

Economic

Credit Agencies

Moody's: Caa1
S&P: CCC+
Fitch: B-

Nominal GDP (2006):

USD 40.9 (e) bn

Population (2006):

13.5mn

Total Trade / GDP (2006):

57.8%

Currency:

US Dollar

Exchange regime:

Dollarized

Merchandise Imports from Canada (2006):

CAD 150.9mn

Main sources of Foreign Exchange (excl. FDI):

Petroleum and related products

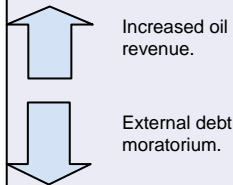
Largest Merchandise Trading Partner:

United States
Colombia
Venezuela

Main imports:

Raw Materials (31%)
Capital Goods (25.3%)

Risks to the Outlook:



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Veronica Lares
vlares@edc.ca

Market Spotlight: Growth will decelerate over the forecasted horizon, given political tensions and increasing uncertainty. The government is planning a very aggressive fiscal expansion in 2008, and expects to finance the deficit with new debt issuances. The likelihood of success of this plan is very low as the government is already using emergency funds in different sectors of the economy, and expectations of a debt moratorium continue to rise.

Real Sector: According to official sources, the oil sector is expected to contract significantly (5.7%) this year, given some production constraints in PetroEcuador. The government expects to increase production capacity over the next year, thanks to some infrastructure investment coming from Venezuela. The highly uncertain political environment is having a negative impact on household consumption and consumer confidence. Families are delaying new expenditures until constitutional issues are resolved. This is helping to keep inflation low; however a deceleration on the consumer side would seriously hurt the domestic economy going forward.

External Sector: Petroleum exports decreased by 8.1% y/y between January and August, given some production capacity constraints. However, non petroleum exports grew by 10.5% over the same period of time. Imports grew by 11.5% y/y, further increasing the existing trade deficit.

Fiscal: Ecuador's budget for 2008 includes a 12.4% increase in fiscal expenditures. This is the result of very optimistic assumptions. The government expects GDP to grow by 4.9% and oil revenues to contract only by 1.8% in 2008. Moreover, President Correa announced an increase in the government's share of profit from oil prices above a set amount to 99%, from 50% previously. The new revenue may reach US\$1.4bn in 2008, according to government estimates. Further the government plans to start auditing contracts signed with foreign oil companies. Also, Ecuador will rejoin OPEC next month, which could improve government revenue if supply constraints are resolved. Despite these facts, the deficit is forecasted to be around 1.8% of GDP, with the difference to be covered by new domestic and international debt issuances.

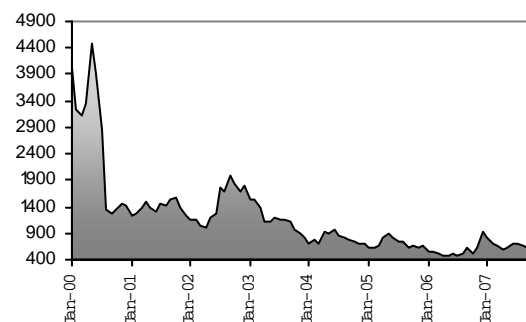
Debt: The fact that the government will rely on new indebtedness to stabilize its accounts raises some questions about the ability of the government to manage the domestic economy. The country is relying once again on foreign financing to cover its deficit, even as investors are expecting the country to declare a debt moratorium in the short-term. The likelihood of success of this plan is very low. Moreover, with the government already using money from 'emergency funds' to cover current expenditures, pressures on the dollarization regime are rising.

Outlook: We remain concerned about the public's appetite for policy restraint and the lack of political consensus surrounding much-needed economic restructuring.

Economic Indicators

	01-06 avg.	2006	2007	2008
GDP (% growth, real)	5.2	4.1	3.2	3.0
CPI (% change, end of year)	11.9	3.3	2.2	3.5
Fiscal Balance (% of GDP)	1.0	3.3	0.6	0.2
Exports (% growth per annum)	15.6	25.2	-2.9	3.0
Imports (% growth per annum)	21.5	16.9	15.4	11.8
Current Account (% of GDP)	-2.2	3.5	-1.7	-3.5
Reserves (month of imports)	1.2	1.1	1.1	1.2
External Debt (% of GDP)	58.6	41.4	42.2	43.4
Debt Service Ratio	29.0	28.1	25.0	19.8
Exchange rate (avg, per USD)	1.0	1.0	1.0	1.0

Ecuador - EMBIG Sovereign Spread



Source: JP Morgan

General Political Environment:

Divisiveness and poor governance are defining characteristics of Ecuadorian politics. Congress often has serious problems in passing legislation and the fragile political system precludes even a strong leader from implementing constructive policies. This situation has led Presidents to adopt authoritarian tendencies, which in turn erode popular support and ultimately lead to the collapse of government. Policy uncertainty is further exacerbated by frequent Ministerial resignations and protractedly unstable administrations.

Rafael Correa, a leftist with no party representation in Congress, won a run-off against Álvaro Noboa of the PRIAN party in November 2006 presidential elections. Correa took office in January 2007. A referendum to establish the Assembly was held April 15 which resulted in a resounding win for President Correa's position. Since then his popularity has dipped due to a major corruption scandal involving former Economy Minister Ricardo Patiño and conflict with the press. The Constitutional Assembly elections are scheduled for September 30th and will be an important test of Correa's perceived legitimacy.

Disruptive strikes and protests are very common and, given the weakness of the state, they have a proven ability to influence the government's course of action.

The powerful National Indigenous Confederation (Conaie) selected Luis Macas as its first-ever presidential candidate for the fall vote. Macas was instrumental in rallying popular support during recent mass protests that pressured the government to adopt nationalist policies. His candidacy signaled a move by Conaie to evolve as a political force rather than continue to seek influence by forming alliances with traditional parties or politicians. Macas polled 6th of 13 candidates in the first round and garnered 2.19% of votes.

Investment Environment:

Foreign investors, specifically in the oil and gas sector, have been engaged in contractual disputes with the government over fiscal matters.

In April 2006, Congress approved a hydrocarbon law reform which enables the government to levy a 60% tax on oil revenues. Governments across the region are adopting similar reforms in order to access a greater share of the windfalls generated by historically high commodity prices. In the long term, this policy change could seriously impact the viability of certain investments.

In May 2006, the government canceled Occidental Petroleum's (Oxy) contract on the basis of a legal dispute which *de facto* resulted in the nationalization of its assets. The case has been brought to international arbitration although the government is claiming that it should be a domestic affair. This dispute has caused investor disquiet. Whether the government ultimately complies with the international arbitration process will further impact investor confidence.

Protesters often manage to block operations at large projects, particularly in the extractive sector. Strong community development programs will be required to avoid or reduce the impact of such disruptions.

Corruption is an issue of serious concern in Ecuador and is entrenched in its institutions.

Canada and Ecuador have signed a double taxation treaty and a FIPA.

Political Violence:

Indigenous groups in north-eastern Ecuador carry out agitation campaigns against infrastructure projects specifically in the oil and gas sector. Foreign oil companies have been forced to bear the cost of these political violence events and subsequent social spending concessions.

Frequent episodes of violence undermine the northern part of Ecuador because of the Colombian conflict that is increasingly spilling over the border. These episodes have resulted in an increase in tensions between the Colombian and Ecuadorian governments.

Political

Political Structure

Presidential Republic

President

Rafael Correa

Vice President

Lenín Moreno

Legislative Bodies

National Congress (100 seats)

Major Parties (seats in Congress)

- Partido Renovador Independiente Accion Nacional (PRIAN) – 28
- Partido Sociedad Patriótica – 24
- Partido Social Cristiano (PSC) – 13
- Izquierda Democratica (ID) – 7
- Partido Roldosista Ecuatoriano (PRE) – 6
- Pachakutik (indigenous movement) – 6

Last Elections

- Presidential: November 2006
- Legislative: October 2006

Next Elections

- Presidential and Legislative: October 2010

Press Freedom Survey:

- 2006 Score: 41 Partly Free (0: Free; 100: Not Free)

freedomhouse.org

Control of Corruption Index:

- 2006 Score: -0.75 (-2.5: Worst; +2.5: Best)

worldbank.org

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Signi Schneider

sschneider@edc.ca

Political Outlook

Political instability will continue for the foreseeable future and frequent changes in government are likely. Broad disillusionment with traditional political parties and rising expectations from the indigenous community have given civil society increasing influence on decision-making. A full-blown civil conflict is unlikely, but political jockeying and brinkmanship is set to escalate as the referendum approaches. Noteworthy is the alignment that exists between Rafael Correa and Venezuelan President Chávez who is eager to increase his pool of allies in South America.