ANALYTICA INVESTMENTS

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An Expensive Billion

The finance ministry this week attracted international bond investors for the fourth time since Ecuador's return to the market in 2014. Ecuador issued another $1b, acting quickly after sensing that the initial shock from Britons' vote to leave the European Union, which derailed the planned issue a month ago, had passed. As has been the case with the three previous issues, the prospectus was not immediately available to the public. Overall, the relative rise of the price of oil facilitated the latest issuance, which was planned in the annual budget. From the first-quarter lows, the rise of Ecuador's top export pulled down yields correspondingly: Yields have fallen by more than 50% since peaking at 1,750 basis points mid-February.

Still, the interest rate once again went into double-digit territory, reaching 10.75%, making it the highest since the return to markets. The previous issues interest rates of 7.95%, 10.5%, and 8.5%, respectively. Also, this latest issue piles pressure on medium-term debt given that it doesn't extend maturities: it is due in March 2022, while $1.5b become due on 2020 and an additional $2b mature in 2024. Under the 2008 constitution, debt may only be used to fund infrastructure projects, and will be used in this sector, one of the most affected by the shrivelled availability of funds for the government. This term however is flexible; the money could go to be outstanding debt to government contractors, which currently stands at around $2b, according to economy minister Patricio Rivera. The latest issuance in any

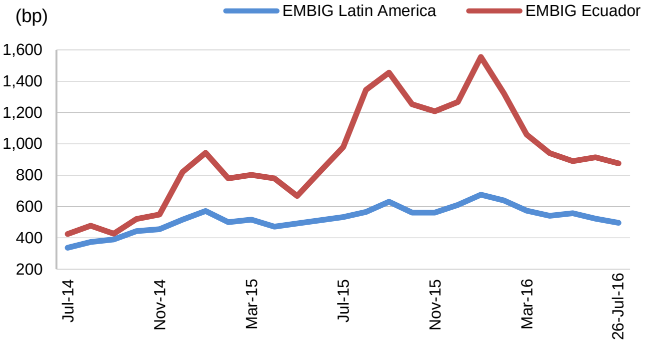
KEY INDICATORS

Ecuador's Global Bond Prices

Bond	Last Price						
	29/07/2016	Jun-16	May-16	Apr-16	Mar-16	Feb-16	Jan-16
Global 2020	100.49	99.38	100.28	95.21	90.54	79.08	74.92
Global 2024	87.49	87.64	89.44	88.04	82.88	72.81	69.63

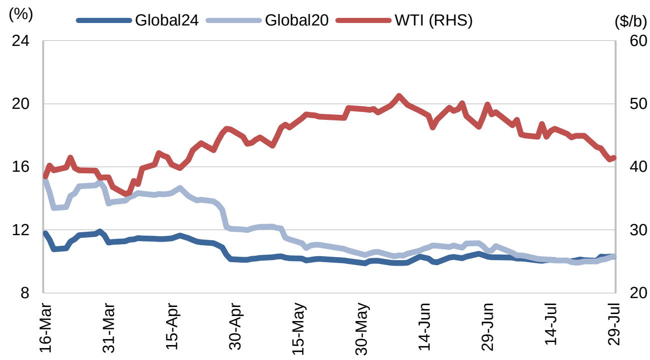
Source: Bloomberg and Analytica

EMBIG Spread



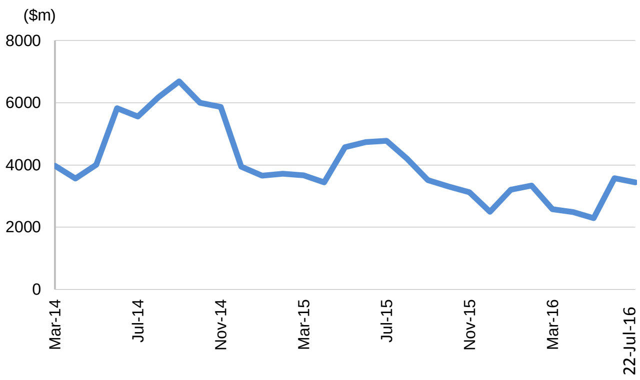
Source: JP Morgan and Analytica

Bond Yields vs. WTI in 2016



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

case reduces some of the short-term fiscal pressure and provides liquidity amid the recession. It also shows a divorce between the worries of local investors, concerned with the domestic situation, and the external market, which looks almost exclusively at the price of oil to gauge Ecuador's financial stability. According to Rivera, the government expects to close the financing gap with loans from multilateral lenders and loans raised by state-owned Petroecuador.

The fresh $1b won't however provide a jolt of confidence in economic policy, which is what Ecuador would really need to help get the economy back on track. The administration of president Rafael Correa administration has indeed had to make concessions to the market. This has included restoring ties with the International Monetary Fund, through Article IV reviews and measures including the increase of value-added taxes in the wake of the April 16 earthquake. As is the case with Ecuador's inability to attract levels of foreign investment in line with those of most other countries in South America, much more will be required however before it can hope interest rates charged by the market drop to levels comparable to those of other countries rated "B" by major international ratings agencies.

Coming Home to Roost

As late as last week, Ecuador's office of the attorney general said that it would pay $112m ($96m plus interest) owed Chevron under an arbitration award into an escrow account, rather than the US oil giant directly. It argued that it was barred from making the payment because a judge in Lago Agrio had ordered the money be paid to a group of plaintiffs suing the company in a civil case instead; in earlier rulings in the convoluted case that began in the early 1990s, the company must pay them $9.4b (that money however won't be forecoming unless a foreign court in a country where Chevron holds significant assets agrees that the ruling here was proper enough for enforcement, a claim that has lost merit since a US court found the plaintiffs' main lawyer guilty of racketeering to win the case in Lago Agrio). Quietly however, the plaintiffs' lawyers asked the injunction to be withdrawn in time for the government to make a timely deposit to Chevron. They argued later that they were seeking to avoid damage to the country's image.

Also last week, economy minister Patricio Rivera said that the payment of $1b to Occidental Petroleum in a separate arbitration case had caused the government's debt to providers to balloon. This however accounts only for half of the debt, and signs have been clear for several years that the government would eventually have to pay for the assets confiscated from the oil company in 2006, under political pressure from candidate Correa. With the political decision having been made a decade ago, at least it could have saved for the eventuality. The payments do mark another welcome, if unenthusiastic, step towards greater economic orthodoxy, as well as a recognition of international legal obligations. Absent a stronger recovery, further down the road – not soon, since payments on foreign debt remain relatively light – one can however imagine a scenario under which, like Venezuela, Ecuador will have to see its public services crumble further in order to service its international debt.

According to some, this has already occurred. The payment to Chevron scandalized public opinion: Center-left opposition legislator Ramiro Aguilar revealed that the amount was covered by a transfer to the treasury account from that created to hold funds collected via the recent increase in value-added tax, among others, aimed for reconstruction of earthquake-hit parts of Manabí and Esmeraldas. The finance ministry called the controversy an "erroneous interpretation" of its activities managing public accounts. "We ratify that the totality of the resources collected by the Organic Law of Solidarity and Citizen Co-Responsibility will be used for the reconstruction and productive development of the zones affected by the earthquake." According to the finance ministry, the funds rather went as a priority to the overdue payment of goods and services provided by companies in the afflicted areas. The earthquake, and the related fiscal weight of reconstruction costs, of course largely are indeed unforseen expenditures. But the inability to pay providers on time shows the lack of preparation for a cooling economy, of whose risk many analysts, including ourselves, have warned for years. Other information revealed by Aguilar is similarly troubling. In a letter to Gabriela Rivadeneira, the president of congress, the head of the "Technical Secretariat for Reconstruction," Carlos Bernal, said that he didn't know how and when exactly money was being spent. Neither his office, nor a reconstruction committee, nor the vice presidency, whose head, Jorge Glas, is trying to become the correísta presidential candidate, "are direct executors, contractors of the different programs and projects that are going ahead within the reconstruction process;" ask the people signing the contracts for the information, he adds. Thus in the end, president Correa has simply added to the bureaucracy, one that isn't hesitating to take political credit for work being done, on top of the local, provincial, and central government instances.

Postgrad Protest

Mid-July, students and professors of the main postgraduate universities, Universidad Andina Simón Bolívar (UASB) and Facultad Latinoamericana de Ciencias Sociales (FLACSO), took to the streets in Quito to demonstrate against the government's delay in meeting its financial commitments and plans to once again change the higher education law. While ignoring UASB, with whom it has a separate fight, Senescyt, the office overseeing universities said that "to take actions based un an unofficial project doesn't contribute to the academic debate." The office's statement was however based solely on a statement by FLACSO, several of whose faculty members have close ties to the Correa administration, and the subsequent street demonstration, which was entirely peaceful and within constitutionally guaranteed rights of opinion.

In practical terms, like many private companies and public entities, both universities are suffering from the government's fiscal woes. Parts of their budgets are funded by the administration, about half of UASB's, jumping to 80% in FLACSO's case. Neither has received money since January, according to their statements. "The resources correspond (to us) via constitutional and legal mandates," the UASB said, adding that, amid its ongoing struggle over university leadership with the government, "several state institutions are harassing our house of studies with overwhelming administrative tasks." The government plans to slash its funding commitment to $1.17m annually, less than 10% of the current $17m, an unconstitutional change, according to UASB. On its part, FLACSO complained that the lack of money risks forcing it to shut its doors; currently, it stands "at the edge of economic asphyxiation."

Aside from budget changes, the universities worry about plans to force them, as part of university reform, to sign agreements with the government that would reduce their ability to provide scholarships and submit them to a severe risk of administrative intervention, such as has been the case with government-run Yachay and IAEN. In particular, they fear the changes will make them lose their status as international universities, recognized by the state in international treaties. In the midst of its own fiscal problems, the government has pulled the class card in this situation, arguing that it shouldn't have to subsidize the privileged who allegedly make up the bulk of postgraduates. While Senescyt says the project isn't yet official, FLACSO says it is already being reviewed by the congressional education committee, even with just six months before elections amid a critical economic and murky political scenario. Unsurprisingly, the universities aren't willing to give the government the benefit of the doubt.

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