ANALYTICA INVESTMENTS

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ECUADOR WEEKLY REPORT®

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Merry Christmas

Even for Ecuador, the number of scandals in recent days has been remarkable, yet one topped them all: Brazilian infrastructure construction firm Odebrecht admitted to paying $788m in bribes to officials in a dozen countries in the Americas and Africa and, together with chemical firm Braskem agreed to pay a fine of $3.5bn to Brazil, Switzerland, and the US, according to a plea bargain made public by the US justice department. More than one official in Ecuador will be losing sleep over Christmas, worrying if and when the other shoe drops. The blow to the prestige of the government of Rafael Correa is considerable only weeks before the vote to elect his successor.

According to the document released by the justice department, in the case of Ecuador, Odebrecht paid $33.5m in bribes; it “realized benefits of more than $116m as a result of these corrupt payments”. A breakdown of the bribery data puts Ecuador in seventh place among the dozen; in Odebrecht’s home country, Brazil, it shelled out the largest amount, with $349m. While it also paid more bribes in the Dominican Republic ($92m) and Panama ($59m), then again, in Ecuador, it paid more than in the larger economies of Colombia ($11m), Peru ($29m), and Mexico ($10.5m), and a similar amount to Argentina ($35m).

Also regarding Ecuador, the report specifies that Odebrecht acknowledged paying the bribes between 2007 and this year, thus coinciding exactly with

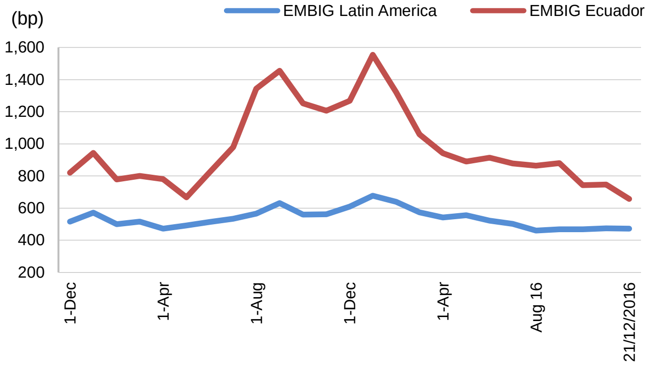
KEY INDICATORS

Ecuador's Global Bond Prices

Bond	Last Price						
	16/12/2016	1-Nov	1-Oct	1-Sep	1-Aug	1-Jul	1-Jun
Global 2020	107.55	105.54	106.13	102.51	102.30	100.49	99.38
Global 2022	108.33	104.94	106.11	102.47	102.89	100.03	N/A
Global 2024	94.88	92.15	94.55	90.25	88.05	87.49	87.64

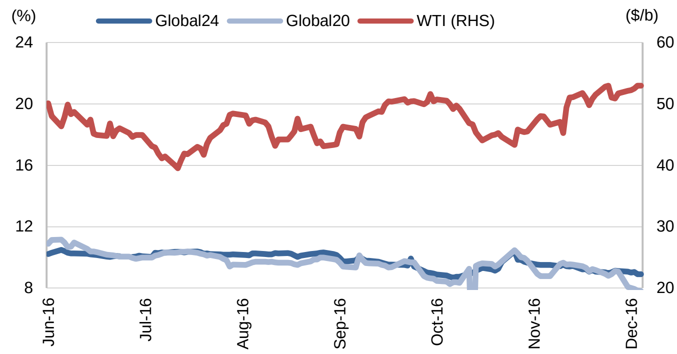
Source: Bloomberg and Analytica

EMBIG Spread



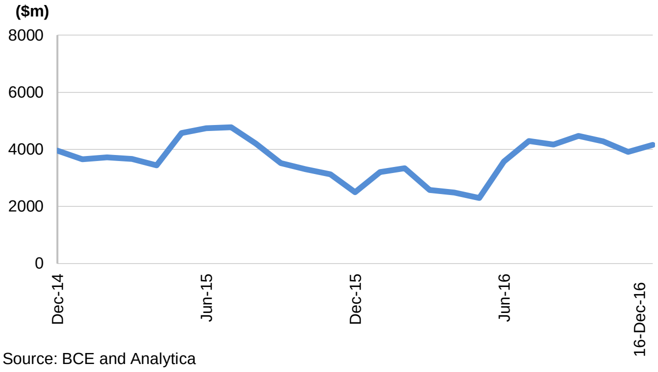
Source: JP Morgan and Analytica

Bond Yields vs. WTI in 2016



Source: Bloomberg and Analytica

International Reserves



Source: BCE and Analytica

Correa's time in office. It noted one example in which it "experienced a number of problems related to a construction contract, and agreed with an intermediary to an Ecuadorian government official with control over public contracts to make corrupt payments to a government official to solve the problems. ODEBRECHT (sic) later delivered these payments in cash to the government official."

Given the time frame mentioned, this can only relate to the San Francisco hydroelectric power plant. The Correa administration in 2008 paid Odebrecht a bonus for timely completion of the plant only to find that shoddy construction severely marred it. Rather than pursue the case in courts, Correa made a huge scandal out of it, "expelling" the company, triggering a diplomatic spat with Brazil. It later quietly readmitted the company in 2010 in exchange for $20m and subsequently awarded it numerous contracts. The Department of Justice thus, between the lines, makes it clear that Odebrecht's return to Ecuador came thanks to the bribery of a public official. The Correa administration however argues the opposite: the presidential legal secretary, Alexis Mera, said that the dispute between the government and the company, which even led Brazil to temporarily withdraw its ambassador, proved how tough it had been on Odebrecht. Any bribe had gone to an impostor, Mera added. The company won all subsequent contracts thanks to public tenders, said Augusto Espín, the minister of strategic sectors, in the same short press conference on Thursday.

The company meanwhile pledged to continue cooperating with public authorities and agreed to a monitoring period of up to three years to ensure compliance with anti-corruption practice. In exchange, it received a 25% cut off the bottom of the potential fine thanks to what the justice department called "full cooperation." Some commentators consider it got off lightly, given that it has 23 years to pay the fine, and its initial refusal to admit any wrongdoing. Considering the desperation for public funds, Ecuador should immediately demand the $116m the company admits to have earned illicitly. Some have already found the acknowledged amount relatively low. It remains clear that the case of the company's involvement in Ecuador, where it has been active for 28 years, requires far deeper investigation. The prosecutor general, Galo Chiriboga, has requested information from the US and Brazil. This is only a belated first step considering the years of suspicion hovering over this case. The comptroller general, Carlos Pólit, should resign or at least refrain from seeking to remain in office for another term considering his lack of diligence regarding Odebrecht. Government officials should make public and permit independent inquiries into Odebrecht contracts, including a recently inaugurated aqueduct for the non-existing Manta refinery. So should the mayor of Quito, Mauricio Rodas, considering that the project for the Quito subway alone accounts for more than half the sum of Odebrecht's contracts in Ecuador, although the role of the company in the consortium building the underground rail has apparently diminished.

Quiet Funding

The bond prospectus for the 2026 included a surprise detail: The government disclosed that it had signed two "pre-sale" debt providing another $900m (the administration refuses to call this type of interest-bearing loan debt). Disbursal of the funds obtained via Petroecuador as well as the interest rate remain unknown; exiting finance minister Fausto Herrera said they were confidential by law until the funds arrived - an argument the government has used for years to avoid providing financial details that in the end is financially counterproductive. The lack of transparency has contributed to making Ecuador more risky than its peers, raising financial costs for the administration of Rafael Correa.

From the information provided in the prospectus, Thai state oil company PTT will provide $600m, to be paid back in crude oil over five years. The remaining

$300m will come from Oman Trading International, the first deal of this type with the company and the first time repayment is to be in fuel oil, to be delivered over 30 months. The deal will logically have been focused on financial aspects for the Omanis to have been interested; Oman of course lies in the Middle East and has close to twice the refining capacity of Ecuador, and is also an oil producer. The previous 11 deals, except for one with PTT all with China, had already committed a large share of oil output over coming years, and had interest rates around 7%.

Together with the sale of the 2026 bonds, the government managed to secure $1.65bn in desperately needed fresh funding in the final weeks of the year. The finance ministry even felt obliged to confirm that it had managed to transfer year-end bonuses (the “13th salary”) in recent days, raising the suspicion that the loans funded salary payments rather than investment, as they are legally required to be spent on. December is a particularly woeful month for public finances in any given year. With somewhat higher oil revenue and near-term tax payments due over coming months, the government can be expected to weather financial obligations at least through the February 19 elections, perhaps also until the end of Correa’s term late May.

In the meantime, Patricio Rivera went back to the finance ministry to replace Herrera, who resigned for health reasons. Sources report that he is indeed seriously ill. Diego Martínez, who as chief executive of the central bank oversaw a $4.3bn surge in lending to the government, succeeds Rivera. If anything, the central bank will continue to lend to the government as Martínez is being replaced by Madeleine Abarca, the deputy finance minister. If newspaper El Comercio’s count is correct, the cabinet changes are the 224th through 226th overall under Correa, but the ministers’ track record indicates that voluntary financial restructuring and austerity aren’t in the cards.

Brass Knuckles

President Correa on December 9 once again changed the military high command, a surprise given that the previous leadership of the joint chiefs of staff (Comando Conjunto) had been in office only since February. Due to seniority rules, the latest changes at the top forced out eight higher-ranking officials, two from the air force and six admirals as Correa has always picked the youngest possible commander. The ceremony then went ahead without Correa in attendance at a naval base in Salinas; past similar events had been marred by incidents such as a lack of applause or even numerous retired generals and colonels walking out during the president’s speech. At the same time, the military is facing key challenges, in particular along the border with Colombia.

According to a report by Guayaquil newspaper Expreso, now, nine rear admirals remain, with 11 departing in the last year, making the navy the hardest-hit among the three military branches. In the case of the air force and army, 10 generals have left amid a series of controversies. The new chief, air force general César Merizalde, is the brother of Pedro Merizalde, chief executive of Petroecuador, the state oil company in charge of fuel sales, transport, and refining, which has been rocked by numerous corruption allegations in recent months. It will take years for the number of generals to return to previous levels, while numerous tasks held by higher officials will now fall to less senior military officers. This leaves some areas in the hands of less experienced officers while the situation along the Colombian border faces a crucial moment. Correa himself has noted that a risk emanates from the peace process across the border because up to a third of the Marxist FARC rebels may decline to participate, fragmenting the rebel group further. For Ecuador, this means the dissidents, as crime groups without the central leash that to some extent existed, could stop treating the country as a safe haven and instead attempt to extend criminal activities like extortion and kidnapping to a greater extent than they already exist.

When Colombia bombed a FARC camp in 2008, Correa said that he was not Carlos Arroyo del Río, the president who in 1941 suffered the Peruvian invasion that forced Ecuador to give up claims to a direct access to the Amazon River and recognized Peruvian sovereignty over around half its claimed territory. But retired generals have harshly criticized the instability at the top of the military. The notoriously thin-skinned president may feel he has had to impose authority as the military has balked in particular at his reforms of the armed forces' social security system and demanded a $41m return of money paid to that system for land in Guayaquil. Retired officers have filed more than 60 suits before the Constitutional Court alleging that the reforms were unconstitutional. With just six months left in his administration and a domestic deployment of military in the restive province of Morona-Santiago, Correa appears unconvinced that his grasp on the military is as strong as he demands. Fortunately, the main body of the military - the army - has suffered relatively little change, somewhat softening the blow.