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DEBT REDUCTION: A POSITIVE STEP

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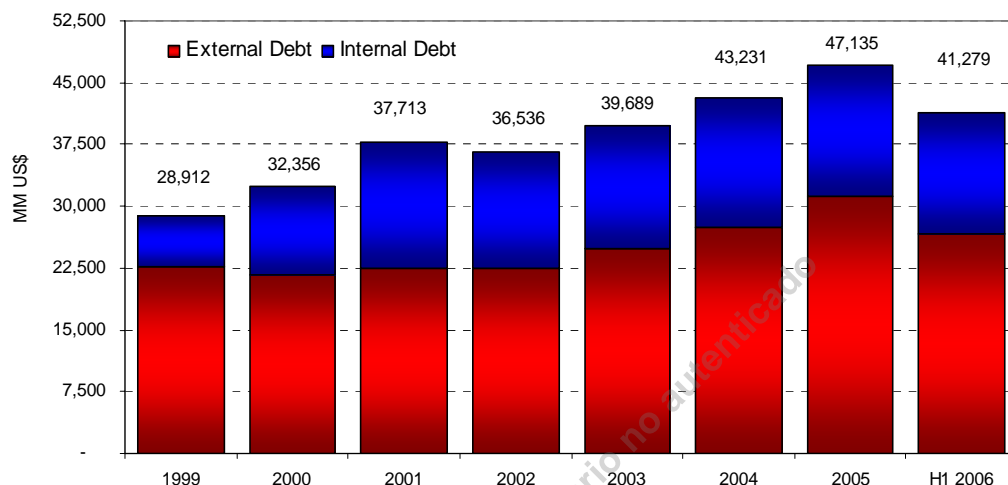
THE CLIENT

Some weeks back, the Ministry of Finance (MF) published the numbers corresponding to the balance of the Republic's public debt (internal and external) for the first half, emphasizing a reduction of 12.4% with respect to the close of 2005. It is important to point out that to date no government has carried out a debt reduction program of such magnitude. And this could well continue, since the Government has the resources to do so, and even more aggressively.

Venezuelan public debt stands at 25% of the GDP at the close of H106

H106 numbers published by the MF indicate that total Venezuelan public debt stands at US\$ 41.279 billion, which according to us is equivalent to 24.8% of GDP. Note that at the close of 2005, public debt was equivalent to 35.5 points of the GDP. This means that over the first half, Venezuelan debt was reduced by 10.7 GDP points (US\$ 5.855 billion). The MF projects that the public debt will stand at 24 GDP points for 2007 and 20% for 2008, implying that the repurchasing programs will continue for the next two years.

Public Debt



Sources: MF and Ecoanalítica

The greatest reduction took place in external debt

Upon analyzing the numbers published by the MF, we find that external public debt was reduced by US\$ 4.476 billion between December 2005 and June 2006. This reduction is due mainly to the debt repurchasing program executed by the MF between March and May this year, aimed at repurchasing high-coupon bonds (Plan Brady and bilateral debt), and also at generating savings in the servicing of Venezuela's external debt.

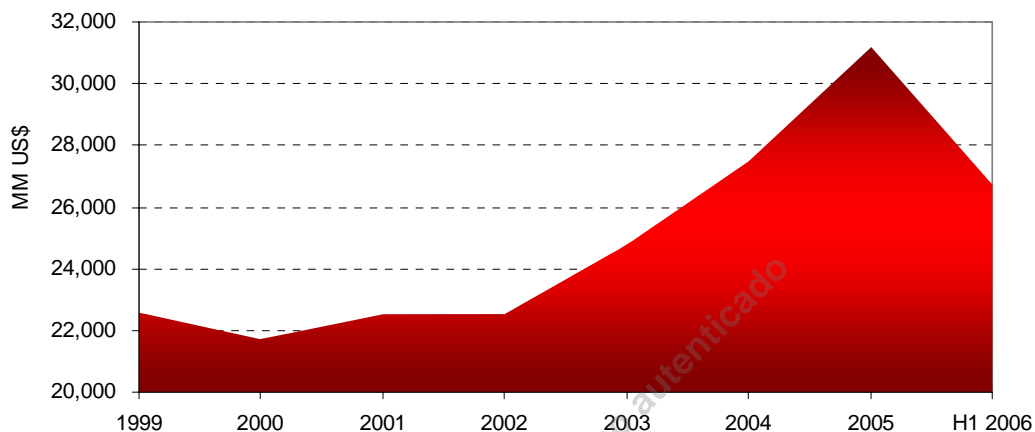
In fact, the item of bonds and liabilities saw a fall of US\$ 3.944 billion during the above-mentioned period, a figure representing 88% of total external debt reduction. In second place is the debt with commercial banks and other bilateral entities, which was reduced by US\$ 358 million, a mere 8% of the total. It must be emphasized that this debt carries onerous financial conditions and at **Ecoanalítica** we would like to see the whole debt repurchased.

Multilateral debt reduced only by US\$ 117 million

Finally comes the debt with multilateral entities, with a reduction of US\$ 117 million (2.6% of the total), in spite of the fact that Minister Merentes had announced that the reduction of our debt with the multilaterals could amount to US\$ 1 billion. This would have made little sense, since this is the least burdensome, being almost wholly destined to finance development programs, reforms in the field of public policy and infrastructure works.

Weekly Report

External Debt

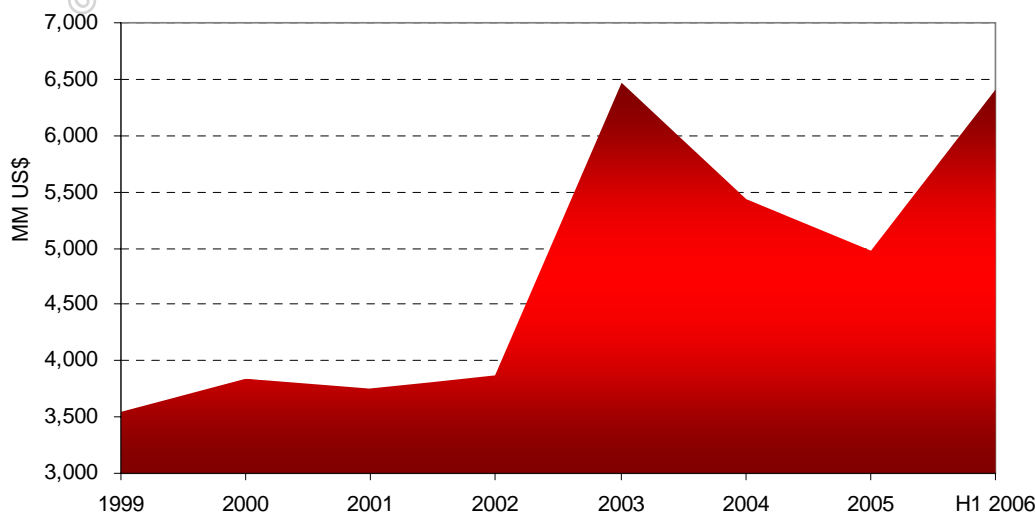


Sources: MF and Ecoanalítica

Impact to be felt in servicing cost

The debt reduction program, although incomplete, generates important advantages: reduced needs for financing, a better debt servicing profile, a better negotiating platform for bilateral and multilateral debt, and greater homogeneity in external debt securities. According to the MF, savings in debt servicing will amount to US\$ 660 million for 2006 and US\$ 450 million as of 2007 and during the next 6 years. This is a significant figure if we take into account that the servicing of Venezuela's external debt has averaged US\$ 4.400 billion over the last 7 years, in other words, a saving of 10% in total servicing cost.

External Service Debt



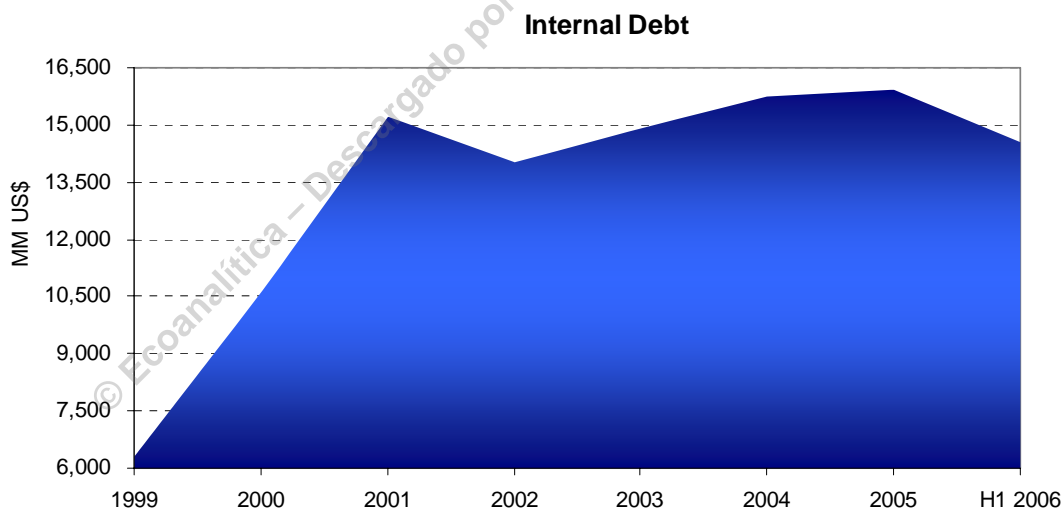
Sources: MF and Ecoanalítica

Weekly Report

Internal debt lowered by US\$ 1.38 billion

On the internal front, the central Government's public debt stood at VEB 31.3 trillion (US\$ 14.544 billion) at the close of H106. This means that compared with the close of 2005, it has experienced a net reduction of VEB 2.3 trillion (US\$ 1.38 billion). The biggest reduction was seen in treasury bonds, with a decrease of VEB 1.2 trillion (US\$ 573 million), whilst the balance of DPN (Public National Debt) bonds went down by VEB 1.1 trillion (US\$ 510 million).

It should be pointed out that as of the middle of May the Government has begun a program to substitute DPN bonds for TIF (Fixed Interest Securities) bonds. These new bonds form part of the process of refinancing internal public debt, which seeks to flatten out the maturity curve of the public debt bonds in the local market. Their principal characteristic is that they are paid quarterly and the coupon is fixed.

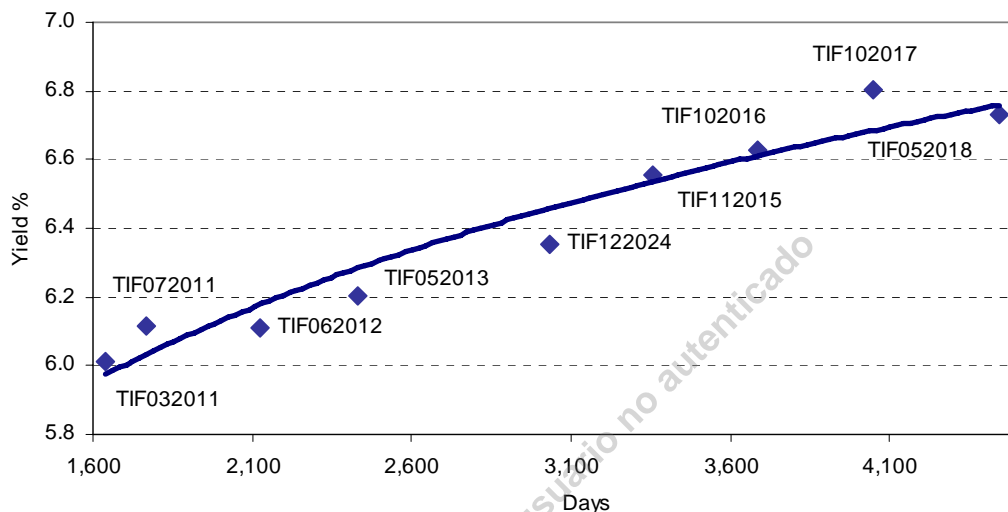


Sources: MF and Ecoanalítica

The most important aspect of the TIFs is that the local market will develop a return curve in local currency

The Government's goal is for the TIFs to have longer maturity periods, so as to construct a long-term return curve in local currency, just as other Latin American countries have done successfully. To date, VEB 3.6 trillion (US\$ 1.674 billion) has been issued with due dates fluctuating between 2011 and 2020.

Yield Curve (Intern Debt)



Sources: BCV and Ecoanalítica

Reduction of internal debt should be more pronounced

On the internal front, the Government should lower indebtedness to a minimum level, since the administration of public finance would thus be clearly sustainable with ordinary tax revenues. Another point that should be borne in mind is the BCV debt. Although this debt has a different nature, because it forms part of the monetary policy, it is still a State liability and it stood at VEB 39.3 trillion (US\$ 18.28 billion) at the close of July. Thus local-currency denominated public debt stands at VEB 70.6 trillion (US\$ 32.837 billion).

Exchange control offers advantages to the Government in its handling of the internal debt

However, 3 important advantages come into play on the internal scenario: 1) long-term local securities are beginning to be issued, cheapening debt service cost and dispersing it; 2) internal debt servicing has tended to come down significantly over the last two years, because of the lowering of interest rates, a result of the excess of liquidity created by currency control, and 3) thanks to the exchange control, the Executive can carry out different kinds of internal debt swaps that allow for a significant stretching of debt maturity and also for reducing their interest rate.

We hope to see a continuing reduction in external debt

Given the current economic situation, the Government can afford to be more aggressive with public external debt reduction programs. We calculate that the Government could use excess resources (mainly

handled by FONDEN) to repurchase up to US\$ 15 billion of its external debt, in other words, three times more than it has already done, without this affecting current expenditure. It could also expand the program over a five-year period, aimed at substituting costly debt for debt assumed under improved financial conditions, given the advantage it has in this sense through the exchange control.

Another transfer of reserves approaches

Minister Merentes has recently indicated that the optimum level of international reserves is US\$ 29 billion, although, as has been the case so far, he has not indicated which study has led him to this conclusion. Let us not forget that in the past, US\$ 18 billion was presumed to be the optimum level. Therefore, it is likely that a new transfer to FONDEN be decreed for the equivalent of US\$ 6 billion, in clear violation of the BCV Law. Nevertheless, at **Ecoanalítica** we ask ourselves: Why not use these funds to lower debt? This would lower the monetary impact of a measure of this nature.

The Government must forge ahead with its debt reduction strategy

The Government must hold firm on its strategy of buying back its debt during periods of oil bonanza. In this way, "extraordinary resources" are used to bring down the liabilities the Government has on its books, and free up the resources of the years to come that could be used to invest in human and physical capital projects.

Economic Tips

Inflation ablaze. According to the BCV, August inflation was 2.2%, more than double the same period last year (1%). So far this year, accumulated inflation has been 10.4%, and over the last 12 months 14.9%.

The genie is out of the box. As of May this year, inflation has halted its tendency to decline and has once again shown signs of increasing. In fact, over the past 3 months, the annualized inflation rate has surged to 19.9%, where, over the 3 previous months, it had stood at 9.3%. According to the BVC, the upswing in inflation is explained by strong rises in the items of food and non-alcoholic beverages. Through August, in fact, inflation for the previous twelve-month period had been 14.9%, but the item in question rose by 26.7%.

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The reasons are structural. However, at *Ecoanalítica* we believe that independently of the fact that the increase in the inflation rate is due to “seasonal” spikes in the food item, particularly those of agricultural origin, there are other factors in play that are a result of the current economic policy. Firstly, the increase in company labor costs; secondly fiscal expansion during a period of currency control, and thirdly, price controls are showing signs of being hopelessly inefficient.

Way off official estimates. We calculate that this year’s inflation will be about 15.7%, because since there is no coordination among fiscal, monetary and exchange control policies, inflation will continue to be the Achilles heel of the economic policy.

WPI shows less volatility. The Wholesale Price Index (WPI) registered an August shift upwards of 1%. National goods increased by 1.3%, while imported goods showed no variation. So far this year the WPI has risen 10.6%, and over the last 12 months 12.2%.

Issue set at US\$ 1 billion. The President of the Finance Commission of the National Assembly, Rodrigo Cabezas, has indicated that the Southern Bond issue will be for US\$ 1 billion, with 50% participation by each country (Venezuela and Argentina). The Venezuelan Government will issue fixed interest securities (TIFs) and the money collected will be used to pay off internal debt. However, MF sources have said that this is the first step of a global issue strategy that could amount to US\$ 5 billion over the next year and a half.

Oil Tips

After the storm, prices down. Following a week of tumultuous movement, the Venezuelan crude basket settled down at the end of last week to close at US\$ 60.18 per barrel, i.e., US\$ 1.61 less than the price quoted the week before. So far this month, the Venezuelan oil basket has averaged US\$ 63.13 per barrel, while the year-to-date average stands at US\$ 58.74 per barrel.

Production ceilings to be upheld. According to the Iranian representative of the OPEC, the production cap is to be kept intact in spite of lower demand for the OPEC basket and the increase in non-cartel countries’ production. The representative insisted that they are doing this so as not to be accused of seeking to force crude prices up by lowering production levels.

PDVSA presents its numbers. According to a press release, PDVSA’s gross revenues were US\$ 33.8 billion between January and July, 2006, of which US\$ 32.2

Weekly Report

billion was received in cash, giving the State oil company a free cash flow of US\$ 1.2 billion. At **Ecoanalítica** we estimate that PDVSA's income for the whole of 2006 will be around US\$ 60 billion. On the other hand, operating earnings for the first 7 months were US\$ 15.8 billion.

Increase in social contributions. The contributions to social development grew from US\$ 4.8 billion delivered during the whole of 2005 to US\$ 5.6 billion between January and July alone this year. If this tendency is maintained, PDVSA will have transferred about US\$ 12 billion to the Government for this concept during 2006, an increase of 150% over 2005, according to our calculations.

Postponement possible. PDVSA is studying the possibility of postponing or even cancelling the issuing of debt bonds on the local market, as had been announced some weeks back, since the perception of the company has been affected by reports that its cash flow would not be entirely assured, and even that there would be a risk of not meeting the goals for 2006 tax contributions. At **Ecoanalítica** we believe that with such a favourable cash flow, PDVSA has no reason to take on debt.

Sectoral Tips

CANTV adjusts its pensions. As of September 1, the pensions of retired CANTV workers will be adjusted to current minimum salary levels. Among other benefits decreed by the Supreme Tribunal (TSJ) is the permanent adjustment of pensions to the minimum salary levels in force as of now. Apart from that, the retirees will begin to receive the equivalent of 4 months of profit-sharing.

“Social” rates lowered. The Housing Ministry announced that the social interest rates on loans had been reduced by 0.67 and 0.43 points. The Executive's classification establishes that for those who hold loans under the Law of Housing Benefits Regime and whose income is below VEB 973,728, the social rate would be lowered from 4.87% to 4.66%. For those earning up to VEB 1.8 million, the interest rate will be reduced from 7.31% to 6.99%, and for those earning more than VEB 1.8 million, the rate would now be 9.31%, down from 9.72%. Those holding loans under the obligatory mortgage portfolio (i.e., from the banks' own resources), the social rate will now be 9.87% instead of 10.54%.

Benefit extended. Workers whose monthly salaries are below VEB 1,536,975 will be entitled to receive food tickets, in accordance with the provisions of the regulations

currently in force. In this way, the minimum salary increase expands the universe of workers who will benefit from the application of this regulation. Daily payment will vary between VEB 8,400 and VEB 16,800, equivalent to between 0.25 and a maximum of 0.5 tax units, according to the regulation's stipulations.

Banpro and Bolívar Banco merge. The President of Bolívar Banco, Eligio Cedeño, has stated that he is only waiting for approval by SUDEBAN to go ahead with the merger. "The idea is to create a universal bank that can offer a complete range of services," he declared. After the merger, the institution will have a capital of VEB 150 billion and VEB 2.2 trillion in assets.

Possible modification to the legal reserve. The BCV might flexibilize the legal reserve ruling for smaller banks by establishing a lower percentage for them. Trino A. Díaz, the Banking Superintendent, pointed out that "the BCV is already studying this situation and realizes that the effects are different according to the size of the banks; that there is a danger that the small banks are being seriously prejudiced, and even, that the development banks now being created can hardly function at all."

Piracy sky high. According to a study by the Business Software Alliance (BSA), an association of leading software developers, based on data from the auditing firm International Data Corporation (IDC), the piracy index at personal computer level in Venezuela had increased by 3% at the close of last year: from 79% in 2004 it rose to 82% in 2005. This situation generated more than US\$ 170 million in losses. The piracy rate in Latin America is 68%, far higher than the global average, which stands at 35%.

Political Tips

Re-election still undecided. In his homecoming speech following a two-week tour of Asia and Africa, the President of the Republic promised he would call a referendum in 2010 to seek reelection for the third consecutive time and to establish the option of a further re-election for the following term. The head of state declared that if he obtained a voting majority the Constitution would be modified to include the possibility of indefinite re-election.

Rodríguez Araque to Cuba. Ex-Chancellor Alí Rodríguez Araque will substitute Adán Chávez as Venezuela's ambassador to Cuba, communicated by Chávez himself.

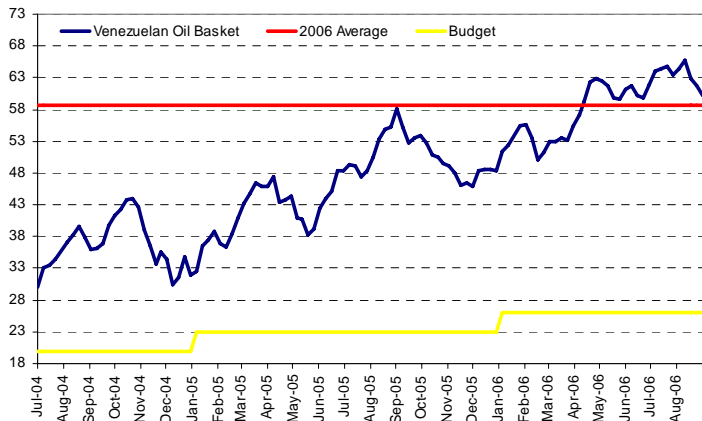
Weekly Report

Changes in the Foreign Office. Nicolás Maduro changed the Vice Ministers of his Office and assigned Rodolfo Sanz, an AN deputy for PPT, as Vice Chancellor for Latin America and the Caribbean, in substitution of Pável Rondón, who will now head Venezuela's Embassy in Colombia. Other changes have been: Vice Minister for the USA (Jorge Valero, representative before the OEA, for Mary Pili Hernández); Europe (Rodrigo Chávez, responsible for the Italian legation, for Jenny Figueredo), and Asia, Middle East and Oceania (Arturo Gallegos, head of the Iranian mission, for Alcides Rondón). The only person holding on to his position is the Vice Chancellor for Africa, Reinaldo Bolívar.

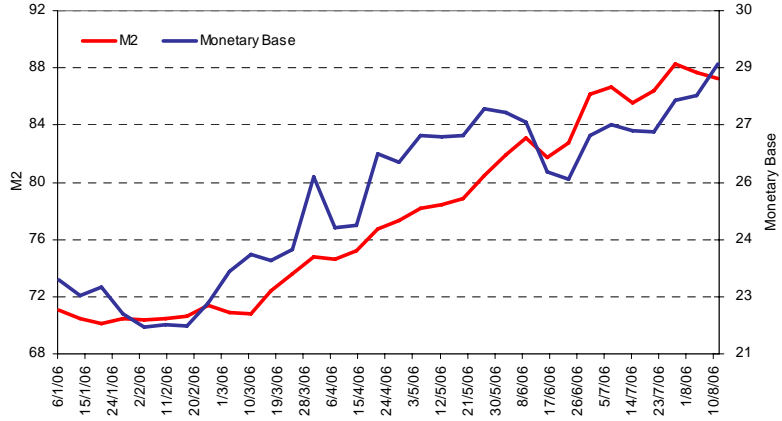
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ECONOMIC OVERVIEW

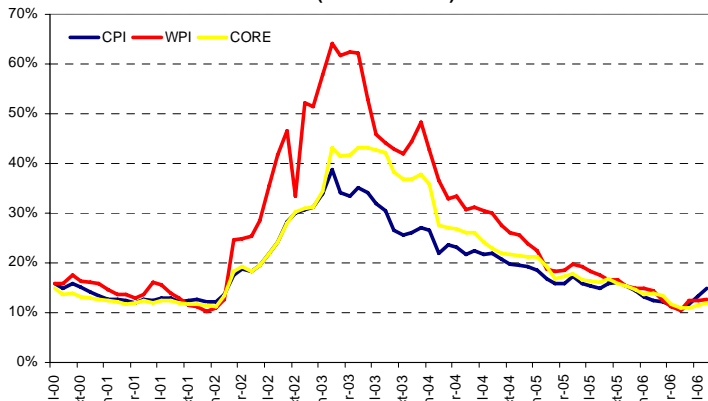
Oil Price
(Venezuelan Basket US\$/pb)



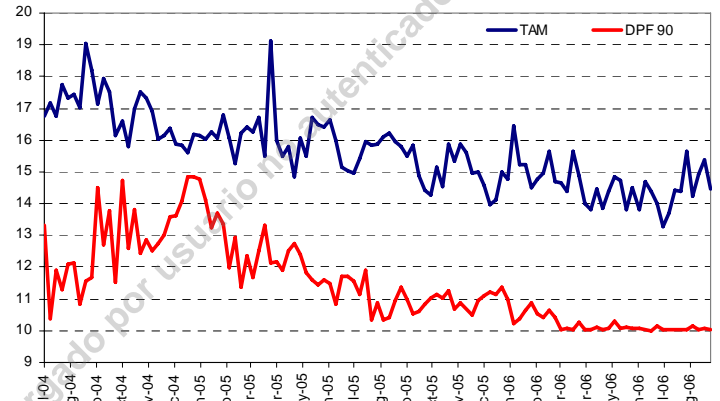
Monetary Base & M2
(VEB Billions)



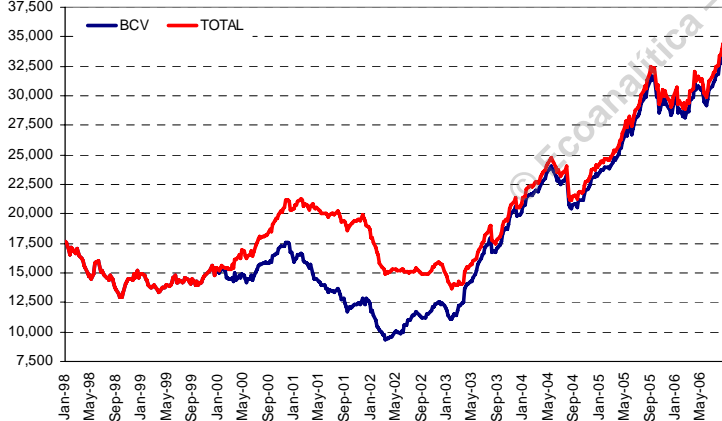
Inflation
(Last 12 Months)



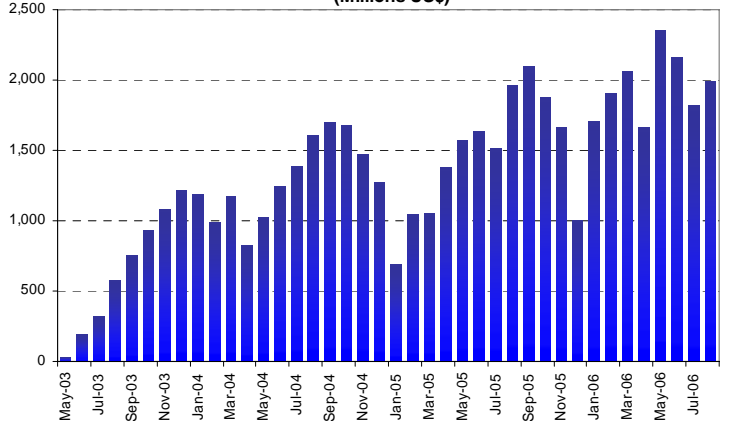
Interest Rate
(Six Principal Banks)



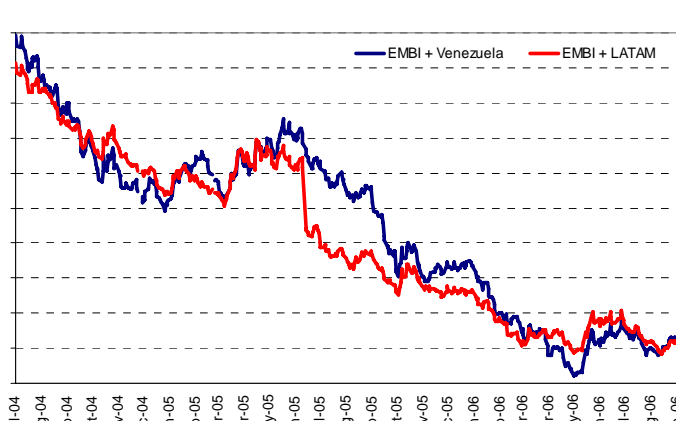
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(VEB Billions)

