ANALYTICA INVESTMENTS

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ECUADOR WEEKLY REPORT®

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Windfall Rerun

Ecuadorian governments have liked to wait for the end-of-year holiday season to push through unpopular measures. Holidays in November and, in particular, December – Quito's weeklong official foundation celebrations culminating December 6 as well as Christmas and New Year – provide popular distraction from everyday politicking. As a moderate inconvenience, this year's Christmas and New Year, each on a weekend, provide somewhat less of a distraction than others. But president Rafael Correa is willing to go out on a limb nonetheless: On December 1, he resubmitted the controversial windfall real estate tax bill that he withdrew ahead of the papal visit of July 2015 after tens of thousands of Ecuadorians protested against it and legislation to raise inheritance taxes. Business groups have already called for it to be cancelled, while, as fast-track legislation, the congress has only this month to debate and vote on it, or else it will become law as Correa submitted it on January 1.

By submitting the law later, he separated it from the inheritance law that perhaps provoked protest to a greater extent than the real estate windfall and that congress passed, also resubmitted, mid-June. Now, he is moving to complete the package he insists will help fight inequality and cap "speculative" gains or those obtained from insider information, arguing that controlling swift real estate gains, in particular those obtained from public works, will help fight social inequality. In public, Correa has frequently said that real estate prices benefitted dramatically surrounding

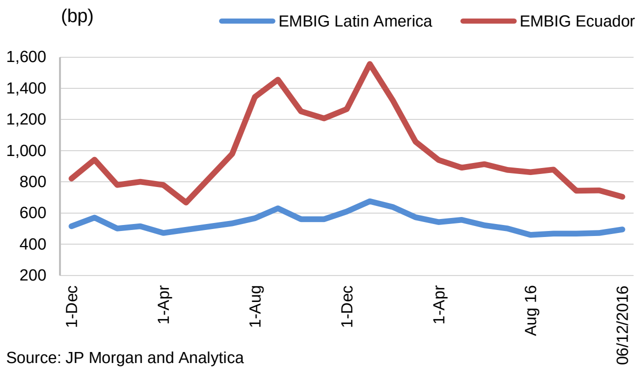
KEY INDICATORS

Ecuador's Global Bond Prices

Bond	Last Price									
	09/12/2016	1-Nov	1-Oct	1-Sep	1-Aug	1-Jul	1-Jun	1-May	1-Apr	1-Mar
Global 2020	106.88	105.54	106.13	102.51	102.30	100.49	99.38	100.28	95.21	90.54
Global 2022	106.17	104.94	106.11	102.47	102.89	100.03	N/A	N/A	N/A	N/A
Global 2024	93.52	92.15	94.55	90.25	88.05	87.49	87.64	89.44	88.04	82.88

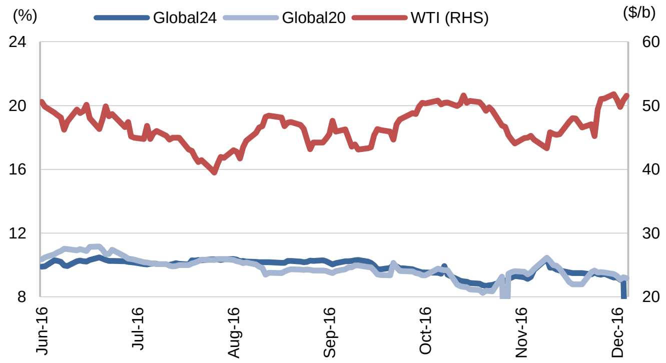
Source: Bloomberg and Analytica

EMBIG Spread



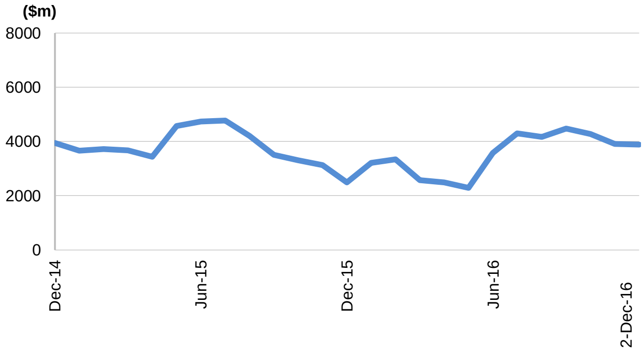
Source: JP Morgan and Analytica

Bond Yields vs. WTI in 2016



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

the $43m headquarters of the UNASUR building built in the far north of Quito near the Equator line, an unneeded white elephant paid by the spendthrift Correa government. Other occasions will not be that easy to find. Real estate values in San Vicente, a coastal town, also benefited from a bridge across the mouth of the Chone river, given easier access to beachfront property. But elsewhere, one can be hard-pressed to find where public investment may have helped property prices to rise. The opposite can be possible, such as in the ill-conceived plan to smash a major overpass onto the already congested area of Plaza Argentina in Quito, the capital, proposed by center-right mayor Mauricio Rodas. The law makes no plans for compensation in the case where a property owner suffers a loss when this is inflicted by public works – like a new refinery in the neighborhood, quite literally a plan that would hit beach towns near Manta in the unlikely event that the refinery, another white elephant, gets funding.

Ecuador already has a 10% tax on gains from property sales, in some cases when the real estate is sold before a 20-year limit. In the latest iteration of the bill, Correa jerks this up to 75%, to be paid when the resale value of housing tops a formula based on the average interest rate obtained by cash deposits with maturities at least longer than 361 days. Municipal cadastral reviews establish taxable property values. In addition to urban real estate, the law now also aims to include rural areas, with the notable exemption of mining properties, which the government now aims to urgently develop, and for which it includes a 48-month tax break. The tax will also now have to be paid before the seller obtains his or her money. Business groups vehemently argue against the tax, as do conservative candidates running for office in the 2017 elections. Indeed, while government officials insist the tax will benefit local officials in particular given that the proceeds are to go to municipal coffers, the conservative mayor of Guayaquil, Jaime Nebot, has strongly criticized the bill because it will likely reduce demand for real estate purchasing, "paralyzing construction and sales" and reducing real estate prices. "From January onwards, if the windfall tax passes, people will have in the state a new lazy and spendthrift partner," Nebot added via his Twitter account. Additionally, the law poses risks of discretional involvement by local and national governments via the setting of interest rates by the government-controlled central bank and through the cadastral evaluations at the municipal level, which scandalized many in Quito when they were jerked higher under Rodas's predecessor, the correísta Augusto Barrera.

Government meddling already served to inflate a bubbling real estate market from which it now appears to be wanting to suck the air out again: it created the BIESS bank, a mortgage entity for the social security institute, designed to stimulate middle-income demand for real estate by undercutting private banks, and in general inflated prices through its extreme public spending increases. Real estate prices might well have been expected to boom amid the recent years of high oil prices, but the government has played a particularly strong role in the past. Now, the government out of ideological reasons appears to be aiming to undermine confidence in the future. One opposition legislator has called it a death warrant for Correa's own political vehicle. That remains to be seen. But for investor confidence, the tax plan is indeed strongly negative.

Taking Credit

Bank regulations issued on November 24 by the Monetary and Financial Junta, the top regulator of the financial system, have commercial bankers up in arms, even warning of a bank holiday. Via Twitter, Fidel Egas, a majority shareholder in Banco Pichincha, Ecuador's biggest private bank, warned that "another (bank) holiday built by (president) Correa could come" via the increase of minimum reserves solely for the seven banks with more than

$1bn in assets. While worrying, the warning that banks could go under is a risky play in the hopes that the public will react in a way that could strengthen banks by increasing political pressure on the government rather than by withdrawing deposits.

The regulatory changes have several components. Firstly, as mentioned by Egas, the minimum reserve requirement more than doubles for the biggest banks to 5% from 2%. “This would seek to immobilize part of the liquidity that private banks have deposited at the Central Bank (of Ecuador), approximately an additional $750m,” said Ecuador’s Association of Banks (BCE chief executive Diego Martínez put the figure at $680m). “Far from reactivating the economy, a measure like this restricts the concession of credit that the banking system and the government itself have been promoting,” the association added. This would however increase the ability of the BCE to lend to the government, which has already reached $4.2bn. Additionally, the Junta reduced some tariffs such as credit card fees, which increased when the government had value-added tax increased to 14% from 12% after the April 16 earthquake. It also redefined the minimum ratio of domestic-to-foreign asset holdings, which will force banks to repatriate additional holdings, and permitted the $2.3bn emergency liquidity fund to lend up to 20% of its holdings to the emergency fund of the much riskier credit cooperative sector of the financial industry, which is much more loosely regulated.

According to the banking association, the seven largest banks already on average park 8% of their cash at the BCE, well above even the newest requirement. This reflects the ongoing difficulties for banks to lend to the private sector amid the recession, beyond Ecuadorians’ traditional preference for short-term dollar deposits over long-term investments given high risk perceptions. Thus, the measures do appear unlikely to trigger the short-term risks that Egas is warning of. The banking association however somewhat more calmly and perhaps more realistically warns of growing risks for 2017 as profit levels are plummeting, leaving returns on equity at the lowest level of Latin America. This, indeed, is reason for concern. (Please see our Ecuador Monthly Report for further analysis).

One More Bond

The Correa administration finally wrapped up funding for the budget for 2016 by selling another $750m in sovereign bonds on December 8. By keeping the issuance under $1bn, it managed to hold the interest rate just under 10%, obtaining 9.65%, according to the finance ministry. The bonds mature in 2026, another minor positive signal as the previous sale from September reopened the issue due in 2022, obtaining 10.75% and $1bn at the time. The funds obtained will go to “public investment,” raising the question in what the government might be able to plow $750m into in the remaining days of the year – perhaps to pay overdue bills owed suppliers, but perhaps also for other pressing issues as December is a fiscally strenuous month, with high salary payments and other matters, while tax revenue is relatively scant.

Also among positive elements, the finance ministry and the sole manager, Citi, showed some market savvy in tapping markets between the benefit obtained from the OPEC decision to cut oil production and the likely further rise in interest rates in the US. The finance ministry said there was interest from Asia, Europe, and North America, adding to a debt load that is clearly above the former official debt ceiling of 40% of GDP. Some in the market may be betting on a more orthodox shift to macroeconomic policy once Correa officially departs the political scene. But with the opposition unhelpfully using the first round of the presidential vote as a primary, correísmo still leads. And whoever takes over from Correa in May will find empty coffers, with this latest issue making it all the more difficult to tap the markets next year.

Correction: In our past Weekly Report, we failed to complete the last name of the secretary general of OPEC, Mohamed Barkindo, and to delete two editorial annotations not meant for final publication.