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## **REFLECTIONS ON FOREIGN EXCHANGE**

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## **THE CLIENT**

In the last three weeks we've changed our perception concerning the foreign exchange market. Despite the fact that distortions are still clearly present in the market, and that these will unfortunately provoke an inevitable devaluation of the official exchange, we now feel that this devaluation will come about during the first quarter of 2009. The main reason for this change in perspective is the new monetary reform (Bolívar Fuerte) which will come into effect soon, and the inconsistent effect that devaluating the currency would have on it. Furthermore, the Ministry of Finance (MF) began to sell structured notes on the financial system, which is the same as selling foreign currency to the non-official market. That's why we believe that the unofficial foreign exchange rate should settle between VEB 3,500 US\$ and VEB 4,000 US\$ for the rest of the year. However, the distortions and the perverse incentive continue to exist in the foreign currency market, which in the end will cause a balance-of-payment crisis in the medium term.

**The last thirty months have seen a real appreciation of the currency**

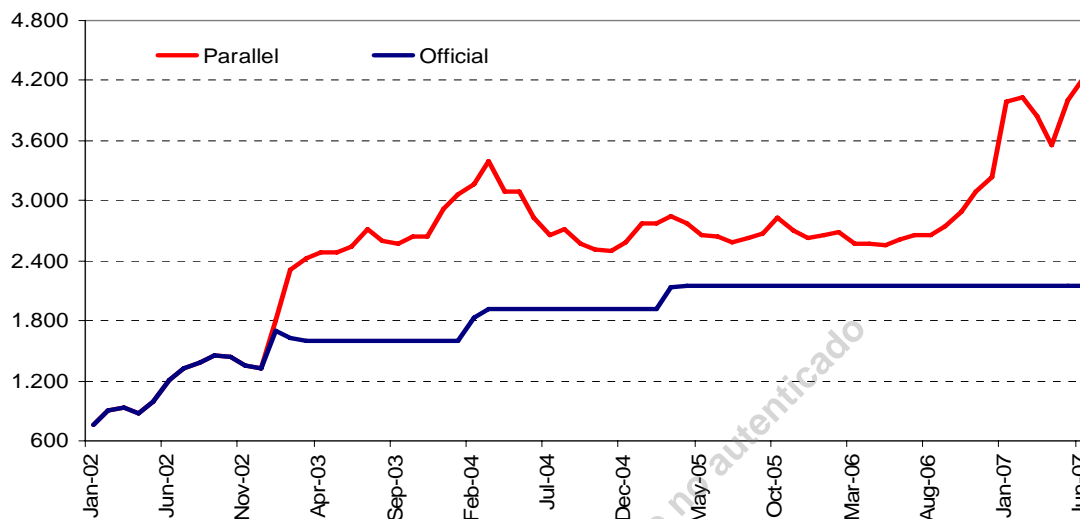
One of the reasons that we think will force the Government to devalue the currency is the differential between the increase of domestic and foreign prices. Since January 2005, when the Government adjusted the exchange rate from VEB 1,920 US\$ to VEB 2,150 US\$, accumulated inflation was at 38.9%. This means that the prices of goods and services in Venezuela had increased by 38.9%, while inflation in the United States, or main trading partner, had been 8,4%. As domestic inflation becomes greater than the inflation of our main trade partners, it becomes necessary to devalue the currency in order to maintain the economy competitive. In the last thirty months, Venezuela has become a lot less competitive than, for example, the United States economy. This makes the economic agents perceive that the exchange rate at VEB 2,150 US\$ is a “cheap” one.

**The perception of the official exchange rate also has to do with the parallel exchange rate**

Another distortion which makes us perceive the official exchange as being very “cheap” and that the Government won’t be able to maintain it at VEB 2,150 US\$ is the rate at which the parallel exchange is at. As we’ve said before, the exchange rate that the economic agents internalize as being the market price is the one that reflects the marginal cost of the last dollar they can buy and that defines the parallel market price. During the last few months, and despite the issues that the Government has made, the parallel exchange rate has reached VEB 4,300 US\$. This rate makes the currency sold at the official rate feel as if it were a US\$ with 50% subsidy and the natural reaction to this is to buy up as many goods and services at this subsidized rate. This is why the need to devalue the currency isn’t only about the general increase in the level of prices which create pressure to devaluation, but that the increase in the parallel exchange rate creates an incentive to frantically buy up foreign currency, as we saw happen in the first quarter of 2007, during which imports increased by 47% with respect to the same period the year before.

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Exchange Rate  
(VEB/US\$)



Sources: Reuters and Ecoanalítica

**Despite all that's happening, we don't expect a devaluation of the official exchange rate until January 2009, that is, as long as the oil prices remain strong**

At **Ecoanalítica** we disagree with analysts who say that the Government and the Central Bank of Venezuela (BCV) are planning to devalue the currency at the same time the monetary reform is being launched. In our opinion, this would underestimate the economic policy analysts. It doesn't make any sense that alongside the announcement and launching of the bolívar fuerte, the BCV would announce the devaluation of the currency. In fact, economic policy logics would indicate that the devaluation of the currency should be done as far apart in terms of time to the monetary reform. This analysis takes us to two scenarios: 1. - to devalue now, and implement some kind of fiscal economic austerity program in order to begin reducing inflation during the second quarter of 2007; or 2. - Wait until after the monetary reform measures are introduced and postpone the devaluation until 2009, if the parallel market and oil prices allow. With oil prices as they are, the second scenario seems the most likely. In both cases, we hope that the Government's devaluation of the currency be a "soft touch" adjusting the rate to VEB 2,500 US\$.

**We expect a significant drop in the parallel exchange rate**

Another reason why we believe that the official exchange rate won't be devaluated until 2009, is that at **Ecoanalítica** we expect there to be a significant drop in the parallel exchange rate. This is because since Thursday, June 21<sup>st</sup>, the Ministry of Finance (MF) has begun to sell structured notes on the market for a value that has been fluctuating between US\$250 and US\$300 million. This sale of structured paper is nothing more than a sale of foreign currency, which taking into account

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its market value, would increase the weekly supply of foreign currency in the unofficial market by US\$ 200 million. That's why during the first two weeks after the beginning of sales structured notes on the parallel market the unofficial exchange rate dropped from VEB4,300:US\$ to below VEB4,100:US\$.

**Gap between the official and parallel Market**



Sources: Reuters and Ecoanalítica

In this scenario, it's important to point out that since the PDVSA issue; the unofficial market has lost a lot of its depth, being traded increasingly small amounts. Shallow markets present great price variations at the slightest shift in demand and/or supply. That's why an increase in the supply of foreign currency of US\$ 200 million should produce a significant effect in its price. The level that the parallel market exchange rate will reach will depend on the reaction of the demand when the rate begins to fall. Despite it being very difficult to predict the prices in this market, if the MF continues to sell notes every Thursday as we expect, the unofficial foreign currency market should maintain itself around VEB 3,500 US\$ to VEB 4,000 US\$ for the rest of the year.

**This exchange market improvement doesn't change our prediction concerning the fact that the exchange control is not sustainable and this is just postponing the adjustment**

It should be clear to our clients that despite the drop in international reserves, we are postponing our devaluation proposal of the official exchange until the first quarter of 2009. Furthermore, as we expect that the MF will continue to sell structured notes throughout the rest of 2007, we believe that the parallel market will significantly improve from here on until the end of the year. However, this much improved exchange rate scenario does not in the least change our stance concerning the fact that the exchange control is not sustainable due to the distortions that it causes. Imports continue to be subsidized in part, and thereby leading us towards a balance-of-payment crisis which will end with very severe economic adjustments. Adjustments like what Venezuelans had to suffer through in 1989 and 1996, which led to the highest levels of inflation ever registered in history and the whole population of the country in general became poorer. This situation could be upon us between 2009 and 2011. It's a shame that a country has to fall in the same pothole so many times, and suffer such devastating effects to its population, especially those with the least amount of resources.

## Economic Tips

**The economy according to Chávez.** The constitutional reforms being introduced by President Hugo Chávez will establish a new socialist model State that will be able to exist alongside a productive private sector, according to the needs of the country. According to President Chávez, the State will develop different types of corporations and social economic property, production, and distribution units.

**Ministry of Finance continues with its strategy of selling notes.** Last week, the MF sold the equivalent of US\$250 million to a number of financial institutions in order to alleviate pressures on the parallel foreign currency market.

**The BCV with less autonomy.** In the constitutional reform draft, the presidential committee in charge of making changes has eliminated the BCV's autonomy that in practice has become much more vulnerable during the last few years. The new proposal contemplates that the nation's monetary policies be controlled by the Executive Office as the administrator of public property, which will coordinate and execute this office alongside the Central Bank.

## ***Weekly Report***

**FONDEN in the new Constitution.** FONDEN which was created due to the modifications made to the BCV Bank Law in 2005 will now be awarded constitutional rank, according to the new proposals being drafted. The Macroeconomic Stabilization Fund (FEM) is being eliminated, making way for FONDEN, and additionally it's being established that the BCV has to turn over its international reserve surplus to the entity.

**Public debt without limits.** The constitutional reform proposal establishes that the Executive Office will no longer have limits with regard to the issuing of papers. The modification made to article 312 indicates that "public credit operations will require a law that authorizes them. The law will define the modalities of the operations and authorize the corresponding budgetary funds."

**A positive aspect.** Also added to Article 312 is that "states and municipalities will not be able to contract public debt other than continued and ordinary management contracts that include a number of fiscal exercises."

**Round-off regulation listed.** The BCV board of directors approved the resolution that will govern the rounding-off process, specifying that prices will be rounded off to the second decimal.

**The exceptions.** Exceptions have been established to this provision, with regard to automobile fuels, liquefied petroleum gas (LPG), water, electric, methane gas, phone, and Internet services; and the shares that are negotiated with the stock exchange market. In these cases, prices will be taken to the third decimal.

**BANDES continues to open offices.** The president for BANDES, Rafael Isea, informed that he is studying a proposal from the Jamaican government to open one of its offices there.

**Unemployment continues to drop.** The National Statistics Institute (INE) reported that unemployment rate dropped to 8% at the close of last month, which means that until May a total of 973,375 people were unemployed. According to the official figures, unemployment was at 10.2% in May last year, which means that in the last twelve months unemployment has dropped by 2.2%.

**The public sector hiring more people.** Little by little the State is encroaching on the space which previously was considered a domain of the private sector, that of employer. The State's payroll is almost at two million. The INE registered a total of 1,969,783 employees in the public sector for the month of May, 159,162 more people than last year. This sector now represents 17.6% of the employed people, compared to a year ago when it was at 16.9% nationwide.

**100% public Social Security.** The constitutional reform is eliminating any possibility that private capital may have anything to do with the Social Security system, according to a draft that the presidential council in charge of writing the new Constitution is working on.

**Appointing the vice-minister of Agrarian Economy.** By decree number 5.413, the Executive appointed Richard Canan as vice-minister of Agrarian Economy. Richard Canan held the office of president of the Inter-Governmental Fund for Decentralization and president of the Venezuelan Agrarian Corporation.

**IV Economic Census will begin in July.** It will be held between the 2<sup>nd</sup> of July and the 31<sup>st</sup> of October, this year, during which time the information corresponding to the IV Economic Census will be gathered. This research hasn't been done since 1963. This information was released by the president of the INE, Elías Eljuri, who pointed out that this census would put an end to all the speculation concerning the size of economic activity according to each sector (commercial, industrial, and services).

**Investments with differentiated regulations.** The presidential council for constitutional reform considers that having the same regulations for both domestic and foreign investments can't be maintained over time, because in the end, it will threaten Venezuelan industries.

**More centralization.** President Hugo Chávez swore into office the Central Planning Commission, that will now be in charge of defining the plans by sectors and by which the autonomy of national entities will be eliminated. The Commission "will elaborate the central map of the national economic structure that will serve as the basis by which to plan and control the building of the socialist model."

**Appointed members of the Central Planning Commission.** Besides the Vice-President of the Republic, who will preside over and coordinate said commission, the following people will also be members: the minister of the People's Power for Planning and Development, who will coordinate the Executive Secretariat; the minister for Basic Industries and Mining; and for Light Industry and Trade; the minister for Communal Economy; and for Energy and Petroleum; and lastly the minister for Labor and Social Security; for Science and Technology; for Agriculture and lands; and for Finance.

**New methodology.** The INE is planning a change in methodology concerning the figures which identify the concept of informality within the work force which may imply a drop of 10 percentage points with regard to this indicator. Consequently, with the new methodology, the informal sector of the economy which is now represented by 44.1% of the population will come to be represented by 34.1% of the population.

**Beneficial cut.** As of July 1<sup>st</sup>, the VAT collected will be 9% and according to minister Cabezas, with this cut, funds in the order of VEB2.8 trillion will be earmarked for investment, savings, and consumption.

## OIL TIPS

**Crude oil keeps going up.** The Venezuelan oil basket price went up US\$2.26 last week reaching US\$63.99 per barrel. The average price of Venezuelan crude for the year has moved from US\$50.08 at the close of the first quarter to US\$54.75.

**Nationalization, a done deal.** PDVSA announced the end of the negotiations by which the strategic associations of the Orinoco Belt and the shared risk exploration agreements all migrate to mixed companies. Out of a total of 11 oil companies, only 7 of them accepted the new conditions. Total, Statoil, Chevron, BP, Eni, Ineparia, and Sinupec came to good terms with PDVSA in order to share operations in the Belt, which ended with memorandums of understanding being signed on the very last day of negotiations set by the Executive.

**Companies that left.** The companies that couldn't reach an agreement were: Exxon Mobil, Conoco Phillips, Petro-Canada, and Opic. With these negotiations concluded, PDVSA controls 78.3% of the shares of the business being done in the Belt. In the past, the State had controlled almost 40% of the shares.

**Reduction of exploration areas.** Along with the migration of mixed companies in the Orinoco Belt, PDVSA announced a redefinition of the exploration areas in Sincor, Cerro Negro, and Ameriven.

**Exxon Mobil is also getting out of the Gas Stations business in Venezuela.** Exxon Mobil's Venezuelan subsidiaries officially gave notice of their pulling out of the domestic gasoline market where they had an 6% share, with 49 gas stations bearing the Mobil name nationwide.

**United States concerned.** The US Secretary of Energy, Sam Bodman, said that he is concerned because the crude and the products coming out of Venezuela could diminish now that companies like Exxon Mobil and Conoco Phillips decided to leave the country.

**Certified the Belt.** The Canadian company, Ryder Scott, certified the existence of 28.65 billion barrels of Stock Tank Oil Initially in Place (STOIP) at the Carabobo-3

block of the Orinoco Oil Belt. This report is joined by the volume certifications of oil existing at Carabobo 1 and 2. The Venezuelan government expects to add 260 billion barrels of crude to the already 80 billion barrels that the country has, for a total crude oil reserve figure of 340 billion barrels.

**Crude sales to the U.S. improve.** After having dropped by 7% in March, Venezuelan crude oil exports to the United States regained their ground in April to 146 thousand b/d (14%) compared to the previous month to reach 1.18 million b/d, reported the EIA. If the volume registered in April is compared to the volume recorded during the same month last year (an average of 1.17 million b/d), a slight increase of 11 mil b/d (0.9%) is appreciated.

**PDVSA fires workers.** A group of more than 150 oil workers from Zulia state went to the CIED installations at La Tahona yesterday, where currently the industry's collective labor agreement is being discussed, to report the unjustified firing of 800 people that had been working on operating the drills that were being nationalized.

**Kenyan-Venezuelan agreement to buy oil.** The agreement signed between the governments of the Bolivarian Republic of Venezuela and Kenya will last for six years with an option for immediate renewal for another six years, reported the Kenyan Minister for Foreign Relations, Raphael Tuju. The Venezuelan government will assist Kenya in the exploration for oil in specific locations, suspected of having hydrocarbon deposits, of the African nation.

## BUSINESS SECTOR TIPS

**AES registers losses due to the takeover of EDC.** ASE Corp reported yesterday that it registered losses for the first quarter of the year due to low prices of shares sold of its electric company in Venezuela. AES announced the loss of US\$455 million, or 67 cents per share, compared with earnings of US\$348 million, or 52 cents per share, during the same period of the previous year.

**Confagan foresees a 10% increase in the production of beef.** The national Confederation of Farmers and cattle Ranchers estimate that with the arrival of the rains, local beef production will increase by 10% during the next few weeks. Therefore it projects that for the coming months until December the supply will be able to satisfy the demand. But, the Confederation also warned that if the necessary precautions weren't taken there could be shortages again by the end of the year.

**Decreed Meat Processing Plants with Social Purposes:** Decrees establishing the takeover of real and personal property and other improvements of the Frigorífico Industrial Barinas, S.A. and Frigorífico Industrial de Carnes de Perijá, C.A., for social purposes. All the assets expropriated will be transferred free from any levies or limitations to the property of the nation.

**Sale of cement increased by 116%.** The sustained growth of the construction industry for 14 quarters has increased the sale of cement by 116% during the last three years, pointed out Enzo Moschella, president of Cemex de Venezuela. The boom in the construction of infrastructure, roads, mass transportation systems like the subway and railways, shopping centers, and housing has significantly affect the commercialization of cement produced in the country, to the point that four years ago the bulk of cement production was exported and insignificant amounts were sold domestically. Cemex figures indicate that for the first quarter of this year, 82% of domestic cement production is being used here and only 18% is being exported.

**Full use of the credit card.** CADIVI statistics register that between January and May of this year, foreign currency authorized for use abroad through credit cards added up to US\$1.23 billion, representing an increase of 186% compared to the same time last year.

**Collective labor contract for bakery industry ready.** Between 15,000 and 20,000 bakery and flour industry workers will be benefited by the signing of the collective labor agreement between the Federation of Workers representing the industry (Fetraharina) and representatives of Employers Chamber of the Capital District, Miranda, and Vargas States.

**Continued trade setbacks with Bolivia.** The Bolivian Foreign Trade Institute (IBCE), which advises the country's exporters, once again accused Venezuela of failing to follow the Andean regulations by imposing import restrictions on Bolivian products.

**Studying possibility of cell-phone mixed company with Nicaragua.** Venezuela is looking into the possibility of creating a mixed company to develop cell-phones with the Government of Nicaragua in order to compete with América Móvil company run by Carlos Slim.

**Foreign flights increased by 20%.** During the first four months of the year, international flights from Venezuela increased by 20% compared to the same period last year, according to AVAVIT. Domestic flights increased by approximately 36%.

## Weekly Report

**Mercantil will issue a public stock offer.** The Financial Services governing board of the Banco Mercantil has decided to ask the National Securities Commission for authorization to issue a public offer of nine common stocks based on the company's authorized capital approved by the Shareholder Assembly held on March 30<sup>th</sup>, 2007.

**MERCAL sales below set goals.** According to figures introduced by the Ministry of Food for the month of May, Mercal daily distribution is at around 4,891 tons of food, significantly below the goals set at 6,000 tons daily, announced in March by Félix Osorio, president of Mercal. This means that the chain is still 22% below expected sales.

**Apartment prices go up.** At the close of the first quarter this year, apartment prices in Caracas increased by an average of 11.8%, putting the cost of the square meter at Bs.2.5 million, while in the last quarter of 2006 the cost per square meter was at Bs.2.2 million. When prices are grouped by municipalities you find that in some places prices have gone up by up to 20%.

**Digital TV on the way.** Jesse Chacón, Minister of Telecommunication and Information Technology, announced that by the third quarter of 2007 the decision will be made as to what standard of digital TV Venezuela will adopt (U.S., Japanese, or European), and it's expect that in 10 years time digital TV will be nationwide.

**Corporation increase.** The INE reports that the number of manufacturing industries operating in the country increased by 15.4%. According to INE studies, at the close of last year around 7,500 manufacturing companies were registered compared to 6,500 companies registered at the close of 2005, according to the Manufacturing Industry Directory done by the INE.

**Recalculation process starts.** The Ministry of Housing and Habitat published in the *Gaceta Oficial* the resolution by which it allows mortgage debtors in foreign exchange to start to calculate their .

### Political Tips

**190 ARTICLES OF THE Constitution will be modified.** Government party sources assure that the constitutional reforms will be ready by mid July. National Assembly representative and member of the Presidential Committee to Reform the Constitution, Carlos Escarrá, didn't comment about the percentages of articles that were being modified.

**Government freezes tuition for the 2007-2008 school year.** Through a resolution published today in the *Gaceta Oficial* N° 38.712, the Ministries of Education, Light Industry, and Commerce decided to freeze school tuitions for the 2007-2008 school year. According to the disposition that appears in the *Gaceta* of June 25<sup>th</sup>, all school tuition and/or monthly charges must be frozen, affecting “private schools that teach primary, basic, and high schools levels, as well as universities.

**Bandes and the Government of Suriname sign a cooperation agreement.** The Economic and Social Development Bank of Venezuela and the Ministry of Natural Resources of the Republic of Suriname signed a memorandum of understanding, as the basis of a future Administrative and Financial contract within the framework of Petrocaribe. The Administration and Financial agreement will constitute a financial alternative in order to contribute to the economic and social development, as well as the poverty index of the Republic of Suriname.

**Chávez denied military membership to PSUV.** Military personnel can not register in the Psuv or in any other party, answered the President in response to a question asked by Eleazar Díaz Rangel, on his first television appearance on TVEs, broadcast on Sundays from 10 to 11:30 pm. Chávez explained that in the constitutional reform certain changes in the structure of the armed forces are being studied in order to make them combined and more effective.

**President Chávez on tour.** The President has been on tour to Russia, Belarus, and Iran in order to sign a series of agreements, especially concerning matter of security and defense.

**Venezuela and Colombia meet.** Foreign Affairs Minister, Nicolás Maduro, met with his Colombian counterpart, Fernando Araujo, in Cartagena. Araujo urged the bilateral work committees to get passed the dialogue stage and start concrete actions.

**The OEA should come.** 57.2% of citizens of age surveyed by IVAD between June 10<sup>th</sup> and 18<sup>th</sup>, agreed with the idea that a mission from the OEA should come to Venezuela to make report about the RCTV case. The study is based on 1,200 home interviews nationwide. The studies reliability level is 90%.

**No to reelection.** With regard to the question of indefinite reelection to the office of President of the Republic that Chávez is proposing, 64.3% do not agree against 30.7% in favor.

**Safety is main issue.** According to the study, personal safety is the main problem that affects all Venezuelans followed by unemployment.

## ***Weekly Report***

**Students and Demonstrations.** With respect to the student demonstrations, most people believe that the demonstrations are held in defense of freedom of speech (56.9%) and a minority believes that it is to destabilize the Government (18.1%). 55.8% believe that the students organize the demonstrations while 37.7% believe that other people, not the students do.

**Military pay raise.** President Chávez announced an across the board 30% pay raise for the military.

**Müller Rojas retired.** The President decided to once again let General Alberto Müller Rojas retire so that he can dedicate himself exclusively to his work in the PSUV.

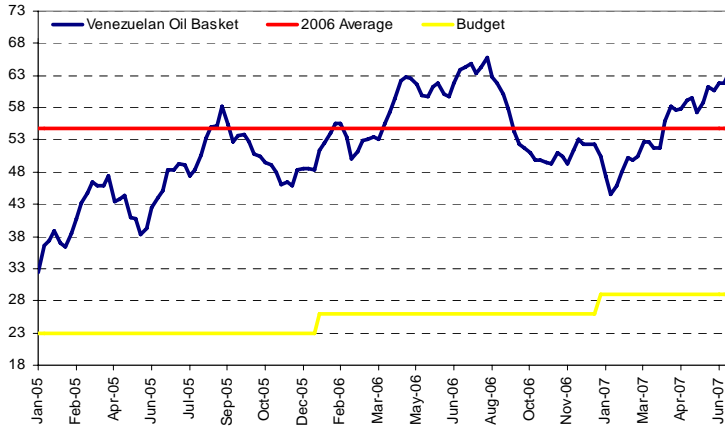
**Changes in the TSJ.** The draft turned into the President by the Presidential Committee for the Reform of the Constitution includes a modification as to the functioning of the TSJ. The modifications have to do with: a new concept with regard to the number of chambers; reducing the period that the magistrates sit on the bench; the requirement in order to be selected; the elimination of administrative decentralization of the judicial jurisdictions; the attributes of the maximum tribunal; and the possible creation of a Constitutional Tribunal that could be higher than the TSJ.

**First to enter.** According to the Brazilian Minister of Foreign relations, Celso Amorim, President Chavez should first become a full member of MERCOSUR before beginning to reform it, as he has mentioned on numerous occasions. The Brazilian Minister continued to say that Venezuela's entry "is good for MERCOSUR, as it's good for them."

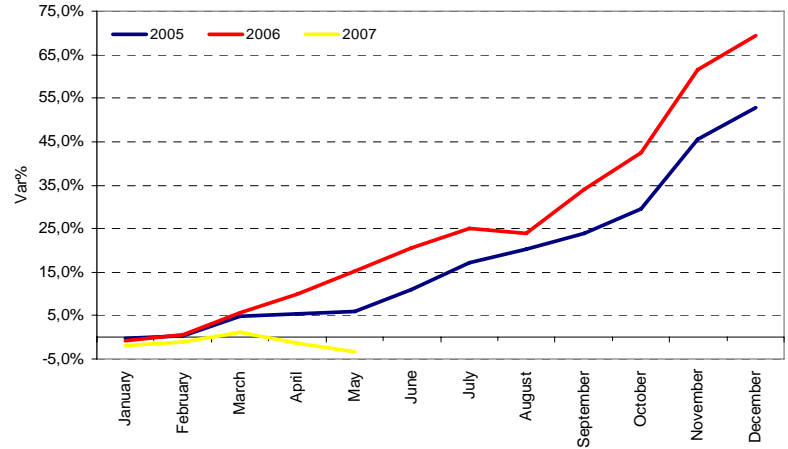
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# ECONOMIC OVERVIEW

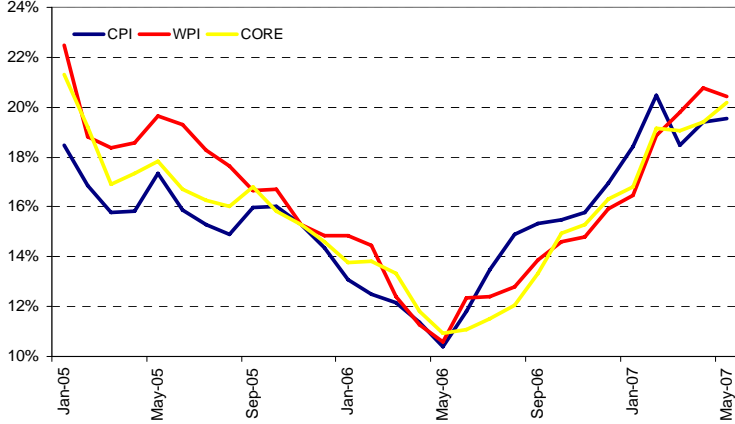
**Oil Price**  
(Venezuelan Basket US\$/pb)



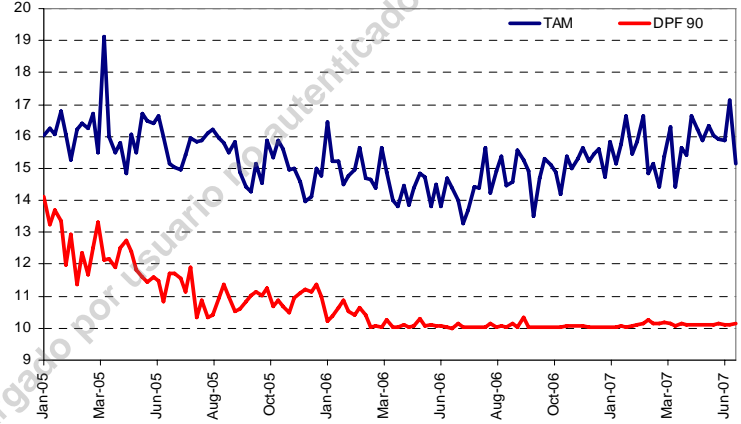
**Real Expansion (M2)**



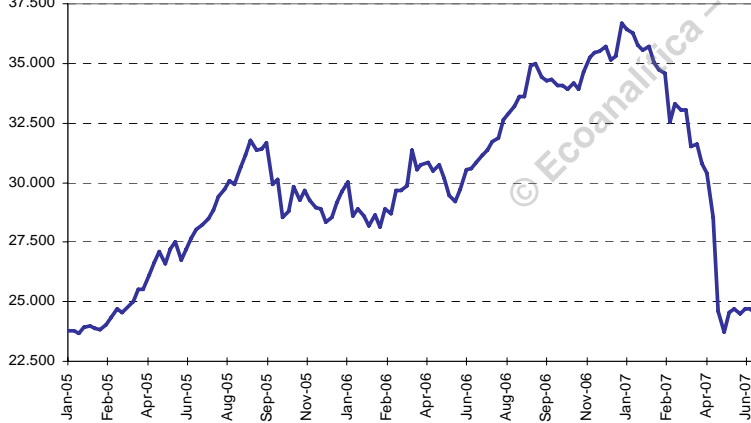
**Inflation**  
(Last 12 Months)



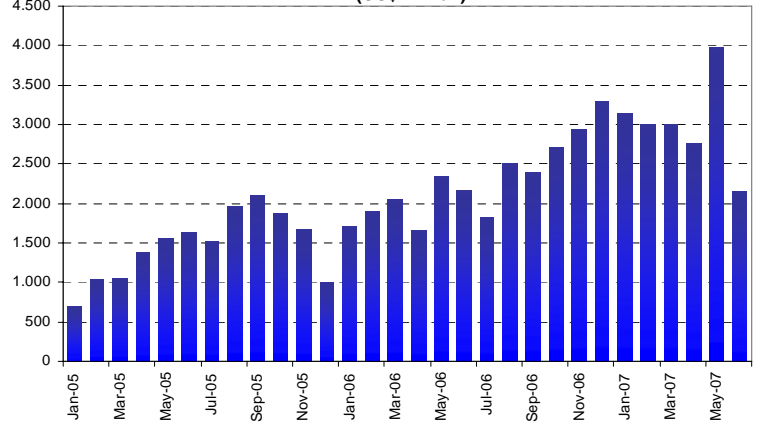
**Interest Rate**  
(Six Principal Banks)



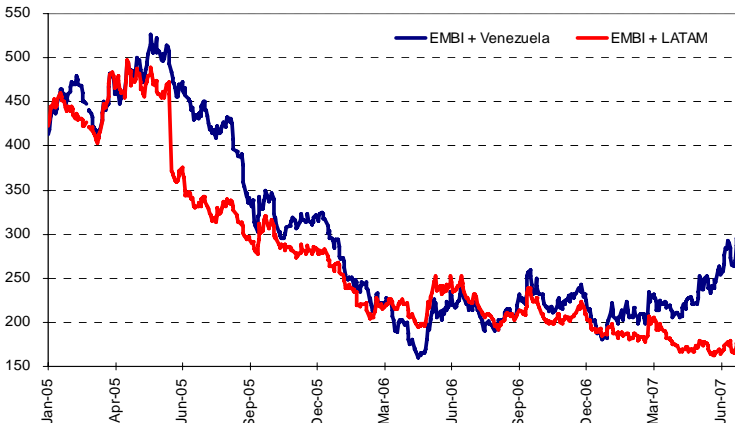
**Fx Reserves - BCV**  
(US\$ Million)



**Disbursement**  
(US\$ Million)



**EMBI**



**Central Government**  
(VEB Billion)

