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**ECUADOR WEEKLY REPORT®**

**KEY INDICATORS**

**For the week of Jan 29 – Feb 2, 2018**

**After the Referendum**

Ecuador's February 4 referendum marks the end of a very unusual, painfully long transitional phase: It will take an extra vote for a president to become independent of his predecessor. Essentially, Sunday's referendum is about getting rid of Rafael Correa as a presidential contender, legally burying his direct political influence days after angry residents of Quinindé buried his state-owned campaign SUV in garbage. Forced to the polls as they have been since 1978 (people who don't vote face a fine and need proof of voting or payment of the fine to be able to carry out myriad bureaucratic procedures), if the polls are right, President Lenín Moreno will win an overwhelming mandate for change. His track record so far makes it doubtful he will make as many correct choices as he can.

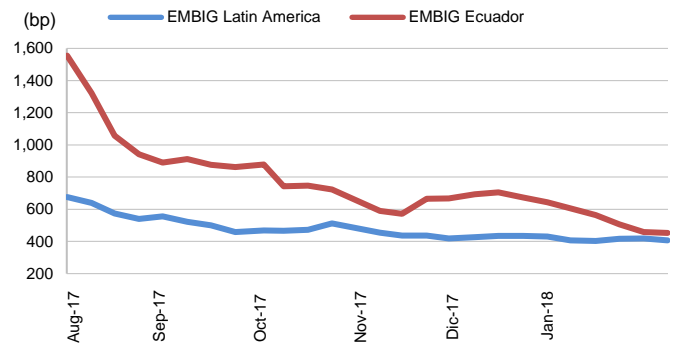
There's a certain ingenuity to the referendum's design. Like clickbait, the seven questions in the referendum are designed to get Ecuador's majority young voters to approve them. The Yasuní National Park in Ecuador's slice of Amazonia gets a cosmetic increase of areas where oil may not be extracted. Voters also get to confirm that no metallic mining may go ahead in urban and protected areas. Mining companies approve the question, given that it indirectly strengthens existing contracts after the surprise (albeit long-rumored) exit of mining minister Javier Córdova. Indigenous organizations called Córdova's resignation this week a triumph after he had engineered a turnaround for the industry from a mining moratorium to a promising start for large-scale

**Ecuador's Global Bond Prices**

Bond	2018		Last Price (end of the month)				
	2-Feb	Jan	Dec	Nov	Oct	Sep	Aug
Global 2020	109.81	109.98	110.94	109.64	109.10	108.03	107.39
Global 2022	116.04	116.32	117.48	115.86	113.13	111.77	110.05
Global 2023	110.10	110.12	110.67	108.46	104.90	103.39	102.34
Global 2024	105.93	106.04	106.60	104.42	100.89	99.14	98.22
Global 2026	114.39	114.40	115.03	112.45	108.04	105.60	105.25
Global Jun 2027	113.55	113.76	114.73	111.66	107.57	105.04	105.01
Global Oct 2027	108.85	109.17	109.90	106.82	102.40	-	-
Global 2028	101.79	102.04	-	-	-	-	-

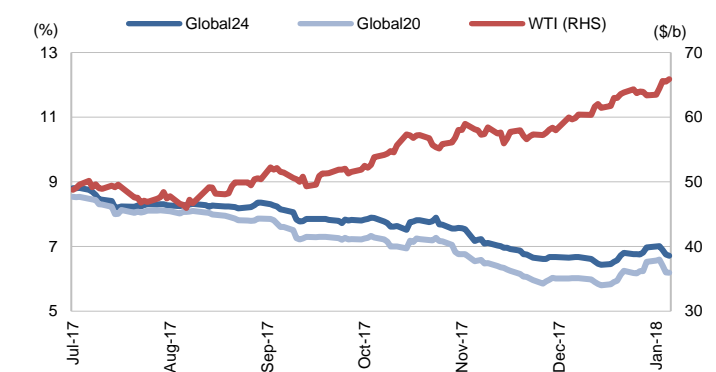
Source: Bloomberg and Analytica

**EMBIG Spread**



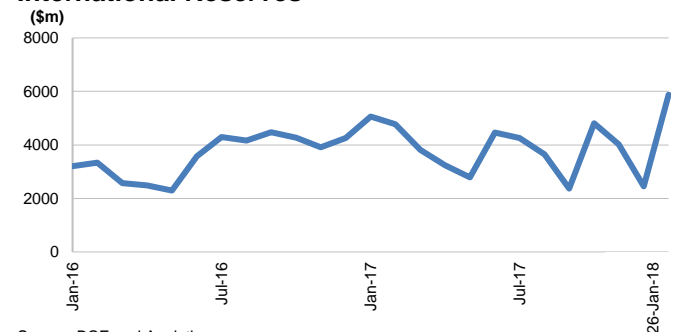
Source: JP Morgan and Analytica

**Bond Yields vs. WTI in 2018**



Source: Bloomberg and Analytica

**International Reserves**



Source: BCE and Analytica

gold and copper projects. Middle-class voters who in 2015 vehemently but peacefully protested against Correa's windfall real estate tax get the satisfaction of voting to eliminate it in the referendum. Hardly anyone will vote against eliminating the statute of limitation for sex crimes against minors, especially after recent horrific evidence of massive rape and other abuses of children in public schools under correísmo. That leaves three more purely political questions: the reintroduction of term limits scrapped by Correa in 2015 (without being brave enough to ask voters about it), the elimination of a person's right to hold public office if found guilty of corruption, and, put succinctly, a temporary right for Moreno to purge the judiciary and other bodies of Correa loyalists. Among them, attorney general Diego García, a childhood friend of Correa who held his post for a decade.

Like the real estate tax and the child abuse, the political questions are strongly linked to current events, in particular, Correa's authoritarian regime and its massive corruption, which eminent historian Enrique Ayala Mora calls the worst ever. The questions are also designed well as they in theory make it difficult for Correa's supporters to vote no, at least in principal. While the correísta Constitutional Court dragged its feet, delaying the referendum past the year-end holidays, the supporters of the former president lost time as they had to say yes to some of the questions and no to the ones that politically hobble their leader. They ended up settling for the slogan of "seven times no" even at the risk of looking like supporters of pederasty. Correa returned to Ecuador for what will probably be his last, ignominious campaign. Except for a glowing monologue on state-owned EcuadorTV (Correa spoke alone for about an hour, while the interviewer, Xavier Lasso, sat in adoring silence and used just five minutes to ask questions), Correa got air time largely in small local radio stations. In general, he desperately sought to portray his estranged successor's handling of politics and the referendum

as a totalitarian power grab. Preposterously, he told *Radio Pichincha Universal* that, if this situation had occurred in Venezuela, it would already have been invaded by "blue helmets." The low point of the campaign came in Quinindé, Esmeraldas province, where, according to morenista mayor Ángel Torres, he harangued local residents in a radio interview, resulting in the pelting with garbage and smearing of his car and a four-hour siege until he could leave the station under police protection. He left the town in a helicopter, leading to comparisons with the flights of deposed presidents Abdalá Bucaram (1997) and Lucio Gutiérrez (2005). The standoff came a day after television network *Teleamazonas* reported that he had filed documents saying that he had payed less than \$3000 for his home, currently valued at close to \$450,000. Other hardline correístas getting bad news just days before the vote included his propagandists Vinicio and Fernando Alvarado. Prosecutor General Carlos Baca, himself facing allegations of wrongdoing, acknowledged an investigation into the fortune the Alvarado brothers allegedly amassed under their patron's 10-year rule.

Moreno surprised many by the way he moved out of Correa's shadow. After all, he had been nominated by Correa's Alianza País (sic) movement, and Correa had dominated almost all aspects of public life, at least since 2011, when a flawed referendum handed him control of the judiciary. It's unfortunate that Moreno has asked voters for a leap of faith in giving him the temporary authority to revert that control in a similar way, and there are plenty of issues with several other questions. Critics also question the president's decision to retain numerous members of Correa's political entourage like justice minister Rosana Alvarado and foreign minister María Fernanda Espinosa, whose scandalous handling of the Julian Assange case has exposed her and Ecuador's foreign policy internationally in recent weeks, to name just two. Still, Moreno has also named outside officials like the very capable oil

minister Carlos Pérez and, while he was Correa's vice president for the first six years of the regime, had toyed with a candidacy for Democracia Sí, an opposition leftwing political movement. Belying his communist first name, he has personally emphasized the need for a free press and independent judiciary, both of which have been essential elements in getting Ecuador where it is now.

But this isn't nearly enough, according to opposition politicians and political scientists. The new-found freedoms rely solely on Moreno's personal management of the vast powers the *correísta* constitution of 2008 and its additional legislation concentrate in the office of the president. The referendum offers both a mandate and a unique opportunity for him to seek to rebuild political institutions. Ecuador needs to issue fair electoral rules and increase pluralism in the National Electoral Council and reestablish checks and balances *de jure*, not just *de facto*. It also needs to gut the populist, incompetent foreign ministry and reenlist valuable diplomatic experience from current and former career diplomats to recover international respect. While he can do the latter on his own, the other matters will require a more broad consensus in congress, but this remains under the control of José Serrano, Correa's former interior minister and a man with an agenda of his own. Congressional volatility may ensue, stymying reform attempts.

If conservative former banker Guillermo Lasso had won the election in April (he might have, as former Moreno chief of staff hinted before having to resign after this comment was leaked to the public), he would have faced a better-organized resistance from *correísmo* than Moreno did. But meanwhile, Moreno has been flat where Lasso would have been competent in economic reform, continuing the *correísta* tax-borrow-and-spend public growth model. Here, too, Moreno has a golden opportunity as the markets will receive a more obviously orthodox economic policy with fireworks. Venezuela's default

and the recovery of oil prices have combined to maintain demand for Ecuadorian debt solid (see below), but many analysts fear disappointment as Moreno seems unlikely to want to risk political capital on fiscal discipline. While he does have some solid contacts with independent entrepreneurs, he is surrounded by leftwing political advisors and socialist economists who are fearful of giving an inch of ground to reformers. We hope Moreno may see the light economically but aren't holding our breath.

### **Audit, Again**

Ever since Rafael Correa used new foreign debt to increase public spending beyond what oil and tax revenue could provide, doubts regarding transparency emerged. A significant share of that debt is now being audited by the acting comptroller general, Pablo Celi. Last August, he launched an official review of debt, supported from January by a group of observers. This has led to questions whether this might lead to a repeat of the situation between 2007 and 2009, during which Correa was elected on an anti-debt platform, called an audit, and misleadingly used it to default on bonds, only to buy them back at a discount. This is not the case now. Instead, the present exercise will hopefully shed much-needed light on recent debt issuance, from which most people stand to benefit.

The market has taken the news in stride. Ecuador's bonds, as reported by *Bloomberg*, gained the most on US Treasuries last week, with the spread narrowing 32 points, the most among emerging markets, to 442 basis points above the US notes. In contrast to how investors see the audit, Correa, in Ecuador to campaign against the referendum called by Lenín Moreno, his former vice president and successor, has decried it mainly for two reasons: he terms it illegal, saying that the debt had already been audited, and accuses Celi of political persecution against his administration. Regarding the first claim, Correa is taking the position that an audit is a criminal

trial and that a person can't be tried twice for the same crime. Before leaving office, Correa had welcomed being audited, saying that he had nothing to hide. An audit however is not a trial, but primarily a review of whether statements have been complete and meet legal standards. Legal responsibilities may of course ensue if the auditor finds that the entity in question failed to account properly. Additionally, while Correa says that the debt he raised had already passed review, the auditor of that debt was none other than Carlos Pólit, who has fallen into disgrace amid the bribery scandal surrounding Brazilian construction firm Odebrecht throughout Latin America and parts of Africa. Pólit has escaped trial by fleeing to Miami (he also has US citizenship). On this background, a fresh audit looks reasonable, and it is part of Celi's job description. A statute of limitation determines the range of the review, from January 2012 through May 2017.

The audit that Correa called analyzed all public debt that existed when he took office. After it found that there were signs of "illegitimacy" of that debt, one of its representatives, Alejandro Olmos, recommended that Ecuador sue. Correa however refused, arguing that going to the courts would push the country into "an unreasonable adventure, that we do not know how it would turn out, that could harm the country." Instead, he simply chose two bonds (the Global 2012 and 2030) he said were illegal and illegitimate and defaulted on \$3.2b. Less than a year later, he decided to try to avoid the permanent pressure Argentina faced from holders of bonds on which it had defaulted on and opted for a buyback. If the bonds had truly been illegal, as Correa said, there would have been no need for the government to undertake such a repurchase.

Correa's intent to have an audit come up with an argument for him to disavow repayments on debt of his choosing contrasts starkly with the audit going on now. First, the audit, or "special exam," was decreed by Celi, not Moreno, albeit acting once the president

said that a review showed that Ecuador's debt was far greater than Correa had claimed, breaking a legal limit of 40% of debt to GDP. Moreno at the time said that debt under his estranged predecessor had reached \$42b, but could potentially increase by \$8b given additional liabilities and risks (since then, he has sold \$7.5b in bonds, including a record \$3b last week). The limit by itself says nothing about the country's capacity to repay its debt, but Correa himself had it established as part of the anti-debt platform on which he was elected, and keeping debt levels low can provide positive signals to the financial markets. Correa's insatiable public spending programs however set the stage for a conflict with this rule. This led to measures beyond normal public relations spin. Loans backed in oil were declared "pre-sales" and thus kept off the books, as was domestic debt with a maturity under 360 days. He also refused to acknowledge debt owed the social security institute, which includes pensions and medical services, decreeing that the total would only include debt owed to non-governmental entities; thus, in practice he lifted the ceiling to allow for additional financing. Furthermore, all debt operations were declared confidential until their maturity. This runs contrary to the principle of accountability for the use of public funds; after all, a bond or other debt in which there was impropriety or worse might mature well beyond a statute of limitation. In this situation, officials cloaking themselves in confidentiality have an obvious risk of conflict of interest.

In his July 31 decree announcing the audit, Celi said that the audit would analyze the legality, sources, and use of the debt. He also said that he would create an observers' panel including economic and legal experts "so that citizens can learn of the developments and results" of the exam. Celi announced the names of the observers early in January. In alphabetical order, the panel also includes Ana Abril, former supreme court judge; Patricio Alarcón, president of Quito's Chamber of Commerce;

Roberto Aspiazu, director of Ecuador's Committee of Entrepreneurs; Magdalena Barreiro, economist, former finance minister and professor at Universidad San Francisco de Quito; Alfredo Corral, former comptroller; Ramiro Crespo, financial expert on debt issues and chief executive officer of Analytica Securities, the publisher of this newsletter\*; Pablo Dávalos, economist, deputy finance minister under Correa in 2005; Marcelo Merlo, a former comptroller general; León Roldós, a former vice president and lawyer; Eduardo Valencia, former chief executive of the BCE. The panel established a legal and an economic sub-panel, respectively, and began weekly meetings. Their goal is to help find out whether public officials complied with their legal obligations when they contracted the debt, including due diligence, and exerted prudence and other care when they spent the money. In an editorial in *El Comercio*, Roldós urged the government to cancel the confidentiality of the debt information to support the audit and the observers' ability to carry out their task. Hopefully, the finance ministry will respond and help to spur the process along. At the same time, even if it doesn't contribute, information on individual transactions can be analyzed from different perspectives, offering auditors approaches from other angles.

As indicated above by the bonds' performance, internationally, the context for Ecuadorian debt is currently supportive. Venezuela's default made Ecuador's bonds interesting for portfolio managers seeking high returns, sparking demand. Oil prices have recovered to more positive levels. Few, if any, bondholders regret Correa's departure. For Moreno, the audit provides a welcome opportunity to set the record straight and provide important information to investors in both bonds and the real economy, as well as a signal to taxpayers as to where the money went. Transparency will provide valuable signals as to when and how maturities could continue to be lengthened, perhaps to 30 years, and how interest rates could continue to decline, in line with the government's

policy of increasing debt sustainability. Bondholders should understand that the only group that could suffer from the audit could be public officials, if they committed crimes while raising and/or spending debt, not good-faith buyers. After all, misdeeds, if they occurred, may have been committed solely regarding internal procedures completely unknown to buyers, even less so if they are in the secondary market. And, even in the most extreme scenario, it wouldn't be an impulsive and angry president but level-headed courts in New York City and London which would have the final say in any legal review of individual debt transactions. Finally, even if crimes may be revealed but courts prove incapable of prosecuting the guilty, Ecuadorians will have the benefit to see how their funds were misspent and by whom.

### **Fearful Blast**

A car bomb at close to 1.30 a.m. on January 27 destroyed the main police station of San Lorenzo and several houses, as well as injuring 28 people. Perhaps thanks to Rafael Correa's ridiculous antics this week and the impending referendum, the attack hasn't translated into hysteria or obvious activism, but also thanks to San Lorenzo's marginal economic and political importance and isolation that has sadly contributed to its backwardness. Ecuador's first-ever car bomb however marks a massive escalation of violence that must be handled with utmost care.

According to initial public statements, the blast was perpetrated by a dissident group of the Marxist Colombian FARC rebels; unlike the main body of the guerrilla, they refused to demobilize as part of the peace agreement that won Colombian president Juan Manuel Santos a Nobel peace prize. While it was clear that the splintering of the FARC was going to happen and posed a risk to Ecuador, the fact that the attack happened in San Lorenzo is notable. Given the relatively recent date of the peace, the group that allegedly carried out the attack was able to achieve several strategic objectives: It managed to wrest and

control a swath of territory along the northwest frontier with Colombia, across the Andes and well west of formerly FARC-controlled territory in Amazonia. Security experts in Ecuador were aware of this, noting the westward shift in narco-violence months ago.

News of internecine violence among criminal gangs seeking to control the area has been scant. Instead, attacks on security forces are escalating. The car bomb goes well beyond a daring ambush of Ecuadorian anti-narcotics special forces on patrol near San Lorenzo in November. It proves the ability of the group to organize as complex an operation as a car bombing. While it also damaged local residents' houses and property, the perpetrators did warn them that something bad was going to happen, apparently in retaliation to the extradition of some locally important individuals in the drugs' trade.

Initially, the administration declared a local state of emergency and sent in more troops and police (the port town also has a navy base). Still, it does appear that the security apparatus was caught off-guard. It must be remembered that Correa received campaign funding from the FARC, according to seized rebel documents, and that that organization, sickeningly, was recognized as a legitimate conversation partner throughout Ecuador's left. Many of those sympathizers remain in public office under president Moreno. Meanwhile, the security apparatus into which Correa plowed millions focused on spying on peaceful critics of the government. Drones with which he replaced the closed US air force base in Manta, which provided surveillance of drug smuggling and a deterrent, and new Chinese radars proved total failures. Moreno asked for Colombian and US assistance in investigating the blast, a positive sign. Hopefully, the Moreno administration's level-headed approach will not mean further negligence. That could have tragic consequences indeed for the whole country. In the long term, it's clear that world drug policy is unsustainable, but most politicians, at least while in office, refuse to pursue a careful legalization

policy that promises to be the only solution to the violence of the drug war.

\* As he regularly does, Ramiro Crespo participated in the preparation and editing of this article; this article does not represent the official position of the observers' panel or the comptroller general's office in any way.

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