ANALYTICA INVESTMENTS

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ECUADOR WEEKLY REPORT®

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More Vuvuzela Than Trumpet

With significant fanfare, president Lenin Moreno and his economic team presented a package of measures they called a new "economic program." After weeks of negotiations with the private sector had led to more than 1,500 reform suggestions, business leaders in particular initially had high hopes for potential reforms. In the hours before Moreno was to unveil the program to the public in a nationwide radio and television broadcast, rumors however started circling that the central measure was to be a return of the corporate tax rate to 25%. They turned out to be right.

Moreno read off a list of measures that played to the general public's fears: he reassured them that fuel subsidies were to remain intact. He repeated that the unpopular real estate windfall tax would be put to voters and that the private financial sector would run the mobile payments system (which still requires a law to back the change). Otherwise regarding taxes, he said that the small companies that provide the bulk of formal employment in the country would be freed from the minimum corporate income tax for which the president previously had shown little understanding. A small company won't pay income tax during the first two years of its existence. According to comments made by finance minister Carlos de la Torre a day later, the government tripled the size of companies it considers "small" to those up to $300,000 in annual sales, amounting to 82% of companies registered in the country. Larger companies will get the money paid in minimum taxes back gradually, starting with

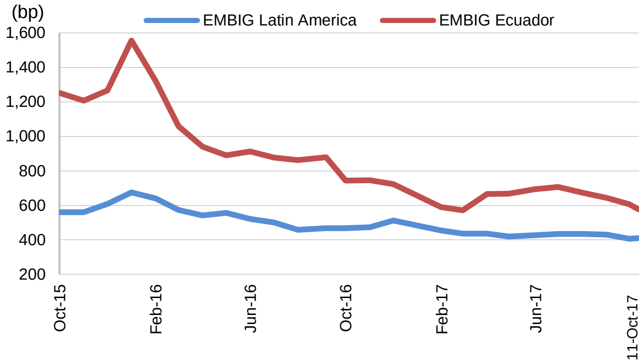
KEY INDICATORS

Ecuador's Global Bond Prices

Bond	Last Price (end of the month) 13-Oct	Sep	Aug	Jul	Jun	May	Apr
Global 2020	108.34	108.03	107.39	106.12	105.83	105.58	107.50
Global 2022	112.95	111.77	110.05	108.20	106.83	107.41	108.63
Global 2023	104.39	103.39	102.34	100.12	98.55	-	-
Global 2024	100.41	99.14	98.22	95.60	93.52	95.05	95.58
Global 2026	107.17	105.60	105.25	102.56	100.71	101.11	102.29
Global 2027	106.59	105.01	105.01	102.19	100.30	-	-

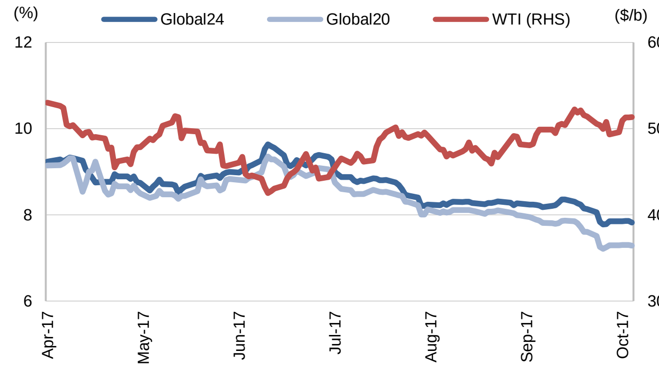
Source: Bloomberg and Analytica

EMBIG Spread



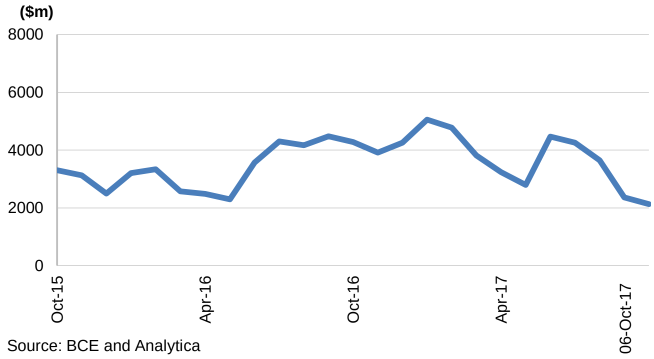
Source: JP Morgan and Analytica

Bond Yields vs. WTI in 2017



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

50% next year, if they at least maintain the number of staffers stable. A tax on idle rural properties is to be canceled. The total amount of tax breaks will amount to a paltry $200m annually.

A few more details emerged regarding the previously announced idea of stimulating the return of money held by Ecuadorians overseas. Moreno will ask lawmakers to approve a five-year suspension of income taxes for funds brought back within the next 12 months. Exporters won't have to pay the 5% currency export tax (ISD) if they too keep the number of full-time employees stable. The tax, which the private sector hoped would be phased out, will remain unchanged to maintain domestic liquidity. "We can't do anything about it" to protect Ecuador's continued use of the dollar, de la Torre said. Meanwhile, as already mentioned, the corporate tax rate will return to 25%, overturning a 2010 decision to reduce it to 22%. This was one of the few business-friendly decisions of the past decade that could help increase hiring. Moreno said he would seek unspecified labor market reforms to boost employment, but the details remain a mystery. To raise the corporate income tax again, along with taxation of year-end bonuses for people with salaries of more than $3,000 a month and a fight against tax and customs evasion, will provide $1.9b, or a $1.7b net of the incentives, de la Torre said. The proceeds of these will go to fulfill public housing projects and other campaign promises. The other main announcement regarded Moreno's plan to tackle smuggling, which he said costs the economy $2b a year, but also unspecified duties to protect domestic industry.

Critics have questioned Moreno's reliance on economic officials from the 2007-2017 administration of his direct predecessor, Rafael Correa. The tepid measures announced by Moreno this week reinforced the impression of economic continuity; the economic team appears to be going around in circles on tiptoes like some kind of protectionist, leftwing ballerina. The maintenance of the ISD will continue to lead foreign investors to look elsewhere for returns, particularly considering the weak growth outlook for the country; this also applies to the repatriation of capital. Business leaders are right to be disappointed. As a small consolation, the potential for Alianza Pais (sic), the governing political movement to split between correístas and morenistas remains, which could lead it to lose its narrow absolute majority in the congress. That would impede Moreno's ability to pass economic measures without reaching out to conservatives, who would be more inclined to seek substantial reforms before voting for his proposals. The latest measures will do little, if anything, to pull the economy out of stagnation.

Correa's Last Bump

The central bank president, Verónica Artola, recently presented surprisingly fast GDP growth for the second quarter, clocking 3.3% on the year. Wisely, she refrained from exaggerating the impact the data might have on the full year, leaving the outlook for the economy unchanged, still estimating 0.7% growth for 2017 and 1.6% for 2018 (the data is scheduled to be reviewed anyway in coming weeks as the finance ministry drafts next year's budget). The surge in growth drew strength from a combination of unique factors: a statistical rebound from crisis a year earlier, when the economy shrank 4% on the year, and large bond placements to the tune of $3b that maintained government spending. On the quarter, growth rebounded 1.9% after shrinking 0.1% in the first quarter. According to the bank's own outlook, that second-quarter flourish is likely to falter.

After returning to the debt market amid the end of the oil boom, the government of Rafael Correa was able to keep up spending came thanks to its return to the bond market. As he governed until May 24, he can still take credit for the second-quarter rebound. Over economic analysts' concerns regarding the sustainability of issuance, the government's ability to continue to sell bonds was helped by an international market awash in liquidity and starved of yields, a condition that continues. This of course was crucial for the electoral bid of Lenin Moreno, regardless of the feud between him and his predecessor that has made international news. While Moreno last week blasted that pace of deficit spending as perhaps designed (by Correa) to make him fail politically, the current president has yet to make more than just symbolic gestures to imply fiscal responsibility, and he, too, relied on a $2b bond placement within weeks of taking office to make ends meet.

The supportive environment for emerging market bonds will make it likely for Moreno to be able to continue muddling through with further bond placements and other debt, and the tax increases (see above) could help offset all-too optimistic estimates of government tax collection, albeit if the companies actually earn enough profits to effectively contribute. Last week, Ecuador obtained $632m from the Latin American Reserve Fund to shore up its balance of payments, and state-owned bank BanEcuador has provided another $400m in the short-term debt market. The reversal on the balance of payments, with a surplus shrinking to $60m versus $954m in the first quarter of 2016 likely led the administration to shy away from eliminating the ISD (see above). The 13.2% annual surge in imports compared with the modest 1.1% increase in exports strengthened the protectionists in the administration, putting their eyes back on raising duties. A credible economic plan, as the private sector has sought for years, will however do more to strengthen the balance of payments than the continuity of policy that has led foreign investors to avoid the country (with the exception of the nascent mining industry).