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# El Salvador Economics and Strategy

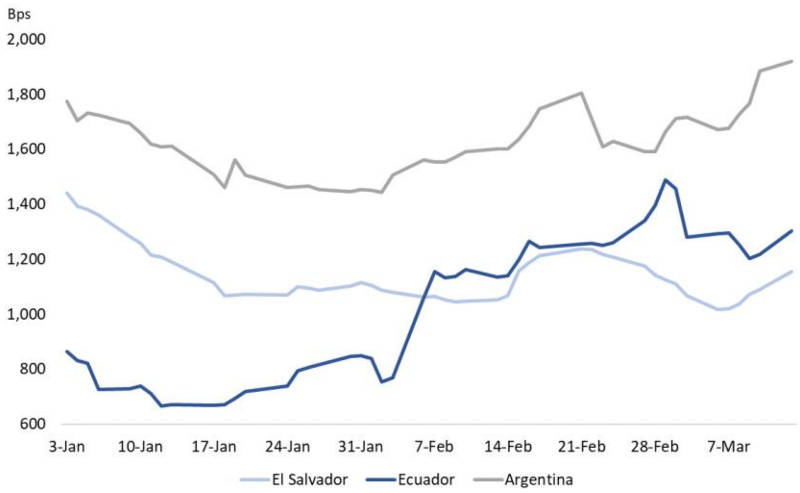
15 March 2023

## Bukele's success in fighting crime bodes well for fiscal accounts and bonds

- **Fiscal prudence remains on track …**
- **… As authorities can leverage in their success in lowering crime**
- **Fiscal performance could surprise to the upside despite looming elections**
- **On the downside, weak external buffers and lingering risks of pension reform**

By 14 March Salvadoran bonds had delivered a weighted average total return of 16.1% YTD, having peaked at 21.7% on 6 March. In the past few days, a more volatile global backdrop has driven some reversal of the impressive spread compression registered by El Salvador and other high-beta names since the outset of the year. Still, since end 2022, El Salvador's relative risk (vs. EMBIG) has narrowed a robust 312bps to an absolute spread level of 1,557bps on 13 March. Against our view (see El Salvador Economics & Strategy: Bukele shows his cards, 26 November 2021), President Nayib Bukele's controversial domestic and external policies boosted the conviction that El Salvador would default on the January 2023 Eurobonds maturity. Instead, possibly on the back of the authorities' awareness of potential hefty costs of default on a small, open and dollarised economy, El Salvador reaffirmed its willingness to pay with two buybacks of the 23s and 25s in 2H 2022, followed by the redemption of the residual amount of the 23s by the due date. **Going forward, we see El Salvador outperforming other high-beta credits, supported by domestic factors**. Based on recent fiscal figures and the growing incidence of crime control on voting preferences, we have cut our fiscal deficit forecast by 0.5ppt to 3.1% of GDP. True, protracted external uncertainty could deepen the inversion of the yield curve, so short-dated notes may not offer enough protection relative to longer tenors. This being said, a positive fiscal surprise in line with our expectations of a modest electoral spending push could have a mitigating effect. As a result, we like the short end of the Salvadoran curve -except for the 25s that could suffer from poor liquidity after the buyback- potentially also profiting from an additional flattening of the US yield curve inasmuch as investor expectations veer towards a recession in DCs. With a current yield of 16.4%, we think that the 29s offer the best risk-adjusted expected return.

### Chart 1. Relative spreads vs EMBIG



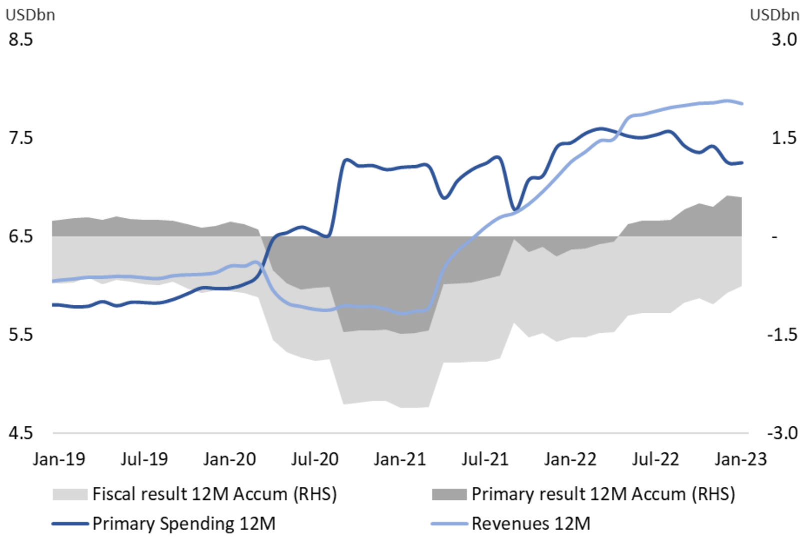

Source: BancTrust & Co. based on Bloomberg.


**Juan Martín Solá**
**Senior Economist**
**jsola@banctrust.com.ar**

**Ramiro Blazquez**
**Head of Research & Strategy**
**rblazquez@banctrust.com.ar**

**Fiscal prudence remains on track…** Following a fiscal adjustment of 3.5ppt of GDP in 2022 that reduced the overall deficit to 3% of GDP (USD860mn), there is still no evidence of a deterioration in public accounts (Chart 2). We estimate the January-23 fiscal deficit at USD9mn (0% of GDP), down from USD76mn (0.3% of GDP) in the same period of last year. Despite the slight reduction of the primary surplus due to weaker revenues, the overall shortfall improved thanks to a sharp contraction in interest payments (-36% y-o-y in real terms). Primary expenditure, in turn, fell by 7% y-o-y in real terms, even after adjusting the published figures for a 30% y-o-y nominal increase in pension spending, which is no longer reported by the central bank as of this year. This was also reflected in government cash deposits, which increased by 45% y-o-y to USD667mn in January, reversing the decline seen last December. Additionally, February tax collection expanded 1.8% y-o-y, after posting five consecutive annual declines.

**Chart 2. Fiscal dynamics**




Source: BancTrust & Co. based on Central Bank of El Salvador (BCR).

**… As authorities can leverage in their success in lowering crime**. While only a single data point, the first fiscal data of this year points to the continuity of healthier fiscal metrics. This being said, as we get closer to the general elections of February 2024, we would expect the government to engage in some kind of fiscal stimulus. Nevertheless, we consider that President Bukele's re-election strategy will be more focused on his homeland security policy rather than on a fiscally expansive bias, as we had previously expected (see 2023 Year Ahead Outlook: "Lingering challenges", 16 December 2022). In recent months, most opposition sectors and the international community have acknowledged the results of Bukele's national security policy, which has almost fully brought gangs down to their knees. Political pundits view this as the President's main achievement and the foremost reason for his sweeping popularity across the country, according to a survey conducted in December 2022 by the independent newspaper La Prensa Gráfica (Table 3). In this context, we think that the ruling *Nuevas Ideas* (NI) party will try to reinforce this perception, as it has been doing since March last year, when the state of emergency was declared for the first time in the country. Based on this, **we shaved our 2023 fiscal deficit projection to 3.1% of GDP from 3.6% previously, implying a fiscal deterioration of a mere 0.1ppt relative to 2022**. The more moderate fiscal stance also makes sense as it would increase the possibilities of regaining market access or reaching an agreement with the IMF after the election, as we suggested in Lingering challenges.

Juan Martín Solá
Senior Economist
jsola@banctrust.com.ar

Ramiro Blazquez
Head of Research & Strategy
rblazquez@banctrust.com.ar

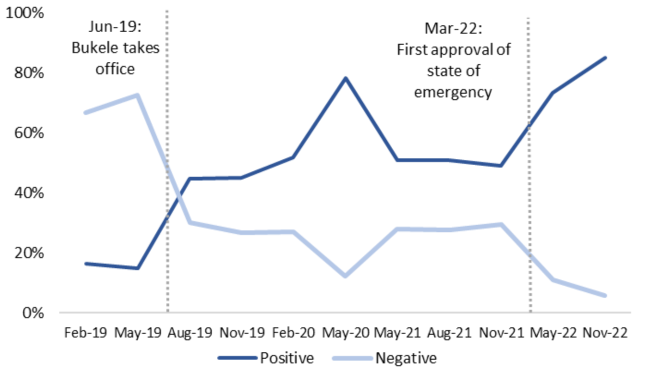
**Lower oil prices will offer some relief to the current account…** The trade deficit has interrupted its upwards trend, and last January it stood broadly unchanged vis à vis January 2022, at USD777mn. In turn, January remittances surprised to the upside and accelerated to 6.4% y-o-y from average growth of 1% y-o-y in 4Q22. While we reiterate the caveat that these figures could be just data points, they are consistent with our expectation of a 4% of GDP current account deficit in 2023, 2.9ppt below our 2022 estimate. On a further positive note, international reserves rose slightly to USD2.5bn in February, from USD2.4bn in December, as new external loans from IFIs partially offset the USD668mn payment of the 23s. Based on our examination of BoP statistics, we still think that there is a substantial probability that El Salvador holds substantial unreported external savings, which have manifested themselves through large error and omission inflows (see El Salvador Flash Report: "Bonds rally as government favours repurchase of 25s over 23s" 22 September).

**Table 1. Perceived main achievement of Bukele**

| | |
|---|---|
| Improvements in security | 32.1% |
| Improvements of the health | 16.5% |
| Improvements in education | 6.2% |
| Public works and improvements of roads | 3.5% |
| Food vouchers | 2.9% |
| Other | 25.1% |
| Do not answer | 9.5% |

Source: BancTrust & Co. based on La Prensa Gráfica, 16 to 21 December 2022.

**Table 2. Perceived safety conditions**




Source: BancTrust & Co. based on La Prensa Gráfica, 16 to 21 December 2022.

**… But external vulnerabilities remain the weak spot**. Even if liquidity concerns should subside somewhat due to the government's improved cash position, the depressed level of international reserves will continue to be a matter of concern. In February, international reserves accounted for only 7.5% of GDP and roughly 100% of short-term debt. Even if the drop in reserves we envisaged in Lingering challenges does not materialise, external buffers are critically low considering the external credit crunch and the still-high current account deficit.

**Lingering risks from the pension reform.** In December 2022, the Legislative Assembly (LA), controlled entirely by NI's lawmakers, passed a pension reform that increases the minimum pension by 30%, financed by higher employer contributions and lower fees for pension administrators. The reform also modified an important part of the system's legal framework, creating the Salvadoran Institute of Pensions (ISP), a new financial entity in charge of the public pension system. As a result, the central bank changed its reporting methodology in January and stopped publishing pension payments under the non-financial public sector statistics. This increases the opacity of El Salvador's statistics and makes it more difficult to understand the impact of the reform on fiscal accounts. On top of this, the new law required a pension-related debt swap between the old institution in charge of public pensions and the ISP before 14 April. While this should be just a debt swap within public entities, ratings agency Fitch flagged that a worsening in the terms of these financial instruments could amount to a default of domestic debt. If confirmed, this could trigger negative headlines that could have a negative fallout on external bonded debt.

Juan Martín Solá
Senior Economist
jsola@banctrust.com.ar

Ramiro Blazquez
Head of Research & Strategy
rblazquez@banctrust.com.ar

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Juan Martín Solá
Senior Economist
jsola@banctrust.com.ar

Ramiro Blazquez
Head of Research & Strategy
rblazquez@banctrust.com.ar