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Ecuador: Running Up the Down Escalator

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Deputy Portfolio Manager David Austerweil visited Ecuador in September and met with government officials, the banking sector, and private sector analysts.

Executive Summary

- Ecuador's external accounts are not in equilibrium despite the government's efforts to cut the fiscal deficit. Year-to-date reserve losses of over $3bn are tracking the same pace as 2017 in spite of higher oil prices and capital expenditure cuts.
- The reserve loss is being driven by an acceleration of private sector capital flight with lending growth of over 20% year-over-year. The government is encouraging this credit growth in order to offset the growth contraction resulting from cuts to capital expenditures.
- The government's relaxation of import barriers is coming at exactly the worst time by releasing pent up demand for automobiles and white goods (refrigerators, dish washers, etc.) that require scarce foreign currency. A proposal by the banking sector to ease liquidity ratios and reserve requirements would lead to further capital flight.
- The only new incremental source of hard currency for the economy is new government debt. But with the debt stock over 50% of GDP and interest rates over 10%, this source is reaching a limit. Reserves tend to decline precipitously in December when year-end bonuses are paid. If this pace continues, it would imply another $4bn in reserve losses for 2018, much more than the meager $2.7bn foreign-exchange reserves at the central bank.
- In short, Ecuador needs more credit to keep running up a down escalator of reserve losses. Only after it crashes to the bottom with no reserves remaining to finance imports will it ask for help from the International Monetary Fund (IMF) to get back on its feet. For this reason, Ecuador gets a failing grade on the Policy test in our investment process and we are closing our position.

Political Developments

In his trip note from December 2017, Portfolio Manager Eric Fine explains President Lenin Moreno's rise to power and three key catalysts for Ecuador's move to a market-friendly economic policy: 1) the removal of the Vice President Jorge Glas; 2) Moreno's consolidation of power through a positive referendum result; and, 3) a cabinet reshuffle leading to a market-friendly economic cabinet. Over six months later, all three catalysts have had positive outcomes and Ecuadorian credit has outperformed.

There have been developments over this time that decrease Moreno's ability to pass reform. About one year ago, Moreno's popularity was at a peak with a 77% approval rating. However, it has continuously declined since that point and the more recent approval rating was just 44%, with almost 50% disapproving. Additionally, up until February 2018, Moreno's party Alianza PAIS controlled 75% of the National Assembly (NA). However, in February the party split into a Moreno faction with about 40% of the NA and an ex-President Correa faction. Even if President Moreno wanted to pass economic reforms, now that he no longer controls a majority of the NA it would be more difficult. For this reason, the local elections coming in March 2019 are being viewed as a test of Moreno's ability to pass more difficult reforms, if needed.

The Fiscal Adjustment

The government now targets a deficit of 4% of gross domestic product (GDP) for the 2018 budget which is an improvement of 2% over the 2017 deficit of 6% of GDP. The fiscal effort year to date has focused solely on cutting capital expenditures. Through August, the government has cut over $1bn in expenditures from the 2018 budget. Oil

revenues have been the sole contributor on the revenue side due largely to the increase in prices vis-à-vis 2017. This reduction in capital expenditures is already starting to weigh on growth and this may make future cuts more difficult. Given the effort so far this year, the 2018 deficit looks achievable.

There are a number of future measures being discussed to help bring the deficit down to 3.2% of GDP in 2019. The removal of the fuel subsidy would be the biggest ticket item, saving 2% of GDP in spending a year and also freeing up more oil to be sold to the export market. In our view, the likelihood of this measure being executed, however, is low as the government plans to hold a national dialogue to get buy-in from the population for a measure with a 75% rejection rate. Earlier this year, the government removed fuel subsidies on the highest octane gasoline and diesel for personal automobiles. While a welcome signal, there are basically no savings from this measure as consumers switch consumption to lower octane fuels to continue to benefit from the subsidy. The measure that would have the most beneficial impact on the budget and economy would be an increase in the Value Added Tax (VAT) from 12% to 15%. The commentary from local economists and political analysts was that the current economic team is highly opposed to raising VAT and so the odds of it being considered were low. Unlike removing fuel subsidies, raising VAT would also require the approval of the NA and so could meet opposition in execution.

The government's economic team appears more focused on smaller ticket items to increase savings such as requiring ministers to provide their own transportation and cell phones and to generate other efficiency gains from streamlining government. While these definitely show good will toward creditors, they are unlikely to add up to much. Another potential source of revenue would be from concessions of existing infrastructure to the private sector from which the government estimates it can raise over $3bn; private sector estimates are closer to $1bn, coming mainly from road concessions.

In 2019, there is $1.5bn in constitutional court-mandated new spending to fund the social security system that ensures the government will need to find larger ticket items to meet that year's deficit target.

Oil Sector Outlook

Oil production has been roughly stable over the past year around 530,000 barrels per day (bpd), underperforming expectations for a meaningful increase in production. The government has been making efforts to repay arrears to service providers in the oil sector in the hope of increasing activity, most recently paying $200 million to Schlumberger to settle a bill from 2016. It remains difficult to get clarity around how many oil sector arrears remain and if this is still restraining oil investment.

Recognizing the lack of progress toward meeting future production targets of 700,000 bpd by 2021, the government is making investment in the oil sector much more attractive with production sharing agreements that have very generous terms. A small, first auction under the new terms raised $1bn and attracted the interest of some oil majors. It will be an important signal to see if the quality and diversity of oil exploration companies investing in the sector increases. There is a lot of potential in the sector as well as a lot of execution risk.

External Financing Requirements

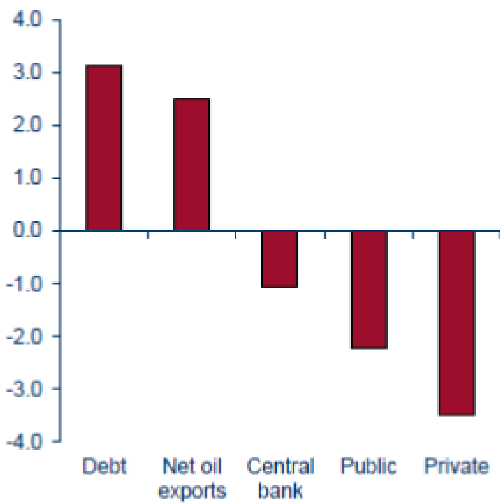
Ecuador continues to have large financing needs to pay for its fiscal deficit. For the remainder of 2018, there is in excess of $1bn borrowing left, but it is highly likely this will be met by a combination of oil-backed bank lending and repo (repurchase) transactions similar to the recent Goldman Sachs (GS) transaction. The GS repo transaction is concerning because the government issued $1.2bn of Ecuador 2020 and 2022 bonds on a contingent basis to over collateralize the repo and receive a lower rate. Since the repo has a 4-year maturity, the 2020 bonds will need to be replaced with new debt before maturity; the government is hoping to do so on more favorable terms when the market improves. The government is particularly adverse to issuing new debt with double digit yields again.

For 2019, the borrowing needs are much larger and even the Ministry shares concerns about raising sufficient funds. In the case where the funds could not be raised, the International Monetary Fund (IMF) was cited as a financing option of last resort. According to the Ministry of Economy, total 2019 financing needs are $8bn. This amount is on the low end of private sector estimates; some economists with less positive outlooks for the economy had an estimated

need as high as $12bn. The government plans to meet this need with $3bn of rollovers from multilateral lenders, $3bn of bond market issuance, and $2bn of undefined sources potentially with lending from China. Additionally, there is a $1.5bn payment required to the social security system that will be paid for with domestic bond issuance to the same social security system.

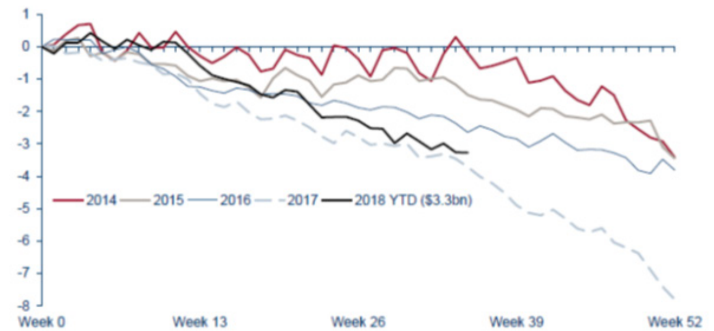
There are valid concerns over Ecuador's ability to meet these borrowing requirements. Additionally, given the reliance of the government on oil revenues, there is not much margin for error should oil prices decline in the future. The larger issue is that even if the fiscal needs are met, the U.S. dollars generated may not be sufficient to cover the needs of the entire economy, given the growing demand for dollars from the private sector. From conversations with government officials and analysts, the government currently does not acknowledge this is an issue and is not willing to take less orthodox steps to curb domestic demand.

Contributions to international reserves by sector
12-month accumulated through July 2018



Source: Credit Suisse. Data as of July 2018.

Cumulative underlying international reserve loss
$bn, net of bond issuances, oil-field financing, and bilateral loans linked to oil purchase-sell agreements



Source: Credit Suisse. Data as of August 2018.

Investment Implications

Ecuador is a strong bucket 1 valuation in our investment process, but after this research trip, it receives a strong fail on the Policy test, moving it to a zero allocation. We do not think any exposure to Ecuador is prudent right now. Reserve losses tend to accelerate in the fourth quarter of the year as public spending needs intensify. The subsequent fall in reserves may pressure Ecuador's credit spreads. The market would need to get significantly worse before Ecuador would consider going to the IMF; we would look to purchase Ecuador debt once the government begins sending the correct signals to the market. Additionally, any improvement in Ecuador's credit spreads will be met by new debt issuance, given the large financing needs. It makes more sense to purchase Ecuador's debt in a primary market issuance where there will be a discount to the prevailing market rate and an immediate replacement of reserves that will buy them additional time.

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