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Frontier Case Study: Ecuador's Path to Economic Sustainability

This paper showcases PGIM Fixed Income's investment approach to frontier markets, which includes a combination of macroeconomic fundamental analysis, insight into the political backdrop, and inferences from in-person discussions with key stakeholders.

Ecuador's adjustment program backed by the International Monetary Fund (IMF) has the scope to address key structural shortcomings that could materially strengthen the country's macroeconomic fundamentals, while providing enough financing to avert any credit event over the life of the program—provided that it is successfully implemented. The administration of President Lenin Moreno appears highly committed to undertake the policies agreed to with the IMF. Room for political compromises and the idiosyncratic features of Ecuador's political system bolster the political viability of the adjustment and reform agenda. However, the program's short-term welfare costs pose risks to governability and the program's continuity. Successful execution of the adjustment and reform agenda could render a positive re-profiling of Ecuador's yield structure and credit ratings.

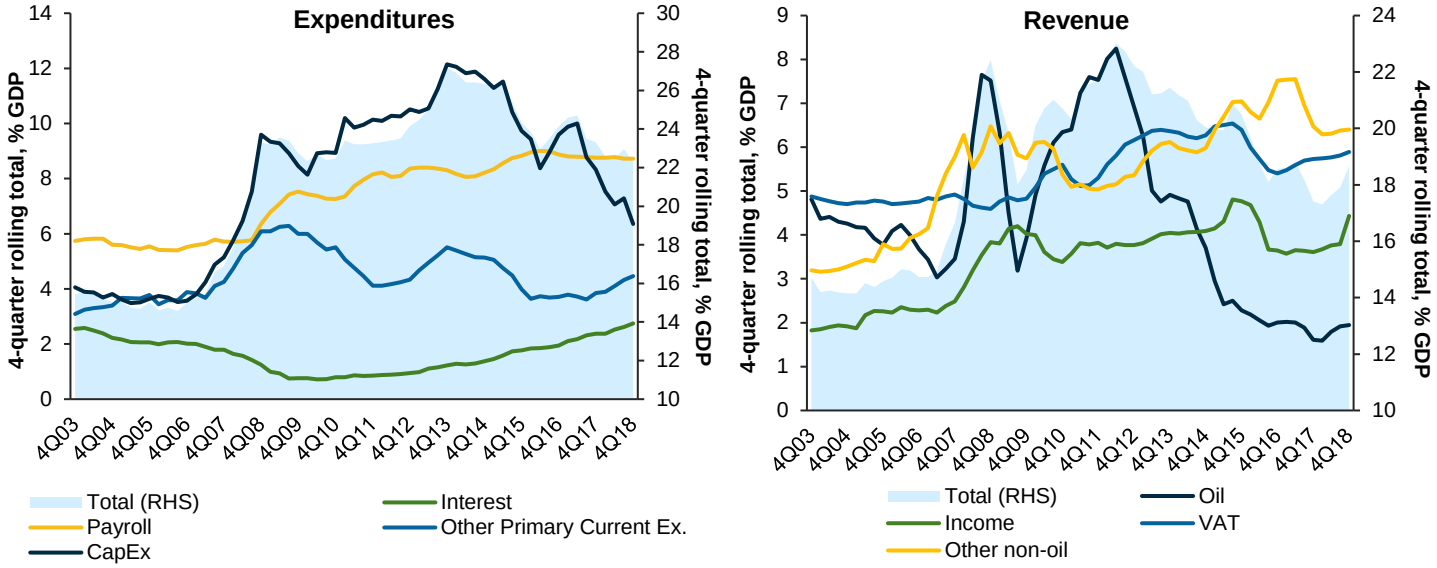
I. BESET BY A DOUBLE WHAMMY

Key traits of the small Ecuadorian economy (per capita GDP of about $11,500 in purchasing power parity as per the IMF's estimate) are centered on its reliance on commodities (primarily oil and agriculture) and historical bouts of economic and political instability. Tenuous governability conditions and a severe economic crisis in the late 1990s culminated in the replacement of the local currency (the Sucre) with the U.S. dollar as Ecuador's legal tender in 2000, swiftly bringing inflation down from triple-digit to single-digit territory in about two years. Rising oil prices generated a terms-of-trade windfall that allowed the economy to grow at an average annual rate of 4.5% from 2001 through 2014 when oil prices started their sharp descent.

The decline in oil prices, combined with the simultaneous appreciation of the U.S. dollar dealt Ecuador a severe double whammy, and insufficient policy responses put Ecuador in a vulnerable balance of payment position. The central government's unsustainable fiscal stance lies at the crux of the economy's fundamental vulnerabilities. During its boom years, government spending rose continuously as part of President Rafael Correa's leftist policy agenda, which was aimed at expanding public investment and the state's role in the economy (Figure 1). As the oil shock beset fiscal revenues (Figure 2), capital expenditures rapidly adjusted, only to be reversed with reconstruction after an earthquake in Q2 2016 and increased outlays leading up to the 2017 elections.[1]

[1] *The recovery in oil prices in 2016-2018 did not provide a boost to the central government's revenue as the windfall was largely used to clear arrears owed by the state-owned oil companies and increase capex in an effort to reverse the decline in oil production.*

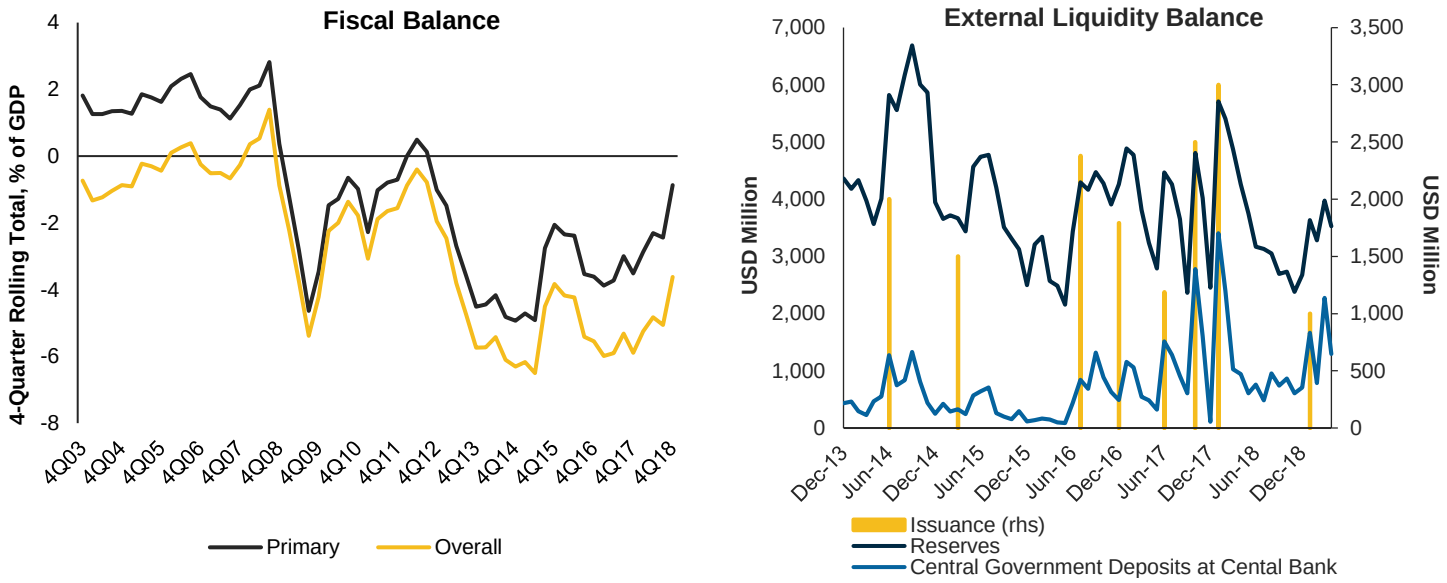
FIGURES 1 AND 2: ECUADOR CENTRAL GOVERNMENT CAPITAL EXPENDITURES AND REVENUE



Source: Haver Analytics as of April 2019

Although President Lenin Moreno's administration was off to a promising start after taking office in May 2017, fiscal consolidation was relegated to the backburner during its first year (Figure 3) amid a favorable global financial environment that enabled it to rely on external debt issuance. Figure 4 depicts the deleterious effect that these fiscal dynamics have had on the economy's external liquidity position, a key vulnerability that eventually led to Ecuador's engagement with the IMF. Foreign exchange reserves rose in tandem after each issuance; nevertheless, FX reserves declined as the government used up the proceeds to meet spending commitments and withdrew deposits from the central bank. An underlying lack of competitiveness, partly on the back of the dollarized system, has hindered the tradeable sector's capacity to offset the drain on reserves, though it has been more contained recently with the surge in oil prices.

FIGURES 3 AND 4: ECUADOR'S FISCAL BALANCE AND EXTERNAL LIQUIDITY BALANCE



Source: Haver Analytics as of April 2019

Despite swifter adjustments that have taken place since a more market-friendly economic team was appointed in May 2018, the market's tolerance for gradual macroeconomic corrections ebbed substantially as financial conditions tightened in 2018. The lingering stigma stemming from Ecuador's track-record of chronic debt defaults and its funding needs over the next few years compounded the market's

trepidation. This backdrop set the stage for the most recent issuance in early 2019 at a hefty interest rate of 10.75%. The prospect of prohibitively expensive access to external financing, without which a credit event would be a likely outcome, prodded Ecuadorian authorities to pursue more favorable financing options from multilaterals—spearheaded by the IMF—via a support package that also addresses some of Ecuador's underlying economic deficiencies.

II. PROGRAM DETAILS

On March 11, 2019 the IMF's Executive Board approved a three-year, normal-access Extended Fund Facility (EFF) for Ecuador. Compared to the IMF's "workhorse" Stand-By Arrangement (SBA), an EFF entails longer engagement with the program and a longer repayment period. This design aims to address the underlying structural shortcomings that brought about the economy's precarious Balance of Payments (BoP) stance, rather than just attending to the short-term liquidity shortfalls. The EFF tailored for Ecuador pursues the following key objectives: (a) restoring fiscal sustainability; (b) buttressing the institutional anchors of Ecuador's dollarized monetary system; (c) lifting competitiveness; (d) safeguarding the most vulnerable segments of the population; and (e) enhancing governance. As per the normal-access financing guidelines, the IMF committed to provide support for U.S.$4.2 billion (435% of Ecuador's quota) as long as Ecuador complies with a raft of quantitative and qualitative conditionalities evaluated on a quarterly basis. The IMF's financial support is complemented by additional funding from other multilateral organizations, amounting to a total package of nearly U.S.$10.3 billion available through 2021 (Figure 5). This package is projected to be enough to strengthen Ecuador's reserve stock while meeting the public sector's funding needs and the economy's external financing requirements without tapping the capital markets (though liability-management operations are possible)

FIGURE 5: ECUADOR'S FINANCIAL SUPPORT PACKAGE

(USD Million)	2019	2020	2021	Total
IMF	1,403	1,403	1,403	**4,209**
World Bank	978	644	122	**1,744**
Inter-American Development Bank (IADB)	1,009	324	384	**1,717**
Development Bank of Latin America (CAF)	600	600	600	**1,800**
Latin American Reserve Fund (FLAR)	278			**278**
European Investment Bank (EIB)	204	175		**379**
French Development Agency (AFD)	150			**150**
Total	**4,622**	**3,146**	**2,509**	**10,277**

Sources: IMF, La Hora, PGIM Fixed Income

Figure 6 summarizes Ecuador's quantitative targets—centered around an aggressive fiscal consolidation plan—and its structural benchmarks, from which one can evaluate the program's implementation. The fiscal consolidation is based on tax reform, expenditure cuts, and fuel subsidy adjustments (Figure 7). It aims to narrow the non-oil primary balance of the Non-Financial Public Sector (NFPS), including fuel subsidies (a more accurate gauge of Ecuador's underlying fiscal dynamics) by five percentage points of GDP by 2021, four of which are slated to be attained by next year. The program targets an ambitious trajectory of reserve accumulation, supported by the increase of public savings stemming from fiscal consolidation and the projected decline in external financing needs facilitated by a current account surplus. Neither additional external arrears, nor further financing from the central bank (BCE) to the NFPS, are allowed under the program.

In terms of structural benchmarks, before the second half of 2019, the Moreno administration is set to submit amendments to existing legislation designed to improve the predictability of fiscal policy as well as the transparency of public debt and arrears to the National Assembly. By the third quarter, the Assembly should receive the tax reform, along with the bill pertaining to the central bank's independence, which is largely meant to reinforce the foundations of dollarization. Although labor reform to improve competitiveness is not part of the program's short-term structural benchmarks, we anticipate that it could be in the near future given the pressing need to loosen the pernicious rigidity of Ecuador's labor market that severely hamstrings the ability of this dollarized economy to achieve sustained improvements in competitiveness.

The program brings to the fore social and anti-corruption objectives, which could potentially lift Ecuador's Environmental, Social and Governance (ESG) standing. Given Ecuador's lingering social development shortcomings, and in anticipation of the program's short-term welfare costs, authorities have committed to moderately raise spending in existing social assistance programs in order to protect the living standards of the most vulnerable socioeconomic strata. A plan to improve spending on primary education and health services is scheduled to be released by September. Ecuador has also committed to crack down on corruption structurally, underpinned by an anti-corruption bill expected to be sent to the legislature by the third quarter. Among other objectives, the bill will seek to strengthen the independence of law-enforcement agencies, the coordination among agencies and foreign counterparts, and the transparency in government operations.

FIGURE 6: PERFORMANCE CRITERIA, INDICATIVE TARGETS, AND STRUCTURAL BENCHMARKS FOR ECUADOR'S FINANCIAL SUPPORT PACKAGE

			2018		Projections[1]		
	2016	2017	Actual	Estimated[2]	2019	2020	2021
Performance Criteria							
Non-oil primary balance of the NFPS incl. fuel subsidies, % GDP	-7.6	-6.2	-5.6	-5.3	-3.3	-1.3	-0.3
Net International Reserves (program definition), USD billions[3]	-1.0	-2.3	-1.7	-1.7	1.4	3.9	7.5
Change in social spending, % GDP[4]					0.4	0.4	0.4
Ceiling on the change in external payments arrears, USD billions[5]					0	0	0
Ceiling on new gross BCE direct or indirect financing to the NFPS, USD billions					0	0	0
Indicative Target							
Overall fiscal balance of the NFPS, % GDP	-7.3	-4.5	-1.2	-0.9	0.0	3.8	2.9
Memorandum Items							
Nominal GDP, USD billions	99.9	104.3	108.4	107.5	106.3	107.7	110.6
Real GDP, %YoY	-1.2	2.4	1.4	1.1	-0.5	0.2	1.2
Primary fiscal balance of the NFPS, % GDP	-5.8	-2.3	1.3	1.5	2.7	6.5	5.5
Current account balance, % GDP	1.3	-0.5	-1.3	-0.7	0.4	1.4	1.5
Gross International Reserves, USD billions[6]	4.2	2.0	2.2	2.2	5.0	7.8	11.4
Oil price (Ecuadorian mix), USD per barrel	34.5	45.6	65.3	60.4	47.8	48.7	49.4
Oil production, x1,000 barrels per day	548	531	517	517	565	589	552

Structural Benchmarks Through Q3 2019 (Selected Items)	Objective	Date
Submission to the National Assembly of amendments to the relevant laws to: limit the discretion of the executive to change the budget approved by the legislature; improve the official definition of public debt; adopt binding targets for the non-oil primary balance of the NFPS; and implement a standard definition of arrears.	Strengthen fiscal management and clarify the fiscal rules framework.	End of June 2019
Publication of a blue print for a tax reform, in coordination with IMF technical assistance, to upgrade the current tax system to enhance revenue collection, efficiency, simplicity, and equity, shifting from direct to indirect taxes and reducing loopholes.	Improve the tax system.	End of August 2019
Submission of an anti-corruption legislation to the National Assembly.	Improve governance and tackle corruption.	End of September 2019
Submission to the National Assembly, in consultation with Fund staff, of amendments to the BCE's legal framework to, among others: grant its autonomy; and ban any direct or indirect (via public banks) financing to the NFPS.	Strengthen the institutional underpinnings of dollarization.	End of September 2019
Submission to IMF staff a plan of arrears clearance.	Strengthen expenditure controls.	End of September 2019
Publication of a plan, in coordination with the World Bank, to strengthen the efficiency and quality of primary education and health spending.	Improve education and health outcomes.	End of September 2019
Submission of a tax reform bill to the National Assembly.	Improve the tax system.	End of September 2019

Past performance is not a guarantee or a reliable indicator of future results. Please see the Notice for important disclosures. Sources: IMF, BCE, Ministerio de Economía y Finanzas, Agencia de Regulación y Control Hidrocarburífero, Haver Analytics, Bloomberg, PGIM Fixed Income

[2] *Estimates and projections contained in the IMF's "Staff Report for the 2019 Article IV Consultation and Request for an Extended Arrangements under the Extended Fund Facility."*

[3] *As per the program's definition, NIR comprise the central bank's (BCE) gross international reserves net of the BCE's reserve-related liabilities to nonresidents (excluding the IMF's lending for budget support) and deposits of domestic commercial banks held at the BCE.*

[4] *As per the program's definition, social spending is the central government's spending on social assistance programs such as the "Human Development Bonus," the "Joaquín Gallegos Lara Bonus," the "Social Registrar," and different pensions schemes.*

[5] *Excluding interest on earlier obligations resulting from the 2008 swap that haven not been claimed by creditors.*

[6] *Gross international reserves (GIR) exclude non-liquid and encumbered assets included in the government's measure of GIR.*

III. DISPATCH FROM QUITO, GUAYAQUIL, AND WASHINGTON, DC

Over the course of the last few weeks, we met with Ecuadorian policymakers, local political and economic analysts, and representatives of the private sector soon after the details of the IMF-backed adjustment and reform program were made public. We also met with IMF staff and rating agencies' sovereign analysts during the IMF-World Bank Spring meetings. We sought to fine tune our views on: (i) the Moreno administration's willingness and ability to advance the adjustments and reforms; (ii) the IMF's general approach to Ecuador; (iii) the degree to which political-economy challenges could thwart the program's execution; (iv) the private sector's attitudes towards the program; and (v) the program's implications on Ecuador's credit ratings. On net, we came away with a constructive view over the prospects of a fruitful implementation of the adjustment and reform agenda, while being more mindful that changes to credit ratings will likely take some time to crystallize.

In our assessment, the commitment of President Moreno's economic team to the program transcends the need to fulfill a set of conditions to secure the financial support of multilaterals. Instead, the team appears to have a genuine interest in "doing the right thing," namely, correcting macroeconomic imbalances, dismantling microeconomic distortions, and providing an institutional framework to anchor those improvements, while being cognizant of the restrictions imposed by Ecuador's vexing political landscape. President Moreno's full backing of his economic team buttresses its wherewithal to pursue such an agenda. The IMF shares the view that the administration's commitment to the program is robust.

FIGURE 7: FISCAL CONSOLIDATION MEASURES

	2019	2020	2021	2019-21
Revenue	**-0.3**	**1.4**	**-0.4**	**0.7**
2019 Tax Reform	0.0	1.4	0.4	1.8
Previously adopted tax changes[7]	-1.2	0.0	0.1	-1.0
Elimination of capital exit tax	0.0	0.0	-0.2	-0.2
Asset monetization (net)[8]	0.8	0.0	-0.8	0.0
Other revenues	0.1	0.1	0.0	0.2
Expenditure	**2.3**	**0.6**	**1.4**	**4.3**
Wages and salaries	0.5	0.3	0.2	1.0
Goods and services	0.5	0.1	0.1	0.8
Other spending	0.0	-0.1	0.0	-0.1
Capital spending[9]	0.0	0.4	0.6	0.9
Fuel subsidies[10]	1.7	-0.1	0.5	2.1
of which: Price change	*1.3*	*-0.1*	*0.0*	*1.2*
Policy Change	*0.4*	*0.0*	*0.5*	*0.9*
Social spending	-0.4	0.0	0.0	-0.4
Total	**2.0**	**2.0**	**1.0**	**5.0**

Sources: Ministry of Finance and IMF staff calculations.

With respect to the fiscal adjustment—the cornerstone of the program—the administration's ability to meet the quantitative targets is strengthened by the buffers it can tap if fiscal consolidation appears to be falling short. Indeed, officials and local analysts note the relatively large portfolio of state-owned assets that could be monetized, as well as the myriad of loopholes that could be closed to complement the tax reform mooring the revenue side of the consolidation effort. On the other hand, the targets set for the accumulation of net international reserves (NIR) might be overly ambitious. Indeed, there may be insufficient progress on easing pressure on reserves amid fiscal consolidation, the tradeable sector's capacity to generate net inflows given the lagged effect of improved competitive measures, and the partial or uncertain repatriation of external assets by the financial sector. The wider current account deficit recorded in 2018 relative to the IMF's estimate reflects a more challenging starting point, feeding the skepticism around the NIR target. Yet, we reckon that the IMF program—and related disbursements—would not be in material jeopardy owing to a potential failure to meet these performance yardsticks. Acknowledging the political and technical constraints that the program faces, the IMF will likely recalibrate targets to more attainable levels, with the strict condition that authorities remain committed to the adjustment and reform agenda and the IMF observes tangible improvements in key macroeconomic metrics. The U.S. Treasury's view of Ecuador as a potential turnaround-from-populism story that could stand in contrast to Venezuela further supports the continued engagement of the Treasury and the IMF with Ecuador.

There are patent challenges to the implementation of the program stemming from Ecuador's intricate political backdrop. First, the popularity of President Lenin Moreno has steadily declined to an approval rating of about 30% since peaking in the early months of the administration

[7] *For 2019, 1 percent of GDP is a one-off effect from tax amnesty collection in 2018, while 0.2 percent of GDP is the effect of other tax changes introduced in 2018.*

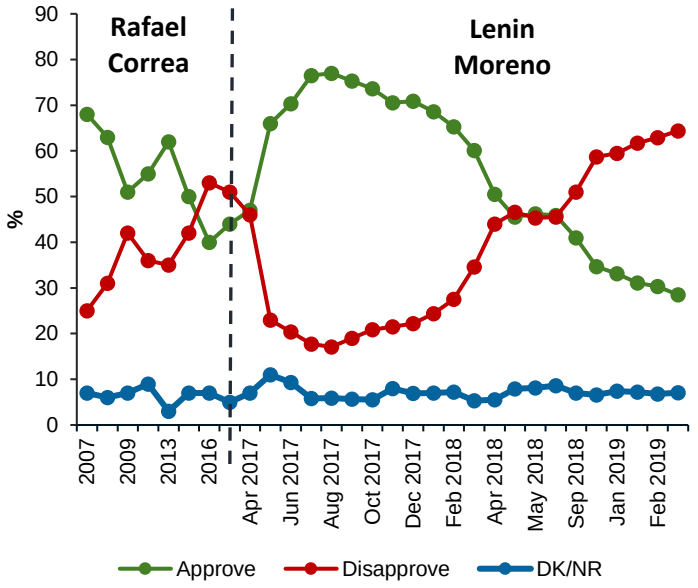
[8] *Refers to revenues from leasing of government assets to private sub-contractors for temporary use and maintenance. For 2019, this includes the proceeds from the concession of the Sopladora hydropower plant. For 2020, it includes the proceeds from the concession of electric lines.*

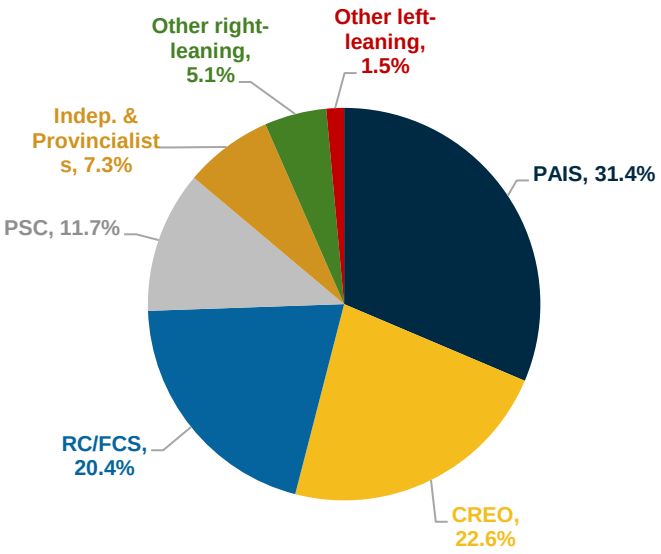
[9] *For 2019, the increase in capital spending following the implementation of the housing program "Casa para Todos" is broadly matched with capital cuts of similar amount in other areas.*

[10] *This includes: (i) increase in the price of retail, domestic and industrial gasoline, (ii) increase in the price of diesel for certain fishing categories, (iii) removal of the subsidies in industrial gas, and (iv) increase in the price of electricity.*

(Figure 8), implying relatively scarce political capital to implement unpopular measures and advance the required legislation through the National Assembly. Second, the composition of the legislature will require that the government, whose PAIS alliance does not hold a majority in the legislature (Figure 9), cobbles together a coalition with parts of the right-leaning opposition (chiefly CREO and/or the PSC) willing to support politically contentious measures. Electoral considerations may increasingly come into play ahead of the 2021 general election. And third, Ecuador has a recent track-record of political upheaval. Indeed, from the mid-1990s until the start of the Correa administration in 2007, Ecuador inaugurated a new president every 18 months on average, some amidst severe economic distress.

FIGURES 8 AND 9: MORENO'S APPROVAL RATINGS AND ECUADOR'S LEGISLATIVE COMPOSITION





Sources: CEDATOS, National Assembly, and PGIM Fixed Income as of April 2019

Ecuador's latest arrangement is the nineteenth IMF-backed program it has adopted since the 1960s, yet it has drawn the full notional amount established at the outset of each program in only six instances. In some cases, countries opt to treat the IMF financing as precautionary and leave it untapped, but in Ecuador's case, failure to keep the program on track and delays in reform implementation prompted the cancellation of the 1994-96 and 2003-04 programs and the ensuing interruption of disbursements. Moreover, Ecuador still bears the stigma resulting from its history of recurrent debt defaults, most recently in 2008 under questionable motives. Together, Ecuador's political environment coupled with its chronic failures with IMF programs and defaults may cast doubts on the prospects for the latest adjustment and reform agenda, whereby in a worst-case scenario, disbursements could be halted, consequently leading to crumbling market confidence and a potential credit event.

Yet, we are of the view that the political-economy hurdles can be overcome, with the pursuit of legislative compromises being a first step. The broad consensus among locals is that President Moreno will not seek reelection in 2021, chiefly due to personal health reasons. This would afford the administration more leeway to pursue potentially unpopular policies as the president's electoral aspirations play a diminished role (however, he may still seek to preserve his party's political standing). Furthermore, in our opinion, the legislative hurdle can also be surmounted despite the prima facie unfavorable configuration of the National Assembly. In particular, the odds that the tax and labor reforms clear the legislative process may increase if both are negotiated simultaneously because they offer features that could pave the way for a quid pro quo between the government and segments of the right-leaning opposition—the latter arguably opposes higher taxes but favors a more flexible labor market. Members of the private sector conveyed that they would support this type of compromise. Moreover, outgoing Guayaquil mayor Jaime Nebot of the right-wing Social Christian Party (PSC) emerged as one of the winners of the local elections held on March 24, 2019 which positions him as an early frontrunner for the 2021 presidential race. According to our local interlocutors, Mr. Nebot is aware of the need to adopt the aforementioned reforms and would be willing to prod his party brethren in the Assembly to reach compromises (even if he publicly opposes some components of the reform agenda) and avoid inheriting a potentially dismal economic situation in the event he is elected president in 2021.

Alternatively, the government can advance the reforms through the legislature via the so-called Law's Ministry (Ministerio de la Ley), which is a legislative mechanism that allows bills to become law if preestablished discussion/negotiation periods expire and the National Assembly fails to garner 2/3 of votes to override the bill's enactment. In case that no compromises can be reached with segments of the opposition, the Moreno administration can resort to this mechanism in order to implement the reforms agreed upon with the IMF. The concomitant negotiation of the tax and labor reforms could hamstring the Assembly's ability to muster the 2/3 threshold insofar as these two reforms further split an already divided opposition.

The private sector will likely remain on the sidelines despite its positive attitude towards the IMF program. Our private sector interlocutors expressed their support for the IMF program, even characterizing it as a credible catalyst that forces the government to "finally get serious." Yet, there appear to be lingering concerns over the long-term sustainability of the adjustments and reforms being implemented. Against this backdrop, private investments will likely remain subdued for some time, thereby constraining their capacity to offset the headwinds to growth owing to the adjustment.

The IMF program materialized later than credit rating agencies expected, leading Moody's and Fitch to revise Ecuador's outlook to negative while maintaining their B3 and B- ratings, respectively. The rating agencies acknowledge the program's positive potential, reckoning that the risk of a credit event has decreased for a while. Yet, they remain concerned over the execution risks and anticipate that some targets will not be met. Ecuador's track-record with IMF programs and defaults further bolsters their skepticism. Insofar as the rating agencies maintain their skepticism towards Ecuador, they may delay upgrades even if the IMF-backed program is implemented with a reasonable degree of success. PGIM Fixed Income's internal rating on Ecuador has an outlook that is slightly more optimistic than those from the rating agencies.

IV. INVESTMENT STRATEGY

We are currently overweight Ecuador in broad EM dedicated accounts, but as active managers, we are always monitoring our positions, and they can change significantly at any time. We have increased the overweight since the IMF program materialized. Our investment thesis is predicated on a baseline view that the Moreno administration will manage to undertake the IMF-backed measures that should improve Ecuador's macroeconomic fundamentals. Nevertheless, we remain vigilant regarding the execution risks that could hamper the adjustment and reform agenda. Policy decisions that are inconsistent with the program's overarching goals could prod us to revisit our exposure to Ecuador.

CONCLUSIONS

While we hold a constructive view of Ecuador's implementation of the IMF-backed adjustment and reform agenda, we are mindful of its challenges. Downside execution risks are latent amidst intricate economic and political constraints that will be tough to overcome. After all, entrenched rent-seeking economic and political structures were created during a populist administration that enjoyed significant financial leeway afforded by high oil prices. Additionally, Ecuador's history with IMF programs and serial defaults set an uncomfortable precedent.

In our view, the Moreno administration has the willingness and capacity to overcome these challenges and implement the adjustment and reform program with a reasonable degree of success. We reckon that that there is room for political compromises. But if these are not achieved, the institutional peculiarities of Ecuador's political system may still enable the Moreno administration to execute the program. We see the depth of the adjustments and reforms as being substantial enough to eventually lead to positive structural shifts in Ecuador's credit ratings and spreads, warranting our current overweight exposure to the credit.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of May 2019.

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