Euler Hermes Economic Research

Country Report

Ecuador

Looking for cash

General Information

GDP	USD84.532bn (World ranking 64, World Bank 2012)
Population	15.49 million (World ranking 65, World Bank 2012)
Form of state	Republic
Head of government	Rafael CORREA Delgado
Next elections	2017, presidential and legislative

Strengths

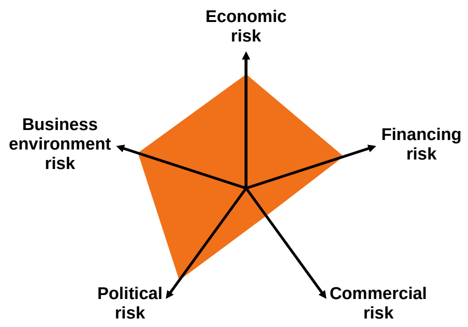
- Limited transfer & currency risk thanks to the dollarization of the economy
- Significant oil reserves
- Financial support from China

Weaknesses

- Dependence on oil production and vulnerability to global oil prices
- Unsustainable pace of public spending
- Lacks access to international markets to finance public debt, due to successive defaults and restructurings

Country Rating

C3



Source: Euler Hermes

Trade Structure

By destination / origin (% of total)

Exports		Rank		Imports
United States	38%	1	23%	United States
Other America	8%	2	13%	China
Peru	8%	3	9%	Colombia
Venezuela	6%	4	7%	Other America
Chile	5%	5	4%	Mexico

By product (% of total)

Exports		Rank		Imports
Crude Oil	50%	1	20%	Refined Petroleum
Agricultural Products	18%	2	4%	Plastic Articles
Meat	6%	3	4%	Cars And Cycles
Refined Petroleum	4%	4	4%	Iron Steel
Preserved Meat/Fish	4%	5	3%	Pharmaceuticals

Sources: UNCTAD, Chelem (2012)

Economic Overview

Growth is slowing down

The economy is highly dependent on oil production (about 30% of government revenues and over 50% of exports) and, as a result, vulnerable to changes in global oil prices. Recently, increased fiscal revenues from high oil prices and robust growth have allowed a strong expansion of public spending in support of President Correa's citizens revolution, thus reducing poverty and improving social indicators significantly. Financial stability and low inflation have been supported by the dollarization of the economy. The outlook is however less favorable for coming years due to lower expected oil revenues and lower growth of credit.

Real GDP slowed from +5.2% in 2012 to +4.6% in 2013 as a consequence of the strong negative contribution of external demand (-1.5ps), while all the components of domestic demand accelerated. The closing of the biggest refinery in the country for renovation resulted in a sharp slowdown in real exports (+2.4% in 2013 after +4.7% in 2012). Alongside, imports bounced by +7% after a meagre +0.8% in 2012, mainly driven by imports of refined petroleum products.

The recovery in exports expected this year after the reopening of the refinery could be more than offset by a slowdown in domestic demand on the back of less public investment and spending. All in all, Euler Hermes expects Ecuador to grow by +4.3% in 2014 and 4.0% in 2015, still above regional average.

Inflation to remain anchored by dollarization

Even if inflation is volatile, consumer prices are anchored by the dollarization of the economy. The inflation rate have been close to 4% on average since 2004, against +100% in 2000, when the USD was adopted as the official currency.

Inflation eased in 2013 to +2.7% (against +4.5% in 2012) mainly due to the implementation of price controls on several edible products. Consumer prices have accelerated since the beginning of 2014 to +4.1% y/y in August on the back of agricultural supply shocks. They are expected to reach +4.5% y/y by the end of the year and to ease gradually thereafter. The inflation rate should stand at +2.3% on average in 2014 and at +4% in 2015.

The banking system is very vulnerable to liquitidy shocks

The Ecuadorian financial system is still underdeveloped: credit by financial institutions to the private sector represents less than 30% of GDP, well below the Latin American average. Albeit broadly sound (capital ratios are comfortable and the institutions rather profitable), the banking system is particularly vulnerable to liquidity shocks. Monetary policy is significantly limited by full dollarization of the economy and the Central Bank cannot act as a lender of last resort. Thus, banks are forced to secure liquidities, determining the level of credit. Consequently, the expected tightening of the monetary policy in the U.S. in coming months could impact negatively the supply of credit in Ecuador.

The State is short on cash

Fiscal policy has been very supportive since the President Correa came into the power. Public spending reached 44% of GDP in 2013 against 25% in 2007. The increase in capital spending has been particularly impressive (15% of GDP in 2013 vs 6.7% in 2007) while current expenses went up to 28.6% of GDP in 2013 against 18% in 2007. The expansion of public spending was broadly financed by strong oil revenues (35% of total revenues) and increase in taxes.

Unfortunately the country failed to build a countercyclical fund in past years, so lower oil prices threaten the

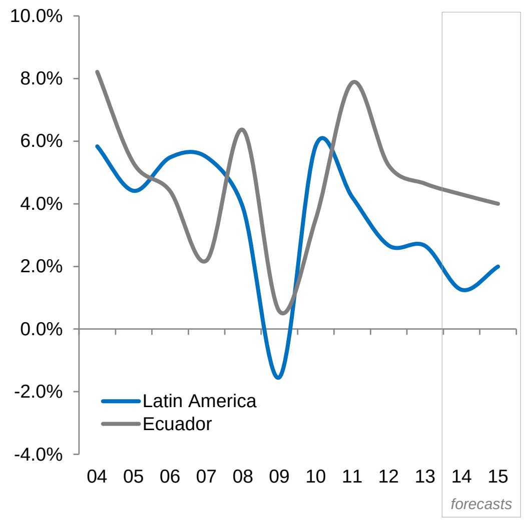
Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	5.2	4.6	4.3	4.0
Inflation (%, yearly average)	5.1	2.7	2.3	4.0
Fiscal balance* (% of GDP)	-0.9	-4.0	-4.0	-3.6
Public debt* (% of GDP)	21.3	24.3	26.2	27.0
Current account (% of GDP)	-0.4	-1.4	-0.8	-0.6
External debt (% of GDP)	16.6	18.5	19.2	21.0

*Includes Central Government; Local Government; Monetary Public Corporations, incl. central bank; Nonfinancial Public Corporation; Nonmonetary Financial Public Corporations; Social Security Funds

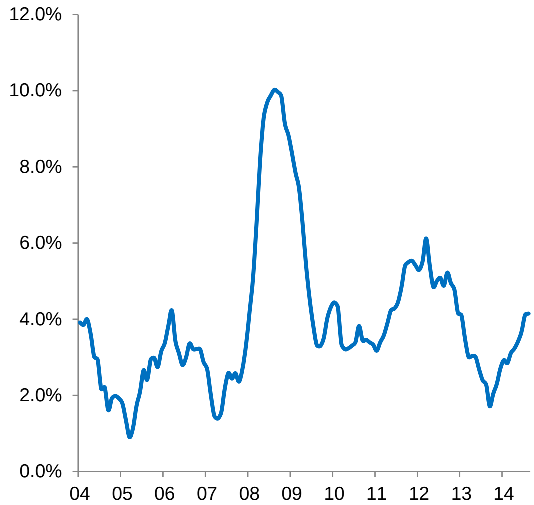
Sources: National sources, IHS, Euler Hermes

GDP growth (%)



Sources: National sources, IHS, Euler Hermes

Inflation rate (y/y, %)



Sources: National sources, IHS, Euler Hermes sustainability of this model. Yet, the government lacks flexibility for fiscal adjustment as a major part of public spending is public wages, subsidies and social spending. The fiscal balance deteriorated sharply in 2013 to -4% of GDP against -0.9% in 2012, according to IMF data. In the absence of rebounding oil revenues, the financing of the deficit appears troublesome as the access of Ecuador to international capital markets remains constraint since the voluntary default in 2008. Ecuador has used its mining concessions or gold reserves as collateral to bring cash, and has received some financial support from China. The coming months are likely to bring tighter financing conditions (Fed's tapering) potentially forcing the government to limit public spending. Euler Hermes expects the fiscal balance to remain at -4% of GDP in 2014, before decreasing slightly to -3.6% in 2015. Accordingly, the public debt should continue on an upward trend and reach +27% of GDP by 2015, still a modest level.

External sector

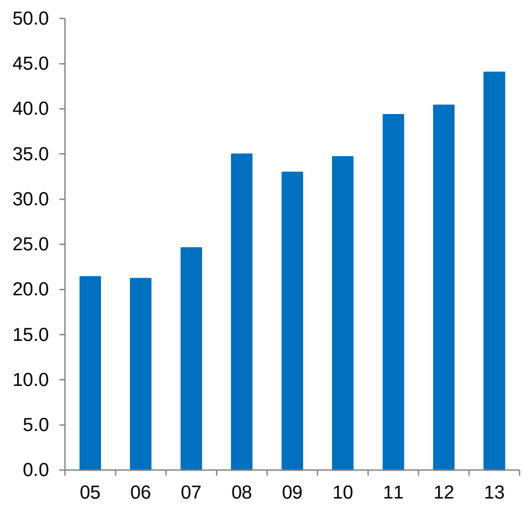
The closing of the biggest refinery in the country for renovations coupled with the stagnation of oil prices resulted in a slowdown of exports (+4.6% after +6.4% in 2012), while imports accelerated to +7.4% (+5.5% in 2012). Consequently, the trade deficit widened to -USD0.6 bn in 2013. Euler Hermes expects it to switch into a surplus in 2014 with the resumption of oil exports and the selective increase in tariffs on 144 products (mostly related to the engineering sector, electronics and construction materials) weighing on imports. Coupled with still strong worker's remittances, Euler Hermes expects the current deficit to narrow to -0.6% of GDP in 2015, after -1.3% in 2013.

The overall external balance is manageable, especially as formal dollarization mitigates Transactional and Currency risk. Net FDI, currently negative, do not help financing the external deficit. However, foreign debt remains low (18.5% of GDP) since the 2008 voluntary default, but is expected to increase to 21% of GDP by 2015, mainly due to higher public external debt (mostly with China).

Broadly stable political system

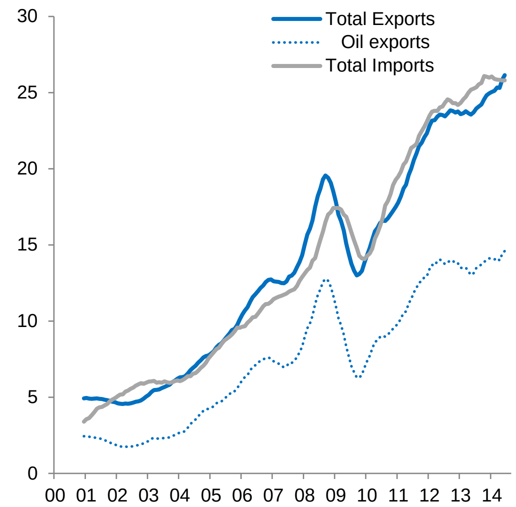
Political stability is ensured by the high popularity of President Rafael Correa, who was re-elected in 2013 for a 4-year term. However, it is to be noted that the new telecommunications law (which limits the freedom of media) and, especially, the decision to drill a part of the oil reserves laying in the natural Park Yasuni has negatively impacted his popularity, notably among the upper-middle class, indigenous groups and ecologists. The gradual strengthening of the opposition was clear in the last municipals elections as the opposition won in the three major cities of the country. This remains unlikely to trigger political instability as the President still enjoys the support of the major part of the population, but the loss of popularity of the government needs to be closely monitored.

Total General government expenses (% of GDP)



Sources: National sources, IHS, Euler Hermes

Exports and imports of goods (USD bn)



Sources: National sources, IHS, Euler Hermes

DISCLAIMER
These assessments are, as always, subject to the disclaimer provided below.

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