

EL SALVADOR: GOVERNMENT IS FACING DEBT DEFAULT AMID WORSENING RELATIONS WITH THE USA



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Event

Mid-December, the USA sanctioned two politicians close to El Salvador's president, Nayib Bukele, based on corruption charges. As a result, their assets were frozen and they were banned from entering the USA. It is a clear sign relations with the USA have deteriorated markedly in the past year amid concerns over El Salvador's commitment to democracy and human rights. Last year, the USA also imposed sanctions on the Constitutional Court judges who might facilitate Bukele's possible re-election in 2024. These judges were recently put in place by Bukele after he fired the entire Constitutional Court in 2021. They backed Bukele in September 2022, when he announced that he would stand for a second term despite a constitutional ban on presidential re-election. The new Constitutional Court ruled, however, that the law was previously misinterpreted.

Impact

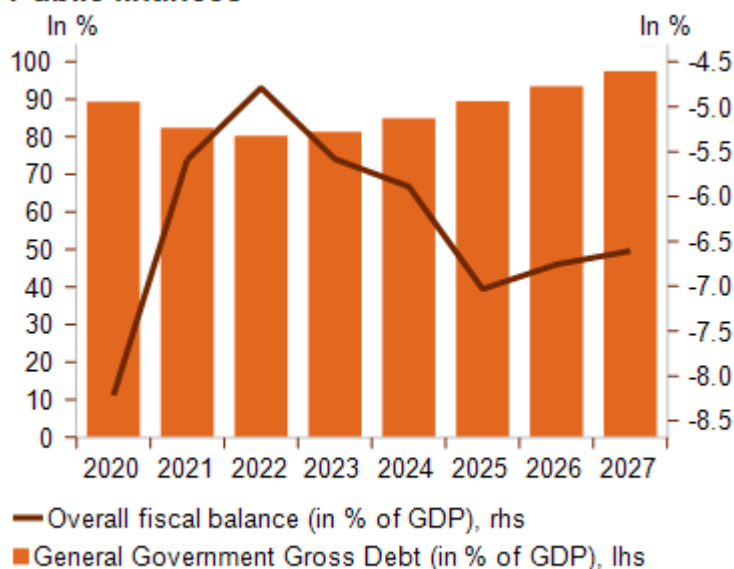
Bukele will probably not change his election plans while the USA is likely to levy further targeted sanctions against individuals and institutions. Moreover, the use of bitcoin as legal tender since September 2021 also increases the risk of US sanctions or of the USA blocking International Monetary Fund (IMF) and other multilateral loan approvals (already in place against Nicaragua). As a result, companies operating in El Salvador face increased counterparty, operational, and compliance-related risks.

The worsening relations with the USA come at a bad time as public finances are under severe stress.

Public debt rapidly increased during the Covid-19 pandemic due to large fiscal packages put in place to alleviate the economic impact, but also due to higher structural social spending that has not been phased out. Though public debt ratios have decreased since their peak in 2020 – mainly thanks to the economic rebound – they remain historically high for the country's small economy at a forecasted 80% of GDP end 2022 (see graph). Heavy structural liabilities such as the pension liabilities (included in the public debt data, which is rare for emerging markets) are not being tackled. On the contrary, the government significantly increased the minimum pension guarantee, thus creating a high burden for the fiscal budget as of 2028. Furthermore, public investment plans and the plan of doubling the size of the army by 2025 will weigh on the budget as well. On top of that, rising public interest payments will soak up a fifth of public revenues as of 2023 and are expected to quickly increase after that. Amid a widening fiscal balance, public debt ratios are expected to increase to almost 98% of GDP in 2027, an unsustainable level for El Salvador's limited economy. The forecast is subject to downside risks as higher fiscal expenditure is very probable in the run-up of the presidential elections in 2024, where Bukele will attempt to secure another presidential term. Furthermore, remittances are likely to turn out lower than the currently forecast, because a bleak economic outlook in the USA – a growth engine for El Salvadorian economy – can deteriorate the public debt ratios more quickly than presently anticipated. Other downside risks are fiscal costs related to climate change, as the Central American country is exposed to earthquakes, floods, droughts and hurricanes. On top of that, the adoption of the bitcoin as legal tender in

though bitcoin seems to be barely used in practice. Furthermore, the government has established a USD 150 million fund intended to guarantee instantaneous convertibility between bitcoin and US dollar. In time, the fund will be exhausted and the government will need to replenish it, thus creating a contingent liability.

Public finances



Source: IMF

As of January 2023, the government will face a series of sizeable biannual external bond payments and limited financing options. Since the adoption of the bitcoin as legal tender, negotiations for a vital USD 1.3 billion Extended Fund Facility from the IMF (of which the USA is a key shareholder) have been stalled. Moreover, El Salvador has been shut off from the international financial markets for already a year, resulting in the second widest bond spreads in the region, after Venezuela only. Not surprisingly, credit agencies have downgraded El Salvador's rating in the past year to levels reflecting a substantial risk of default. In the last twelve months, the country has been resorting to short-term domestic debt, but local banks and pension funds have shown declining demand as debt levels are historically high and near a legal ceiling. A plan to issue USD 1 billion in bitcoin-backed bonds in March 2022 has been stalled and would not solve debt issues anyway as it is intended to finance bitcoin purchases and the construction of a 'Bitcoin City'. A recent bond repurchase of the 2023 bond at discounted prices and the intention to use foreign exchange reserves will likely prevent a sovereign debt default next year, but not after 2023. As the financial markets are closed, short-term domestic debt is nearing a ceiling and with no IMF deal in sight, it remains to be seen how the country will find new financing in the medium term. In this context, Bukele has been seeking closer ties with China, which could provide fresh debt but increase the risk of debt insolvency. The decision to use foreign exchange reserves to meet sovereign external debt service payments is weighing on liquidity. Foreign exchange reserves reached around two months of import cover in June 2022 – a ten-year low – and are declining at a rapid pace. An important positive feature though relates to the fact that El Salvador is a fully dollarised economy, which provides for monetary stability and a moderation of the non-transfer risk. That being said, even though the fact that the country is dollarised mitigates the political risk, it does not alleviate it. In a context of full dollarisation, declining foreign exchange reserves

risk was downgraded to category 5/7 while the medium- to long-term political risk (category 5/7) has a negative outlook.

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