El Salvador

Country Report: Liar, Liar

- The new draft budget includes an overly optimistic forecast of tax revenues, which are expected to increase by 11.9% (USD 656 mn), jumping to 22% of GDP, 4.5 p.p. higher than the 2020 level.
- We estimate that the primary deficit will reach -1.1% of GDP, 1.9 p.p. lower than that projected by the government, and the overall balance will close at -4.3% of GDP (vs. -2.5% estimated by the government).
- The Bukele administration will need to find USD 1.75 bn (6.1% of GDP) in financing and reaching an agreement with the IMF would be key to fulfilling that objective.
- Nonetheless, we believe the government will not be able to reach a deal with the fund.

News Highlights

- S&P Global downgraded El Salvador outlook to negative and maintained its credit rating at "B-"
- The Monthly Economic Activity Index grew 10.46% YoY in August
- Salvadoran government bought another 420 Bitcoin

Emerging Markets

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Background

After eleven days of delays and some complaints from opposition representatives and non-governmental organizations, the government published the full content of the 2022 draft budget. No explanation about the delay was provided, in a new sign, that transparency remains at the bottom of the list of priorities for the Bukele administration.

Introducing the unrealistic budget

The revenues presented in the draft budget are slightly higher than what we calculated in our previous report when the actual budget figures were still unknown (USD 6,759 mn vs. our estimate of USD 6,715 mn). On the other hand, the tax revenue figure announced by the finance minister is slightly lower than that of the budget proposal (USD 6205.6 mn vs. USD 6148 mn). Although the difference is small, the figures should be the same, which raises the question: was the minister wrong, or have there been modifications to the original budget proposal?

Beyond the somewhat suspicious figure, **the tax revenue forecast looks overly optimistic since it implies an increase of 11.9% (USD 656 mn), taking the tax intake to 22% of GDP**, an increase of 4.5 p.p. compared to 2020. All this, without introducing new taxes or increasing existing ones, can only be interpreted as wishful thinking. We estimate that tax revenues will slightly increase (from 19.7% of GDP to 20.1% of GDP) because the growth rate of remittances and, therefore, consumption, has slowed down in recent months, affecting VAT collection, which represents around 40% of tax revenue. Furthermore, the government will add high volatility to tax revenues due to the recent approval of paying taxes using bitcoin, a risky move, in our opinion.

Table 1 shows our fiscal estimates for 2022. Maintaining the expenditures budgeted by the government, **we estimate that the primary deficit will reach -1.1% of GDP, 1.9 p.p. lower than the surplus of 0.8% projected by the government, while the overall balance will close at -4.3% of GDP (vs. -2.5% estimated by the government).**

Table 1: Operations of the Central Government (% of GDP)

Assumptions	2020	2021	2021	2022	2022
Nominal GDP (SRD mn)	24639	26,670	27,943	27,937	28,637
Real GDP Growth	-7.9%	6.0%	9.6%	2.4%	1.4%
Inflation (eop)	-0.1%	2.1%	4.9%	0.8%	2.4%
	Executed 2020	**Modified budget 2021**	**EMFI 2021**	**Draft budget 2022**	**EMFI 2022**
Revenue	**19.5%**	**23.9%**	**21.3%**	**24.2%**	**21.7%**
Current Income	**18.3%**	**23.9%**	**20.5%**	**23.5%**	**20.9%**
Tax revenues	17.5%	19.9%	19.7%	22.0%	20.1%
Capital income	0.1%	0.2%	0.0%	0.1%	0.0%
Special contributions income	1.2%	0.0%	0.9%	0.6%	0.8%
Expenditure	**28.5%**	**29.8%**	**27.2%**	**26.7%**	**26.0%**
Current	**24.2%**	**23.6%**	**22.6%**	**19.0%**	**18.5%**
Consumption	10.7%	11.0%	9.5%	9.9%	9.6%
Interests	3.0%	3.3%	3.1%	3.3%	3.2%
Current Transfers	10.2%	8.9%	9.2%	5.7%	5.5%
Others	0.2%	0.1%	0.1%	0.2%	0.2%
Capital	**3.7%**	**5.6%**	**3.9%**	**5.1%**	**5.0%**
Special contributions	0.6%	0.6%	0.6%	0.6%	0.6%
Primary balance	**-6.0%**	**-2.5%**	**-2.8%**	**0.8%**	**-1.1%**
Overall balance	**-9.0%**	**-5.9%**	**-5.9%**	**-2.5%**	**-4.3%**

Sources: Ministry of Finance, Emfi Analytics

No help (from the IMF) in sight

Adding amortizations of USD 512 mn, we calculate that the financing needs will reach USD 1,748 mn or 6.1% of GDP. In our last report, we anticipated that the budgetary gap of USD 498mn announced by the Minister of Finance Alejandro Zelaya, seemed far from the real figure, with the budget confirming our suspicions. A simple review shows that the budget includes USD 1,209 mn in public debt, of which USD 710.6 mn correspond to bilateral and multilateral loans, and USD 498.4 mn to securities issues in the foreign market, a figure that suspiciously matches with the financing gap previously announced by minister Zelaya.

Breaking down the financing sources, the government expects to obtain USD 32.6 mn from government agencies in Japan and Germany, and USD 677.9 from multilateral organizations, divided into USD 345 mn from CABEI, USD 146 mn from IBRD, USD 149 mn from the IDB, and USD 37 mn from other organizations (see **Table 2**). The government did not include any fresh IMF funds - which we consider good practice, given that there is no agreement with the multilateral - but, according to El Diario de Hoy, the budget indicates that "the fiscal gap will be covered mainly with sources from Multilateral Organizations, specifically with the International Monetary Fund, the World Bank and the Inter-American Development Bank, once the agreement with the IMF is signed". **This would mean that the loans from other multilaterals would be conditional on reaching an agreement with the IMF,** therefore, the financing sources seem less secure than the budget shows.

Regarding the negotiations with the IMF, they seem to be going at a very slow pace. According to the acting Director of the IMF's Western Hemisphere Department, the negotiations will begin once the Article IV review, which will "soon be underway", is concluded, likely towards the end of the year, meaning that we do not expect to see further progress on the negotiation until 2022.

We also believe that beyond the Article IV consultation, there are bigger obstacles that hinder an agreement with the IMF: 1) Bukele's authoritarianism has deteriorated relations with the international community and especially with the US, the IMF's largest shareholder (see our **Country Report: Bukele vs. the World**), 2) the multilateral programs emphasize governance, while in El Salvador accusations of corruption and lack of government transparency increase by the day, and 3) the government of El Salvador is showing no effort to move closer to the IMF, as the current budget does not introduce any fiscal adjustment measure, while the adoption of Bitcoin as legal tender has raised eyebrows at the multilateral, particularly due to the money laundering risks associated with the move.

Table 2: Financing needs and sources

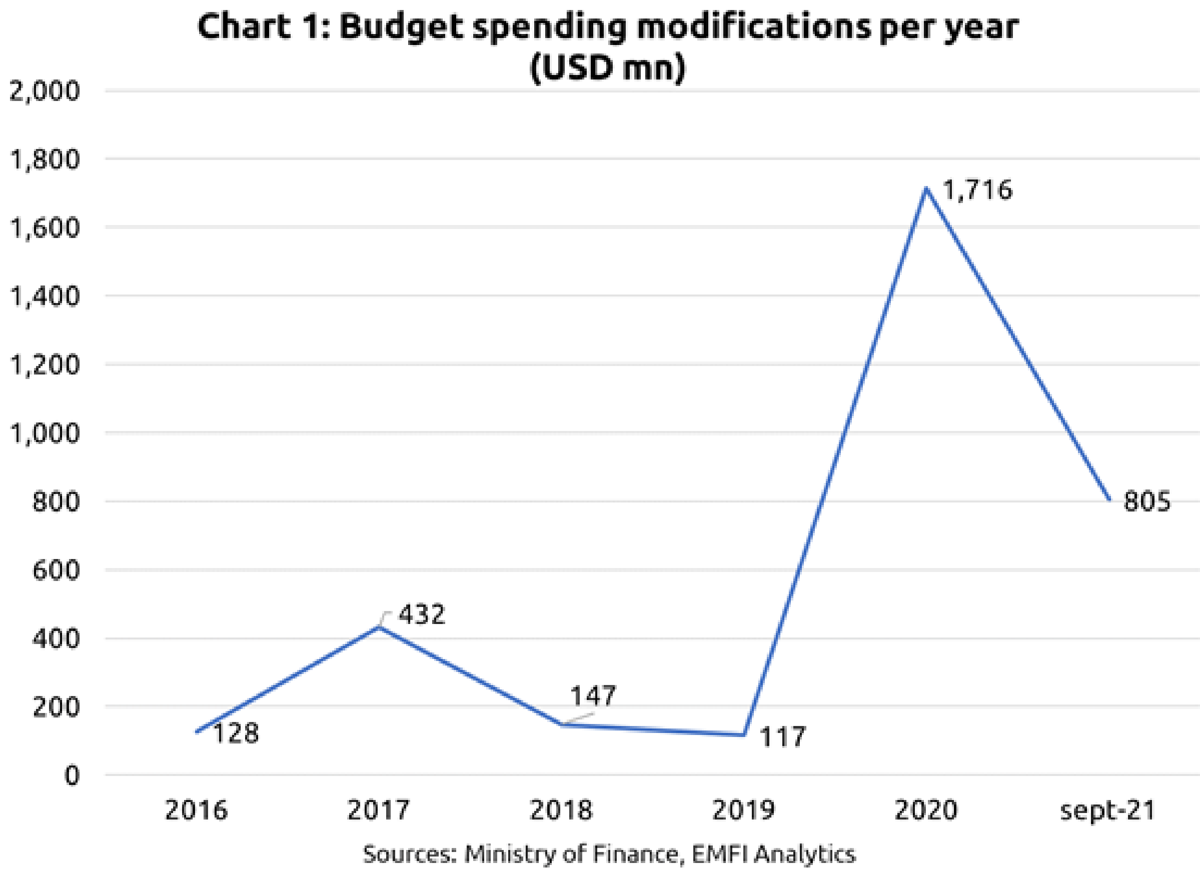
	USD mn	% of GDP
Overall balance	(1,236)	-4.3%
Amortizations	512	1.8%
Gross financing needs	**1748**	**6.1%**
Eurobonds	498	1.8%
Bilateral	33	0.1%
Multilateral	678	2.4%
CABEI	345	1.2%
IADB	149	0.5%
IBRD	147	0.5%
Others	37	0.1%
Gross financing sources	**1,209**	**4.3%**
Financing Gap	**539**	**1.8%**

Sources: Ministry of Finance, Emfi Analytics

Widely open to changes

Historically, Salvadoran governments have not been recognized for their efforts to comply with budgets as originally approved, however, during the Bukele administration, the situation has worsened, and budgets have been modified much more than in previous years. In 2020, expenditures exceeded the original budget by USD 1,716 mn (7.0% of GDP), and as of September this year, budget modifications have added USD 805 mn (2.9% of GDP) to the original budgeted amount (see **Chart 1**).

Although the increase in expenses in 2020 was associated with the outbreak of Covid-19, we believe that the modifications to the 2021 budget are mainly related to a lack of fiscal commitment. It would be easy to think that the previous opposition-controlled Assembly denied resources to the government last year, and now that pro-government lawmakers lead the Assembly, they are making the necessary changes to make the original budget reflect the government's fiscal needs, however, there were no differences between the estimated spending of the 2021 draft budget presented by the finance minister in September 2020 (before the ruling party gained control of the Assembly) and the budget approved. **Thus, we are bracing for future modifications as budget changes seem to be a Bukele thing, and the new cyan assembly will certainly be open to modifying the budget as much as he wants.**



What to expect

We believe that the government is being overly optimistic about increasing tax revenues, and therefore, our estimate of a fiscal deficit of -4.3% of GDP is higher than that of the government (-2.5%). **The Bukele administration will need to find USD 1.75 bn to cover the budget deficit, and while reaching an agreement with the IMF seems essential to fulfill that objective, we still believe that this is an unlikely scenario.**

With the Legislative Assembly in its favor, the weak checks and balances, and the advantage of not having to comply with the Fiscal Responsibility Law (which was suspended due to the pandemic and has not yet been resumed), the government can modify the budget spending at its convenience; thus, its main obstacle will be getting the resources needed to cover its financing needs.

As El Salvador is a dollarized country, it cannot resort to monetary financing like other countries, therefore, it is limited by the debt it can issue. As it has done so far, the government could continue resorting to issuing short-term debt in the domestic market to finance itself, however, it seems that the Salvadoran financial system does not want (or cannot?) to help much more to the government. Previously, we have pointed out that the government has another tool to finance the deficit resorting to the pension funds, by seizing them or putting pressure on the AFPs. Also, we don't rule out that other unconventional financiers for El Salvador, such as China, could come to the rescue. Due to the recent tensions between the Bukele administration and the US government, this is a scenario that is gaining ground.

Fact Sheet

Benchmark bond:
ELSALV 7 5/8 02/01/41

Price:
$73.21
(▲ 5.40% from 1m ago)

Benchmark yield:
0.00
(▼ 100.00% from 1m ago)

EMFI Team Evaluation

EMFI Team Evaluation	HOLD

Our benchmark bond, ELSALV 29, is trading at 80 cents on the dollar, up 22 bps over the last month. The inverted yield curve compressed 65 bps on average, with stronger action in the short-end than in the long-end.

We are concerned about substantial financing needs of 6.1% of GDP for the next year and limited funding options. In this regard, we are pessimistic about the possibilities of an agreement with the IMF, given the rising tensions between the Salvadoran government and the United States, but we believe that the government can still turn to unconventional sources to fill the financing gap.

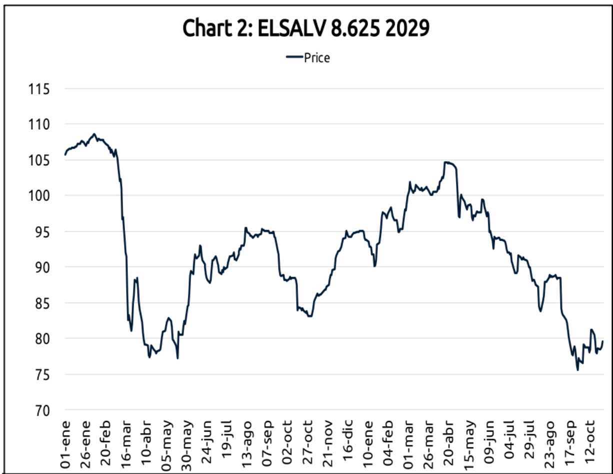
Rating agencies are also gloomy.S&P Global retains a rating of B- but revised the outlook to negative from stable, citing the growing liquidity risk associated to cover the sizeable financing gap in 2022. Likewise, Fitch Rating pointed out “a sharp increase in financing constraints and a deterioration in prospects for fiscal consolidation or growth that further weakened debt sustainability,” and Moody’s also highlighted the deterioration of fiscal policy and the weakened institutional framework.

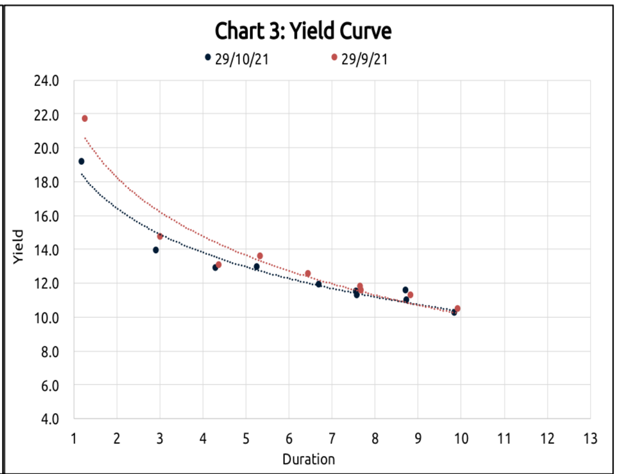
We maintain our HOLD rating the lack of significant maturities before 2023 and the strong economic recovery during this year, however, the narrowing financing space to cover the fiscal gap for next year and the limitations in the domestic financing market put higher risks on the public finances of the country.

Table 3: Credit Indicators

Indicator	Value	Credit Impact
Credit Rating		
Composite Rating	B-	Neutral
Liquidity		
12m External Debt Service (% of Exports)	13%	Neutral
12m External Debt Service (% of Fiscal Revenues)	18%	Negative
12m External Debt Service (% of FX Reserves)	33%	Negative
Solvency		
Total Public Debt (% of GDP)	88%	Negative
Total Public Debt (% of Fiscal Revenues)	453%	Negative
Total Public Debt (% of Exports)	334%	Neutral

Sources: Bloomberg, Ministry of Finance, Central Bank, EMFI Securities



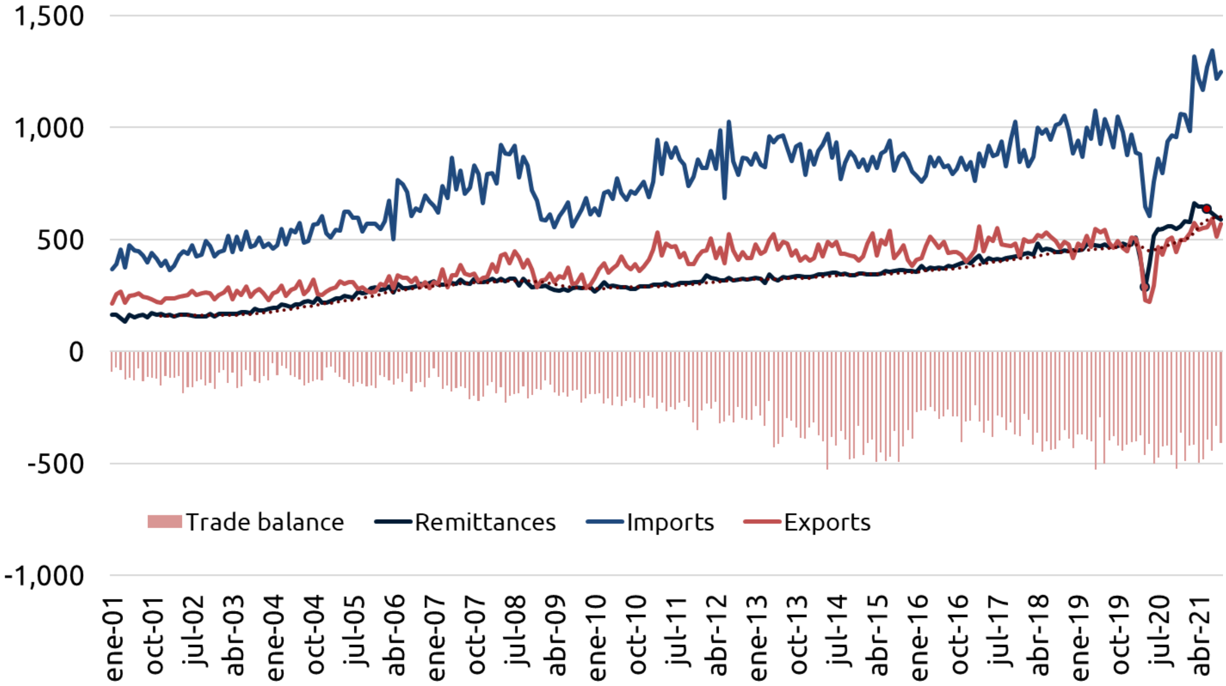


Sources: EMFI Securities, Bloomberg

Key Macroeconomic Forecasts

With the slowdown in the economic activity index and remittances rising at a slow pace in recent months, we expect lower growth in the third quarter of the year; however, we maintain our forecast of a 9.6% GDP expansion for 2021. Likewise, the strong domestic demand generates higher inflationary pressures; consumer prices rose 0.4% MoM and 4.97% YoY in September, which is in line with our forecast of an inflation rate of 4.9% for 2021. Regarding the external front, the increase in worker´s remittances (+31.1% in the Jan-Sep period) has offset to some extent the trade imbalance resulting from the rise in imports of foreign goods (+47.3% in the same period). Nevertheless, we maintain our projections of a current account deficit of 1.8% of GDP.

Figure 1: Trade in goods and Workers' Remittances (millions of USD, seasonally adjusted)



Source: Banco Central de Reserva de El Salvador

El Salvador

Summary of Economic Indicators and Forecasts

	2017	2018	2019	2020	2021(F)
Real GDP growth rate (%)	2.3	2.4	2.6	(7.9)	9.6
Inflation (end of period, %)	2.0	0.4	0.0	(0.1)	4.4
Unemployment (% of work force)	7.0	6.3	6.3	8.1	5.3
Output Gap (% of GDP)	2.0	3.0	4.4	(5.0)	2.9
Nominal GDP (millions of USD)	24,979	26,021	26,897	24,639	27,943
Current Account (% of GDP)	(1.9)	(3.3)	(0.6)	0.5	(1.8)
Exports (millions of USD)	7,225	7,565	7,982	6,290	7,892
Imports (millions of USD)	11,336	12,323	12,453	10,816	14,020
Real Effective Exchange Rate (ave., Jul17=100)[1]	99.6	101.0	102.7	104.3	104.99
Central Government (figures in % of GDP)					
Revenues	19.1	19.3	19.0	19.9	21.3
Expenditures	19.3	20.4	20.7	29.1	27.2
Interest payments	3.1	3.4	3.5	4.2	3.1
Primary balance	3.0	2.3	1.8	(5.0)	-2.8
Overall balance	(0.1)	(1.1)	(1.6)	(9.2)	-5.9
Total debt	73.6	72.9	73.6	91.8	87.7
Addenda, IMF estimates (October 2021)					
GDP (millions PPP, int'l dollars)	54,006	56,630	59,162	55,118	62,258
Population (millions)	6.39	6.42	6.45	6.49	6.52
GDP per Capita (PPP, int'l dollars)	8,454	8,819	9,167	8,498	9,552

[1] The figure for 2021 corresponds to the January-August average. An increase (decrease) indicates a rea depreciation (appreciation).
Note: Figures in brackets represent negative values.
Source: IMF, EMFI Analytics estimates, Banco Central de Reserva, Dirección General de Estadísticas y Censos

SECURITY	BID	ASK	YIELD	SPREAD	CHANGE	52 WK LOW	52 WK HIGH
ELSALV 7 3/4 01/24/23	87.80	88.35	5.90	568	0.14	0.00	111.20
ELSALV 7 3/4 01/24/23	88.05	88.60	5.82	560	0.25	0.00	106.25
ELSALV 5 7/8 01/30/25	79.75	80.30	6.41	582	0.29	0.00	108.50
ELSALV 5 7/8 01/30/25	79.65	80.15	13.74	1279	0.40	0.00	105.82
ELSALV 5 7/8 01/30/25	79.60	80.15	6.37	578	0.29	0.00	104.70
ELSALV 6 3/8 01/18/27	76.75	77.30	6.73	576	0.70	0.00	110.90
ELSALV 6 3/8 01/18/27	76.90	77.45	6.86	588	0.24	0.00	105.15
ELSALV 8 5/8 02/28/29	79.85	80.40	7.30	605	0.86	0.00	124.30
ELSALV 8 5/8 02/28/29	79.90	80.45	7.30	605	0.90	0.00	113.75
ELSALV 8 1/4 04/10/32	77.80	78.35	7.59	609	0.82	0.00	124.30
ELSALV 8 1/4 04/10/32	78.05	78.60	7.58	607	0.94	0.00	112.20
ELSALV 7 5/8 09/21/34	73.80	74.35	7.91	628	0.68	0.00	111.01
ELSALV 7 5/8 09/21/34	73.95	74.50	7.92	630	0.30	0.00	105.35
ELSALV 7.65 06/15/35	74.85	75.40	7.60	595	0.94	0.00	117.95
ELSALV 7.65 06/15/35	75.30	75.85	7.69	604	0.08	0.00	107.80
ELSALV 7 5/8 02/01/41	72.95	73.50	7.77	600	1.02	0.00	117.75
ELSALV 7 5/8 02/01/41	73.25	73.80	7.75	599	1.22	0.00	105.40
ELSALV 7.1246 01/20/50	71.15	71.70	7.70	587	1.43	0.00	106.44
ELSALV 7.1246 01/20/50	71.55	72.10	7.70	587	1.34	0.00	98.30
ELSALV 9 1/2 07/15/52	81.95	82.50	8.68	690	1.29	0.00	116.50

ELSALV 9 1/2 07/15/52	82.60	83.15	8.75	697	-2.63	0.00	116.40

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