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Ecuador Flash Report

01 March 2023

More pain to come

- **Both the opposition and the indigenous have higher incentives to get Lasso out of the picture**
- **Even if the impeachment founders again, we see the indigenous radicalising ahead**
- **Further political noise and potential spending spree to weigh negatively on bonds**

Both the opposition and the indigenous have higher incentives to get Lasso out of the picture. We believe that the probability of President Lasso stepping down, either through a successful impeachment or his resignation, has increased substantially after we moved to UW on 6 February (see Ecuador Flash Report: "Reduce exposure on bonds as governability is set to deteriorate"). Late on 1 March, a legislative committee recommended moving forward with Lasso's impeachment after a 9-hour hearing. In June 2022, the impeachment had failed because support fell short by 12 votes of the 92 required to oust the president. However, following the government's electoral debacle on 5 February, we see higher chances that several lawmakers, who back then had rejected the impeachment, switch sides. In this regard, Rafael Correa's Revolución Ciudadana's victory on 5 February could encourage 19 independent and smaller party legislators to trade their votes, anticipating the return of Correism to power. In a similar vein, the opposition has less to fear from Lasso's implicit threat of dissolving the National Assembly by resorting to his constitutional powers (what is typically referred as cross-death).

On another note, **if the impeachment attempt foundered again** (due to lack of legislative endorsement or validation of the Constitutional Court), **we look to the indigenous movements radicalising further** in a bid to obtain additional concessions from a weakened Lasso or his eventual successor, Vice-President Alfredo Borrero. Noteworthy, since year-end the indigenous have been gearing up to resume mobilisations, arguing that the government has disappointed most of the promises made in the aftermath of the June 2022 protests. The corruption scandals surrounding Lasso's relatives could also serve as an excuse to flare up social tensions.

Even if Lasso dodges the bullet, **we see no upside catalyst on bond prices**. Before the buildup of political headwinds, we were already anticipating difficulties to avoid fiscal slippage in 2023. In this vein, we are still forecasting a 3.0% of GDP primary deficit for the central government, up from a 1.8% of GDP deficit in 2022 Ecuador Economics and Strategy: "Limited upside", 23 November 2022). Furthermore, we are convinced that President Lasso can only cling to power by giving in to pressures to materially ramp up spending. This would also be the case if Vice-President Borrero takes over. In this backdrop, political noise would be followed by weaker fundamentals and a higher financing risk, as securing IMF funding would be more difficult to achieve if fiscal accounts deteriorate sharply.

The question remains on whether at current levels bond prices already fully reflect this gloomy outlook. In our view, **there is potential for more pain down the road, even if Lasso defuses the political bomb through massive concessions**. On the other hand, in the event of a Borrero or a left-wing presidency, we do not anticipate an imminent default given that buffers are significant and debt payments manageable until 2026. The case against an imminent default is, to us, well supported by significant buffers and manageable debt payments until 2026, so

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that costs of default would outweigh short-term benefits. However, under a populist administration we would eventually see an erosion in the willingness and the ability to pay, paving the way to a new restructuring. Under the assumption that markets also anticipate a high probability of coupons being cashed in during this year and the next, then the implicit recovery value at the current price of the 5.5% 30s would hover around 40 cents on the dollar. This level may still feel rich for a serial defaulter such as Ecuador. Hence, from a tactical (i.e. undershooting of prices caused by negative headlines) as well as a fundamental point of view, we would be comfortable holding the 5.5% 30s below a price threshold of 43 cents (-8% versus 1 March closing price).

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