El Salvador Watch

Trip Notes: In Pursuit of the IMF deal

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GEM Economics
LatAm | El Salvador

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IMF: International Monetary Fund

Key takeaways

- We spent two days in San Salvador, meeting with policymakers, politicians, business leaders, local investors, and economists.
- The trip reaffirmed our previously optimistic views on El Salvador. Improved security is translating into a growth dividend.
- Unlike in past years, President Bukele is taking ownership of efforts to get an IMF deal. But the outcome remains uncertain.

Two days in San Salvador: optimistic, like before the trip

We spent two days in San Salvador, meeting with policymakers, politicians, business leaders, local investors, economists, and a multilateral organization. Overall, the trip reaffirmed our previously optimistic views on the Salvadoran economy. The unprecedented improvement in security conditions seems to be yielding a GDP growth dividend. Also, the government is more focused on getting an IMF program which is the key to ensure public debt sustainability. On the negative side, the risks are the overreliance on domestic financing that can weaken the pension system and crowd out private borrowers (firms and households), and the low level of international reserves. We think both issues could be tackled with an IMF program.

Possible IMF deal: President Bukele taking ownership

The difference between now and the last three years – during which El Salvador has been discussing a potential program with the IMF – is that President Bukele is getting more involved. In October 2023, he told the press, *"at the end of the negotiations we will reach an agreement. I would expect the agreement to come after the elections [February 4th, 2024]. [...] There have been very productive conversations and we expect a deal in the future. We have the willingness to do it and understand they [IMF] do too."*[1] To the best of our knowledge, this was the first time President Bukele spoke about the timing and likelihood of an IMF program.

IMF acknowledges capacity of El Salvador to deliver

Meanwhile, the IMF's Director for the Western Hemisphere, Rodrigo Valdes, argued that Bukele's high political capital could be valuable to deliver the reforms that an IMF program would entail. *"To some extent, they have a big opportunity that few countries have in the region: they have the governance and support to do what is needed to be done."*[2] Bukele has consistently polled in the 80%-90% during his administration. His party, Nuevas Ideas, commands a super-majority (over two thirds) in Congress. Polls suggest the representation of Nuevas Ideas in Congress will increase after the February election.

[1] See https://diarioelsalvador.com/presidente-bukele-ve-un-panorama-positivo-para-un-acuerdo-con-el-fmi/418779/.
[2] See https://www.reuters.com/world/americas/imf-says-recent-el-salvador-mission-was-very-productive-2023-10-13/.

The sticking point is Bitcoin's legal tender

We know from the IMF's last Article IV report, published in 2022, that the IMF doesn't support bitcoin as legal tender. In addition, there is the precedent of the Central African Republic (CAR), which also adopted Bitcoin as a legal tender and later sought an IMF program. The staff report from the IMF shows that repealing the legal tender status was a prior action (pre-condition) for an IMF program.

Perhaps in the case of El Salvador an intermediate solution, short of repealing legal tender status, could be found. For example, an agreement that all payments and contributions to the IMF will be in US dollars. It is likely that the IMF would also require measures to mitigate the financial risks of Bitcoin, including related to anti-money laundering and financing of terrorism.

But if the IMF does not show flexibility on repealing Bitcoin's legal tender status, the ball will be in Salvador's court. Public policy students are taught that leaders must distinguish between battles of necessity and battles of choice. For El Salvador, we believe Bitcoin is a battle of choice, whereas obtaining an IMF program is a necessity in the sense it would unlock the external financing to make the economy thrive.

The GDP growth dividend associated to improved security

President Bukele's signature achievement in the last five years has been the drop in the crime rate. El Salvador has gone from having a war-like crime rate before Bukele (106.8 per 100k people in 2015) to one of the lowest in the LatAm region (2.4 in 2023).

Tellingly, a recent IMF study – co-authored by Rafael Machado Parente and Rodrigo Valdes – estimates that reducing a Latin American country's homicide rate to the world average would increase GDP growth by 0.5 percentage points.[3] The estimate is higher (0.8pp) for countries where insecurity had been most prevalent (like El Salvador). If the IMF is consistent with this research, we should expect an increase in their estimates of El Salvador's long-term, potential GDP growth rate (2% in their latest projections, October 2023 WEO), which could imply a softer fiscal consolidation target.

Channels whereby security influences economic growth are multiple: tourism, labor productivity, property values, extortion payments liberated for capital investment of SMEs, lower transactions costs, human capital accumulation (lower outward migration, among others).

Tourism is where the security dividend is most tangible

Before the pandemic, in 2019 tourism exports in the balance of payments were US$ 1.3bn (4.9% of GDP), a record high. Since then, tourism revenues soared to US$ 2.4bn (7.2% of GDP) in the rolling four quarters ended in 3Q2023.

The Salvadoran Tourism Institute (ISTU) estimates full-year growth at 43%. Their tourism revenue estimate (US$ 3.8bn for 2023) is significantly larger than what is reported in the balance of payments statistics (which is the hard data for us) but the growth rates are usually very similar. The point is that tourists avoid places that are not safe, and the opposite seems to be happening in El Salvador.

Of course, events to attract tourists have also helped (Miss Universe, Lionel Messi's game, stops of the global surfing tour, golf tournaments, among others). The New York times included El Salvador in the list of 52 places to visit in 2024.

Because of booming tourism revenues and a better trade balance, we estimate that the current account deficit narrowed from 6.6% of GDP in 2022 to 2.3% in 2023.

Fiscal slippage in 2023

With fiscal results published up to December 2023, we can see El Salvador had slippage

[3] See https://www.imf.org/en/Blogs/Articles/2023/12/18/latin-america-can-boost-economic-growth-by-reducing-crime.

in 2023. The primary surplus of the Non-Financial Public Sector, excluding pensions, shrank from a large 3% of GDP in 2022 to 1.6% of GDP in 2023. If one includes pensions – considering that by convention the Non-Financial Public Sector must include social security – then the primary surplus went from 2.1% of GDP in 2022 to 0.4% of GDP in 2023.

We estimate the increase of the pension deficit by taking the US$ 318mn observed in 2022 and multiplying by 1.3, given the pension reform increased pension payments by 30% (for both the AFPs and the retirees of the old "pay-as-you-go" regime).

Local economists think the pension deficit might have been a bit larger if one considers that the government increased non-contributory (solidarity) pensions in 2023. The issue is that the pension data is no longer being reported in the fiscal statistics, under the argument the Salvadoran Pension Institute (ISP) was redefined as a financial institution outside the perimeter of the Non-Financial Public Sector.

But there's a robust plan to adjust in the next years

Despite the slippage between 2022 and 2023, we expect the primary balance to improve by 0.6pp of GDP in 2024 and 1pp of GDP in 2025. If El Salvador wants to work towards an IMF deal they cannot derail on the fiscal adjustment.

There's a number of powerful measures from the expenditure side – already approved – whose effects should gain traction in 2024. We are talking about the slash in the number of municipalities (to 44 from 262), the elimination of fuel subsidies (except for propane gas), the restriction of automatic wage adjustments in the health sector (aka "escalafon"), hiring freezes, early retirement, and other public sector downsizing actions.

The Bukele administration believes in a smaller and leaner government. Revenue measures might be announced after the elections. The government says they generally agree with the size and pace of the necessary fiscal consolidation for the coming years, to achieve debt sustainability.

Current financing strategy is sub-optimal

Another amber light, in our opinion, is the financing strategy that is relying too much on domestic financing (arrears, domestic banks, pension funds), and the trade-offs could become increasingly unattractive over time.

One could see the glass as half full from the optic that domestic institutional investors – the banks and the pension funds (AFPs) – are showing commitment to defend macroeconomic stability. The banks agreed to swap US$ 1.4bn of short-term Treasury securities (LETES and CETES) for bonds with maturities of up to 7 years. US$ 450mn have been swapped so far.

On the pension side, the Salvadoran Pension Institute (ISP) issued US$ 1.098bn of COPs in 2023, purchased by the AFPs. COPs replaced the CIPs (pension securities) that were restructured in 2023 as part of the pension reform. AFPs have been disinvesting their foreign investments. They receive around US$1bn in annual contributions from their affiliates.

We believe the government can continue with this strategy of relying on domestic financing in the coming years, without defaulting. But it would reduce the availability of credit for households and firms, clashing with the Bukele administration's goal of boosting private investment. Moreover, it would force the pension funds to have a less diversified portfolio, liquidating foreign investment, and thus lowering the next external wealth of El Salvador.

An IMF program could relieve these pressure points by unlocking several sources of external funding. We would expect other multilaterals to increase their support of El Salvador through budget support loans. In addition, lower risk premiums could facilitate external issuances.

Exhibit 1: Macroeconomic forecasts for El Salvador

We expect GDP growth to increase to 2.8% by 2025, with the dividend from improved security, up from the average of 2% in the 15 years prior to the pandemic

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023F	2024F	2025F
GDP growth (%)	1.7	2.4	2.5	2.3	2.4	2.5	-7.9	11.2	2.6	2.8	2.7	2.8
Nominal GDP (US$ bn)	22.6	23.4	24.2	25.0	26.0	26.9	24.9	29.5	32.5	34.4	35.8	37.4
CPI inflation (end-of-period, % yoy)	0.5	1.0	-0.9	2.0	0.4	0.0	-0.1	6.1	7.3	1.2	1.9	1.4
NFPS, including pensions, overall balance (% of GDP)	-4.0	-3.6	-3.1	-2.5	-2.7	-3.1	-10.0	-5.5	-2.5	-3.4	-2.8	-1.8
NFPS, including pensions, primary balance (% of GDP)	-1.3	-0.9	-0.2	0.7	0.9	0.6	-5.7	-1.0	2.1	0.4	1.0	2.0
Public Sector gross debt, including pensions (% of GDP)	69.5	70.8	72.6	73.6	72.9	73.7	90.7	82.7	78.0	78.2	79.0	78.8
Current account balance (% of GDP)	-5.4	-3.2	-2.3	-1.9	-3.3	-0.4	1.6	-4.3	-6.6	-2.3	-2.3	-2.4
Net international reserves (US$ bn)	2.661	2.670	2.923	3.273	3.354	3.937	2.915	3.342	2.440	2.646	2.940	3.340

Source: BofA Global Research, Ministry of Finance (Hacienda), Central Bank (BCR), Haver

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