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ALL YOU EVER WANTED TO KNOW ABOUT THE FINANCIAL SYSTEM'S STRUCTURED NOTES

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The Ministry of Finance has set a time limit for all banks to sell off all the paper they hold in US-dollars which appear on their books as “structured notes,” a mechanism banks have used to surpass the legal limit of foreign currency they may hold, which was set at 30% of the bank’s equity, and which in some cases was used in capital coverage operations, due to the ever increasing risk and uncertainty posed by the current exchange and political environment. The time limit expires on August 19th. There has been a lot of speculation going on regarding this issue, and the disinformation has reached such levels that the Ministry of Finance has requested that experts from the International Monetary Fund (IMF) come and evaluate the financial system’s real position. At ***Ecoanalítica***, we believe that in general terms, and based on the public information available up until December 2007, that the issue is delicate, but it has been blown out of proportion. Some banks that are involved, instead of covering losses, may in fact be trying to hide profits. We feel that the best solution is that the authorities act as quickly as possible and treat each case (bank) individually, offering individual solutions, and not just offer-up a general blanket solution.

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What are structured notes?

Structured notes are financial instruments that have a number of modalities depending on their objective and/or how complex one wants them to be. The notes held by each bank in the financial system are very different from each other, but in general it's about a financial structure where local Venezuelan banks bought assets in US-dollars, placed them in financial institutions abroad, and received a note in bolivars backed by the papers. This process appears registered in local banks as an instrument in local currency.

The notes in the hands of the financial system are not the same that FONDEN sold.

At *Ecoanalítica*, we don't understand the recent statements made by former Minister of Finance, the economist Rodrigo Cabezas, when he said that the notes that the financial system had were the same as those sold by FONDEN. It's very odd that a person who was at the head of the Finance Ministry could make such an error. As we have stated, the structured notes in the hands of the financial system are denominated in bolivars and the ones that FONDEN has are denominated in US-dollars. Furthermore, the financial system designed these notes so that they could surpass the bank's legal holding limit of foreign currency, which was set at 30% of the bank's equity, and in some cases to be used in capital coverage operations. In FONDEN's case, the only explanation one can give for buying those notes, which were so complex, is that it is much more difficult and less transparent to determine its price, therefore they can be traded and generate great returns for the trader by at a great loss for the Republic, which in the end is covered by the exchange differential. In some cases, the notes sold by the FONDEN could have been subjacent assets in US-dollars to create a new note. However, we believe this to be the exception rather than the rule. Nevertheless, we share the Minister's opinion that in both cases the structured notes purchase could be harmful for the financial system, and for the Republic.

Why has the Minister of Finance asked that they be sold?

Since the structured notes have assets in US-dollars, the Ministry of Finance, with its May 19th resolution is looking to increase the amount of foreign currency supply in the unofficial foreign currency exchange market by forcing the banks to sell them. This in turn, will help close the gap between the official and unofficial exchange rate. Wit out a doubt, the Ministry of Finance has been very successful at maintaining the unofficial exchange rate at a considerably lower rate than it has been at for the past 12 months. But, this resolution was issued without fully measuring some of the consequences that the sale of these notes will bring about for the financial system, on the foreign debt, and the

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country's risk level. Plus, it doesn't seem to be a measure that will have a very lasting effect on the unofficial foreign currency market.

Some speculate that the sale of these notes could cause the financial system to suffer significant losses

In order to avoid speculation, at *Ecoanalítica*, we studied the financial system's audited balances for the last two years, and we found that at the close of December 2007, twelve banks held structured notes for VEF 11.3 billion or US\$5.25 billion calculated at the official exchange rate. Recognized experts in the field point to the fact that these notes have generated significant losses and that the banks have preferred to look the other way putting them on the books on maturing. In general terms, from the information gathered from the audited balances, we believe that the issue of the enormous losses that may be suffered by the financial system has been overblown. If the situation is dealt quickly and requesting that the banks which have suffered losses be re-capitalized, this problem can be solved relatively easy.

It's important to know when the assets in US-dollars were acquired in order to calculate profits or losses

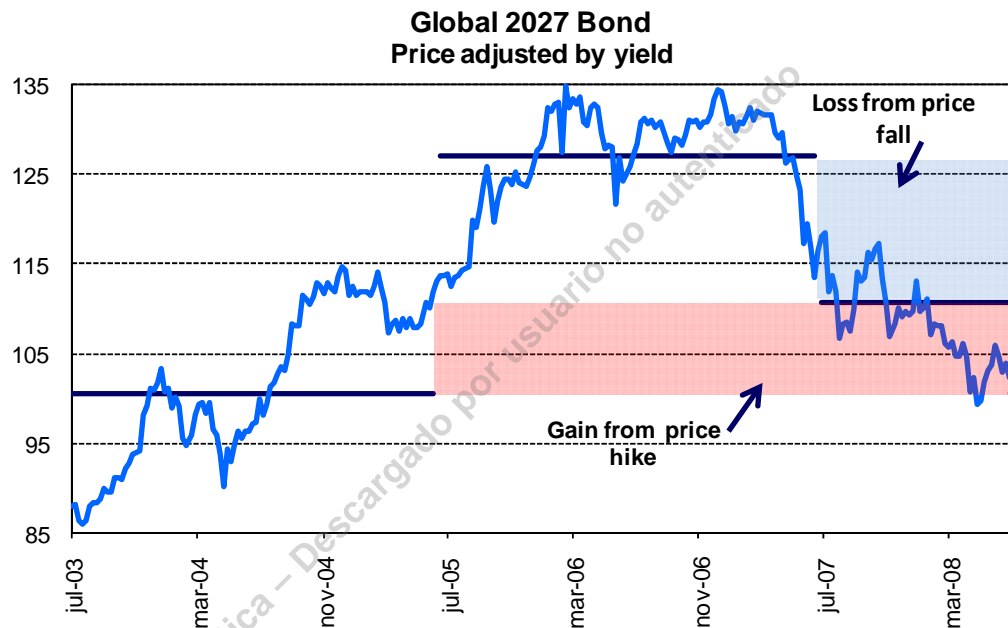
Looking at the individual balances during the last two years of each one of these banks we have found that 67.2% of the notes that appear in the balance statements at the close of 2007 were acquired during the first quarter of 2007 or before, at an average exchange rate of VEF 2.8/US\$ (or less, since they may have been acquired before 2006); the rest of them were purchased during the second semester of 2007 at an average exchange rate of VEF 5.4 /US\$. Of the twelve banks that had structured notes, seven purchased them during the second semester 2007, and one of them noted on its balance sheet that "(positive) results, along with the bank's equity soundness, have allowed it to fully absorb the impact of having to disincorporate from their assets the total position of structured notes denominated in bolivars that they held, with a face value of VEF 120.9 million. These notes were earmarked for the financing of import letters of credit for clients during the second semester 2007." These seven banks, if they had maintained their position during the first semester 2008, would have reflected accumulative losses for VEF 2.02 billion or US\$ 595 million.

Added to these exchange losses would be losses/profits attributed to subjacent assets

On the publication balances it's not as clear which are the subjacent assets. Of the positions that were acquired before the second semester 2007, 63.8% of them tell us that they are backed by Global 27 bonds. If these bonds were purchased during the second semester 2005 or before, when its price was between a range of 60% and 118%, they

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would accumulate additional profits¹. But, if the bonds were purchased between the first semester of 2006 and the first semester of 2007 (a period when its price was around 125%), investment in these bonds would generate average losses of 13%. It's important to point out that these calculations have already taken into account the bonds yield, which counteracts the changes registered in its price.



In conclusion, for the bonds purchased during the first semester of 2007 or before, and assuming the worst case scenario (December 2006), the implicit exchange rate would be VEF3.44/US\$, which in the end would represent a 2.6% loss compared to the unofficial exchange rate at the close of the first semester 2008. The best case scenario would be if the investment took place between 2003 and 2004, the implicit exchange rate of the operation would be at VEF1.73/US\$, which would represent a 93.6% profit compared to the unofficial exchange rate at the close of the first semester of 2008. At **Ecoanalítica**, we expect that those banks that find themselves in this position are not interested in dismantling the notes since they could bring in some very nice profits and would be subject to taxes.

¹ It's necessary to remember that to estimate an investment's profit/losses you have to know the variation of the price and also bond's interest rate. In the case of Global 27, the coupon is 9.25%.

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Of the notes acquired during the second semester of 2007, only 12.7% of them are backed by Global 27 bonds. In this case, Global 27's loss of value is compensated for by the profit earned on interest, therefore, the average implicit exchange rate for the operation would remain at VEF 5.4/US\$. It's important to point out that the audited balances don't specify 53.3% of the subjacent assets of the total amount of structured notes being held. Plus, it's possible that the notes were structured during the second semester of last year, with foreign currency assets purchased before, therefore the implicit exchange rate, and consequently, any possible losses, could be much less than the VEF 5.4/US\$ previously calculated.

We expect the effect these measures will have on the debt and the financial system will be minimum

In this case, the best thing that could happen would be for the Ministry of Finance to act as quickly as possible instead of waiting for rumors to begin to circulate questioning the state of the financial system. From what we have been able to observe in the balance sheets, the situation is very different from bank to bank, with different amounts and different types of structured notes being held. Therefore, the answer can't be one catch all blanket solution. Furthermore, we believe that the actions that the Government may take, with the backing of the IMF, will minimize the negative effects that dismantling the notes may have on the foreign debt, as well as the state of the financial system itself. And lastly, we don't rule out the possibility of the financial system designing new more creative structured notes, which may allow them to avoid dismantling the structured notes in question. In conclusion, we don't expect there to be a massive sale of Venezuelan papers by the financial system, and therefore, we don't expect a significant increase in the supply of foreign currency in the unofficial market. The drop reflected by Venezuelan bonds which began last week was more in response to global factors than a reaction to the possible dismantling of the structured notes in question. With respect to the exchange rate, at *Ecoanalítica*, we continue to recommend carrying out coverage operations of a non-speculative nature.

Economic Tips

Inflation alert. Inflation figures corresponding to the month of June worried the Economic Cabinet given that the inflation goal for the year, 19.5%, seemed to be

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slipping even further away. Inflation was already at 15.1% at the close of the first semester 2008. The committee for macroeconomic coordination (made-up of representatives from the BCV, and the Ministry of Finance, and the Ministry of Planning) will evaluate the results and determine what actions may be taken.

The National Assembly prepares a proposal. The president of the Finance Commission of the National Assembly, Ricardo Sanguino, announced that the Commission has prepared a number of “suggestions” for the Ministry of Finance, which if applied, would help to regulate inflation. The suggestions would have to do with evaluating public spending and supplementary appropriations, the issue of public bonds, as well as matters relating to the banks holdings in structured notes and the possible buy-back of public debt.

The notes were risky. In a recently televised interview, former Minister of Finance, Rodrigo Cabezas, pointed out that “he didn’t make any purchase of structured notes in 2006 (...) I thought it was a bit too risky. Now, the State has been steadily getting rid of them.”

“Positive balance” for the monetary conversion program. In a press release, the BCV pointed out that during the first semester of 2008, the monetary conversion process has reflected a positive balance. According to the BCV, more than 954 million new bills and more than 420 million new coins are already in circulation.

New name change. Will it solve anything? The President of the Republic, Hugo Chávez Frías, announced that the Ministry of Finance will from now on be called the Ministry of Economy and Finance, and that “its basic objective will be to keep an eye on socialism’s economic construction project.”

Colombian-Venezuelan agreements. The Colombian Minister of Commerce, Industry and Tourism announced that he will present to Venezuela, within the framework of the presidential summit that will be held during the second week in July, four economic proposals to further ties between both countries.

The agreements. Said agreements, mainly have to do with increasing the import quota of Colombian cars, an agreement to reciprocally promote and protect investments, and to make the overland transportation of merchandise more flexible.

Increase credit with IDB. The Government is studying the possibility of asking the Inter-American Development Bank (IDB) for an increase in the credit it already has with the bank in order to finance the construction of the Tacoma reservoir on the Caroní river.

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International reserves. International reserves during the second week in June are at US\$ 33.62 billion, down by 0.87% or US\$ 300 million in less than one week, thereby putting an end to what looked to be tendency to continue to increase for the rest of the month.

Interest rate. For the second week in July, lending interest rates for the six main banks in the country rised in 1.13% to settle at 24.54%, breaking the downward trend that existed in the last weeks. On the other hand, fixed term deposits rised in 0.57% and closed that week out at 17.36%.

Monetary liquidity. Monetary liquidity was at VEF 158,874 million for the first week in June, down 0.50 percentage points with respect to the previous week.

Oil Tips

Crude oil prices stop surge. Last week, the Venezuelan oil basket price dropped US\$ 0.56 remaining at a round US\$ 125 per barrel. So far for the month of July, the average cumulative price of a barrel of Venezuela oil is at US\$ 125.60, up almost US\$ 7.00 over the price of oil in June (US\$ 119). The accumulative price for the Venezuelan oil basket for 2008 is at US\$ 101.22 per barrel.

OPEC basket also down. The OPEC basket was also down last week, dropping US\$ 1.23, going from US\$ 136.40 to US\$ 136.10 per barrel. The WTI, August delivery, closed at US\$ 145.10 the barrel and Brent, August delivery, closed the session at US\$ 144.50.

Production levels remain the same. According to the Energy Information Administration (EIA), during the first semester of the year, Venezuela maintained its oil production at 2.4 million barrels a day. The EIA didn't register any changes in average crude oil extraction during the past month nor it production capacity. It also pointed out that Venezuela had no surplus production.

OPEC production increases. According to the EIA, OPEC member countries jointly extracted an average of 32.5 million b/d in June, which represents a 20,000 b/d increase compared to the previous month. This stopped the recent joint production slide tendency which had been reflected during the last few months.

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Estimate increase in demand. In its report, the EIA mentioned the worldwide demand for crude oil, saying that it expected it be at 87.7 million b/d next year which would represent an increase of 860,000 b/d compared to this year.

OPEC adjustment not defined. The secretary general of the OPEC, Abadlá Salem El Badri, refused to confirm whether the cartel was preparing to announce an increase in production at its next meeting to be held in September, and thereby stop prices from rising. According to Salem El Badri, there is enough oil in the market and in reserves.

Calculation method modified. The Ministry of Energy and Petroleum issued Resolution 195, which reformed the method by which the settlement of Windfall profits will be calculated. The main modification consists in making the Venezuelan crude oil and oil by-products basket price the base reference for calculating the tax. Before, the base price used was Brent oil.

Special fund. According to official sources, the Government is studying to create a new fund financed with windfall resources. There are two proposals. One is considering creating a scheme that is similar to FONDEN with its own structure and guidelines. The other is a fund which will belong to FONDEN.

In Bolivia. PDVSA announced that by the end of the month it would begin to explore natural gas and condensed deposits in Bolivia. The electric drill that will be used was made in China but will be operated by Venezuelan technicians. They will be operating the drill at between 5,000 meters to 8,000 meters (3.1 miles to 5 miles) "in traditional and non-tradition exploration areas in Bolivia."

Luis Vierma is out. Luis Vierma, the current vice-president of PDVSA Exploration and Production has been replaced by Eulogio del Pino, the current president of the CVP. The future of Luis Vierma, who has been in PDVSA for 30 years, is uncertain.

Supply to PETROCARIBE has gone up since 2006. The volume of oil and oil by-products being supplied to PETROCARIBE members has increased by 66% since 2006. According to PDVSA's financial statements, at the close of last year, the quota available to the 14 member countries was 138,800 b/d excluding Cuba, which benefits from another separate agreement in which it receives more than 92,000 b/d.

Thanks to PETROCARIBE. Currently, PETROCARIBE sells oil and oil by-products through a payment mechanism which allows for 50% payment of what's due at 90 days and the rest over 25 years at 1% annual interest with a two year grace period. Ramírez assured that thanks to PETROCARIBE, 200,000 b/d of oil and oil by-

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products are being supplied to its member countries, and at the same time, fuel storage and transportation infrastructure has been developed. It has also earmarked, up until now, US\$ 100 million in social investments.

Agreement adjusted. During the 5th Extraordinary PETROCARIBE Summit, President Chávez decided to adjust the conditions of the agreement, given current high oil prices. If oil prices are over US\$ 100 per barrel, member countries will pay 40% of what's owed and the other 60% will be financed at 25 years with a two year grace period at 1% annual interest. But if the price per barrel reaches US\$ 150, member countries will pay 30% of what's owed at 90 days and the other 70% have special financing. President Hugo Chávez also reminded that PETROCARIBE members may cancel their debts with goods and services.

Beyond mere financing. President Hugo Chávez announced that one of the Orinoco Oil Belt blocks will be assigned to PETROCARIBE and he commented that the new production could be refined in the member countries. Guatemala was also accepted as a member during the summit.

Fertilizers too. Supplying fertilizers with subsidies to improve agriculture was another issued discussed among the leaders of the member countries during the summit. The President decided to earmark 100,000 tons of urea production to member countries at a 40% discount. Urea consumption in these countries is 200,000 tons.

More funds... Within the framework of the summit, President Chávez commented that Venezuela would create a fund to improve the food situation. The fund would have around US\$ 460 million. The President said that when the price of oil is over US\$ 100, US\$ 1.00 will be put aside for food: US\$ 0.50 will be for the recently created food fund and US\$ 0.50 will be set aside for a special international help scheme.

Business Sector Tips

CADIVI US-dollar mostly for imports. According to figures released by CADIVI, 78% of all the US-dollars authorized this year have been for the import of goods and services. Use of US-dollars through Credit cards is down by 77% during the same period. This is mainly due to the cutback on the allowed quota for internet purchases and by the reduced gap between the official and unofficial foreign exchange rate.

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Delays will improve. Between March and June, the BCV has liquidated US\$ 2.70 billion to CADIVI, besides the US\$ 3.80 billion it supplies it with every month. According to CADIVI president, Manuel Barroso, these additional resources have already helped improve delays in liquidation.

New measure moving forward. Barroso also pointed out that from August, the new liquidation scheme, without all the requirements, will begin to be operational for all foreign currency requests of US\$ 50,000 or less. The list of goods that will benefit from this measure will be published in the next few days.

Chávez expects to create a Russian-Venezuelan bank. The President that he will visit Russia on July 22nd in order to set in motion the creation of a Russian-Venezuelan state-run bank that will finance bi-national projects. Chávez will also look at tanks that Venezuela may be purchasing. These tanks, if purchased, would be added to the 24 planes, 50 helicopters, and 100,000 rifles that it has already purchased from Russia in the last three years for US\$ 2.0 billion.

Imports do not necessarily translate into investment. Of the total volume of imports in 2007, only 10.2% were earmarked for the acquisition of capital goods, ships, and vessels which are the items which most impact economic growth. This figure differs by 30% from what was announced by former Minister of Finance, Rodrigo Cabezas, who also includes goods like computer equipment, radios, trucks, televisions, and medical equipment.

Construction sector with big inflation problems. According to figures published by the BCV, the wholesale price index level for the sector during the last 12 months increased by 23.6% and at the producer level it was at 26.5% compared to the previous year. This high inflation is mainly due to problems with supply.

Housing construction begins to bounce back. According to the president of the Venezuelan Construction Chamber (CVC), Fernando Azpúrua, starting in the second quarter of 2008, general works spending in things like railways and subway lines began to increase compared to the first quarter of 2008. Specifically in the housing sector, 40,000 units were built, of which 15,000 corresponded to the public sector and 25,000 to the private sector. More than 100,000 housing units are under construction.

Small and medium sized businesses investing in expanding. A survey taken by Fedeindustria given to hundreds of small and medium sized businesses show that

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77% of them are currently investing in expanding their production capacity and only 23% of them are not carrying out any type of investment.

Friendly agreement between Ternium and Chávez. Despite the fact that they didn't come to an agreement regarding the steel company's purchase price, the Venezuelan State officially took control of the plant. Both parties reached an agreement to make evaluations and fix a price in a maximum of two months.

Changes began. In the middle of transferring operations to the State, SIDOR added 400 workers who used to work as contractors to its workforce. In total, 1,600 workers have been absorbed by the company since the nationalization process began.

Expected price. In the Grupo Technit's opinion, Ternium-SIDOR majority shareholders, the price that it would be willing to accept from the Venezuelan Government for 50% of the shares of the company is fluctuating between US\$ 1.65 billion and US\$ 2.0 billion.

PDVAL flour to bakeries. In an attempt to cover the deficit that exists and to guarantee the product being sold at regulated prices, PDVAL is preparing to supply wheat flour at a low price to bakeries in the Sucre and Capitolio perishes.

Imports from Brazil increase. The Minister of Agriculture and Livestock of Brazil announced that sales to Venezuela have increased by 152.4% between June 2007 and June 2008. This is due to greater volumes of soy bean, meats, sugar, and alcohol, being imported by the Administration in order to supply its national food chains.

Banco del pueblo (People's bank) will finance informal economy employees. The Minister of Communal Economy, through the *Banco del Pueblo* and the Economic Transformation Financing Plan will grant loans for more than VEF 105 million to around 4,000 informal economy workers.

Delays in the telecommunication sector. According to the Chamber of Telecommunication Service Companies (CASETEL), sector company inventories, including telephone operators, and cable TV operators, among others, are running low. This is mainly due to the Ministry of Industry and Commerce recent modification to the list of products that may be imported without submitting National Production Certificates or Insufficient Production Certificates. The changes have generated delays of between 90 and 120 days.

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Dealerships will have to pay. The National Assembly created a commission to be in charge of investigating irregularities in car sales, especially those related to overpricing. Representative Elvis Amoroso pointed out that the idea was to prepare a law that would go after dealerships that have overpriced cars and make them payback illegal amounts collected to the car owners.

Political Tips

Nepotism IN THE National Assembly. The secretary general of the National Assembly Workers Union, William Díaz, denounced irregularities in the way workers were selected for the National Assembly, that it was pure nepotism. Díaz said to have proof of at least forty family members and friends of Cilia Flores, the president of the Parliament, that have gotten jobs at the National Assembly in a very irregular manner.

Chávez and Uribe, friends again. President Chávez and Colombian President, Álvaro Uribe, reconciled last Friday during Uribe's official visit to Venezuela. During a press conference, both president's announced that political, social, and economic relations between both countries was fully reestablished. They both agreed to cooperate in the war against drugs, and in development projects like the building of a railway to connect both countries. President Chávez showed willingness to once again mediate to help kidnapped victims and in the relations between Colombia and Ecuador.

Under the table. President of Bolivia, Evo Morales, admitted to receiving resources directly from Venezuela through the Venezuelan embassy in La Paz in order to, according to him, get around the bureaucracy of his country's Central bank.

Electronic *cédula* in January 2009. For the third time now, the new electronic *cédulas* (Venezuelan National Identity card) which will include a micro chip have been delayed. Originally, it was suppose to come out by the end of 2007 or the beginning of 2008. Then they said it was going to be ready by the second semester 2008, around the second week in July. Now, the president of the Onidex says the new date set is January 2009.

FARC in Venezuela. The National Cattle Ranchers Federation (Fedenaga) announced that there are groups of the FARC in the State of Apure. He added that these camps are along the banks of three important rivers in the region. They are

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currently establishing the exact location of these camps and they assure that the Venezuelan Army is fully aware of their location.

Other Tips

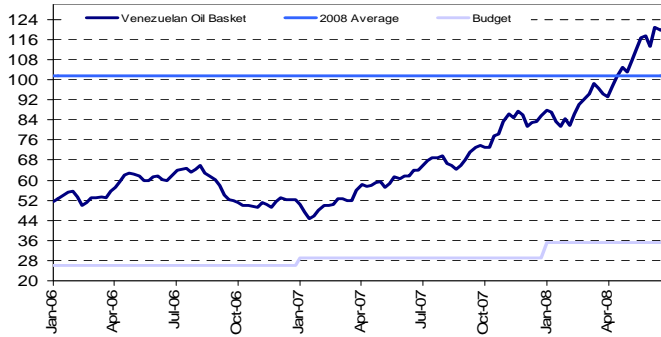
Visa to travel to London. The Government of Great Britain announced last week that it is considering adding eleven new countries to the list of countries that it requires to have entry visas. Among these eleven new countries are Venezuela, Bolivia and Brazil. After a trial period of not requiring visas, these countries were added on because of the high risk of illegal immigration, crime, and safety.

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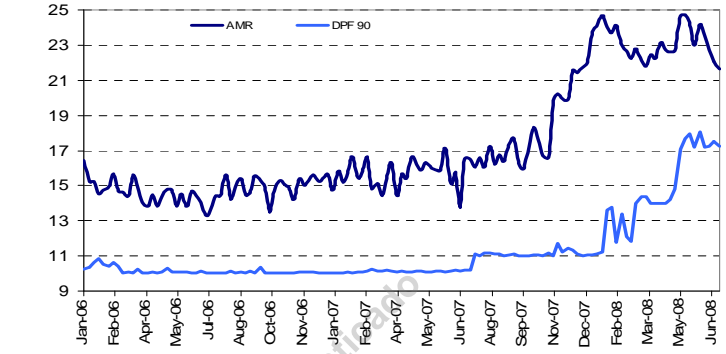
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ECONOMIC OVERVIEW

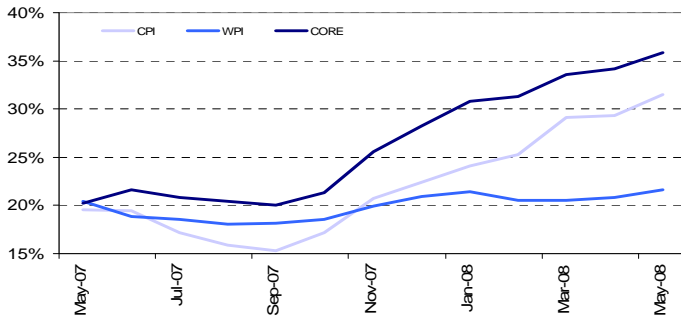
Oil Price
(Venezuelan Basket US\$/pb)



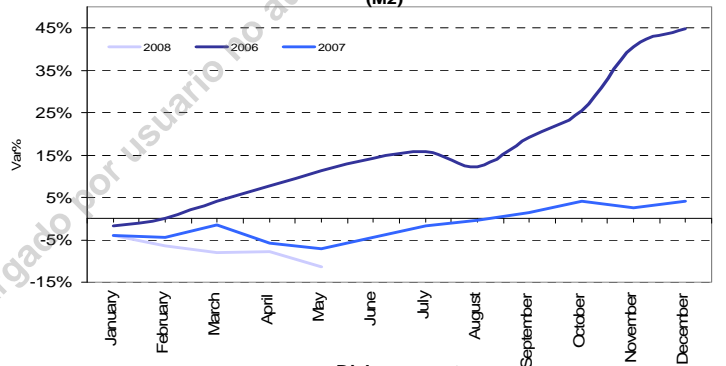
Interest Rate
(Six Principal Banks)



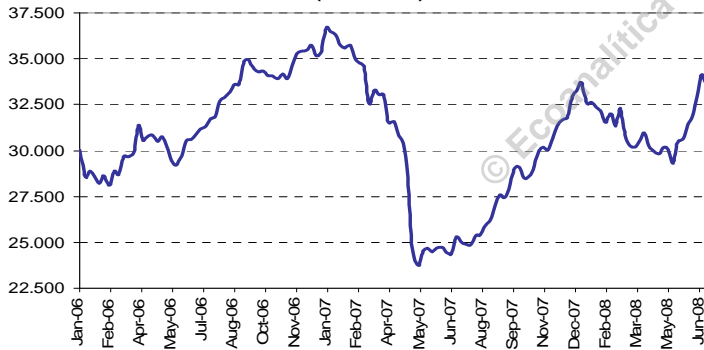
Inflation
(Last 12 Months)



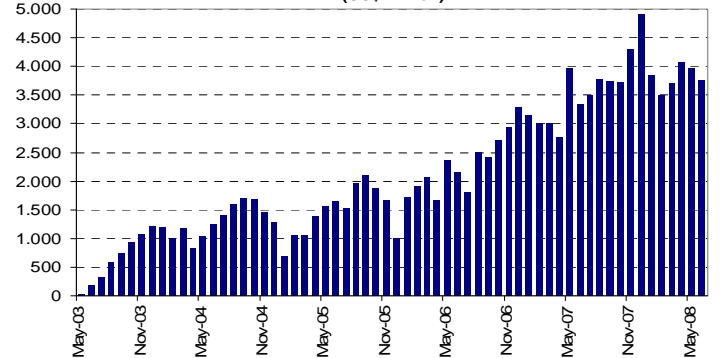
Real Expansion
(M2)



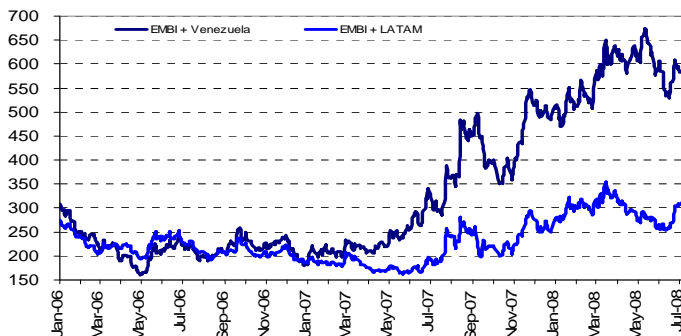
Fx Reserves - BCV
(US\$ Million)



Disbursement
(US\$ Million)



EMBI



Central Government
(VEB Billion)

