



Volume 3, Number 40
Week IV, October 2007

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**PARALLEL MARKET:
DISTORTED BUT IMPORTANT
MARKET**

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The parallel market (or swap market) is not a very deep market. It's spasmodic and very opaque. However, this doesn't mean to say that it isn't an important market for the economy. This market is very important when it comes to fixing prices and creating forecasts. Therefore, it is imperative that the Government reduce the gap between the parallel market and the official one. The foreign currency authorized for credit cards and the sale of cars is a good example of the distortions that currently exist in the market.

**A market full of
distortions**

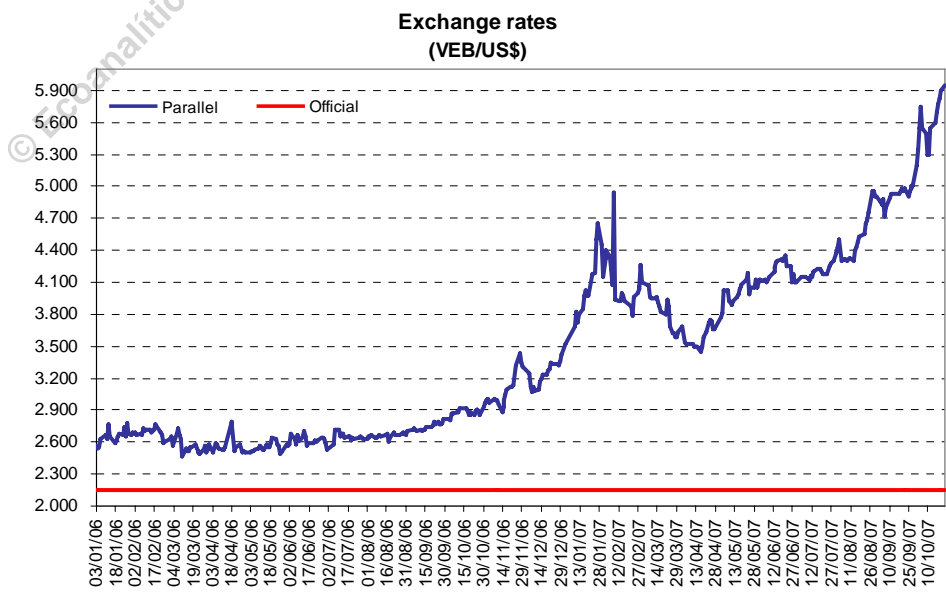
It's absolutely true that the non-official foreign currency market has serious flaws. It's a market with very little depth, which is to say, it handles a very low level of transactions. In 2006, 82% of imports were financed at the official exchange rate, in other words, only 18% of imports were financed by the parallel market. The fact that the parallel market lacks depth causes significant changes in the price of foreign currency with every slight modification of demand or supply. Furthermore, since this market is so opaque, with very little transparency, and at certain times, significant differentials exist between the purchase price and the sale price, generating substantial

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profits for the operators of this market. Another factor to consider is that the market includes players that have the power to manipulate foreign currency price as they see fit and not necessarily in the country's best interest. The main player is the State, which up until now has manipulated the price of foreign currency with sporadic placements. These placements have proven to be inefficient and ineffective in controlling the exchange rate, since they create a sensation of "this is the last time we will get a chance to buy foreign currency at a moderate price." Despite all these realities, it's false to think that the non-official foreign currency market is a marginalized market or that it is not important to the economy.

The non-official foreign currency market price is mainly for the economy

The non-official US-dollar price has a significant impact on creating expectations since it's the price that commercial agents internalize as the foreign currency "market price." For example, investors will always try to maintain profit margins in foreign currency. And that's why they will try to peg the price of their merchandise to the non-official US-dollar, plus adjustments for inflation. Currently, parallel market foreign currency is trading at VEB6,000:\$. This is why at **Ecoanalítica**, we don't believe that the Government will be able to successful with its anti-inflationary policies, if it has any.



We're tired of saying that the foreign currency price differential between the official market and the non-official one create distortions that are the main "threat" to the economic bonanza that we are currently in.

This statement that we have repeatedly made was reinforced by the words of Joseph Stiglitz, 2001 Nobel Prize winner for Economy, when he said that "the wider the gap between the official exchange rate and the parallel market rate, the more chance of problems arising." These words contradict what many of the Government's spokespersons have recently been saying. Statements range from saying that the parallel market is a joke, to if you want to buy US-dollars at VEB6,000 then do it. In this report, we will highlight a few of the distortions that are occurring in the market.

Buying credit card foreign currency balances

One of the cases which attracts a lot of attention is the incentive that the exchange rate price differential produces to buy credit card foreign currency balances. In fact, there a number of companies on and off the internet that charge between 8% and 20% commission in order to issue a "gift certificate" or an "insurance policy" that the client can refund for cash whenever they wish. We calculated the profit margin based on an intermediate commission price of 14%. A person using their credit card at anyone of these internet sites would have to pay VEB6,580,000,00 (VEB3,000 times 2,150 plus 2.0% commission). In exchange, this person will receive the equivalent of US\$2,580, from the US\$3,000 they bought minus the 14% commission. If you factor these numbers together, the implicit exchange rate of this operation comes out to VEB2,550:\$ which compared to the parallel market exchange rate of VEB6.000:\$ looks very attractive indeed. In other words, this person completes the transaction as described above and then sells the US-dollars purchased online, they will "magically" make a profit of VEB8,900,000,00¹.

Naturally, with these kinds of profit to be made, authorization requests for credit card foreign currency allotments have increased dramatically. Something else is motivating the SENIAT's decisions

Just in the month of September, Cadivi has approved and given out US\$592.4 million, which represents 15.8% of total foreign currency allotments paid during this period. If we do the same transaction procedure as before, but with the average exchange rate for the month of September which was at VEB4,864:\$ the magic profits made would equal VEB1.4 trillion. We recognize that we are over simplifying the situation by assuming that the total amount of foreign currency allocated has only been used to buy gift certificates and insurance

¹ It's worth noting that Manuel Barroso, president of Cadivi, in an article published in the Universal on Saturday, October 20, said that the purchase of gift certificates or insurance policies "is being evaluated, but it could constitute a violation of the regulation." If the president of Cadivi isn't even sure if the regulation is being violated, how are the rest of us supposed to know?

policies. But you decided the percentage of these authorizations that are being used for these kinds of transactions, and you calculate the “terrible” profits that these “revolutionary” policies have made possible. So far this year, according to Cadivi, US\$3.9 billion have been approved, and our calculations indicate that if these tendencies continue during what’s left of 2007, US\$ 4.5 billion will be the final tally of approved foreign currency allotments by Cadivi.

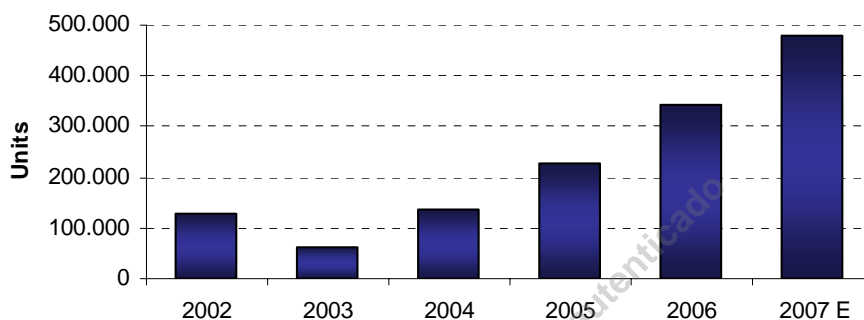
The State has a time limit to do something

We want to emphasize that this distortion is a product of the exchange rate differential. How many of our readers ever heard anything about buying foreign currency credit card balances when the exchange rate differential was at 21%? Despite being able to make a reasonable profit, the market preferred to assume the risk. But now, the current market is different. After having had a year to get to know the system, and very much aware that the credit card allotments are re-set after December 31st. Speculators are all ready, with the knowledge they have learned this year, with a solid data base, and a list of clients all with approved credit cards, they’re all set to make a killing. We calculate that if the Government doesn’t react and do something, outgoing foreign currency flows could reach up to US\$3.0 billion just counting the month of January.

Another example of distortions in the market can be seen in car sales

In the case of credit cards, it’s just the exchange rate differential that creates an opportunity of such magnitude that speculators are willing to get into the market. Another example of exchange rate distortions is the car sales market. In this case, you have to take into consideration that the Government subsidizes automobile imports through “cheap” US-dollars or “preferential” US-dollars. Furthermore, the Central Bank of Venezuela (BCV) has maintained negative real interest rates throughout the whole exchange rate control period and the Government has experienced significant fiscal expansion up until 2006, when it increased, though not in a sustained manner, the income of Venezuelan people. This combination of factors has led to an explosion in cars sales that has gone from an average of 10.719 cars sold in 2002, to 46.720 cars sold in August 2007. It’s worth noting that more cars haven’t been sold due to supply restrictions and that the wait in line for a new car is more than 6 months.

Annual Car Sales



Sources: Cavenez and Ecoanalítica

Please, get to the root of the matter

The Nobel Prize winner in Economy also said that “exchange rate controls are sources of corruption” and we add that corruption becomes worse as the exchange rate differential becomes greater. That is why it’s so worrying that to date, the Government’s upper level economic policy makers aren’t attacking the root of the matter: the exchange rate differential. Up until now, the only thing that is being done is that lists are being published, there is talk of restricting the use of pre-paid credit cards, of trying to “scare” the speculators, among other things. But all these measures simply don’t attack the problem at its roots. If they restrict the pre-paid cards, they will simply be creating an incentive for the credit card with an established line of credit. Plus, there is a sizable population of family members living abroad which could be the “object” of receiving transfers, Venezuelans to whom one could make a gift of a trip abroad. With the differential like it is, the sky’s the limit when it come to thinking up ideas of what one could do to get around the system.

Eliminate the distortions that the parallel market presents and increase the supply of foreign currency in it.

If the Government knows that the problem with the parallel market is that it lacks depth and it has an opaque and spasmodic supply of foreign currency, then the solution is to inject more foreign currency into the parallel market system. This would create depth, and it could be done through a transparent mechanism like an auction, which could be held weekly, if not more often. The sad thing is that there are a number of people in the public sector that know what should be done.

The problem is that they can't come to an agreement on who controls the parallel market. While the power struggle continues, the economic agents get poorer and their perspectives deteriorate. If the Government continues to do nothing, the unofficial US-dollar will continue to depreciate.

Economic Tips

Unemployment rate goes down. The unemployment rate fell to 8.3% at the close of last month, which reflects a drop of 1.2 percentage points compared to the same month last year when unemployment closed at 9.5%. According to figures provided by the National Statistics Institute (INE), this drop means that the economy, in the middle of its boom, placed 139,477 people in new jobs during the course of this past year.

Public jobs will continue to increase. By the end of next year, the Government workforce will reach 803,291 workers which represents an increase of 9%. But the increase will be mostly among contracted workers which will equal 37,462 workers, versus 22,669 workers that are considered to be filling temporary positions for that year. This reflects an increase from one year to another of 65.2%. In contrast, full time permanent employees, though the majority only grew by 7.4%, while half time permanent workers increased by 6.1%, according to Government figures.

As well as the spending required to pay for it. In order to be able to pay the complete Government personnel payroll the Administration's spending will increase to VEB32.7 trillion, which represents 23.7% of the national budget set by the Ministry of Finance for 2008.

IMF predicts economic slowdown. The International Monetary Fund (IMF) predicts that next year the Latin American economy will experience a slight slowdown going from 5.5% last year to 5% this year, due mainly to the slowdown currently being experienced by the United States. Venezuela will see its GDP go from 10.3% in 2006 to 8.0% in 2007, slowing down to 6.0% in 2008.

IMF estimates Venezuelan inflation at 19%. The director for Latin America of the IMF pointed out that countries in Latin America should pay special attention to inflation since the price of food has noticeably increased and that they will see themselves even more affected by domestic oil prices. The director specifically pointed out that Venezuela and Argentina will be the two countries with the highest levels of inflation in the region next year with rates reaching 19% and 12.6% respectively.

Latin America won't need financial assistance from international organisms. According to the president of Ecuador, Rafael Correa, with the creation of the *Banco del Sur*, Latin America won't have to look for financing with international organisms like the World Bank or the IMF anymore, now that the continent has its own bank it can count on. This coming November 3, in Caracas, will be the signing of the founding of said entity which will have its headquarters in the same city.

Public spending won't go down. The Governments expansive public spending policies will continue into 2008. Next year's national Budget was set at Bs.F137.5 billion (VEB137.5 trillion), which represents 27.3% of Gross Domestic Product (GDP). The Minister of Finance, Rodrigo Cabeza, stated during a speech before the National Assembly that the assignation at the close of the exercise would be around 30% or 31% of GDP due to the use of the surplus in 2007 which allowed to cover those projects that weren't included in the spending.

Worse outlook. Though the Fitch Ratings "BB-" risk classification was maintained, the long term Venezuelan debt outlook dropped going from "stable" to "negative." According to information released by the company, the drop in rating responds to the vulnerability of the fiscal accounts, the parallel exchange rate increase, and the persistence of inflation, elements that determine the "unsustainability of macroeconomic policies."

Country-Risk also reflects this. Said unsustainability is also reflected by the performance of the Venezuelan Country-Risk indicator (EMBI+), which has clearly been following an upward trend throughout the year. Between 01/02/2007 and 10/19/2007, this indicator has increased by 90%.

More debt. The Government approved an issue of public debt bonds for US\$4.24 billion (VEB9.6 trillion). The conditions governing the bond issue was published in the *gaceta oficial* and establishes that "all or part of the issue can be done through a primary placement, exchange operations, or to re-open previous issues that are already on the market." The Minister of Finance is responsible for issuing the instructions so that, according to the program, the BCV will proceed with the placement.

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Accept not being able to meet inflation goal. The Pluriannual framework of the National Budget, submitted to the National Assembly to be reviewed, indicates the projected values of this year's macroeconomic variables. This document reveals that the Government's estimates with regard to inflation for the close of 2007 is at 15.6% (the initial goal was 12%), while GDP growth was estimated at 7%.

The economy is socialist. The National Assembly sanctioned the reform of article 112 of the Constitution, which defines the State as being the promoter of one single productive economic model, founded on common interests. The approval of this new constitutional text by the referendum would eliminate the regulation that guaranteed all Venezuelans the right to freely pursue the economic activity of their choosing. The new reformed text highlights the importance of placing common interests above personal interest in the model that's being developed. Also eliminated is the States responsibility to promote private initiatives, instead it will focus on developing different types of social property units and businesses.

Almost half. More than 45% of all the coins and bills that will be used on January 1, 2008 are already in the country assured the National Customs and Tributary Superintendent, José Vielma Mora.

Is on hold. Venezuela's decision to leave the International Monetary Fund and the World Bank "is on hold," announced Minister of Finance, Rodrigo Cabeza, who didn't participate this week in the Annual Assembly of both organisms. "It's a political decision that has already been made," said Cabeza at a news conference, he later continued to say that "at this moment...it's on hold, waiting for any reactions that the G-24 countries may have." The G-24 is an intergovernmental organization that brings together countries from Africa, Asia, and Latin America.

Finance looks the other way. Before the question of if the Government plans to do anything to stop the drop of the parallel market US-dollar which has already broken the VEB6,000:\$ barrier, Carlos Ramones, vice minister of finances, emphatically stated that "what we have done is to issue bonds and they have be done so as was normally planed. Who ever wants to buy US-dollars at VEB5,000; VEB4,000; or VEB6,000; go ahead and buy!" With that attitude, the Ministry of Finance continues to refuse to take the appropriate measures to stop the parallel US-dollar from falling.

OIL TIPS

Venezuelan basket at record levels. Ever increasing oil prices spurred on by Middle East tensions benefited Venezuelan oil last week, surpassing last weeks average price for oil by US\$4.48 reaching US\$77.67 per barrel.

Will continue high. Oil prices will continue to be high until the second quarter of 2008, announced the Algerian Minister of Energy and vice president of OPEC, Chakib Jelil. "The tendency for prices to increase could continue since the demand is strong during the fourth quarter. It will be even stronger during the first quarter of 2008 and even stronger if the winter is harsh," said Jelil at a conference organized by the Government newspaper El Mudyahid.

Difference between oil production and number of active wells. Oil experts, Diego González and Carlos Granier, director of the Center for Energy Studies of Venezuela, warned that the official crude oil production figures released by the Ministry of Energy and Petroleum and PDVSA don't match the number of active oil wells that Petroleum and other Statistical Date (PODE) officially gathers. According to what they explained, if you compare the statistical information you find that the wells that traditionally have been exploited are producing more crude oil now in stead of following a naturally declining pattern.

PDVSA will increase number of rigs. According to the Minister of Energy and Petroleum, Rafael Ramírez, following the Government's strategy to achieve what it calls "complete oil sovereignty," PDVSA will count on 273 rigs, of which 191 are working, taken care of due to the hiring process and the acquisition process that the company has already started, including the purchase of 13 sets of perforation equipment from China.

Venezuela and Iran will create an oil company. Under the name of Venezuelan Iranian Oil & Gas Co. (VENIROGC), it's expected that by the end of the year this multinational oil company will be registered and it will belong to PDVSA and PETROPARS.

South Africa as well. The South African state-run energy group Petrosa expects to sign an agreement with PDVSA on projects which include the exploration for oil in Venezuela. Petrosa operates out of Mossel Bay, on the south coast of South Africa,

and is one of the largest liquid gas technology refineries in the world and it is actively exploring for crude oil in Equatorial Guinea, Gabon, and Egypt.

USA imports less and less Venezuelan crude oil. The US Energy Information Agency (EIA) indicated that Venezuela has lost importance with regard to US imports. In 1960, Venezuela supplied the US with 50% of oil imports, in 2006 it supplied 10%.

But more to China. According to PDVSA's Trade and Supply Division, Venezuela has delivered an average of 197,000 b/d of crude oil and by-products to China so far this year. In September, PDVSA sent to China a record volume of 359,000 b/d hydrocarbons. These figures show that although these exports were similar in terms of crude and fuel oil proportion earlier this year, the increase in shipments in September registered because sales of fuel oil, a fuel that is difficult to place on the market, went up to almost 74% to average 243,330 b/d.

Another Citgo's asset to be sold. The oil company Marathon Oil Corporation agreed to buy four storage terminals in Ohio and a stake in the continental oil pipeline owned by CITGO Petroleum. Marathon announced that this purchase will facilitate their fuel transportation activities to the mid-western area in the U.S. The company didn't reveal, however, the value of the transaction. CITGO is also considering offers to sell the two asphalt refineries that are operating directly in that country: Paulsboro and Savannah.

Staff increase at PDVSA: 45% (almost 17,500 workers) of PDVSA's new personnel hired over the next three years will be assigned to oil exploration and production activities in the country. Furthermore, most of the personnel will be assigned to work at the new PDVSA's subsidiaries: PDVSA Servicios, PDVSA Naval and PDVSA Industrial. A source close to the corporation informed that "the remaining new staff (55%), around 21,400 people, will be distributed throughout the areas of refining, commercialization, contractors, and administration. The increase in staff (which amounts to 38,900) takes place within the framework of the Socialist Economic Development Plan 2007-2013.

BUSINESS SECTOR TIPS

Patience for consumers. Venezuelan consumers have had to be patient to face the two major problems that now plagues Venezuelan society: inflation and shortages. In

order to buy all basic products needed, Venezuelans try to stretch their money by buying price-controlled items, and visiting an average of 3 different shops in order to find everything.

More concerns. According to the pollster Datos, the high cost of living is the second concern of Venezuelans, after personal safety. They also report that shortages are one of the causes for price increases.

Shortages of price-controlled products. Food shortages have not been resolved by the strategies implemented by both the government and the private sector. A survey carried out by Datanálisis during the last week, in 60 stores in Caracas (supermarkets, grocery stores, markets, Mercal and informal commerce), revealed that shortage levels of price-controlled products ranges between 20% and 25% over the last six months, whereas food products that are not controlled register moderate shortage, between 5% and 11%.

Sugar price increase demanded. The National Federation of Venezuelan Farmers' Association (Fesoca) claims that farmers "are in emergency due to the price freeze that has been in force since 22 months ago." The currently regulated price is VEB 1,000/kg sugar, which is in force since December 2005. The Federation expects that the price is increased up to VEB2,195/kg, or 62.8%.

Milk for December. The minister of food, General Rafael Oropeza, assured yesterday that the government will import 10 million kg powder milk in December in order to meet national demand of the product.

Decrease in milk imports. According to Teresa López, executive director of the Venezuelan Chamber of Dairy Products (CAVELACTEOS), the dairy sector has imported between 35% and 40% of the volumes allowed by import licenses during the last six months. This situation is the result of the high price of milk on the international markets, plus the barriers imposed by all the paperwork involved in requesting official foreign exchange quotas and price controls.

Business are looking at the stock market. The president of the National Securities Commission (CNV), Fernando De Candia, reported that so far this year the amount of securities public offers placed by companies on the Venezuelan capital market exceed 6% of the 2006 total amount. "From January to September this year, 52 authorizations have been granted, which account for 74% of the total authorizations awarded in 2006, which amounted to 70." In this regard, De Candia pointed out that 2005 public offers totalled VEB1.3 trillion whereas those of 2006 totalled VEB3.8 trillion. "We have

already surpassed the goal for this year in terms of authorized amounts. This amount is on the order of VEB4.00 trillion,” added De Candia.

The Bank Law could be ready before the end of the year. According to Bank superintendent, Trino Díaz, the Administration, within the framework of the Special Power's Law could be ready with the reform of the General Law of Banks and Other Financial Institutions before the end of the year. According to Díaz, the new Law could increase the taxes in order to finance certain “social and strategic sectors.”

Low power demand. During the third quarter of the year, the demand for power from the National Electric System (SEN) dropped by 1.55% compared to the same period in 2006, according to official figures. This results places the sector power demand under what it was last year “in two of the three months” of the period being studied, July and August. The Interconnected Systems Operation Office (OPSIS) points out that in September the demand increased by 3.10% compared to the previous month.

Gran Caribe telecommunications created. The creation of a Cuban-Venezuelan telecommunications company called Gran Caribe was published in the *Gaceta Oficial* N° 38.791. It will be in charge of installing the 1,555 km (966 mile) underwater cable that will go from La Guaira to Siboney.

Political Tips

Intellectual property is safeguarded by international agreements. According to Hoet, Peláez, Castillo & Duque's Franklin Hoet-Linares, the legal titles to inventions and works as well as economic rights derived from them are safeguarded by international agreements signed by Venezuela in this area, which are of supranational nature and, therefore, must be complied with by the country.

Government supports reform proposal of article 337. The Government assured that it supports the decision of the National Assembly to include the elimination of the rights to information and due process during a state of exception in the constitutional reform proposal submitted by President Hugo Chávez, pointed out the communication minister, William Lara.

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New articles are being included in the discussion of the constitutional reform in the AN. Besides the original reform proposal presented by President Hugo Chávez, which comprised 33 articles, the AN Mixed Commission included other 25 articles for discussion last week, and this Friday, at the request by representative Carlos Escarrá, other three were added that curtail centralization as has been known so far. Therefore, the possibility that new articles are added to the third discussion, now taking place at the AN, over the next days is not discarded.

Podemos goes to the TSJ. Ismael García announced today that the political party he represents will request the TSJ to clarify the new articles that were included into the reform proposal. According to Podemos, the AN should not incorporate new articles to the 33 originally included in the reform proposal presented by President Chávez.

Electoral roll is ready for the referendum. 16,104,396 Venezuelan will be eligible to vote in the next referendum to approve the constitutional reform. The Electoral and Civil Registry Committee of CNE approved the preliminary Electoral Roll that closed on October 7th. The announcement was made by the chairperson of the Committee, Sandra Oblitas. According to the report, 154,298 new citizens registered in the Electoral Roll, which now totals 16,261,555 voters. Of the total number, 157,157 are foreigners, who, according to National Constitution, do not have the right to vote in referendums.

Street surveys. According to Datanálisis, 33.2% of the Venezuelans approve of the reform; 31.2% disapprove of it; and 24.6% has not made their minds. However, 55.8% of those that support the reform are going to vote and 64.5% of those that reject it are going to stay at their homes on the referendum day. The main reason for the high abstention level is the lack of electoral guaranties. According to opinion surveys by Datos, close to 50% of voters do not trust the arbiter of the electoral process.

Indefinite re-election has come. The National Assembly approved article 230 of the constitutional reform proposal, which establishes that the presidential term will last 7 years, with the option of indefinite re-election.

Other Tips

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Shortening the working day for Central Government employees. According to José Ramón Rivero, Minister of Labor and Social Security, a new workday schedule will be initiated starting from January 2008, in order to comply with the new working day of 6 hour, 36 hours a week. However, this change only applies to Central Government employees, and excludes the private sector as well as decentralized entities, autonomous institutes, and State-run companies.

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Weekly Report

ECONOMIC OVERVIEW

