ANALYTICA INVESTMENTS

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ECUADOR WEEKLY REPORT®

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Debt to Society

The comptroller general's office this week presented its final report of its special examination of debt contracted domestically and internationally from January 1st, 2012, through May 24th, 2017, the day Rafael Correa left office after a record consecutive time in office that topped a decade. The analysis is a textbook review of how Correa concentrated rule in his own hands by eliminating checks and balances. Piece by piece, document by document, the audit carefully examines how Correa changed the legal system, putting legal hierarchy on its head, introducing conflicts of interest, and not hesitating to break laws to do so. This set the stage for the fiscal crisis his successor, Lenín Moreno, and Ecuadorian society by extension must now solve – and the comptroller general sternly warned finance minister María Elsa Viteri to apply the report's findings. And the investigations will continue.

In summary, the report in a cool, neutral language describes how Correa dismantled existing laws, regulations, and controls and installed discretional management of public debt as he disregarded rules written into his own 2010 Organic Law of Planning and Public Finance. He and the officials commanded by him arbitrarily used language, including redefining what infrastructure, investment, and debt constitute. Combined with the concealment of information, keeping debt off the books, and an illegal presidential decree, debt issuance blew beyond the legal limit of 40% of GDP well before the end of his term. Beyond Correa, officials mentioned by title by Celi include the

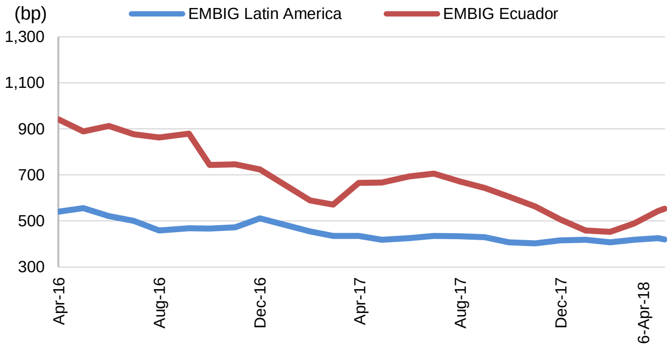
KEY INDICATORS

Ecuador's Global Bond Prices

Bond	Last Price (end of the month) 2018				2017		
	13-Apr	Mar	Feb	Jan	Dec	Nov	Oct
Global 2020	106.77	108.42	108.75	109.98	110.94	109.64	109.10
Global 2022	110.40	111.06	113.07	116.32	117.48	115.86	113.13
Global 2023	102.52	104.68	106.64	110.12	110.67	108.46	104.90
Global 2024	98.49	100.70	102.06	106.04	106.60	104.42	100.89
Global 2026	104.37	107.37	110.44	114.40	115.03	112.45	108.04
Global Jun 2027	104.05	107.08	110.35	113.76	114.73	111.66	107.57
Global Oct 2027	99.04	102.19	105.58	109.17	109.90	106.82	102.40
Global 2028	94.52	96.76	99.23	102.04	-	-	-

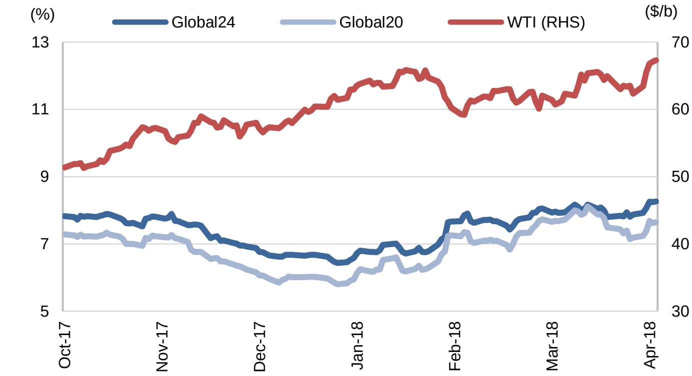
Source: Bloomberg and Analytica

EMBIG Spread



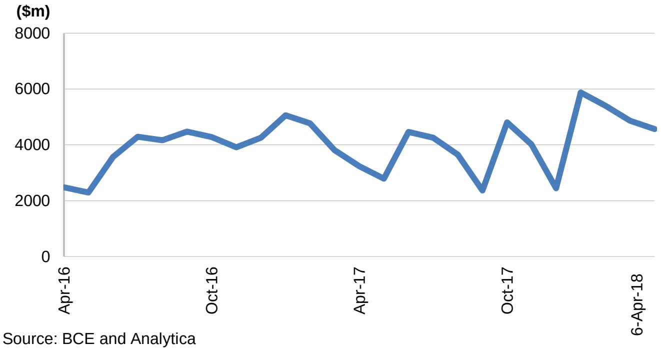
Source: JP Morgan and Analytica

Bond Yields vs. WTI



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

finance ministers (Patricio Rivera and Fausto Herrera), oil ministers (Carlos Pareja) as well as undersecretaries for public finance, officials at downstream oil company Petroecuador, the Senplades government planning office, and others. They face potential jail time, and/or fines, hinging on whether public prosecutors indict them.

Key measures included creating a uniform panel composed solely of cabinet officials to approve debt issuance, creating a conflict of interest; keeping certain parts of the debt, including oil-backed loans and domestic debt with maturities under 360 days off the official debt ledger. While the *Ecuador Weekly Report* and foreign media from the start refused to follow this argument – the debt, while being repaid in oil, after all carried an interest rate – local media faced fines if they dared to challenge the official terminology. Now, beyond indeed tallying $8.2b of these loans from Unipec, China National Petroleum Co., and Thailand's PTT as debt (about a third less than indicated by current oil minister Carlos Pérez), the comptroller general's office said that the whole procedure was illegal, as was the use of Petroecuador as an agent to obtain liquidity for the central government. Debt contracts were declared confidential until maturity, again reflecting a conflict of interest.

After returning to the debt market in 2014 and amid the accumulation of bilateral debt with China, the debt ceiling quickly became an issue. Rather than follow the legal rules, which would have meant a debt sustainability plan and its approval by Ecuador's congress – an easy task at the time given Correa had a three-quarters majority but perhaps politically uncomfortable – in late 2016 he issued Decree 1218 that redefined "consolidated debt." By refusing to account debt owed social security and other public-sector institutions, he artificially reduced debt levels, allowing him to raise the debt ceiling, arguing that this complied with the International Monetary Fund's guidelines regarding intra-governmental liabilities. The report explicitly debunks this argument and says that the real aggregate debt amount grew to reach $65.7b at the end of 2016, close to two thirds of GDP. This has not stopped Correa from still insisting that he observed the IMF specifications and that he is in fact being politically persecuted for doing so. Overall, the auditors discovered close to 40 violations of laws and regulation, including six articles of the 2008 constitution.

It will be up to prosecutors to carry out their own investigation. It's unlikely for this to proceed in the near term as the prosecutor general, Carlos Baca, a former Correa legal aide, is facing impeachment by Ecuador's congress, but also likely to be removed from his functions by the temporary "Citizens' Participation and Social Control Council" put in place after voters on February 4th ratified president Lenín Moreno's plan to have it review recent top judicial and regulatory appointees. Baca's deputy, Thania Moreno (no relation to the president) meanwhile has been suspended pending other investigations. The prosecution thus looks rudderless and in transition, with no clarity yet regarding a permanent successor to Baca. Still, that person will hardly be close to Correa and unlikely to be close to the current president. Additionally, according to León Roldós, a former vice president and lawyer who spoke after Celi, there is no statute of limitations on a number of issues related to the audit's discoveries. Additional investigations will include a debt-gold swap with Goldman Sachs and the exact terms and conditions, including commissions paid, under which recent debt was sold in the bond market.

Viteri's predicament meanwhile looks more urgent as she must deal with a range of orders emanating from the final version of the audit at the same time as she seeks to get the fiscal deficit under control and lighten the debt load. In what looks like loyalty to Correa, under whom she already served as finance minister during the bond default and discounted buyback 2008 and 2009, she recently said that she personally believed that the Asian oil-backed loans (mostly owed China) weren't debt and defended Correa's arguments regarding the 40%/GDP debt ceiling. Thanks to the audit's findings, as the person running the finance ministry, she must now prepare legislation to temporarily raise the ceiling and, crucially, to get it down to sustainable levels more credibly than in the economic and financial plan revealed last week. Celi also ordered her to properly account for the debt, with the books currently in disarray, and make them available to interested parties, particularly the comptroller, of course. She must also repeal the confidentiality order and ready a bill to replace Correa's decree 1218. Both the finance ministry and Petroecuador must unravel the legal problems regarding the Asian debt. As a result, this could saddle the government with additional debt since this part of state liabilities was illegally transferred to the state-owned company. Viteri would do well to heed Celi's orders as he hasn't hesitated to use a previously arcane legal provision allowing him to fire officials who have failed to comply with his office. As far as this regards upcoming legislation, the audit hands opposition parties major influence given Moreno's lack of an official outright majority in the legislature. It's unfortunately not clear that all of the opposition will rise to the occasion.

Slow Surgery

In the wake of last week's outlining of economic and fiscal reform, three cabinet officials this week presented plans for a reduction in government spending that included reductions in civil servant headcounts as a result of the closing or merging of government offices and state-owned companies. They also presented plans to reform the latter group of companies, including liquidating some immediately. As usual, it's difficult to foresee how positive an impact these measures will have after the Moreno administration's false starts. While they point in the right direction, they may be too slow to jump-start confidence in the economy. One of its most tantalizing promises is sadly also its most vague. Lastly among caveats, the combined $1b in savings presented by the officials has sown some confusion because Moreno pledged to save that amount annually, not together.

Regarding ministries, the government will reduce the number of ministries to 22 from 27 (still seven more than Germany) by having the oil ministry absorb the mining and electricity ministries and appending the sports ministry to the education ministry again. Duplicate administrative functions, such as their financial offices, will be eliminated. The government will immediately lay off 365 highly paid non-permanent consultants. Among public companies, the government will roll back the separation of Petroamazonas, the upstream oil company, with its downstream sister Petroecuador, to be completed in 2021. Airline Tame and the electrical utilities are to be restructured so that they may be interesting for concessions or partial privatizations. Economically minor companies like the state cement company are to be liquidated immediately, others wound down as existing projects are (perhaps) completed. This will reduce the headcount by another 1,000 people.

In parallel, the government this week agreed to partially deregulate labor contracts for tourism and hotel services, agriculture and fishing, among industries that require seasonal employees. While ruling out outsourcing and pledging maintenance of full social benefits, this step signals willingness to address labor rigidity that has increased fixed costs and weighed on employment (close to two thirds of working-age Ecuadorians don't have a steady job). Additionally, the officials – chief of staff Andrés Mideros, planning secretary Edzon Romo, Edisson Garzón, the head of state corporate holding Emco, and labor minister Raúl Ledesma – said that within the next 180 days, all government offices will have to justify all of their requirements for bureaucratic procedures. If they fail to do so, the rules will be scrapped. If that were to actually happen, we'd be ecstatic, but the vagueness of the announcement makes it unclear how this will go ahead in detail. Still, we hope that business associations will take the scuttling of often inane rules to heart and press hard for their elimination. That could lead to a watershed moment for Ecuador.

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