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## Focus

### Ecuador

#### *Fundamentals to Pay for Political Crisis*

- **We went underweight Ecuador on April 4<sup>th</sup>, on concerns that Bucaram was going to cause a spiralization of the political crisis.**
- **Despite the fact that a new President has been appointed and the bonds have underperformed significantly, we reaffirm our call – stay underweight.**
- **We believe that we might not yet have seen the end of the crisis, as Palacio's appointment could prove transitional.**
- **Economic fundamentals are likely to pay for the political crisis in the form of a weaker fiscal stance, no reforms, and little foreign investment in the oil sector.**
- **From a financing point of view, the central government might have to resort to politically costly means to access funds from the rest of the public sector.**
- **We see little chance of an interruption in the oil flow.**

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## What Happened?

By the time we went to press, local media reported that President Lucio Gutierrez had been removed from his post by a unanimous vote of 62 deputies out of the original 100 who met outside the Congress. Vice-President Alfredo Palacio was sworn in to replace Gutierrez, who is reportedly seeking asylum from Venezuela. Soon after the vote, the Head of the Joint Chiefs of Staff, Victor Hugo Rosero announced that the military had withdrawn its support for Gutierrez.

Current president Alfredo Palacio swiftly announced some members of his new cabinet; however, it is still uncertain who will be the new Minister of Economy. Importantly, he reconfirmed Victor H. Rosero as Joint Chief of Staff, securing for now military support. Palacio is seen as a weak political figure, but for now, the main leaders of the influential Social Christian Party (PSC) have welcomed his designation.

Palacio made the order to close the borders, claiming he wants to prosecute members of the government and other political figures. The new General Prosecutor ordered the arrest of former presidents Lucio Gutierrez and Abdala Bucaram, former Supreme Court President Castro Dager, and former Minister of Social Works Gonzalez. While Bucaram appears to have left the country, Gutierrez may still be in Ecuador.

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## What May Happen?

We believe the political situation remains very much in flux, and that we might not have yet seen the end of it. Therefore, at this point, it is very difficult to forecast how the crisis would end up being resolved. However, we believe that:

- 1) A Chavez-like return by Gutierrez is highly unlikely – Gutierrez does not count with the support of any sizable portion of the military or the general population.
- 2) We see little chance of an interruption in the oil outflow. There are no reasons to believe that the political crisis in Ecuador would lead to a strike that would paralyze oil extraction, transportation or shipping. In contrast to the case of Venezuela, in Ecuador, there does not exist a unionized group against the government.
- 3) While Palacio has been sworn in by Congress, his position may still be weak. While Palacio appears to be the new President, by the time we went to press he had not yet arrived to the presidential palace. The local media informed of popular demonstrations against Palacio and violent attacks against some politicians.
- 4) The position of the US government will be crucial in this respect. On one hand, the US has always called for an institutional exit to the political crisis, and while the removal of Gutierrez was not the cleanest, the appointment of Palacio follows the line of succession established by the Constitution. On the other, however, Palacio has been always critical of the policies followed by Gutierrez, which were welcomed by the US.
- 5) Former President Abdala Bucaram appears to be the major loser in the crisis. An order by the Supreme Court terminating all lawsuits against him and his later return to Ecuador from his exile in Panama marked the acceleration of the crisis. When returning, Bucaram called himself a “political tsunami”. Yesterday's events showed he was right, and now Bucaram appears to have left the country again.
- 6) The Social Christians (SC) appears to have emerged as winners. Its two principal political enemies, Bucaram and Gutierrez, are on the run, while the SC party still maintains power in the influential city of Guayaquil, and strong Congressional representation. They also enjoy a good relationship with the army.
- 7) The indigenous people are calling for a National Assembly, but may end up empty-handed. Recall what happened in January 2000, when an indigenous revolt led by Colonel Vargas and ended up with the removal of President Jamil Mahual, only to have Vargas end up empty-handed, while then Vice-President Gustavo Noboa took office.

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## What's the Impact on Bonds?

- 1) Palacio's potential policy agenda seems to imply that bonds are not inexpensive enough. If we were to forecast Palacio's economic policy, based on his declarations as a Vice-President, we think that Palacio will depart dramatically from what was done during the Gutierrez administration, of which he was severely critical. Palacio has spoken out against fiscal restraint, the payment of external debt, and the IMF. He would not likely support any of the structural reforms presented to Congress two months ago. Given that there is a significant probability that Palacio will stay in office, we might be just witnessing only the beginning of a long-term deterioration in Ecuador's fundamentals.
- 2) Political noise may remain high, so volatility is also likely to remain high. As we said above, we believe there is still room for the political crisis to return one more surprise.
- 3) Political fragility is likely to limit room for economic reforms, and discourage foreign companies from becoming involved in the oil sector in the near future. It also will likely make very difficult for Ecuador to access the international capital markets, which leaves the central government in a weak financial position, forcing it to draw cash from other public sector institutions, which has been always a source of political noise. Also, should the need for political support lead whomever is in charge to increase spending, the lack of a devaluation to later correct such fiscal excesses could put pressure on dollarization down the road.
- 4) We would only see bonds finding a solid ground if Palacio's nomination were to receive crucial international support (G-7 support is key to receive multilateral lending), and a reasonable Minister of Finance is appointed. Should Palacio not be the final president, however, we would focus on the policy agenda of whomever takes office and his ability to generate support for the program.

*– Lucila Broide  
– Pablo A. Goldberg*