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El Salvador Strategy Flash

The fiscal position clocked in at -1.7% of GDP in February

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El Salvador's 12m- accumulated fiscal position came in at -1.7% of GDP in February, while the primary balance clocked in at +2.6p of GDP, worsening since January. After January's compression, the fiscal deficit returned to Dec-22 levels, widening by 0.2pp. During February income dropped by -0.1pp relative to January, while outlays climbed by +0.2pp, with both segments pushing for a widening in the fiscal deficit. NFPS income totaled 23.8pp of GDP in February (-0.1pp vs January). The variation in the segment was singlehandedly explained by a 0.1pp drop in tax revenues, with the rest of the sectors coming in flat relative to December, with no significant variations in any subsections, as the composition of Income sources remained unchanged. Therefore, tax revenues came in at 19.3% of GDP, accounting for 81.1% of Total Income, decreasing marginally relative to January's figures.

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Outlays totaled 25.5pp of GDP in February, rising by 0.2pp relative to January. The increase in expenditure was driven by a dual hike in Interest payments and Public Investment. Current outlays clocked in at 22.8pp of GDP dropping by 0.1pp relative to January. In turn, inside the segment, Interest payments spearheaded the widening, rising by +0.1pp relative to January, with the rest of the sectors standing flat against last month's figures. Capex also contributed to the enlargement of the deficit, increasing by +0.1pp, resulting from a 0.2pp rise in Gross investment, while Capital Transfers dropped by 0.1pp. Public Investment now stands at 2.7pp of GDP, with gross investment accounting for 2.3pp of GDP. With NFPS Income dropping by -0.1pp and NFPS expenditures rising by +0.2pp of GDP, the primary balance worsened by 0.2pp relative to January, with the excess rise of NFPS outlays coming in line with the hike in interest expenses. Still, the balance continues to stand at the very healthy +2.6% level, well inside positive territory.

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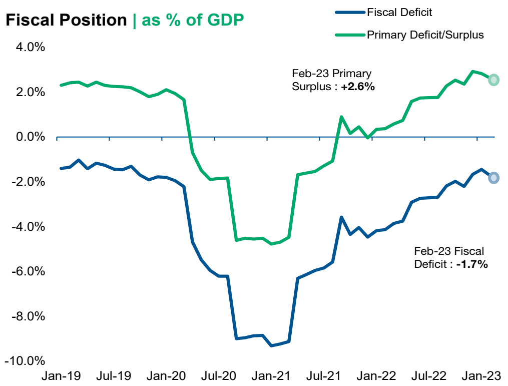
While the government is committed to improving its fiscal position, we believe the slowdown in economic activity is likely to dampen consolidation during 2023. The slightly underwhelming 2022 GDP print reaffirms our expectations of income growth becoming more sluggish, as its biggest contributor, tax revenues, is poised to slow down following the economic scenario. In addition, we continue to believe 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, which seem to be tied to 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.

Figure 1: February's fiscal figures



12m accumulated | % of GDP	dec-21	dec-22	jan-23	feb-23
Total Income	**24.1%**	**24.3%**	**23.9%**	**23.8%**
Current Income	24.1%	24.2%	23.9%	23.7%
Tax Revenues	19.6%	19.7%	19.4%	19.3%
Social System Contributions	2.2%	2.2%	2.2%	2.2%
Rest	2.3%	2.3%	2.3%	2.3%
Total Mandatory Outlays	**28.6%**	**25.9%**	**25.4%**	**25.5%**
Current Ouytlays	25.3%	23.3%	22.8%	22.8%
Consumption	15.6%	14.6%	14.5%	14.5%
Interest Payments	4.4%	4.6%	4.3%	4.4%
Current Transfers	5.3%	4.1%	4.0%	3.9%
Capital Expenditure	3.3%	2.7%	2.6%	2.7%
Net Loan Granting	0.0%	0.0%	0.0%	0.0%
Primary Balance	**0.0%**	**2.9%**	**2.8%**	**2.6%**
Pensions and Trusts	-1.0%	-1.0%	-0.9%	-0.8%
Net lending/borrowing	**-4.5%**	**-1.7%**	**-1.5%**	**-1.7%**

Source: TPCG Research based on BCR

BoP flows start to look less unflattering

On positive news, BoP flows started to align, as the 4Q Current Account deficit compressed by USD125mn, closing 2022 at -USD2.57bn (-7.9% of GDP).

On positive news, BoP flows started to align, as the 4Q Current Account deficit compressed by USD125mn, closing 2022 at -USD2.57bn (-7.9% of GDP). In this context, the external sector proved slightly more supportive during the last part of the year. This mostly came on the back of an improved Services balance, whose surplus widened by USD365mn. Instead, the Trade Balance came mostly flat relative to 4Q21, as did imports. This is consistent with the slowdown in activity showcased by the 4Q22 GDP figures. A silver lining is that energy imports already started to drop, falling by nearly USD100mn yoy during 4Q22. However, this was compensated by an USD84mn rise in food imports, leaving the segment mostly unchanged. Exports remained mostly flat (-USD30mn) with 4Q21 figures, showcasing that the sector is starting to run out of momentum. Primary income shaved USD230mn from the CA improvement, while Secondary Income, and therefore remittances, plateaued, showing practically no yoy variation. The financial account did not prove supportive, leaving the reserve position to plug the gap, and explaining the worsening of the GIR&NIR position during the last portion of 2022. In the yearly department, the Trade Balance widened by nearly USD1.8bn, most of it explained by the current account, which saw its deficit go from USD1.5bn in 2021 to USD2.6bn in 2022. The worsening was mostly encompassed by the rise in Imports (+USD2.5bn), and particularly, the Energy (+USD0.7bn) and Food (+USD0.4bn) subsections, even as the economic rebound did fuel the rest (+USD1.4bn) of the segments as well. Exports rose by USD0.7bn, just compensating for the blowup in energy imports. However, the services balance (+USD0.7bn) also managed to partly plug the gap. Instead, remittances had a relatively disappointing year, rising by only 200mn after their huge growth in 2021.

Figure 2: The slowdown in growth should continue to align BoP flows

USD mn	2021 1Q	2021 2Q	2021 3Q	2021 4Q	2022 1Q	2022 2Q	2022 3Q	2022 4Q	2021	2022	Δ
Current Account	**-169**	**-154**	**-549**	**-613**	**-797**	**-679**	**-604**	**-489**	**-1485**	**-2570**	**-1085**
Trade Balance	-1646	-1945	-2109	-2523	-2328	-2624	-2513	-2529	-8223	-9993	-1770
Imports	3225	3529	3740	4124	4203	4455	4352	4098	14617	17108	2491
Energy Imports	402	441	499	582	644	768	768	488	1925	2669	744
Food Imports	432	468	469	506	534	546	573	591	1875	2244	369
Rest	2390	2620	2772	3036	3025	3141	3010	3019	10818	12195	1378
Exports	1579	1584	1631	1601	1876	1831	1839	1569	6395	7115	720
Clothing/Maquila	627	655	688	655	712	697	753	584	2624	2746	122
Rest	952	929	944	946	1164	1134	1086	985	3771	4369	599
Services balance	252	280	199	149	300	386	428	514	881	1628	747
Primary Income	-449	-417	-430	-270	-543	-382	-442	-500	-1566	-1867	-301
Secondary Income	1674	1927	1790	2032	1773	1940	1922	2026	7422	7662	240
o/w Remmitances	1691	1936	1819	2006	1786	1956	1895	2033	7453	7670	217
Capital Account	**33**	**152**	**47**	**38**	**131**	**43**	**41**	**47**	**270**	**261**	**-9**
Financial Account (- indicates inflow)	**542**	**-562**	**-1312**	**-363**	**-449**	**-420**	**-477**	**963**	**-1694**	**-384**	**1310**
FDI	-166	-230	25	64	227	57	-236	52	-308	101	409
Portfolio Investment	202	-51	-485	30	-97	-48	426	222	-303	503	806
Derivatives	0	0	0	0	0	0	0	1	0	1	1
Other Investment	506	-281	-852	-457	-579	-429	-668	687	-1083	-989	94
Net Errors&Ommisions	**65**	**-350**	**-17**	**190**	**661**	**362**	**-106**	**305**	**-113**	**1222**	**1335**
Reserve Assets	**-621**	**210**	**793**	**-23**	**443**	**146**	**-193**	**-1098**	**359**	**-702**	**1061**
GDP (USDmn)	**6828**	**7269**	**7370**	**7985**	**7746**	**8104**	**8107**	**8533**	**29451**	**32489**	**-3037**
Current Account (as % of GDP)	**-2.5%**	**-2.1%**	**-7.4%**	**-7.7%**	**-10.3%**	**-8.4%**	**-7.5%**	**-5.7%**	**-5.0%**	**-7.9%**	**2.9%**

Source: TPCG Research based on BCR

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Looking at 2023, we expect the tightening trend to continue, with the external sector still carrying the largest risk of derailing the Salvadoran economy and the government's fiscal consolidation. 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 exception regime on consumption wears off. In addition, the service balance should improve 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. 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 started to plateau already by 2H22, conveying there is little juice left for the country to capitalize. All in all, we expect the external situation to improve, 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. Still, in a scenario where remittance flows towards the country reduce, 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 once again raise questions about debt sustainability.

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