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Research Update:

Republic of El Salvador Long-Term Rating Raised To 'B-' On Debt Refinancing Approval; Outlook Is Stable

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Ratings

Foreign Currency: B-/Stable/B
Local Currency: B-/Stable/B
For further details see Ratings List.

Overview

- El Salvador's Congress approved the issuance of new external debt to cover the payment of the eurobond due in December 2019.
- El Salvador's debt trajectory has stabilized following lower fiscal deficits that we expect to remain over the next three years. However, limited monetary flexibility, a weak economy, and a damaged debt payment culture constrain the ratings.
- We are raising our sovereign credit ratings on the Republic of El Salvador to 'B-/B' from 'CCC+/C'.
- The stable outlook reflects our expectation of consistently moderate fiscal deficits and stable debt levels in next three years.

Rating Action

On Dec. 28, 2018, S&P Global Ratings raised its long- and short-term sovereign credit ratings on the Republic of El Salvador to 'B-/B' from 'CCC+/C'. The outlook is stable. Our 'AAA' transfer and convertibility (T&C) assessment is unchanged.

Outlook

The stable outlook reflects our expectation of consistently moderate fiscal deficits and stable debt levels, along with consistent, albeit moderate, economic growth in next three years.

Faster-than-expected economic growth and a stronger fiscal and external stance that ultimately reflects in declining debt levels could lead us to raise the ratings within the next 12 to 24 months.

In contrast, we could lower the ratings if its economic performance deteriorates significantly, so that its GDP per capita grows less than 1.5% annually, along with fiscal deficits consistently above 4% of GDP, and if the country faces additional challenges in accessing external financing in the next 12 to 24 months.

Rationale

The upgrade reflects the Congressional approval of new external debt to cover the $800 million eurobond coming due in December 2019. The approval was in tandem with the 2019 budget approval, which includes additional financing requirements to comply with other debt maturities and interest payments.

The upgrade also reflects our view that the correction to the general government deficits and the stabilization of El Salvador's debt level over the last two years will continue through 2021.

El Salvador's limited monetary flexibility (fully dollarized economy) and its vulnerability as a small and open economy, highly dependent on external financing, are also incorporated in our ratings, as are the limited contingent liabilities arising from its stable banking system.

Flexibility and performance profile: Lower fiscal and external deficits should keep financing requirements moderate over the next three years

- Ongoing fiscal correction will keep the change in general government debt below 3% of GDP and interest payments below 15% of general government revenues in 2019-2021, on average.
- We expect current account deficits (CADs) to remain moderate, keeping external financial requirements at current levels.
- Dollarization should continue to lead to low inflation rates in the coming years.

The Fiscal Responsibility Law (FRL)--enacted in November 2016--and the approval of the pension reform last year enabled El Salvador to consolidate its fiscal correction. For this year, we are forecasting a general government deficit of 2.7%, down from 4.4% in 2013, which should remain below 3% of GDP, on average, up to 2021.

We are assuming the rate of general government revenue growth will be similar to nominal GDP growth, as the government has ruled out tax increases ahead of the election cycle early next year. Moreover, we are assuming a moderate increase in expenditures as the government is committed to complying with the FRL that caps expenditures for wages and goods and services.

Overall, El Salvador's fiscal flexibility will continue to be limited, which, along with the very restricted monetary flexibility, remains a fundamental limitation to its credit quality. Significant shortfalls in basic services and infrastructure constrain the government's ability to reduce its expenditures, while a large informal economy limits its ability to raise additional revenues.

Following moderate fiscal deficits, we forecast net general government debt to stay around 66% up to 2021--where it has been over the last two years. Unlike previous years, this implies a change in general government debt below 3% of GDP over the same period. The debt burden had risen in recent years, largely because of the need to fund obligations of the pension system, highlighting the importance of the pension reform approved last year.

As of September 2018, 30% of its debt--excluding debt to pensions--is with multilateral institutions while 51% is bond issuances. Most of it is external (74%), with internal debt consisting of short-term loans (LETES) and long-term special bonds (CIPs). LETES represented a moderate 5.8% of total debt. Interest payments increased to 13.6% of general government revenues in 2017, from 12.8% a year before. This increase partially reflects the liquidity pressures and default that the sovereign went through in 2017. We expect this ratio to stay broadly stable now that Congress has approved the rollover of its debt maturing in 2019.

Externally, El Salvador's position has also improved. In 2018, we expect a CAD of 2.2% of GDP, balancing higher oil prices with remittances growth. This compares positively with the CAD of close to 4% of GDP, on average, over the previous five years. We expect relatively higher CADs in the next three years as a result of likely less dynamic remittances. Our forecast also incorporates U.S. growth of about 3% that would continue to benefit the country's exports.

Over the next three years, the CAD will be partly funded by foreign direct investment (FDI), which may remain around 1.2% of GDP. We expect that El Salvador's gross external financing needs will remain stable around 100% of current account receipts and usable reserves, while its narrow net external debt will stay around 82% of its current account receipts.

Overall, the government's high debt burden continues to expose the sovereign to potentially adverse shifts in market sentiment, in particular given the importance of Eurobond maturing in 2019. Relatively low FDI has led to reliance on external debt to fund the country's persistent CAD.

The country moved to full dollarization in 2001, and we believe this will continue in the coming years. This supports our 'AAA' T&C assessment, as well as our opinion that the sovereign would not restrict dollar outflows by private parties to make debt-service payments. While we expect that dollarization continues to lead to low inflation rates, the inflexible monetary regime has not helped to promote growth and investment.

We assess El Salvador's banking system in our Banking Industry Country Risk Assessment (BICRA) group '10'. (BICRAs are grouped on a scale from '1' to

'10', ranging from what we view as the lowest-risk banking systems [group '1'] to the highest-risk [group '10'].) We believe that the banking system and the public-sector enterprises pose a limited contingent liability to the sovereign. El Salvador has a relatively small state-owned enterprise sector, thanks to privatization the sovereign implemented in previous years.

Institutional and economic profile: Economic growth remains weak as political stalemate and crime hurt investment

- The historically polarized political environment could be changing with the emergence of new political figures.
- Uncertainty about the government's ability and willingness to comply with its financial obligations has eased.
- GDP per capita growth could reach close to 2% in the next two years.

The ruling political party, Frente Farabundo Martí para la Liberación Nacional (FMLN), has little common ground with El Salvador's other major party, the Alianza Republicana Nacionalista (ARENA), which has led to political gridlock and has damaged government effectiveness in the past. In April 2017 the sovereign defaulted following Congress denying to approve a budget reallocation to cover payments owed to the country's private pension funds (certificates for pension investments, or CIPs). However, this situation might be changing with the emergence of new political figures.

A competitive presidential election in February 2019 could incentivize major political parties to cooperate with the next administration and among one another, especially in FMLN, whose candidate is doing poorly in the presidential polls and now has a weaker position in Congress. In the last Congressional election, in March 2018, ARENA strengthened its position by two seats to a total of 37 seats, while the FMLN lost eight seats to end with 23 seats. The FMLN also lost its veto power--it needed to hold at least 28 seats (one-third of Congress) to maintain veto power.

With Congress approving the refinancing of the $800 million eurobond due in December 2019, the sovereign is now allowed to access external financing next year, easing uncertainty about its ability and willingness to pay. The approval should also help increase investor confidence over the next few years.

We expect GDP growth to hover around 2.3% this year, the same as in 2017. Resolution of the default last year mitigated, to a great extent, the effect on investors' confidence, as shown by increased FDI that continued growing this year. For the next three years, we are forecasting a slightly stronger economic performance. On a per capita basis, this would translate to growth of close to 1.9%, on average, up to 2021. El Salvador's GDP per capita would surpass $4,000 at the end of this year.

Historically low GDP growth has been fueled by low investment, high emigration, weak competitiveness, and political gridlock. On the other hand, private consumption is underpinned by remittances growth that in 2017 accounted for 21% of GDP. As a small and open economy, El Salvador's performance is closely linked to the U.S. because close to 50% of its exports go to that country. Also, about one-third of its population has moved to the U.S.

El Salvador continues to rank poorly on the Human Development Index, and over the last year, it has fallen to 121 from 117 (out of 188 countries). El Salvador falls under the "medium human development" category, signaling significant shortfalls in basic services and infrastructure.

Raising potential growth in coming years will require reforms to foster competitiveness and investment, supported by measures to reduce crime. Job creation through more dynamic economic activity is essential to tackle the large informal sector, which represents about 70% of the working-age population, according to the International Monetary Fund.

Relative to a year ago, termination of the Temporary Protected Status (TPS) and massive deportations is now less likely because a U.S. local court ruled against such termination. There are about 195,000 Salvadorians currently benefiting from TPS, accounting for around 16% of the Salvadorian migrant population in the U.S.

We've seen progress made on tackling corruption in the country. The current attorney general imprisoned the former attorney general as well as El Salvador's former president Antonio Saca. Still, El Salvador is poorly ranked in the Corruption Perceptions Index from Transparency International. In 2017, its score worsened, and it's now ranked at 112, out of 180 countries.

El Salvador's World Bank Ease of Doing Business ranking also worsened in 2018, to 85 from 73 a year earlier (out of 190). The main challenges are dealing with construction permits, protecting minority investors, starting a business, and enforcing contracts.

Key Statistics

Table 1

El Salvador--Selected Indicators

(Mil. $)	2011	2012	2013	2014	2015	2016	2017	2018f	2019f	2020f	2021f
ECONOMIC INDICATORS (%)											
Nominal GDP (bil. LC)	20.28	21.39	21.98	22.59	23.17	23.91	24.81	25.96	27.19	28.49	30.13
Nominal GDP (bil. $)	20.28	21.39	21.98	22.59	23.17	23.91	24.81	25.96	27.19	28.49	30.13
GDP per capita (000s $)	3.3	3.4	3.5	3.6	3.7	3.8	3.9	4.1	4.2	4.4	4.6
Real GDP growth	3.8	2.8	2.4	2.0	2.4	2.6	2.3	2.3	2.4	2.4	2.4
Real GDP per capita growth	3.3	2.3	1.9	1.5	1.9	2.1	1.8	1.8	1.9	1.9	1.9
Real investment growth	7.4	0.9	(1.8)	(0.0)	(2.4)	1.5	12.3	2.3	2.4	2.4	2.4
Investment/GDP	17.8	17.8	17.2	16.4	15.6	15.1	16.9	16.9	16.9	16.9	16.9

Table 1

El Salvador--Selected Indicators (cont.)

(Mil. $)	2011	2012	2013	2014	2015	2016	2017	2018f	2019f	2020f	2021f
Savings/GDP	12.3	12.0	10.3	11.0	12.4	13.0	14.9	14.7	14.4	14.1	13.6
Exports/GDP	29.0	28.5	29.2	28.9	29.0	27.9	27.6	27.2	26.7	26.3	24.9
Real exports growth	7.2	0.3	4.6	2.3	2.8	1.6	2.2	2.3	2.4	2.4	2.4
Unemployment rate	6.6	6.1	5.9	6.2	5.5	7.0	7.0	6.0	6.0	6.0	7.0
EXTERNAL INDICATORS (%)											
Current account balance/GDP	(5.5)	(5.8)	(6.9)	(5.4)	(3.2)	(2.1)	(2.0)	(2.2)	(2.5)	(2.8)	(3.3)
Current account balance/CARs	(11.3)	(12.0)	(14.0)	(11.0)	(6.5)	(4.2)	(3.9)	(4.3)	(5.0)	(5.7)	(6.8)
CARs/GDP	48.6	48.3	49.2	49.0	50.0	49.3	51.2	50.6	50.2	49.9	49.3
Trade balance/GDP	(23.5)	(23.0)	(24.1)	(23.4)	(21.5)	(19.4)	(19.5)	(19.8)	(19.8)	(19.8)	(19.8)
Net FDI/GDP	1.1	2.2	0.8	1.4	1.7	1.5	3.2	1.3	1.3	1.2	1.2
Net portfolio equity inflow/GDP	0.0	(0.0)	0.0	0.0	0.0	0.0	(1.2)	0.0	0.0	0.0	0.0
Gross external financing needs/CARs plus usable reserves	100.9	99.2	98.6	102.3	102.2	101.7	99.5	100.4	98.6	99.7	101.8
Narrow net external debt/CARs	79.0	86.3	88.3	94.0	84.4	90.2	85.9	84.4	83.1	82.8	79.2
Narrow net external debt/CAPs	71.0	77.0	77.4	84.8	79.2	86.6	82.7	80.9	79.2	78.4	74.1
Net external liabilities/CARs	121.0	132.9	135.2	132.9	127.2	135.1	131.8	131.4	130.9	131.1	125.3
Net external liabilities/CAPs	108.7	118.6	118.6	119.8	119.5	129.6	126.8	126.0	124.7	124.1	117.4
Short-term external debt by remaining maturity/CARs	19.2	11.2	13.5	16.7	19.5	21.5	20.9	23.4	19.1	18.5	17.8
Usable reserves/CAPs (months)	3.2	2.6	3.1	2.7	2.6	2.7	2.9	3.1	3.0	2.8	2.5
Usable reserves (mil. $)	2,503	3,176	2,744	2,692	2,786	3,238	3,567	3,540	3,482	3,319	3,319
FISCAL INDICATORS (%, General government)											
Balance/GDP	(4.5)	(3.8)	(4.5)	(4.0)	(3.7)	(3.1)	(2.5)	(2.7)	(2.9)	(3.0)	(3.0)
Change in net debt/GDP	5.5	4.4	4.6	3.9	3.7	3.4	2.8	2.8	2.8	3.0	3.0
Primary balance/GDP	(2.0)	(1.3)	(1.8)	(1.4)	(0.9)	(0.2)	0.7	0.5	0.4	0.3	0.2
Revenue/GDP	21.8	22.0	22.3	22.0	22.3	23.1	23.7	24.0	24.1	24.1	24.0
Expenditures/GDP	26.2	25.8	26.7	26.0	25.9	26.2	26.3	26.8	27.0	27.1	27.0
Interest /revenues	11.5	11.2	11.9	12.0	12.4	12.8	13.6	13.6	13.7	13.6	13.5
Debt/GDP	57.5	62.3	62.3	64.4	66.3	68.1	68.3	68.0	67.7	67.6	67.0
Debt/Revenue	264.4	282.8	279.8	293.3	297.9	294.6	287.8	282.8	281.2	280.1	279.3
Net debt/GDP	55.8	57.3	60.4	62.7	64.8	66.2	66.6	66.4	66.2	66.2	65.6
Liquid assets/GDP	1.7	4.9	1.9	1.8	1.5	1.9	1.7	1.6	1.6	1.5	1.4
MONETARY INDICATORS (%)											
CPI growth	5.1	0.8	0.8	0.5	1.0	(0.9)	2.9	2.3	2.3	2.3	3.3
GDP deflator growth	5.9	2.6	0.4	0.8	0.2	0.6	1.4	2.3	2.3	2.3	3.3
Exchange rate, year-end (LC/$)	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Table 1

El Salvador--Selected Indicators (cont.)											
(Mil. $)	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018f**	**2019f**	**2020f**	**2021f**
Banks' claims on resident non-gov't sector growth	5.1	3.5	9.6	6.7	5.3	5.0	2.8	4.7	4.8	4.8	5.8
Banks' claims on resident non-gov't sector/GDP	47.5	46.6	49.7	51.7	53.1	54.0	53.5	53.5	53.5	53.5	53.5
Foreign currency share of claims by banks on residents	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign currency share of residents' bank deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real effective exchange rate growth	(1.6)	1.2	0.8	(0.1)	(1.3)	2.3	1.8	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. N/A--Not applicable. f--Forecast. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

El Salvador--Ratings Score Snapshot	
Key rating factors	
Institutional assessment	6
Economic assessment	5
External assessment	5
Fiscal assessment: flexibility and performance	5
Fiscal assessment: debt burden	5
Monetary assessment	6

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC'

Ratings, Oct. 1, 2012

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- El Salvador 'CCC+' Long-Term Rating Affirmed; Outlook Remains Positive, Dec. 13, 2018
- Sovereign Ratings History, Dec. 7, 2018
- Banking Industry Country Risk Assessment Update: November 2018, Nov. 23, 2018
- Global Sovereign Rating Trends: Third-Quarter 2018, Oct. 3, 2018
- 2017 Annual Sovereign Default Study And Rating Transitions, May 8, 2018
- Sovereign Debt 2018: Latin American And Caribbean Commercial Borrowing Is Likely To Decline In Absolute Terms To Near $355 Billion, Feb. 22, 2018
- Sovereign Risk Indicators, also available at www.spratings.com/sri

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts. The committee agreed that "external risk" had improved. All other key rating factors were unchanged. The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Upgraded; Outlook Stable

	To	From

El Salvador		
Sovereign Credit Rating	B-/Stable/B	CCC+/Positive/C
Senior Unsecured	B-	CCC+

Ratings Affirmed

El Salvador	
Transfer & Convertibility Assessment	AAA