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TPCG LATAM
EL SALVADOR STRATEGY VIEW

LATAM Strategy – El Salvador
February 28, 2023

2023 Scenario Update: Another year, another muddle

- **We expect El Salvador's growth to slow to +1.8% in 2023 after closing 2022 with a +2.7% GDP increase.** 2022's growth drivers could be found mostly in the solid performance of PCE and the Services sector, and it is difficult to see said dynamics spilling over in force to 2023. We expect a slowdown in remittances to hamper growth, forcing it to slow down to the 1.8% mark, even as the external sector risks arresting the positive momentum.
- **Recent polls shed some light on Mr. Bukele's high popularity levels, which seem to be sustained by the major security improvements in the country.** Given that the administration can maintain security levels and reduce inflationary pressures, the President is headed toward an easy win in the 2024 elections. In our view, this confirms that the risk to policy continuity does not stem from a regime change but from a shift in the administration's policy. The lack of substantial institutional frameworks hints that Mr. Bukele can pivot its policy bias with little cost, maintaining the political premium on the space high.
- **The long-awaited pension reform only cosmetically modifies the current system, albeit presenting some advantages for the administration in the short run.** In 2023 the reform will probably be net positive for the administration, adding roughly 200mn of net new money, plus another 400mn in rollover or swaps to the newly issued COPs. The overall balance is more uncertain in the long term as the govt. is now burdened with a new string of liabilities that will gradually erode the cash flow it will receive via the reinforced Solidarity Guarantee Account (CGS).
- **After a stellar 2022, fiscal consolidation will slow in 2023 as income sources lose momentum and the administration pauses outlay compression.** In 2022 the primary position closed the year with a +3% of GDP surplus, while the fiscal balance clocked in at -1.7%. With fiscal figures already hovering over historical averages, we expect income sources to lose momentum in line with the general economy. In this context, the administration's budget totals USD8.9bn and is consistent with a primary surplus of +0.9% of GDP and a fiscal deficit of -2.6%.
- **With the payment of the 2023 Eurobond out of the way, GFNs now look manageable, amounting to 5.4bn for the year.** In addition, most of the financing needs come from internal sources, leaving the administration in pole position to exploit the gap it created in the external payment profile with the bond buybacks during 2H22.
- **With external sector figures on the brink of unsustainability, we expect the current account deficit to compress in 2023, aided by tourism and a more constructive international scenario.** The current account is poised to close 2022 with a deficit nearing the -10% of GDP mark, a heavily unsustainable figure. Still, we expect the current account deficit to tighten back to -3.6% of GDP in 2023 on the back of a slowdown in consumption, reduced energy import cost, and increased tourism. However, risks remain tilted to the downside, as we believe an external sector shock carries the largest risk of derailing the government's consolidation plan.
- **We maintain our OW rating in a context where the administration managed to cancel its Eurobond payment in Jan-23.** Given that the 2025s outstanding was reduced significantly, it should be riddled with liquidity issues, making the 2027s our top pick in the front end of the curve, as we believe it still should have some space to compress.

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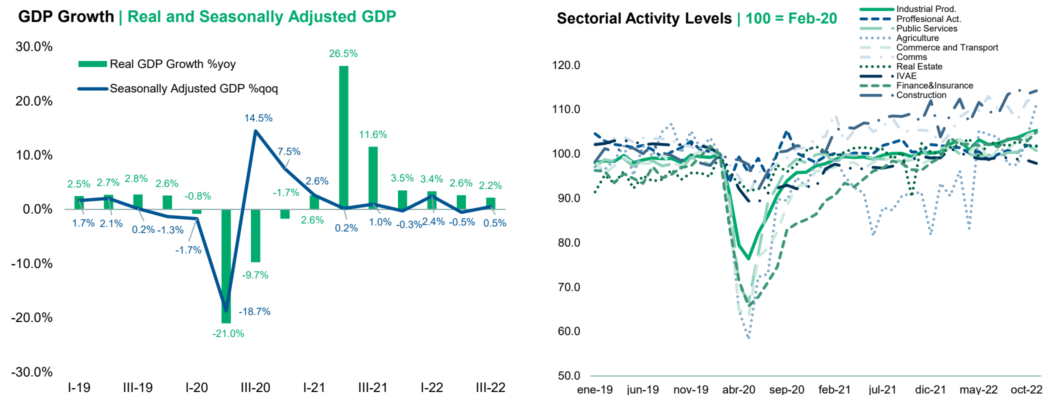
2023 Scenario Update: Another year, another muddle

We expect GDP to grow by +2.7% in 2022, followed by +1.8% in 2023

Activity levels have performed robustly throughout 2022, comfortably leaving behind pre-pandemic figures.

Activity levels have performed robustly throughout 2022, comfortably leaving behind pre-pandemic figures. Looking at the seasonally adjusted IVAE for Nov-22, we find it accumulates a +5.1% increase over Dec-21 levels and clocked in a positive variation in eight of the last ten months. In addition, it portrays a +5.3% variation over pre-pandemic levels, conformably standing over 2019 figures, solidifying the current trend. However, sectorial performance showcases some divergences. The standout performer has to be Construction, which stands at +29.5% over Dec-21 levels and is poised to bolster yearly investment, as reduced uncertainty helped the sector. Communications (+7.7%), Professional Activities (+6.9%), and Commerce and Transport (+6.5%) also outperformed the headline index, as the tertiary sector generally enjoyed a good year, recovering from pandemic lows. Industrial production and Public Services came in slightly below the general trend, Increasing by +2.4% and 2.2%, respectively. On the other side of the spectrum, Financial Services put in an uninspired performance at +1.3%. Finally, Agriculture and Real Estate lost ground YTD, standing marginally under Dec-21 levels. The first posted a superficial -0.3% variation, while the latter dropped by -1.2%, a timid decrease. All in all, the economy continued to enjoy positive dynamics during 2022, performing constantly and surely throughout the year. 1H22 closed with a +1.9% growth, which could be slightly opaqued by 2H, as since June, high-frequency indicators posted a seasonally adjusted +3.1% rise.

Figure 1: Sectorial activity levels performed well in 2022

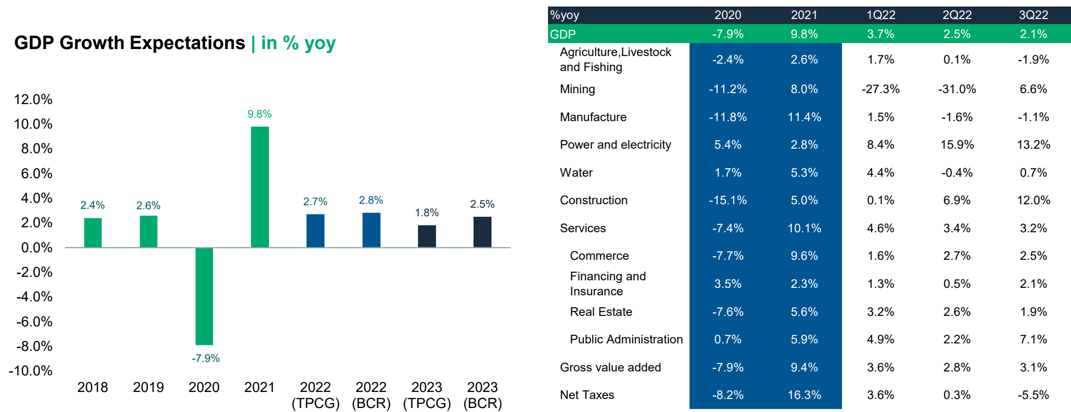


Source: TPCG Research based on BCR

In the context of solid economic performance, 2022 is poised to close,exhibiting a +2.7% growth, mostly in line with the BCR's +2.8% baseline.

In the context of solid economic performance, 2022 is poised to close exhibiting a +2.7% growth, mostly in line with the BCR's +2.8% baseline. 3Q22 GDP data clocked in at +2.1%yoy, which results in a +0.5%qoq growth, seasonally-adjusted. In this context, the year-on-year indicator was now facing stronger baselines as the pandemic effect in 2021 wears off, causing the index to deaccelerate from +3.7% in 1Q, +2.5% in 2Q and +2.1% in 3Q. Instead, the qoq index presented strong growth during 1Q (+2.4%) before dropping marginally by -0.5% in 2Q, to finally rebound by the same margin in 3Q. In this context, just the statistical carry is poised to cause a +1.9% GDP growth this year, assuming a -0.7%yoy drop in 4Q—instead, a scenario where the 4Q exhibits no yoy variation results in a +2% yearly growth. The BCR expects GDP to close +2.8% over the 2021 levels, which would require a +3%yoy growth during the last quarter of the year. In our view, even as high-frequency gauges continue to perform solidly, we believe GDP growth will fall slightly below the +2.8% target. We expect GDP growth in 4Q to hover around the +2.5% mark, putting growth for 2022 at +2.7%.

Figure 2: Growth steadily deaccelerated throughout 2022



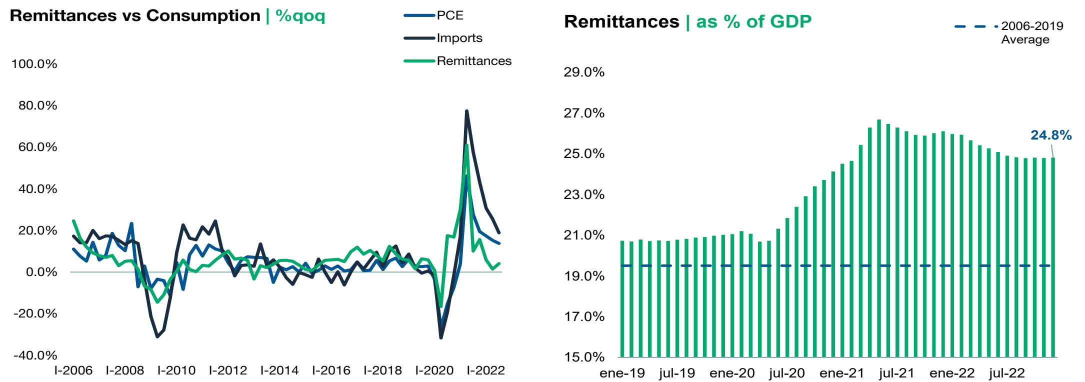
%yoy	2020	2021	1Q22	2Q22	3Q22
GDP	-7.9%	9.8%	3.7%	2.5%	2.1%
Agriculture,Livestock and Fishing	-2.4%	2.6%	1.7%	0.1%	-1.9%
Mining	-11.2%	8.0%	-27.3%	-31.0%	6.6%
Manufacture	-11.8%	11.4%	1.5%	-1.6%	-1.1%
Power and electricity	5.4%	2.8%	8.4%	15.9%	13.2%
Water	1.7%	5.3%	4.4%	-0.4%	0.7%
Construction	-15.1%	5.0%	0.1%	6.9%	12.0%
Services	-7.4%	10.1%	4.6%	3.4%	3.2%
Commerce	-7.7%	9.6%	1.6%	2.7%	2.5%
Financing and Insurance	3.5%	2.3%	1.3%	0.5%	2.1%
Real Estate	-7.6%	5.6%	3.2%	2.6%	1.9%
Public Administration	0.7%	5.9%	4.9%	2.2%	7.1%
Gross value added	-7.9%	9.4%	3.6%	2.8%	3.1%
Net Taxes	-8.2%	16.3%	3.6%	0.3%	-5.5%

Source: TPCG Research based on BCR

Looking at 2023, we expect growth to slow down significantly, hovering around the +1.8% mark.

Looking at 2023, we expect growth to slow down significantly, hovering around the +1.8% mark. Even as the economy is expected to close the year positively, it isn't easy to see the positive catalysts from 2022 spilling over to 2023. Remittance growth slowed in the latter part of the year. Their momentum will likely fade during 2023, in a context where an adverse global scenario should hamper remittances, weakening consumption, as consistently, remittance growth is closely related to PCE. The remittance slowdown is especially important if we factor in El Salvador's increasing dependence on said income. By Dec-22, remittances amounted to 24.8% of GDP, standing 5pp over the historic average, making the threat of an unfavorable external scenario even direr. The only silver lining in the reduction of remittances could be a drop in imports, which grew significantly during 2022, straining the current account to its limit. YTD, the current account exhibits an -8.5% of GDP deficit, which is unsustainable in the medium run. Our baseline scenario sees internal demand slowing down, mimicking remittances, with the external sector contributing slightly to growth. Exports continue exhibiting positive dynamics, and imports slow down, driven by sluggish consumption and lower energy prices. In this context, we find the BCR's 2-3% estimate too optimistic, and we expect the economy to expand by +1.8% in 2023.

Figure 3: With remittances poised to suffer, PCE and Imports should be the largest losers.



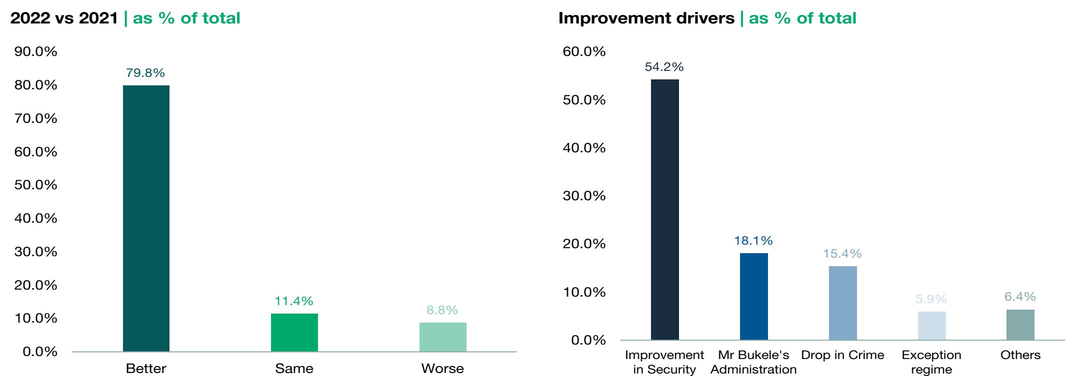
Source: TPCG Research based on BCR

Politics: Policy continuity depends on the government not doing a U-turn

Dissecting Mr. Bukele's popularity, we find the exception regime is the largest driver behind the President's sky-high approval ratings.

Dissecting Mr. Bukele's popularity, we find that the exception regime is the largest driver behind the President's sky-high approval ratings. A recent poll sheds light on Mr. Bukele's popularity, of which a large share seems to stem from the Exemption regime, which has been in place since 1H22. A set of polls by the College Institute of Public Opinion of the Central American University presented the view of Salvadorans in 2022. The key takeaway from the survey is that the exception regime heavily conditions the citizen's perspective on the country's situation and its institutions and political actors. To highlight the issue, 80% of Salvadorans agree that the country is better off than in 2021, with 11.4% seeing no significant change and 8.8% noticing a worsening situation. In contrast, when asked about the country's economic situation, the polled split into thirds, with only 33.3% believing the country is better than in 2021. 32.5% believe the situation is mostly the same, and 34.1% believe the situation is worse than in 2021. It is not surprising then that those who think the country is better than in 2021 point at the effects of the Exception regime as the main point of improvement, engulfing around 75.5% of the polled, with another 18% attributing the improved conditions of El Salvador directly to the good management of Mr. Bukele's administration. On the other hand, inflation is the biggest issue pulling the country back and explaining nearly 60% of the negative answers to the country's economic performance, adding higher living costs (32.3%) and price increases (27.1%).

Figure 4: The exception regime sustains Mr. Bukele's popularity levels

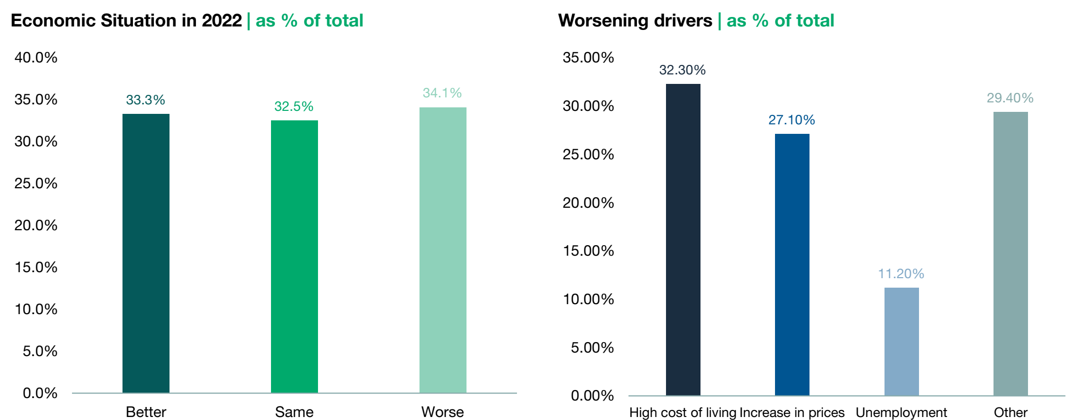


Source: TPCG Research based on UCA

Looking at security issues, most Salvadorans feel safe and believe there has been an improvement in the justice system and a substantial drop in crime.

Looking at security issues, most Salvadorans feel safe and believe there has been an improvement in the justice system and a substantial drop in crime. The poll indicates nearly 88.2% of Salvadorans feel very safe (16.8%) or safe (71.4%). In addition, 68.7% believe the Salvadoran justice system is working better than in 2021, while 21.4% believe it remained mostly the same, and 6.8% believe it is now worse. Of the Salvadorans who say justice has improved, 45.9% indicate it is due to the exception regime, which allows the administration to jail criminals. However, on the other side of the spectrum, of the 6.8% who believe the justice system is worse off than in 2021, 42.5% believe it is due to the unjustified arrests happening within the framework of the Exception regime. However, the main landslide comes in the crime section, as 90% of the population believes it has decreased, again with the Exception regime driving 86% of the answers. In addition, families who reported a gang-related crime decreased from nearly 10% in 2019 to 2.1% by the end of 2022.

Figure 5: The improved situation is not explained by economic performance

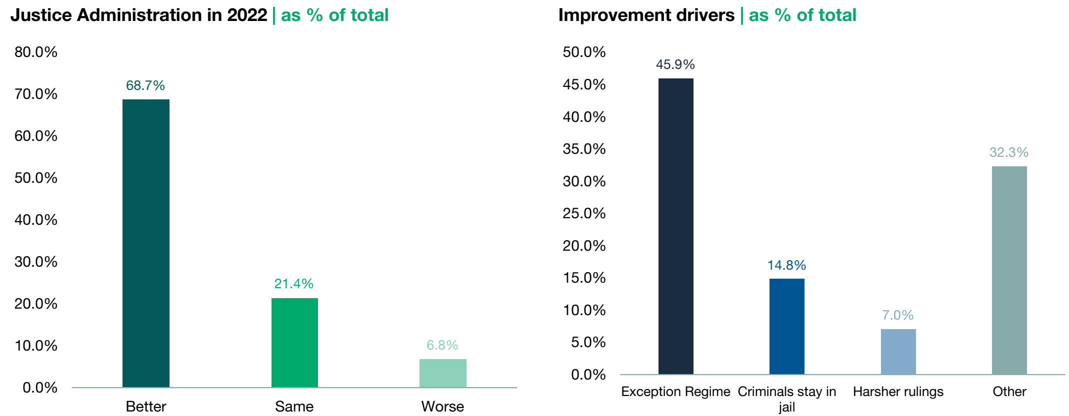


Source: TPCG Research based on UCA

Polls position Mr. Bukele as the most trusted political actor and the least corrupt, while traditional political parties find themselves on the other side of the spectrum.

Polls position Mr. Bukele as the most trusted political actor and the least corrupt, while traditional political parties find themselves on the other side of the spectrum. The administration's popularity is off the charts, with the economy performing okay and impressive security metrics. Of the polled, 63.5% strongly trust Mr. Bukele, while 15.6% moderately trust him, making up for an aggregate 79.1% of total confidence. He is followed by the Armed forces (77.1%), the Police (73.4%), and the Central Government (70.6%) as the institutions which compound the best confidence ratings in the country, again highlighting the importance of the Exception regime on popularity metrics. On the other side of the spectrum, the institutions to which the Salvadorans grant the least trust (strongly distrust + moderately distrust) include political parties (67.3%), local governments (61%), and businessmen (56.7%). The image conveys a similar outcome on perceived corruption, as the President has the lowest metrics (6.4% strongly corrupt, 13.9% somewhat corrupt). In comparison, political parties are perceived as the most corrupt institutions in the country (43.3%, 26%). The polled were also asked to rate the performance of the actors and institutions in the country during the year. Unsurprisingly, the marks present the same trend. Mr. Bukele leads the ratings, with an 8.37 out of 10, followed by the armed forces (8.2) and the Central Government completing the podium (8.04). On the other side of the spectrum, Businessmen (5.99), Local Governments (5.69), and Political Parties (5.47) were the worst-rated institutions, with the average mark coming in at 7.

Figure 6: The justice system is also perceived as more efficient in the context of the exception regime.

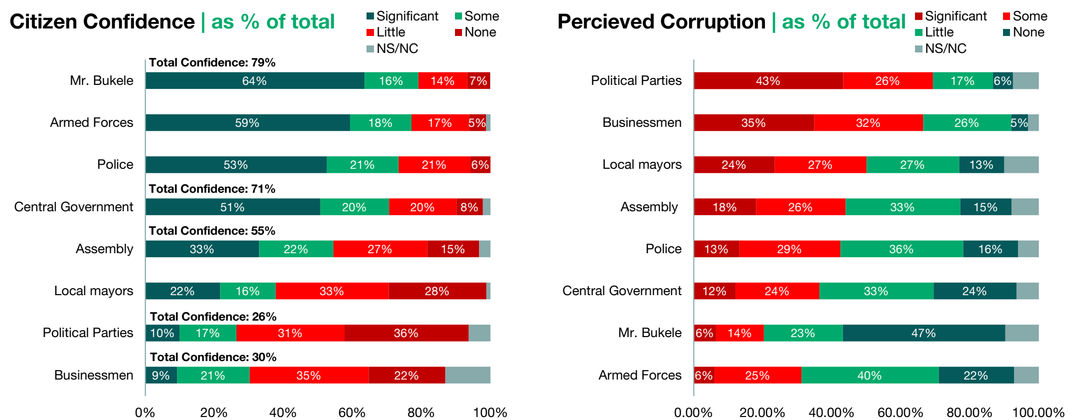


Source: TPCG Research based on UCA

The poll clearly outlines the strengths the administration currently possesses and the weaknesses it must address before the 2024 elections.

The poll clearly outlines the strengths the administration currently possesses and the weaknesses it must address before the 2024 elections. On the one hand, the administration's popularity is largely driven by the reduction in crime and the exception regime in a less supportive economic environment. On the other hand, the high cost of living related to the high inflation the country experienced during 2022 poses the largest threat to the government. 68% of Salvadorans indicate they have strongly perceived the impact of the higher cost of living, with another 16.9% suffering it moderately. In our view, the administration should have more problems conserving its advantages than facing threats. With global inflation expected to deaccelerate in 2023, the inflationary pressures in El Salvador are poised to subside, with prices plateauing, which should improve the population's perception of the government, even as the economic situation could suffer some reversals accounting for a more hostile international context. However, it could be somewhat problematic for the administration to maintain the exception regime. Even if Mr. Bukele has the power to continue extending said measure, it should come a time where he could need to institutionalize it, providing a more stable, permanent, legal framework to the regime, which could become problematic. If Mr. Bukele manages to keep the security train running and inflation starts to ease, he is bound to be reelected in 2024. And with current approval ratings for the traditional parties, it seems as if the political system could be again flooded by the "Nuevas Ideas" cyan.

Figure 7: The actors closely related to the exception regime enjoy the highest confidence levels and lowest perceived corruption.



Source: TPCG Research based on UCA

Therefore, the risk to policy continuity does not stem from a regime change but from a shift in the administration's policy.

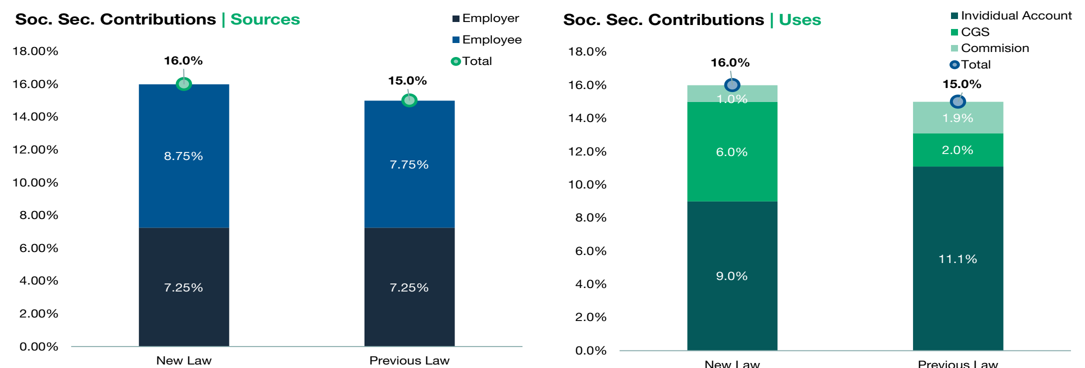
Therefore, the risk to policy continuity does not stem from a regime change but from a shift in the administration's policy. Mr. Bukele's administration has been relatively market-friendly, with the President paying back the 2023 maturity and establishing a hawkish fiscal policy to balance government accounts. We expect this bias to continue throughout 2023 and 2024. In addition, if he can maintain his incredibly strong ratings, he is headed towards steamrolling his opposition in 2024's dual elections, granting him once more control of the Assembly and the presidential seat for one more term. The prospect of a government landslide win means that few checks and balances will remain relevant after 2024. Mr. Bukele's popularity and command of the political landscape would mean there would be little backstop if he wanted to pivot in any direction. In the current context, the threat of a policy change does not emerge from a regime change, but from a change in Mr. Bukele's policy itself, and even more, due to the lack of a solid institutional framework to prevent it. Even though the administration's track record in both the fiscal and debt departments is impeccable, if the said approach does not bear the fruit Mr. Bukele expects, he might easily shift his policies, as there are no significant institutions that could present an obstacle to impede it. While we believe current incentives are not lining up in that direction, the lack of weights and balances to counteract Mr. Bukele's power drives us to expect the political risk premium charged on the ELSALV curve to remain persistent.

The Pension system reform: Clearing the smoke

The long-awaited pension reform only cosmetically modifies the current system, albeit presenting some advantages for the administration.

The long-awaited pension reform only cosmetically modifies the current system, albeit presenting some advantages for the administration. Looking at the general changes, the reform increased pensions below USD2,300 per month by 30%, with the minimum pension remaining unchanged at USD304 per month. However, current minimum pensions will receive a 30% increase, leaving them at USD400. In addition, it slightly altered the employee contributions, which will now total 16% of their base income, increasing by 1% relative to the previous 15%. Now, the employee will contribute 7.25% of its base income, with the employer chipping in the remaining 8.75%. However, only 9% will go to the employee's individual savings account. On the other hand, 6% will now be contributed to the Solidarity Guarantee Account (CGS), and the final 1% will be kept by the corresponding fund (AFP) as a commission. Instead, the previous law established that an 11.1% share would go to the individual's account, with the pension fund commission totaling another 1.9%, with the final 2% going to the CGS. However, it also demanded pension funds to pay for worker insurance which amounted to 1% of monthly contributions. Now, that burden has been taken away from the pension fund's shoulders and undertaken by the CGS, leaving pension fund margins virtually unchanged net-net. Furthermore, the new law does not allow individuals to take an advance of 25% of their pension, which the previous system did contemplate. Finally, the new law establishes a cap for pensions, which stands at USD3,000 per month. The retirement age will remain as is, standing at 60 years for men and 55 years for women. Finally, the reform does little to address the low coverage of the system, which accounts for 60% of the population, conditioned by the high percentage of informal labor present in the country.

Figure 8: Soc. Sec. Contributions were increased to 16%.



Source: TPCG Research based on the Assembly of El Salvador

The creation of the Salvadoran Pension Institute and the refurbishing of the previous FOP system complete the reform.

The creation of the Salvadoran Pension Institute and the refurbishing of the previous FOP system complete the reform. The former will be the institution responsible for monitoring the new pension system and will be authorized to issue debt to finance the latter's needs. This brings us to the disassembly of the FOP (Pension Obligation Trust). The trust was established in 2006 and forced the private pension funds to purchase CIP (Pension Investment Certificates) bonds for the administration to fund public pensions. Since then, the FOP grew to amass USD8bn, representing 65% of the total pension system. The trust will transfer its assets and liabilities to the Salvadoran Pension Institute. In addition, the CIP bonds will now be converted to CFTs (Transition Financing Certificates). From now on, the institution will be able to issue COPs (Pension Obligation Certificates) to finance itself. A key item in the reform is that there will be no limits to pension fund investment in the COP securities, while the amount of CIP bonds in the total portfolio was capped. Furthermore, Art. 9 of the law approving the creation of the COPs established that Pension funds are required to buy the totality of the COPs issued in each instance. Compounded, these two clauses present nearly unrestricted access to pension fund monies, as the ISP can print as many COPs as it wants (or needs), and the AFPs are forced to absorb any issuance. Anyhow, previous administrations already heavily tapped pension funds, and their ability to provide new money is limited. The new law also establishes that pension funds cannot purchase any government securities, except for the new COPs issued by the Salvadoran Pension Institute. In a context where the funds are positioned in both external and internal Salvadoran securities, this final provision looks strange, even as the previously discussed clauses hint the administration is planning on exchanging the market debt for the refurbished non-market instruments. The pension system had around USD10.3bn in government securities by Oct-22, of which around USD8.2bn belonged to the FOP. This leaves an odd USD2bn of market government securities in the pension funds' possession, which will probably have to be replaced by COPs issued by the Pension Institute.

Figure 9: Pension funds possess nearly USD10bn in Govt. debt

Pension Fund Composition	oct-22		
	in USDmn	as % of total	as % of GDP
Total	**12,834**		**44.7%**
In Public Institution securities	10,296	80.2%	35.8%
In bank securities	583	4.5%	2.0%
In national company securities	10	0.1%	0.0%
In assets of development organizations	0	0.0%	0.0%
In foreign securities	955	7.4%	3.3%
In securitization funds	798	6.2%	2.8%
Others	192	1.5%	0.7%
By security type			
Fixed Income	12,017	94%	42%
Equity	809	6%	3%
12-m rolling collection	**1,154**	**9.0%**	**4.0%**

Source: TPCG Research based on SSF

We believe the reform is slightly net positive for the administration in the short term from a financing POV, while in the long term, the overall balance is more uncertain.

We believe the reform is slightly net positive for the administration in the short term from a financing POV, while in the long term, the overall balance is more uncertain. On the negative side, the increases in pensions are estimated to cost the administration an additional USD150-200mn in 2023, a figure which should compound upwards in the coming years. In addition, now the Solidarity Guarantee Account will finance the pensions of the people whose individual funds have run out or are affected by specific ailments, in addition to worker insurance, which amounts to 1% of the monthly contributions. Finally, the new law prohibits pension funds from investing in market instruments but grants the new Salvadoran Pension institute the ability to issue debt, which the funds must buy, which in turn could lead to replacing local market debt (which is short-tenor) with new non-market debt. This could have a silver lining, as the new non-market instruments (COPs) are poised to accrue a 7% annual coupon, marking a slight reduction in the rates on CETES or LETES, which averaged a 7.5% interest rate in 2022 issuances. It is also an improvement relative to most global bond coupons, which

average an +7.63% annual coupon throughout the curve. In addition, even as the CIP bonds pay +6% interest (+1% below COPs), their replacements, the CFTs, still have to be drawn up, and their terms will likely remain similar to the original CIPs. This means the reduction in financing costs by swapping market instruments for the new non-market paper should not be outweighed by an increase in coupons in non-market instruments, as the new COPs will not replace the CIPs, decoupling financing costs between instruments poised to replace the old non-market securities and the ones going to replace market securities which the funds cannot hold. On the strictly positive, now the administration will be able to manage the Solidarity fund, which should this year add around USD380mn of new money to government financing, as nearly 1/3rd of the collection will go into the CGS. Furthermore, the impediment to cash out the 25% advancement gives the administration an extra rollover capacity. Pension funds were prepared to disburse around USD400mn in advance payments in 2023, which can now be kept invested in government securities, or switched to the new COPs. So, in 2023 the reform will probably be net positive for the administration, adding roughly 200mn of net new money, plus another 400mn in rollover or swaps to the newly issued COPs.

Figure 10: The reform could present marginally lower financing costs for the administration.

Available financing instruments	Market			Non-Market		
	Local		Global Bonds			
	CETES	LETES		CIP	CFT	COP
Current annual Financing Cost	7.50%	7.50%	7.63%*	6%	TBD	7%
Average Tenor	1 year	1 year	13.3 years	50 years	TBD	50 years
Current Status	-	-	-	To be replaced by CFT's	Will replace outstanding CIP's	New funding instrument for the ISP
Current Size	USD1.06bn	USD1.2bn	USD6.3bn			-
Cap	Budget	Budget	Budget	45% of the AFP's portfolio	-	No Cap

* Average of face value Coupons throughout the curve

Source: TPCG Research based on SSF, Assembly of El Salvador, and TPCG Trading Desk

In the medium term, the pension reform outcome is clouded by uncertainty.

In the medium term, the pension reform outcome is clouded by uncertainty. The administration acquired a liability flow through pensions with benefits that extend beyond 20 years or special cases. This liability flow is likely to increase as life expectancy extends, as the law divides the employee's savings spreading them out for 20 years once it retires. If a man lives beyond 80 or a female over 75, the administration is bound to pay their pension for their remaining years. With the life expectancy for men at 68 and female life expectancy at 78, it is relatively unlikely that the liability flow will exceed the proceeds from the administration's fund. Still, it could lead to an increase in the retirement age in the long run.

The Fiscal position performed stellarly in 2022

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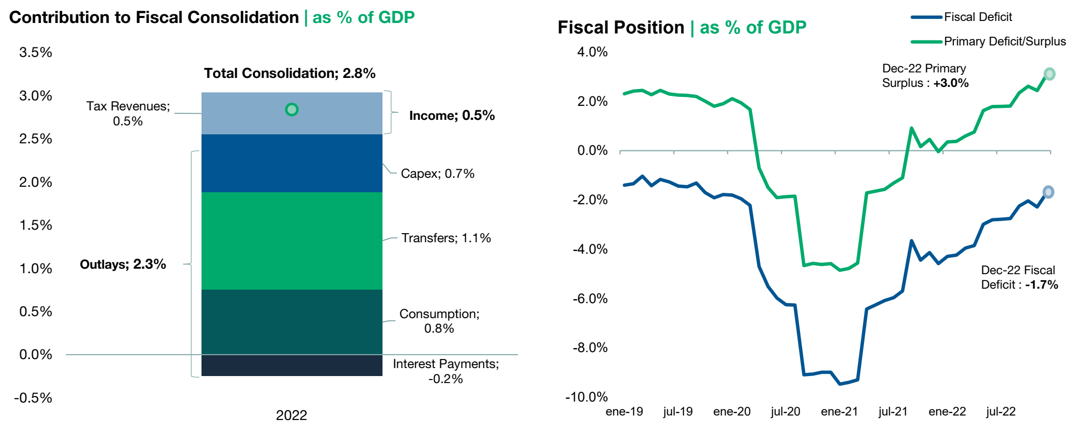
Fiscal consolidation was stellar in 2022, as the primary position closed the year with a +3% of GDP surplus, while the fiscal balance clocked in at -1.7%. The primary position improved steadily throughout the year, building over the already solid 2021 consolidation. In nominal terms, the improvement came mostly from a surge in income sources, with the country posting its record year in tax collections. Outlays were also slightly trimmed, aiding consolidation. In GDP terms, the economic growth caused Outlays to plummet, with Tax revenues managing to offset the baseline effect, still able to post growth. The fiscal deficit closed the year at -1.7% of GDP, marking a 2.8pp compression over 2021's -4.6% eop figure, explained in its entirety by the widening of the primary surplus, which started the year near a neutral position and stood at +3% of GDP by the year's end.

Total income rose by 0.5pp of GDP relative to 2021, now standing at 25.3% of GDP. Inside the segment, the rise came on the back of a sizable +0.5pp increase in Tax revenues, partly offset by a -0.1pp reduction in Non-Tax income—however, dual increases in SocSec contributions and the SOE's operative surplus managed to overcome said drop. Looking at Outlays as % of GDP, the yearly drop was substantial, as expenditure fell by 2.3pp of GDP relative to 2021. In this context, Current Outlays spearheaded the consolidation, compressing by 1.6pp. The Goods & Services subsection led the drop, falling by 0.8pp, with Current Transfers decreasing even further by 1.1pp. However, increased financing costs marginally offset said drops, as interest payments rose by 0.2pp. Capex also contributed to the consolidation, dropping by -0.7pp on the back of a 1pp reduction in Gross Investment and a 0.3pp increase in Capital Transfers. In this context, with a 0.5pp increase in Income sources and a 2.3pp drop in Outlays, YTD consolidation totaled 2.8pp, driving the fiscal deficit from -4.6% of GDP to -1.7% of GDP. The primary balance performed similarly, as after ending 2021 near the neutral mark, it sprinted to a +3% of GDP surplus by year-end.

Figure 11: Consolidation amounted to 2.8% of GDP in 2022



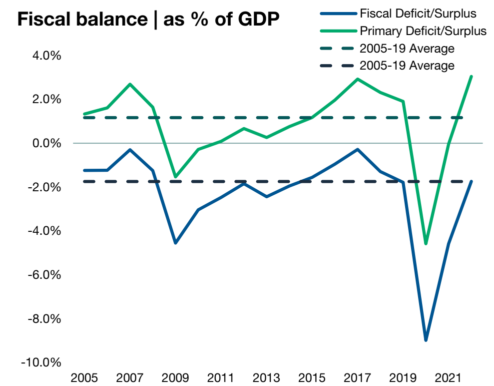
Source: TPCG Research based on BCR

For 2023, we expect consolidation to slow down as income sources lose momentum, with fiscal figures already hovering over historical averages.

For 2023, we expect consolidation to slow down as income sources lose momentum, with fiscal figures already hovering over historical averages. With activity also slowing down in 2023, we expect income growth to become more sluggish, as its biggest contributor, tax revenues, is poised to slow down following the economic scenario. In addition, it is unlikely the administration would commit to a large trim in government outlays, especially with dual elections dangling menacingly close in early 2024. Still, the administration's popularity does not seem to stem from fiscal impulse, as two consecutive years of massive consolidation did not even scratch Mr. Bukele's popularity ratings. As discussed above, these seem to depend on the massive improvement in security metrics generated by the exception regime. With this in mind, it is not likely that the administration would increase expenditure massively to win the elections, as it does not need to. Still, it is as unlikely as the government continuing to trim outlays in a context where their primary balance metrics exceed the historical average and stand close to its maximums. All in all, we expect the government to maintain relative order in the fiscal balance, not only due to its track record but also due to the fact that the administration pushed its financing sources to the limit during 2022 to pay the 2023 Eurobond, which should still leave the administration with financial constraints, tightening its spending possibilities. In this context, we expect the primary balance to clock in at +2.3% of GDP in 2023, with the fiscal deficit hovering around the -2.5% of GDP mark.

Figure 12: The fiscal position surpassed historic averages

12m accumulated | % of GDP	dic-20	dic-21	dic-22
Total Income	**23.4%**	**24.7%**	**25.3%**
Current Income	22.9%	24.7%	25.2%
Tax Revenues	18.5%	20.1%	20.6%
Social System Contributions	2.4%	2.3%	2.3%
Rest	2.5%	2.4%	2.4%
Total Mandatory Outlays	**32.3%**	**29.3%**	**27.0%**
Current Ouytlays	27.7%	25.9%	24.2%
Consumption	17.0%	16.0%	15.2%
Interest Payments	4.4%	4.5%	4.8%
Current Transfers	6.2%	5.4%	4.3%
Capital Expenditure	2.8%	3.4%	2.8%
Net Loan Granting	1.9%	0.0%	0.0%
Primary Balance	**-4.6%**	**0.0%**	**3.0%**
Pensions and Trusts	-3.4%	-1.0%	-1.0%
Net lending/borrowing	**-9.0%**	**-4.6%**	**-1.7%**



Source: TPCG Research based on BCR

The administration's budget totals USD8.9bn and is consistent with a primary surplus of +0.9% of GDP and a fiscal deficit of -2.6%.

The administration's budget totals USD8.9bn and is consistent with a primary surplus of +0.9% of GDP and a fiscal deficit of -2.6%. The government expects to collect nearly USD6.8bn in current income sources (+3% vs. 2022), with capital income and other sources chipping in an additional USD200mn. Tax revenues would total USD6.3bn, remaining level with the accrued yearly tax collection by Dec-22, with the prospect of slower economic growth threatening an increased tax intake. On the outlays side, total expenditure is expected to increase by 6% relative to 2022, totaling USD8.9bn. Most of the increases would come in the shape of Capital Expenditure going from USD0.73bn in 2022 to USD1.5bn in 2023 and the hike in Amortizations, which would come at USD1.1bn instead of last year's USD0.9bn. Current expenditure, in turn, is poised to drop by 15%, from USD6.5bn to USD5.5bn. Finally, to close the expenditure section, Pension Outlays are budgeted at USD570mn for 2023. In this context, total income sources would amount to roughly USD7bn, while Outlays excluding amortizations total USD7.8bn, which is consistent with a -2.6% of GDP deficit, worsening by 0.7% relative to 2022. Subtracting interest outlays, which are budgeted at USD1.06bn, would leave the government with a primary surplus of 0.9% of GDP. Consistently, the budget's financing gap would amount to nearly USD1.9bn, which the government plans to fund with USD472mn in local bond issuances, USD43mn in bilateral financing, and USD1.4bn worth of multilateral agreements. Of these, USD667mn were used to fund the amortization of the 2023s, while the government expects additional BID disbursements for USD180mn, BCIE funding for USD300mn, and BIRF loans for USD225mn.

Figure 13: The budget is consistent with a -2.6% deficit for 2023

USDmn	2022 (Accr. Dec-22)	2023	Δ USDmn	Δ %
Total Income	8006	8903	897	11.2%
Current Income	6582	6795	214	3.2%
Tax Revenues	6376	6327	-49	-0.8%
Rest	206	468	263	127.7%
Capital Income	25	12	-13	-53.5%
Financing	1207	1914	708	58.7%
Local Bonds	828	472	-355	-42.9%
Bilateral & IFI's	379	1442	1063	280.6%
o/w IDB	-	178	-	-
o/w CABEI	-	293	-	-
o/w World Bank	-	224	-	-
o/w 2023 amortization funding	-	667	-	-
Other Income	193	181	-11	-5.8%
Total Outlays	8361	8903	542	6.5%
Current Outlays	6512	5554	-958	-14.7%
Wages	2391	2462	70	2.9%
Goods & Services	595	357	-239	-40.1%
Interest payments	1070	1059	-11	-1.0%
Transfers	2455	1676	-779	-31.7%
Capex	734	1481	747	101.7%
Amortizations	932	1116	184	19.8%
Other Outlays	183	181	-1	-0.7%

Source: TPCG Research based on El Salvador Finance Ministry

With the 2023 sinking out of the way, GFNs seem manageable

GFNs are poised to increase by USD0.8bn to USD5.4bn in 2023. However, with the payment of the 2023 Eurobond out of the way, the remaining maturities look manageable.

GFNs are poised to increase by USD0.8bn to USD5.4bn in 2023. However, with the payment of the 2023 Eurobond out of the way, the remaining maturities look manageable. Gross Financing Needs for 2023 comprise USD1.5bn of Interest payments, USD2.9bn in principal payments, and USD1.1bn in other liabilities, including pension system payments. Eurobond interest payments compose roughly one-third of the total, amounting to USD0.5bn, with the rest coming on the back of internal financing costs. In the amortization department, the largest sinking is already out of the way, as the administration disbursed the USD0.6bn principal payment corresponding to its 2023 Eurobond. The rest comes on the back of another 0.6bn in IFI and Bilateral payments, in addition to 1.7bn in maturing local debt. Looking at sources, the administration is on its way to securing 1.4bn in multilateral funding for 2023. Domestic debt payments should not cause much trouble, as the government should have the capacity to roll over its short-term LETES and CETES debt with little effort. In addition, the current consolidation path should present a solid income stream in the form of a primary surplus to complete the funding picture. In line with what was previously discussed, we expect the administration to run a 0.9bn primary surplus, slightly below 2022 figures.

Figure 14: GFN's for 2023 total USD5.4bn

In USDbn	2022	2023	2024	2025	2026
Gross Financing Needs	4.6	5.4	5.4	6.3	5.5
Interest payments	1.4	1.5	1.6	2.0	2.1
Eurobonds	0.6	0.5	0.5	0.5	0.5
Rest	0.9	1.0	1.2	1.5	1.6
Principal payments	2.0	2.9	2.6	3.2	2.3
External	0.3	1.2	0.8	1.0	0.4
Eurobonds	0.0	0.6	0.0	0.4	0.0
Rest of IFIs & Bilaterals	0.3	0.6	0.8	0.6	0.4
Domestic	1.7	1.7	1.9	2.2	1.9
o/w Short Term (LETES)	1.4	1.5	1.6	1.6	1.6
Other	1.1	1.1	1.1	1.1	1.1
Identified financing	4.6	5.5	4.3	5.0	5.0
Primary Surplus	1.0	0.9	0.4	0.6	0.8
IFI financing	0.7	1.4	0.7	0.7	0.8
Domestic market rollover	1.7	1.8	1.9	2.2	1.9
Others	1.1	1.4	1.4	1.5	1.5
Net financing needs	**0.0**	**0.0**	**1.1**	**1.3**	**0.5**
Liquid Assets	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Use of assets	0.0	0.0	0.0	0.0	0.0
Financing Gap (market)	**0.0**	**0.0**	**1.1**	**1.3**	**0.5**

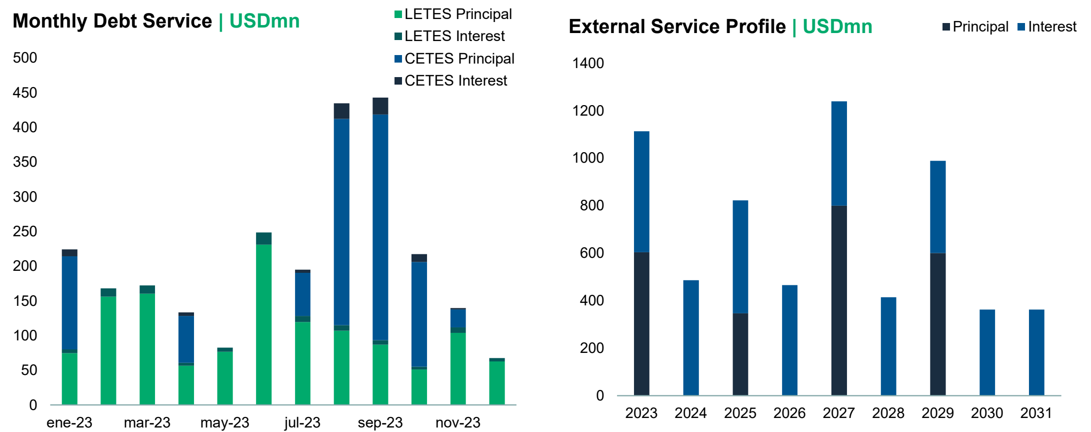
Source: TPCG Research based on BCR and IMF

In this context, the administration is in pole position to exploit the gap it created in the external payment profile

In this context, the administration is in pole position to exploit the gap it created in the external payment profile. The biggest concern looming over Salvadoran finances in the last year came from the substantial USD0.8bn 2023 principal payment. Mr. Bukele managed it brilliantly, opening two windows to buy back the weakly priced bonds. The repurchase, which included the 2023 and 2025 bonds (and focused on the latter, due to the reduced price on the second), left the 2023's outstanding at USD0.6bn and the 2025's at USD0.35bn, from an original size of 0.8bn in both cases. The move yielded impressive results, totaling savings of USD290mn, decompressing the external payment profile by USD726mn. Still, the administration faced the challenge of paying outright the USD0.6bn in principal outstanding for the 2023 notes. Now that the bridge was crossed, the administration will enjoy the brunt of the buyback's benefits. It only must face a relatively small USD350mn payment in

2025, followed by USD800mn of the 2027s in the corresponding year. With the local debt under control and the administration consolidating the fiscal balance substantially, it seems the government is poised to have an easy time in the medium term. The external debt should present no threat in the short term, and the administration has only to stay current with coupon payments, a relatively simple task. In this context, we believe neither the local nor external payment profiles present serious threats to the administration in the medium run, with only an external sector shock or a substantial policy shift carrying the risk of derailing El Salvador's payment capacity.

Figure 15: The repurchases left a gap up until 2027 in the payment profile



Source: TPCG Research based on Bolsa de Valores del Salvador

The external sector is the administration's Achilles heel

The current account is poised to close 2022 with a deficit nearing the -10% of GDP mark, a heavily unsustainable figure.

The current account is poised to close 2022 with a deficit nearing the -10% of GDP mark, a heavily unsustainable figure. The current account deficit of the year closed on 3Q22 stands at nearly USD3bn, close to the -10% of GDP mark. This is an alarmingly wide gap, as the recent historical average of the country presents a -3.6% deficit, which stands to be tripled in 2022. YTD, most of the worsening comes on the back of the sky-high fuel prices, which leaves El Salvador in a very vulnerable position, as the country is a net importer of hydrocarbons, having little to no energy sources in the country, save for some instance of geothermal energy. Imports rose by USD2.6bn YTD, comparing the Jan-Sept period for 2021 and 2022. Energy imports, in turn, rose by nearly USD1bn. Commodity price increases also affected Food imports, which rose by another USD300mn, with international prices explaining USD1.1bn of the deterioration. The rest of the imports also experienced a substantial increase, showcasing a USD1.4bn variation over 2021 levels. This variation has more to do with the improvement in disposable income the country experienced, as consumption rose spearheaded by two prongs. The first comes on the back of the increased remittance levels showcased this year, especially during the first half of the year, even as they lost momentum during the 2nd half. 12m accumulated figures exhibited a +20.3%yoy rise in March, which dissolved into a timid +3.2%yoy improvement by December. The second improvement in disposable income directly results from the exception regime, as extortion tariffs dropped, leaving additional income for families to spend. Exports did increase, offsetting part of the widening in the current account, improving on 2021 numbers by USD760mn, which compounded with a USD360mn rise in the Services balance to put the final deficit figure at -USD2386mn YTD, worsening by USD1.3bn.

Figure 16: The CA deficit could close the year at the two-digit mark

USD mn	2021 1Q	2021 2Q	2021 3Q	2022 1Q	2022 2Q	2022 3Q	Jan-Sept-21	Jan-Sept-22	Δ
Current Account	**-283.6**	**-228.6**	**-570.9**	**-930.8**	**-745.1**	**-710.7**	**-1083.1**	**-2386.5**	**-1303.5**
Trade Balance	-1754.2	-2015.8	-2142.4	-2464.3	-2679.7	-2655.3	-5912.5	-7799.3	-1886.8
Imports	3358.8	3667.1	3817.9	4352.3	4582.1	4553.8	10843.7	13488.2	2644.4
Energy Imports	424.3	476.5	488.3	660.5	797.9	867.2	1389.1	2325.6	936.4
Food Imports	488.8	501.0	501.2	578.3	597.9	610.1	1491.0	1786.3	295.4
Rest	2445.7	2689.6	2828.3	3113.5	3186.3	3076.5	7963.6	9376.3	1412.6
Exports	1604.5	1651.2	1675.5	1888.0	1902.4	1898.5	4931.2	5688.9	757.6
Clothing/Maquila	630.8	658.4	692.4	715.0	700.8	756.2	1981.6	2172.1	190.4
Rest	973.7	992.8	983.1	1173.0	1201.6	1142.2	2949.6	3516.8	567.2
Services balance	262.8	298.3	226.0	309.4	388.1	449.7	787.1	1147.3	360.2
Primary Income	-464.6	-437.0	-444.4	-549.2	-393.6	-427.4	-1346.1	-1370.2	-24.2
Secondary Income	1672.5	1925.9	1789.9	1773.3	1940.1	1922.3	5388.4	5635.7	247.3
o/w Remmitances	1691.5	1936.4	1820.1	1785.7	1955.9	1894.8	5448.0	5636.3	188.4
Capital Account	**28.8**	**152.3**	**47.1**	**130.5**	**42.9**	**40.5**	**181.1**	**173.4**	**-7.7**
Financial Account (- indicates inflow)	**459.8**	**-483.5**	**-1304.1**	**-487.7**	**-322.4**	**-452.0**	**-1327.9**	**-1262.1**	**65.8**
FDI	-175.6	-238.0	19.2	212.4	56.0	-222.9	-394.3	45.5	439.8
Portfolio Investment	202.4	-51.0	-484.7	-97.3	-43.3	465.1	-333.2	324.5	657.7
Derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Investment	432.9	-194.6	-838.7	-602.8	-335.1	-694.2	-600.4	-1632.1	-1031.7
Net Errors&Ommisions	**93.5**	**-197.3**	**12.3**	**756.0**	**525.5**	**25.1**	**-91.5**	**1306.6**	**1398.1**
Reserve Assets	**-621.1**	**209.9**	**792.6**	**443.4**	**145.7**	**-193.1**	**381.4**	**396.0**	**-14.6**

Source: TPCG Research based on BCR

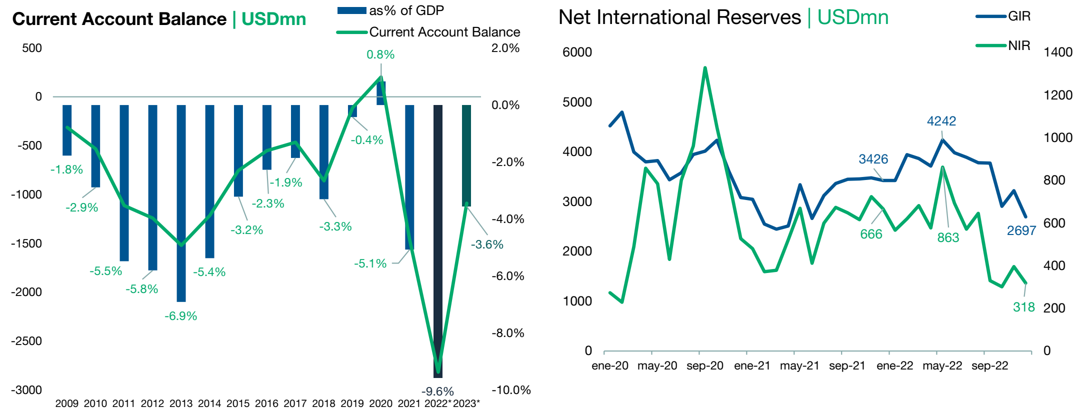
Consistently, the reserve position of the BCR has suffered, with NIR dropping by USD350mn during 2022.

Consistently, the reserve position of the BCR has suffered, with NIR dropping by USD350mn during 2022. The unflattering external scenario was hard on the reserve assets of the BCR, pummeling the GIR and NIR positions, which had improved steadily during 2021. The GIR position started the year at USD3.4bn, and after a surprisingly good 1H22, edged the USD4bn mark before dropping back to USD2.7bn by December. The NIR position suffered a similar dynamic, dropping from USD660mn back in Dec-21 to USD318mn by the end of 2022. Most of the worsening came on the back of a reduction in deposits, which fell by nearly USD500mn since the start of the year. This is consistent with the country's massive CA deficit during 2022, as the drawdown in deposits probably came on the back of increased external consumption (i.e., imports). On some positive news, the capital inflows towards the country impeded larger bleeding, as several multilateral disbursements managed to plug the gap, preventing further reserve loss. Still, the situation is not very flattering for the administration. For 2023, we expect the current account deficit to stop straining the reserve position to the limit, allowing the country to accumulate some reserves. However, suppose the current situation persists, and multilateral funding and capital flows are cut off. In that case, the country could face a severe external shock, which in turn could seriously threaten growth and fiscal consolidation.

Figure 17: The reserve position suffered in line with the Current Account

USDmn	dic-20	dic-21	jun-22	dic-22	Δ YTD
GIR (By Currency)	**3083**	**3426**	**3984**	**2697**	**-730**
Foreign Currency	2765	2737	3328	2403	-333
SDR's	234	609	576	212	-397
Gold	83	80	80	80	0

USDmn	dic-20	dic-21	jun-22	dic-22	Δ YTD
GIR (By Composition)	**3083**	**3426**	**3984**	**2697**	**-730**
Short Term Liabilities	-168	-84	-501	-256	-172
Medium&Long Term Liabilities	-404	-759	-700	-673	86
Deposits	2388	2676	2790	2123	-554
NIR	527	666	693	318	-348



Source: TPCG Research based on BCR

We expect the current account deficit to tighten back to -3.6% of GDP in 2023 on the back of a slowdown in consumption, reduced energy import costs, and increased tourism.

We expect the current account deficit to tighten back to -3.6% of GDP in 2023 on the back of a slowdown in consumption, reduced energy import costs, and increased tourism. Looking at the forward curve for Brent Oil prices and modeling an increase in imported volumes in line with the economy's growth, we expect energy imports to total USD1.9bn, dropping by USD800mn relative to 2022's USD2.7bn. In addition, the rest of the imports should also slow down as remittance growth becomes more sluggish and the effect of the exemption regime on consumption wears off. We expect them to total USD15.9bn. We expect exports to grow by +2.5%, slightly over the general economy, improving by USD200mn. Finally, the service balance should total USD1.6bn, improving by 300mn relative to 2022. We expect tourism to drive the improvement, as forecasts put the number of tourist arrivals in the country back to 2019, which should result in a USD500mn rise in tourism income. In turn, the sector should continue to prove a key source of USD if the administration manages to control the security issues that have riddled El Salvador in the last decade. Finally, looking at remittances, we expect them to grow in line with the general economy, slowing down significantly relative to 2021 and 2022, as they have started to plateau by 2H22, conveying there is little juice left for the country to capitalize. All in all, we expect the external situation to improve substantially, as a slowdown in consumption and lower commodity and energy prices, should result in a decrease in Imports, which in turn should tighten the economy's current account deficit, bringing it back to more sustainable levels.

Figure 18 : We expect the CA deficit to tighten as energy prices drop, and consumption slows down.

USDmn	2022*	2023**	Δ
Current Account	**-2815**	**-1088**	**1727**
as % of GDP	***-9.6%***	***-3.6%***	***6.0%***
Trade Balance	-9993	-8671	1322
Imports	17108	15964	-1144
Energy Imports	2673	1900	-773
Food Imports	2053	1459	-594
Rest	12382	12605	223
Exports	7115	7293	178
Services balance	1319	1,619	300
Primary Income	-1882	-1916	-34
Secondary Income	7741	7880	139
o/w Remmitances	7742	7881	139

Source: TPCG Research based on BCR

Given El Salvador's economic structure, we believe an external sector shock carries the largest risk of derailing the government's consolidation plan.

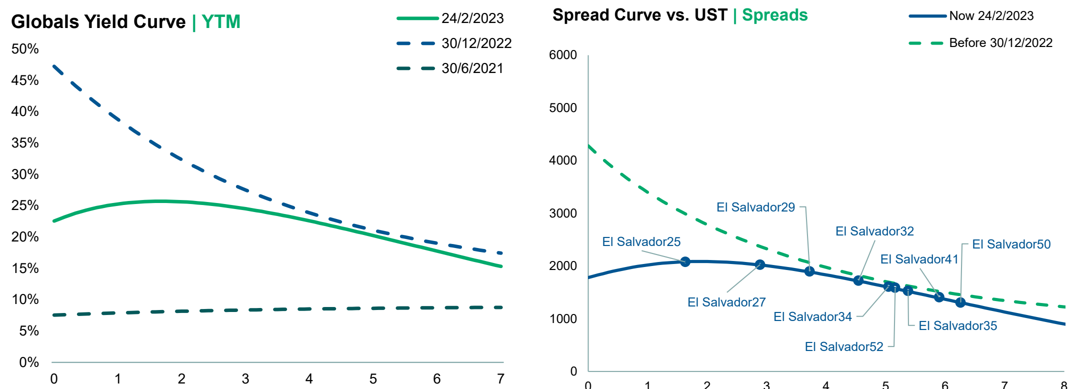
Given El Salvador's economic structure, we believe an external sector shock carries the largest risk of derailing the government's consolidation plan. Although we believe several factors hint at a compression of the current account deficit in 2023, the situation remains fragile. This is due to the adjustment mechanism of the Salvadoran economy to external shocks. With a perennial trade balance deficit, the country has always depended on external remittances to balance the external accounts. In a context where their flow towards the country reduces, on the back of an unflattering international scenario or a recession in the US, the economy will not be able to sustain its Import rates and, in turn, its consumption. This scenario would strain tax revenues and force the administration to push for increased outlays to contain the massive drop in disposable income. This, in turn, should limit the government's fiscal policies and, with reduced financing sources, should raise questions about debt sustainability once again.

Strategy: We maintain our OW rating in ELSALV

We maintain our OW rating in a context where the administration managed to cancel its Eurobond payment in Jan-23, driving the space to rally YTD, as we expected.

We maintain our OW rating in a context where the administration managed to cancel its Eurobond payment in Jan-23, driving the space to rally YTD, as we expected. Since the start of the year, the space commanded a significant rally, driven mostly by the short end as it became increasingly clear the administration would honor its commitments related to the 2023 Eurobond. Consistently, the front end enjoyed the largest compression, with tenors compressing an average of 1110bp, spearheaded by the 2025s and 2027s. Instead, the long end continued to trade relatively flat to December, experiencing much more modest tightening, hovering around the 130bp mark. The belly mimicked said gains, albeit slightly edging them, compressing by 150bp. With the rally being explained mostly by idiosyncratic factors, spreads relative to the UST also experienced a major compression, roughly mimicking the performance of the global curve. In this context, the curve looks rather steep, making us remain constructive on the short end and belly. With the yield curve still inverted, the space should have more space to compress in the front rather than the back. Given that the 2025s outstanding was reduced significantly, it should be riddled by liquidity issues, making the 2027s our top pick in the front end of the curve, as we believe it still should have some space to compress. The argument for the 2027s comes from the administration having a large oasis in its external payment profile due to the buyback, giving it substantial time to accrue primary surpluses to face its payment. In addition, while the 2024 elections could riddle the space with some volatility, Mr. Bukele currently seems headed to reelection, which should (in theory) guarantee some policy continuity. Alternatively, in a context where the space is gaining some momentum, the coupon-rich back end could present some opportunities for carry trades, as ELSALV50 and ELSALV52 continue to exhibit low parities.

Figure 19: The short end still has some space to compress yield-wise



Source: TPCG Research based on TPCG Trading Desk

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