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ECUADOR WEEKLY REPORT®

KEY INDICATORS

For the week of Mar 19 – Mar 23, 2018

Under Fire

On March 20, a roadside bomb near Mataje killed three Ecuadorian marines and injured 11 as violence against military and police reached a new extreme in the northernmost province, Esmeraldas. The sixth terror attack in the province this year was the first one to claim lives. Among the injured, three were hurt so badly they had to be transferred to the military hospital in Quito, including one who lost both legs and is in intensive care. The dramatic escalation of violence has led to fears of a loss of control in the zone bordering on southwest Colombia. In response, president Lenín Moreno held a national emergency broadcast to convey a message of a tough but measured response.

Moreno blamed the attack on narcotics traffickers operating in the area, a staging ground for smuggling of drugs towards Central America amid mangrove forests and complicated geography of inlets and remnants of tropical forest. The attacks have come in response to the government’s militarization of the area with more than 12,000 troops and police, resulting in the captures of drugs, materials used to manufacture them, weapons, and other goods as well as of 14 high-ranking individuals linked to these organized crime organizations. Moreno valued the toll of the efforts on the gangs at \$600m. In a blunt warning, he said “we will hunt them, we will capture them, and they will regret their criminal acts.”

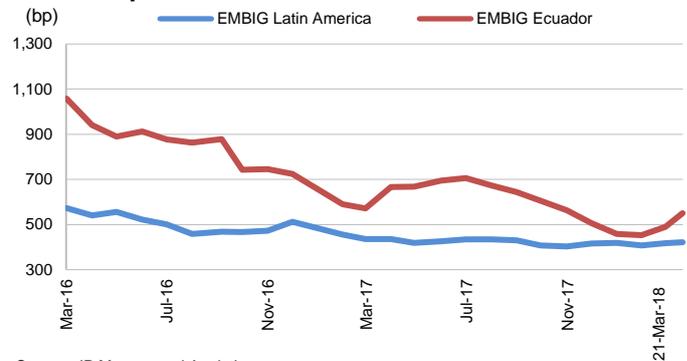
Besides just clamping down on the region, which remains in a state of emergency, the government is expanding efforts to provide social services. This

Ecuador's Global Bond Prices

Bond	Last Price (end of the month)						
	2018		2017			2017	
	23-Mar	28-Feb	Jan	Dec	Nov	Oct	Sep
Global 2020	106.68	108.75	109.98	110.94	109.64	109.10	108.03
Global 2022	108.85	113.07	116.32	117.48	115.86	113.13	111.77
Global 2023	102.65	106.64	110.12	110.67	108.46	104.90	103.39
Global 2024	98.91	102.06	106.04	106.60	104.42	100.89	99.14
Global 2026	104.96	110.44	114.40	115.03	112.45	108.04	105.60
Global Jun 2027	104.62	110.35	113.76	114.73	111.66	107.57	105.04
Global Oct 2027	99.74	105.58	109.17	109.90	106.82	102.40	-
Global 2028	93.83	99.23	102.04	-	-	-	-

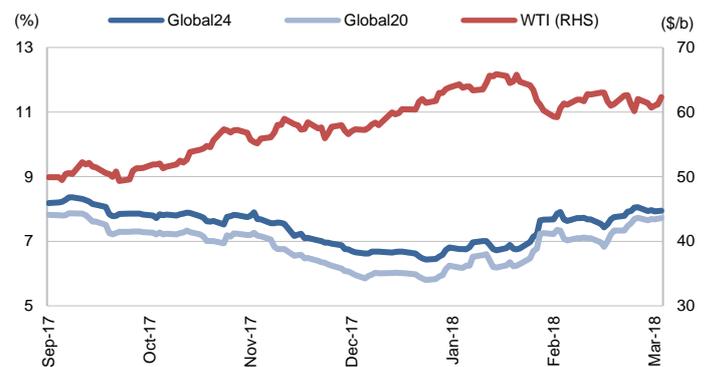
Source: Bloomberg and Analytica

EMBIG Spread



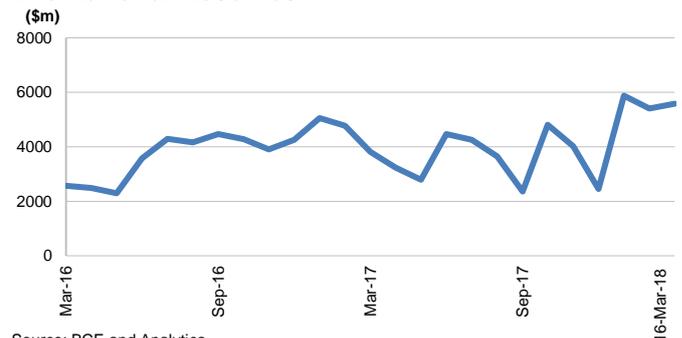
Source: JP Morgan and Analytica

Bond Yields vs. WTI



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

appears to aim to correct the dissatisfaction of local residents with the state of emergency. According to newspaper *La Hora*, which has several regional editions including one from the city of Esmeraldas, the provincial capital, some people there criticize the increased presence of police and soldiers as causing problems for normal business activities, and reports of flight from the affected area are grown. The region has long suffered from lawlessness, besides drug trafficking including illegal gold mining, logging, extortion and combinations of the above, alongside legal activities like ranching and fishing.

The administration has also sought help from the US and Colombia. In a joint statement, Moreno and Colombian president Juan Manuel Santos pledged to intensify quick responses on both sides of the border. Ecuador has long said that Colombia failed to adequately patrol its territory while using its southern neighbor as an anvil against which it could press its irregulars. To some extent, this is true, but the long neglect that has allowed the growth of criminal activities can't be blamed on Colombia alone. News reports have chronicled problems of Ecuador's military with poorly chosen materiel bought under the previous administration that has fallen into disuse, including Dhruv helicopters from India and Israeli drones. Rafael Correa (2007 – 2017) had noted that the peace between the Revolutionary Armed Forces of Colombia (FARC) and government could cause an increase in violence for Ecuador as a sizeable contingent of FARC rebels were expected to refuse to demobilize. At the same time however, he removed leading generals at an alarming rate amid a struggle for control over a military that, unlike in Venezuela or Bolivia, refused to be brought into the "revolutionary" fold.

Given the scale of the problem, it is worth asking whether there was just administrative incompetence and negligence or also a criminal connivance that allowed the current situation to emerge. The escalation of violence reflects a possibility that

informal comfortable arrangements between the gangs and at least some officials in the state security apparatus existed under Correa. An unexplained photo of Correa with suspected drug traffickers published by *El Nuevo Herald* last year underscored this last point. This week, Moreno also announced the disbanding of SENAIN, the security secretariat created by Correa that became notorious for domestic spying, including (apparently) Moreno's own office, but mainly on opposition activists and journalists critical of the regime. While reform of the intelligence services is a correct move, sadly, it was long overdue.

Slick Patch

In April 2013, Ecuador's oil output crossed the threshold of 515,000 barrel-a-day (b/d) production. This year, despite a recovery of oil prices, output has dropped below that level again. While the oil ministry has moved to roll back policy mistakes, the difficulties reflect the multiple struggles it and the public and private oil industries must currently deal with. Fiscal realities and legal issues imply that, aside from the issue of the OPEC/non-OPEC output reduction agreement, it is looking increasingly difficult for the Moreno administration to reach its target of increasing oil output to 700,000 b/d by 2021.

Thanks to production-sharing agreements, the industry standard for emerging market oil operations, and the construction of the OCP heavy crude pipeline in the first years of this century, oil production reached an erstwhile record of 560,000 b/d before president Correa took office. His hostile desire for a sharply increased government share of the profits from the industry along with his inability to reach a deal weighed on production even amid record crude oil prices. Output therefore dropped well below 500,000 b/d, with the losses masked by the high prices. After the 2010/2011 new contracts, under which the government paid the companies a fee per barrel of output, production recovered and managed

to eke out slightly higher levels than in the pre-Correa times, peaking late in 2016.

This became undermined by the fall of the price of oil, for which Correa left Ecuador woefully unprepared. This has had several impacts on oil production. With the government falling behind on payments for services, private companies have faced financial problems, weighing on investment. The state upstream oil company, Petroamazonas, has stabilized, according to its chief executive, Alex Galárraga, and has slashed production costs dramatically. But it remains underfunded, receiving about \$1b from the finance ministry, a third of what it requires. It has struggled to find investors for some fields that it put on the block, also hampered by Correa-age legal limits that prohibit it from departing from the per-barrel fee for suppliers.

The weight of fulfilling loan repayments from Asian (mainly Chinese) sources has weakened downstream oil company Petroecuador's ability to profit from higher prices, though it has been able to negotiate a return to spot market sales. Foreign oil companies appear unenthusiastic, with output stagnating or falling. It appears that Chinese oil companies are pulling out of some areas near the Amazon southeast that the ministry, led by the very capable career oilman Carlos Pérez, aims to tender this year. Environmental doubts compound planned development of that area. The Ishpingo-Tambococha-Tiputini field currently under development to its north is going ahead but, while the field has been found to have close to 1.6b barrels of crude, twice the previous estimate, the quality of the oil is set to decline as it is heavy, less viscous crude, comparatively weakening potential revenue streams relative to Ecuador's older fields further west. Pérez is fighting to solve the myriad problems, but his most ambitious targets look out of reach.

Kicking Quito

An article in the *New York Times'* travel section on March 12 singled out Quito as a place to avoid, calling it one of the "the five most dangerous destinations in the world right now." A cursory look at the cities on the list – places at war like Damascus or Juba are missing – raises a discerning reader's doubts. Quito certainly has a long list of problems that weigh on its ability to attract foreign travelers, some due to economic problems at the national level, others due to local issues. The contradictory and badly researched article however strikes a blow that has deservedly sparked a sharp rebuttal from the municipal tourism office.

The article in question focuses on petty crimes as well as so-called express kidnappings, in which the victims are detained to force them to withdraw undefined "large sums" from automated teller machines. It takes Quito from an *Economist Intelligence Unit* ranking of urban safety in its Safe Cities Index, published every two years, which in the most recent study last year put the city near the bottom. In fact however, the ranking puts Quito, included for the first time in the survey, at number 53 of 60 cities on the list, begging the question of why it was listed as one of the five worst. Unlike what the article insinuates, the *EIU* ranking has little, if anything, to do with what tourists might encounter. In its analysis, it lists categories including digital security (the protection of public services from events like hacking); health security, i.e. the quality of public health services; infrastructure security; and personal security, and aims to be a tool for policymakers. The *NYT* article makes no reference to this, instead referring largely to petty theft and express kidnappings, the latter a problem that, while there is reason to question the drop in overall crime statistics in recent years, seems to be a receding problem.

Quito does have significant problems that reduce its potential as a tourism hub, several of them in fact addressed by the *EIU* ranking. Its cultural highlight, the historic center, has made recent gains by removing some particularly negative eyesores but in general continues to suffer from street noise and exhaust from traffic, particularly urban buses, which mars the experience for visitors and locals alike. Pollution is a top problem for the whole city, besides buses including poor garbage collection that has scandalized public opinion. The city under the past two administrations has appeared adrift, putting most energy into its metropolitan subway project. The current administration finally appears to be at least tolerating one of the best transportation tools for visitors, i.e. ride-hailing applications like Cabify and Uber, after initial hostility. Hopefully, besides protesting against the bad article, it will do better at improving the quality of services for residents and tourists alike.

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