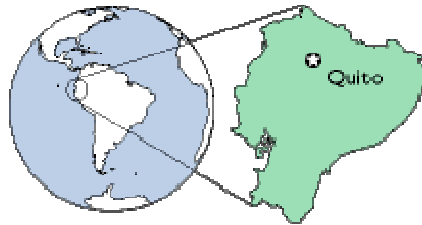


COUNTRY REVIEW

Ecuador



12 July 2010

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EULER HERMES COUNTRY RISK GRADE: D

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Oil reserves
- Formal dollarisation minimises inconvertibility risk in the short term

Weaknesses

- Commodity dependence, especially oil, with correspondingly high vulnerability to external shocks
- Weak institutions and unstable political system, radical-left agenda of current government
- Formal dollarisation imposes monetary rigidity, increasing the need for fiscal and structural flexibility but the track record in these areas is poor and unlikely to improve
- Weak Structural Business Environment that has deteriorated under the current administration

Country Risk Assessment

Ratings	Ecuador		Median Grade D	Peers		
	Latest	Previous		Nicaragua	Venezuela	Ukraine
Systemic Political Risk:	P4	P4	P4	P3-	P3-	P3-
Systemic Economic Risk:	E5	E5	E6	E6	E6	E6
ME rating:	ME5	ME5	ME6	ME6	ME5	ME6
<i>Structure</i>	5.7	5.7	6.0	6.0	5.7	5.7
<i>Policy</i>	4.9	3.5	5.2	5.2	6.0	6.0
<i>Solvency</i>	3.3	3.3	4.0	5.8	1.3	4.6
<i>External Liquidity</i>	4.3	4.8	4.0	4.8	2.3	3.8
SBE rating:	SBE6	SBE5	SBE6	SBE5	SBE6	SBE5
COUNTRY GRADE:	D	D	D	D	D	D

Nomenclature:
 Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
 Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
 ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
 The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
 SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
 Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

Political Stability

Ecuador has a long history of political instability and ineffective government. Traditional rivalries based on geography—notably between the coast (Guayaquil) and the highlands (Quito)—personality-based parties and the influence of interest groups work against consensus, creating congressional stalemates and conflict between the executive and legislative branches of government. Non-elected groups—the military, indigenous movements and organised labour—are also powerful de-stabilising influences in a society deeply divided along income and ethnic lines. Three presidents were forced from office prematurely in the decade to 2005—the most recent was President Gutierrez in mid-April 2005. In October 2006, however, radical leftist Rafael Correa was elected president and assumed office in January 2007.

Correa moved quickly to consolidate his position and further his “citizen’s revolution” which aims to improve social justice by state intervention, a strategy that has involved large increases in public spending and reform of the energy sector to allow a bigger share for the state. The government has also defaulted international bonds issued by its predecessors which it deemed (unilaterally) to have been illegitimate. A constituent assembly, formed in September 2007, drafted a new constitution which was approved by referendum and became effective in October 2008. As required by the new constitution elections were held for president, vice-president and the National Assembly in April 2009. President Correa was re-elected comfortably (52%) and his Alianza Pais (AP) won the largest number of seats in the Assembly, though not an outright majority. The new constitution allows four-year terms for the president and re-election to consecutive terms and it also established a seven person Citizen Participation Council, which has oversight of institutions.

It remains to be seen where the boundaries of the president’s agenda lie and what measures will be adopted if growth remains low and fiscal revenues constrain expenditure, but there is some risk of more extensive interventionism. The president retains a good level of support and the opposition is weak and divided, though indigenous groups have recently demonstrated against the government (a major de-stabilising force in previous administrations) and the opposition have frustrated legislation in the National Assembly. There has been speculation for much of this year over the possibility of President Correa calling a recall election to underpin his position, as he could rule by decree until the elections, which if held he would probably win. In the meantime without a majority in congress he may continue to struggle to pass legislation that would progress the radical agenda.

According to World Bank Institute’s governance indicators, Ecuador is well below the regional and income group (lower middle income) median for political stability, government effectiveness, and below the median for Voice and Accountability.

Internationally, relations are strained with neighbouring Colombia over incursions by the latter against FARC insurgents. Ecuador maintains relations with the US, but is also close to Venezuela and a member of ALBA (the regional economic grouping of the radical left led by Venezuela).

Economic Stability

Ecuador is a lower middle-income, highly vulnerable to external shocks, as oil accounts for around 50% of exports and just under 30% of fiscal revenues. Over the past ten years annual average growth of real per capita GDP was an adequate 2.9%. In 2009 growth of real GDP slowed sharply, but remained positive, at 0.4%, despite a fall in oil output. Growth in Q1 2010 remained low at 0.5% yr/yr, as oil output continued to fall and probably will not exceed 2-2.5% for the year as a whole. A similar pace is likely in 2011, though much depends on the outlook for oil prices. A key constraint on growth is declining oil output and the likely negative effect of radical policies on private sector investment. A new hydrocarbons law effectively nationalises oil and gas production, with private oil companies having to renegotiate production sharing agreements into service contracts or face a state takeover of their assets, albeit with compensation. This is likely to deter new investment and unlikely to reverse the recent trend of falling oil output.

Increased public spending, which more than doubled between 2006 and 2008, turned a fiscal surplus into small deficit as a proportion of GDP by 2008 (-0.4%) even though revenues in that year rose sharply as a result of high oil prices. In 2009 lower oil prices and GDP growth caused revenues to drop sharply, which was only partially offset by a modest reduction in expenditure (as a proportion of GDP) notwithstanding a 0.6% of GDP reduction of interest payments and the deficit widened to 5.1% of GDP. A large fiscal stimulus focused on construction projects was announced by the government at the end of 2009, which should maintain expenditure at high levels in 2010, though financing may be a constraint. Revenues should also increase on higher oil prices. Overall, the deficit may still be in the 4-5% of GDP range in 2010 and 3-4% in 2011.

Financing of the fiscal deficit is constrained by lack of access to international finance following debt restructuring after the 1999 crisis and again after the government defaulted and restructured two bonds in 2009 issued by its predecessor which it deemed illegitimate. The finance minister has said that financing for 2010 is in place but has not provided specifics. In 2009 the government used the central bank's international reserves as financing and may do so again (the constitution gives the president the right to use the reserves) though this is a negative constraint on growth as it reduces the monetary base. The public debt-GDP ratio fell to a low 17.8% at end-2009—partly the result of debt restructuring—but may increase slightly in 2010.

Formal dollarisation proscribes an independent monetary policy and requires a high degree of fiscal prudence along with structural flexibility, though neither is prioritised by the Correa administration. President Correa, indeed, is a known sceptic regarding dollarisation, but has not changed the system. While to some extent this may be a tacit acknowledgement of the riskiness of such a move, if overall growth of the economy remains constrained de-dollarisation could be on the agenda. Inflation has should remain relatively low in 2010-11 at around 4%. The real exchange rate is overvalued.

The external current account slipped into small deficit in 2009 of 0.5% of GDP, as oil export earnings plunged, while the fall in imports was less marked. Remittances also fell sharply. Higher oil prices and stronger remittances should offset an increase in imports in 2010 but the current account may remain small deficit and widen to 2.3% of GDP in 2011. Net FDI flows are likely to remain limited and cover less than half the current account deficit in 2011. FX reserves decreased at the end of 2009 (see above) but increased to USD3.5bn in May 2010. Import cover is low (around two months) as is FX cover for external debt due in 2008, but dollarisation reduces the significance of these indicators and continues to mitigate inconvertibility risk. Nonetheless, there is a risk that if financing constraints were to become acute the government may seek to force further repatriation of banks offshore assets, which could de-stabilise the banking system. External debt as a proportion of GDP and export earnings (goods, services and transfers) is low, though this is partly the result of the restructuring of defaulted debt. Interest payments as a proportion of export earnings are moderate.

Structural Business Environment

The Structural Business Environment is weak in our assessment (165 out of 210 countries assessed).

Based on data and definitions from the World Bank's 2010 Doing Business Survey, Protecting Investors, Trading Across Borders, Enforcing Contracts and Closing a Business were weaker areas, ranking below average, while Starting a Business and Employing Workers were particularly weak. The World Bank Institute's Governance Research Indicator puts Regulatory Quality, Control of Corruption and the Rule of Law all well below average for the lower middle income group of economies and for the Latin American Region, with Rule of Law particularly weak. Transparency International's Corruption Perception Index, 2009, assigns Ecuador a score of 5.1—on a scale of 1 (bad) to 10 (good)—and a ranking of 146= out of 180 (the same as Russia, Ukraine and Kenya among others). As a broad measure of the pro-business environment The Heritage Foundation's 2010 Index of Economic Freedom ranks Ecuador 147 out of 179.

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Charts

