



Volume 3, Number 14  
April 27, 2007

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## *Venezuela: First state in history to launch a merciless attack on its own international reserves*

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**THE CLIENT**

The nation's international reserves have been savagely attacked by the State over the first four months of the year. The result has been a significant reduction in these resources, brought about by the flight of private sector capital - encouraged by a public sector company - and the transfers of hard currency to funds whose risk and liquidity levels are questionable.

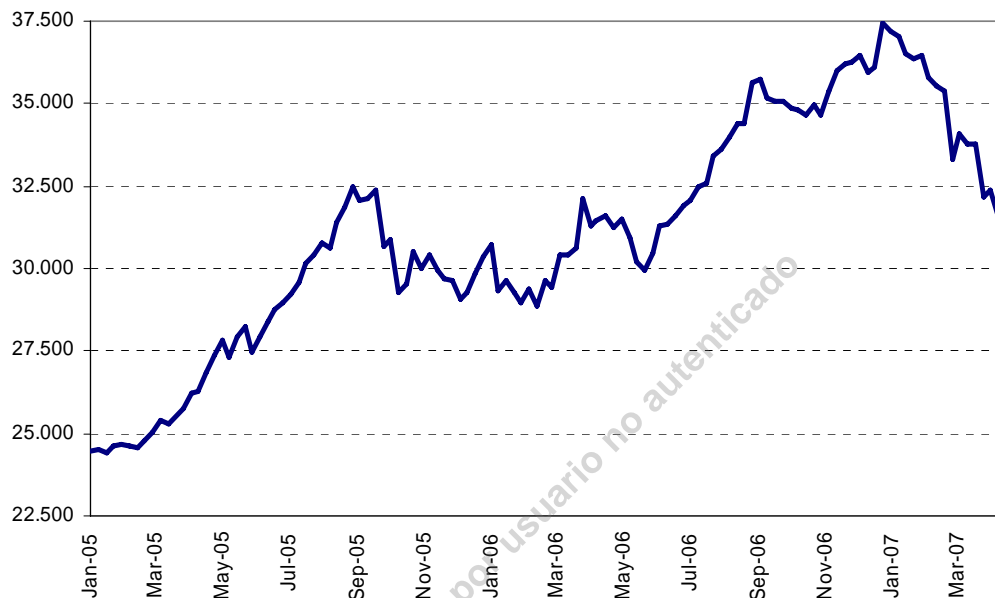
The excuse bandied about by the Executive for these extraordinary withdrawals is that it is seeking to control inflation and reduce monetary aggregates (M1). However, at **Ecoanalítica** we have no doubt whatsoever that there are far more effective ways of controlling price increases, starting with fiscal discipline, for example.

**International reserves  
have so far fallen by 22%  
in 2007 – equivalent to  
something over US\$ 8  
billion**

On December 31, 2006, Venezuela's international reserves (not including the Macroeconomic Stabilization Fund) stood at US\$ 36.7 billion, substantially more than this year's April 25 figure of US\$ 28.6 billion. The responsibility for this reduction lies "surprisingly" in decisions taken by the public sector.

# Weekly Report

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



Sources: BCV and Ecoanalítica

**One of the reasons for the fall in the reserves is the transfer of funds to FONDEN**

During the first quarter of the year, the Central Bank of Venezuela (BCV) had transferred US\$ 3.7 billion of international reserves to the National Development Fund (*Fondo de Desarrollo Nacional - FONDEN*). At that point there was a transaction pending for US\$ 2.3 billion to be completed in April, making a total migration of resources for US\$ 6 billion. At *Ecoanalítica* we are not absolutely sure whether the latter transaction has been so far completed, but we think not, since these transfers tend to be made on the last business day of the month, and we therefore expect it will be executed next Monday, April 30.

**Once foreign currency exits the international reserves, it loses its security and liquidity guarantees**

It is important to emphasize that the character of the foreign currency resources held by the State in its account with the Central Bank of Venezuela is not the same for such funds when they are transferred to be spent through FONDEN. It must be borne in mind that the international reserves are the sums held in foreign currency that serve

to support the value of Venezuela's own national currency, whilst the currency transferred to FONDEN is converted into Bolivars, thus increasing liquidity and this is - precisely - one of the cause of the Bolivar's loss of value.

A second point to be mentioned is that the international reserves and the funds transferred to FONDEN do not have the same levels of security or liquidity. In this sense the declarations of Rodrigo Cabezas, Minister of Finance, have to be taken into account, particularly when, at the beginning of the year, he announced that the FONDEN held structured notes for US\$ 6.2 billion. If this is true, it must be remembered that such notes are deemed high risk and low liquidity, and are therefore less transparent and their prices more easily manipulated.

## PDVSA bonds - an incentive for private sector capital flight

Following a terrible fiscal, monetary and foreign exchange administration that allowed the parallel market rate to attain levels of over VEB 4,500/US\$1, the State decided to start subsidizing capital flight by selling the foreign currency at prices close to VEB 3,000/US\$1 through the emission of US\$ 7.5 billion in State-owned oil company securities. **Ecoanalítica** has no doubt at all that PDVSA has been able to place an amount superior to the US\$ 5.0 billion previously offered or the US\$ 7.5 billion issued, but this operation is nothing less than a frontal speculative attack on the national currency that was this time organized, incredible though it may seem, by Venezuela's main public company. In this regard, it must be added that as PDVSA continues to buy the currency it has sold to the private sector from the BCV, the international reserves will continue to fall.

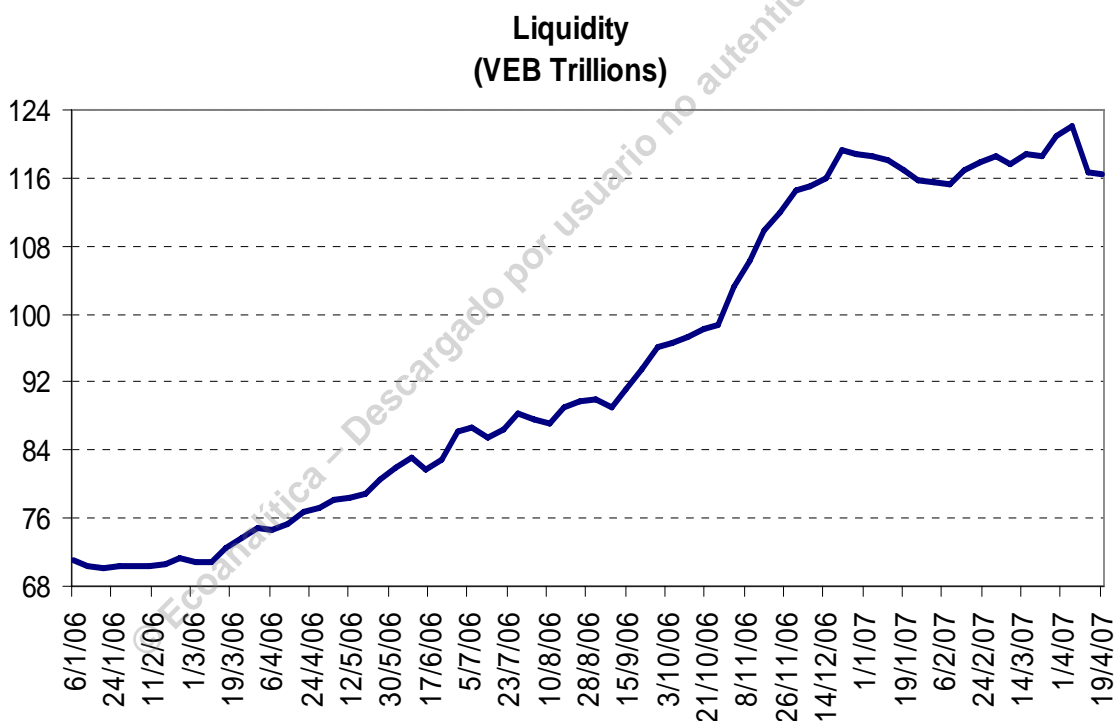
## The drop in international reserves will continue throughout May

At **Ecoanalítica** we calculate that if PDVSA eventually acquires foreign currency enough from the BCV to cover 80% of its securities issue (US\$ 6.33 billion), and to this is added the last transfer of funds to FONDEN (US\$ 2.3 billion) and the approximately US\$ 3 billion authorized by CADIVI, the reserves will suffer a total reduction of a massive US\$ 11.63 billion. Once US\$ 3.75 billion of oil income is deducted from this figure, we estimate that the reserves will have fallen to around US\$ 25.3 billion, and that this level will remain unchanged through the end of May.

# Weekly Report

**The excuse used for this meticulously planned speculative attack on the country's currency is controlling inflation by soaking up liquidity**

The PDVSA bonds definitely brought about a contraction in liquidity, but during the week ending April 13, the amount of money in circulation fell by a mere VEB 5.6 trillion in comparison with the previous week, dropping from VEB 122.1 trillion to VEB 116.6 trillion as a consequence of having paid in Bolívars for the US\$ 7.5 billion security issue by PDVSA. This means that the real contractive effect of the VEB 17 trillion securities emission on liquidity was approximately one third of the total value of the bonds issued.



Sources: BCV and Ecoanalítica

**Ecoanalítica believes that the contraction in liquidity was not what PDVSA expected**

Inside the State oil company – which is not supposed to understand monetary planning – people must be scratching their heads and asking themselves why liquidity only fell by VEB 5.6 trillion if the payout by the economic agencies had been VEB 17 trillion. The answer is that monetary liquidity depends on the one hand on “high-powered money” or the monetary base, and on the other on the multiplying factors of this base, which are none other than the effects of the financial system’s expanding the monetary aggregates.

If the economic agents acquired PDVSA bonds using 30% of their own resources and the remaining 70% by taking on debt, the effect of the issue over liquidity is only 30% of the amount issued. In other words, a proportion of one third of the value of the PDVSA securities acquired was done so using the economic agents' own resources, thus impacting the levels of their deposits, and the deposits are one of the components of the above-mentioned high-powered money.

The remaining two thirds were financed by taking on debt, and this drives up the liquidity-multiplying factor. Obviously, there is no reason why PDVSA should know the meaning or results of these terms, and this is precisely why it should not be assuming attributions that belong exclusively to the issuing agency.

**Issuing bonds is an inefficient mechanism for controlling monetary aggregates, and therefore inflation**

These bond issues are usually acquired using a high level of leverage, therefore their effect on liquidity is only moderate. Moreover, this is a temporary restriction, since once the entity issuing the bonds starts spending the resources, they go right back into the financial system.

The reason this measure is inefficient is that its growth is the result of massive fiscal indiscipline. As we have had occasion to repeat over and over again, if the Government keeps up the rhythm of expenditure growth, financed by oil resources and monetary emissions – transfers of international reserves that are to be spent through FONDEN – the increase in monetary aggregates will also continue to grow, as will the pressure on prices. Therefore the impact of these operations on inflation and even on the non-official exchange rate is limited. On the other hand, this significant fall in international reserves is worrying, given the scant hard currency support for our currency. If this drop in reserves materializes, they will be supporting just 46% of the country's monetary liquidity. Moreover, this drop in international reserves will start alarm bells ringing throughout international markets, and the country risk factor will be pushed upwards.

## Economic Tips

**SENIAT increases March VAT collections.** March non-oil collections were VEB 8.1 trillion (US\$3.767 billion), a nominal increase of 34.8% over the last twelve months or a real increase of 13.8% in respect to March 2006. The greatest increase was seen in Income Tax, which grew by 20.9% in real terms. It should be pointed out that in spite of a three-point reduction in the VAT rate, which went down from 14% to 11% in March, collections of this tax rose by 26.9% in nominal terms, or 7.1% in real terms, when compared with the same month of the year before. This result could only have been achieved through a sharp cutting down on evasion.

NATIONAL TAX COLLECTION (VEB Billions)		MARCH		
	2007	2006	Var %	Var % Real
<b>TOTAL</b>	8.051	5.972	34,8%	13,8%
<b>Income TAX</b>	5.038	3.517	43,2%	20,9%
<b>Tax</b>	1.526	1.202	26,9%	7,1%
<b>Customs</b>	1.349	1.135	18,9%	0,3%
<b>Others Incomes</b>	138	118	16,5%	-1,6%
<b>Debit Tax</b>	0	0	0,0%	0,0%

NATIONAL TAX COLLECTION (VEB Billions)		JANUARY-MARCH		
	2007	2006	Var %	Var % Real
<b>TOTAL</b>	16.517	12.205	35,3%	13,6%
<b>Income TAX</b>	7.356	5.154	42,7%	19,8%
<b>Tax</b>	4.907	3.696	32,8%	11,5%
<b>Customs</b>	3.915	2.720	44,0%	20,9%
<b>Others Incomes</b>	339	312	8,6%	-8,8%
<b>Debit Tax</b>	0	324	0,0%	0,0%

Sources: SENIAT and Ecoanalitica

**The SENIAT continues to increase its contributions to the Treasury.** During the first quarter of the year non-oil collections rose by 35.3% in nominal terms or 13.6% in real terms, to stand at VEB 16.5 trillion. The most dynamic taxes have been those of the customs, which grew by 44.0% in nominal terms. This is explained by the policy of subsidizing the importing sector, begun around the beginning of 2003.

**Banco del Sur will perhaps not be counting on Brazil among its members.** The Banco del Sur project, promoted by Venezuela's President Hugo Chávez, and vaunted as a potential competitor for the Banco Interamericano de Desarrollo (BID), may not be able to count on the important presence of Brazil. According to Brazil's Treasury Minister, Guido Mantega, Brazil will only participate in the project if it can enter into the discussions as an equal and if the institution in question is constructed using modern banking principles.

**Companies have to take into account the changes brought about by the State.** "Twenty-First Century Socialism" as it is called, has caused a lot of headaches for Venezuelan businessmen, particularly because of the profound changes being incorporated at a breakneck speed. Humberto Sanchez, Senior Manager at Arthur D. Little de Venezuela, is recommending that companies become strategically more flexible in order to respond to the changing conditions of the market, and also to move closer to the public sector and the mass markets.

**Venezuelan exports to Colombia down by US\$ 48 million.** Colombia increased its imports by 32% during the first two months of the year, going from US\$ 3.5 billion in 2006 to US\$ 4.6 billion this year. In spite of this growth in the trade of our sister Republic, business with Venezuela fell by 18.4%, going down from US\$ 260 million to US\$ 212 million during the same period this year. Colombian imports from the rest of the Andean Community (CAN) grew by 25.6% during the first two-monthly period of the year.

## OIL TIPS

**Venezuelan oil basket up.** Last week (16/04 to 20/04), the average price of Venezuelan crude stood at US\$ 57.9 per barrel, an increase of 0.4% over the prices of the week before. This increase in international oil prices is partly due to uncertainty over the elections in Nigeria, ongoing tension in the Middle East and worries over gasoline supplies in the USA.

**Friction between Venezuela and Brazil at energy summit.** The main causes of this friction were, firstly, disagreement over the inclusion of an article in the final statement against ethanol production. The pressure was so strong that Chávez opted to change his opinion and support the production of ethanol, saying that Venezuela would commit to buying 200,000 barrels of ethanol per day from Brazil. Secondly, doubts were cast as to the feasibility of the project, since Brazil only wants the gas pipeline to reach as far as Arrecife, rather than cross the whole Continent. Finally, in view of its

difficult relationship with Bolivia, Brazil opposes the creation of a new gas-producer cartel.

**Faja transition process almost complete.** The deadline for initiating the conversion of the four strategic associations operating in the Orinoco oil belt into joint-venture companies - *Empresas Mixtas* - is May 1. Corporación Venezolana del Petróleo (CVP) will sign a first memorandum of understanding with the six foreign oil majors, establishing the general conditions of the migration process. However, actual participation percentages and financial evaluations will be excluded at this stage. Financial and operating administration will be taken over by CVP, thus concluding the transition period.

**Process to continue after June.** June 26 is thus fixed for the start of the second stage, when formalities such as the percentage participations of each partner (CVP's holding cannot be less than 60%) will be decided upon. A manual of operations transfer, subscribed to by PDVSA, has been drafted so as to avoid interruptions in the exploration, production and upgrading processes.

**Negative note imprinted on the Faja migration process by Minister Ramírez at Margarita summit.** At the summit, Minister Ramírez commented that some companies operating in the *Faja* were not entitled to receive any compensation whatsoever. We fail to understand the reason for this statement, since all the companies have in some way or another invested capital there, and to date PDVSA's policy has always been to recognize investment by foreign companies, even when the parties' valuations are at odds. Given PDVSA's need to keep its operating partners on board, at *Ecoanalítica* we doubt that this comment will come to anything. In fact, it would have a negative impact on the value of the oil bonds.

**Contraction in OPEC exports.** Consultants *Oil Movements* foresee a drop in overall OPEC exports of about 90,000 b/d, from the current 24.1 million barrels per day to the 24.0 million b/d estimated for May 5. This result is a further consequence of the exports reduction policy in force since November 1, 2006, which has managed to take between 900,000 and 1,000,000 barrels per day out of the market.

**PDVSA and Ecuador now oil partners.** The agreements signed by Petróleos de Venezuela and the Ecuador Government cover exploration plans in the bay of Guayaquil, oil field production (in the area known as ITT, Ishpingo-Tambococha-Tiputini), and also joint work on updating Esmeraldas, the country's main refinery. These plans, announced by President Correa at the First South American Energy Summit, also put forward the idea of a mega-refinery on the Pacific coast for exports to Asia.

**Paraguay too.** Venezuela and Paraguay plan to construct a refinery on the outskirts of the Paraguay's capital Asunción. Construction work is to begin later on this year on the Venezuela-financed plant, which will have a refining capacity of 40,000 barrels per day. The refinery will be run by a joint-venture company (*empresa mixta*) set up by State-owned companies PDVSA and Paraguay's PETROPAR.

## BUSINESS SECTOR TIPS

**Electricidad de Caracas (EDC) to organize transition board.** The transitional board of directors is to be chosen this week, with members from Electricidad de Caracas and the Government, the latter being promoter of the Public Share Offering. It is said that the Executive has already assembled the team of technicians and professionals that will take over decision-making positions in the electricity company. The names of the managers that will keep their jobs for a period of three to six months has been announced internally.

**Shareholders told not to sell out to the Government.** The Federation of Telecommunications Workers (FETRATEL) has recommended that CANTV Class C shareholders not unload their shares, at least not within the current framework of the takeover of their company by the State. Ygor Lira, President of FETRATEL, has stated that the price established in the Public Takeover Offer (*Oferta Pública de Toma de Control* - OPTC) is extremely low, and insisted that the workers are simply seeking a fair price for their shares. Lira stated that the workers' minimum negotiation price for their shares was US\$ 4.71, their value when issued in 1991.

**CANTV Board declares itself neutral.** Nevertheless the Board of Directors last week issued a communiqué recommending that the Government resolve the price differences existing between Venezuela shareholders and those holding ADSs in the USA. Telecommunications Minister, Jesse Chacon, has insisted that the price offered to the shareholders is fair, and that the Executive is legally impaired from offering different prices to the shareholders.

**Arbitration opportunities arise as a result of this scenario.** Venezuelan investors pushed the Caracas Stock Exchange Index up by 2.8% this week, as CANTV (+12%) and EDC (+4.8%) share prices rose on the local market. The purpose of these investors is to convert the shares into ADRs and ADSs and then sell the shares to the Government in US Dollars.

## ***Weekly Report***

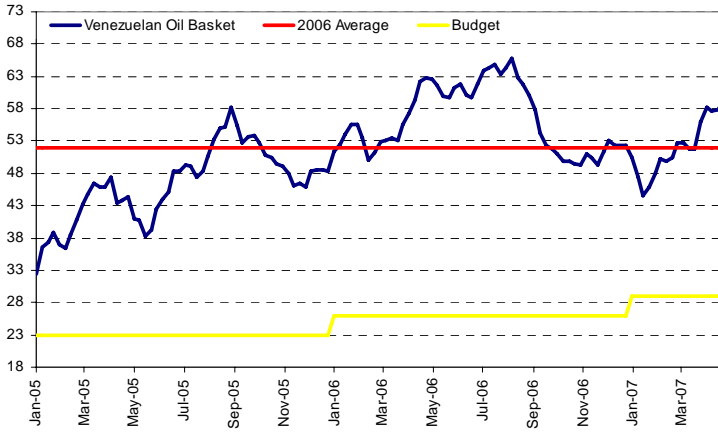
**Uncertainty abounds over SIDOR nationalization announcement.** Top Government officials nevertheless deny such a move.

**Consumer credit grows by 121% in March.** Low interest rates and scant incentive to save due to high inflation; have generated a huge increase in consumer credit, which leapt from VEB 6.6 trillion in March 2006 to VEB 14.6 trillion in March this year. In real terms, Venezuelans' credit card debt increased by 116% year-on-year, and financing of auto purchases increased by 128% over the year 2006.

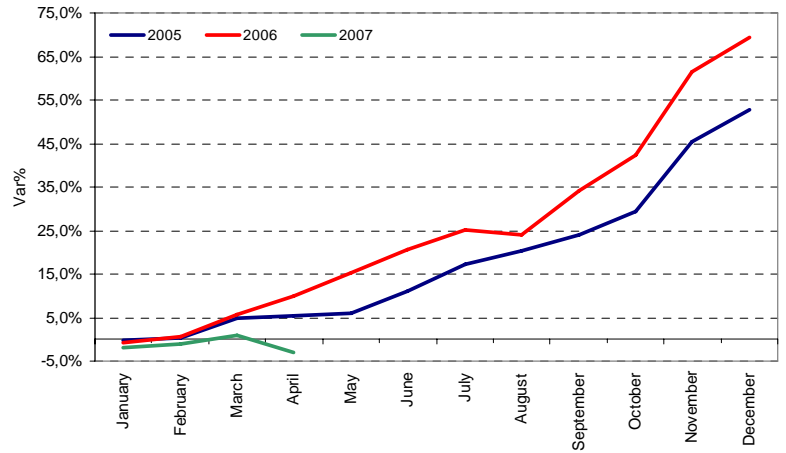
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# ECONOMIC OVERVIEW

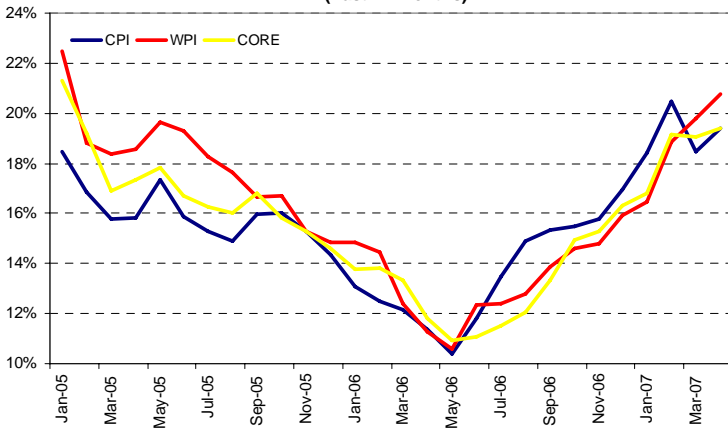
**Oil Price**  
(Venezuelan Basket US\$/pb)



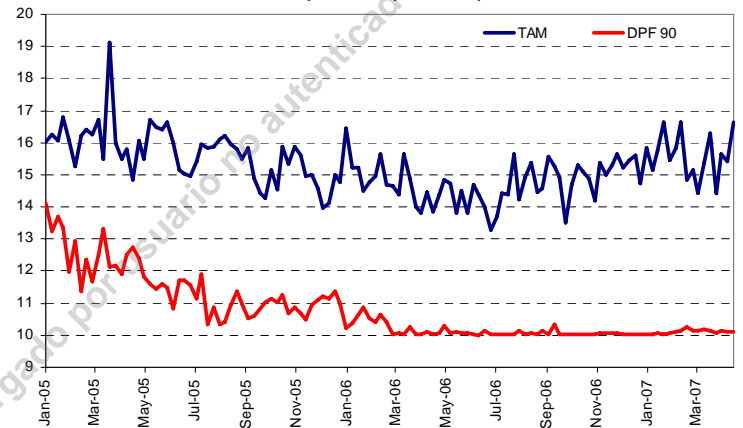
**Real Expansion (M2)**



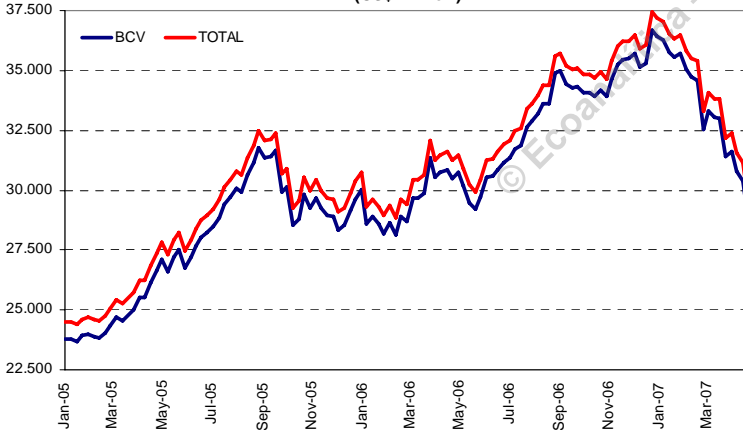
**Inflation**  
(Last 12 Months)



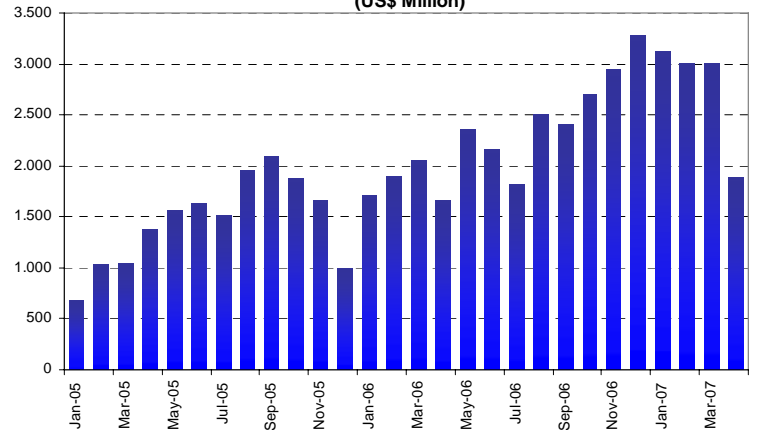
**Interest Rate**  
(Six Principal Banks)



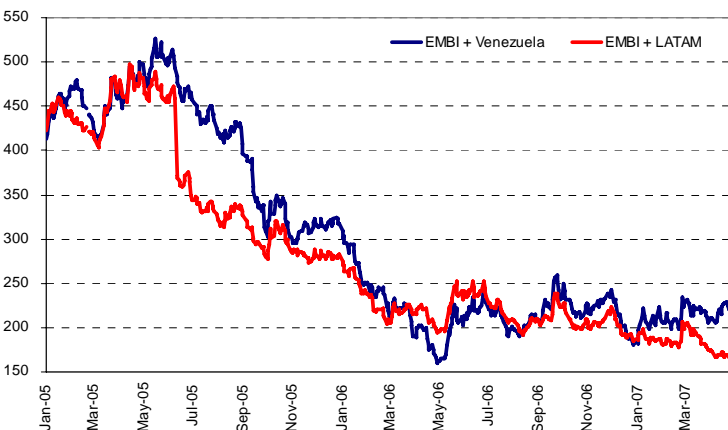
**Fx Reserves**  
(US\$ Million)



**Disbursement**  
(US\$ Million)



**EMBI**



**Central Government**  
(VEB Billion)

