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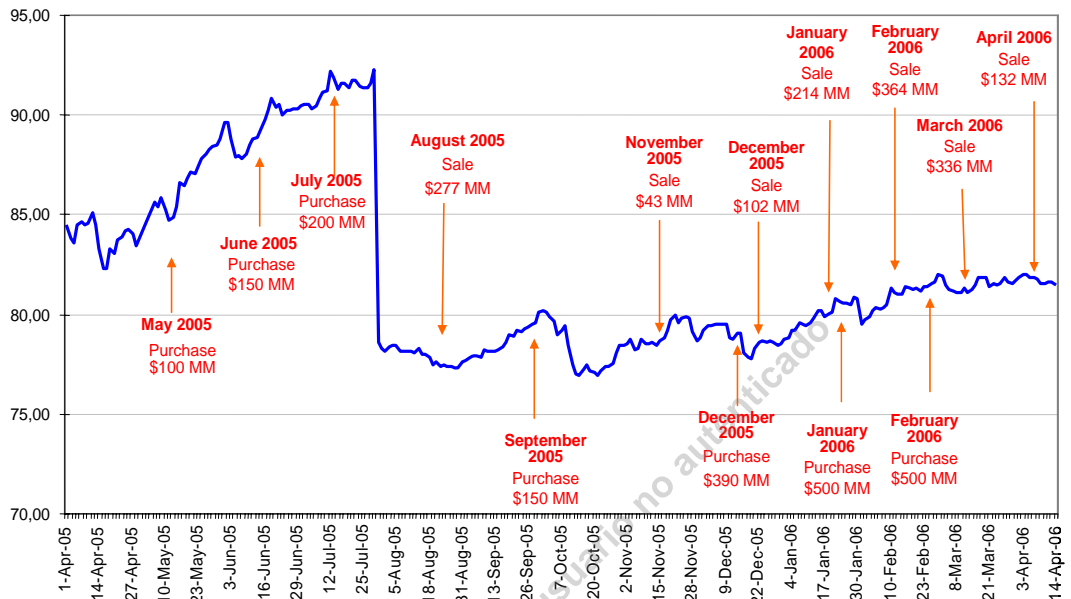
## *Operations with Argentine bonds: juicy profits for a few*

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### **THE CLIENT**

In April, the Ministry of Finance acquired US\$2.30 billion in Argentine bonds: US\$2.00 billion maturing in 2012 (Bonden12) and US\$300 million in 2015 (Bonden15). An amount of US\$1.47 billion was sold and US\$821 million were conserved in portfolio. Although the price of Argentine bonds has not risen since their purchase, the ministry claims that these trading operations "have resulted in profits of US\$119 million." Where do these profits come from? What is the ministry's real intention with the Argentine bond trading?

## BODEN12's Price



**Purchases BODEN12: US\$1.990 Millions.**  
**Sales BODEN12: US\$1.468 Millions.**  
**Profit BODEN: US\$119 millions.**

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**Structural deficit on the private-sector capital account likely to put upward pressure on parallel exchange rate**

As we have often commented, the Venezuelan private sector has a structural deficit on its capital account. More economic agents want to buy foreign currency, than are willing to sell. In the exchange control regime, the demand for foreign currency on the parallel market is higher than supply, which pushes the parallel rate up. This effect has not been felt so far because the Executive has found a variety of ways of selling dollars to the private sector.

**The Executive has maintained a parallel exchange rate for Venezuelan debt operations and the sale of Argentine bonds**

The two main mechanisms that the government uses to sell currency to the parallel markets are placement of Venezuelan debt and, more recently, Argentine debt denominated in dollars, but which can be paid in bolivars. The private sector simply buys the debt bonds at lower than market price, and then sells them at market prices to obtain the currency. The resulting exchange rate depends on the buying and selling spread of the bond in question. The Executive simply arbitrages the spread between the official rate (2.150 VEB/US\$), and the parallel rate (average 2.550 VEB/US\$). At the start these operations were with new issues of Venezuelan debt, but with the increase in borrowing, the Executive decided to act as intermediary for the debt of other

countries, for the time being with Argentine debt. In our opinion, due to the advantages offered by placements of the debt of other Latin American countries, the number and frequency of Venezuelan debt placements will decline.

### **The profit on Argentine bond trading comes from the exchange differential**

According to the Ministry figures, the government has acted as broker for US\$1.47 billion in Argentine bonds. To simplify, we assume that the bond price does not change and that they do not earn interest<sup>1</sup>. The ministry bought the bonds at the official rate, at a cost of VEB 3.2 trillion. If they were then sold at the average parallel rate (2,550 VEB/US\$), the proceeds would be VEB3.8 trillion, with a profit of VEB0.6 trillion or US\$273.3 million.

### **Most of the profit has stayed in the hands of "friendly" banks.**

If the Ministry only reports profits of US\$119 million, that means that the rest, US\$154 million, is in the hands of the financial system. A simple calculation reveals that the bonds that the Ministry bought at the official rate were sold at an average rate of 2,324 VEB/US\$, which generates a gain of VEB174 on each US dollar brokered. The financial system bought the bonds at this average rate to sell them later at an average of 2,550 VEB/US\$, giving a profit of VEB226 per US\$.

### **Either scrap exchange controls or make the award mechanisms transparent.**

This arbitrage rate is simply the result of the structural characteristics of the Venezuelan economy and exchange controls. Obviously the priority recommendation is to dismantle exchange controls so that the dollar can move again according to the free play of supply and demand. With high world oil prices and low expectations of devaluation, this is the best time to dismantle exchange controls. But if President Chávez, for political reasons, wants to continue controlling the capital account, *Ecoanalítica* recommends more transparency and a public award process, or better still auctions. Handing out windfall profits of US\$154 million, as the ministry has been doing, is a clear source of corruption.

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<sup>1</sup> Since prices have moved up slightly and the bonds are earning interest, the profit calculation would be higher.

## Economic Tips

**FONDEN tops US\$13.00 billion.** Finance Minister Merentes cleared up a few things about FONDEN (which only he can do). The Fund holds US\$13.00 billion, including the latest transfer of international reserves of US\$1.70 billion in April. An amount of US\$550 million is still pending transfer from the international reserves. Merentes confirmed that PDVSA would continue its weekly transfers of US\$100 million.

**Execution by FONDEN is increasing.** The government has used US\$4.50 billion from the Fund to finance projects and debt repurchase (approximately US\$1.00 billion), a 35% execution rate. The use of these resources has speeded up from only 15% at the end of 2005. According to the Ministry, most of the funds are earmarked to the sectors of energy, infrastructure, basic industries, mining and agriculture. The rest go to health, housing, defense and finance.

**The FONDEN funds are spent domestically and abroad.** With the setting up of FONDEN and the initial transfer of reserves, the central government said it would spend the funds abroad to reduce the monetary impact. In fact, official information reveals that a large part of these resources are being spent domestically, with the inevitable expansion of the monetary aggregates. This type of parallel mechanism has limited the degree of freedom of the Central Bank to conduct monetary policy.

**May is the thing.** The repurchase of foreign debt will conclude in mid-May, one month early, according to Minister Merentes, leaving only 10% of Brady bonds to be repurchased. By the end of this month, the government will have repurchased approximately US\$4.80 billion in Brady bonds. Merentes did not clarify the situation of the debt with the multilateral organizations.

**Monetary policy has to change.** The Central Bank has recently ceased to publish its balance sheet. The reasons are the capital losses suffered by the monetary authority due to the cost of monetary policy and the transfers of the international reserves. Aside from the capital losses, current monetary policy is unsustainable. The Central Bank, in coordination with the Finance Ministry, has to design a new strategy that includes an overhaul of exchange control and fiscal policy.

**Monetary reform reemerges.** Just when we thought that the government had shelved this project, Rodrigo Cabezas, chairman of the National Assembly finance committee, said that monetary reform was coming and that the Central Bank was currently carrying

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out a technical study. **Ecoanalítica** is skeptical about the effectiveness of this measure. It is not just a matter of taking zeros off the bolivar, monetary reform has to be accompanied by fiscal, monetary, exchange, and even commercial policy measures.

**Seniat receipts rising.** According Seniat, receipts from non-oil revenue in the first four months were VEB17.4 trillion. In April taxpayers contributed VEB5.2 trillion. In 2006 Seniat hopes to collect VEB50.00 trillion, a highly feasible target which could even be overtaken.

**Now it's G3's turn.** President Chávez said that Venezuela may leave the Group of Three formed by Colombia, Mexico and Venezuela. This could only be justified on strictly ideological but not commercial grounds, as President Chávez himself recognized.

### Oil Tips

**New oil tax.** President Chávez announced a new levy known as the oil extraction tax. This tax, whose calculation and collection is identical to the royalty, would provide the State with 33.3% of the value of each barrel extracted in the oil industry. The joint ventures will not have to pay more tax because, with the traditional royalty and the extraordinary royalty which goes to the regions, they are already paying this amount. PDVSA will have to pay 3.3 additional points because its royalty rate is only 30%. The hardest hit are the Orinoco Oil Belt operating agreements, whose royalty payments jump from 16.7% to the 33.3% stipulated in the Law. However, for these companies the price is based on the low quality oil that the companies produce, not on the high quality synthetic product that they market. Chávez added that income tax would be increased to 50% in all the oil business including the extra-heavy crude projects of the Orinoco Belt which pay only 34%.

**Feeble increase in oil production.** According to a survey by Bloomberg, Venezuela increased oil production in April by 30,000 barrels a day to 2.67 million. OPEC (including Iraq) produced 30.1 million barrels a day in April, an increase of 290,000 barrels between March and April.

**Production by operating agreements fell 19,300 barrels a day in March from October.** It would be interesting to look at the trend in the last two months but the figures are not available. **Ecoanalítica** believes that this downward trend will continue

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throughout the year because of the migrations to joint ventures. The private oil companies warned that since July 2005 total production had fallen 7.8% to 37,600 barrels a day.

**Belt production has also fallen.** Average production in the Belt from the four strategic associations dropped from 625,147 bpd in October to 589,955 bpd in March, down just over 35,000 bpd. This fall, also recognized in the International Energy Agency report, has been attributed to the shutdown of the Cerro Negro upgrader, whose maintenance, originally planned for the beginning of the year, was delayed until March.

**Price of basket falls.** The Venezuelan basket of crude and products fell this week 35 cents to average US\$62.48 per barrel. So far this year the average price of the Venezuelan basket is US\$55.30 per barrel.

**National Assembly approves the agreements.** The National Assembly unanimously approved the 21 agreements that will convert the operating agreements into joint ventures with an average 63% State equity. According to Deputy Mario Isea, chairman of the hydrocarbon subcommittee, the agreements were not submitted to the full session until business plans for each of the new joint ventures were approved. This is the reason for the delay in final approval. The government deadline for the joint ventures was the end of the first quarter. *Ecoanalítica* expects that the agreements approved by the Assembly could be signed in the next few days.

**Investments in non-oil business.** According to Corporación Venezolana de Petróleos, PDVSA subsidiary, the joint ventures will invest approximately US\$70 million in strengthening the endogenous development nucleuses. CVP President Eulogio Del Pino explained that this was consistent with the new policy for joint ventures, which is to settle the social debt of the State with the Venezuelan people.

**Eni gets paid.** PDVSA paid Eni VEB50 billion, even though the operator has a precautionary embargo on its accounts receivable from the industry. The amount relates to the fees for the first quarter of this year which PDVSA owed the Italian operator. The government has said that, although the investments in the agreement will be recognized, the Company will not be compensated for losses.

**Crisis at the pump.** Service stations will begin applying restrictions on operations if the Energy and Oil Ministry does not respond to their repeated requests for an adjustment of trading margins. So far the ministry has not taken a decision on this matter.

## Sectoral Tips

**British and Spanish landowners get preferential treatment.** The National Land Institute (INTI) agreed to pay VEB6.80 billion in compensation to 12 producers of Spanish descent who owned properties in Yaracuy state with a total area of 1,154 hectares. This type of agreement had been reached in the past with British citizens in a similar situation, after diplomatic pressure.

**Unpropitious investment climate.** According to a study by the Economic Commission for Latin America and the Caribbean (ECLAC/CEPAL), only a few Latin American countries have been successful in attracting foreign investments into the region, despite government efforts to create a favorable climate. ECLAC recognizes that in the era of globalization, foreign direct investment is a crucial factor for economic development. The study recommends that Latin American countries forge closer ties with Spain, which is now the leading investor in the region, while keeping in mind China and South Korea, which are increasing their foreign investments.

**Bill to regulate public services.** The National Assembly could be preparing a Public Services Framework Bill. The substance of the measure is that the State would guarantee citizens "the right to public services and the freedom to use them or not." In the section on the electricity sector, the new legislation establishes that the State will promote competition in the electricity service where necessary and will regulate monopoly situations where free competition does not guarantee the efficient service on economic terms.

**Regulating the informal sector.** The Ministry of Finance will hold a series of extraordinary meetings with representatives of the private sector, the National Guard, the Public Prosecutor and Seniat to evaluate what public policies can be adopted to tackle the problem of the informal economy and integrate these workers into the formal sector. In the long run, Seniat would like to have the informal workers give receipts and pay taxes, but ruled out applying a special single tax in the short or medium term.

**Vehicle sales slow down.** Total sales of new automobiles ended April at 19,695 units, a paltry 2.2% increase from April 2004, but a 20.1% drop from March. Sales in January to April totaled 85,957 units, up 38.9% from the 61,905 units sold in the same period 2005.

## ***Weekly Report***

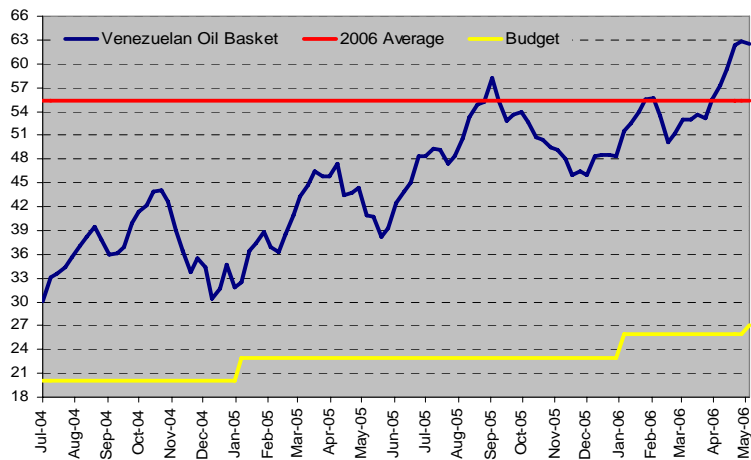
**CEMEX to pay dividends and issue paper.** One of the highlights of the shareholders' meeting of CEMEX Venezuela was the declaration of a cash dividend of VEB120 per share. The deadline for the transaction is May 12 this year. The meeting also approved an issue of commercial paper.

**Conviasa President named.** President Chávez moved the Conviasa state airline to the Ministry of Infrastructure (from Tourism) and named José David Cabello as president. Cabello had been director general of Maiquetía International Airport Autonomous Institute for last three years.

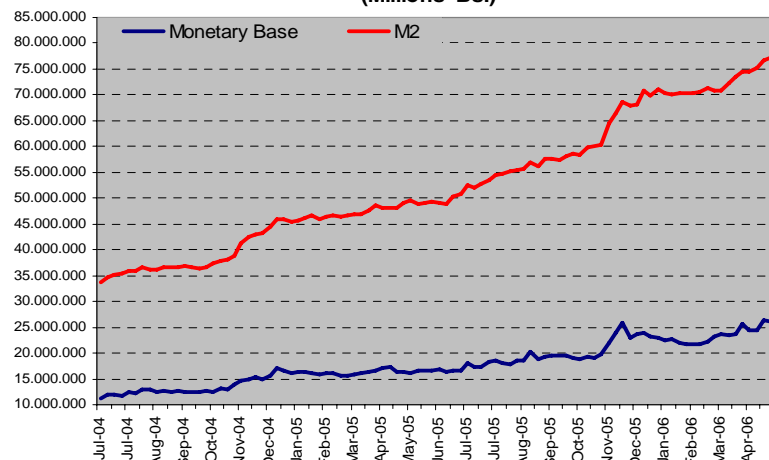
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# ECONOMIC OVERVIEW

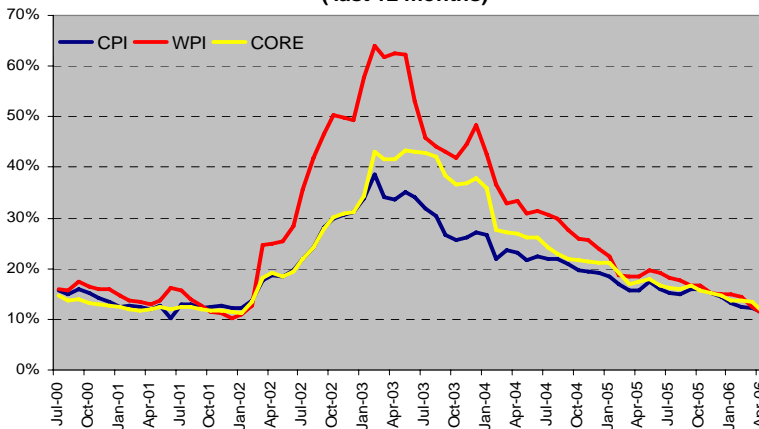
**Oil Price**  
(Venezuelan Basket US\$pb)



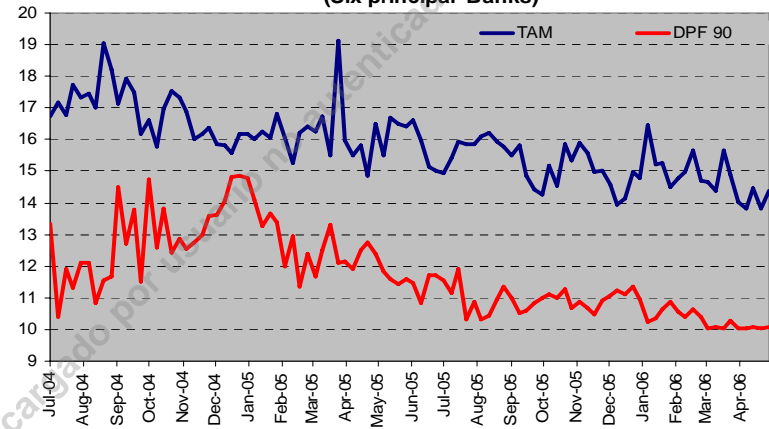
**Monetary Base & M2**  
(Millions Bs.)



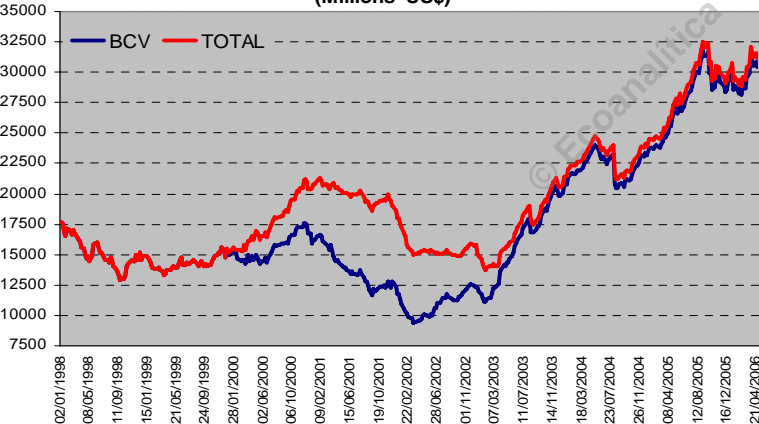
**Inflation**  
(last 12 months)



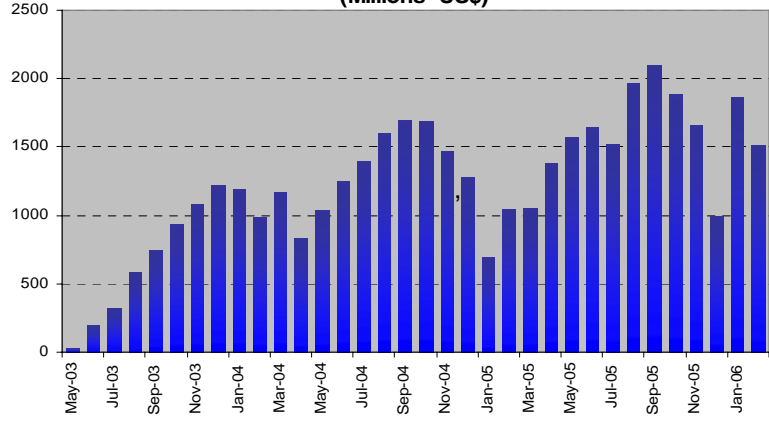
**Interest Rate**  
(Six principal Banks)



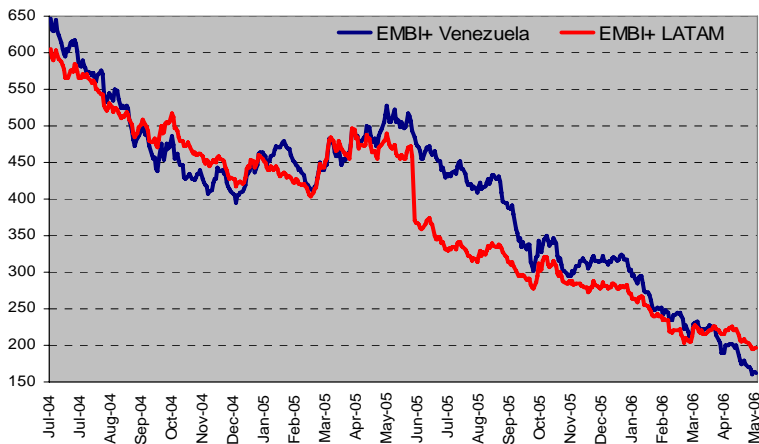
**Fx Reserves**  
(Millions US\$)



**Disbursement**  
(Millions US\$)



**EMBI**



**Central Government**  
(Billions US\$)

