TPCG

Santiago Resico
LATAM Strategist
sresico@tpcgco.com
+54 11 4898 6615

Strategy Flash – El Salvador

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El Salvador Strategy Flash

The IMF presented its preliminary finds amidst Article IV talks with El Salvador

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On the risks side, the IMF identifies the external sector and lack of financing as the main challenges to address going forward.

On the risks side, the IMF identifies the external sector and lack of financing as the main challenges to address going forward. The current account deficit is estimated to have risen to about 8 percent of GDP, on account of weaker terms of trade and import volume growth, driving a drop in international reserves to around 2 months of imports. The IMF expects improved terms of trade to support some narrowing of the current account deficit in 2023, although it should remain high, with fund estimates putting it at 5.4% of GDP. Looking at financing, even as EMBI spreads continued to drop post-2023's Eurobond payment, the Treasury still lacks access to international capital markets. Under a baseline without market access, the IMF envisages short-term government debt to grow, preventing the restoration of adequate reserve buffers. In this context, the IMF believes the risks to the outlook are high and tilted to the downside. On the external front, a pronounced slowdown in the United States could undermine exports and remittances. A drop in net private capital inflows could force a sharper correction of the current account, with negative implications for growth. On the domestic side, policy slippages could weaken investor confidence, and liquidity shocks could dampen private sector credit and growth. In addition, shocks due to climate change and other natural disasters cannot be discarded.

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On the fiscal front, even as the Fund does highlight the administration's consolidation throughout 2022, it still believes further improvements should be made in several areas. With public debt at 77% of GDP the IMF believes it is still on an unsustainable path, and it needs to be addressed going forward. According to the fund, the administration still must embark in a structural 3.5% of GDP consolidation to regain investor confidence, in conjunction with a financial plan in order to gradually rebuild reserve buffers, avoid overreliance on short-term domestic debt, and return to international capital markets at lower costs over the medium term. In addition the Fund identifies four key areas to improve fiscal accounts, including Tax Revenues, the Public Wage bill, Energy Subsidies and Pensions. Regarding the first, the fund believes the government should maintain its anti-evasion plan, and possibly increase collections by rising consumption tax rates. On the wage front, the IMF still believes there is still space to trim outlays via a civil-service reform, focusing on shifting current indexation mechanisms to further align qualifications with compensation. In addition, the fund emphasizes fuel subsidies should be cut, especially as commodity prices return to lower levels, after price freezes costed the administration 1.75% of GDP in 2022. Finally, the IMF was critical of the new pension reform, pointing out the 30% increase

in pensions will likely result in larger Treasury liabilities over the medium term. Similarly, while the proposed debt exchange between the old bonds issued by the FOP and the new bonds issued by the ISP could provide some temporary Treasury cashflow relief, it would reduce the funds available for private investment and exacerbate the fund's concentration in public sector securities.

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Finally, the IMF also points out El Salvador still must address Bitcoin risks, in addition to governance issues. Regarding Bitcoin, the fund sustains risks have not materialized due to the lack of use the cryptocurrency currently has, but they remain latent, and should be addressed. The IMF's opinion related to the issue remains unchanged since last year, pointing out underlying risks to financial integrity and stability, fiscal sustainability, and consumer protection persist, and that greater transparency related to the financial situation of the state-owned Bitcoin-wallet (Chivo) remains essential. In this line, the fund also urged El Salvador to continue and improve its accountability, as strong governance, fiscal transparency, and accountability are critical to improve resource management, lower borrowing costs, and build trust. This should be achieved by completing audits on pandemic-related emergency spending, the Chivo wallet and the Bitcoin trust, in addition to the publication of medium-term macro-fiscal and financing plans.

TPCG Analysts & Staff

Research

Juan Manuel Pazos	**Chief Economist**	**jmpazos@tpcgco.com**	**+54 11 4898-6606**
Paula La Greca	Corporate Research Analyst	plagreca@tpcgco.com	+54 11 4898-6638
Federico Martin	Strategist	famartin@tpcgco.com	+54 11 4898-6633
Santiago Resico	LATAM Strategist	sresico@tpcgco.com	+54 11 4898-6615

Sales & Trading

Juan Manuel Truppia	**Head of Sales & Trading**	**jmtruppia@tpcgco.com**	**+54 11 4898-6659**
Juan Martin Longhi	S&T Director	jlonghi@tpcgco.com	+54 11 4898-6656
Lucia Rodriguez Pardina	S&T Director	lrodriguezpardina@tpcgco.com	+54 11 4898-6614
Agustina Guadalupe	Sales	aguadalupe@tpcgco.com	+54 11 4898-6682
Maria Pilar Hurtado	Sales	mhurtado@tpcgco.com	+54 11 4898-6616
Juan Ignacio Vergara	Sales	jivergara@tpcgco.com	+54 11 4898-1936
Santiago Baibiene	Sales	sbaibiene@tpcgco.com	+54 11 4898-6648
Pedro Nollmann	Sales	pnollmann@tpcgco.com	+54 11 4898-6617
María Ruiz de Castroviejo Salas	Sales	mruizdecastroviejo@tpcgco.com	+54 11 4898-6643
Victoria Faynbloch	Desk Analyst	vfaynbloch@tpcgco.com	+54 11 4898-6635
Felipe Freire	Trader	ffreire@tpcgco.com	+54 11 4898-1921
Homero Fernandez Bianco	Trader	hfbianco@tpcgco.com	+54 11 4898-6667
Andres Robertson	Trader	arobertson@tpcgco.com	+54 11 4898-6693

Corporate Banking

José Ramos	**Head of Corporate Banking**	**jramos@tpcgco.com**	**+54 11 4898-6645**
Camila Martinez	Corporate Sales	cmartinez@tpcgco.com	+54 11 4898-6621
Fernando Depierre	Corporate Sales	fdepierre@tpcgco.com	+54 11 4898-6636
Sol Silvestrini	Corporate Sales	ssilvestrini@tpcgco.com	+54 11 4898-6641
Nicolas Iglesias	Corporate Sales	niglesias@tpcgco.com	+54 11 4898-6612

Capital Markets

Fernando Lanus	**Head of Capital Markets**	**flanus@tpcgco.com**	**+54 11 4898-6632**
Nicolás Alperín	Investment Banking Analyst	nalperin@tpcgco.com	+54 11 4898-6604

Asset Management

Ileana Aiello	**Portfolio Manager**	**iaiello@tpcgco.com**	**+54 11 4898-6611**
Claudio Achaerandio	**Portfolio Manager**	**cachaerandio@tpcgco.com**	**+54 11 4898-6618**

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