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WHAT'S HAPPENING IN THE FOREIGN CURRENCY MARKET?

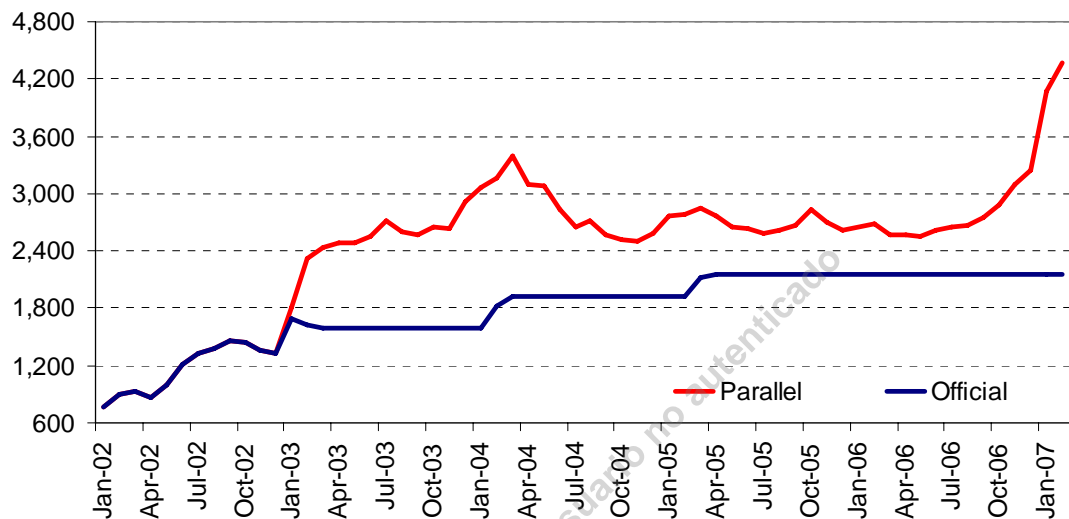
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THE CLIENT

After more than two years of relative stability in the foreign exchange market, the last four months have been characterized by a 64.1% depreciation of the bolívar in the parallel market, going from an average of VEB2,660/US\$ in August 2006, to VEB4,365/US\$ in February 2007. In order to be able to make recommendations, it's necessary to be aware of the fundamental elements that usually affect this sector: oil prices, interest rates, inflation, liquidity, fiscal spending, etc. It seems that the Government is searching for different ways to control the non-official foreign exchange market, worried about the effects said market will have on prices. Even though it is too soon to tell, in our opinion, the Government is moving from a position of greater repression, control, and/or coercion towards measures that are more in tune with the market. Needless to say, the latter measures are more effective at reducing the parallel market's volatility.

Weekly Report

Exchange Rate
(VEB/US\$)



Sources: Reuters and Ecoanalítica

Collective Hysteria: transactions have taken place at almost VEB5,000/ US\$

A surge in imports provoked by seasonal factors; managerial changes in CADIVI; the elimination of more than 3,500 tariff codes for items that were eligible to receive foreign currency at the official exchange rate, and that now must turn to the parallel market; a lack of dollar auctions in the parallel market; the announcement of nationalizations; etc., have all led to a severe reaction concerning the expectations of the economic agents, which in turn, has led them to buy foreign currency in the parallel market at more than double the price of the official market.

A lack of transparency and the absence of a foreign exchange policy haven't contributed to the stability of the foreign currency market

Based on the balance-of-payments figures published by the Central Bank (BCV), it is possible to calculate that the Ministry of Finance (MF) sold around US\$6.5 billion in different financial instruments to the parallel market. On a number of occasions, **Ecoanalítica** has pointed out the need to maintain this kind of operations because they offer multiple benefits in terms of exchange stability, reducing liquidity, lower inflation, economic borrowing, etc. The problem is that besides the 500 million Argentinean bonds that were transparently and publicly auctioned off in the "Bono del Sur," the rest (around US\$6.0 billion) were directly allocated in a less than transparent manner and with strong signs of corruption.

This lack of transparency reduces the efficiency of the positive impact of these operations on the parallel market. Furthermore, everything seems to indicate that with the changes that have been going on in the MF, these types of operations are a thing of the past, thereby reducing the supply of foreign currency and increasing the pressure on the unofficial market.

Despite the fall in prices, the current oil market is able to satisfy the demand for dollar

In spite of the 25.3% fall in price of the Venezuelan oil basket that went from US\$64.1/bbl. in July 2006, to US\$47.9/bbl. for the first part of February 2007, there is still enough foreign currency circulating to satisfy the market.

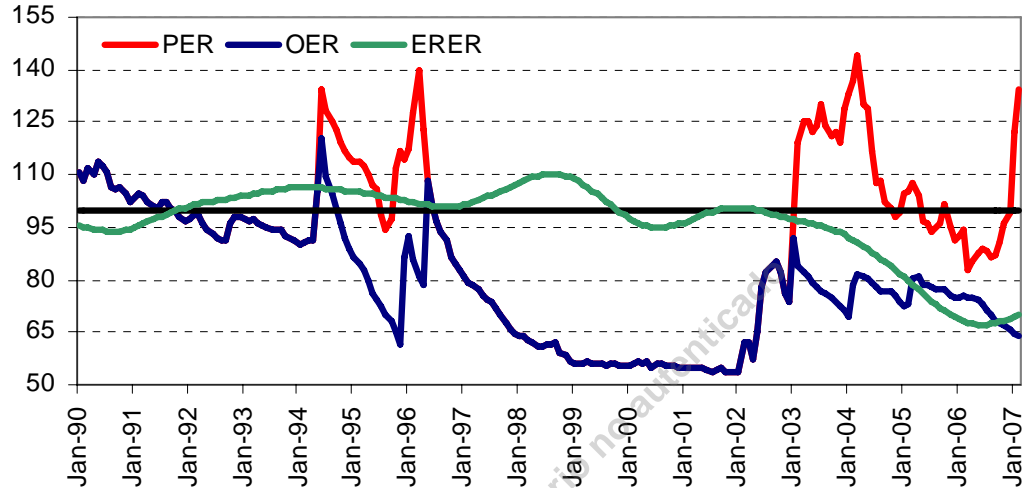
On a monthly average, US\$3.6 billion enter the country due to oil exports and close to US\$500 million due to non-oil exports. Foreign currency demand for imports settled at a monthly average of US\$2.6 billion in 2006, and could go to US\$3.2 billion in 2007. This means that if oil prices stay the same as they are now, the country would maintain a solid foreign position and the State wouldn't have to use the US\$55 billion it has in its accounts (US\$35 billion in international reserves and approximately US\$20 billion in other funds).

What should the balanced exchange rate be?

In *Ecoanalítica* we have made our own model for the real exchange rate (TCR) for Venezuela. It established two balanced real exchange rates. The first one is based on historic oil prices and we fixed the balanced TCR at 100 so that it coincided with the average on 1990-93. The second one is based on the same period but changes according to the price of oil. This means that during high oil prices, the economy is able to maintain a substantially more appreciated exchange rate than when prices are low.

Based on what has just been stated and taking into account average historic oil prices, a balanced exchange rate should be substantially higher than the current exchange rate, at VEB3,360/US\$. Now then, taking into account the high oil prices, we would find that the current official exchange rate is slightly overvalued and that a more balanced exchange rate would be at VEB2,360. According to these calculations it is clear that, independently of the oil market, the bolívar shouldn't be any higher than VEB3,400, which shows that the recent spike in prices totally lacks economic foundation and therefore, we don't recommend purchasing.

Real Exchange Rate
(Official, Parallel and Equilibrium)



Source: Ecoanalítica

Will they implement a dual market?

It seems like the Executive office wants to honor its decision not to move the official exchange rate during the current year. Before such a self-imposed restriction, the administration has begun to consider the possibility of creating a second kind of exchange rate for the so called “non essential” imports. And this makes sense, if the Government is going to arbitrarily continue to eliminate tariff codes, then it should offer these sectors a way to acquire foreign currency in order to be able to continue importing. However, at **Ecoanalítica**, we believe that a dual system will breed more corruption. What should be done is that once and for all the parallel market should be legalized, transparently intervened by the Government (preferably the BCV) in such a way that the market will gain depth and be less volatile.

Economic Tips

The Government looks to reduce inflation. The Government, worried about the latest surge of inflation, is studying a number of measures in order to curb its rise. These measures include:

1. The issuing of a new “*Bono del Sur*” and PDVSA’s bonds in order to stop the increase in liquidity and the parallel exchange rate.

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2. Holding back a portion of the revenues generated by the accounts in dollars from the National Treasury, thereby preventing that a significant amount of public sector funds remain in trusts in the financial system.
3. Establishing a temporary bank reserve requirement for public sector deposits that are in the banks.
4. Increasing savings interest rates to stimulate savings.
5. More efficient delivery of foreign currency by Cadivi as well as periodic revisions of the lists and provisions.
6. Revitalizing the MERCAL program.

Insufficient measures. At *Ecoanalítica* we're convinced that these measures will have a very limited effect on the inflation rate because they don't attack the root of the problem which is, the way in which fiscal policy is implemented and the design of the exchange control. We ratify our estimates of inflation for 2007 at being at 23.7%.

Fiscal management in November 2006. According to the BCV, November spending reached an all-time high of VEB15.2 trillion, while revenues totaled VEB9.0 trillion. And so, the Central Government closed the month with a deficit of VEB6.2 trillion.

FISCAL BALANCE CENTRAL GOVERNMENT (VEB Billions)	November	November	Nominal Variation	January-November	January-November	Nominal Variation	Real Variation
	2006	2005		2006	2005		
Total Revenue	8.952	7.522	19,0%	97.238	73.842	31,7%	16,2%
Non-Oil Revenue	4.835	3.523	37,3%	43.853	32.000	37,0%	20,9%
Oil Revenue	4.116	4.000	2,9%	52.388	36.622	43,1%	26,2%
Central Bank Earnings	-	-		997	5.220	-80,9%	-83,1%
Total Expenditure	15.196	11.910	27,6%	104.432	68.529	52,4%	34,5%
Primary Expenditure	14.668	11.311	29,7%	96.810	60.125	61,0%	42,1%
Interest Payments	528	598	-11,7%	7.622	8.403	-9,3%	-20,0%
Domestic Debt	232	375	-38,2%	2.903	3.845	-24,5%	-33,4%
Foreign Debt	296	223	32,8%	4.719	4.559	3,5%	-8,7%
Quasifiscal Expenditure	-	-		-	-		
Fiscal Balance	(6.244)	(4.388)		(7.194)	5.313		
Primary Balance	(5.716)	(3.789)		428	13.716		
Non Oil Balance	(10.360)	(8.387)		(60.580)	(36.529)		
Debt Amortization	125	118		5.789	4.408		
Net Monetary Injection	9.756	7.832	24,6%	57.277	27.439	108,7%	84,2%
Financing Requirements	6.369	4.506		12.983	(906)		
Foreign Debt	0	27		256	157		
Domestic Debt	433	450		4.371	8.938		
Treasury Bonds	425	450		4.359	7.621		
Treasury Debt	8	-		13	1.317		
Others	5.936	4.029		8.355	(10.001)		

Sources: BCV and Ecoanalítica

Spending Boom. Upon analyzing the past year's fiscal management for the period of January – November, figures reflect that spending reached VEB104.4 trillion, which represents a real increase of 34.5%. During the same period, fiscal revenues increased in real terms by 16.2%. Consequently, the Central Government accumulated a deficit of VEB7.2 trillion which contrasts with the surplus of 5.3 trillion for the same period of the previous year. Even more worrying is the significant fiscal deficit increase of the non-oil sector, going from VEB36.5 trillion in 2005, to VEB60.6 trillion in 2006.

The BCV to transfer exchange rate profits. The BCV will transfer to the Central Government the equivalent of VEB145.38 trillion (US\$67.6 billion) in exchange rate profits generated during the second quarter of 2006. Though the amount is pretty low, at *Ecoanalítica* we ask ourselves, how can said profits be generated if the official exchange rate hasn't been devaluated?

More about the tax reform. According to sources at the SENIAT, within the framework of the Enabling Law, 5 judicial instruments are expected to be reformed. Said reforms look to tax luxury goods, and to do so they will have two options: continue with the Aggregated Value Tax (VAT) surtax and apply the Personal Assets Tax. This option eliminates the need for a selective consumption tax; rather the so-called luxury goods will fall under the IVA Law.

A new tax. Another important reform issue is the creation of a personal assets tax which would be paid by those who have assets valued at over 15,000 tributary units (VEB560 million) and have to pay somewhere between 0.5% and 1%. The other instruments that will be revised within the framework of the Enabling Law are the Income Tax and the Organic Tax Code.

Tax on Idle Lands ready. The SENIAT also informed that starting from May 2nd, the Tax on Idle Lands will begin to be collected, thereby following what's stated in the Land Law.

Maza reflects. The next slated to leave the BCV, director Domingo Maza, shares his ideas with us with the candor he is known for, concerning a number of topics related to current economic policy:

- He recommends that FONDEN functions be specified and that it render its accounts before the nation.
- He cautions that any process of transformation should take into account the economy's concrete variables and proceed in stages and not all at once and in a hurry.

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- Current reforms, according to Maza, "haven't focused on the fundamental challenge, which is how to convert an oil economy into an integral reproductive economy, and understand that the economy continues to be a market economy, where the most important formal employment indicator still comes from the private sector. Without it, there can't be a viable transformation."
- Maza also points out the main reason responsible for inflation is fiscal management through public spending, recognizing that price controls have been deteriorating lately and Mercal is failing.

OIL TIPS

Oil basket is up again. Venezuelan crude and by-products basket went up again this week reaching \$47.96 per barrel, up \$2 from the average of the previous week. So far this year the average is US\$46.96.

PDVSA to the markets. According to sources inside PDVSA, the company started taking the formal steps required to beginning issuing debt to the domestic market in the next few months, as was announced in 2006. It's estimated that US\$3.5 billion will be issued in the form of bonds in dollar to be paid in bolívares at the official exchange rate. However, at *Ecoanalítica* we believe that this could be done in various stages.

Everybody wins. With an issuance of this kind, the Government simultaneously gets fresh money at low cost, momentary drains liquidity, and reduces pressures on the parallel foreign currency market. However, this action won't be enough if it's not done within the framework of an integral reform of current exchange control regimen, because the issue will only have effects in the short term

PDVSA received a credit line. PDVSA received a credit line for US\$1.0 billion through the French bank BNP Paribas. According to sources, the credit will be used to inject cash flow into the company. According to the information released by BNP Paribas in a statement, the credit includes the commitment to borrow the money from the ABN AMRO, Banco do Brasil, Citibank, Deutsche Bank, and JP Morgan Chase. .

First draft. According to the Energy and Oil minister and president of PDVSA, Rafael Ramírez, there is already a "very advanced" draft of the nationalization bill that contemplates migrating the four strategic associations of the Orinoco Oil Belt to the joint venture status. However, Ramírez pointed out that negotiations with the oil companies continue and the law will only become a reality if definitive agreements can't be reached with the partners involved in the Belt. Executives close to the companies have said that

there is no opposition to participating as minority partners, the only thing pending are the compensation amounts and how they will be paid.

The value of the Oil Belt. According to UBS, based on figures from Wood McKenzie, the four Orinoco Oil Belt associations have a current net value of US\$28 billion, of which US\$17 billion correspond to the private companies and US\$10.6 billion to PDVSA. So, by the Government wanting to become the major stockholder with a 60% share, this would mean that US\$16.8 billion would correspond to the State, and US\$11 billion to the foreign companies.

BUSINESS SECTOR TIPS

Agriculture portfolio goes up. The Executive office decided to increase the percentage of total compulsory loans that the banks grant for agriculture activities. The resolution sets forth that farm loans be, by close of December this year, at 21% of the total, while in 2006 the percentage was at 16%. So now, compulsory bank loan portfolios reach 36.5% of total loans.

Airline ticket sales increase. According to the Venezuelan Airline Association (ALAV), airline ticket sales could experience an increase of 20% in 2007 compared to sales in 2006. It's expected that for Carnival sales increase by around 15%.

Increase in house prices. Estimates issued by the Venezuelan Real Estate Chamber (CIV) during the first quarter reflect that house prices will be adjusted by 20%. This is mainly due to the uncertainty that reigns over the country and the rise reflected in the parallel exchange rate, added to the fact that the Government has yet implement the price control mechanism for construction inputs.

Car sales continue to boom. New car sales went up 43.3% in January compared to the same period last year. According to the Venezuelan Automotive Chamber (Cavenez), 28,619 cars were sold in January.

Drop in US investment. According to VEAMCHAM, US company investment in Venezuela has dropped by 95%. US capital invested in Venezuela for the past years has usually been between US\$600 million and US\$1 billion a year. However, in 2006, these amounts barely reached US\$30 million, 5% of the normal volume.

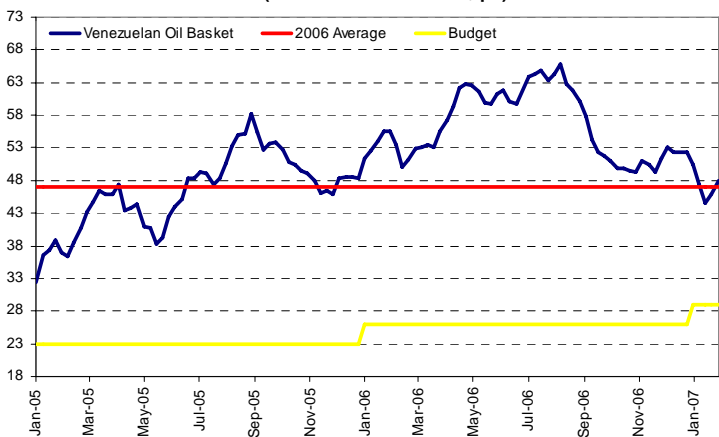
Political Tips

New president for the TSJ. Judge Luisa Morales will replace judge Omar Mora Díaz as the president of the Supreme Court (TSJ) for the period 2007-2008. Judge Morales was president of the Constitutional Chamber of the TSJ and is considered being close to President Chávez. She is also a member of the Presidential Commission for the reform of the Constitution.

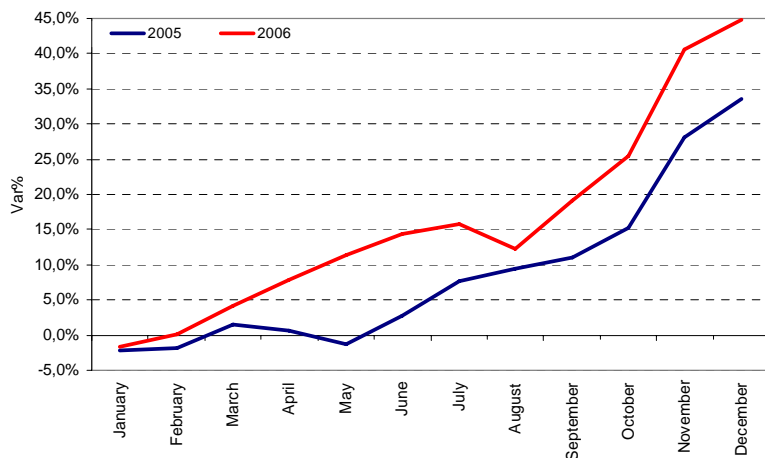
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ECONOMIC OVERVIEW

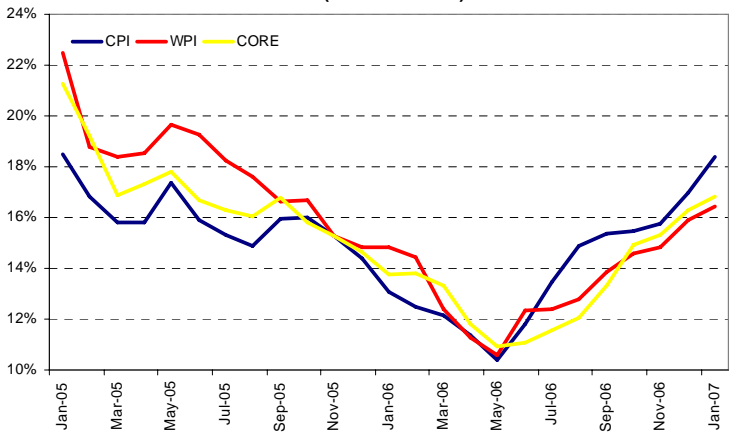
Oil Price
(Venezuelan Basket US\$/pb)



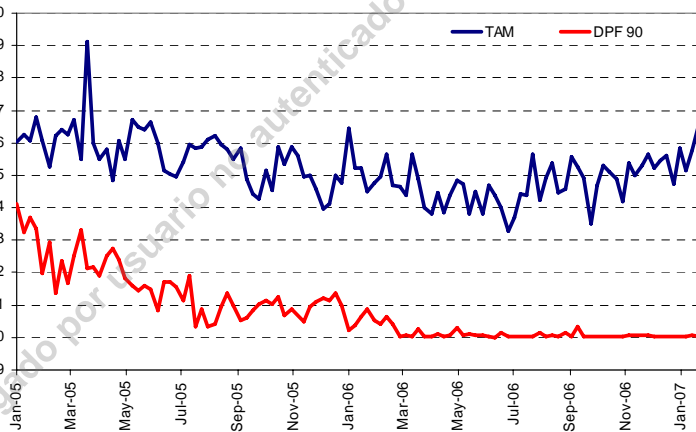
Real Expansion (M2)



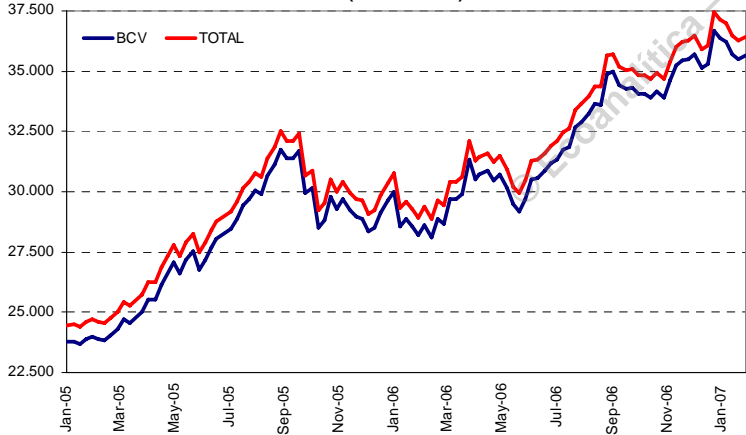
Inflation
(Last 12 Months)



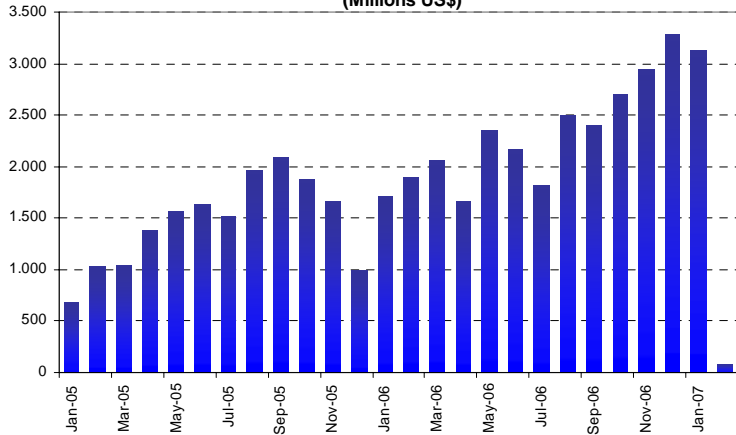
Interest Rate
(Six Principal Banks)



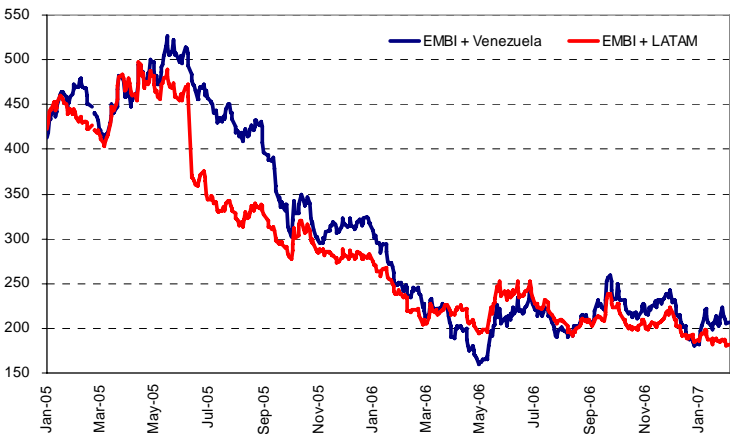
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(VEB Billions)

