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Bukele shows his cards

- **Bukele is looking for alternative financing sources to bypass taxing IMF conditions**
- **The odds of a pension fund nationalisation have risen substantially**
- **High odds of muddling through until the presidential election**
- **We remain UW but find value in the 23s**

Bukele is looking for alternative financing sources… On 20 November President Bukele announced a plan to issue USD1bn in Bitcoin-backed securities early next year. The novelty of this 6.5% coupon and 10-year tenor bond is that half of its proceeds would be immediately invested in Bitcoin for at least the next five years. With the expected profits of Bitcoin appreciation, after the fifth year the bond would pay an additional interest. The news confirms that the government would be seeking alternative financing sources to the IMF (see El Salvador Economics & Strategy: Risky business, 16 July 2021). While we do not see traditional investors participating in this issuance, policymakers would target tapping Bitcoin enthusiasts and retail investors. A successful issuance could result in proceeds of USD500mn (1.7% of GDP) that would mostly close the financing gap built into the 2022 budget draft (see El Salvador Economics: Long way to fiscal consolidation, 22 October). Moreover, we cannot rule out further Bitcoin-denominated debt placements if demand is high in the first auction. Indeed, Blockstream's CSO Samson Mow, who accompanied President Bukele at the announcement, said that up to ten of these issuances would be in the pipeline, which could imply total funding of USD5bn for budgetary needs if conditions replicate those of the first Bitcoin bond.

Conditions for an IMF programme would be too taxing for Bukele. Shortly after the announcement of the Bitcoin bond on 22 November, the IMF published its customary Article IV review of the Salvadoran economy. On the one hand, the IMF Staff recommended a 4ppt of GDP fiscal adjustment over the next three years, both through tax increases and spending cuts. This fiscal consolidation strategy could hamper Bukele's 2024 re-election goal. Unsurprisingly, at least part of the proposed adjustment was quickly dissmised by Finance Minister Alejandro Zelaya this week, who said that tax increases were not "negotiable". On top of this, the IMF strongly advised reducing the government's exposure to Bitcoin by unwinding the Bandesal trust fund or by cutting public subsidies to the state-owned *Chivo* e-wallet. This would be also unacceptable for Bukele, who has already invested a large part of his political capital in promoting the usage of Bitcoin. Thus, backtracking on the Bitcoin law would entail a hefty reputation cost for the President. Also this week Mr. Zelaya praised the new Bitcoin framework, underscoring the positive results obtained so far in the implementation of Bitcoin as a legal tender, signaling that there are no official intentions of backpedaling with the measure.

The odds of a pension fund nationalisation have risen substantially. Boosting the chances of a Bukele re-election commands minimising the uncertainty on financing sources. External default can hardly be an option since the empirical evidence points to a severe political weakness of the incumbent in the wake of a default. By seizing the assets and the contributions flowing to the private pension funds (SAP), the government could bridge this uncertainty in the run-up to the 2024 ballot. Of course, doing so would preclude any possibility of an IMF deal, since the multilalteral would never support the seizure despite reckoning the need of a reform of the pension

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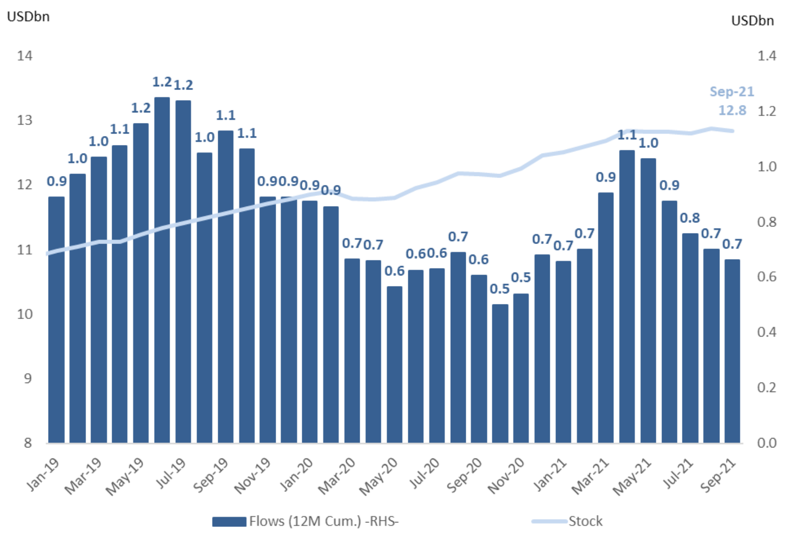
system (see El Salvador Economics & Strategy: Bukele steps up the conflict with the US, 05 November). With IMF funding almost fully out of the picture, the opportunity cost of moving forward with SAP nationalisation has plummeted, in our view. We estimate that **the government could raise fresh funds for up to USD1.8bn (6% of GDP) over the next year if it decides to take over the private pension system**. According to El Salvador's financial regulator (SSF), by end-September SAP's assets had amounted to USD12.9bn, up by USD662mn from a year earlier (Chart 1). The annual increase of SAP's assets depends on the difference between individual contributions and investment returns minus spending in pensions and administration costs. Thus, considering external investments and sight deposits, the government could tap up to USD1.4bn in SAP's liquid savings (Table 1). On the flow side, we calculate that the authorities could rely on USD0.4bn per year, after netting out the resources already devoted to funding the old public pension system (SPP) and the increase in pensions recently promised to the unions. In this regard, we think that additional evidence that SAP nationalisation is in the cards would be the decision to postpone the pension reform, so as to include the demands of the trade unions calling for the demise of SAP and a gradual but steady rise in pensions.

Chart 1. Evolution of the Private Pension System (SAP)'s assets



Source: BancTrust & Co. based on Superintendency of the Financial System of El Salvador

Table 1. Private Pension System (SAP)'s assets as of September 2021

	USDmn	As % of total
Public	**10,237**	**80%**
Pension Obligations Trust Fund (FOP)	7,923	62%
Eurobonds	2,153	17%
Other Public Institutions	162	1%
Private	**2,596**	**20%**
Financial Instruments of Domestic Banks	611	5%
External Assets*	1,145	9%
Deposits	187	1%
Investment Funds	49	0%
Other Private Debt	603	5%
Total	**12,833**	**100%**

*Includes external stocks and issues of corporates and Sovereigns outside El Salvador

Source: BancTrust & Co. based on Superintendency of the Financial System of El Salvador

High odds of muddling through until the presidential election. The aforementioned financing sources would amount to 7.7% of GDP. Factoring in the already committed multilateral lending, we think the government could

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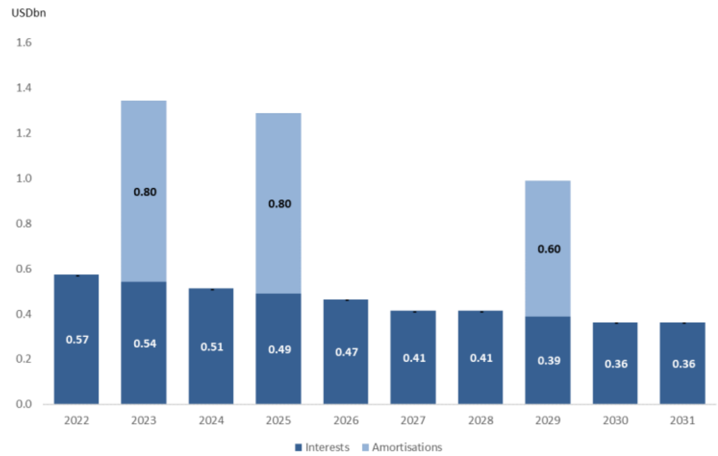
muddle through at least until the next presidential election scheduled for February 2024. This would imply running fiscal deficits in the range of 3 to 4 percent of GDP both in 2022 and 2023, and also settling the first USD800bn Eurobond maturity in January 2023 (Chart 2). **Importantly, our scenario also assumes that there will be no US sanctions against Bukele.** Given the close ties between the US and El Salvador's business cycles, trade and/or financial sanctions would be highly disruptive for the domestic economy and could place the country on the brink of a severe BoP crisis. True, the bilateral relationship with the US seems to be hanging from a thread. This week the Biden administration withdrew its ambassador Jean Manes, who left El Salvador highlighting the domestic authorities' unfriendly stance to the US. However, the Assistant Secretary for Western Hemisphere Affairs of the US Department of State, Brian Nichols, yesterday said that a new ambassador would be appointed soon. Although it cannot be ruled out, we do not expect major US sanctions to El Salvador since a crisis similar to the one of Venezuela could aggravate the already worrying illegal migration metrics at the US Southern border.

Chart 2. Eurobonds debt profile



Source: BancTrust & Co. based on Bloomberg.

We remain UNDERWEIGHT, but find value in the 2023s. The unsupportive news flow could undoubtedly take a further toll on bond prices even if spreads are currently hovering 1,200bps. We maintain our broad UW on Salvadoran bonds but we think that the 23s offer a handsome risk-reward equation. We have already argued that financing would be enough to pay off those bonds that are currently priced to yield almost 28%. In addition to this, the pension fund nationalisation could actually reduce the redeemable amount outstanding, lowering default probabilities. The SAP holds USD2.1bn in Eurobonds (Table 1), which accounts for c33% of total outstanding Eurobonds (USD7.5 in face value). Even though we have not been able to find the breakdown of these holdings, it is very likely that pension funds own a large portion of the 23s. If confirmed, the chances of the government defaulting on the 23s would drop dramatically, in our view. Therefore, if El Salvador seizes the remaining domestic liquidity pockets we would expect to observe a disinversion trend of the yield curve, with yields narrowing in the short-end of the curve but widening in the belly and long-end. In such context, we would **re-open our El Salvador trade idea BUY ELSALV 7.75% 23s – SELL ELSALV 7.125% 50s** that we closed on 5 November with an excess performance of 1.7x the targeted profit (see Relative Valuation Monitor, 5 November 2021).

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