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## ***ALL THAT GLITTERS IS NOT GOLD: DISTORTIONS OF THE EXCHANGE CONTROLS BECOME MORE SEVERE***

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**THE CLIENT**

When analyzing the figures relative to foreign currency movements published by the Central Bank of Venezuela (BCV), three things stand out that worry us and that we will explain here:

1. Imports financed by the parallel market have been increasing since the exchange control was implemented.
2. There is a significant level of foreign currency leaving the country that the BCV can't explain.
3. The control that the BCV has over foreign currency coming from oil revenues, 87% of our total exports, is progressively more limited.

**In 2006, there are significant differences between CADIVI's figures and imports**

The BCV has published its figures corresponding to the foreign exchange movements in 2006. A number of important facts stand out, the most significant one being that foreign currency issued through CADIVI (which the BCV books as controlled market expenses) reached US\$20.85 billion which translates to a daily average of US\$86 million. In 2005, CADIVI granted a total of US\$16.70 in foreign currency, i.e. a daily average of US\$69 million, which is to say that

# Weekly Report

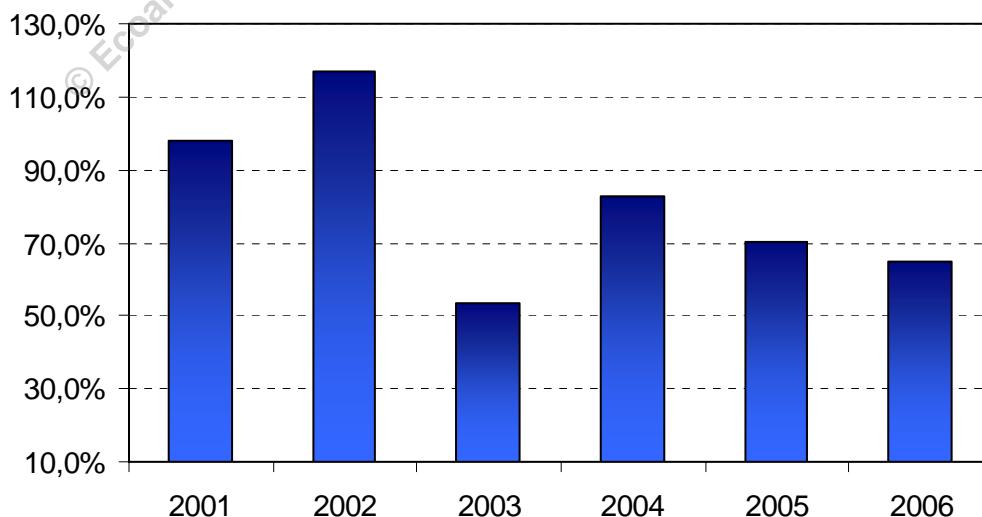
between 2005 and 2006 foreign currency granted by CADIVI increased by 24.8%.

According to the 2006 Balance of Payments figures, imports totaled US\$32.22 billion, which represents a growth of 36% with respect to 2005. It can be seen then that the foreign currency granted through CADIVI represented 65% of total imports. Therefore, and contrary to what government representatives have been saying, the parallel market would have been financing around 35% of imports. And this is part of what explains January and February's inflationary spike due to the surge of the dollar in the parallel market.

**As time goes by, the parallel market begins to become more important**

The exchange controls were introduced in 2003, but it wasn't until May of that same year that CADIVI started to grant foreign currency. That's why, for 2003, the funds CADIVI granted represented 54% of total imports. In 2004, under more normal conditions, this figure increased to 83%, which is to say that the parallel market only covered 17% of imports. In 2005, the figure dropped, and CADIVI granted funds for 71% of imports. So by looking at these figures all together you can see how the parallel market has doubled its participation with regard to the financing of imports between 2004 and 2006, going from 17% to 35%.

**Percentage of Imports financial by the Official Market**



Sources: BCV and Ecoanalítica

# Weekly Report

## Even though the Government won't admit it, they know it

According to Minister of Finance, Rodrigo Cabezas, liquidity has affected the evolution of prices and in order to control inflation and meet projected goals, the Executive decided to introduce certain measures. Cabezas pointed out that these measures would come mainly in two forms: the issuing of bonds, and the establishing of two special accounts in the National Treasury where foreign currency oil revenues will be deposited, just as was announced a few weeks ago.

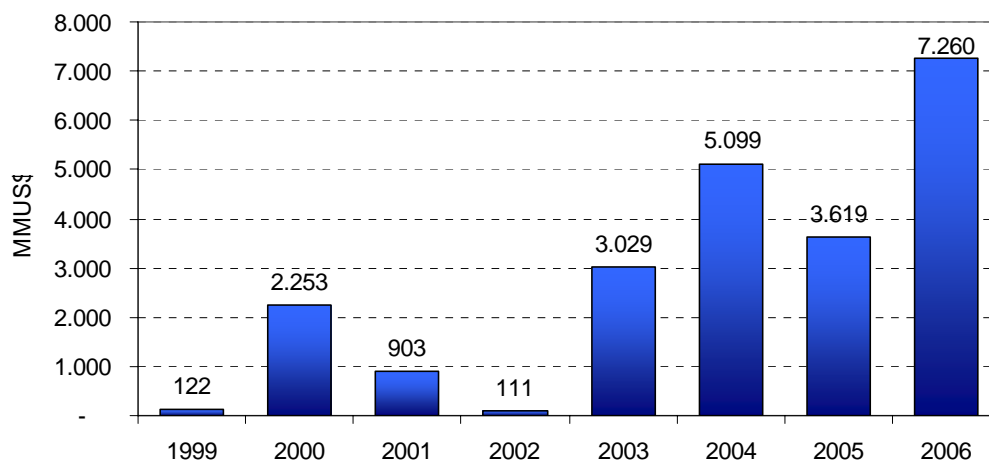
The issuing of bonds not only looks to control liquidity, but at the same time it looks to lower the exchange rate on the parallel market, because as this indicator depreciates, it will have a positive effect on inflation since more than 30% of imports are financed with unofficial dollars.

## An unexplained spending is increasing

Within the category of foreign currency outlays that the BCV publishes, an unusual increase stands out concerning the figures related to "other expenses" which as its name indicates, are unspecified expenses pertaining to traditional items (imports, external debt service, Government spending abroad, among others). Between 1999 and 2006, this component reflected variation of 5,851%, going from only US\$122 million in 1999 to US\$7.26 billion in 2006. Between 2005 and 2006 it increased by 101%.

At *Ecoanalítica*, we also found that the greatest increases happened after the exchange controls were introduced. Between 1999 and 2002, "other foreign currency expenses" averaged US\$847 million, but between 2003 and 2006, the same average was at US\$4.75 billion.

Other foreign currency expenses



Sources: BCV and Ecoanalítica

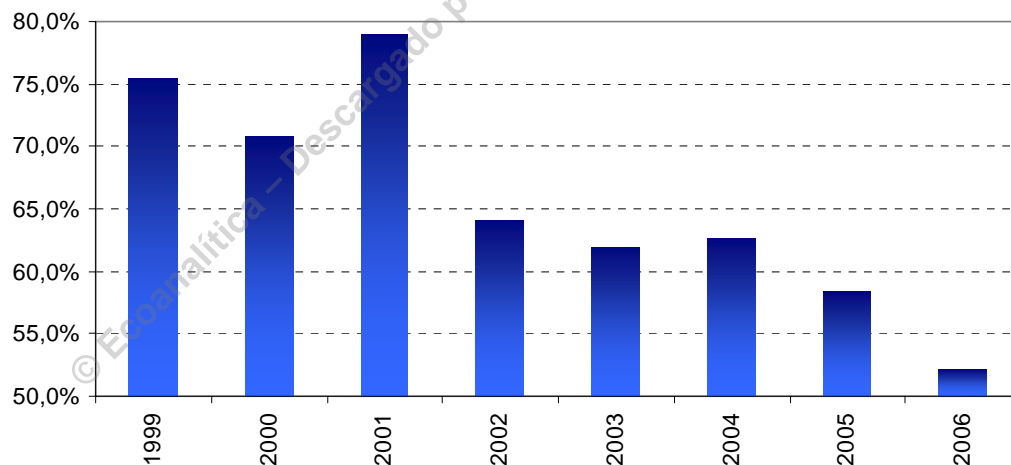
One possible explanation for this is that this item is considering capital outflows, especially from the public sector, as well as the purchases of foreign bonds, namely Argentinean bonds, by the Government.

**The BCV management of foreign currency coming from oil revenues is progressively more limited**

When you analyze the figures from the balance of payments and the foreign currency movements, you realize that the amount of foreign currency from oil exports that the BCV receives is steadily becoming less. This is due to the normative changes that the Government has been introducing. In this case, the BCV is losing a lot of the freedom it had to manage monetary policies in order to control inflation, since it no longer has direct control over the country's main company.

In 1999, total foreign currency from oil exports turned over to the BCV was at 75%. In 2006, this indicator was at 50%. The lowest it's ever been since Chávez came to power.

**Crude Oil / Total Oil Exports**



Sources: BCV and Ecoanalítica

**Modifications to the Exchange Agreement haven't been positive**

It's not a mystery to anyone the importance PDVSA has with regard to the Venezuelan economy. Two figures can help illustrate this fact: 87% of exports are oil-industry related and around 50% of fiscal revenues come from this one source. This impact can be measured in the real sector (power to buy goods and services), as well as in the monetary market (the entrance and exit of bolivars from the system that could cause abrupt spikes in the interest rates, and if it were the case, movement in the exchange rate). With regard to the latter impact,

remember that the old BCV Law established that PDVSA had the obligation to sell all its foreign currency to the BCV, with the exception of a fund that it would keep to be used for its operations (called revolving fund and which didn't accumulate more than US\$600 million). This way the emitting institute served as a buffer for the monetary impact that PDVSA created in its different operations.

However, from 2005 this dynamics changed. The BCV Law was modified, especially Article 113, which allows PDVSA to keep foreign currency funds. Then, in November 2005, the Exchange Agreement No. 9 is established, and its 1st Article states that PDVSA "will sell to the BCV only the amount necessary to cover operational spending...and the taxes that according to the law it is obliged to pay, for the amount estimated by the Venezuelan Budget Law." This is to say that, PDVSA is currently obliged to sell in bolivars to the BCV only foreign currency required to pay for its operational spending and taxes, with which the oil company can constitute funds in bolivars and dollars.

**And the Agreement was recently modified again**

Recently, the BCV and the Ministry of Finance released a statement whereby they introduced a new modification to the Exchange Agreement between PDVSA and the BCV which allows PDVSA to buy dollars from the BCV at the official rate. And it also states that PEQUIVEN will be eligible to do the same. This modification was made at the same time that PDVSA issued its US\$5.0 billion in bonds which will mature in 2017, 2027, and 2037.

The main placement of these bonds will be in bolivars. This new modification seeks to allow PDVSA to buy dollars necessary for its seeding project and the partial payment of the compensation owed to the Orinoco Belt companies with the bolivars it will collect through the issue. We estimate that 60% to 70% of what's collected will be used to buy dollars, though it's very difficult to predict when this transaction will occur.

**This, along with the transfers to FONDEN, will provoke a drop in international reserves**

*Ecoanalítica* expects that there will be a significant drop in international reserves. On February 27th, resources were transferred to FONDEN for an amount of US\$2.0 billion. We expect the same amount to be transferred by the end of March and by the end of April.

With respect to the issue, in our reserve simulation, we assume that 70% of the issue will be purchased in April. By the close of April, we

estimate that international reserves will be at US\$26.87 billion, which will reflect a drop of US\$7.4 billion with respect to the levels reached on March 27th.

**For now, these distortions aren't generating any problems to our foreign accounts**

At **Ecoanalítica** we are convinced that during 2007 and including 2008, the Government will be able to sustain this situation without getting into a foreign sector or a balance of payments crisis. But, just as with the fiscal accounts, our foreign sector is vulnerable to a change in the oil scene.

Given the robustness of the current oil prices, everything seems to indicate that Venezuela will maintain its foreign accounts in order during 2007. In 2008, if the distortions are corrected, the current accounts will start to show significant signs of deficit. However, this won't be reflected by a significant drop in international reserves because the Government has foreign funds which can be repatriated so that there will be a capital surplus registered for 2008.

## Economic Tips

**Successful PDVSA bond issue.** After almost 6 months of waiting, PDVSA placed on the market a bond issue equivalent to US\$5.0 billion, US\$1.5 billion more than what was originally announced. The issue was composed of US\$2.0 billion in 10-year bonds (2017), US\$2.0 billion in 20-year bonds (2027), and US\$1.0 billion in 30-year bonds (2037). The bonds are denominated in dollars but can be bought with bolivars at the official exchange rate.

**Important to be cautious.** At **Ecoanalítica**, we consider the issue to be quite attractive. However, you should be aware of a number of aspects:

- a. Unlike *Bonos del Sur II*, the investor should probably hold on to these bonds a bit longer in order to get better dividends. It's estimated that it could take up to two months or more for the issue to be stabilized on the secondary market.
- b. This is the largest issue that has ever been done in Venezuela and one of the largest in Latin America over recent years, so our main concern is how volatility will such a volume make domestic as well as foreign markets be.

c. The issue is not registered with the US Securities and Exchange Commission (SEC) since PDVSA has not been turning over its balances since 2004.

d. Therefore, the issue is being governed by the Regulation S (Securities Act). Its main implication is that the issue may only be offered to US investors 40 days after the initial date of issue.

e. Currently there is no bond issue like it on the market which could indicate what possible market value could be assigned to these bonds.

**The implicit parallel exchange rate is attractive.** It's important to point out that usually, oil company bonds are sold on foreign markets at a higher discount rate than what's applied to the sovereign bonds. We consider that the price may stabilize around 78% of the nominal value. This would be the same as buying the dollar at around VEB2,850/US\$ and VEB3,100/US\$. Our main recommendation is patience and caution, and not to make hasty buy/sell decisions. It's expected that at the first moment many people will sell.

**The Government expects moderate growth.** The Minister for Planning, Jorge Giordani, pointed out that the country's economic growth rate "obviously has to be a bit more moderate. We've always estimated an annual growth rate of 6% to 7%, and it's what we estimate it will be for the next six years." On the other hand, Giordani ratified that the inflationary goal for 2007 is 12% and he said that the Government expects the open unemployment rate to drop to 7%.

**New methodology for the CPI.** The National Statistics Institute (INE) is currently preparing a new methodology in order to expand the calculation of the Consumer Price Index (CPI), which up to the moment only has the Caracas Metropolitan area and the city of Maracaibo as reference. The INE expects to expand the reference areas to include Barquisimeto, Barcelona-Puerto La Cruz, Maracay, Ciudad Guayana, Valencia, San Cristóbal, Maturín, and Mérida. This national indicator will have the first half of 2007 as its base year and it will be issued for the first time in November this year. Afterwards it will be reported on a monthly basis by the BCV and the INE.

**The poor are receiving less.** According to the Economic Commission for Latin America and the Caribbean's (ECLAC) statistic yearbook, in a period of fifteen years people living in poverty have gone from receiving 4.3% of the GDP in 1990 to being able to share in 3.4% of their nation's wealth by close of 2005. On the other hand, the percentage of poor people dropped during this period going from 39.8% in 1990 to 37.1% at the close of 2005.

**And the number of people living in poverty increases.** Taking population growth into account, the number of people living in poverty increased, going from 7.8 million in 1990 to 9.8 million people in 2005, according to ECLAC figures. This means that, for the last two years, almost 10 million poor people only received 3.4% of the GDP, while in 1990 around eight million people shared 4.3% of the GDP.

**The distribution of wealth is deteriorating.** The ECLAC report highlights that the distribution of domestic wealth was unequal between social classes. The poor received less while those with the most resources managed to accumulate even more. More than half of the GDP is in the hands of the country's richest people, and they don't make up 10% of the total population. GDP distribution among the highest social level went from 51.1% in 1990 to 53.2% in 2005, when around 800 thousand people made up this group of the country's most wealthy.

**The middle class stagnates.** The ECLAC report points out that two years ago, the middle class received 43.5% of the GDP, almost the same that they shared 15 years ago (43.7%).

**Bank reserve requirements for newly created banks.** The BCV issued a resolution where it specifies that newly created financial institutions or those that have deposits and assigned investments under VEB90 billion shall have a reserve requirement between 12% and 15% of their total deposits. However, if the institution passes the VEB90 billion mark, "the application of a 30% coefficient" will be established. This measure will maintain the incentive for banks that specialize in micro-financing that registered significant growth last year, to continue their expansion. For all the rest of the financial institutions, the BCV maintained the current bank reserve requirement in effect for March 27th.

## OIL TIPS

**Slight increase.** The Venezuelan crude oil and by-product basket was up slightly, US\$0.07 after having been dropping for two weeks consecutively. Its average is at US\$51.76 per barrel. This puts March's cumulative average at US\$52.18 per barrel, up from the US\$50.41 posted in February and the US\$46.83 registered in January. The cumulative average for the year-to-date for the national basket is at US\$49.55 which is down almost US\$7 from the US\$56.44 reached in 2006.

**There's going to be a Gas OPEC.** By next April 9th, a group of five countries including Algeria, Iran, Qatar, Russia, and Venezuela are planning to come together and form a Gas OPEC. The idea is to create an organization just like the Organization

of Petroleum Exporting Countries (OPEC), but that will be in charge of regulating the buying and selling of natural gas in the world. This organization will be created in Doha, the capital of Qatar, during the Gas Exporting Countries Forum meeting, an organization which was created in 2001 and which currently guarantees the stability of the supply of gas for a number of countries in the world.

**The Government is searching for new buyers.** Venezuela hopes to increase its supply of oil that it sends to China and reach one million barrels daily by 2012. Currently there is a project being developed to create a number of mixed companies between PDVSA (60% shareholder) and the Chinese National Petroleum Corporation (CNCP) (40% shareholder) in order to develop certain blocks of the Orinoco belt. These companies could be up and running in two or three years time and produce up to 600 thousand barrels of crude daily.

**And new refineries.** The Government is looking to start up another mixed company in China which will build three refineries that are designed to work with the crude coming from the Orinoco Belt. For this project PDVSA will only be a 40% stockholder. A third mixed company is also in the works with mixed capital from both countries, 50% from each, in order to manage a fleet of oil tankers.

## BUSINESS SECTOR TIPS

**CADIVI to streamline processing of foreign currency to airlines.** CADIVI reported that due to the crisis that the national airline industry is going through, it will modify its administrative procedures with regard to the dollar granting to airlines. This change is motivated by special circumstances that surround the airline industry, such as the import and export of parts and supplies specific to the industry which require special legislation.

**CAF to introduce new issue.** The Andean Development Corporation (CAF) announced its third issue of securities in Venezuela in less than a year. This time the issue was worth VEB127.5 billion (US\$59.3 billion) to mature in 2012. This is the third time the National Securities Commission (CNV) approves an issue in 2006 for a total of VEB450 billion (US\$209.3 million). The first series was issued in June 2006, for an amount of VEB215 billion (US\$100 million), the second was in February 2007, for VEB 107.5 billion (US\$ 50 million).

## ***Weekly Report***

**Taking advantage of it.** It's important to point out that given the foreign exchange control in Venezuela and the distortions that it generates, these types of issue for multilateral organisms are at a very low cost and not very problematic in order to get foreign currency at the official rate, clearly overvalued.

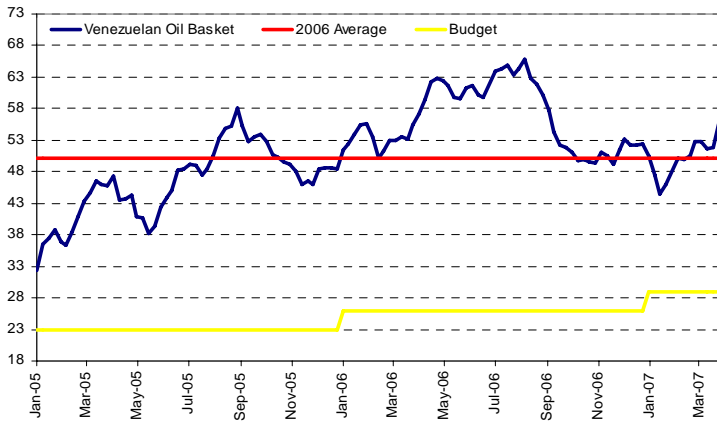
**Cooperatives only on paper.** According to the information collected by the National Superintendence Department of Cooperatives (SUNACOO), approximately 60% of cooperatives are dedicated to services and production. Juan Alemán, head of the Superintendence, informed that there are around 184,000 cooperatives registered with this organization. Of these, 60,000 are active, which leaves a total of 124,000 that are inactive, 66% of the total registered. Concerning the irregularities detected in the performance of cooperatives, the one that most occurs is of administrative nature, because of not being able to correctly manage accounting procedures and balances.

**Fifth market in Latin America.** According to the German luxury car manufacturer, Audi, in 2006, the leader in units sold was Chile, followed by Venezuela, Colombia, Dominican Republic, Guatemala, and Peru. These figures didn't include Mexico, Argentina, and Brazil.

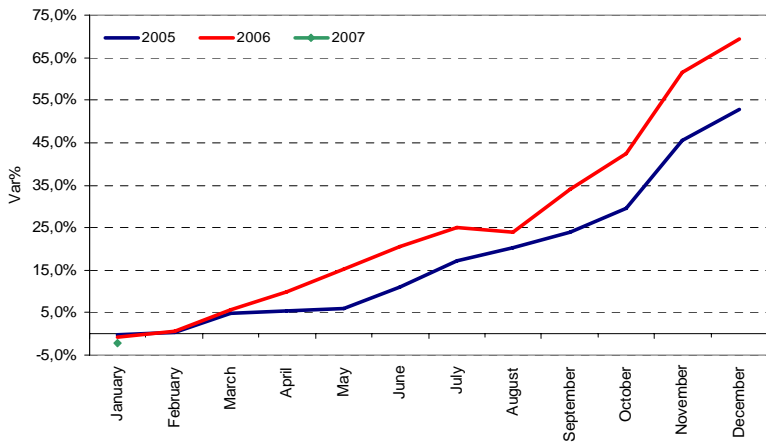
**Venezuela going backwards.** Venezuela dropped two places, according to the Global Technologies and Information Report 2006/2007 that the World Economic Forum puts out. The country was 83rd in the report which measures the access, the application, and use of information technology. In 2005, Venezuela was ranked 81st. Countries ranked higher than Venezuela are: Argentina, Colombia, and Panama (ranked 63rd, 64th, and 65th, respectively); Uruguay and El Salvador (60th and 61st) and Mexico, Brazil, and Costa Rica, ranked 49th, 53rd, and 56th. The highest ranked country of the region was Chile in 31st place.

# ECONOMIC OVERVIEW

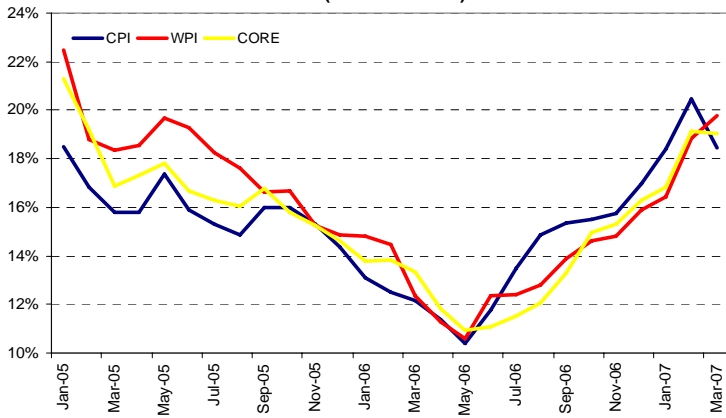
**Oil Price**  
(Venezuelan Basket US\$/pb)



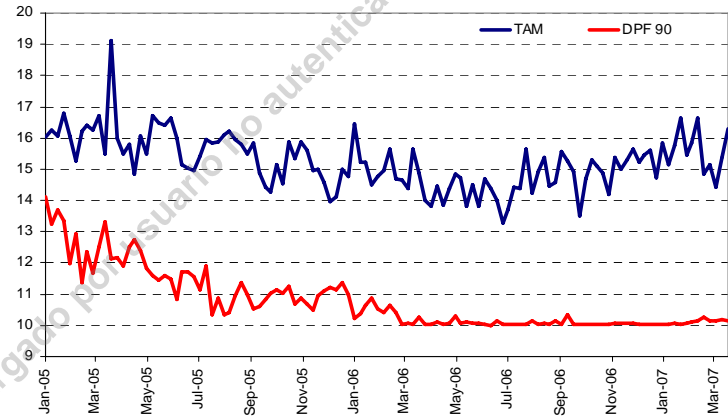
**Real Expansion (M2)**



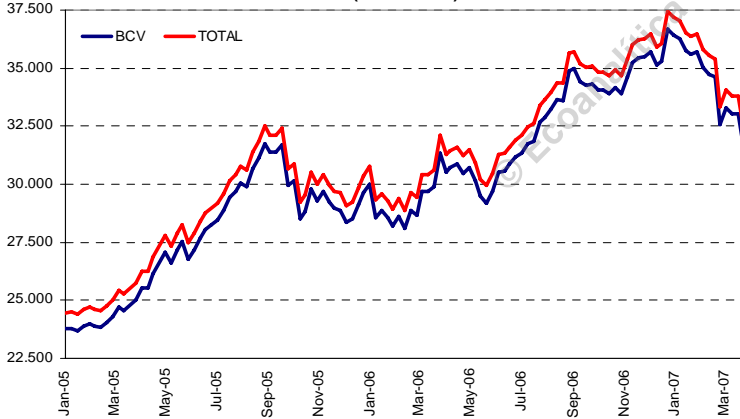
**Inflation**  
(Last 12 Months)



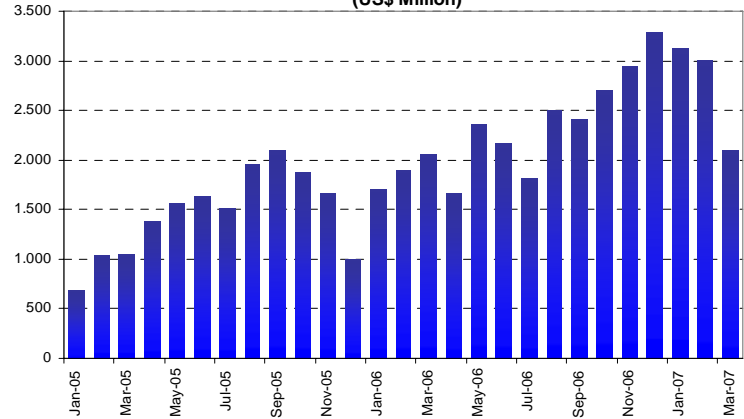
**Interest Rate**  
(Six Principal Banks)



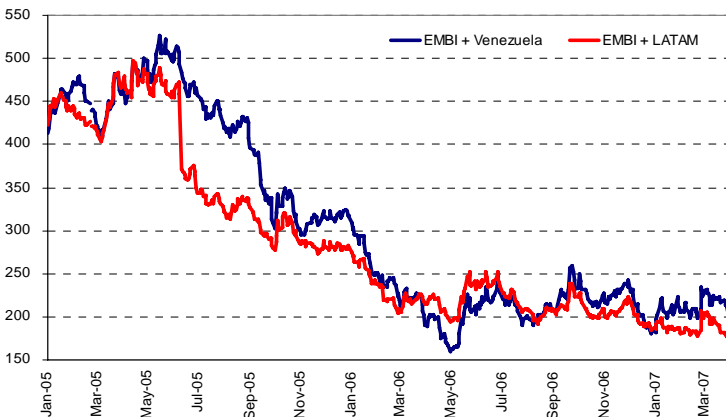
**Fx Reserves**  
(US\$ Million)



**Disbursement**  
(US\$ Million)



**EMBI**



**Central Government**  
(VEB Billion)

