ANALYTICA INVESTMENTS

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ECUADOR WEEKLY REPORT®

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A Little Smugness

In recent trading, Argentine bonds have yielded more than those of Ecuador. For local officials, this brings a bit of relief and status. Ecuador has remained little-touched by contagion from the most recent turmoil in emerging markets trading. A bond repurchase operation announced by the finance ministry at the close of this edition allowed Ecuador to pocket a $500m loan from Goldman Sachs with interest 30% cheaper than the going market rates for bonds due in 2022, reopened for the transaction. Ecuador thus continues to have access to market funding. The crisis in Argentina should nevertheless worry financial officials enough for them to take another look at the slow pace of reforms here and urge political officials to take notice.

Some pundits point out that the current turmoil in the emerging market bond and currency trading has affected primarily some economies indebted largely in US dollars, including of course Turkey and Argentina. With a flight from emerging markets into dollars both because of rising US interest rates and due to worries regarding the future of world trade, those two countries have been hit particularly hard. Other currencies have been hit as well of course, including the Brazilian real, South African rand, and the Indian rupee. To the chagrin of Argentine nationalists and the joy of those across the River Plate (Río de la Plata) in Uruguay, for the first time ever, the Uruguayan peso is worth more in dollars than its Argentine counterpart. The case of Argentina might also elicit some smiles for Ecuador as Ecuador's

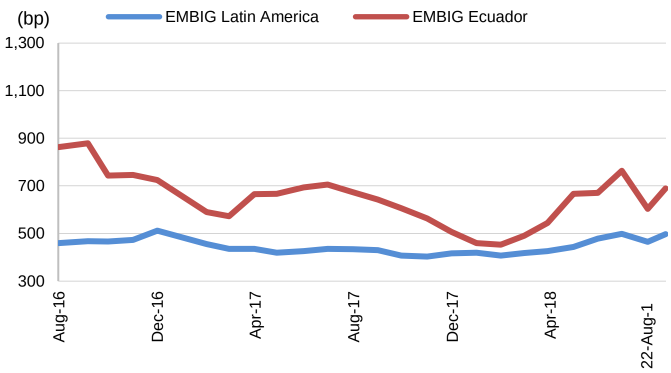
KEY INDICATORS

Ecuador's Global Bond Prices

Bond	Last Price (end of the month) 2018						
	31-Aug	31-Jul	29-Jun	May	Apr	Mar	Feb
Global 2020	103.02	105.54	102.24	104.12	103.10	108.42	108.75
Global 2022	104.12	108.28	102.55	105.36	105.54	111.06	113.07
Global 2023	96.29	100.21	93.71	97.75	97.89	104.68	106.64
Global 2024	91.56	96.56	89.25	94.06	94.11	100.70	102.06
Global 2026	96.87	100.99	93.58	99.08	98.50	107.37	110.44
Global Jun 2027	95.94	100.61	93.33	98.70	98.11	107.08	110.35
Global Oct 2027	91.23	96.60	89.16	94.49	94.36	102.19	105.58
Global 2028	86.79	91.40	84.02	88.66	88.53	96.76	99.23

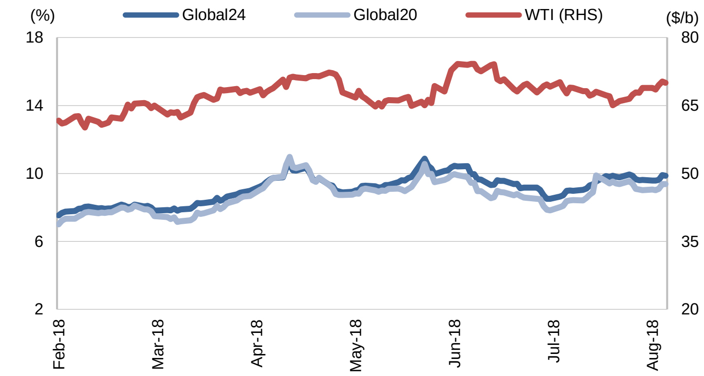
Source: Bloomberg and Analytica

EMBIG Spread



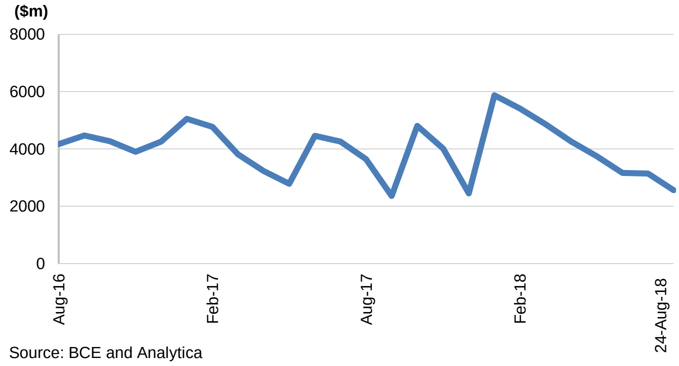
Source: JP Morgan and Analytica

Bond Yields vs. WTI 2018



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

bonds are now only the third most risky in the region. *Bloomberg* pointed this out this week, however in an article that was more glass-half-full than upbeat on Ecuador because it reminded readers that Ecuador has been the country with the second-most defaults since 1800. Still, Ecuador has had some positive runs in bond trading in recent weeks.

Argentina's current plight highlights some risks of going to the International Monetary Fund. First, financial markets can celebrate the move as a sign of getting serious about fixing the economy because it comes with reform requirements. In June, the IMF agreed to support Argentina with as much as $50b as inflation spirals higher due to a large fiscal deficit. But the initial applause quickly fizzled out and the worrying started again. A current account deficit as well as the flight to the dollar have continued to put pressure on the peso, leading the central bank, under fire for appearing to lack independence until before the IMF deal, to jerk its key interest rate to an eye-watering 60% that will choke off credit growth. The IMF deal now looks like a liability as Macri has asked for an early disbursal of additional funds. He looks like the manager of a bank seeking an emergency credit only to see a stampede of depositors. Relations with parts of the business community are fraying.

Ecuador shares some similarities with Argentina, including a poor reputation among creditors, a recent heritage of a wasted, corrupt decade under a populist leftwing government, weak rule of law and wasteful energy subsidies. It too is struggling to gain control over a burgeoning fiscal deficit. Investors may be pleased with the recent reform announcements, following a law that promises to lead to a deficit of zero before interest payments by 2021, as they point in the right direction after more than a decade of irresponsibility. The Goldman repo, which is to be followed by similar deals, aims to provide liquidity without inflating the issuance as the bonds in the repo will not be on the market (unless there is a default which this administration pledges to avoid under all circumstances). But like Argentina, the government has pledged only a gradual pace of reform.

There is consensus in Ecuador that a drastic austerity plan could derail the entire reform by leading poverty rates to soar. That risks a return of the corrupt populists to power who left office in time to avoid being blamed for the crisis. Like in Argentina however, the pace of change is extremely difficult to manage. After being elected on a platform promising reform, Macri, a businessman, has been in power for two years and is being spurned by markets. Along with the parallels, there are some important differences between Ecuador and Argentina. Lenín Moreno won only narrowly (and perhaps through fraud) on a pledge to keep most things as they were under his populist former mentor, Rafael Correa. With economic gravity forcing a change of course, he has surprised markets in a positive way. Additionally, Ecuador is in a slight deflation, insulating it from inflation despite a fiscally unsustainable level of public spending. Its use of the dollar insulates it from the currency risk involved in the repayment of debt. A stronger dollar can however quickly undermine the price of oil. A poll by Cedatos shows only relative approval of the economic reforms, probably because of the (necessary) inclusion of the elimination of the subsidy on higher octane gasoline because voters (hopefully correctly) see this as the beginning of the end for fuel subsidies. Irresponsible leftwing interest groups have reflexively demanded they be stopped, and only 24% of those polled supported the end of the subsidy. There is even an association in defense of public purchasing that wants the government to keep buying goods at the same level as in past years. To listen to these people too much could reduce market confidence quickly, with problematic results.

A Test for Diplomacy

Venezuela will probably not show up on Monday to a regional meeting on how to deal with the crisis the flight of its citizens has triggered. The absence of the source of the problem will at least not be a stumbling block to reaching a consensus. Depending on how many of the 13 invited countries attend, it could mark a successful return by Ecuador to the diplomatic scene. With high-level technical officials on migration attending, hopefully they can move forward on a constructive platform after countries in the region have all made unilateral decision. The hosts are no exception.

As a career diplomat, José Valencia has quickly helped Ecuador to restore some of the prestige the country's foreign service lost under president Correa. The handling of the crisis related to the influx of Venezuelans has however been quite poor. Ecuador won sympathy when it declared a humanitarian emergency in three provinces due to the massive influx of Venezuelans, which, after an entry of more than half a million this year, showed signs of accelerating even further. But by unilaterally starting to require passports from Venezuelans as an emergency measure to shut the gate, it lost credibility. Venezuelans, particularly the poor who are now fleeing, face enormous problems including long waits and extortion by corrupt officials to obtain passports. Ecuador's decision thus was the equivalent of slamming the door on their entry.

Domestically, the measure has become embroiled in a legal battle over its legality. An initial challenge by Gina Benavides, the public ombudswoman, led a judge to declare it illegal; the government promptly demanded apostilles for identity cards that are similarly hard for Venezuelans to obtain. Benavides says she will challenge this too. Internationally, it's not known what its ambassadors told Bogota and Lima, who besides the Venezuelans themselves were the immediate victims of the measure as Venezuelans either had to mass on the Colombian side of the border at Ipiales or rushed to cross the border near Tumbes in Peru. Coordination was also absent as Peru a week later scrambled to impose similar measures, apparently in reaction to what Ecuador did. They look a lot like when European governments bounced balls into other countries' courts as they sought to close the "Balkan Route" by Syrian and other refugees from Asia in recent year.

For the moment, the neighbors appear to have taken the move in stride as Valencia has correctly called for a regional response to the crisis and blamed the Venezuelan dictatorship for the crisis. Ecuador, Peru, and Colombia met in Lima to discuss the crisis this week without finger-pointing at the Moreno administration, at least not publicly. Foreseeable challenges for the participants will be the distribution of emigrants within the region, and the sharing of the financial burden, paired with a reasonable request for international aid. Latin Americans have tended to point fingers at Europe and the US for their handling (or mishandling) of immigration of poor foreigners. They now have a chance to show how good they are at managing the same type of crisis. In the streets, Ecuadorians can now see the misery the deepening of the socialist experiment has produced. The only way to truly end the crisis is a change to the Venezuelan economic model that will be impossible with the same people who have run it into the ground over the past 20 years.

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