

16 AUG 2023

## Fitch Downgrades Ecuador's Long-Term IDR to 'CCC+'

Fitch Ratings - New York - 16 Aug 2023: Fitch Ratings has downgraded Ecuador's Long-Term Foreign Currency Issuer Default Rating (IDR) to 'CCC+' from 'B-'. Fitch typically does not assign Outlooks to sovereigns with a rating of 'CCC+' or below.

A full list of rating actions is at the end of this rating action commentary.

### Key Rating Drivers

**Downgrade:** The downgrade of Ecuador's ratings reflects heightened financing risks emanating from a significant deterioration in fiscal accounts, with limited scope for additional local market financing, and a challenging external financing backdrop. Liquidity constraints have resulted in a sizeable build-up in arrears since YE 2022. There has been an increase in political risk and governability challenges, and regardless of the outcome of upcoming general elections, Fitch does not anticipate significant reform progress to address Ecuador's fiscal and financing challenges in the remaining 18-month presidential term. This will continue to hinder the sovereign's market access and ability to secure an IMF successor program.

**Political Uncertainty Impacts Financing Options:** General elections were announced for Aug. 20 after President Lasso disbanded the National Assembly in May to avoid impeachment. Polls point to a presidential election runoff in October. Luisa Gonzalez, from the Citizen Revolution Party and Correa loyalist, is leading them, with high uncertainty around the runner-up, which could be former Vice President (VP) Otto Sonnenholzner, indigenous activist Yaku Perez, businessman Jan Topic, or Christian Zurita. The assassination of presidential candidate Fernando Villavicencio underscores the heightened political and security risks. Fitch expects a similar composition in Congress relative to the makeup before dissolution.

In Fitch's view, the next president will be challenged to address the difficult economic, fiscal, and security situations amid political uncertainty as the caretaker government (and National Assembly) serves until May 2025, with general elections scheduled for early 2025, constraining external bond access and ability to negotiate a successor IMF program that would unlock additional multilateral financing. Further, Fitch considers Ecuador to have a relatively low debt tolerance, and several of the candidates are calling for a debt audit and/or renegotiation of the debt.

Ecuadorians will also vote on two referendums that could impact oil extraction in three fields in the Amazon and mining exploration and production near Quito. If the referendum passes, the estimated oil output fall would be 12%, resulting in a USD600 million fall in fiscal revenues, and a net fall of

USD600 million in net exports.

**Public Finances Weaken:** The central government's (CG) fiscal position has started weakening after significant improvement since Ecuador entered into an Extended Fund Facility with the IMF in 2020. Under the deal, which ended in December 2022 and was the first program the country completed in over 20 years, Ecuador rolled out a tax reform under President Lasso, improved the quality of fiscal data, and adopted more prudent fiscal policies. The CG deficit fell to 1.2% of GDP in 2022 from 8.1% in 2020 and deposits more than doubled to USD1 billion during this time period. In 2023, Fitch forecasts the CG fiscal deficit to rise to 3.2% of GDP, above the government's pro forma 2023 budget target of 2.1% due largely to lower oil receipts and higher spending due to higher interest on debt and increases in salaries and social security transfers.

Fitch forecasts the deficit to rise further to 3.4% by 2025 as revenues adjust to slower growth, lower oil revenues, and the impact of President Lasso's tax cuts, while expenses increase due to rising interest on debt and social demands. Downside risks to our forecast include from a stronger-than-expected El Niño; approval of the vote to halt oil extraction; or the next interim president loosening fiscal policy to garner support ahead of elections in 2025.

**Financing Challenges:** Fitch expects CG financing needs to rise to USD11.6 billion (10% of GDP) in 2023. Fitch projects the CG raises USD10.2 billion, leaving a financing gap of USD1.4 billion. To finance the growing deficit, the CG had drawn down deposits to USD458 million from USD1 billion at YE 2022 per central bank (BCE) data as of the end July and built up arrears, which were USD1.2 billion as of the end May per Ministry of Finance data. In Fitch's view, amid the political turmoil, the sovereign will not be able to raise financing in the external bond market or via an IMF successor program.

Fitch anticipates the government will finance itself with support from multilaterals and domestic financing as well as some further drawdown on deposits and arrears. The CG may not have much space to cut expenses as capex has already been significantly reduced, further challenging the executive's ability to address indigenous groups' demands and wider social discontent.

While Fitch sees external bond debt service (interest plus amortizations) as manageable in the near term, we expect repayment capacity to come under greater pressure ahead of amortizing IMF debt starting in 2025 and step-ups in interest payments on restructured external bonds starting in 2026.

**Public Debt Stable:** Fitch forecasts gross general government debt (GGGD) ends 2023 at 61.4% of GDP in 2023 (from 61.8% in 2022) helped by the debt-for-nature swap, which compares favorably with the 'B'/C'/D' rated peer median of 71.6%. Fitch projects GGGD to GDP to remain around 61% through 2025 as GDP growth returns to its low trend pace, and fiscal deficits widen. Government interest to revenues (4.9%) compares more favorably to the 'B'/C'/D' median (11.1%), though Fitch forecasts this ratio to rise to 7% by 2025 as the effects of higher global interest rates and step-up coupons on restructured bonds feed through.

**Political Uncertainty Weighs on Growth:** Fitch forecasts GDP growth to slow to 1.4% in 2023, well below the 'B'/C'/D' median of 2.9% and the average over the last 15 years of 2.1%. This will be driven by a weakening in investment prospects amid political uncertainty and potential for renewed social

unrest, slowing growth in credit, and fall in oil output due to disruptions. However, remittances will support activity, growing at 6% in 2023. Fitch projects real GDP to converge to its low trend growth of 1.9% by 2025.

**External Liquidity Position Weakens in 1H23:** Fitch forecasts the current account surplus at 1.5% of GDP in 2023. The current account surplus and multilateral loans had supported historically high international reserve levels, but there has been a large decline in reserves since the start of the year and there is a risk that they continue to fall despite the current account surplus. Per BCE data, reserves stood at USD7 billion at the end July, which represents a 22% fall since July 2022 and is equal to 2.1 months of 2023 CXP (which compares unfavorably to the peer group median of 3.1).

The liquidity position of the BCE is important in the strengthening of the foundations of Ecuador's dollarization regime (guided by the Defense of Dollarization Law). BCE reserves provide full coverage of bank reserves (a 2025 target) and the reserve requirements of other financial institutions (a 2035 target), but they are still insufficient to cover public-sector deposits (a 2035 target).

**Country Ceiling:** Despite the IDR downgrade, Fitch has maintained Ecuador's Country Ceiling at 'B' in line with the recently updated country ceiling criteria. The updated criteria considers that dollarization reduces the risk of capital controls being imposed, although it does not wholly eliminate them. Ecuador's +2 notches uplift from the IDR reflects our view that risks of foreign exchange controls are mitigated by the absence of a separated legal tender, but also takes into account that the risks of imposing capital controls is expected to be higher for lower-rated sovereigns, especially low subinvestment grade.

**ESG - Governance:** Ecuador has an ESG Relevance Score (RS) of '5' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBG I) have in our proprietary Sovereign Rating Model. Ecuador has a low WBG I percentile ranking at 38.5 reflecting a rising political uncertainty, moderate voice and accountability, moderately weak rule of law and government effectiveness, and weak control of corruption.

## RATING SENSITIVITIES

### Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--**Public Finances:** Signs of more acute financing stress that could jeopardize repayment capacity or of weaker willingness to service commercial debt.

### Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--**Structural:** Reduction of political risk and uncertainty over the near- and medium-term, consistent with improved governability, economic policy and/or access to external markets and IMF program support;

--**Public Finances:** A sustained alleviation of sovereign financing constraints, for example due to

improved fiscal performance.

## **Sovereign Rating Model (SRM) and Qualitative Overlay (QO)**

Fitch's proprietary SRM assigns Ecuador a score equivalent to a rating of 'B+' on the LTFC IDR scale. However, in accordance with its rating criteria, Fitch's sovereign rating committee has not utilised the SRM and QO to explain the ratings in this instance. Ratings of 'CCC+' and below are instead guided by Fitch's rating definitions.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a Long-Term Foreign Currency IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

## **Country Ceiling**

The Country Ceiling for Ecuador is 'B', 2 notches above the LT FC IDR. This reflects strong constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of +1 notch above the IDR. Fitch's rating committee applied a +1-notch qualitative adjustment to this, under the Long-Term Institutional Characteristics, reflecting Ecuador's fully dollarized economy.

## **Best/Worst Case Rating Scenario**

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

## **REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

The principal sources of information used in the analysis are described in the Applicable Criteria.

## **ESG Considerations**

Ecuador has an ESG Relevance Score of '5' for Political Stability and Rights as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high

weight. As Ecuador has a percentile rank below 50 for the respective governance Indicator, this has a negative impact on the credit profile.

Ecuador has an ESG Relevance Score of '5' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Ecuador has a percentile rank below 50 for the respective governance indicator, this has a negative impact on the credit profile.

Ecuador has an ESG Relevance Score of '4' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGI is relevant to the rating and a rating driver. As Ecuador has a percentile rank below 50 for the respective governance indicator, this has a negative impact on the credit profile.

Ecuador has an ESG Relevance Score of '4' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Ecuador, as for all sovereigns. As Ecuador has a fairly recent restructuring of public debt in 2020, this has a negative impact on the credit profile.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/topics/esg/products#esg-relevance-scores](http://www.fitchratings.com/topics/esg/products#esg-relevance-scores).

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## Rating Actions

ENTITY/DEBT	RATING		RECOVERY	PRIOR
Ecuador	LT IDR	CCC+	Downgrade	B- 
	ST IDR	C	Downgrade	B
	Country Ceiling	B	Affirmed	B
	• senior unsecured LT	CCC+	Downgrade	B-

## RATINGS KEY OUTLOOK WATCH

POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

## Applicable Criteria

[Country Ceiling Criteria \(pub.24 Jul 2023\)](#)

[Sovereign Rating Criteria \(pub.06 Apr 2023\) \(including rating assumption sensitivity\)](#)

## Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v2.0.0 [\(1\)](#)

Debt Dynamics Model, v1.3.2 [\(1\)](#)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.14.0 (1)

## Additional Disclosures

[Solicitation Status](#)

## Endorsement Status

Ecuador    EU Endorsed, UK Endorsed

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