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Ecuador: Waiting for Mr. Correa

Correa promises protectionist policies, but may gain some support for a debt renegotiation instead of a default.

BY CHRONICLE STAFF

Guayaquil, the bustling Pacific port city and Ecuador's main business center, should be full of anxiety these days. After all, the "city's" candidate, banana billionaire Alvaro Noboa, lost the presidential election to a socialist rival 10 days ago. Yet, life goes on as normal and there's even talk of promoting the city as a business-friendly contrast to the rest of the country as it prepares to become more radical.

"Guayaquil is offering zero taxes for 10 years for new energy and infrastructure investments in this area," says a prominent business leader in Guayaquil who declined to be identified. That comes on top of the new, \$450 million deepwater port 100 miles outside the city.

"I heard last night that an American company is considering investing \$300 million in the city," he says.

Such optimism contrasts with the general mood among foreign investors who fear a deteriorating investment climate in Ecuador as a result of the November 26 presidential elections. The winner, Rafael Correa, is promising to implement radical economic policies, which include a possible debt default, more protectionism and a larger state role in the economy.

"Correa has stirred unease in financial markets with his calls to revise foreign oil companies' contracts in Ecuador, renegotiate the nation's foreign debt and expel the World Bank representative," says Jerry Haar, a professor of management and international business and associate director of the Knight Ridder Center for Excellence in Management in the College of Business Administration at Florida International University.

DEFAULT OR RENEGOTIATION?

The debt issue is especially causing anxiety, as a moratorium will affect the private sector as much as the public sector.

"The history of sovereign defaults is that the defaulting country's economy contracts severely because not only is government's credit cut off, but private credit as well," says Mark Cymrot, a partner in the Washington, D.C. office of Baker Hostetler. "The result is increased unemployment, and when the government tries to spend money it does have, inflation grows. I am not aware of any country that has defaulted without contracting its economy."

And ironically, Ecuador would only save less than \$400 million on interest payments next year, a sum it can afford to pay, as planned, according to Haar. "If Correa were to default on the debt, Ecuador would be financially ostracized and the country would save less



CAN WE BE FRIENDS? Ecuador's president-elect Rafael Correa receives U.S. Ambassador Linda Jewel in his office on Friday. (Photo: RafaelCorrea.com)

than \$400 million next year on interest payments," he says. "Ecuador has twice defaulted on its debts in the past 25 years, but can now easily afford to service them."

However, although Correa is threatening to default, it may only be a negotiating strategy aimed at getting better terms on its current debt payments, Cymrot says. And if that's the case, he may be able to succeed, says the lawyer who successfully defended the Republic of Peru in 55 lawsuits in five countries brought by major international banks seeking repayment of more than \$10 billion of sovereign debt.

If Correa were to seek renegotiation of the terms rather than a moratorium, he might be able to succeed, Cymrot says.

"I think there is a general perception in the market that Ecuador didn't get as a good deal as it should have," he says. "The negotiations in Argentina resulted in a much deeper discount. I think there would be an understanding in the market that Ecuador should get some additional relief. If that is the case, a properly structured exchange offer might be successful."

The debt that will be affected includes restructured Global12 and Global30 bonds as well as the last bonds issue, which took place at the end of 2005. "Given Correa's attacks on multilateral institutions, it is also possible that Ecuador could declare a moratorium on its official liabilities contracted with the World Bank," U.S.-based consultancy Global Insight warns. However, loans granted by the Inter-American Development Bank and the Andean Corp. for Development will receive better treatment because their lending sometimes bypasses the central government and is allocated directly to specific projects without state guarantees, the consultancy says.

PROTECTIONIST POLICIES

While a potential debt default is getting most of the attention, it isn't the only issue of concern to business.

"The direction of economic policy will also be a concern," Haar says.

Correa's likely economy minister Ricardo Patiño has stated that the new government will implement protectionist economic and trade policies. "If we have to protect the Ecuadorian economy we will do so," he told *El Comercio* on Friday.

Correa will likely pressure private banks to lower interest rates and fees as well as return to Ecuador the billions of dollars held in reserves abroad. He will also likely reduce the power of the Central Bank, according to Global Insight.

Fiscal policy, which will affect everything from Ecuador's credit ratings to inflation and the stability of its recent dollarization, will also change. With Ecuador enjoying a windfall in oil export revenues thanks to high world prices, there will be substantial pressure on the next government to spend more on social projects, healthcare and education, Haar points out.

Correa has pledged to double the size of a direct subsidy for impoverished people (to US\$212 million), construct 50,000 houses with a direct subsidy of US\$180 million, increase the budget for education by 0.5 percent of GDP (to US\$219 million), and double expenditure on health (to US\$600 million), according to Global Insight.

"He has a record of preferring state spending," Haar says of Correa.

Correa's track record at the finance ministry in 2005 where he oversaw dismantling of a special oil-stabilization fund — designed to be used to manage and channel excess oil revenues to debt repayment — suggests that he would loosen the purse strings, according to Haar.

"This would generate risks to the country's hard-won fiscal stability," he says.

SURPLUS ALLOCATED

Thanks to still-high oil prices, a hydrocarbons reform approved in early 2006, and the takeover of oilfields previously in the hands of American Occidental Petroleum Corp., the overall public sector currently has a large surplus, according to Global Insight. However, these financial resources are allocated to different trust funds, have specific uses, and cannot be included arbitrarily in the fiscal budget, the consultancy says.

"The central government's finances are already in the red, lack the required liquidity, and face increasing arrears that need to be addressed in coming months (most likely, at the beginning of the next presidential period)," Global Insight said in a recent analysis.

Unlike Venezuela, Ecuador does not have enough oil revenue to cover a dramatic boost in public expenditure. Given the aggressive fiscal expansion observed in the last year, and worse prospects for 2007, Ecuador's oil revenue might last just a few quarters without additional borrowing, Global Insight says.

"As long as oil prices remain buoyant, economic heterodoxy may do little visible damage," Haar says. "But a slump could lead to debt default and a messy exit from dollarization."

Dollarization, which was implemented in 2000, has likely helped reduce inflation during the political instability the past few years. Ecuador's inflation went from 96.1 percent in 2000 to 37.7 percent in 2001 and 12.6 in 2002. Last year it reached a historic low of 2.1 percent, which was the lowest in all of Latin America.

But dollarization is not enough to offset any rise in inflation. "I don't think dollarization is a bulletproof protection against inflation," says the Guayquil business leader. "Everyone keeps on jacking up prices."

Ecuador will likely reach 3.3 percent inflation this year, according to the International Monetary Fund. The fund had predicted 3.0 percent next year, but if Ecuador follows Venezuela's example of boosting public expenditure without fiscal prudence, it may end up with the highest inflation in Latin America. (See [Inflation Forecast: Venezuela Worse](#))

ANOTHER OIL POLICY

And in the oil sector, Correa's promises of greater state control could freeze investments by oil companies, Haar warns.

A change in oil policy comes on top of previous changes that have been criticized sharply by foreign oil companies. They include the May expropriation of the Ecuador operations of US-based oil producer Occidental (the top foreign investor in Ecuador at the time) and a new hydrocarbons law approved in April that raises the government take of oil receipts from 20 to 50 percent. Correa has promised to increase that stake further.

The Oxy expropriation led the U.S. government to stop negotiations for a free trade agreement. Ecuadorian exporters had hoped the agreement would be in place before the Andean Trade Preferences and Drug Eradication Act (ATPDEA) expired at the end of this year. The ATPDEA provides dutyfree access for around 5,600 products from Ecuador and the other ATPDEA beneficiaries, Bolivia, Colombia and Peru.

In a letter to the US Congress last month, Correa pledged his support for an extension of the ATPDEA. However, despite his support, it is far from uncertain whether lawmakers will approve it for Ecuador and what will happen if Correa declares a moratorium on debt payments.

"Gaining U.S. Congressional approval to extend the [ATPDEA] beyond 2006 for Ecuador is complicated in the context of an apparently hostile new government," Global Insight says. "Correa's refusal to allow U.S. anti-drug soldiers to remain on the Manta military air base beyond 2009 makes a rapprochement with the United States less likely. "

U.S. lawmakers, expected to vote on the ATPDEA before Christmas, may also be reluctant to grant the trade preferences to a country that subsequently will default on debt to U.S. institutions.

Another possible scenario is that Ecuador gets an extension and that it is then unilaterally lifted by the U.S. government should Correa default.

"Trade preferences are discretionary and a perception that a country is defaulting without a severe fiscal crisis, might cause the U.S. to withdraw the preferences, particularly if the country is expropriating U.S. companies' property," Cymrot says.

Meanwhile, Correa is expected to either leave, or downgrade Ecuador's membership in, the Andean Community (CAN) and instead join Mercosur, the South American common market. That would mean he would follow in the footsteps of Venezuela and its president Hugo Chavez, who left CAN in April. Correa has already secured support from Argentine president Nestor Kirchner for a possible Mercosur bid, according to Global Insight.

POLITICAL MESS

Following years of political instability, including seven presidents in 10 years, Ecuador is now set for yet another round. Correa's party, Alianza Pais (AP) has no seats in the new assembly, where the largest bloc now belongs to his rival Noboa.

"Without a presence in Congress, a functioning democratic government is a slim possibility with the isolated AP in power," Global Insight says.

Speculation is thus growing that Ecuador will see everything from mass protests and strong confrontations between the new government and the national assembly to a departure of Correa before his term ends in 2011.

"Unless Mr Correa proves to be as astute as president as he was as candidate he risks descending as fast as he has risen," says Haar.

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