



Central America

Costa Rica is disappointing, while El Salvador is moving on

- **Strategy:** Switch out of Costa Rica (UW) 2023s, 2025s into El Salvador (OW) 2025s, 2027s.
- Initial expectations that the new government of Carlos Alvarado in **Costa Rica** could get its fiscal reform approved by October of this year are fading. Furthermore, there are increasing risks that the government could conform to a watered-down version that could deliver up to 0.8pp of GDP less than initially expected. Such efforts would be insufficient to solve the urgent fiscal situation.
- Negotiations are undergoing with the opposition mainly to reinsert taxation on basic goods. But public rejection of fiscal packages is increasing and could undermine political support for the project in the Assembly. Unions have called for a national strike next Monday.
- Meanwhile, the public deficit continues to widen and is expected to end 2018 at 7.1% of GDP, from 6.3% in 2017. The central bank has warned that without reform, the public debt could reach more than 70% of GDP in 2022 from the current 55%.
- The government has also submitted a request for an extraordinary budget approval since the current budget does not include some short-term debt issued at the end of last year.
- In **El Salvador**, focus is on the presidential elections to be held in February 2019. Poll leader and self-described political outsider Nayib Bukele accomplished his registration in the last minute at the end of July as he formalized an alliance with the GANA party. The opponents from the traditional parties will be Carlos Calleja from ARENA, who is generally perceived as the most market-friendly candidate, and Hugo Martinez from FMLN.
- Campaigning will start in October. We expect more clarity on candidates' agendas as they develop, and there is much time for preferences to move. For instance, there is uncertainty on how recent corruption scandals from former President Saca could affect the campaigns, while Bukele might lose support due to accusations of embezzlement.
- In the meantime, the Sanchez Ceren administration continues to pursue new issuance of USD3,200mn in bonds. Those resources would be used to meet short- and medium-term debt obligations. This could advance in the next couple of weeks, but first, a compromise on a new fiscal responsibility law is needed. We believe that the government and other political forces continue to have a strong conviction that this issue should be sorted out before the elections. In the meantime, the government might spend more on the electoral season.

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Expectations for approval of the fiscal reform this year have been diminishing

Switch out of Costa Rica 23s, 25s into El Salvador 25s, 27s

Credit Strategy: The initial expectations that Costa Rica’s (UW) new administration, led by Carlos Alvarado, could push through quick approval of the fiscal reform have been fading, and the tax reform bill is being watered down. Indeed, even if the reform is passed in its current form, the fiscal path remains challenging. Just part of this expected deterioration is priced in; however, we think that it puts Costa Rica in a vulnerable position amid challenging EM markets. Meanwhile, we think that El Salvador (OW) is likely to deliver on the liability management transaction proposed by the executive branch. The proposed transaction aims to take out ES 2019s and 2023s. We believe that the El Salvador curve would benefit if the transaction is approved by the National Assembly. Moreover, we believe that front-end (ES 2019s and 2023s) and belly bonds (ES 2025s and 2027s) would benefit disproportionately. We recommend switching out of Costa Rica 2023 and 2025s into El Salvador 2025s and 2027s. February’s presidential elections are still too far out to be a factor, and Bukele economic views are still unclear.

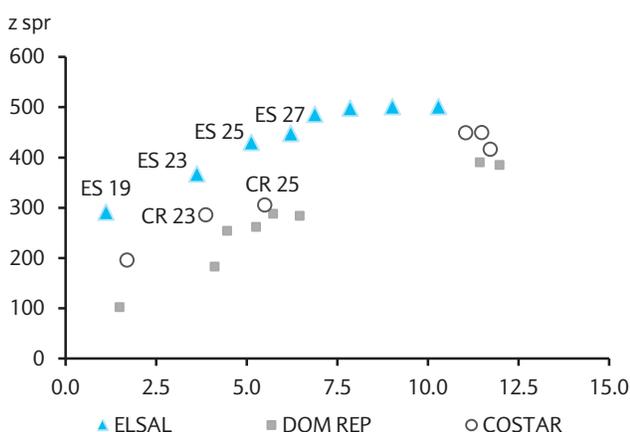
Costa Rica: It was easy to say, hard to implement

The initial estimate for the fiscal reform was that it could increase revenues by 1.9% of GDP, due mainly to the transformation of a sales tax to a VAT at a 13% rate, with some differentiation in private services and basic goods at 4%, and a new global income tax. Nevertheless, after different modifications, it is now estimated to increase fiscal revenues only 1.1% of GDP. The government is trying to fix the project, but as time passes and progress does not materialize, expectations that the final reform could come out in the next months diminishes. In addition, even if it is approved, it might be insufficient to stabilize public debt.

Several setbacks in the legislative have watered down the original project by about 0.8pp of GDP

The challenges started in May of this year, when the newly elected congress started its session. The lawmakers asked to review again the fiscal reform and asked for modifications. The new government decided to send a first replacement to the fiscal text, trying to gather support from the opposition. This text reduced the VAT on basic goods to 2% from 4% and made some adjustments in the global income tax. In sum, this represented about 0.2pp of GDP less from tax collection. Nevertheless, despite those efforts, the project was rejected by the legislative commission. Then, the government conceded more and reduced the VAT rate on private education and health services to 2% from 4%, which could cost up to 0.3pp of GDP. This new text was approved by the Commission at the beginning of August, but

FIGURE 1
Switch out of Costa Rica ‘23s, ‘25s into El Salvador ‘25s, ‘27s



Source: Bloomberg, Barclays Research

FIGURE 2
Costar and El Salvador have both underperformed CAC peers



Source: Bloomberg, Barclays Research * Jamaica, Guatemala, Honduras, Dominican Republic

along with almost 900 motions to modify it. Since then, motions to give full tax exemption status to basic goods and private education services have been approved. This trimmed almost another 0.3pp of GDP from the revenues expected from the reform. 436 other pending motions could subtract another 0.1pp (Figure 1).

Following that exemption, the government threatened to cancel the fiscal project in order to negotiate further with legislators. In the end, they decided to continue to discuss this in the plenary of the legislative and are evaluating options to include again at least the tax on basic goods, potentially with a devolution system to the poorest people following a proposal from a lawmaker from the opposition. In fact, the government has reached an agreement to put to a vote in the legislature the reincorporation of this tax, but at a rate of 1%. This could increase about 0.1pp the current estimate from the fiscal reform.

Political support for the project is weakening in the Assembly; unions held a national strike on September 10

Any change in the reform needs to be approved by the fiscal commission with five of nine votes and then be approved in the plenary with the support of 29 of 57 lawmakers. The official party, PAC, has only 10 seats, so it needs its usual alliances with PLN and PUSC, which have nine and 17 votes, respectively, to move forward with its proposals. Nevertheless, internal division among those parties has emerged regarding the reintegration of the exempted taxes, and the PRN, the main opposition to the project, has 14 seats. The project could lose support in the Assembly as the popular opposition increases. Recently, diverse unions in Costa Rica held a national strike against the fiscal measures on September 10. It was held amid large public demonstrations and affected mainly government services.

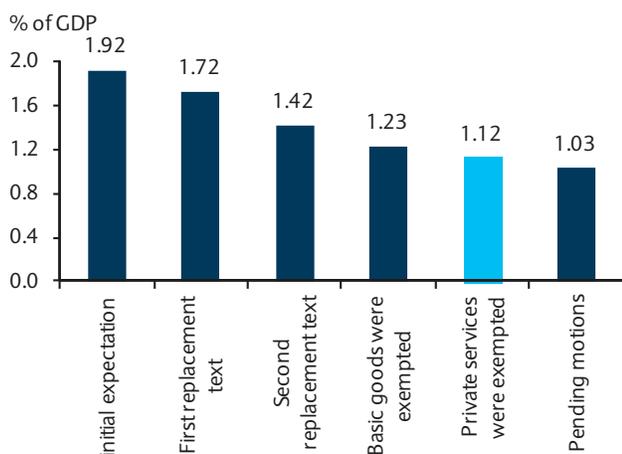
A comprehensive project could be pushed into next year, or the government might acquiesce to a weaker version

The initial timeline for the fiscal reform – a first debate before September ends and approval by October of this year – has started to seem unfeasible, and risks that the project could be pushed into 2019 have increased. Another major risk is that the government could accept the watered-down version in order to get something approved this year and be able to access international markets this year or potential loans from the IMF or the World Bank. In any case, the persistent vulnerability of the fiscal accounts will likely continue to put pressure on President Alvarado.

The total fiscal adjustment could be insufficient to revert the widening of the deficit and public debt

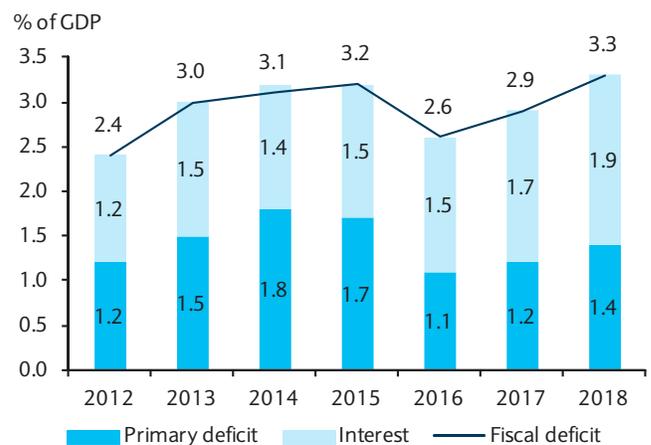
Overall, the current project represents fresh resources of only about 1.1% of GDP, which, along with the savings announced at the beginning of the administration and a new public employee law, would represent an improvement in the deficit of only about 2.2% of GDP by 2022, well below the minimum of 3% sought by the administration and recommended by the IMF. Meanwhile, the fiscal deficit continues to widen, as it reached 3.3% of GDP this year up to June, the highest in recent years (Figure 4), and is expected by the central bank to

FIGURE 3
Resources expected from the fiscal reform have decreased; the current expectation is 1.1%



Source: Ministry of Finance, Barclays Research

FIGURE 4
The fiscal deficit reported for this year up to July 2018 is the highest in recent years, as interest payments are increasing



Source: Ministry of Finance, Barclays Research

end 2018 at 7.1% of GDP, from 6.2% in 2017, with central government debt at 55% of GDP, from 34% in 2012. Furthermore, the central bank has mentioned that if any fiscal reform is approved, the public debt could reach 71% of GDP in 2022, while a comprehensive fiscal project could stabilize debt slightly above 60% of GDP.

The government has also requested an extraordinary budget to meet short-term local debt

Last month the government also requested an extraordinary budget of C\$600,000mn, about 1.7% of GDP, to address short-term debt payments. The new administration explained that the previous government issued short-term debt after the fiscal budget for this year was approved, so it was not included. Minister of Finance Rocio Aguilar even said that for June, July and August, the government had to make payments outside of the approved budget since it was not in a position to meet its obligations on debt payments. That declaration raised some concerns about the legality of those actions, but whether the issue can be investigated remains unclear. Meanwhile, the extraordinary budget was already approved by the fiscal commission on August 21 and could be voted before mid-September. The ministry has also warned that it could present another request for an extraordinary budget of C\$300,000mn (0.9% of GDP), due to lower tax revenue than expected.

El Salvador: Bukele is in, but so is the government

Bukele made it onto the final ticket ahead of the presidential elections

After some drama, the popular former mayor of San Salvador, Nayib Bukele, managed to register as a presidential candidate with the GANA party. This was his only option after the party he founded, New Ideas, could not register in time for primary elections, while his first option to make an alliance, the CD party, had his registration stripped after a verdict from the Supreme Court and the Electoral Court. The next elections will likely be a race between Bukele; businessman Carlos Calleja, who is ARENA's candidate; and Hugo Martinez, the candidate from the official party FMLN.

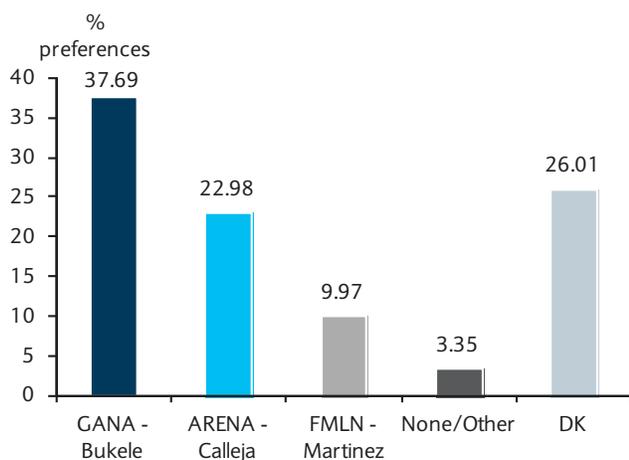
Polls continue to be headed by Bukele, with 38% of preferences

The latest poll from the University of Francisco Gavidia (UFG) conducted between August 18 and 22 showed that Bukele continues to lead. He reached 37.7% of preferences, while Calleja has 23%. Far back in third place is Martinez with 10%. A minor candidate, Josue Alvarado, from the VAMOS party, is in fourth place with 2%. Finally, about 26% said they do not know how they will vote. Nonetheless, this poll indicates that there could be a second round of elections since Bukele would fail to achieve more than 50% of the votes.

ARENA could be the most competitive option against Bukele

Bukele defines himself as an outsider to the political system, but his economic agenda is unclear. Furthermore, despite being perceived to be on the left of the political spectrum, his alliance with GANA, a right-wing party, could make the construction of a common agenda difficult, especially on fiscal terms. Meanwhile, Calleja, who is generally perceived as the

FIGURE 5 Latest presidential poll from UFG (Aug 2018)



Source: UFG, Barclays Research

FIGURE 6 Electoral calendar ahead

Date	Event
October 2 2018.	Official campaigns start. They will last until January 30 2019. Main runners will be Nayib Bukele (GANA party), Carlos Calleja (ARENA) and Hugo Martinez (FMLN)
February 4 2018	Election Day
March 10 2019	Potential second round between two front-runners if any of the candidates do not reach more than 50% of the votes.
June 1 2019	Inauguration day for new administration

Source: TSE, Barclays Research

most market-friendly candidate, is also perceived as the most competitive candidate to run against Bukele. This follows the good performance of ARENA in the past legislative elections, in March 2018, when it won a plurality with 39 seats of 84 members.

Agendas and preferences could move as campaigns start in October, with corruption scandals likely taking center stage

With still a long way to go before the elections, agendas from the candidates should be better known as the campaigns start in October. Furthermore, preferences could be affected by potential developments on the corruption scandals after former President Antonio Saca pleaded guilty at the beginning of August to embezzling hundreds of millions of dollars in public funds during his 2004-2009 government. The resurgence of this case could play a major role in campaigns, but it is not clear who would benefit the most. Saca was president while a member of ARENA, although he was expelled from it in 2009. He then founded GANA, which currently is in alliance with Bukele.

New issuance to re-finance debt remains on the government's agenda

Meanwhile, the Sanchez Ceren administration continues to pursue new issuance of bonds of USD3,200mn. The transaction would be used to meet \$800mn of LETES (short-term debt) obligations and the rest to swap seven bonds that mature between 2019 and 2024 (local and external law). The administration has been optimistic and recently mentioned that it expects to advance on this topic with the legislature in the next three weeks, just before elections kick off. However, members from ARENA warned that this discussion will not progress until the government submits new reforms to the fiscal responsibility law following the adjustment to the new calculation of GDP. The government mentioned that those reforms could be presented in a matter of days. Failure to deliver could compromise the new financing plans. However, we believe that the government and the opposition forces have the incentive to sort out the public finance outlook for the coming months, as the government also is spending more on the electoral season. In that sense, it seems that the political outlook has not changed the consensus on strengthening public finances in the short term.

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Materially Mentioned Issuers/Bonds

COSTA RICA GOVERNMENT INTERNATIONAL BOND, CD/J/K/M/N

COSTAR 4 1/4 01/26/23 (USD 93.29, 13-Sep-2018)

COSTAR 4 3/8 04/30/25 (USD 90.26, 13-Sep-2018)

EL SALVADOR GOVERNMENT INTERNATIONAL BOND, CD/J/K/M

ELSALV 5 7/8 01/30/25 (USD 92.38, 13-Sep-2018)

ELSALV 6 3/8 01/18/27 (USD 92.25, 13-Sep-2018)

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