ANALYTICA INVESTMENTS

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This is Going to Hurt

After María Elsa Viteri wasted her time at the finance ministry making Ecuador's bonds the worst performers in a poor market, the naming of Richard Martínez indicated a long overdue shift towards responsible fiscal management. Along with assembling a credible team at the ministry, the market has been wanting this new team to provide a "credibility shock" to keep interest rates for new bond sales from nose-bleed heights. The fast-track economic legislation submitted on May 24 is the first step in that direction, but still short on details, and a lot could go wrong. Nonetheless, there is room for cautious optimism given that Martínez (37) is receiving some advice from very experienced private-sector economists, well beyond the limited information that officials have made public. It's a so-far unheard of situation under president Lenín Moreno wherein steps forward in economic policy don't appear to mean any simultaneous steps to the rear.

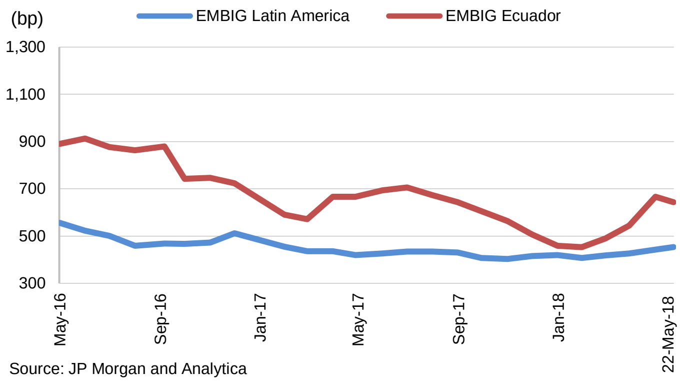
The presentation of the law fell short of what the market hoped for. Martínez had announced that it would be put forward before May 24. In the end, Moreno made the briefest of mentions of it during his first state of the nation speech before having it officially submitted to the legislature for its 30-day review. Out of protocol reasons, so the argument went, the ministry didn't want to step on the toes of officials at the National Assembly and make the bill public. Those officials couldn't be bothered to publish the bill during the afternoon after Moreno's speech (since 2013, Ecuador's congress has refrained from

KEY INDICATORS

Bond	Last Price (end of the month) 2018						2017
	1-Jun	May	Apr	Mar	Feb	Jan	Dec
Global 2020	104.12	104.12	103.10	108.42	108.75	109.98	110.94
Global 2022	105.20	105.36	105.54	111.06	113.07	116.32	117.48
Global 2023	97.65	97.75	97.89	104.68	106.64	110.12	110.67
Global 2024	93.91	94.06	94.11	100.70	102.06	106.04	106.60
Global 2026	98.79	99.08	98.50	107.37	110.44	114.40	115.03
Global Jun 2027	98.42	98.70	98.11	107.08	110.35	113.76	114.73
Global Oct 2027	94.29	94.49	94.36	102.19	105.58	109.17	109.90
Global 2028	88.41	88.66	88.53	96.76	99.23	102.04	-

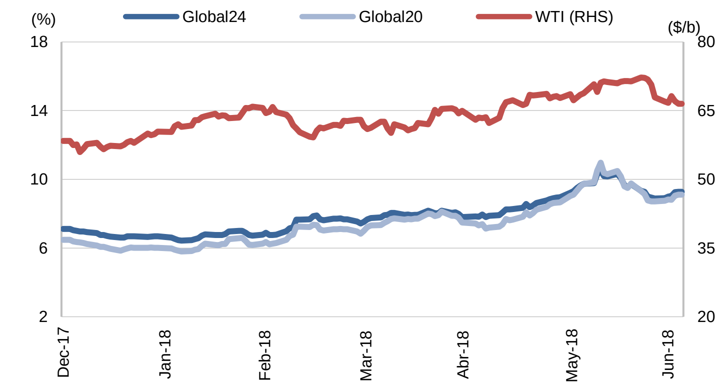
Source: Bloomberg and Analytica

EMBIG Spread



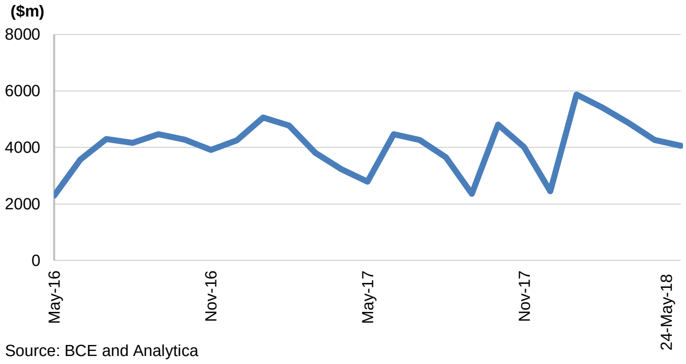
Source: JP Morgan and Analytica

Bond Yields vs. WTI



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

making draft legislation available on its web site). Friday, a holiday, came, and Quito's chamber of commerce published a summary, angering financial journalists who hadn't received official access to a copy of the bill. When the economic team, including new heads of the tax and customs services, presented the bill on Monday, U.S. markets were closed for Memorial Day. While facing numerous challenges and acknowledging a need to communicate to markets better, the finance ministry stumbled early, but will have a chance to make that up with a near-term visit to Washington and New York City to speak with investors and other key market influencers.

The bill includes a few elements previously announced, as well as some promising ideas for the future. It aims to convince companies and entrepreneurs to front-load investments in the next two years (up to 24 months after the law goes into effect) to offset the recessive impact that spending cuts are bound to generate on the economy. To obtain that, the government will suspend income taxes, the part of the bill that Moreno emphasized in his speech. Hopefully, that will also create jobs. At the same time, the plan aims to get public finances on a sustainable track by the end of Moreno's term or perhaps sooner, if oil prices help. The near and medium term aims mean to stabilize government finances to reach a balanced primary budget net of interest in 2021, mostly by cutting costs. Martínez says that means that the budget would have to be slashed by at least one percentage point of GDP annually. This year, cost-cutting will take the budget to 5.3% of GDP, below the 7.7% otherwise likely without emergency corrections. The legal debt ceiling of 40% of GDP would be suspended during this time. The next phase would be of "convergence," including a primary budget surplus to cut back the debt load until it again drops to 40% of GDP. Finally, at an undetermined future stage, long-term sustainability would mean maintaining budgets without primary deficits, obeying the debt ceiling, and creating a new savings fund fed by windfall income from non-renewable resources, which by then hopefully would include metals.

Among ideas kept on from reform plans presented back in April, the government will decree a tax amnesty aimed at collecting $774m from companies by 2020, mostly this year as large companies will have only 90 days to apply for it. Two long-criticized taxes stand to end, starting with the minimum corporate income tax, to be abolished from 2019. Secondly, the currency export tax could be phased out starting next year, hinging on economic growth and fiscal space. The cost-cutting implications mean that the closing of loss-making state-owned companies will probably remain in place, though no news on these has emerged in the first days of Martínez's tenure. The law also includes tweaks in oil and mining legislation, creating a mechanism to link future production-sharing oil contracts to price increases to correct a problem of the past (windfall price increases led to contract disputes between the government and companies) and scrapping a windfall price tax for mining companies, respectively. The new bill sensibly drops higher taxes on some insurance. Verónica Artola, who amid the current crisis seems to believe the most important thing she needs to do is endlessly repeat presentations on gender equality in central banking, will stay on as the head of the monetary authority, but it will no longer lend money to the finance ministry. That debt is currently $3.1b.

Regarding the investment incentives, the government promises to suspend corporate income tax for some industries including tourism, low-income housing, and export-oriented companies for eight years in Quito and Guayaquil, rising to 10 for other jurisdictions, and up to 20 years for cantons along the borders. While attractive, there is still red tape to deal with, and proper oversight for these kinds of incentives are always a challenge to avoid abuse of the type of having some company install a tiny headquarters in Tulcán on the Colombian border only to create more substantial operations in the Quito or Guayaquil hubs. Overall, the plan points in the right direction after the flawed legislation last November and Viteri's plan that never made it to the legislature.

For his team at the ministry, Martínez has enlisted center-left economist Santiago Kaviedes as deputy minister for economics, who held a similar position under Katiuska King, a left-wing economy minister with a short-lived stint under president Rafael Correa in late 2010. The new deputy minister for finance will be Fabián Carrillo, who worked there under Mauricio Pozo before the Correa administration and is very well regarded among the local financial industry. The outlined economic plan aims at a gradualist approach to fixing the economy, with the slow pace aiming to maintain support among the voters by insulating them from the worst hardship. A fair bit of consensus for this approach also exists among private-sector economists, including Pozo. The challenges of this can be seen in the tribulations of the administration of Mauricio Macri in Argentina, who had to reach an emergency deal with the International Monetary Fund to stabilize the peso. How the legislation will get through congress and what it will look like in a month is another question.

When Correa took office in 2007 on an anti-debt platform, Ecuador's debt was a very manageable sub 25% of GDP. The scale of the problem he left behind, with debt now more than double that rate with a substantially bigger GDP, is one indicator of the scale of mismanagement the economist with a Ph.D. from Illinois inflicted. Another is the herd of white elephants in refinery projects, hydroelectric plants, universities, schools, and public buildings where critics' dire warnings have been proved correct. The criminal evidence unearthed by the recent comptroller's debt audit will likely lead to an indictment of Correa and his assistants at the finance ministry. Ecuador didn't just waste a decade, but rolled back progress of previous years. It would be a worthy deterrent for future populists to have the former president and his cronies pay for criminal negligence and other responsibilities with jail time.

The Great Transition

Lenín Moreno's approach to speechmaking is not necessarily for the faint of heart among his advisors. He loves to pepper them with references to "quantum physics," actually a rather discrete metaphysical approach to life, and with obscure anecdotes, risking to make them appear insubstantial. His first state of the nation speech suffered as a result and was weaker than his inaugural speech, also because it was heavy on Ecuador's numerous social programs and smothered in platitudes. Just two pages of the 44-page speech dealt with the economy, four on the fight against corruption. The coming year, he said, would focus on restarting the economy, mainly to create jobs. At the same time, he aims to continue to "consolidate transparent, autonomous, and fully democratic institutions," to create functioning institutions where this concept was distorted and broken by his predecessor under his long decade in office. This is good news given the ingrained opposition to this by his nominal support group in the congress and, frankly, the general weakness of political parties across the spectrum and the continued interest in using the state for personal benefit. Despite the intense personal loyalty he appears to have towards foreign minister María Fernanda Espinosa, her permanent departure from that position seems to have gone ahead now that she took a leave of absence to campaign to become president of the United Nations' General Assembly. This week, at the first Council of the Americas event held in Quito in close to a decade, Moreno pledged to boost Ecuador's foreign policy in line with the importance of international trade, thus aiming for a kind of special relationship with the U.S., Ecuador's biggest trading partner. These remarks have gone down well internationally and outline polices aimed at reconstructing ties willfully severed in the recent past. Perhaps there is a system to Moreno's vagueness after all.

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