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IS OUR EXCHANGE RATE REALLY OVERVALUED?

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The real exchange rate (RER) can be used to analyze the trend in domestic costs and prices, taking into consideration the impact of external prices measured through the exchange rate. The RER is a measure of a country's competitiveness. A real appreciation of the currency implies that domestic costs, measured by inflation, go on growing at a higher rate than the exchange rate. In these cases the country becomes less internationally competitive. A real depreciation of the currency means a devaluation that is greater than inflation, so the prices of external goods rise more than domestic prices which strengthens the country's competitive position. In Venezuela, the real appreciation or depreciation of the currency, as well as the estimate of the real equilibrium exchange rate, must take into consideration the weight of the oil sector.

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The real exchange rate: an abstract - but important - concept

For economists, the real exchange rate is an abstract but extremely important concept. The RER can be defined as a relative price that reflects the state of internal and external equilibrium in an economy at than the prices of their point in time. At times when inflation is higher than devaluation, the costs of domestic companies rise faster international competitors, so the country loses competitiveness. These are periods of exchange appreciation which are reflected by a fall in our index. When devaluation is more than inflation, companies become more competitive because their costs in dollars contract. These are periods of real depreciation of the currency and the index rises.

When does the real appreciation/depreciation of the currency leads to an over/undervaluation?

To monitor the trend in an economy like the Venezuelan one and determine if the appreciation/depreciation of the currency results in over or undervaluation, it is necessary to calculate the real equilibrium exchange rate (REER). If the RER is above the REER, we are in the presence of a real undervaluation of the currency. That is, a competitive country where citizens have more domestic than external purchasing power. If, on the other hand, the RER is below the REER, the country becomes more expensive and its citizens have greater purchasing power abroad than at home. These periods are popularly known by the phrase "it's cheap, give me two." The problem is that the REER is not an observable variable and so its calculation requires some type of estimate.

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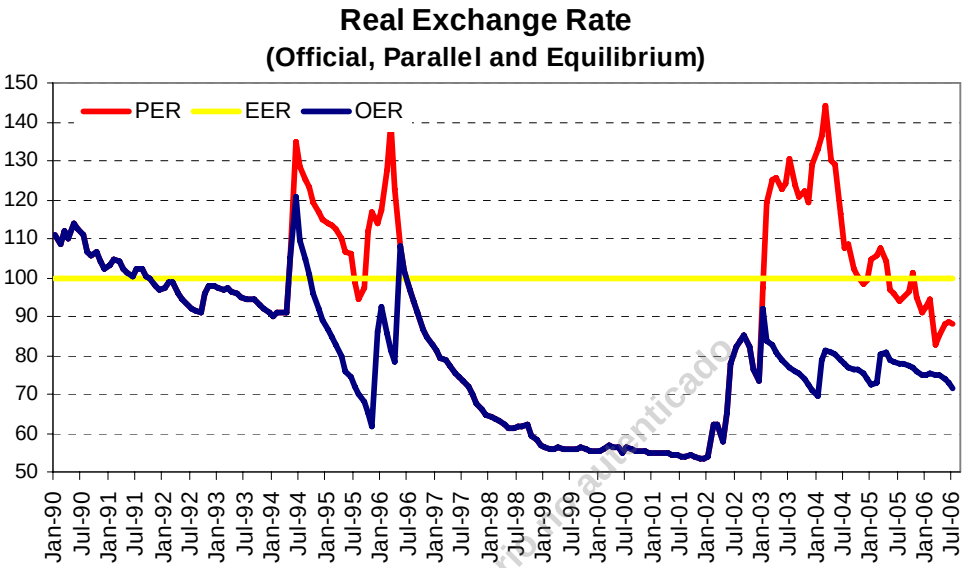
A convincing estimate of the REER has to include some fundamental variables

If the REER is to give an idea of the degree of non-alignment or distortion in an economy, it has to respond to the changes in a set of fundamental variables in the economy and, in the Venezuelan case, the fundamental variable is the oil price.

Why do we say the exchange rate is overvalued?

At ***Ecoanalítica*** we constructed a RER index for Venezuela based on the wholesale prices of the country's three main trading partners (United States, Colombia and Brazil) and the local consumer price index. We also set the equilibrium rate at 100 taking as base the average for the 1990-1993 period. Using this information, we find that our official RER has always had a trend toward overvaluation[1] , so we have a "cheap" (appreciated) exchange rate, way below the equilibrium value, which increases purchasing power abroad, favoring imports.

[1] Overvaluation is when the index is less than 100 and overvaluation when it is over 100



Source: Ecoanalítica

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The private sector has become less competitive

Following this methodology, since the introduction of exchange controls, the official re al exchange rate has appreciated 22.1%, while the parallel rate has appreciated in real terms only 9.7%. So according to the official exchange rate, during the present exchange controls inflation has been 22.1% higher than devaluation. Based on this methodology, the official rate is currently overvalued by 28.6% and the parallel by 12%, which gives an equilibrium exchange rate of VEB3,011 per dollar.

The eternal problem of the Venezuelan economy: the fluctuating RER

Any estimate of the REER in Venezuela has to take into account the weight of the oil sector in the economy. The vulnerability of the external sector is well known because the main problem of our economy is dependence on a single product and almost total lack of diversification of exports. As a result, in a period of high oil prices the non-oil export sector fails to develop.

Oil bonanza makes an overvalued exchange rate possible

When oil prices rise, the flow of foreign exchange from the bonanza increases national income and with it the demand for tradable (exportable) goods and non-tradables (not externally traded, such as services), which has an impact on relative prices.

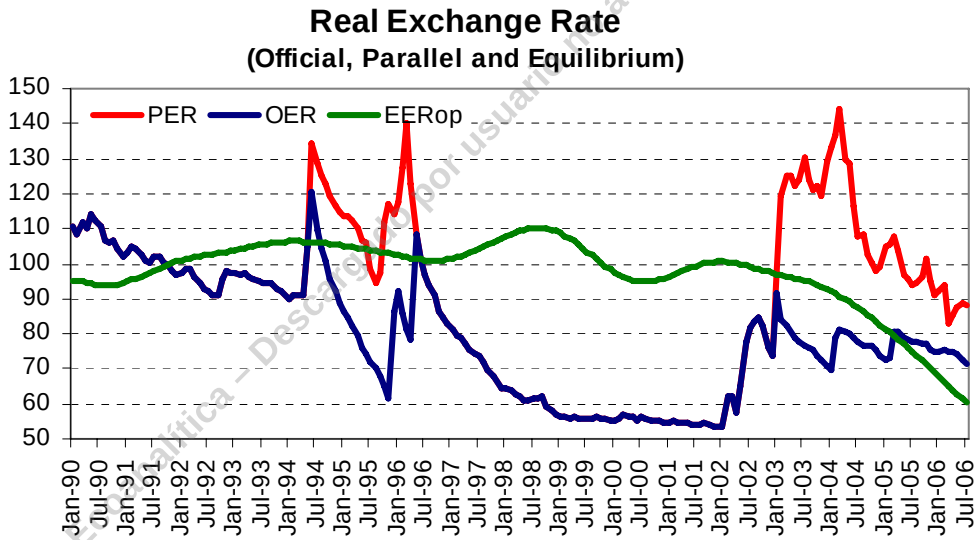
Non-oil tradable sector becomes less competitive

In the case of tradable goods, the stronger demand can be met by the vast range of products available on the international market. With the abundance of dollars from oil finances, imports increase. The prices of

non-tradable goods, which are not imported, rise as a result of the increase in domestic demand in relation to supply. So a change in the value of relative prices leads to a shift of resources from one sector to another, in the sense that the higher prices of non-tradable goods create incentives for their production. Consequently in an oil bonanza the non-tradable sectors grow faster.

What role does oil play?

The chart given below shows the official real, parallel and equilibrium exchange rates, taking into account the effect of oil prices on the latter. This chart, which is a variation of the last one, reflects the role played by changes in the Venezuelan oil basket, so the REER is not static but dynamic, changing over time.



Source: Ecoanalítica

Pick your own scenario

Our exchange rate has been appreciating during the current period of record oil prices which keep the real rate at such high levels. Considering REER based on oil prices, we could say we have an 18.5% exchange overvaluation. If current oil price levels continue into July, the equilibrium dollar would be around VEB1,753 per US dollar. As prices increase, the appreciation of our official exchange rate tends to accentuate because the oil bonanza is accompanied by an increase in the flow of foreign exchange into the country.

However, if oil prices fall to the real average of the last 15 years (US$24.62 per barrel), the overvaluation of the official rate would be 20.6% and the exchange equilibrium would be VEB3,011 per US

dollar. Pick your oil scenario and make your own conclusions. ***Ecoanalítica*** believes it is better to underestimate oil prices and make less optimistic forecasts.

Economic Tips

High service of the public debt forecast for 2007. The director of the National Public Credit Office of the Ministry of Finance, Rudolf Romer, said that in 2007 the interest to be paid on the public debt would be covered by recurrent revenue. In the past most of the payment has been covered by extraordinary sources, especially borrowing. The service could total US$8.40 billion (equivalent to 4.3% of GDP). The interest payments estimated by Romer are very high and would double the amount paid in 2006.

Debt reduction: more repurchases, fewer emissions. In addition to the payment scheme, the government plans to continue with the repurchase of obligations and reduction of issues. The senior financial official said that these measures were intended to bring the debt service down to US$5.40 billion from 2009. This strategy seems positive because it uses the windfall revenue from the current oil bonanza to reduce debts, mainly external.

Bond of the South in trouble. According to Romer, the Venezuelan side of the Bond of the South is ready but Argentina has not yet defined the instrument to be used on its side of the operation. Venezuela will offer fixed interest bonds; however, sources say that the Argentine government could be considering not issuing more debt for the rest of the year because its borrowing requirements are covered. Even so, Venezuela may continue with its part by selling its Bonden 15 (US$300 million), jointly with the fixed-interest TIF bonds.

More on the Argentine bonds. Romer, who was very informative this week, said that the government had so far acquired US$3.70 billion in Argentine bonds and 70% had been sold to the domestic banking system (US $2.5 9 billion). Additionally the Finance Ministry said that sales to the banks would continue because the portfolio still has paper (US$1.11 billion). The government is not planning any more purchases of Argentine bonds during the rest of the year. The weekly sales to the financial system could fluctuate between US$60 and US$120 million a week until mid-December. Gains for the ministry have been US$309 million. Our May 10 issue analyzed where these gains come from.

Other countries to participate in debt transactions. *Ecoanalítica* believes the executive will look at other Latin American bond markets in countries like Ecuador,

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Brazil, Paraguay and Bolivia, as well as some Central American countries such as Costa Rica.

Devaluation on standby. The Director of Public Credit said that next year the exchange rate would remain at 2,150 bolivars per US$; however, he added that the last word was with President Chavez, who has to review the macroeconomic variables for 2007. ***Ecoanalítica*** is waiting for the presentation of the 2007 budget bill on October 15 to see what the executive's real commitment will be. In the last three years, the Chavez administration has respected the exchange rate presented in the budget bill.

More money in FONDEN. According to government sources, PDVSA contributed an additional US$1.10 billion to the National Development Fund (FONDEN), increasing the balance of this mechanism from US$15.90 to US$17.00 billion. This special contribution is part of the revenue obtained from the sale of the oil company's interest in the Lyondell refinery in the United States.

BANDES expands internationally. According to Edgar Hernández Behrens, president of the Economic and Social Development Bank (BANDES), the institution has expanded its international presence from Uruguay into Bolivia, Haiti, Honduras and Guatemala, as well as Paraguay.

BANDES to end purchases of Central Bank CDs. The BANDES President said that public financial institutions had begun to coordinate measures to regulate liquidity levels and that the development bank would no longer purchase certificates of deposit (CDs) from the Central Bank.

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Oil Tips

Going down … and down. According to the Ministry of Energy and Oil, the price of the Venezuelan basket fell US$1.98 this week to an average price of US$52.3 per barrel. Since the end of July, the cost of the Venezuela oil basket has fallen US$12.1. However the average for this year is still US$58.4 per barrel, US$32.4 above the estimate in the national budget.

Exports to USA rise moderately. According to monthly figures from the Energy Information Administration (EIA), the statistical arm of the US Energy Department, Venezuelan crude shipments to the United States grew to 1.2 million b/d in July, up 183,000 b/d from June. However, this figure is still lower than the 1.4 million b/d exported in July 2005. This year Venezuelan crude exports to the United States have

averaged 1.16 million b/d, down from the almost 1.33 million b/d shipped in the same period of 2005. In July, Venezuela was the fourth crude supplier to the US market.

SENIAT claims more back tax. According to SENIAT, ChevronTexaco and British Petroleum must pay US$19.4 million and US$37.2 million respectively for back tax from last year. The assessments for unpaid tax arise from errors in the calculation of income tax in 2005.

PDVSA goes all the way with the new economic model. PDVSA announced that from October 1 this year all the companies that participate in contracting processes initiated by the state oil company will have to be registered in the Register of Social Production Companies (EPS). The EPS system receives, organizes and centralizes the legal, technical and financial information on the companies in the EPS program which participate in the contracting processes of PDVSA and its subsidiaries.

PDVSA controls the Caribbean market. Caribbean countries consume 417,000 b/d of crude of which Venezuela supplies 201,000 b/d, 48.2% of the total.

Orimulsion - The End. The Ministry of Energy and Oil officially announced the end of Orimulsion production, following an exhaustive review of the products and applications of Venezuelan extra-heavy crude.

Sectoral Tips

Another step for the Mines Bill. According to sources in the National Assembly, the new Mines Bill should be passed by mid-October. The new law will create joint ventures in the sector with a majority State interest, similar to those implemented in the oil sector,.

Less competitive. According to the latest report from the World Economic Forum, Venezuela has dropped back in terms of competitiveness from position 88 to 92 in the Global Competitiveness Index (GCI) for 2006-2007. The report says that the most important obstacle for Venezuela is the "insufficient quality of the institutions especially for combating corruption, abuse of power in decision-making, and reduction of government intervention." Another country on the decline is Argentina, which fell from position 54 to 69 pressured by "a certain deterioration in various indicators," along with the high level of public debt and an inefficient market. Chile consolidates its position as the most competitive country in Latin America, followed by Mexico and Peru. First place at world level goes to Switzerland, while the United States, which last year headed the list, has dropped to sixth place.

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CANTV pensioner problems not over yet. According to representatives of the CANTV Pensioners' Association, the recalculation of the retroactive and interest owed to retired formal workers is now in the hands of SENIAT and the Controller General the Republic. They do not recognize the study by the Central Bank. The Central Bank has published the results of its study on its website and so far neither the court nor CANTV have pronounced in this respect. In ***Ecoanalítica*** we do not agree with retroactivity in calculating severance pay. However, according to sources consulted, the Central Bank calculations are very much in line with those of the company.

Venezuelan broadband among the most costly. According to a study by the IDB, broadband internet connection in Venezuela costs 26% of the monthly minimum wage. Even so, two Latin American countries are even more expensive, broadband in Colombia costs 35% a month, and in Peru 40%. The figures show that the cost of access to information and communication technology (ICT) in Venezuela is among the highest in Latin America. Obviously connectivity is only for the affluent.

Aviation sector performs well. According to figures from the International Air Transport Association (IATA), both domestic and international airlines increased their sales 12% in August from the same period last year. This year, international sales have risen 2.7% and domestic sales 3.4% in dollar terms.

One stop office for clearance certificate. According to sources in the Ministry of Labor, the government will open a "one stop office" for applications for clearance certificates, INCE payments, social insurance and housing savings for companies that need them for CADIVI and contracting with the State. If the proposal works, it would be a positive step which would speed up paperwork and reduce opportunities for corrupt practices.

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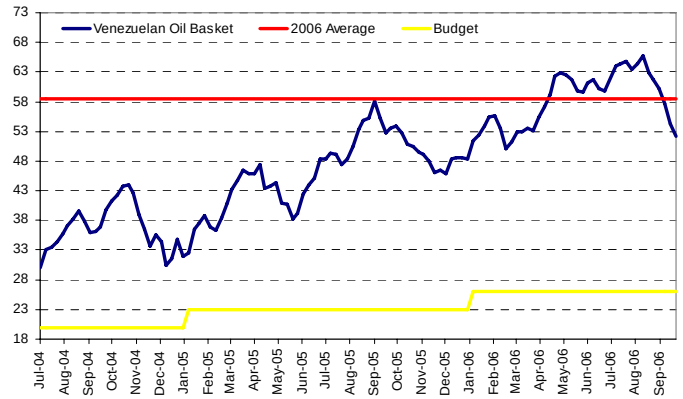
Political Tips

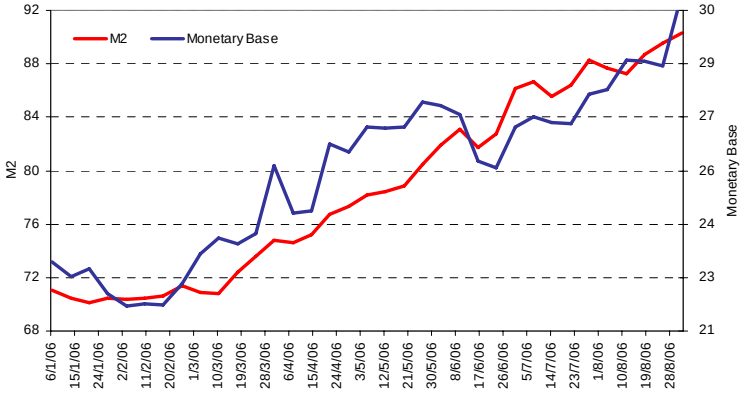
Stricter rules for international observers. The National Electoral Council is about to discuss draft regulations prepared by its legal department on the regime for international observers during the December 3 presidential elections. The most important points are that the international observers in the upcoming presidential elections will have to watch their public exposure carefully, and comply with a rigid accreditation procedure. According to analysts, this regulation is the most restrictive ever imposed in a Venezuelan election.

ECONOMIC OVERVIEW

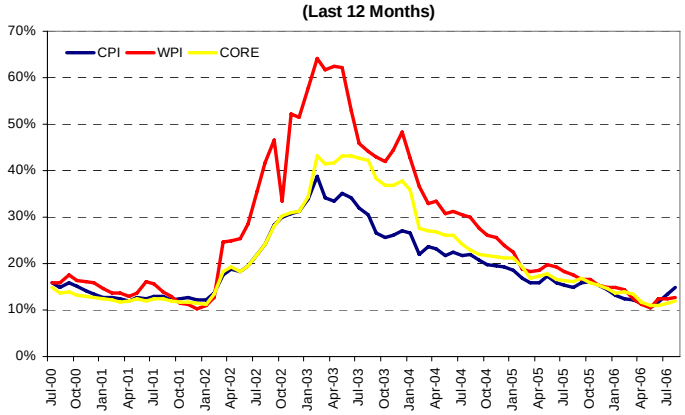
Oil Price
(Venezuelan Basket US$/pb)



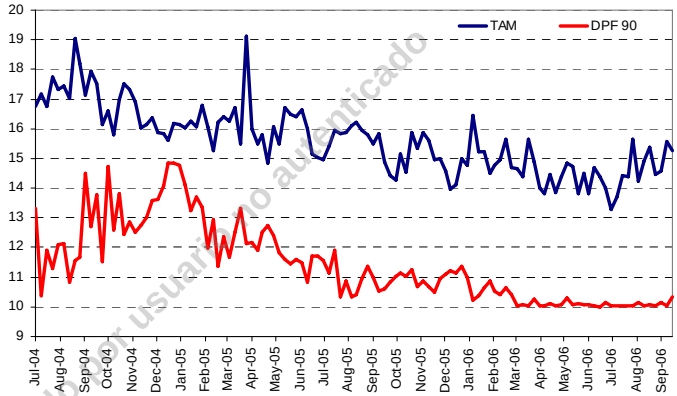
Monetary Base & M2
(VEB Billions)



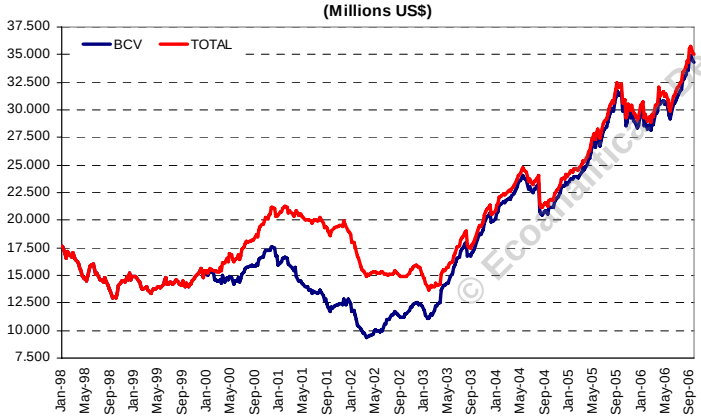
Inflation
(Last 12 Months)



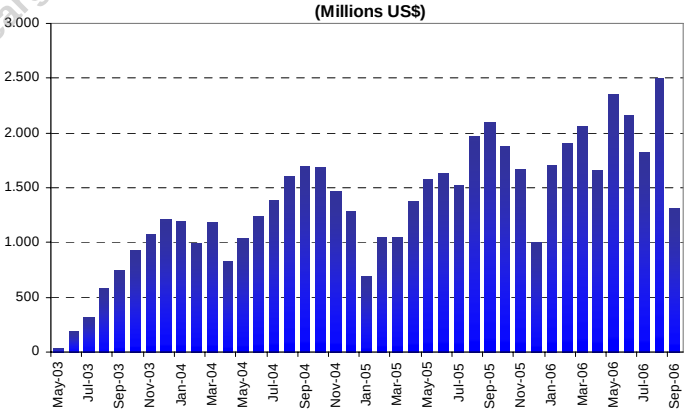
Interest Rate
(Six Principal Banks)



Fx Reserves
(Millions US$)



Disbursement
(Millions US$)



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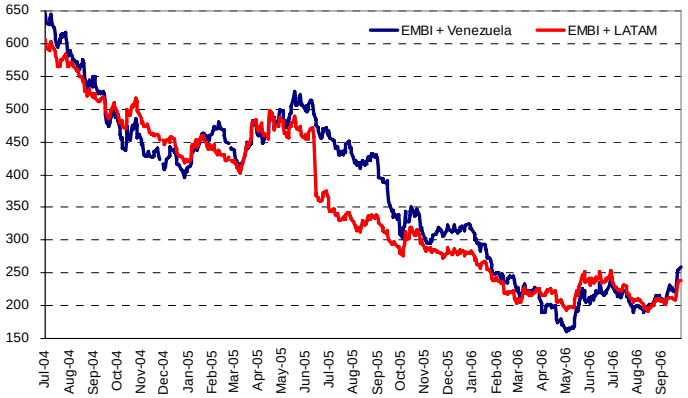
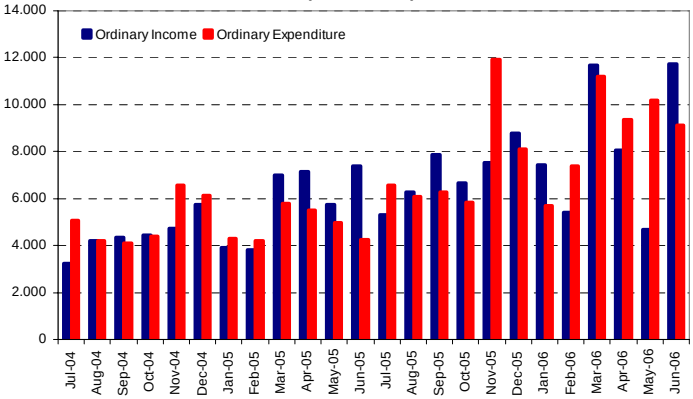


Central Government
(VEB Billions)



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