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## *Positive plan to reduce public debt and improve its conditions*

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### **THE CLIENT**

In March the Finance Ministry announced a plan to reduce the foreign public debt and improve the conditions of the domestic debt to smooth out the debt maturity profile and improve debt service. At **Ecoanalítica** we have repeatedly said we disagree with a fiscal strategy based on spending all the windfall resources from high oil prices at the same time as increasing debt levels. We see using the increased revenue to reduce and improve the public debt profile, in an environment of controlling the capital account, as very positive.

**Internationally, the ministry is planning the early repurchase of US\$4.75 billion of foreign debt**

According to the ministry, the repurchase timetable should be 99% completed by May 18, a decrease in foreign debt from US\$31.06 billion at the end of 2005 to US\$26.31 billion at the end of May. In terms of output, the foreign debt is reduced from 23.4% to 16.4% of GDP; consequently both the reduction of the numerator and the increase in the denominator in dollars are due to economic growth and real appreciation of the currency. The ministry is hoping to reduce debt

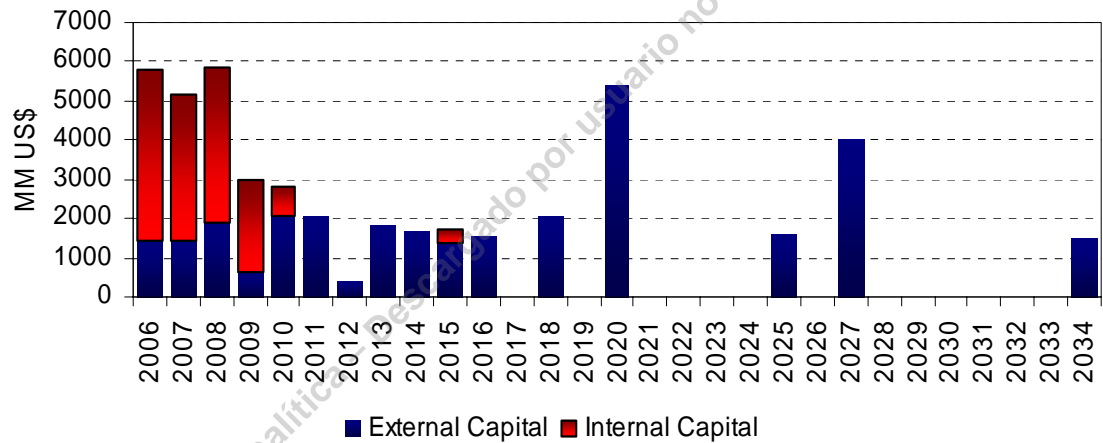
# Weekly Report

service by US\$676 million in 2006 and US\$450 million in 2007.

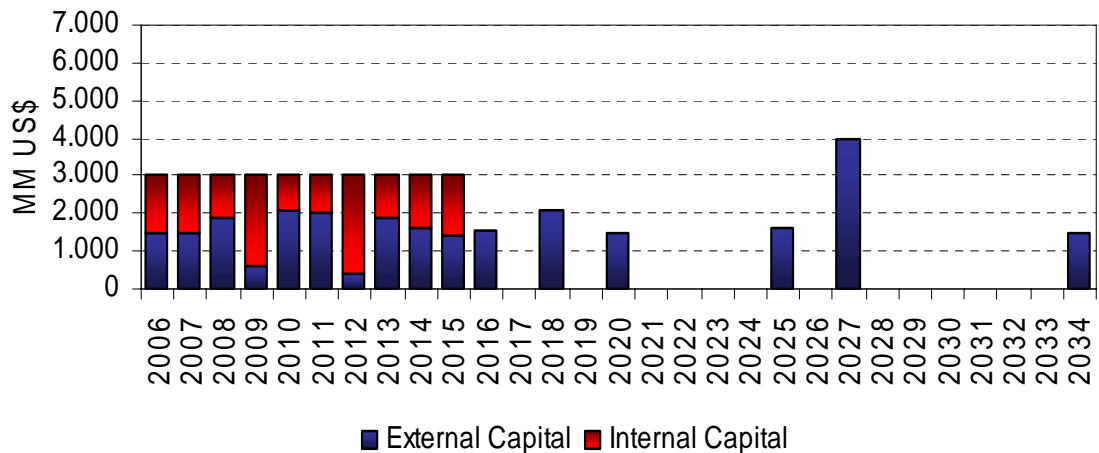
**Early repurchase of US\$3.92 billion of Discount and Par Brady bonds. Repurchase of bilateral and multilateral loans totals US\$683 million**

The repurchase produces qualitative gains including a 22% reduction in the financial conditions of the debt from 822 to 640. On bilateral and multilateral loans, the number of contracts declines from 454 before early repayment to 361 afterwards. The objective is to reduce the number of contracts to 95 at the end of the refinancing process. This reduction in the complexity of the Venezuelan debt structure will have a positive effect on the reorganization of the Public Credit Office

## Last



## Optimal



**Placement of fixed interest bonds (TIF) to begin this week**

These new bonds are part of the process of refinancing the domestic public debt to smooth out the maturity curve of public-debt bonds on the local market. These public securities will be issued by the Republic with quarterly payments, and a fixed coupon. The ministry seems to be signaling that the coupon will be similar to the rates applied by the Central Bank in its liquidity absorption operations, which are currently 28 days at 10% and 14 days at 9.25%. **Ecoanalítica** considers that the rate will be closer to the second than the first, so that the bonds will be traded at discount.

**The key aspect of the TIFs is that the local market will develop a return curve in domestic currency**

The government's objective is that the TIFs will gradually replace the traditional DPNs. Their longer date will build a long-term return curve in bolivars on the local market, as other Latin American countries - such as Mexico, Brazil, Colombia and Chile - have successfully done. These papers are included in the VEB3.0 trillion (US\$1.40 billion) authorization recently approved by the National Assembly and published in the Official Gazette on May 9. The new bonds will have maturities between 2007 and 2012.

**The government must continue its strategy of reducing the debt service**

Early debt repurchase is a good stabilization strategy in times of high oil prices. Windfall revenue is earmarked to reduce the liabilities of the Republic, which releases resources in future years for use in investments in physical and human capital. Debt service in 2005 totaled over US\$12.00 billion, so it is essential to continue applying a financial strategy to reduce its weight.

## Economic Tips

**Spending on the rise.** According to a report by the National Assembly Finance Committee, the Inter-Governmental Fund for Decentralization (FIDES) transferred to state and local governments and communal councils a total of VEB1.4 trillion in the first five months of the year. Since the reform of the FIDES Law, these funds must be deposited in accounts in the Central Bank because FIDES cannot open trusts for state and local governments. The Law also establishes that FIDES can no longer approve

projects for the states, instead authorization is in the hands of the state councils. In our opinion, this procedure creates the risk of weaker mechanisms of control and audit on execution of spending.

**Competition for the IMF.** Finance Minister Nelson Merentes said that the administration is considering creating in the short term a species of International Monetary Fund (IMF) for Latin America to aid troubled economies in the region. Its objective would be to help the economies of the region without the "political requirements" that the IMF imposes. However, the only shareholder of this parallel IMF would be the Venezuelan state, which could underpin the fund only while the current oil bonanza lasts.

**Surprising fall in poverty.** According to INE President Elías Eljuri, poverty in Venezuela fell from 55% to 37% between 1997 and the second half of 2005. Eljuri said that the decline in poverty was influenced by the social and economic policies of the government. INE uses the Poverty Line Method, which finds that wage recovery has given the population the purchasing power to buy the basic food basket.

**Extreme poverty on the rise.** Extreme poverty increased from 10.1% to 15%. Around 4.2 million Venezuelans are now living in these miserable conditions. does not understand how extreme poverty can increase significantly in an economy with huge oil revenue at the same time as a fall in general poverty. INE should reveal details of the method it uses to measure poverty levels so that we can understand how these figures are calculated.

**Fed raises rates again.** The US Federal Reserve (Fed) raised interest rates a quarter point last week for the 16th consecutive time. The Fed said that if necessary it would continue raising rates to control inflation, although it left the door open for a possible pause in the campaign of hikes which has lasted for two years. The dollar continues to be marked by weakness, with the euro now over 1.2950.

## Oil Tips

**More on the extraction tax.** The Energy and Oil Ministry introduced into parliament an additional change to the new Hydrocarbon Law. The new measure creates the extraction tax, whose calculation and collection are identical to a royalty but cannot be paid in kind. The new tax guarantees that the State will receive 33.33% of wellhead

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value from each barrel of crude produced in the country. The Law will come into force when published in the Official Gazette, which is expected before the end of this month.

**Everyone is equal.** According to the government, the extraction tax will apply to the entire oil industry: PDVSA's own production, the strategic associations of the Orinoco Belt, joint ventures, risk exploration and profit-sharing agreements.

**But some are more equal than others.** However, each case will be taxed differently. For PDVSA's own production a 30% royalty will continue to be levied and the extraction tax will complete the payment to 33.33%. The joint ventures will have to pay the new tax but are already paying 33.33% with the traditional royalty plus the extraordinary royalty which goes to the regions and to endogenous development. The Belt associations will continue paying 16.66% of royalty and in future another 16.66% for the new tax. Lastly, the risk exploration agreements will pay the shortfall needed to reach the 33.33%, after paying royalties and the Special Participation Profit (PET) established in the agreements.

**Another oil tax.** In another development, the Hydrocarbon Organic Reform Bill introduces a new tax to be known as the Export Registration Tax levied at 0.1% on the value of the hydrocarbons exported, calculated on the sale price. According to the government, the purpose of this new tax is not fiscal but is intended to exercise greater control over oil exports. Seniat and the Finance Ministry have publicly expressed their doubts about the tax.

**Fiscal pressure tightens.** With these tax changes, the State is guaranteeing average receipts of 56% of gross oil revenue. It was originally thought that this percentage would be 50%.

**Oil basket slips again.** The price of the Venezuelan basket of crude and products dropped for the second consecutive week to US\$61.68 per barrel, down 80 cents from the average of the last period. So far in May, the Venezuelan basket has averaged US\$62.34, while the average is US\$55.67 per barrel for 2006.

### Sectoral Tips

**More cooperation between private and public sectors.** The directors of Fedecámaras, Conindustria, Consecomercio, Fedeagro and Fedenaga met with Labor Minister Ricardo Dorado to ask for more flexible requirements for processing the new

labor clearance certificate (solvencia laboral). The business leaders also discussed topics related to the Labor Organic Law Regulations, the application of the Labor Prevention, Conditions and Environment Organic Law (Lopcyemat), the job freeze and attendance at the annual conference of International Labor Organization (ILO). These meetings are positive because they create a dialogue between the private sector and the Labor Ministry.

**Changes for bank balance sheets.** As expected for some time, the Banking Superintendency (Sudeban) has instructed the financial institutions to gradually transfer their off-balance sheet operations (known as ceded investments) to the balance sheet over the next 20 quarters. As we have said before, this decision is positive and sound because it will give a more complete and realistic view of the financial situation of the Venezuelan banking sector.

**Accounting effects.** When shown on the balance sheet, the ceded investments will be included in the operations that are used to calculate the capital ratio, so the banks' shareholders will have to increase their capital. Sudeban is expected to reduce the minimum ratio from 10% of capital over assets to 8%. In our opinion, the indicator should remain at 10% and the banks should be obliged to increase their capital.

**Mobile phones gains ground again.** According to Conatel, the preliminary figures for the first quarter of the year show that the telecommunications sector has generated operating revenue of around US\$1.39 billion, while private investment totaled US\$138 million, a 72% increase from the same period of 2005. In telecommunications services, mobile telephony grew most in terms of subscribers to 13.7 million lines, up 55.5% from the same period last year, generating a mobile penetration indicator of 50.9%.

**Internet expanding at good rate** The Internet service ended the quarter with 679,944 subscribers, a 38.3% increase from the same period of 2005. The segment with dedicated or broadband access represents 58.6% of the total, 65.3% growth since last year. Lastly, the local fixed telephony service grew 8%. Telephone penetration was 13.8%. Cable TV increased 11.7% from 2005, with a total of 1,136,508 subscribers in the first quarter of 2006. The data shows that 18 of every 100 households have this service.

**Consumption strengthens.** According to the Shopping Center Chamber (Caceco), department stores or large retail facilities reported 25% growth of sales in nominal terms in the first quarter of the year, compared with the same period of 2005.

**Not at all competitive.** The World Competitiveness Yearbook of the Swiss-based IMD business school reports that Venezuela is the least competitive nation out of a sample

of 61 countries. To determine the positions in the ranking, the analysis takes into account a series of variables such as foreign investment, employment, public finances, institutional framework, productivity, labor market, basic infrastructure and education, among others.

**Private sector in the doldrums.** According to the study, the Venezuelan private sector has been shrinking in relation to the size of government, and public and private policies are not on the same wavelength. Chile is the most competitive country in Latin America at number 24 in the ranking, followed by Colombia (40), Brazil (52), Mexico (53), while Venezuela is at the bottom of the ranking (61). The most competitive countries are the United States, Hong Kong and Singapore.

**Electricidad de Caracas (EDC) presented its results for the first quarter of 2006.** Operating revenue fell 1.1%, EBITDA was down 7.4% while operating expenses increased 4.0%, compared with the first quarter of 2005. However, the company reported a net profit of VEB44.30 billion, a good result bearing in mind the VEB57.78 billion loss posted in the first quarter of 2005. In our opinion, this situation will improve in the next few quarters because of the tariff hike, reduction in the cost of gas, and growth of demand for power in the country, due to economic growth. In IQ06, EDC reported a net comprehensive financing cost of VEB7.10 billion attributable to a lower level of borrowing, lower local interest rates and exchange stability. EDC also reduced its financial debt by 35.2% to US\$395 million. The average life of this debt is six years with a total weighted cost of 10%.

## Political Tips

**Electoral Council unbendable.** Last week the Electoral Council (CNE) met with the leading opposition candidates. Although election conditions that guarantee transparency and participation in the elections on December 3 were mentioned, the CNE president said that, despite the criticism of the opposition candidates, all the technological platform that the CNE has developed will be used in the presidential elections. These include use of touch-screen voting machines, biometric identification of voters through fingerprint reading equipment, and a full "audit" in 47% of election centers.

**Meeting with leading candidates.** However, a positive fact that came out of the meeting between presidential hopefuls Julio Borges, Teodoro Petkoff and Zulia State Governor Manuel Rosales with the CNE directors was the promise that the electoral body would define the conditions and rules for the presidential election in the last week

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of July or first week of August. In our opinion, as the election campaign develops and the performance of the candidates is assessed, we will see how far the CNE will grant guarantees.

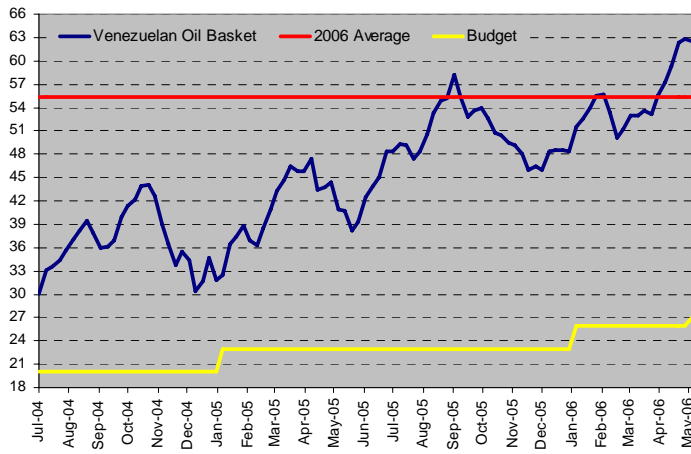
**Latest Hinterlaces poll.** The latest poll from Hinterlaces taken in March with a sample of 1,000 people over 18 in the most important cities with a 3% margin of error shows that 70% of Venezuelans would prefer a different choice to President Chávez and the "neo-liberal policies" of the opposition in next December's elections.

**Chávez is safe.** The poll shows that 71% of those polled believe that Chávez will be reelected and 41% expressed sympathy for the president against 47% who oppose him. Voting intentions are led by Chávez with 38%, followed by Julio Borges of Primero Justicia (9%), Manuel Rosales (7%), Teodoro Petkoff (5%) and Roberto Smith (1%).

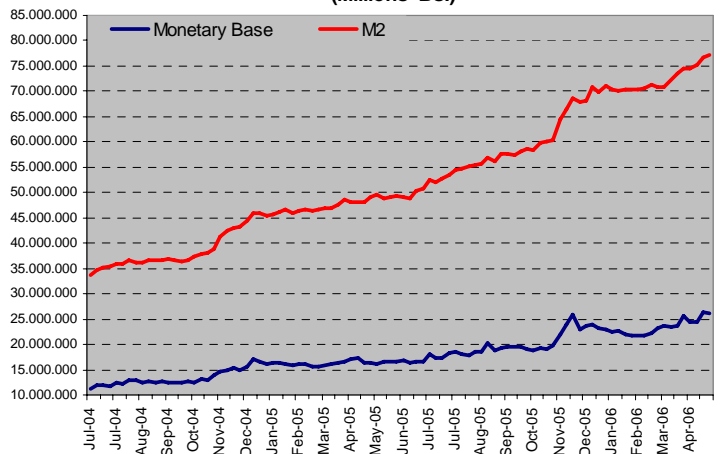
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# ECONOMIC OVERVIEW

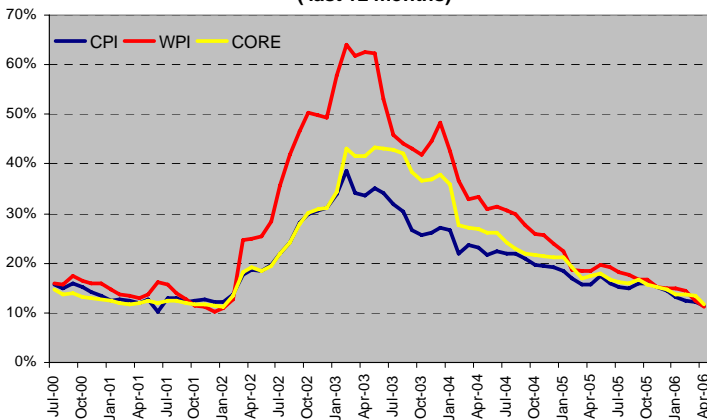
**Oil Price**  
(Venezuelan Basket US\$pb)



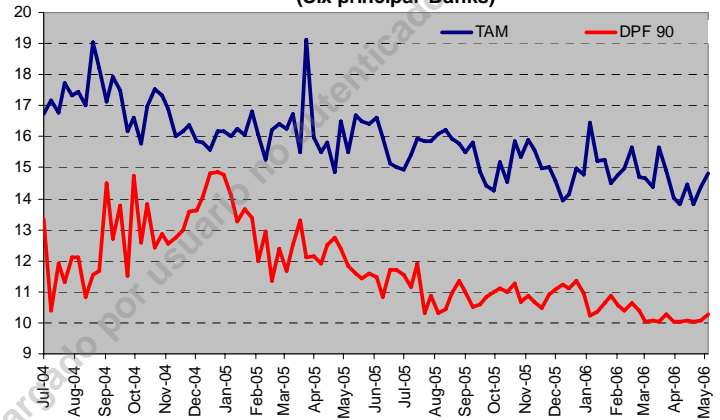
**Monetary Base & M2**  
(Millions Bs.)



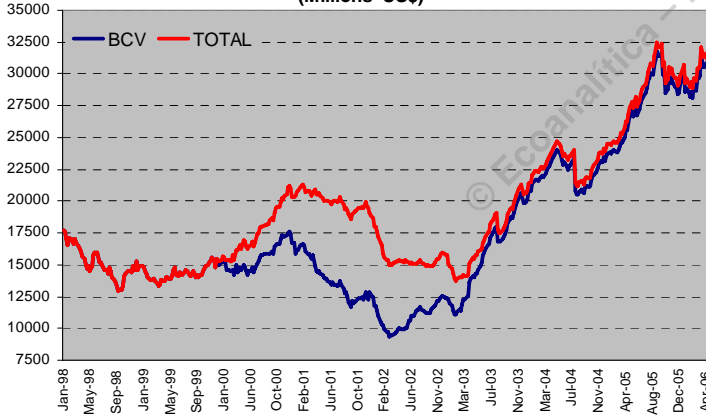
**Inflation**  
(last 12 months)



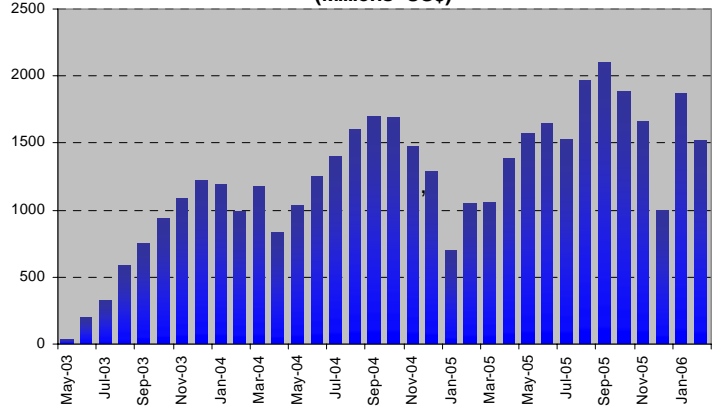
**Interest Rate**  
(Six principal Banks)



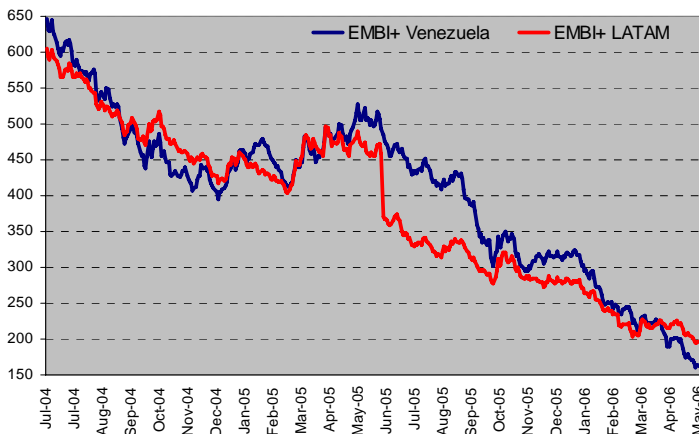
**Fx Reserves**  
(Millions US\$)



**Disbursement**  
(Millions US\$)



**EMBI**



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

