ANALYTICA INVESTMENTS

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ECUADOR WEEKLY REPORT®

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A Dim View

The International Monetary Fund has found a way to give the public a sneak peek at the Article IV report the government managed to keep from publication. In a report issued last week, the IMF published a series of charts regarding debt and projected growth, most notably predicting recession through 2020. Government officials rejected the presentation as based on estimates of major spending cuts it would refuse to consider.

In a 38-page staff report linked to the disbursal of $364m under its emergency "rapid financing instrument" following the 7.8-magnitude earthquake of last April, the IMF estimated that the government's financing needs peaked last year at $12.34bn, but would continue high, reaching $10.8bn this year, and staying above $4bn through 2021. With GDP slightly below $100b, the large scale of financing needs becomes obvious, although it does forecast that the debt will remain below the legal limit of 40% of GDP throughout the next five years. Private-sector economists locally estimate that the government has already breached this ceiling. Meanwhile, overseas debt payments will top 8% of GDP each year until 2020 - an enormous effort to be carried by taxpayers and future generations. Growth will decline 2.3% this year, a decline accelerating to 2.7% in 2017, the IMF data said, revising an estimate of a 4.5% decline this year and of 4.3% next. Thus, while significantly reducing its view of the depth of the recession, it does see the situation getting worse before getting better; and only in 2021 would the economy return to growth,

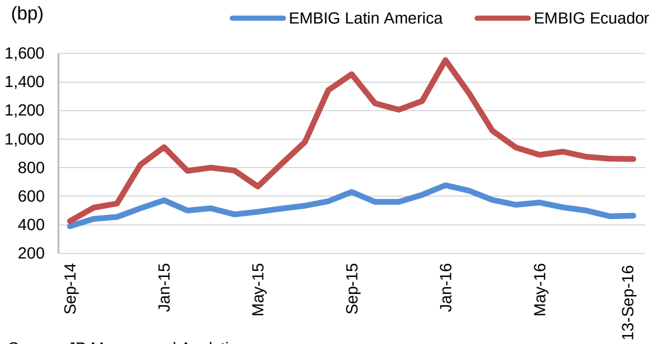
KEY INDICATORS

Ecuador's Global Bond Prices

Bond	Last Price								
	16/09/2016	Aug-16	Jul-16	Jun-16	May-16	Apr-16	Mar-16	Feb-16	Jan-16
Global 2020	101.49	102.30	100.49	99.38	100.28	95.21	90.54	79.08	74.92
Global 2022	100.98	102.89	100.03	N/A	N/A	N/A	N/A	N/A	N/A
Global 2024	87.56	88.05	87.49	87.64	89.44	88.04	82.88	72.81	69.63

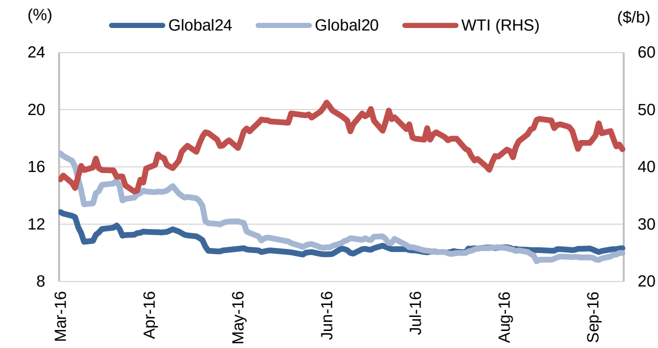
Source: Bloomberg and Analytica

EMBIG Spread



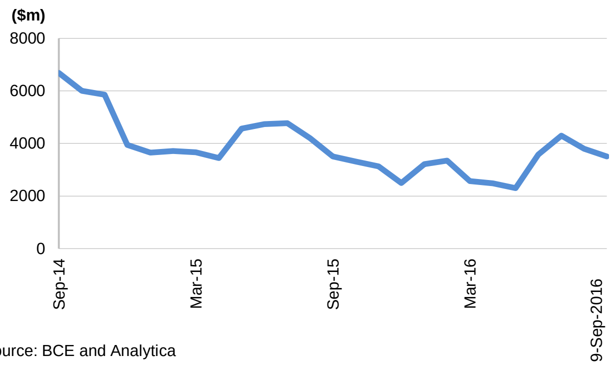
Source: JP Morgan and Analytica

Bond Yields vs. WTI in 2016



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

eking out 1.5% growth that year.

The government had a mixed response. President Rafael Correa scoffed at the Fund, to which it grudgingly returned to secure renewed access to international financial markets. “A small error of almost 100%,” he said of the change in estimate to -2.3%, adding that because of the long-term estimate, “they moved on from being economists to astrologers.” For comparison, Ecuador’s central bank (BCE) estimates the decline will be 1.7% this year; in 2015, it estimated growth would reach 1.5%; it grew 0.2% in real terms and fell 2.1% in nominal terms. Economy minister Patricio Rivera said that the IMF’s 5-year negative outlook, which mars the government’s claim of a (past) decade of gains, was based on a view that the current administration would impose further fiscal austerity, which it would refuse to do (and over his 10.5 years in office, Correa will have presided over 3.5 years of recession). The Fund’s charts show that this claim is false. Additionally, BCE chief executive Diego Martínez said that while the economy is improving, one shouldn’t expect data in positive territory in the short term, to some extent contradicting Correa’s claim that the second half will reflect a rebound in economic activity.

Officials have denied that the government censored publication of the Article IV report. In an interview with *El Comercio,* Martínez said that “we are in talks with the IMF because in the current dynamics of the Ecuadorian economy we have serious discrepancies.” Additionally, he revealed that the IMF said Ecuador should consider labor market reforms that could reduce salaries, which the government will refuse to consider. On his part, Rivera said that Ecuador hadn’t blocked the release of the report, but that “there was an error in the process of the request.” This type of argument has become commonplace. In a document published by independent legislator Ramiro Aguilar on Twitter last week, the finance ministry decreed all public debt transactions to be confidential.

Dangerous Delay

As European bureaucrats return to work this month after their summer break, Ecuadorian officials headed to the Old Continent in a last-ditch effort to complete the free trade agreement (FTA) that will allow local goods duty-free access to their biggest non-oil market. Foreign trade minister Juan Carlos Cassinelli and vice president Jorge Glas held meetings in several countries, large and small, to secure support for the accession to an FTA that already went into effect between the European Union, Colombia, and Peru in 2013. The situation, however, is desperate.

This should have been completed much earlier as the parties already came to an initial agreement in July 2014. According to the EU, they only had to “engage in the relevant internal procedures for its approval.” The devil in the detail has hamstrung the ratification process however. In particular, Ecuador has insisted on restricting imports to deal with the twin external shocks, the fall of the price of oil and the parallel global strengthening of the dollar, its currency (disingenuously, the government blames the currency woes on “devaluations” by Colombia and Peru). It introduced emergency tariffs as high as 45% on numerous imports and, despite promising to eliminate them last June, has kept them in place, lowering them just 5 percentage points. Other trade barriers also exist, in part to boost local production. The Correa administration only grudgingly returned to the table after being warned of the severe threat that the loss of duty-free EU access poses for local jobs. In a slightly positive sign, the government this week announced that the top duty will fall to 35% from 40% and the mid-level 25% would be eliminated, with goods in that tier being charged the lower-level 15%, however all of this, as before still on top of existing tariffs.

Even though these benefits will run out December 31, little real progress has been made on the fine print. Christoph Saurenbach, the EU’s chargé d'affaires in Quito, told *El Comercio* that just three issues have been resolved: the special tax on alcoholic beverages (soon to be removed), labels, and restrictions on ham imports. Obstacles that remain include quotas for European cars and restrictions on other foods, as well as the future of the duties, which local importers say should be scrapped swiftly in any case since Ecuador now has a trade surplus. It remains clear, however, that government's interest in maintaining duties goes beyond their intention to shield external accounts to tax revenues concerns.

On his part, president Correa said that the accord will go into effect in March at the latest. Referring to the gap in duty-free access between January 1 and April 1, "if we lose a quarter means that we lose about $100m (in export revenue) that the state can compensate," he said. Strained as public finances are, the government will face large challenges in being able to provide these funds. Red tape alone will mean that the cost to the budget will be higher than $100m, and exporters will have to expect that they will be paid late, putting jobs at risk. More importantly even is the additional loss of face that Ecuador will suffer if it fails to get a completed deal implemented before December 31. Local companies, particularly those offering relatively generic products, will lose buyers, severing relationships that may well take longer than just three months to restore. In summary, a lose-lose outlook.

Pistols at Dawn

The fate of the Chinese-made Kalashnikov (AK47) assault rifles continues to cause worry in Ecuadorian public opinion. The issue of the 10,000 weapons delivered last month, along with munitions, in a shipment of donations for earthquake victims have now been compounded by the publication of videos showing an apparent paramilitary training exercise led by soldiers and individuals close to Alianza Pais (sic), the correísta political movement. Additionally, president Correa has pushed the judiciary to sanction individual soldiers, and debate over the future of the military pension fund simmers.

Videos posted anonymously showed two men in army uniforms, AP deputy legislator Rodrigo Collaguazo and AP activist Carla Delgado teaching a group of apparent AP members in techniques of violent repression. Participants spoke of both "shock" and "intervention" groups. While abbreviated videos showing the more violent methods of repression were provided for quicker viewing, the leaker also uploaded four full-length videos into the public domain. Christian Zurita, one of Ecuador's leading investigative journalist, later identified the men as active-duty soldiers. Coupled with the unknown destiny of the large cache of AK47s and the official entry of members of the Latin Kings and Ñeta street gangs, euphemistically called "urban cultures," into AP, the videos have led to controversy. Prosecutor general Galo Chiriboga announced an investigation, as did army commander Luis Castro. Chiriboga indeed recognized that, if unchecked, the situation would imply the state losing its monopoly over force; "if this is permitted we would be taking away a state responsibility to pass it on to citizens," he said. But he also invited widespread social media ridicule by downplaying the events, saying that insurgencies would hardly train in broad daylight and in the public view. Critics noted the discrepancy in Chiriboga's official downplaying of the case and public prosecutors in the past having had alleged leftwing conspirators jailed in Quito for possessing Che-Guevara T-shirts and hard-left literature or even putting a low-income driver behind bars in Guayaquil for transporting a sheep figure as a "potential weapon" to an anti-Correa demonstration.

On his part, Collaguazo provided Chiriboga with spin, claiming that the videos were actually two separate events, one providing self-defense training. In the other, he was providing "oratory" training along with Delgado, who added that the videos were shot during an AP “picnic and athletic morning” in Quito parks. Scoffing at the notion of paramilitary training, he said that “people who know of these things know that they have to be done in a clandestine location, not in a park.” Delgado, who has been photographed with leading AP figures including the president, called the event “a picnic.” Photos of people wearing paramilitary garb in support of AP, including self-declared Amazon indigenous warriors in front of the Carondelet presidential palace, have however made the rounds on social networks. Additionally, defense minister Ricardo Patiño has pushed for Venezuelan-style repression of dissent, documents published by investigative site *Milhojas* show, lending credence to the more frightening interpretation of the videos as evidence of a government plot to create paramilitary structures to cling to power even though Ecuador faces general elections next February.