



2003

**Year-end address
president**
The Central Bank of Venezuela

2003

**YEAR-END ADDRESS
PRESIDENT
THE CENTRAL BANK
OF VENEZUELA**



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I	PRESENTATION	5
II	THE INTERNATIONAL SETTING	9
III	ECONOMIC POLICY SUMMARY	11
IV	MAIN MACROECONOMIC RESULTS	13
V	INSTITUTIONAL CHANGES	15
VI	CHALLENGES AND PRIORITIES FOR 2004	17

2003
YE-AR END ADDRESS
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The end of the year is an opportune moment to reflect upon the country's economic and social development. As we noted in the Year-End Address for 2002, according to law, accounts of institutional activities have to be rendered within the first quarter of each year; it would seem convenient, however, to make some comments now even if they have to be based on preliminary figures that will be subject to revision in the first few months of 2004.

We have been through a tremendous upheaval in Venezuela, in the full meaning of the word. The peace, the order of things, and people's opinions have all been disturbed. This upheaval was brought about by a set of non-economic circumstances that had been brewing during the previous year and culminated with tremendous impact in the first few months of 2003 in, among other forms, with a staggering blow to the heart of our economy, namely our oil industry, which, like a tidal wave, almost swept away the country's economic, social and cultural foundations with unimaginable consequences in terms of the population's basic welfare.

The decade of the eighties was called "the lost decade" for the countries of Latin America. Now people are speaking of the "second lost decade", despite the fact that twenty years have passed, and that rather than lost, this period has been catastrophic; not only for the countless economically marginalized sectors in the region, but also for urban professionals and even some sectors of the population involved in the domestic market.

This process is happening throughout Latin America and is related to the market-oriented reforms, which Nobel Prize winner Joseph E. Stiglitz has classified as being a failure in Latin America; among other things, because they expose countries to greater risk, without simultaneously implementing precautionary measures to deal with that risk. The reforms implemented failed to award sufficient importance to the improvement of the public sector, instead they set about reducing it together with the role of the State. More importantly, they generated greater instability and more poverty.

In the case of Venezuela, which since 1999 had been pursuing a more autonomous path, the action of internal and external factors intensified, facilitated without a doubt by the openness of the Venezuelan economy, which left it more exposed to the complex interplay of international and transnational relations.

This exposure, or vulnerability, is clearly apparent in the effects the market-oriented reforms had on the Venezuelan economy. The Human Development Index for Venezuela, as estimated by the Central Office of Statistics and Information (*Oficina Central de Estadística e Informática* –OCEI by its Spanish acronym), has declined since 1992, mainly due to the deterioration of the income component of this index (measured as purchasing power parity in US\$), the relative weight of which is greater than the life expectancy and educational achievement components, which have actually improved since 1999.

I/ PRESENTATION

The recent disturbances experienced by the Venezuelan economy made 2003 an extremely complicated year, and a huge effort had to be made to halt the fall in Gross Domestic Product, curb inflation and, as far as possible, reduce unemployment

The most notable positive signs were the preservation of the country's external payment capacity and the comfortable level of international reserves, after facing a drop in oil income and considerable capital flight at the beginning of the year

Banco Central de Venezuela (BCV) directed its efforts towards reducing the inflationary pressure generated by the monetary imbalances recorded during the year. A strategy was therefore developed to keep the growth of the monetary aggregates within pre-established ranges and to pave the way for a gradual reduction of interest rates

Evolution of the Human Development Index in Venezuela, 1990-2002

Year	Life expectancy	Life expectancy component	Literacy rate	Combined matriculation rate	Educational achievement rate	Income \$PPP (1)	Income component \$PPP	H.D.I.
1950	55,19	0,5032	50,96	27,59	0,4317	2.520	0,4474	0,4607
1960	58,06	0,5510	63,30	45,26	0,5729	3.896	0,7128	0,6122
1970	63,85	0,6475	75,92	49,87	0,6724	4.074	0,7471	0,6890
1980	67,70	0,7117	84,73	58,23	0,7590	5.349	0,9931	0,8213
1990	71,20	0,7700	90,90	(2)	0,7302	5.192	0,9628	0,8210
1991	71,20	0,7700	90,90	62,31	0,7302	5.192	0,9771	0,8210
1992	71,20	0,7700	90,90	62,56	0,8145	5.241	0,9722	0,8522
1993	71,20	0,7700	90,90	60,86	0,8089	4.910	0,9084	0,8291
1994	71,20	0,7700	90,90	61,24	0,8101	4.329	0,7963	0,7921
1995	72,38	0,7897	90,90	57,94	0,7991	4.157	0,7632	0,7840
1996	72,38	0,7897	90,90	60,35	0,8072	2.672	0,4767	0,6912
1997	72,57	0,7928	90,90	61,63	0,8114	2.858	0,5126	0,7056
1998	72,8	0,7967	90,90	60,12	0,8064	2.647	0,4720	0,6917
1999	72,94	0,7990	90,90	63,38	0,8173	3.284	0,5947	0,7370
2000 (3)	73,34	0,8057	90,90	64,12	0,8197	3.477	0,6320	0,7525
2001 (3)	73,53	0,8088	92,98	67,25	0,8440	3.739	0,6826	0,7785
2002 (3)	73,72	0,8120	92,98	69,06	0,8501	2.336	0,4120	0,6914

Source: Human Development Index and Situation in Venezuela, 1990/OCEI
 Human Development Index and Situation in Venezuela, 1999/OCEI
 Human Development Index and Situation in Venezuela, 2000/OCEI
 Human Development Index and Situation in Venezuela, 2001/OCEI

Note: (1) Does not include domestic service.
 (2) For the educational achievement component, the mean value of education was used (5.59).
 (3) Preliminary figures.

Process: Own calculations. Living Conditions Indicators Unit,
 Division of Social, Demographic and Environmental Statistics
 National Statistics Institute (INE by its Spanish acronym)

Summary of economic indicators related to opportunities, stability and solvency

	2003	2002	2001	Average 1994-2003
Opportunities				
Growth in per capita GDP (%) (1)	(11.7)	(10.8)	0.7	(3.1)
Private sector credit (% Total credit)	42.9 (a)	64.4	73.1	72.7
Real lending rate (%)	(0.2) (b)	24.3	22.0	7.5
Real borrowing rate (%)	(7.3) (b)	13.3	13.7	(2.7)
Export growth rate (US\$ current)	(12.4) (c)	(1.9)	(19.0)	7.0
Open unemployment rate (%)	16.7 (a)	16.2	12.8	12.3
Real minimum wage (Bs.) (1)	726.5	697.5	759.7	655.9
Public spending on education/GDP (%) (2)	4.4	4.6	4.7	3.8
Stability				
Inflation (variation in annual terms)	26.1 (b)	31.2	12.3	40.1
Trade surplus/GDP (%)	14.5 (c)	13.4	9.0	10.7
Current account surplus/GDP (%)	9.3 (c)	7.4	3.8	5.2
Real effective exchange rate index (Base: 1997=100)	91.9 (c)	86.4	57.5	94.9
Central government deficit/GDP (%)	(5.1) (d)	(4.8)	(4.7)	(3.2)
Solvency				
Gross international reserves of the BCV (months of imports)	23.3 (c)	11.7	8.5	14.1
Domestic debt/GDP (%)	16.9 (d)	13.7	11.5	10.0
External debt/PIB (%)	24.8 (d)	25.9	17.2	31.2

- (a) Figures for October.
 (b) Figures for November.
 (c) Figures for January-September.
 (d) Year-end estimates.

- (1) Calculated on the basis of constant prices (Base: 1984=100).
 (2) Corresponds to the spending agreed by the Ministry of Education, Culture and Sport.
 Source: BCV, INE. Own calculations.

Generally-speaking, the evolution of the income component of the Human Development Index is linked to: economic growth and increased opportunities; solvency in the country's external accounts; fiscal solvency and public spending, and the cost of living and family income levels. In this respect, the figures in the second table show macroeconomic evolution in terms of opportunities, stability and solvency, which are self-explanatory.

The disturbances the Venezuelan economy went through in 2002 made 2003 an extremely complicated year, and a huge effort had to be made to halt the fall in Gross Domestic Product, curb inflation and reduce unemployment. Furthermore, all this had to be achieved within a climate of democracy, with respect for human rights, including the right to own property, and unrestricted freedoms, especially freedom of speech, and despite the fact that the tension generated was seriously affecting both the economy and society in general.

There were some positive signs: despite facing a drop in oil income and significant capital flight at the beginning of the year, the country managed to preserve its external payment capacity and maintain its international reserves at comfortable levels.

In this context, Banco Central de Venezuela (BCV) directed its efforts towards reducing the inflationary pressure generated by the monetary imbalances recorded during the year. A strategy was developed to keep the growth of the monetary aggregates within pre-established ranges and to pave the way for a gradual reduction of interest rates.

It should be pointed out that, in the awareness of the fundamental role it has to play, BCV, in the face of the challenges the determining factors of the socio-economic, political, legal and technological setting pose to its performance, also continued to pursue a series of institutional and organizational changes that will enable it to generate the capacity needed for it to function properly in a changing environment and establish itself as an efficient and creative organization that performs its tasks with a sense of responsibility, commitment and excellence.

Although the third and fourth year of the new millennium have been marked by international terrorism and its considerable geopolitical impact, world economic growth for 2003 is expected to be 3.2%, similar to the rate recorded for 2002, despite predictions of a slightly higher rate at the beginning of the year and the persistent uncertainty of the world situation. As a whole, the advanced economies continued to record slow growth (1.8%), particularly in the euro zone (0.5%). The United States economy, on the other hand, recorded rapid growth during the third quarter that was much higher than its growth in the preceding one, and this had a positive effect on the other economies in the world.

The differences in monetary policy management and the asynchronous nature of the economic cycle reveal a noteworthy difference among the developed countries. In the euro zone, the Central European Bank has implemented a relatively restrictive monetary policy, aimed basically at consolidating its achievements in the area of inflation control and at maintaining its credibility. This has attracted capital and contributed to the appreciation of the euro. The United States, on the other hand, has implemented expansive monetary and fiscal policies combined with exchange policies that have led to the depreciation of the dollar.

At the same time, the geopolitical tensions affecting oil prices pushed these up during the year to an average of US\$/b 4.52 for OPEC, WTI and Brent crudes. Low inventories in the main consumer countries, together with the uncertainty surrounding the sustainability of production in some OPEC countries and the growing demand of the People's Republic of China, also contributed to international oil prices remaining high throughout the year.

As in 2002, developing countries continued to increase their participation in gross world product, with India and China in Asia, and the Middle East recording the most significant results in this respect. China's economic growth was particularly beneficial for some Latin American countries that have been increasing their exports, especially of raw materials, to that country.

According to the Economic Commission for Latin America and the Caribbean (ECLAC), GDP in Latin America and the Caribbean is expected to grow 1.5%. The economic crisis affecting the region, however, has meant that the trend of economic stagnation has still not been reversed, and per capita GDP continues to be lower than in 1997. The slackening of the pace of the advanced economies' growth has been one of the factors behind this stagnation. Basic product prices recovered in 2003, however, compared with 2002, and this marks the end of the steady decline in the terms of trade that has been recorded since 1998.

Unlike in the preceding year, capital flows were more favorable in 2003, with countries obtaining funds in the markets at costs that were on average lower than in 2002. Government securities also recovered, and capital flight abroad slowed down. According to preliminary ECLAC reports, foreign direct investment fell to 29 billion dollars, far below the level recorded for 2002. ECLAC points out that, after half a century without recording any current account surpluses, the region obtained a surplus of around 6 billion dollars in 2003. Latin America and the Caribbean is still facing limitations as far as investment and long-term growth are concerned, however, due to the lack of external savings and the low levels of domestic savings.

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The unfolding of political and economic events in Venezuela throughout 2002 worsened the country's macroeconomic imbalances, and this made it necessary to change the economic policy strategy initially drawn up for 2003. Although at the end of 2002 it had been agreed to maintain the free floating exchange scheme, the impact of the Venezuelan oil and production shock in January 2003 increased inflation and depreciation expectations and the pressure on the country's international reserves. This made it necessary to modify the exchange scheme and implement exchange controls in order to recover the country's external equilibrium, despite the effects this would have on international transactions and consequently on economic activity in Venezuela in general.

With the new exchange rules in place, the role of monetary policy was limited as far as reining in inflation was concerned. This situation was the natural result of monetary sterilization through exchange control and the subsequent increases in the money supply. In this context, BCV redirected its interest rate policy towards a gradual reduction in interest rates, by keeping open the possibility of surpluses in the money supply being absorbed through open market transactions.

In the implementation of this strategy, BCV took into account that a sudden drop in interest rates could trigger a rise in inflation, excessive growth of the country's monetary aggregates and a drastic decline in the yield of the financial system's investment options. These variables were therefore constantly monitored throughout the year, and care was taken to check that the monetary aggregates did not rise substantially above the established levels of reference.

At the same time, the temporary halt in the flow of oil income and the drop in internal tax revenue, heightened the fiscal imbalance recorded during the year, making it necessary to obtain significant amounts of financing by other means. This was basically achieved by issuing public debt securities on the domestic market and was facilitated by the large monetary surplus generated by the exchange controls that had been implemented.

As a result, public debt has ended up representing a significant portion of the financial system's assets. This means that the country could find it increasingly difficult to service its public debt due to the structural weaknesses in the Venezuelan economy regarding its capacity to achieve sustained growth and generate sufficient primary surpluses to do so.

The ensuing imbalances in the markets and the belief that devaluation would have the unwanted effect of driving up domestic prices, led the government to also impose price controls on a set of goods and services deemed to be of prime necessity that make up 50.7% of the basket of goods used for calculating the Consumer Price Index (CPI) in Venezuela.

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The impact of the supply shocks caused by the partial paralysis of the production sector, and the oil sector in particular, at the beginning of the year, together with the effects of the subsequent exchange and price controls, deepened the crisis in the Venezuelan economy, a crisis which has meant a fall in Gross Domestic Product (GDP) in annual terms over nine consecutive quarters. It should be pointed out, however, that since the second quarter of 2003, there have been some signs of recovery, especially in the oil, manufacturing, construction, transport, electricity and financial services sectors. This inter-quarterly surge in economic activity was brought about by a rise in private sector consumption, investment and export levels, and as a result, unemployment fell to below the levels recorded in the first part of the year.

According to the preliminary figures available, in the third quarter, GDP shrank 7.1% in annual terms, compared with contractions of 27.7% and 9.4% in the first and second quarters, respectively. This meant that during the period January to September 2003, GDP recorded a greater drop (14.7%) than it had over the same period in 2002 (6.2%). One of the notable elements of this decline in GDP was the 47.0% drop in investment. If this downward trend in investment continues, Venezuela's possibilities of attaining sustained economic growth could be severely limited.

The decline in domestic economic activity also had a negative effect on the demand for credit in the private production sector despite the drop in the lending rate in 2003. Nominal lending and borrowing rates in the financial market dropped 14.1 and 12.6 percentage points, respectively, and stood at 19.7% for the lending rate and 14.5% for 90-day deposits on December 19, 2003.

In November 2003, the inflation accumulated by the CPI was 24.8%, less than for the same period in 2002 (29.9%). This figure has been largely determined by the rise in the prices of uncontrolled items, which rose by 35.7% in the course of the year, compared with 16.0% for items subject to price controls. The accumulated variation in core inflation was 35.4%, which reflected the higher inflation recorded in goods that are not subject to price controls or seasonal variations.

Accumulated inflation up to November, as measured by the Wholesale Price Index (WPI), recorded an accumulated variation of 45.3%. This figure was affected in the last three months by the trends in goods of national origin whose prices varied more than those of imported goods. The Producer Price Index (PPI) meanwhile recorded an accumulated variation of 31.8% over the same period.

The country's international reserves (BCV and FIEM), on December 19, 2003, amounted to US\$ 20.596 billion, which represents a US\$ 5.736 billion increase compared with the figure for the end of 2002. This was to some extent due to the operational delay in the distribution of foreign exchange, which had a negative effect on imports, and the lower level of economic activity recorded during the year, while oil income remained relatively steady despite the significant drop in this income at the start of the year.

Preliminary figures for the period January to September 2003 show that the balance of payments recorded a surplus of US\$ 6.955 billion thanks to the drop in imports (33.3%) and improvements in the export sector. The deficit recorded by the country's capital and financial accounts (US\$ 1.949 billion) was lower than in the previous year.

Since the second quarter of 2003, there have been some signs of recovery, especially in the oil, manufacturing, construction, transport, electricity and financial services sectors

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As far as the exchange rate is concerned, despite the implementation of exchange controls prohibiting capital transactions, the negotiations of the debt securities that are issued by the Republic in United States dollars but made payable in bolivars, suggest that there is a significant gap between the official exchange rate and the one implicit in such operations, and corrective measures will have to be adopted as a result.

In any case, Venezuela's high level of international reserves, the fact that oil prices remained within the range established by OPEC, and the positive impact of the debt management strategy together created conditions that enabled the country's investment risk-rating to be improved, as evidenced in the adjustment made to the risk classification of the country's long term bond issues.

In order to meet its objectives, BCV has adopted a performance model that reflects the necessary articulation between its autonomy to formulate and implement the policies that fall within its realm of competence and the internal effectiveness of its activities in macroeconomic coordination, with the basic principles underlying its pursuits being transparency, accountability and public responsibility.

This has meant that, in order to fulfill its mission, BCV has devoted part of its efforts not only to coordinating its actions with the government, but also to building the capacities and architecture needed for its work to be effectively coordinated in such a way that it increases the well-being of each and every one of the Venezuelan people.

We have therefore paid special attention during the past year to some factors that we consider to be essential to the success of the country's monetary and exchange policies as well as the BCV's performance as an institution.

In regard to the former, measures were taken to strengthen the BCV's institutional infrastructure for handling macroeconomic coordination; to guarantee the continuity of monetary policy in light of its objectives; and to design and implement the BCV's functions in a global, impartial, objective, responsible, transparent and credible way, without benefiting any one sector in particular, but instead by acting according to the objectives and commitments assumed, by providing timely information on the execution of monetary and exchange policies, policy decisions and their underlying principles, the results obtained and the reasons behind them, and by making these messages coincide with the BCV's performance.

As far as the various aspects of the BCV's institutional performance are concerned, the most noteworthy are: the autonomous performance of the duties and functions assigned it by law that was, however, also coordinated with the corresponding government entities; the legitimacy and continuity achieved by ensuring the constant fulfillment of its objectives and its internal policies; the improvement of its technical image; the respectability and credibility it earned in national and international spheres; the human resources at the BCV with their technical, managerial and personal skills, whose values coincide with those of the institution; and the improvement, development and constant updating of the BCV's information processes, systems and applications, its organizational structures, and the material and equipment it needs to fulfill its mission.

It should also be pointed out that the guiding principles of the BCV's activities have led to the organization of Banco Central as a more transparent institution that is accountable and fully assumes its responsibilities with respect to society at large. There has also been a notable increase in the quantity and the quality of the information BCV publishes for various audiences about its operations, policies and performance, to thereby provide direct and regular accounts of its functions, responsibilities, acts and decisions.

To name but a few examples, our website publishes, among other items, regular features, working papers, research reports, notebooks containing technical and educational information, statistics, and financial balances and statements. To our great satisfaction, in 2003 our website was, for the second year in a row, the winner of the "Lo Mejor de Punto Com" (the best of dot com) award in the state institutions category.

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BCV has drawn up a permanent agenda designed to facilitate dialog and agreement between the BCV and government representatives and promote the strengthening of the institutions involved in macroeconomic coordination and research

The effectiveness of monetary policy in Venezuela, in terms of stabilizing prices and preserving the value of the currency, has been limited by several factors: persistent macroeconomic imbalances; institutional weaknesses and flaws in the process for coordinating fiscal, exchange and monetary policies; political vulnerability, and the lack of awareness in society of the importance of price stability being understood as a public asset. In this respect, it is essential that the right balance among the various policies be found and for them all to be focused on furthering human development (that is democratic by nature) and the pursuit of economic growth with equity.

In this context, the BCV has drawn up a permanent agenda designed to facilitate dialog and agreement between the BCV and government representatives and promote the strengthening of the institutions involved in macroeconomic coordination and research with a view to ensuring that the technical and organizational capacities required for handling the Annual Policy Agreement are in place when, in 2005, the agreement becomes binding and not merely indicative.

This agenda also aims to concentrate the BCV's activities on its core functions, spread economic-financial knowledge and promote innovation and adaptability in its management, administration and control practices.

Our task at BCV is to continue to make progress in the resolution of difficult and complex situations and to renew our efforts and apply formulae that will enable us to achieve our objectives.

One of the opportunities Venezuela could face in 2004 depends on the world economic situation continuing to improve. This would provide the country with a relatively steady flow of oil income. Venezuela must, however, undertake every effort to make itself an acceptable risk for investors, not only in order to obtain financing, but also in order to attract direct investments to complement internal investment.

2004 is a year in which agreements must be forged so that economic activities can be carried out in a more favorable climate. The Venezuelan economy has significant potential, and this makes it imperative to strive to put together an economic policy that will provide the population with the greatest possible amount of well-being. This responsibility is shared among the authorities and the other actors in the economy and should be translated into a joint effort to attain stability and stimulate the human development the country seeks.

For this to happen, the macroeconomic balances will have to be restored, which means promoting improvements in public finances and introducing reforms that will guarantee fiscal sustainability in the medium and long term. It will also be essential to create a climate of confidence that paves the way for investment initiatives in the production sector that contribute towards the economy achieving sustained and stable growth and the creation of more jobs.

In this context, BCV reaffirms its commitment to take all the actions necessary to attain the balances required in the medium term; to create the monetary and credit conditions that will enable the economy's financing needs to be addressed, and to guarantee the country's external solvency. These monetary policy efforts to stabilize the economy will require effective coordination with the country's other economic policies, especially its fiscal policy.

With a sustained economic growth that allows sufficient primary surpluses to be generated to service the new debt, the Venezuelan economy will be less dependent on the viability of public finances. This attains greater importance in light of the fact that, as of 2005, compliance with the macro-fiscal regulations established in the legislation currently in force will become obligatory.

Certain events and results in the past year do provide some signs of hope. The return to reality and the democratic fold of groups that had been pursuing their aims through unorthodox tactics and confrontations, and the clear demonstration of the civic maturity of the citizens of Venezuela, who expressed their rejection of such pursuits, are highly encouraging signs on the political and social front. The efforts underway in the country in the fields of education and health, as basic components of human development, are also motivating. In the same way, it is gratifying, in the economic arena, to note the marked improvement in the country's risk classification, as well as its new debt profile, the slow-down of inflation and the country's comfortable situation as far as international reserves are concerned. All of these achievements are creating a framework for overcoming the country's difficulties and steering it and the population towards more advanced stages of development.

Diego Luis Castellanos E.

Caracas, December 29, 2003

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Este Mensaje de fin de año
del Presidente del BCV
se terminó de imprimir en Caracas,
Venezuela,
en los talleres
del BANCO CENTRAL DE VENEZUELA,
durante el mes de febrero
de dos mil cuatro.