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ECUADOR WEEKLY REPORT®

KEY INDICATORS

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What's the Question?

Each of the past two Mondays, president Lenín Moreno has dangled the prospect of a referendum to Ecuadorians as a way out of the institutional Gordian Knot left behind by his predecessor. In his latest comments, he said he was thinking about "proposing the changes that must be introduced to guarantee a full democracy, without authoritarianism and with transparent entities that guarantee the management of the public interest." Moreno's hints leave many questions regarding the what, why, and how of political reform. They also deepened the rift between him and parts of the Alianza Pais (sic) movement on whose ticket he was elected and whose president he officially is.

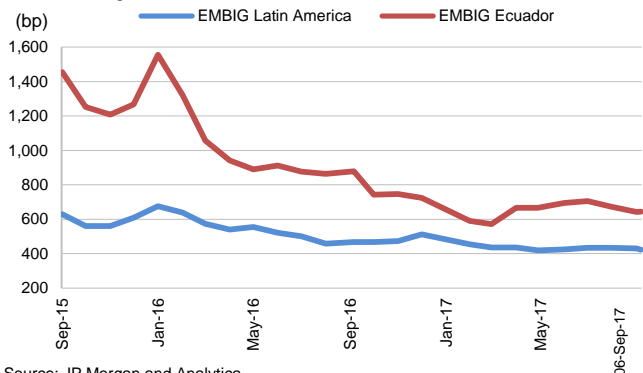
AP leadership met in Quito on September 5 to discuss the situation, without Moreno present. After the discussion, it published a manifesto in which it roundly criticized his policies of dialogue with members of civil society like indigenous organizations and the financial industry, among many others. It darkly warned against "oligarchic powers, social and economic regression, political destabilization" and a risk of damaging "constitutional institutionality." By floating the idea of a referendum, Moreno has put the loyalists of his predecessor, Rafael Correa (2007-2017), on the defensive. They had to acknowledge that they would "always" support a referendum as a "legitimate instrument of democracy," but demanded it be limited to increasing "rights, social justice, and equality of opportunities," a dubious insistence since the 2011 referendum crushed freedom of the press

Ecuador's Global Bond Prices

Bond	Last Price (end of the month)						
	8-Sep	31-Aug	Jul	Jun	May	Apr	Mar
Global 2020	107.98	107.39	106.12	105.83	105.58	107.50	106.65
Global 2022	110.43	110.05	108.20	106.83	107.41	108.63	106.66
Global 2023	102.59	102.34	100.12	98.55	-	-	-
Global 2024	98.43	98.22	95.60	93.52	95.05	95.58	94.57
Global 2026	105.34	105.25	102.56	100.71	101.11	102.29	103.92
Global 2027	105.04	105.01	102.19	100.30	-	-	-

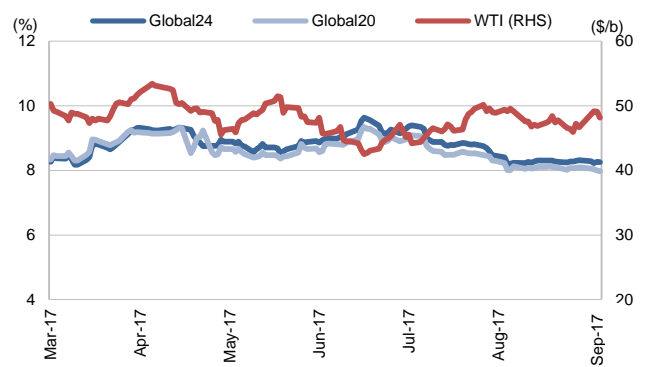
Source: Bloomberg and Analytica

EMBIG Spread



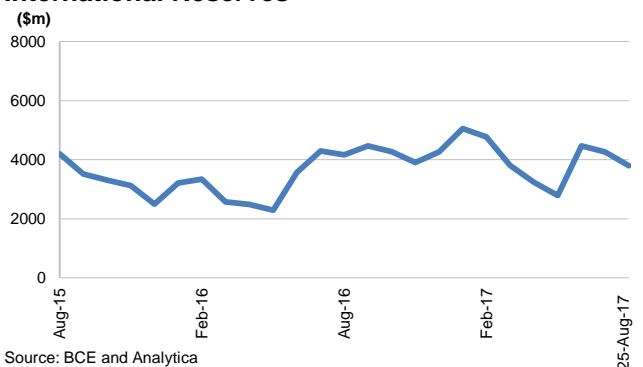
Source: JP Morgan and Analytica

Bond Yields vs. WTI in 2017



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

and put the judiciary under government control.

Should Moreno seek to change the structure of the constitution, the loyalists warned that AP would demand a new constitutional assembly, which has led many to think of the ominous new assembly in Venezuela. Ironically, it was AP that just a decade ago demanded a new constitution which, when finished in 2008, it called "the best in the world," ready to last 300 years, and which helped Correa set up an authoritarian regime. The Correa loyalists' position demonstrates their arbitrary interpretation of the law and rights according to political convenience. Threatened with a loss at the polls in an eventual referendum, as opponents demanded, Correa had the constitution changed in 2015 to end term limits, strip the comptroller's office of key attributes, and limit the scope of referendums, among other things. Thanks to a gerrymandered supermajority and a friendly Constitutional Court, Correa had the changes passed by congress. Now, with only an absolute majority in the legislature, the AP leadership is pursuing an opposite course, trying to delay Moreno as his popularity may well decline as he deals with the dire economic situation inherited from Correa and to keep voters – the sovereign – from commenting on decisions made by officials, some of them, like those of the court, not even elected.

Many may still question whether Moreno and Correa have truly parted ways, but the former has voluntarily relinquished much of the repression that characterized the past years, contributing to soaring popularity – an approval rating of around 80% – that has topped even that of Correa at his apogee. A referendum would be an instrument to prove to the AP rank and file who is in charge and help him to take control of it. Among critics of the constitution, one key demand is the removal of the "Citizens' Participation and Social Control Council" (CPCCS), which proved analysts' worst fears right by picking apparently corrupt officials to head key positions in the judiciary and other organisms. The other is the reintroduction

of term limits to avoid the return of "the beast," as Moreno has called Correa, in 2021. The CPCCS is not resting however and working to extend the influence of *correísmo* by picking a new comptroller and continuing to stock the National Electoral Council (CNE).

This may force Moreno's hand, but it's not clear that he can legally call a referendum to shutter the CPCCS. Overall, several constraints legally limit the scope of questions Moreno may ask the citizens to approve, including some introduced by Correa's constitutional reform in 2015. The legitimacy of a vote could marginalize Correa's dwindling but powerful loyalists. The Constitutional Court's say in the matter will force its judges to choose between Moreno and the majority or Correa too. But a referendum won't fix the problems with Ecuador's political and legal system rooted in the quagmire left behind by the Correa constitution in 2008. Roberto López, a constitutional lawyer from Guayaquil, recommends Moreno call for a "depositional" (rather than a constitutional) assembly to immediately remove the CPCCS directors and other questionable officials from their positions. López argues that article 444 of the constitution permits Moreno to call a new assembly and set up the electoral rules for it. He may then legally proceed to have all authorities suspended. Ecuador has had, on average, a constitution every decade since independence. Sadly, that implies yet another constitution to avoid the problems that Moreno mentioned last Monday – and it remains to be seen if a new charter is capable of solving the matters the other 21 failed to.

Why Even Bother?

Refurbishing the Esmeraldas refinery has proven an economic, environmental, and political disaster. Under the 2007-2017 administration of Rafael Correa (Alianza Pais), the cost of restoring its refining capacity to 110,000 barrels a day exploded to \$2.2bn from less than \$190m. Less than two years after it

was officially completed, this has been shown to have been a complete waste, though his allies in congress continue to boast about it and the former leader, in late-night rants from his new home in Belgium, calls it fully operational. It may be running, but, as oil minister Carlos Pérez has diplomatically put it, “if the refinery is working at 100% today, it’s not doing it adequately nor optimally.” According to investigative journalist Fernando Villavicencio, exiled for his efforts to reveal the enormous corruption in the oil industry, the refurbishment of Esmeraldas lacked adequate planning. This mustn’t be repeated now, and alternatives should be carefully considered. With repairs having to be paid fully by the government – the Correa administration failed to bother to complain about the shoddy work before the guarantees ran out – Pérez should consider a more radical idea: to close the practically condemned facility altogether.

The plant faces a catastrophic amount of problems. The fluid catalytic cracker, the refinery’s central unit, will have to be shut down for an estimated 45 days of repairs; since a shutdown costs \$1.25m a day, this will cost \$56m even without considering the material cost of the repair and the working hours. The FCC unit is consistently overheating and has suffered emergency shutdowns 16 times to date this year alone. Last year, the refinery was offline for almost an entire month of the year. At present, even though it’s working, according to opposition legislator Rina Campain (CREO), who is from Esmeraldas, more than half of what the refinery produces is residue rather than fuel Ecuador’s drivers and industry require – an appalling level of waste that stems from the fact that the country has progressively had to extract heavier, highly viscous crude oil compared with the light, fluid oil the refinery was originally designed for in the mid-1970s. Among other problems, the electrical system is faulty, with new backup generators required, and the storage tanks need extensive repairs because 43% of the storage capacity is in a critical state. These repairs should

cost a relatively modest \$6m. The oil ministry also acknowledges the issuance of sulfur into the environment is highly problematic and will only stop in October thanks to works to modernize an old system ignored by the onerous restoration.

Thinking outside the box of continuing business as usual, the current situation begs the question why the government, before spending tens or hundreds of millions of dollars amid a fiscal crisis, doesn’t finally put the sunk costs of the old facility out of its misery as it is already about to do with the similarly wasteful project to build a new refinery near Manta. Arguments its supporters will brandish against this will include industrial policy, sovereignty of fuel supply and local jobs. We would like to suggest the plant’s shutdown as part of a much more cost-efficient, modern approach less prone to corruption. Firstly, industrial policy has not lived up to its promise, though the Correa administration used it to argue in favor of the Manta project. Even locally, refining’s impact has been negligible on industry. Despite accounting for most of Ecuador’s refining and all of its oil exports, Esmeraldas has remained a poor port city – a literal backwater – that only recently managed to begin supplying drinking water to its residents, who are suffering from the plant’s environmental problems along with their friends and family who work there. Regarding safeguarding supply, Ecuador has a spotty history. Supply of high-octane fuel is no longer the problem it was in recent decades, but fuel supply in Amazonia, ironically the source of the overwhelming majority of Ecuador’s oil, can still be problematic. But overall, one thing the Correa administration proved during the refurbishment is that the country, in this case via Petroecuador, is perfectly capable of importing enough fuel to meet demand. Storage capacity would need to be reviewed to ensure adequate supply, but this is a separate matter from refining.

Petroecuador should lose its monopoly over fuel imports, while the foreseeably long-term low price

environment for oil prices mean that the Moreno administration has an opportunity to make significant changes to Ecuador's incredibly wasteful and corrupt system of fuel subsidies without triggering inflation. Additionally, refining is a low-margin business: refiners buy crude at market rates and can only sell derivatives at a slight markup, while cost-cutting allows crude producers to earn much more by producing a barrel of oil perhaps for \$17 per barrel and selling it for \$42. Ecuador could feasibly earn more money by exporting more crude than by refining a large amount of it domestically, improving the balance of payments amid a difficult economic situation exacerbated by high debt payments (David Ricardo explained this some 150 years ago in his theory of comparative advantages). Replacing derivatives from Esmeraldas would have another immediate positive impact that must receive macroeconomic consideration: Fuel quality and thus air quality would improve dramatically by importing better fuel from overseas refineries. Meanwhile, even the oil ministry this week indirectly provided yet another argument for shutting down Esmeraldas: State upstream oil company Petroamazonas slashed demand for diesel fuel by a third by switching to electricity provided from hydroelectric power plants and aims to largely eliminate its former demand for 6m gallons of diesel a month by the end of Moreno's term. Why keep up refining capacity when demand for diesel is set to drop (and why wasn't this done years ago)?

Finally, regarding jobs, the issue need not be as painful as it initially would appear, though some hardship would unfortunately likely ensue. Petroecuador employs around 1200 workers in refining, not all of them at the plant; those laid off, relocated or retrained should be able to receive proper compensation and training without causing the company major financial problems, compared with the likely savings. Some pundits have already suggested using the 1,255 hectares deforested and flattened by

controversial Brazilian construction firm Odebrecht, which is at the center of an international corruption scandal throughout Latin America and Portuguese-speaking Africa, for an alternative energy project: using the vast lot to install a photovoltaic power station. If set up as a fixed-tilt site, it's large enough to have a capacity of around 700MW. At least for the installation, perhaps Esmeraldas refinery workers could find employment there. Agriculture is another possibility for the empty lot since the one part of infrastructure completed there is a major aqueduct. Other alternatives to spending the money to be earmarked for the Esmeraldas refinery include funding the technical schools Moreno during his campaign pledged to build. According to education economist Ludger Wößmann, recently quoted by the *Frankfurter Allgemeine Zeitung*, there is a strong correlation between the wealth of countries and their ability to provide quality public education in hard sciences like physics and biology. The opposite is true for countries like Ecuador, and Moreno is correct in trying to change this.

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