Ecuador

A delicate situation

Since taking office in May 2017, Lenin Moreno has launched a radical transformation of Ecuador's economy. The aim is to increase the private sector's weight, clean up public finances and boost the country's attractiveness in the eyes of foreign investors. In the very short term, however, the economy faces the effects of the growth slowdown and the sharp increase in public debt, which have been registered since commodity prices dropped off in 2014. Although the proposed measures are welcome, they might not suffice to strengthen the government's solvency.

The end of the "citizen revolution"

In May 2017, Lenin Moreno was elected president of Ecuador with the backing of his predecessor, Rafael Correa (in power since 2007) and the Alianza Pais party. As soon as he took power, the new president distanced himself from his party and "21st century socialism". He made fighting corruption the top priority of his mandate, and is increasingly signalling his openness to the private sector.

A referendum and popular consultation was held in early February, marking Moreno's determination to emancipate himself completely from the previous government's policies. The consultation covered three main subjects: restoring term limits to a maximum of two (reversing the policy of "unlimited re-elections" introduced by the previous government in 2015), banning anyone convicted of corruption from participating in political life, and reorganising the Citizen Participation and Social Control Council (created by the Correa government and directed by the former president's close associates).

The "Yes" vote won nearly two thirds of the vote for most of the questions, which strengthened the government's legitimacy, not only for the replacement of political staff but also for the pursuit of more liberal economic policies. The elimination of "unlimited re-elections" will also prevent Rafael Correa from running in the 2021 presidential elections.

Economic growth rebound in 2017, but structural slowdown

The drop-off in commodity prices in 2014 triggered a sharp slowdown in Ecuador's growth. GDP growth averaged only 0.5% between 2015 and 2017, compared to an average of 4.4% between 2005 and 2014. Although GDP growth rallied to 3% in 2017, it is expected to slow again in 2018 and 2019, and hold closer to 2%. The government's stimulus measures will gradually wind down, and the rebound in commodity prices will not suffice to offset sluggish domestic demand.

Backed by the referendum results, the government proposed an economic plan in early April with four key vectors: 1) consolidate public finances, 2) reform the public sector, 3) maintain the current account balance, and 4) improve the business climate, deregulate the private sector, boost the country's competitiveness and attract foreign investors. The measures will be spread out over the remainder of the presidential mandate, which ends in 2021.

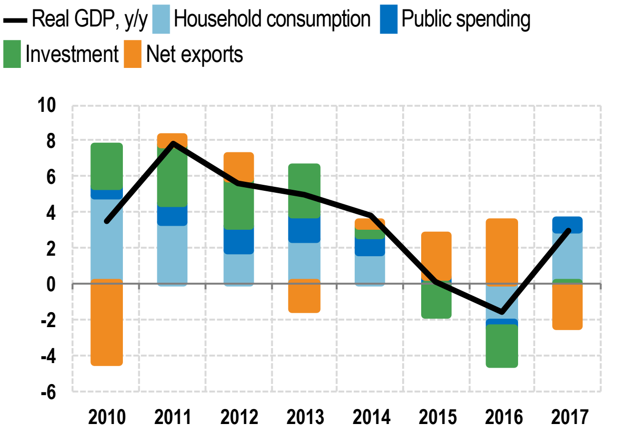
1- Forecasts

	2016	2017e	2018e	2019e
Real GDP growth (%)	-1.6	3.0	2.0	1.8
Inflation (CPI, year average, %)	1.7	0.4	0.6	1.6
Cent. Gov. balance / GDP (%)	-8.3	-5.3	-5.0	-3.7
Cent. Gov. debt / GDP (%)	42.9	45.0	48.0	50.1
Current account balance / GDP (%)	1.5	-0.2	0.1	-0.1
External debt / GDP (%)	34.9	38.3	42.7	43.7
Forex reserves (USD bn)	4.3	2.5	3.7	3.5
Forex reserves, in months of imports	2.7	1.3	1.9	2.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Economic growth rebound in 2017

GDP, year-on-year in %, and contributions to growth in percentage points



Source: Central Bank

On the fiscal front, the priority is to reduce gradually the deficit to 2.5% of GDP in 2021. The deficit has swelled sharply since 2013, driven up by the combined impact of oil infrastructure improvement projects set up by the previous government and the sharp drop in commodity prices. The deficit rose from an average of less than 1% of GDP between 2004 and 2013 to more than 5% of GDP between 2014 and 2017.

In 2018, the deficit is expected to slip to 5% of GDP, from 5.3% in 2017. The proposed measures are mainly designed to increase revenue, which currently accounts for less than 20% of GDP (19.4%

in 2017), and to optimise spending (24.5% of GDP in 2017). These measures were strengthened by new commitments and a draft law proposed by the new finance minister, named in early May. The government also announced the creation of a stabilisation fund.

Yet economic policy is unlikely to change radically in the short term, given the execution problems that the country often encounters. Moreover, to get the fiscal measures approved, the presidential party will need to join forces with the opposition, which is another big challenge.

Economic policy is also constrained by total dollarization: in the year 2000, the dollar was adopted as the exclusive legal currency. The conversion of money in circulation, deposits, credits and loans outstanding into dollars helped stabilise the country's macroeconomic fundamentals after the economic, banking and political crisis of 1998-2000. After hitting 91% in 2000, the inflation rate has stabilised at a relatively low level (average of 3.8% between 2007 and 2017, and 0.4% in 2017).

Yet the cost of total dollarization is relatively high: 1) the central bank had to abandon seigniorial rights that were levied on issues in the national currency (which were transferred to the monetary authorities of the issuing country), 2) the possibility of intervening as the lender of last resort is conditioned on the existence of surplus foreign exchange reserves, and 3) the dollarized country is deprived of an independent monetary policy. Money supply can only be increased through a net inflow of foreign currency, which can arise from a current account surplus, foreign direct investment or bond issues.

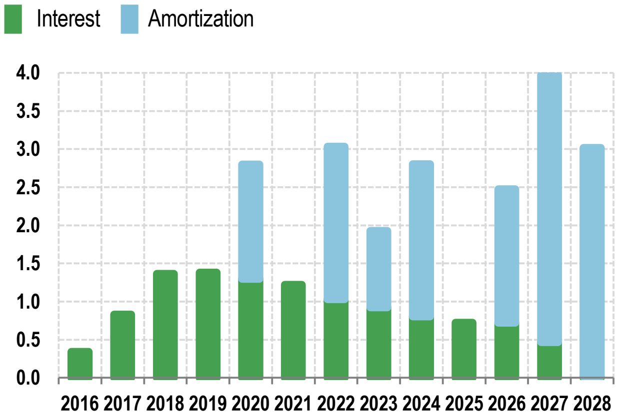
Public debt swells

Since 2014, the only way for Ecuador to increase money supply was has been by issuing bonds. The current account balance has shown a slight deficit since 2015 (-0.3% of GDP on average), despite sharp import restrictions. Foreign direct investment (FDI) has been relatively low since the public sector plays such a big role in the economy. FDI accounted for only 0.6% of GDP in 2017.

Public debt rose from 27% of GDP in 2014 to 45% in 2017, reflecting the upturn in fiscal deficits, the slowdown in GDP growth and higher interest charges. The debt profile is not favourable: the country borrows at high interest rates (9% on average) and interest payments have doubled in just a few years. They accounted for 2.4% of GDP in 2017, compared to 1.2% in 2013.

In 2016, the government changed the way it calculates debt by excluding debt due to public institutions. This accounting change artificially reduced the debt and kept it from surpassing 40% of GDP, the threshold above which the government is required to seek parliament's approval for any new debt issues and to set up a fiscal adjustment plan. As soon as the Moreno government took power, it reversed these measures and committed to greater fiscal discipline and transparency. Public debt is expected to swell further in 2018, to an estimated 48% of GDP, before levelling off at about 50% of GDP in 2019-2020.

3- Debt service
USD bn



Source : Ministry of finance

Ecuador is currently in a delicate situation. While awaiting the fruits of any structural reforms, the government may have to make new debt issues to cover its liquidity needs. Its financing needs could increase to dangerously high levels over the next two years: in 2019 and 2020, debt servicing alone will amount to USD 1.4 bn and 2.8 bn, respectively.

In June, the government contacted the IMF after breaking off relations for nearly 10 years. Renewed relations with international institutions would make it easier to obtain the necessary liquidity, but in return, donor funds will certainly demand a more rapid fiscal consolidation than what the government has announced so far.

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