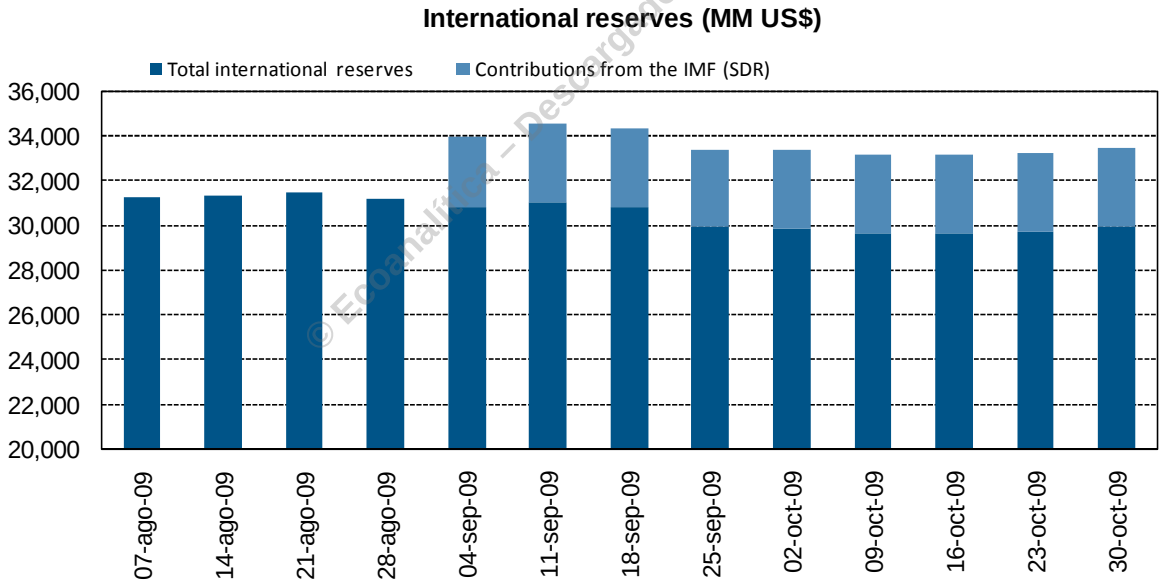

Sources: BCV and Ecoanalítica

The main force that led us to lower our prior Current Account (CA) estimate is the little elasticity of demand for imported goods by Venezuelan consumers, which allowed imports recorded in the balance of payments during the first quarter to drop only 5% from the same period in 2008, despite a 37.3% decrease in the allocation of foreign currency at the official exchange rate by CADIVI. This means that the market was able to transfer 32.0% of private imports to the swap market, without this leading to

inflation rates higher than those in 2008, thanks, in part, to the strong economic deceleration.

It is also necessary to consider the backlog between imports and foreign currency allocation, which makes it impossible to know the exact magnitude of the swap exchange rate. However, the fact that major supply problems due to the drop in foreign currency allocations are not expected leads us to conclude that the swap market was able to cover almost the entire drop in CADIVI allocations.

As a consequence of this, we raised our total import estimate for 2009 from US$ 39.5 billion to US$ 41.0 billion, and those corresponding to the following years are going to be readjusted in a similar proportion, because we are certain that CADIVI will increasingly restrict the allocation of foreign currency at the official exchange rate. The private sector, in turn, showed during 2009 that it is perfectly capable of adapting to adverse situation. The Administration is also aware of this fact, which is another reason for not increasing the allocation of foreign currency at the official exchange rate in 2010 (something that is extremely costly for the Administration) and has decided to apply the Merentes' Plan to stabilize the swap market.

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According to the BCV, during the first half of 2009, the CC recorded a US$ 2.027 billion surplus, in contrast with the huge surplus of US$ 25.067 billion posted during the same period last year, when prices of the Venezuelan oil basket averaged US$ 95.1/bbl. as compared to US$ 46.7/bbl. for the first half of 2009. For yearend, we are projecting a CC surplus of US$ 7.2 billion, thanks to the oil price recovery, which will be close to US$ 70/bbl. during the last quarter of 2009.

In 2010, with an expected average of US$ 71/bbl. for the Venezuelan oil basket (and running the risk of falling short in this projection) and import levels similar to those of this year (due to the Administration announcement that CADIVI foreign currency budget for 2010 will be 40% lower than this year), the Balance of Payments will record a high surplus, although it will not return to 2008 bonanza.

Summary of the Balance of Payments	2009		2010	
	Previous	*Current*	*Previous*	*Current*
Oil Price (Brent)	61.0	62.0	81.5	81.5
Oil Price (Venezuelan Basket)	53.4	55.0	71.2	71.2
Diferential	0.9	0.9	0.9	0.9
Current Account (% of the GDP)	3.2	2.2	8.6	8.6
Current Account (US$ MMM)	8.8	7.2	22.2	22.8
Balance of Trade (US$ MMM)	12.8	11.2	26.0	27.0
Exports (US$ MMM)	52.3	52.2	63.2	69.5
Oil Exportation (bl/day)	2.4	2.4	2.2	2.5
Imports (US$ MMM)	-39.5	-41.0	-37.2	-42.5
Services & Income Balance (US$ MMM)	-4.0	-4.0	-3.8	-4.1
Capital Account (US$ MMM)	-17.9	-16.5	-19.4	-16.4
Foreign Direct Investment (US$ MMM)	0.7	0.7	0.6	0.6

Source: Ecoanalitica

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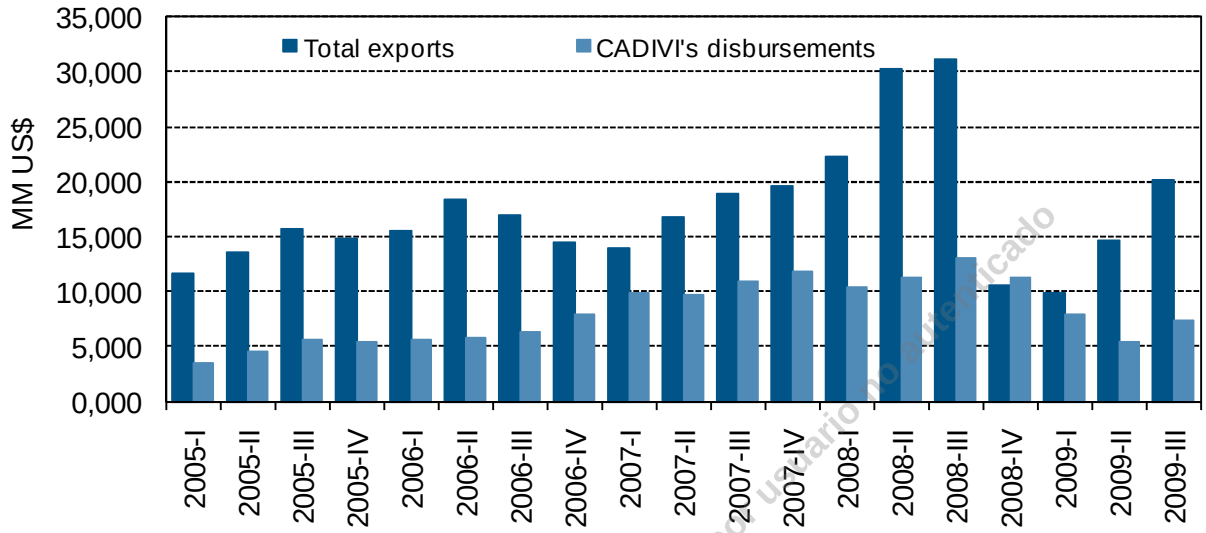
Exchange policy. Merentes and Chacón share the job

The Executive announced the economic measures and, specifically, those concerning exchange policy. However, not much was said. Significant changes have occurred in the Venezuelan exchange market, because until a few months ago, according to the Administration logic, the swap market was tiny, almost inexistent; but now President Chávez boasts of him being able to close the gap between both exchange rates. Now from august to October, the parallel market exchange rate dropped 21,0%. The Administration is trying its new strategy that includes what we at ***Ecoanalítica*** have called job sharing: on the one hand, the BCV president is trying to curb pressures on the swap market, and Jesse Chacón is applying the famous foreign exchange budget which will rule the official exchange market (CADIVI), on the other.

Total exports vs. CADIVI's disbursements



Sources: BCV, CADIVI and Ecoanalítica

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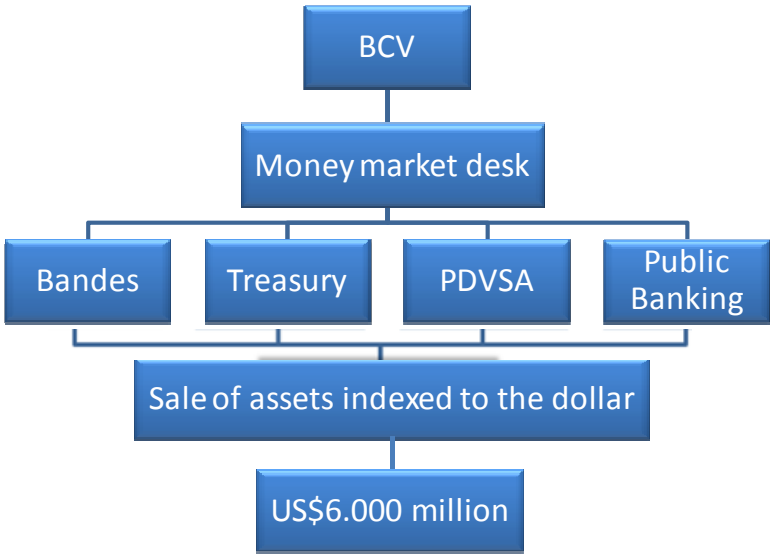
The swap market strategy is based on selling dollars, between US$ 150 – US$ 180 million every two weeks, through the financial system. This offer will be made in the form of dollar indexed instruments and may come from the Ministry of Finance, public banks, FONDEN and PDVSA. The key is that Merentes and his team would centralize the offer and the monitoring of resources. The BCV doesn't want to repeat past mistakes and the aim is that "dollars" get to companies and do not remain in the financial system. To this end, the administration has resources equivalent to about US$ 4.0 billion, without including the purchases of the recent bond issued by public entities.



Additionally, and after the two last issues for more than US$ 8.0 billion, two further issues of dollar indexed titles for about US$ 3.0 billion are being prepared. With this strategy, the Administration is trying to have swap rate to range within the VEF 4.8 – 5.5 U$ band.

The Balance of Payments figures for the first half seem to justify this decision. According to ***Ecoanalítica's*** preliminary estimates, for the first half of 2009, the swap market had financed imports in the order of US$ 9.426 billion, or 49.1% of the total private imports. In the same period of 2008, this percentage was at 21.4%, hence Merentes' concern about trying to stabilize the market.

CADIVI's situation is complex. Its debt with the private sector is high, but, in contrast to what Minister Chacón has said, it cannot be paid from one day to the next, given the current flow of foreign exchange. Vis-à-vis this situation, Merentes' solution is, more or less: *While CADIVI takes its time, I offer a stable swap market*. Jesse Chacón has underscored that 2010 foreign exchange budget is going to operate based on production sectors, this is, CADIVI is going to address priorities only. Giordani has ratified this idea.

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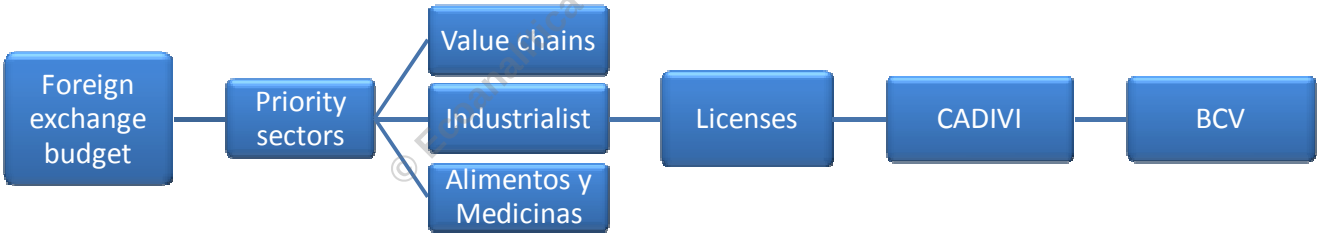
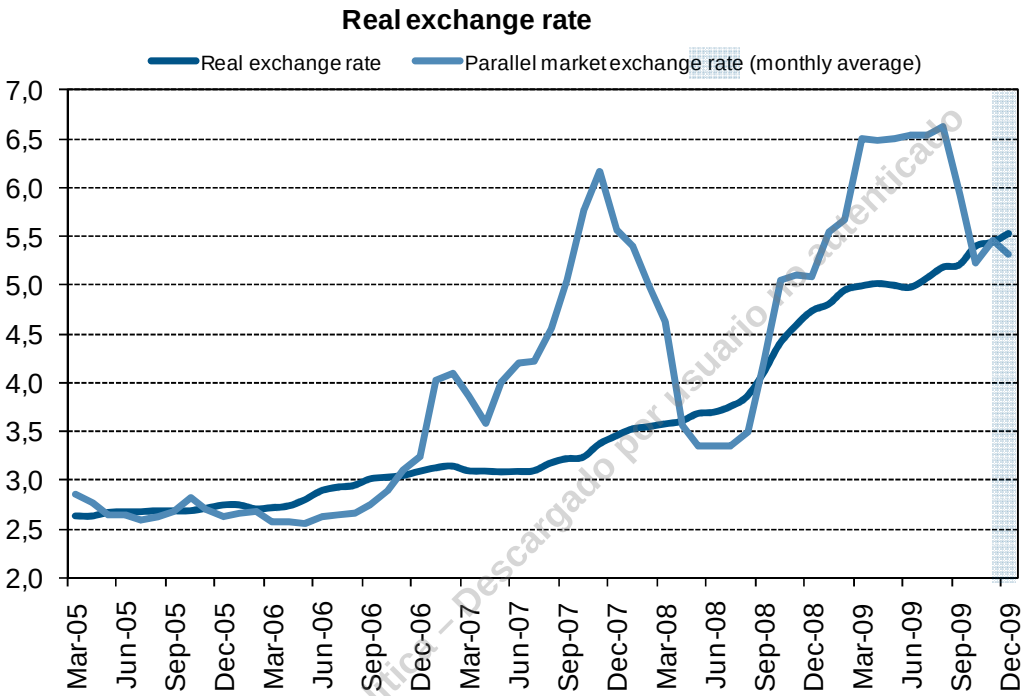


What will happen with swap rate? This is going to depend on whether Merentes continues or not with his strategy.

Our real exchange rate model allows us to analyze the evolution of domestic costs and prices, taking into account the impact of foreign prices, which are measured by means of the exchange rate. Our real exchange rate is built with respect to the dollar, the Colombian peso and the Brazilian real, using the average between 1990 and 1993 as base period. In this way, the implicit exchange rate for October would be VEF 5.23 per dollar, that is,143% over the official exchange rate. It is worth highlighting that the current swap rate is higher than this value. Our recommendation in this regard is simple: while the official exchange rate is close to, or even better, below the real

exchange rate, the opportunity is excellent to buy dollars. This point is essential for the evolution of this market in 2010.



Source: Ecoanalítica

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Basically, swap market in 2010 will be more dynamic, with an increased participation of the Administration and the BCV (the reform of the BCV law points to this), whereas the official market will be restricted to priorities set by the Executive and to the budget availability. The Administration has pointed out that this budget could amount to US$ 30.0 billion. Therefore, according to our estimates, imports of goods and services would reach US$ 23.34 billion. Therefore, the swap market would be financing US$ 19.16 billion, or 45% of the total.

Concerning the official exchange rate, we continue to sustain our thesis that the Administration will adjust the official exchange rate upwards. Devaluation would be justified by PDVSA, the country's main exporting company, which is being affected by the currency real appreciation, by seriously compromising the fiscal contribution in VEF for next year.

Two comments with regard to this point: the Administration may delay devaluation, given the exchange readjustment that began this year and that will be deeper the next, which will make unbalance greater and will provide a lower margin of play in fiscal terms. Second, given PDVSA's exchange autonomy, a mechanism will likely be established through which PDVSA will more actively participate in the swap market in order to alleviate it financial situation. This is counterproductive, not only due to the lack of transparency of most of these operations, but also because this would make the exchange market distortions deeper and would become an element pushing an increase of the inflation rate.

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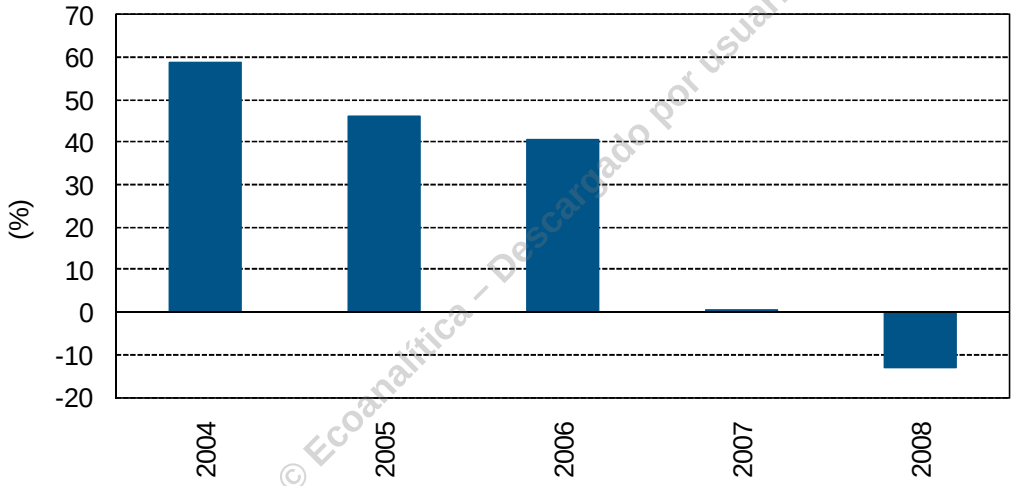
Real variation of the fiscal contribution from PDVSA*



* Includes social programs
Sources: PDVSA and Ecoanalítica

It is clear that the most suitable mechanism for the Administration is to correct exchange rate, together with an institutional reform that recognizes and formalized the parallel market. Unfortunately, we believe that the Administration will not make this decision.

Fiscal policy. A worrying borrowing spree

The Administration has just announced a possible CVG and PDVSA debt issue, after having placed more than US$ 8.0 billion in less than one month. Already in the first half of the year, the country's gross borrowing exceeded US$ 16,000 billion.

According to the Ministry of Economy and Finance (MEF), at the close of the first half of this year, total public debt of the Central Government totaled US$ 50.335 billion. This

represents an increase of 14.3% from December 2008, or a net borrowing of US$ 6.28 billion. This borrowing has been made under different modalities: domestic (financial system) and foreign (bonds, bilateral and multilateral loans). The key strategy of Chávez' government to face the crisis, especially since April 2009, has been increasing public debt.

During the second half of the year, gross domestic borrowing has amounted to US$ 4.646 billion. Therefore, we expect that borrowing for the second half of 2009 will be at about US$ 9.0 billion, down US$ 2.0 billion from our initial estimate. On the foreign side, up until now a loan granted by CAF for US$ 600 million and the placement of sovereign and PDVSA's bonds for US$ 8,852 billion have been announced.

Bilateral loans that the Republic would be agreeing with China, Japan and Brazil are delayed and they have not been still executed. Other loans that are still to be agreed, according to ***Ecoanalítica's*** sources, include one granted by Russia to purchase weapons for US$ 2.0 billion and the third trench of China's contribution to the China-Venezuela bi-national fund. Based on our initial projection, these bilateral credits would amount to US$ 6.7 billion; however, according to the current pace, the only one that could be materialized before yearend is the pending trench of China's contribution to the bi-national fund (US$ 4.0 billion, with Venezuela having to contribute the equivalent to US$ 2.0 billion).

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At the end of 2009, the Republic's consolidated debt will close at almost US$ 100.0 billion, for an increase of 49.4% in comparison to 2008. For 2010, the Administration's expected net borrowing is estimated at US$ 18.605 billion.

US$ million	2006	2007	2008	2009	2010
Adjusted* GDP	165,060	168,852	237,332	322,247	266,603
GDP MEF	184,251	227,753	313,361	394,993	315,635
External Debt (including PDVSA and others)	30,400	42,300	50,500	70,000	82,000
Internal Debt	16,847	16,740	14,193	25,999	35,999
Total Public Debt	47,247	59,040	64,693	95,999	117,999
Debt/adjustedGDP ratio	28.6%	35.0%	27.3%	29.8%	44.3%
Debt/GDP	25.6%	25.9%	20.6%	24.3%	37.4%

Sources: BCV, MEF and Ecoanalítica

Borrowing will continue to take the same route next year: public borrowing through the financial system; dollar denominated issued to give a break to the swap market (one of these issues could take place every quarter); a timid foreign debt repurchase (depending on the oil price behavior); and finally, bilateral borrowing with some countries, particularly China and Brazil.

In terms of spending, the 2010 fiscal spending budget has been set at VEF159.41 billion, a figure which is conservative, to say the least. In fact, this figure is 17% less, in nominal terms, than what this year's spending is being estimated to close at (VEF 192.94 billion). But, keep in mind that 2010 is an election year.

With these spending figures, the drafters of the Budget seem to be strictly following the President's mandate to spend with "austerity," even while basing the Budget on a US$ 40 per barrel price, which is much lower than international projections. But, it's common practice now for the Administration to spend more than what's set in the Budget through supplemental appropriations. Keep in mind that for the 2009 Budget, spending was set at VEF 167.47 billion, which was later cut to VEF156.38 billion, but increased through supplemental appropriations, in part financed with 2008 surplus resources that were deposited into the Miranda Fund, and public debt, and FONDEN.

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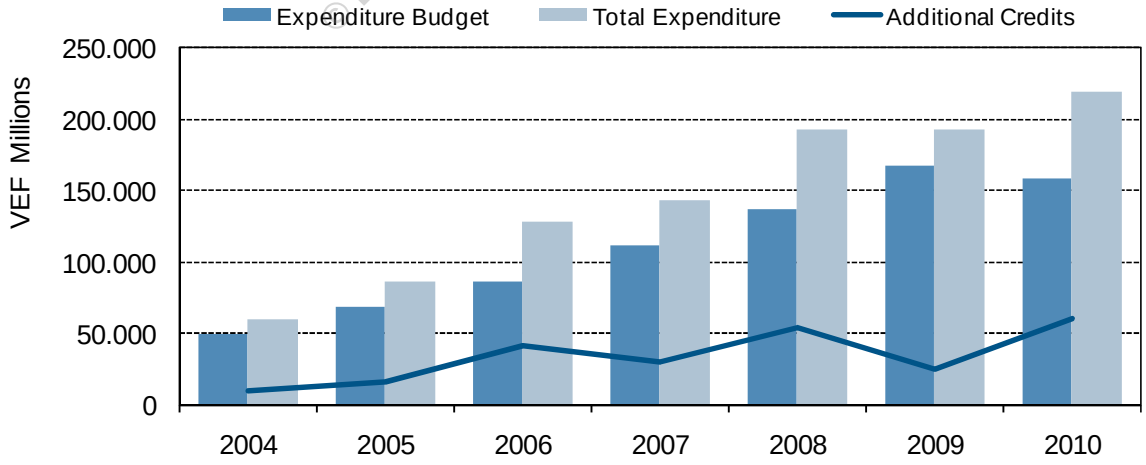
Expenditure budget , Total Expenditure and Additional Credits (2004 – 2010)



Sources: Asamblea Nacional. ONAPRE and Ecoanalítica

The same thing could happen in 2010, a year in which ***Ecoanalítica*** is estimating that public spending will be slightly higher than 29.1% of GDP or VEF 220.14 billion. Our estimate is higher than the official figure not only because we expect a higher level of spending to be financed through borrowing and surplus resources, but also that the appreciation of the exchange rate tends to "inflate" fiscal accounts in nominal terms.

Non - oil Extra Budgetary Balance (% of the GDP) (General Summary)	**2009F**	**2010F**	**2011F**	**2012F**	**2013F**	**2014F**
Fiscal Revenue (% of the GDP)	20.1	26.5	25.5	25.7	24.8	28.3
Oil Revenue (% of the GDP)	11.0	14.5	13.7	14.0	14.0	16.2
Non Oil Revenue (% of the GDP)	9.0	10.5	10.5	9.8	9.9	11.0
Total Expenditure (% of the GDP)	25.8	29.1	27.0	31.5	28.2	27.5
Primary Expenditure (% of the GDP)	23.8	25.8	23.4	27.6	24.3	23.3
Fiscal Balance (% of the GDP)	-5.7	-2.6	-1.5	-5.8	-3.4	0.8
Primary Fiscal Balance (% of the GDP)	-3.7	0.7	2.1	-1.9	0.5	5.0
Amortization (% of the GDP)	2.4	3.5	3.9	4.2	4.5	5.5
Government Financing Requirements (% of the GDP)	8.1	6.1	5.4	10.0	7.9	4.7
Extra Budgetary Expenditure (% of the GDP)	2.5	3.1	2.7	3.0	2.5	2.6
Non - oil Extra Budgetary Balance (% of the GDP)	-19.2	-20.2	-17.9	-22.8	-19.9	-18.0

Source: Ecoanalítica

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We estimate that given the price differential, in 2010 the Administration will take in around US$ 26.02 billion in extraordinary revenues. The Budget anticipates a fiscal deficit equal to 3.9% of GDP. In this case, the estimate of the deficit is quite high, but in accordance with a projection of fewer oil revenues. At ***Ecoanalítica***, we believe the fiscal deficit at the close of 2010 will be at around 2.6% of GDP. If to this we add an amortization level equal to 3.5 points of GDP, the result points to financing needs for around 6.1% of GDP. Quite a different figure than what is being estimated by the Government at 3.9 percentage points of GDP.

The 2010 Budget Law hides what will most likely be the policies implemented in 2010. If oil prices remain at favorable levels, then the Government will increase spending through supplemental appropriations and managing extraordinary resources at its discretion, along with an aggressive borrowing plan in order to avoid depleting out-of-budget resources. This Administration never learns that sustained and permanent growth can't be achieved just through spending.

Comparison of the 2010 budget premises vs. Ecoanalítica

	MEF	Ecoanalítica
GDP Current Prices (VEF Million)	896,403	756,486
Oil price Venezuelan Basket (US$/bl)	40.0	71.2
GDP Growth(%)	0.5%	1.4%
Inflation (%)	22.0%	34.6%
Oficial Exchange Rate - end of the yea	2.2	2.9
Oficial Exchange Rate - average (VEF/I	2.2	2.8
Total Income	**13.8%**	**26.5%**
Non Oil Income	**9.4%**	**10.5%**
Income tax	2.9%	3.2%
Duty	1.2%	1.3%
VAT	4.3%	4.7%
Others	1.1%	1.3%
Oil Income	**4.4%**	**14.5%**
Income tax	1.9%	6.4%
Duty	2.2%	7.3%
VAT	0.2%	0.8%
Others	0.1%	0.3%
Central Bank profits	0.0%	1.5%
Total expences	**17.7%**	**29.1%**
Primary expences	**15.9%**	**25.8%**
Interests	**1.9%**	**3.3%**
Internal Debt	1.0%	1.8%
External Debt	0.9%	1.5%
Fiscal Balance	**-3.9%**	**-2.6%**
Primary Balance	**-2.0%**	**0.7%**
Fiscal Balance excluding oil income	**-8.3%**	**-18.6%**
Amortization	n/a	**3.5%**
Financial Needs	**3.9%**	**6.1%**
Total Debt	3.9%	5.8%
External Debt	n/a	3.0%
Internal Debt	n/a	2.8%
Others	0.0%	0.3%

Sources: MEF and Ecoanalítica

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Conclusions

So, from what we have presented in this Report one can gather that next year, because it is an election year, public spending will increase significantly which will allow consumption levels to recover. This is good news. But, inflation, the ever increasing deterioration of the infrastructure and public services, and real salaries continuing to drop do not paint such a rosy picture for the coming months.

We still have to see if Merentes-Chacón will continue with their strategy and if it produces the results the Administration is expecting, which more than just lower the gap in the exchange markets, looks to see the BCV having control over the exchange market and generating confidence in the private sector in its control of the swap-market. Furthermore, we still have to see how CADIVI and the new foreign currency budget will work next year. At ***Ecoanalítica***, we believe that if the Administration is able to establish a serious strategy (credible) with respect to exchange policies, this would be very positive for the private sector and the economy in general. The key to achieving this is confidence.

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Another factor that is worrying is the amount of debt the public sector is acquiring. The Administration has been excessively aggressive with respect to its recent borrowing policy, and should adjust this trend for the coming year, especially considering that it has out-of-budget resources available. We are not only worries about the rhythm with which the Administration is borrowing, but also the new role the BCV will be playing, and the fact that entities other than the Republic and PDVSA may be permitted to borrow. Furthermore, the Administration still has not released and/or explained the conditions governing the debt acquired through other countries such as China, Japan, Russia, and Brazil. Though the Administration may still have margin to continue borrowing, too much borrowing too quickly makes the fiscal budget much tighter and less flexible in the medium and long term.

There is no doubt that Venezuela is sitting on a time bomb, though the timer still allows us a bit of time to maneuver. The fiscal adjustments that have been implemented in Venezuela based on repeated adjustments of the exchange rate and permanently cutting back on spending have created a situation of permanent fiscal tension and have been very costly in terms of economic growth and stability in the long term. Adjustments in Venezuela produce cutbacks in public investment, fiscal spending which can't absorb cutbacks, high inflation, and continual impoverishment of the population.

The Administration must understand, in fact, it has the obligation to understand that if it does not change its economic policies, sooner rather than later, the country will be facing very serious imbalances and risk the wellbeing and quality of life of the population.

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	2008	2009F	2010F	2011F
National Accounts				
Real GDP Growth (% Annual)	4.9	-1.1	1.4	2.0
Oil Sector	3.0	-7.8	2.5	2.0
Non Oil Sector	5.3	-0.2	1.4	2.3
Consumption (% Annual)	6.3	-3.1	1.7	2.5
Public Consumption (% Annual)	5.7	1.9	2.2	1.6
Private Consumption (% Annual)	6.4	-4.1	1.6	2.8
Investment (% Annual)	-2.1	-6.0	1.0	1.1
Exports (% Annual)	2.7	-11.6	2.5	3.1
Imports (% Annual)	2.7	-13.1	2.2	2.9
GDP (US$ MMM)	319.4	322.2	266.6	289.7
GDP per Capita (US$)	11,483.3	11,412.5	9,301.9	9,958.1
Population (MM)	27.8	28.2	28.7	29.1
Inflation, Exchange and Interest Rates				
CPI Inflation-National (end of year) (%)	30.9	27.5	34.6	36.1
CPI Inflation (end of year) (%)	31.9	28.3	35.0	36.2
WPI Inflation (end of year) (%)	23.2	34.0	40.1	34.1
Official Exchange Rate (end of year)	2.2	2.2	2.9	2.9
Official Exchange Rate (Average)	2.2	2.2	2.8	2.9
TAM Interest Rate (end of year) (%)	24.2	19.2	22.5	24.2
TAM Interest Rate (Average) (%)	23.2	21.7	20.9	23.4
Lending Rate (end of year) (%)	16.2	12.6	14.0	15.0
M2 (end of year) (VEB Trillions)	196.5	250.0	340.0	450.0
M2 (% Annual)	26.0	27.2	36.0	32.4
Fiscal Policy Indicators				
Fiscal Revenue (% of the GDP)	24.5	20.1	26.5	25.5
Oil Revenue (% of the GDP)	15.0	11.0	14.5	13.7
Non Oil Revenue (% of the GDP)	9.5	9.0	10.5	10.5
Foreign Exchange Profits and Others (% of the GDP)	0.0	0.1	1.5	1.3
Total Expenditure (% of the GDP)	27.4	25.8	29.1	27.0
Primary Expenditure (% of the GDP)	25.4	23.8	25.8	23.4
Interest (% of the GDP)	2.0	2.0	3.3	3.6
Fiscal Balance (% of the GDP)	-2.9	-5.7	-2.6	-1.5
Primary Fiscal Balance (% of the GDP)	-0.9	-3.7	0.7	2.1
Amortization (% of the GDP)	2.7	2.4	3.5	3.9
Government Financing Requirements (% of the GDP) a	5.6	8.1	6.1	5.4
Quasi-fiscal Expenditure (% of the GDP)	6.0	2.5	3.1	2.7
Non - oil Quasi-fiscal Balance (% of the GDP)	-23.9	-19.2	-20.2	-17.9
Debt Profile				
Foreign Exchange Reserves (US$ MMM)	43.2	33.9	33.3	36.4
Total Public Debt (US$ MMM)	60.2	79.5	83.1	83.7
Domestic Debt (US$ MMM)	14.0	23.2	23.0	25.5
Foreign Debt (US$ MMM)	46.2	56.3	60.1	58.2
Total Debt (% of the GDP))	18.8	24.7	31.2	28.9

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