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ECUADOR WEEKLY REPORT®

KEY INDICATORS

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Not Quite Speechless

Ecuador’s decade-old government loves to present itself as a beacon of intellectual leadership, full of cutting-edge academic thought. The reality, however, falls far short of lofty goals, often to involuntarily comic depths. Foreign media fail to find the space to describe this, by omission contributing to an erroneous overseas image of the current administration as a successful, progressive government. Yet these comments frequently have a sinister side, and, in practical terms for the investment climate, a periodic review of statements by leaders of Alianza Pais (sic), the ruling political movement, does hold some merit.

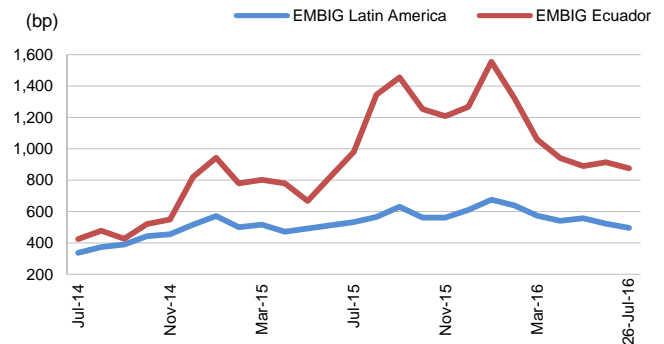
Among recent outbursts, Fander Falconí, a former foreign minister of president Rafael Correa, roiled local social media after linking the wildly successful Nintendo game app "Pokémon Go!" with 19th-century bounty hunters of runaway slaves in the United States. In an editorial, Falconí blasted industrialized societies for creating “a resolved subsistence that appears to bring existential problems, like low self esteem, anorexia, bulimia, self-mutilation,” without the least attempt at any specification. According to him, these troubled societies lack the sensitivity to reject games like the wildly popular “Pokémon Go” app, as of this week also available in Ecuador. Singling out the US demonstrated his bias against that country; he could have mentioned the Soviet example of its own tracking down of escapees from gulags in Siberia, for example.

Ecuador's Global Bond Prices

Bond	Last Price						
	05/08/2016	Jul-16	Jun-16	May-16	Apr-16	Mar-16	Feb-16
Global 2020	100.32	100.49	99.38	100.28	95.21	90.54	79.08
Global 2024	87.25	87.49	87.64	89.44	88.04	82.88	72.81

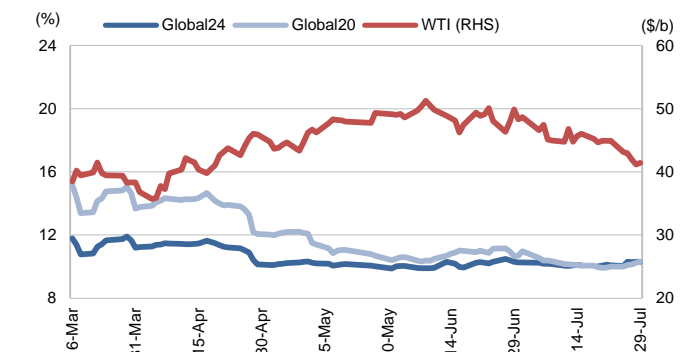
Source: Bloomberg and Analytica

EMBIG Spread



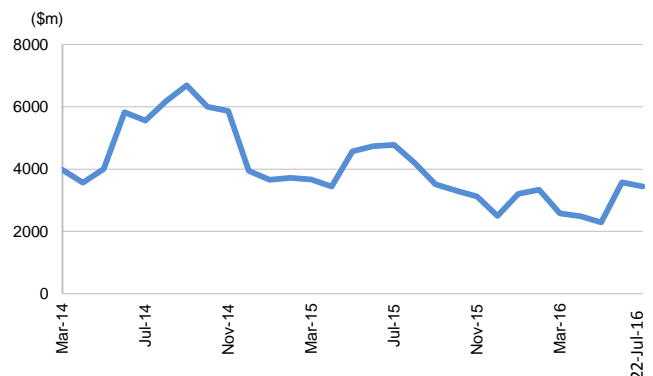
Source: JP Morgan and Analytica

Bond Yields vs. WTI in 2016



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

Falconí in the past refused to acknowledge that the value of the bonds of Ecuador, an OPEC member, rises and falls closely linked to the price of oil. Fortunately, he appears to have no influence on financial policy as the government aptly moved to place an albeit pricey \$1b during a short window before the latest fall of oil prices in recent days.

Of course, Falconí may be pleased with the public impact his statements had, but they reflect the anti-entrepreneurship and intolerant, anti-democratic mentality of Ecuador's current political leaders and their willingness to make wild statements based on half-backed tangential assessments. In this vein, one shouldn't forget limits on mobile phone imports Correa imposed and the contract disputes that put Ecuador at the back end of the rollout of fourth-generation, high-speed mobile communication in Latin America. Separately, Marcela Aguiñaga, a former longtime cabinet member currently a vice president of congress, has become embroiled in controversy for proselytizing in favor of AP in parallel to the offering of government-controlled public services.

She denied erasing the compromising photos from her Twitter account, which in fact happened, and blasted unnamed others for campaigning outside of the electoral period, while AP has been under a nonstop campaign for a decade. Correa, meanwhile, made relatively brief but equally dangerous comments regarding private property. While attacking opposition politicians for owning investments offshore tax havens like Panama, he said that people should not use their own money as they see fit. Correa, who famously bought an apartment in Belgium with money he won as president in a civil suit against Banco Pichincha, the country's biggest bank, that "it may be legal up to now, but it has always been illegitimate, and it's even immoral, because to make money in your own country ... and to take it out to tax havens, is immoral." He added that "some say 'I can do whatever I feel like with my money,' that's even an amorality, to have lost the reference (sic) between

good and evil, not have any social conscience, no love for the fatherland." He however legitimized an offshore company of Pedro Merizalde, head of Petroecuador, arguing that no transactions ever came of it and that Merizalde has pledged to dissolve it.

As some commentators have pointed out, this also implies that foreign investors in Ecuador are being unpatriotic towards their own homelands. The politicians' statements are largely geared towards a domestic audience and don't necessarily imply policy changes, and we don't foresee an inability to meet external debt payments. The administration has in fact preferred not to pay domestic providers and others to whom it has financial obligations to meet debt payments and pay arbitration losses to Occidental Petroleum and Chevron in order to maintain at least external commitments. But, as the case of Turkey shows, an exacerbation of these conflicts can roil relations with credit rating agencies, and has strong macroeconomic implications. And, as was the case with 4G mobile networks or the media law, measures emerging from the government's convoluted spasms of thought can cripple whole industries. Correísmo's intellectual banality reflects the careless management of political power and the waste of an economic bonanza from which, whatever the result of the February 2017 elections, Ecuador will need a long time to recover.

Pickups and Gas Stations

New car sales and manufacturing, which in Ecuador means assembly of "complete knock-down" (CKD) kits, are in the throes of the worst crisis in the past decade. Sales plunged more than 35% on the year in the first half of 2016, and car assembly plants have gone offline. News that Volkswagen had entered a deal that will lead to CKD-based production of Amarok-model pickup trucks in Ecuador therefore led to a fair amount of enthusiastic coverage among both government and private media.

But, at the same time, Petroecuador announced that it had failed to sell its three main gasoline stations, which it had wanted to privatize for about a year.

Among the coverage, that of El Universo appears to have gotten it best, and matches our own information obtained from VW. Germany's biggest carmaker signed a deal with Fisum, a unit of Cuenca-based conglomerate Eljuri, to supply Amarok CKDs. Elsewhere, VW manufactures them directly in Argentina. In the case of Ecuador, another Eljuri unit, Aymesa, will assemble the pickups in a plant in Quito.

Eljuri thus will expand its own assembly capacity beyond the South Korean Hyundai and Kia models it already produces. Initial output will be of 2,000 cars a year. It appears that Eljuri has been able to bring the government on board given the duty implications for imported CKDs; the foreign trade ministry, rather than the more likely industry or production ministries, announced the deal. Our VW source considered additional statements that spoke of 120,000 annual production at a new plant in Manta too early to be confirmed at this stage. For VW, the financial risk is limited at a moment when it must consolidate given the expensive cost of extracting itself from the scandal of having manipulated its models' diesel emissions.

Still, Eljuri's move is a positive signal for a troubled industry as, at the same time, Petroecuador was unable to attract bidders for its main filling stations. In Ecuador, private companies have been able to sell gasoline more expensively than the government-controlled company despite providing a near-generic product in a market that is normally quite sensitive to changes in subsidized prices. Fresh sales data from these private companies amid the recession are unavailable. PDV, a unit of Venezuela's state company PDVSA, is the lone company that offers fuel at prices comparable to those of Petroecuador.

Of course, Petroecuador has gone through turmoil at its leadership in the past months, and may yet face more administrative problems.

That shouldn't necessarily make it impossible to sell a few major gas stations however – two in Quito and one in Guayaquil, with combined average monthly fuel sales of 2.4m gallons. That's just three stations out of 49 it owns, as well as 212 brand affiliates. The company said that the offer had attracted visits by nine interested parties. It's too early to say whether the sale will fail, or whether it may ultimately succeed, and it may be linked to Ecuador's traditional inability to carry out privatizations going back to long before the emergence of *correísmo* rather than to the poor macroeconomic situation. What the cases of VW and Petroecuador do show is that there's much more work to be done to attract major foreign investment and that the private sector is much better than the public sector in this regard.

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