Ecuador Flash Report

02 February 2023

Court rules to uphold tax reform and reduces fiscal uncertainty

- **Ecuadorian bonds rallied amidst risk-on sentiment and positive news on the tax reform**
- **The news reduces uncertainty about Ecuador's fiscal outlook**
- **We remain OVERWEIGHT on Ecuador but potential of political noise persists**

Ecuadorian bonds are up between 3.8% to 5.3% in today's trading, amidst risk-on sentiment and positive news on the tax reform. Ecuadorian bonds are showing a better performance relative to other distressed credit, such as Argentina (1/2.5%) or El Salvador (0.6%/1.6%), despite the 0.5% fall in crude oil prices. We believe the better performance of Ecuadorian bonds could be associated with the news the Constitutional Court (CC) ruled that the tax reform repeal approved by the National Assembly on 29 November 2022 was unconstitutional. The government celebrated the news, announcing the CC's decision "would preserve USD1bn revenues". These USD1bn could be broken down into the permanent yield of the reform (USD0.8bn) and the one-off contributions. According to the last IMF review, the tax reform would have a permanent annual impact on revenues of 0.7% of GDP.

Even though the tax reform was expected to remain in place until 2023, **the news reduces uncertainty about Ecuador's fiscal outlook**. As a reminder, President Lasso had vetoed the repeal of the tax reform in December 2022, which upheld the validity of the bill at least until 2024. Since our forecasts (see our 2023 Year Ahead Outlook: "Lingering challenges", 16 December 2022) did not include a potential repeal of the tax reform, **we keep our non-financial public sector fiscal deficit projections** for 2023 and 2024 at 2.1% and 2.3% of GDP, resepctively. On the other hand, **we stick to our view that further spending downsizing will be needed** for Ecuador to secure additional financing, either by tapping international markets or through multilateral lending (i.e. IMF).

We remain OVERWEIGHT on Ecuador as we think bonds could continue benefitting from higher risk appetite as long as the government remains committed to fiscal discipline. Nevertheless, we have seen political risks building up in the last months, due to alleged corruption in Ecuador's state-owned companies (see our Ecuador Economics and Strategy: "Political risk back to the spotlight", 26 January). As we mentioned in Political risk back to the spotlight, investigations could have severe implications for governability if the allegations are confirmed, but it is too soon to make that call. In our view, there is at least the risk is that the investigation partially muffles the impact on the government's popularity of a political victory in the 5 February referendum.

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