



*Analysis from **THINK TANK***

First-half growth exceeds expectations

EVENT: GDP growth reached 9.3% in the first half of 2005.

SIGNIFICANCE: The growth of the economy this year has exceeded all expectations, largely as a result of renewed political stability and high oil prices. However, substantial questions remain about the quality and sustainability of such high rates of growth. If economic risks are accentuated in the longer term, these may contribute to a spiral of political and economic instability.

ANALYSIS: The Venezuelan Central Bank (BCV) reported on August 18 that second quarter GDP growth reached 11.1%, year-on-year, bringing growth for the first half of 2005 to 9.3%. In the second quarter, growth continued to be stronger in the non-oil economy, up 12.1%; the oil sector grew just 2.5%. Domestic demand is driving current growth:

- Private sector consumption rose by 18.1% over the period, stimulated by improved access to credit, the government raising some salaries, and the impact on disposable income of both the government's social programmes and associated rise in employment -- the number of people employed rose by 3.7% in the first six months of this year.
- Public sector consumption rose by 6.7%, particularly in the fields of defence and education.
- Gross fixed capital formation increased by 41.6%, with public sector construction growing particularly quickly.

Growth outlook. This pattern of exuberant domestic demand is likely to continue well into 2006, generating growth of at least 7% this year, and only slightly lower next year. This will be sustained primarily by rising government expenditure, which, in turn, is partially dependent on high oil prices. Enhanced government access to the BCV's foreign reserves will ensure that even an unexpected sharp downturn in oil prices over the next 18



months would not necessarily lead the government to rein in spending significantly. Nevertheless, the foundations for sustained long-term growth have yet to be laid:

- Private investment in productive capacity remains weak, and dependence on imported capital goods is rising, leading to bottlenecks that are constraining the pace of some of the government's construction and infrastructure programmes. Although the government's courting of foreign public industry investment from countries such as China and Iran may, in the medium term, generate inflows that help alleviate this private investment shortfall, as yet the scale of such investment has been limited.
- The bolivar is increasingly overvalued.
- The government is not saving for future macroeconomic stabilisation.

Record reserves. The rise of the BCV's foreign reserves has continued, as a result of high income from oil exports. These reserves reached 31.6 billion dollars on August 23, including 700 million dollars in the Macroeconomic Stabilisation Fund (FEM) -- down from 11 billion dollars in January 2003. This substantial cushion against any future risk of default was the main contributing factor in the decision by Standard & Poor's earlier this month to raise Venezuela's long-term foreign currency debt rating to B+.

New fund. However, as had been expected following intense pressure from the highest levels of government over recent months, the National Assembly on July 19 amended the BCV Law to enable the government to access 6 billion dollars from the BCV's reserves, in addition to -- from 2006 onwards -- an additional proportion of newly earned foreign currency from oil exports. These will be transferred to a new National Development Fund (Fonden), which will be merged with the opaque Economic and Social Development Fund (Fondespa) operated by state oil company PDVSA, believed to contain about 3 billion dollars. The government will use this new fund to pay for social development and possibly defence projects, or pay off or restructure a proportion of public debt.



However, the passing of this law has several negative ramifications:

- International doubts over the policy of allowing the government to spend Central Bank reserves will affect the perceived credibility of overall economic policy, despite the fact that there is little fiscal risk as long as the oil price remains high.
- Unless the government puts into practice plans to replenish the FEM in the near future, it will increase the economy's long-term vulnerability to any sharp drop in the oil price, which, in turn, could generate public debt repayment difficulties.
- It is another step in the erosion of the BCV's independence, and more generally solidifies further the executive's control over many of the country's key institutions.

Spending plans. Central government expenditure in the first five months of this year rose by 36% year-on-year to 29.1 trillion bolivars (13.5 billion dollars), in part to generate support for the government in the August 7 municipal elections . This spending increase has been made possible through an even faster rise in government revenues. Central government revenues over the period were 39.2 trillion bolivars, 65% higher than in the same period in 2004. This is the result of several factors:

- The most significant factor is high oil prices and hence high earnings from oil royalties and oil-related taxes. The average price of the Venezuelan basket of oil over the first five months of this year was 41 dollars (and has been several dollars higher since then), compared to the 2005 budget estimate of 23 dollars.
- The government has also extended maturities on portions of its public debt to free up cash for current expenditure.
- The value of taxes collected reached 13.4 trillion bolivars over the period, substantially higher than expected.

Total budgeted expenditure for this year is 69.4 trillion bolivars. However, the actual amount is likely to be higher, as a result of spending pressures



generated by the national legislative elections at the end of this year and the availability to the government of the additional funds being obtained from the BCV. In addition to the Fonden, the Central Bank is paying the government 1.6 trillion bolivars in 'foreign exchange profits' for the first half of this year. Preliminary government reports suggest that the 2006 budget will include a 15% annual rise in budgeted expenditure, which seems a conservative estimate, and will be based on the very low assumption of an average price of oil of 25 dollars per barrel.

Liquidity rise. Consumer prices rose by 8.9% in the first seven months of this year, substantially less than the 12.6% registered over the same period of 2004. Continuing price controls on a number of basic goods are limiting consumer price inflation. However, the rise in liquidity in the economy is likely to generate renewed inflationary pressure over the next several months. Liquidity in the economy as of August 5 reached 54.7 trillion bolivars, 19% higher than at the start of this year; it is likely to rise further during the remainder of this year due to the greater-than-expected availability of funds to the government.

CONCLUSION: Over the next 18 months, the government is set to increase further its expenditure commitments, with an eye to legislative elections in December and presidential elections next year. While high oil prices and further government access to Central Bank reserves will prevent problems in meeting these commitments in the short-to-medium term, the government is increasingly likely to find itself overcommitted fiscally in the longer term.

Accord paves way to oil venture

Energy Minister Rafael Ramirez signed a preliminary agreement in Beijing yesterday, through which state oil companies PDVSA and CNPC are to set up a joint venture to drill for oil and gas in the area of Zumano, as well as a study of the Junin 4 block in the Orinoco belt. That preliminary study will be followed by discussions for "a joint project for the production and upgrading of crude, combined with a project to refine in China"; other state oil companies purportedly considering joining the project include Brazilian Petrobras, Russian Lukoil and Gazprom, Spanish Repsol YPF and Indian ONGC. The initiative forms part of ongoing Venezuelan attempts to



diversify export markets and foreign investment sources, not least in the light of continuing conflicts with the United States.