STANDARD & POOR'S

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Ecuador (Republic of)

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Ecuador (Republic of)

Major Rating Factors

Sovereign Credit Rating
CCC+/Stable/C

Strengths:

- Low debt level, which partly reflects default on global bonds in 2008 and 2009; and
- Macroeconomic stability under dollarization.

Weaknesses:

- A challenging, divisive political environment;
- Poor prospects for growth and private-sector oil production given pervasive uncertainty in "rules of the game;" and
- Limited policy flexibility given dollarization of the economy, fiscal balances dependent on oil, and restricted financing options.

Rationale

Questions surrounding Ecuador's willingness to pay on debt have assumed a prominent role in the country's credit dynamics, and Standard & Poor's Ratings Services expects these uncertainties to continue. In December 2008 and February 2009 the Correa government defaulted on $3.2 billion (6.2% of 2008 GDP) of its Global Bonds. The government considered the 2012 and 2030 Global Bonds "illegitimate" and defaulted based on "willingness" rather than "capacity" to pay. This marked the third time the Ecuadorian government defaulted on the underlying debt with a haircut on face value. The first instance was the issuance of Brady bonds in 1994, and the second was the restructuring of these Brady bonds into the 2012 and 2030 Global Bonds in 2000. In this last default, instead of issuing new bonds, the government bought back outstanding 2012 and 2030 Global Bonds at a 65% discount in a reverse-Dutch auction in May/June 2009.

The low rating on Ecuador reflects the country's challenging political environment--namely its weak institutions--and an unpredictable, divisive political landscape marked by conflicting vested interests along regional and ethnic lines. In sharp contrast with recent Ecuadorian governments characterized by the failure of elected presidents to complete their term in office, President Rafael Correa has maintained significant popular support. During his first term in office, he secured passage of a new constitution via national referendum in September 2008. He was then re-elected as president in April 2009 for a four-year term.

Widespread disillusion with the political class and the country's institutions underpinned support for the National Constituent Assembly (CA) and the new 2008 constitution. Systematic, repeated failures of previous governments to foster sustained economic prosperity and reduce poverty and inequality have led to changes in the nation's economic institutional and legal framework under the new constitution. The failure of prior governments has also reinforced support for the government's controversial economic policies.

We expect a strong deceleration in Ecuador's growth in 2009 and 2010 because of the global recession, lower oil prices, and because the government's default limits access to financing for the private sector. Standard & Poor's projects Ecuador's real GDP to decline 1.5% in 2009, and grow 1% in 2010. Policy uncertainties about the roles of the private sector in the economy--including energy, banking, and telecommunications--exacerbate long-standing weaknesses that limit diversified growth in Ecuador in the next three to five years. As a small, open, commodity-dependent economy, Ecuador's growth is vulnerable to external shocks. Declining oil production by Petroecuador (the government-owned oil company) is not being adequately redressed, and private-sector oil investment is not likely after changes were made to the decree implementing the 2006 hydrocarbons law that increases the government's take from extraordinary profits under existing oil contracts.

Under dollarization, Ecuador's economy has stabilized--a supporting factor for creditworthiness. However, policies to strengthen the dollarization framework have not been enacted by successive governments since dollarization went into effect in 2000. The growing balance of payments pressures and banking sector and fiscal weaknesses could undermine dollarization in the coming years.

The 2008/2009 default further reduced Ecuador's already low debt burden. In 2009 to 2010, we project Ecuador's gross general government debt to be 17% of GDP, and debt net of liquid assets at 11% of GDP. Despite this low level of debt, Ecuador's fiscal accounts suffer from budgetary inflexibility, vulnerability to oil prices, and limited financing options.

Central government payroll, subsidies on pensions, and petroleum derivatives (including cooking gas) constrain room to maneuver. Under President Correa, capital expenditure more than doubled in 2008; this reflected pre-electoral spending when oil prices were favorable. Rigid expenditures impair Ecuador's ability to absorb a reduction in oil revenues, which were almost 40% of revenue in 2008, but are projected to fall sharply this year.

The government's financing options are essentially limited to the local social security institute (IESS) and multilateral creditors Corporación Andina de Fomento (CAF), Fondo Latinoamericano de Reserva (FLAR), and the Inter-American Development Bank (IADB). The government last tapped global capital markets in December 2005. Considering their unwillingness to pay on debt, which led to their 2008/2009 default, we do not expect Ecuador to have access to the international capital markets for at least the next two years.

Outlook

The stable outlook underscores the evenly balanced pressures on the rating. Creditworthiness could improve if consistent policy signals restore confidence and strengthen the outlook for investment and growth prospects in the next three to five years, which would, in turn, improve the outlook for more predictable access to financing. If Ecuador's willingness to pay on the only outstanding global bond (the Global 2015s) deteriorates, spending does not adjust in line with sustained low oil prices, or limited financing alternatives become even more scarce, we could lower the rating or revise the outlook to negative.

Table 1

Republic Of Ecuador--Selected Indicators

	--Year ended Dec. 31--					
(%, unless otherwise noted)	**2005**	**2006**	**2007**	**2008**	**2009e**	**2010f**
GDP per capita (US$)	2,817	3,130	3,397	3,900	3,949	4,175
Real GDP (% change)	6.0	3.9	2.5	6.5	(1.5)	1.0
Real GDP per capita (% change)	3.8	2.8	1.4	6.5	(2.6)	(0.3)
Consumer Price Index average annual rate (% change)	2.1	3.3	2.3	8.4	4.0	4.0

Table 1

Republic Of Ecuador--Selected Indicators (cont.)						
Central government balance/GDP	(0.5)	(0.2)	(0.3)	(1.2)	(2.5)	(1.7)
Central government primary balance/GDP	1.8	2.0	1.7	0.3	(1.5)	(0.7)
Net central government debt/GDP	23.1	17.3	16.7	14.3	10.3	10.7
Central government interest/central government revenue	14.1	13.7	10.8	5.8	5.2	5.7
Net public sector external debt/CAR	61.4	47.2	37.0	24.4	31.9	34.3
Net banking sector external debt/CAR	(16.3)	(14.3)	(17.8)	(15.2)	(18.6)	(14.3)
Net nonbank private debt/CAR	18.2	14.6	10.1	7.3	9.5	13.5

e--Estimate. F--Forecast. CAR--Current account receipts.

Comparative Analysis: Political Uncertainties And Economies Dependent On Commodities

- Political uncertainty and weak institutions have underpinned unpredictable policy in Ecuador, as in similarly rated credits.
- Ecuador's fiscal debt compares favorably with those of its peers, especially following its default, but budgetary rigidities and limited financing options impair fiscal flexibility.
- Ecuador's growth depends on commodities, similar to many peers. Growth prospects are somewhat uncertain as a result of the new constitution and problems in the oil sector.

Volatile political environment and weak institutions characterize Ecuador and its peers

A common characteristic of 'B' and 'CCC' credits is that political factors provide an important source of uncertainty. Given the underlying political weaknesses and unpredictable political dynamics, Ecuador and most of its peers have a limited capacity and/or willingness to redress long-standing fiscal and/or economic weaknesses. This is certainly the case for Ecuador, where the absence of broad political support and effective institutions has manifested itself in political stalemates and/or crises that have stymied effective, consistent policy implementation during recent history. Questions surrounding "willingness to pay" have and are expected to continue to assume a prominent role in Ecuador's credit dynamics.

In addition, for Ecuador and a number of its peer credits, the military has at times stepped in to prematurely end a government's mandate and facilitate political transition. These countries include the Republic of Bolivia (foreign currency sovereign credit rating: B-/Stable/C, local currency ratings: B-/Stable/C), the Islamic Republic of Pakistan (foreign: B-/Stable/C, local: B/Stable/C), the Republic of Argentina (foreign: B-/Stable/C, local: B-/Stable/C), Ukraine (foreign: CCC+/Positive/C, local: B-/Positive/C), the Republic of Honduras (foreign: B/Stable/B, local: B/Stable/B), and the higher-rated Bolivarian Republic of Venezuela (foreign: BB-/Negative/B, local: BB-/Negative/B).

Ecuador and some of its peers are struggling to strengthen democracy, or rather, to put in place more representative governments and broaden economic prosperity to deal with poverty, income inequality, and widespread disenchantment with the traditional political class. In Ecuador, Bolivia, and Venezuela, the traditional political and economic elite of Spanish ancestry have been discredited. Poverty is concentrated in the indigenous and historically less enfranchised population. Repeated policy failure and corruption led to the rise of such political outsiders as Presidents Evo Morales of Bolivia, Rafael Correa, and Hugo Chavez of Venezuela. Each ran on the platform of reconstructing their nation's political frameworks through Constituent Assemblies.

In all three countries, political upheaval has undermined predictable policy. After the ouster of President Lucio Gutiérrez under interim President Alfredo Palacio, President Correa moved onto the national stage. The charismatic former finance minister garnered popular support and ran on a platform of changing the constitution, reforming the economy to redress unemployment and underemployment, and prioritizing social spending over debt service.

President Chavez has significantly polarized Venezuelan society with his authoritarian style of governance and attacks on the interests of the traditional elite. With a core support base of 40% of the population, he has successfully consolidated power across branches of government and eroded Venezuela's system of democratic checks and balances. Established property rights and rules of the game have been overturned.

In Bolivia, discontent with political and economic conditions facilitated the rise of antisystemic, indigenous-led movements culminating in the election of President Morales in December 2005. Somewhat similar to Alianza Pais in Ecuador, Movimiento al Socialismo (MAS) is not a coherent party but a collection of interests, some with more radical views than President Morales. As in Ecuador and Venezuela, policy entails a greater role of the state and undoing terms of previously negotiated contracts.

Institutional insecurity has long characterized Pakistan with frequent military interventions, internal terrorism, and civil strife. In Ukraine political instability, characterized by sharp disagreements within the governing class and frequent disputes with the Russian Federation, has undermined policy predictability as well.

Jamaica's (foreign: CCC+/Negative/C, local: CCC+/Negative/C) institutions are more solid than Ecuador's, and the country has clear democratic transfers of power and a strong commitment to pay the government's debts despite the high debt burden.

Honduras' political stability has been undermined by the coup d'état in June 2009 and the deterioration in relations with the government's main trading partners. This has exacerbated the country's historically weak institutions and lack of checks and balances.

Political uncertainty in Grenada (foreign: B-/Stable/C, local: B-/Stable/C) is associated with discontent with mismanagement and a lack of transparency. However, the absence of social unrest reflects somewhat greater strength in the institutional frameworks compared with other 'B' peers, including Ecuador and Bolivia.

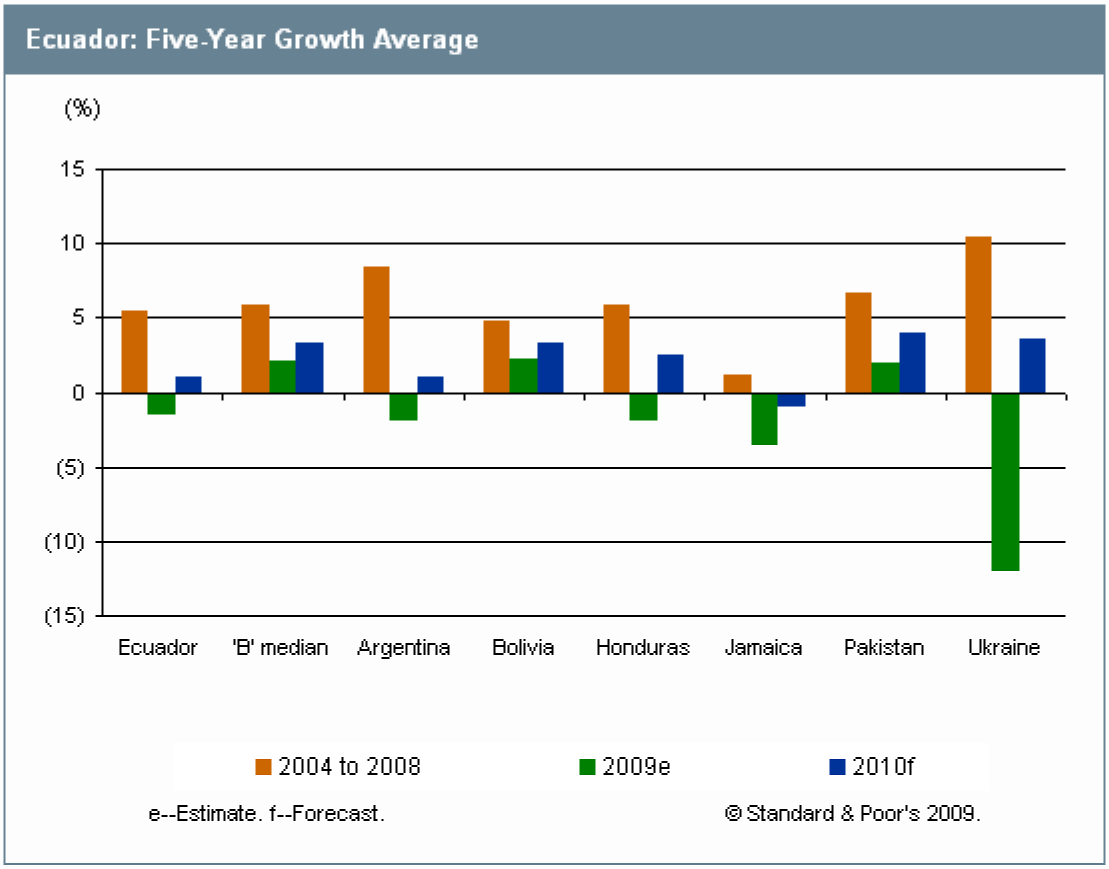
Among these peers, Ecuador fares the worst in terms of perceptions of public-sector corruption. This has no doubt contributed to the disillusionment of Ecuador's electorate with the political establishment. According to the 2008 Transparency International Corruption Perceptions Index, Ecuador ranks 151 of 180 (with 1 being the best and 180 the worst). Other peers are ranked as follows: Venezuela, 158; Pakistan and the Ukraine, 134; Honduras, 126, Argentina, 109; Bolivia, 102; and Jamaica, 96.

Weak or undiversified bases for growth similar to peers

The economies of Ecuador and a number of its peers are not well diversified, and there tend to be widespread income disparities. These economies are dependent on commodities and/or vulnerable to changing global conditions for finance or tourism. The failure to more evenly distribute the benefits of growth has contributed to the various political pressures in each country and an unpredictable political dynamic. In recent years, strong global growth supported economic activity in these countries and permitted more political room for maneuver (see chart 1).

However, we project growth to be lower in the next several years, which could exacerbate institutional weaknesses in these countries.

Chart 1



Ecuador and a number of its peers (especially Bolivia and Venezuela) have bountiful and diverse natural resources that, if developed under prudent macroeconomic policy conditions, would generate robust growth. The same holds true for growth in the non-commodity sector under stable and strengthened policies. A good example of this is prudently managing hydrocarbon revenue in a countercyclical manner and instituting a hydrocarbon sector policy that entails takes better advantage of private-sector technological know-how and capital. Pakistan depends heavily on textiles, Jamaica on tourism, and Ukraine on steel, which highlights the limited diversity of their economies.

Problematic fiscal stances at lower rating levels

A legacy of poor fiscal management and the pressures of a high debt burden led Ecuador to default in 1999, the first sovereign to default on Brady debt. Following the 40% haircut embedded in the 2000 restructuring, subsequent economic stabilization and favorable oil prices enabled various governments to reduce debt further. Despite having among the lowest net general government debt-to-GDP ratio and interest-to-revenue burden among its peers, the government defaulted on the global bonds it issued in 2000 (see charts 2 and 3). Even before coming to office, President Correa highlighted the burden of Ecuador's debt and raised questions of the legitimacy of some debt. We project that Ecuador's net debt will decline to 11% post-default in 2009 from 15% of GDP in 2008. In comparison, the 'B' median net debt is 30% of GDP. Only peer Venezuela has a similarly low debt level. Ukraine's debt is increasing amid economic distress and devaluation of its currency from its formerly low base. Jamaica has the highest debt burdens of these peers.

Chart 2

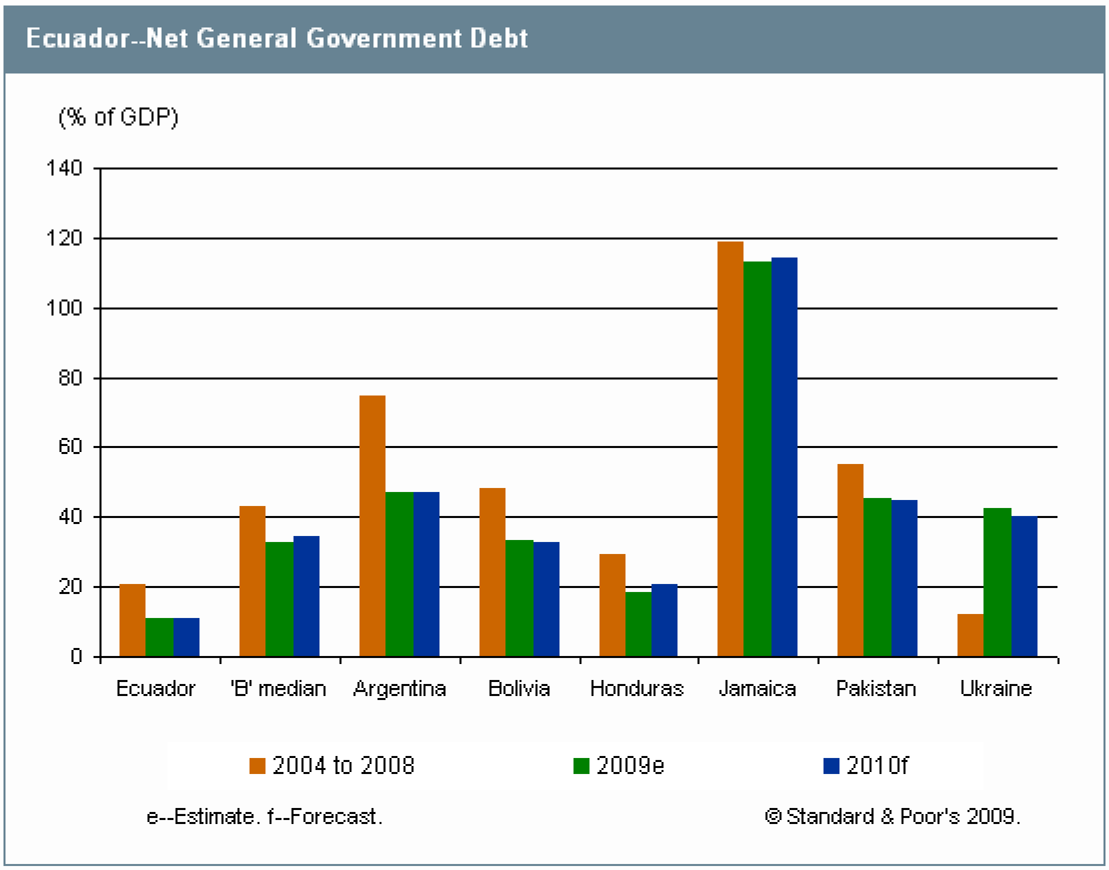
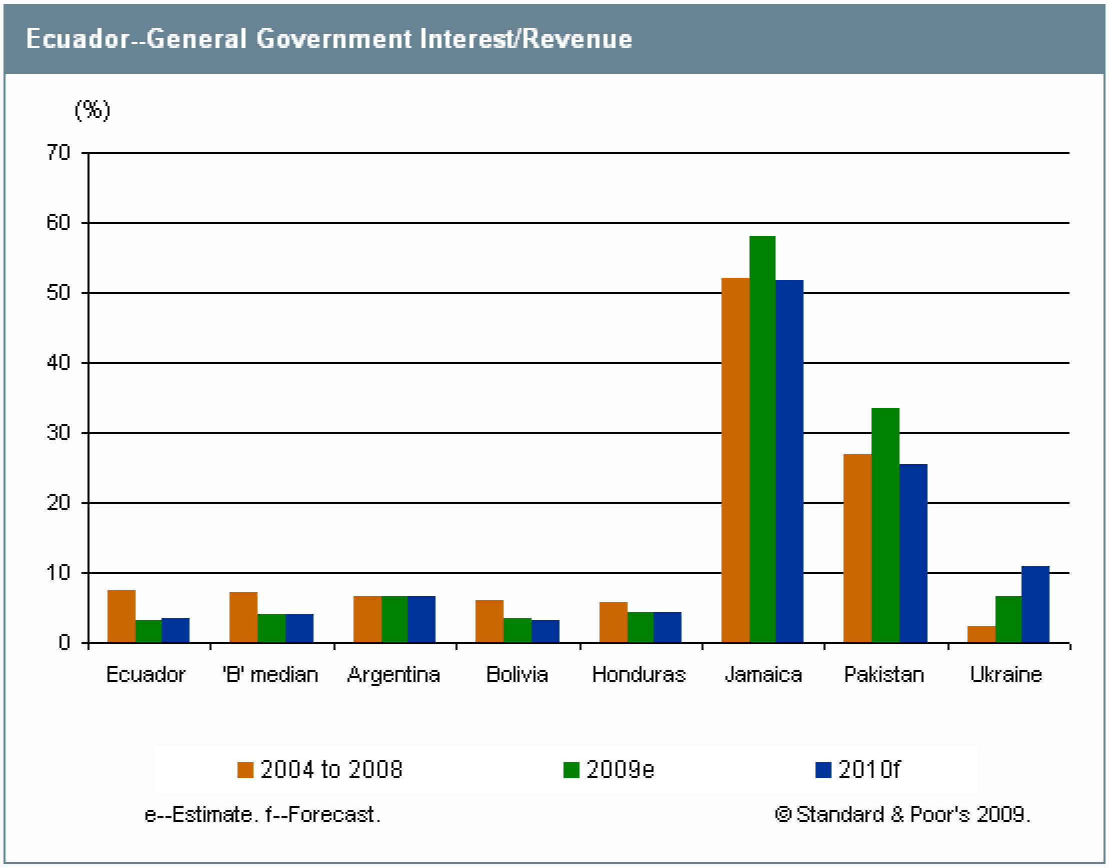


Chart 3



Ecuador's has and has had comparatively stronger fiscal balances vis-à-vis most of its peers. The low deficits mask budgetary vulnerability. Tax and expenditure rigidities include a high public-sector payroll, poorly targeted subsidies for refined petroleum products, other subsidies, and earmarked revenue. Like Bolivia and Venezuela, a significant portion of Ecuador's central government revenue depends on oil revenue. In contrast with Bolivia (for gas) and Venezuela, the benefits from high oil prices accruing to Ecuador's fiscal accounts are muted by the fact it imports a significant portion of subsidized refined oil products.

In addition, Ecuador's low imbalances reflect has more limited financing options that most peers given the harder budget constraint implied by dollarization. Furthermore, private-sector appetite global or locally issued debt is almost nonexistent given its legacy of default; the government last tapped global markets in December 2005. Comparatively limited financing options are common for very low speculative-grade credits. Most do not tap international capital markets and instead rely on a combination of local market and official creditor financing. Argentina has only issued locally since its default in 2001. Bolivia's external debt (on which it has received significant debt relief) is with multilateral and bilateral creditors. Argentina can only issue in local markets. As with many sovereigns in the 'B' and 'CCC' categories, Ukraine and Pakistan are now largely dependent on multilateral creditors.

Political Environment: A Volatile Landscape

- An unpredictable political climate reflects conflicting vested interests, regional divisiveness, corruption, and poverty.
- President Correa's first-round presidential win in April 2009 reflected his popular support and a discredited opposition, both of which give him extensive policy discretion.
- A new constitution was approved in 2008 consolidates the power of the executive.

Recent debt default was a question of willingness rather than ability

A government commission issued a report on illegitimate debt in late November 2008 that indicated irregularities and possible fraud in the government's 2012 and 2030 Global Bonds. Soon after, the government went into arrears awaiting a decision and ultimately defaulted on the 2012 and 2030 Global Bonds. The government's remaining 2015 Global Bond, however, was deemed legitimate. Questions regarding willingness to service debt payments will continue. The default led to fears of a bank run, and questioned the sustainability of dollarization, especially considering the low oil prices and high fiscal spending taking place at year-end 2008. In addition, the default limited access to multilateral banks.

President Correa's economic policy is more interventionist those of his predecessors and gives the state increased control over the private sector. For example, Correa has raised taxes on capital outflows to 2% from 1%, and enhanced import controls by imposing new tariffs on 1,346 import items from Colombia. President Correa also declared that if international oil prices continued to rise, he would increase public investment expenditure to $3.8 billion in the second half of 2009 from about $2.8 billion.

Correa will ride strong at start of second term

Correa will enjoy greater powers under the recently approved constitution, which allows the president to dissolve congress once during his four-year mandate and gives the president absolute freedom to call popular referenda to introduce reforms and changes without prior authorization from congress. President Correa will also have control over the new National Assembly, where the ruling Alianza Pais party will enjoy a majority in alliance with a number of smaller parties. This majority gives Correa relative freedom to set a legislative agenda that will continue to be heavily interventionist. Correa is in a strong position, but his staying power in the longer run will be tested by a heterogeneous and poorly disciplined governing coalition and a challenging economic outlook marred by low investor confidence and limited access to international funding.

Bilateral relations with Colombia continue to be difficult

Presidents Correa and Colombian President Alvaro Uribe have regularly exchanged barbs since both countries cut diplomatic ties in March 2008 following a military incursion into Ecuador to track down and kill high level FARC members in the country. Commercial relations have also suffered following Ecuador's decision in August to impose import duties on hundreds of Colombian goods and the Colombian government's threat to retaliate in kind. A solution to this conflict is nowhere in sight.

The government wants to increase its participation in oil, mining, and energy-related activities and is analyzing all contracts signed with private-sector companies in areas that the government deems as "strategic" (oil, mining, and energy-related). The government has indicated that it will revoke any contract that presents "irregularities" or that does not benefit the country's interests. The government also intends to give priority to strategic alliances with other state companies, especially Latin American companies. Oil production averaged 495,000 barrels per day (bpd) in the first half of 2009, down 2.6% year over year. Meanwhile, Petroecuador produced 57% of Ecuador's total output in the first half of 2009, up from 52% in the first half of 2008. The government seized control of French oil company Perenco's assets in July 2009. Perenco, which produced roughly 22,000 bpd or approximately 5% of Ecuador's total oil production, was in the middle of a tax dispute with the government that long threatened to result in a state takeover. The company had been protesting the government's decision to raise the windfall tax to 99% from 50% in October 2007, refused to pay the extra tax, and filed for international arbitration. Perenco had been threatening to halt operations after the government began to seize the company's oil production earlier this year and attempted to sell it in the spot market as payment. Correa's push for greater state control will continue to create a great deal of uncertainty and poses a threat to oil production, which has already fallen to about 485,000 bpd in May 2009 from about 515,000 bpd when he assumed office at the start of 2007.

Volatile political landscape

Ecuadorian politics have been characterized by instability, regional divisiveness, and the absence of entrenched and predictable institutions. Since the end of military rule in 1979, successive civilian governments have alternated between populist and centrist-left parties. The last three elected presidents before President Correa were forced from office before the end of their terms via questionable congressional means and/or the military.

Regional divisions are significant. The Ecuadorian coast favors small government and minimal taxation; it views the Quito-based political class as living off its productivity and favors sovereignty in the extreme. The Sierra region disdains perceived corruption and tax evasion by the coast. The Amazon region feels it has not received the appropriate benefits associated with oil production from its region. In general, oil wealth has supported a culture of entitlement that has complicated reform efforts and facilitated corruption. The indigenous community, about one-quarter of the population, has been politically marginalized.

Politics tend to be personality based, with parties led by strong individuals. As those individuals have become discredited, so have their parties. During the mandate of Mr. Gutierrez widespread disdain with the entire political establishment peaked as the nation not only called for his ouster but also the dismissal of Congress. The support for President Correa is greater than that for the Alianza Pais movement. As a presidential candidate, Mr. Correa founded the Alianza Pais, which did not run any congressional candidates during the 2006 election, although it allied with other parties. This in effect facilitated his efforts to circumvent Congress and formally support its dissolution and the formation of a CA in 2007 to transform Ecuador's political system.

Profound change under President Correa

A charismatic political outsider promising to reform Ecuador's economy and political system, Mr. Correa came from behind to win the second round of the 2006 presidential elections with 57% of the votes. Then in April 2009, he was re-elected with 52% of the votes in a first-round victory, the first instance in which a candidate has won in the first round in the last 30 years of democracy. His vision that Ecuador's political and economic system has corroded amid widespread vested interests and corruption engenders broad support. Mr. Correa spearheaded efforts for the CA to draft a new constitution.

The president has in effect a great deal of policy discretion. In fact, policymaking is being concentrated in SENPLADES (the technical agency in charge of national planning) to in effect circumvent the traditional bureaucracy in lower ranks in various ministries.

Mr. Correa wants to render Ecuador less dependent on both private and foreign investment. He supports a greater role of the state in the economy to ensure that the benefits of economic growth translate into lower underemployment and unemployment, poverty, and inequality. With the stroke of a pen, in October 2007, he raised the state's take from extraordinary oil revenues under production-sharing agreements to 99% from 50%, as permitted by law, without prior discussion with the private sector. He supports renegotiating the relationship between the public and private sectors in existing public-private-sector partnerships (PPPs) and has taken issue with various concessions. The president questioned the servicing of illegitimate debt that ultimately led to default on two of its international bond, and of debt in general amid a crisis. In addition, he does not support dollarization, but he has no current plans to abandon the system.

In terms of international relations, Mr. Correa supports stronger regional ties and the formation of the Bank of the South. Although relations with multilateral agencies became strained, they are improving as of late. Bilateral trade discussions with the U.S. vis-à-vis extension of the Andean Trade Preference Expansion Act are mixed. Ecuador has rejoined OPEC, and does not accept international arbitration under the World Bank's International Centre for Settlement of Investment Disputes.

Economic Prospects: First Drop In GDP Growth Since 2000

- Given the uncertain climate for private investment and global recession, Ecuador is experiencing its first drop in growth since 2000.
- As a small, commodity-dependent economy with exports of about 35% of GDP, Ecuador is vulnerable to external shocks.
- The medium-term prospects for increasing oil production look poor.

Commodity-based economic structure

Ecuador's economy is commodity-based and vulnerable to external shocks. Nearly one-third of GDP is agro/mineral-based and most manufacturing is related to the processing of raw materials or textiles. Strong potential exists for additional agricultural diversification beyond shrimp, bananas, tuna, and flowers. The potential exists for development in mining (currently less than 1% of GDP), including gold, copper, lead, and zinc.

The oil sector requires additional investment to boost growth

Following the completion of Ecuador's second oil pipeline in late 2003, oil exports have accounted for more than 50% of exports since 2004. They generate 30% to 40% of central government revenue, including transfers from the various oil funds. Disappointing drilling results, inadequate maintenance, poor management practices, an inadequate investment budget, and reported corruption have limited investment by Petroecuador. As a result, oil production has been on a secular decline. Petroecuador now accounts for more than half of Ecuador's total oil production but only after the government took over Block 15, which was formerly operated by Occidental Petroleum Corp.

Given the state of management at Petroecuador, private-sector investment is crucial for Ecuador to maintain the current level of production, let alone raise its production potential. Such investment is unlikely to be forthcoming because President Correa instead seeks to limit private-sector participation to production service contracts. The "99/1 rule" for production-sharing contacts, which raises the windfall tax on extraordinary oil revenues to 99%, is one of many setbacks for private investment: a still-pending value—added tax dispute with oil companies, the increased government take from extraordinary revenues, the takeover of Oxy's Block 15, and the assumption of operations of Citi Oriente for failure to pay according to the 50% rule. We expect a slow decline in production to continue, notwithstanding Ecuador's return to OPEC. Prospects are further clouded by periodic production stoppages in the Amazon region and uncertainty about how and whether the most prolific oil fields operated by Petroecuador might be developed.

Table 2

Ecuador--Economic Indicators

	--Year ended Dec. 31--					
(% change)	**2005**	**2006**	**2007**	**2008**	**2009e**	**2010f**
GDP per capita (US$)	3.8	2.8	1.4	6.5	(2.6)	(0.3)
Real GDP	6.0	3.9	2.5	6.5	(1.5)	1.0
Real GDP per capita	3.8	2.8	1.4	6.5	(2.6)	(0.3)
Unemployment rate (%)	10.7	10.1	8.8	8.5	9.3	10.0
Consumer prices	2.1	3.3	2.3	8.4	4.0	4.0
Domestic credit growth (%)	22.5	15.1	13.9	23.8	2.4	7.1
Domestic credit/GDP (%)	23.1	23.7	24.6	26.5	26.5	26.5

e--Estimate. f--Forecast.

Weak growth prospects amid uncertainty

Standard & Poor's projects Ecuador's real GDP growth to fall by 1.5% in 2009 and is projected at about 1% to 2.5% in 2010 to 2011. Average real GDP growth was 5.1% per year during 2002 to 2006 (see table 2). The marked deceleration in growth reflects the combination of stagnant investment amid unclear and constantly changing laws and regulations, and a falloff in oil and non-oil exports. Oil exports were down in the first half of the year in terms of prices and volumes. In addition, the growth in non-oil exports has decelerated sharply from last year.

Productivity in Ecuador's economy has been under pressure since the initial exchange-rate gains under dollarization dissipated. Private-sector productivity remains constrained by a shortage of skilled labor, human capital flight, physical infrastructure needs, and non-competitive electricity sector costs. If President Correa's plans to expand the country's hydroelectric energy supply and road network are realized, growth and productivity should benefit. Other measures to improve productivity, such as via a smaller, more efficient government and increased labor market flexibility, are unlikely. Finally, the government is keen to lower costs in the banking sector, but through a problematic banking sector reform law instead of through enhanced competition.

Risks to growth include a decline in oil prices and uncertainty about Ecuador's economic model. President Correa's various controversial policy proposals have undermined the climate for private investment. Pervasive uncertainty is likely to persist. The dollarization framework has provided an important anchor for consumption and investment decisions, but questioning this framework is also problematic for the outlook for the next three to five years.

Fiscal Flexibility: Defaults Improve Debt Profile, But Limit Financing Options

- Persistent changes in Ecuador's fiscal rules.
- Low fiscal imbalances and net general government debt of less than 15% of GDP mask widespread fiscal rigidities.

- Improved debt profile as a result of recent defaults, but limited financing options.

Changing nature of fiscal policy guidelines

To support dollarization, Ecuador established a fiscal institutional framework. It passed a fiscal responsibility law in 2002 that put parameters on fiscal management to strengthen medium-term fiscal performance. The law stipulated limits on growth in primary (noninterest) spending, the size of the non-oil fiscal deficit, and a declining path for the debt–to-GDP ratio. Heavy crude oil revenue (from the second oil pipeline) was shifted off-budget to an oil fund named Fondo de Estabilización, Inversión Social, y Reducción del Endeudamiento Publico (FEIREP), which financed certain social spending, an emergency fund, and debt buybacks.

These rules, however, have not been consistently implemented, but have been changed on various occasions, first under President Palacio led by then-Finance Minister Correa, and subsequently under the Correa government. Modifications include more flexible spending limits, lower funds for debt reduction, and the creation of various oil funds with different purposes.

President Correa has moved most of the off-budget oil revenues onto the budget. This is detrimental to medium-term fiscal management. However, all recent governments have continued to run extremely procyclical fiscal policy. In the meantime, allowing easier access to the funds while continuing to treat them as capital revenue would actually improve fiscal transparency.

Table 3

Ecuador--Fiscal Indicators

	--Year ended Dec. 31--					
	2005	**2006**	**2007**	**2008**	**2009e**	**2010f**
(as a % of nominal GDP)						
Central government balance	(0.5)	(0.2)	(0.3)	(1.2)	(2.5)	(1.7)
Central government primary balance	1.8	2.0	1.7	0.3	(1.5)	(0.7)
Central government debt	33.0	27.2	26.4	21.3	16.2	16.2
Net central government debt	23.1	17.3	16.7	14.3	10.3	10.7
Public sector debt	35.4	29.5	28.5	23.2	18.0	17.9
Net public sector debt	24.9	19.0	18.8	16.1	12.1	12.4
(as a % of central government revenue)						
Central government balance	(3.0)	(1.3)	(1.6)	(4.5)	(13.0)	(9.4)
Central government interest expense	14.1	13.7	10.8	5.8	5.2	5.7

e--Estimate. f--Forecast.

Fiscal performance characterized by low deficits

Ecuador's fiscal performance deteriorated significantly in 2008 to 2009, reflecting falling revenues partly related to both oil prices and production, and increases in spending (some related to the election cycle) despite limited financing options. The central government deficit averaged 0.6% of GDP from 2002 to 2007, and weakened to a deficit of 1.2% in 2008 (see table 3). We expect Ecuador's deficit to rise to 2.5% in 2009, and reach 1.7% in 2010, mainly as a result of a lack of financing options.

The Correa government has implemented an expansionary policy with plans to markedly increase social and investment spending in 2009, despite the government's limited capacity to undertake large investment projects.

Despite increased spending, Standard & Poor's expects a modest decrease in the deficit in 2010 because of the government's lack of financing options.

Fiscal rigidities imply need for reform

Reducing expenditure rigidities would render Ecuador's fiscal accounts more compatible with the dollarization framework. About 85% of central government spending is non-discretionary, with the largest category being payroll, which accounts for 40% of revenue. About 25% of spending is on subsidies, many poorly targeted, such as cooking gas and pensions, and a similar amount of spending is earmarked. The elimination of revenue earmarking and the reduction of tax incentives that are--in effect--loopholes is warranted, but have systematically failed to progress in Congress given strong vested interests.

Lower debt burden and better profile, but financing alternatives are still limited

We project net central government debt to be 11% of GDP in 2009 to 2010. Net central government debt was 70% in 2000 and almost 175% in 1999. In addition to debt relief and defaults, the decline in debt reflects recovery in nominal GDP, primary surpluses, and net repayment of external official debt. The interest burden has declined as well; central government interest/revenue is projected at 5.6% in 2009 and 11% in 2007, versus 30% in 2000 and more than 40% in 1999.

Despite a reduced debt burden since default, satisfying financing needs has not been easy. Local private-sector participants have limited interest in government paper since the 1999 crisis. Only the social security fund (IESS) and other government entities purchase local paper. Except for CAF, disbursement from multilateral creditors has been uneven.

Uncertainty about willingness to pay became more acute in early 2007 after President Correa took office. A commission to investigate the legitimacy of debt (both official and non-official) reported results in November 2008, eventually leading to cessation of payments in December 2008 and ultimate default in 2009.

Off-budget and contingent liabilities

Nonfinancial public-sector enterprises tend to run modest surpluses on balance, but are undercapitalized. Standard & Poor's assumes nonperforming loans would reach 50% to 70% of total loans in a reasonable recession or stress scenario. With domestic credit at 26% of GDP, this generates potential contingent liability of 13% to 18% of GDP for the sovereign. Other potential liabilities that could increase debt of the central government include liabilities to the IESS, electric generators/distributors, and possibly private-sector oil companies.

Monetary Policy: Credit Growth Could Slow Because Of Uncertain Economic Policies

- Inflation is projected to average 4% in 2009 to 2010, near that of trading partners.
- Uncertain policy prospect threatens potential for increased lending.
- Risk to the banking system and dollarization in the next three to five years.

Stabilization of inflation under dollarization

Ecuador's monetary and exchange-rate regime underwent dramatic change in 2000 when, amid a crisis, the government adopted the U.S. dollar as legal tender. Since then, inflation fell dramatically from 96% in 2000 to an annual average of 2.6% during 2004 to 2007, near that of trading partners. The sharp rise in commodity prices brought inflation to 8.4% in 2008. However, we project annual inflation to average 4% in 2009 to 2010.

Under dollarization, the central bank has no control over the money supply, which is determined by balance-of-payment flows. Without the ability to inject discretionary liquidity, the central bank also lost its role as "lender of last resort" for the banking system. Ecuador's international reserves include required reserves of the banking system held at the central bank, which, although limited, provide an important form of liquidity for the banking system.

President Correa opposes dollarization, but indicated that there are no plans for a change during the current administration. With a sharp drop in oil prices, it would not be surprising to see change in the policy. The government could in effect issue a parallel currency concurrent with lower revenue.

Banking system limited lending

Ecuador's banking system has consolidated since the crisis; the four largest banks account for almost 60% of assets and deposits. The system has enjoyed steady deposit and credit growth during the past several years following the crisis and the switch to dollarization. Credit bottomed at 18.9% of GDP in 2003, but has grown at an average annual rate of nearly 18% during 2004 to 2008, rising to 26% of GDP in 2009. However, Standard & Poor's expects the pace of growth to slow significantly in 2009 to 2010 as a result of general uncertainty about economic policy and the possibility of measures detrimental to the banking system. Standard & Poor's expects average growth of 5% in 2009 and 2010.

In 2007, the government passed a law aimed at bringing down costs in the banking system by establishing maximum rates and eliminating commissions. Additional intervention occurred in 2009, including a requirement that banks bring onshore liquid assets held abroad.

According to official data, nonperforming loans were 5% of total credit to the private sector as of August 2009. However, this may understate problem credit. The banking system suffers from a poor payment culture; historically, debtors have selectively chosen to repay loans to private, but not public, banks looking for a bailout. The difficulty in recovering loans and collateral leads banks to roll over, or "evergreen," problem loans and fully provision for them, which raises lending costs.

External Finances: Low Oil Prices And A Lack Of Financing Options Limit Liquidity

- Ecuador's dependence on and vulnerability to oil and commodity exports volatilize its current account position.
- We estimate the current account deficit will rise sharply in 2009 to 7% of GDP, and only fall marginally in 2010 as a result of lower oil prices and production, which could cause a drop in exports and remittances.
- We project external debt as a share of current account receipts, net of liquid assets, to be 45% to 55% in 2009to 2010, compared with 120% in 2004.

Table 4

Ecuador--External Indicators

	--Year ended Dec. 31--					
	2005	2006	2007	2008	2009e	2010f
(as a % of nominal GDP)						
Current account receipts (CAR)	37.3	40.8	41.5	43.8	29.4	29.5
Trade balance	1.1	3.1	3.1	2.0	(7.0)	(4.5)
Current account	(0.1)	2.8	2.7	1.7	(7.0)	(4.5)
Net foreign direct investment	1.3	0.7	0.4	1.9	0.9	0.9
(as a % of CAR, unless otherwise indicated)						
Trade balance	2.8	7.7	7.4	4.5	(23.8)	(15.1)
Current account balance	(0.2)	6.8	6.4	3.8	(23.7)	(15.2)
Total external debt	124.4	100.4	92.0	73.0	89.2	84.8
Narrow net external debt	86.6	68.4	50.7	34.2	48.1	52.3
Net public sector external debt	61.4	47.2	37.0	24.4	31.9	34.3
Gross financing requirement/reserves plus CAR (%)	118.7	109.4	110.4	102.5	121.1	125.2
Debt service (excluding short term)	19.1	14.8	14.4	10.2	12.5	11.5
Debt service (including short-term)	38.6	36.7	35.5	27.4	37.1	34.0

e--Estimate. f--Forecast.

External liquidity dependent on oil production and prices

Standard & Poor's estimates Ecuador's current account balance will drop sharply in 2009 and 2010 in line with a pronounced decline in the trade surplus (see table 4). The strength of petroleum and other commodity prices, as well as the U.S. dollar, are key to Ecuador's trade performance.

We expect the trade deficit to be about 7% of GDP in 2009, a sharp deterioration from the 2% of GDP surplus in 2008. The decline reflects the combination of a nominal decline in oil exports (owing to comparatively unfavorable prices in the first half of 2009 year and lower average production), and the mediocre performance of non-oil exports. We project that oil exports will modestly recover in 2010 as production somewhat stabilizes and prices are likely to be more supportive.

More than 50% of Ecuador's exports are oil-related. Other important exports are also commodities: shrimp, bananas, coffee, and nontraditional commodities, including flowers and tuna (which have become more important). About 40% of exports are to the U.S. and 25% to Latin America. ATPDEA has been extended for six months in 2009 (until Dec. 31), although prospects for its renewal afterward are unclear.

Although the income and services accounts register a sizable deficit of about $3.5 billion, this is mitigated in part by a large inflow of transfer payments. Remittances from Ecuadoreans living abroad account for about 85% of all transfers, but we project that they will drop to about US$2.7 billion in 2009 to 2010 from $2.9 billion in 2008.

We project foreign direct investment will remain subdued in 2009 to 2011 given the policy uncertainty. Private oil companies are not investing in new exploration and production as a result of unfavorable changes in contract terms.

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Public sector external debt burden eased since restructuring

Ecuador's external debt burden continues to ease since its 2009 debt default and buyback. The decline in public-sector external debt net of liquid assets reflects debt restructuring, which reduced the stock of bond debt by 40%; the limited ability to tap international capital markets; and net repayments to multilateral creditors. In recent years, only CAF has consistently lent to Ecuador. In 2007, CAF became the leading multilateral borrower to Ecuador, overtaking the stock of lending from the IADB.

Private-sector external debt is increasing

The nonfinancial private sector has increased external borrowing since 2001. Most of the borrowing, however, is repatriation of capital by residents in the form of "loans" so that "borrowers" can take advantage of a tax loophole, deducting the interest they pay on the "loan." Hence, repayment of this debt is not as problematic as at first glance. The financial sector is estimated to be a net external creditor.

Ratings Detail (As Of October 6, 2009)*	
Ecuador (Republic of)	
Sovereign Credit Rating	CCC+/Stable/C
Senior Unsecured (1 Issue)	CCC+
Senior Unsecured (2 Issues)	D
Sovereign Credit Ratings History	
15-Jun-2009	CCC+/Stable/C
15-Dec-2008	SD/--/SD
14-Nov-2008	CCC-/Watch Neg/C
20-Nov-2007	B-/Stable/C
19-Jan-2007	CCC/Negative/C
04-Oct-2005	CCC+/Stable/C
23-Aug-2005	CCC+/Watch Neg/C
20-Jun-2005	CCC+/Stable/C
21-Apr-2005	B-/Watch Neg/C
24-Jan-2005	B-/Stable/C
Default History	
Defaulted on US$3.2 billion of 2012 and 2030 Global Bonds in December 2008 and February 2009, and then bought the bonds back in a reverse-Dutch auction in May and June 2009. Restructured US$6.6 billion of Brady and Eurobonds (in default since September 1999) with issuance of US$3.9 billion of Global Bonds in 2000 Rescheduled US$1.3 billion (overdue since 1996) with Paris Club creditors in 2000 Unilaterally restructured domestically issued government securities in 1999 Brady Plan restructuring of medium- and long-term commercial bank debt worth US$7.6 billion (in default 1982-1994) in 1994-1995 Rescheduled US$354 million (overdue since 1986) with Paris Club creditors in 1994	
Population	14 million (2009, forecast)
Per Capita GDP	US$3,949 (2009, forecast)
Current Government	
President Rafael Correa, who heads Alianza Pais, was re-elected to a second term in April 2009 under Ecuador's new constitution.	
Election Schedule	
Presidential and legislative: Last April 2009 Next April 2013	

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard

Ratings Detail (As Of October 6, 2009)* **(cont.)**

& Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.