

Trip Notes

Central America Trip 2023

Aktia

Central America Policymaker Meetings

Picture from the World Bank building in San Salvador

- Countries visited: Panama, Costa Rica, El Salvador and Guatemala.
- We visited four countries in five days, with 30 meetings in total with Ministers, Central Banks, Debt Offices, congress members, opposition politicians, World Bank & IMF country representatives, consultants, and independent local researchers/strategists.
- These countries have had quite a positive rebound after Covid-19 but higher living costs are still pressuring budgets and financing sources are not equal for all countries.
- Elections are around the corner in all four countries, but no major regime changes are expected. The real problem is that the focus will be more on the campaigning and elections, not on much needed reforms.



Overview

Aktia's EMD team participated in an investor trip in Central America end of January with a group of other international EM sovereign investors. We visited four countries in five days, had 30 meetings in total with Ministers, Central Banks, Debt Offices, congress members, opposition politicians, World Bank & IMF country representatives, consultants, and independent local researchers/strategists. The topics varied a lot. The discussions were very valuable and gave further insight on the current economic situations, political environment and shed more light for the near-term future.

These countries are at various stages in their development. However, one could find at least a few common themes. The region is still recovering after Covid-19 and trying to cope with increased living costs. Nonetheless, the 2022 recovery was remarkably strong and there are many signs implying that the worst is behind. Growth expectations are moving back towards potential levels and inflation is expected to halve by the end of this year.

Issues are similar to rest of the EM world. Authorities are still struggling to find a balance between higher than usual expenditures (due to social support etc.) and higher financing costs. Governments are under pressure from two sides; on the other hand, voters' opinions are often sharp-tempered due to a higher cost of living, while external financing institutions are demanding fiscal consolidation to keep budget and debt levels under control.

One common and crucial factor for all countries are elections in 2023 and 2024. Elections are not expected to be real a "game changer" in any of the countries but they will have consequences. The political focus will be on elections and campaigning, while the much-needed reforms are unfortunately on hold in many cases. It is not a given that all elections will be fully fair, money could unfortunately have large impact on results and neither corruption nor even violence can be ruled out.



One common and crucial factor for all countries are elections in 2023 and 2024. Elections are not expected to be real a “game changer” in any of the countries but they will have consequences.

Panama

Panama – 23.1.2023

Panama is one of the brightest spots in the area which is also reflected in its current credit rating (BBB). Panama has a very stable socioeconomic, economic and political environment. It is one of the fastest growing countries in Latin America and had robust growth last year (9% growth in GDP) and expectation for this year growth is 5-6% (long term potential 5%), according to the Ministry of Finance & Economy. The economy is well diversified across sectors and due to strong tailwinds in growth, the size of the economy is now exceeding pre-pandemic levels. For this year, the main drivers of growth are infrastructure projects in the form of highways, metro and electricity lines, and construction (both public and private).

The general expectation is that the positive growth picture will take care of the fiscal deficit which is expected to reach or even exceed the target of 3% of GDP this year (final fiscal deficit is expected to be 3.8-4% of GDP for 2022). Authorities are planning to tackle financing needs of USD 4bn with international bonds (expectation of USD 1-1.5bn in H1), multilateral financing and local markets.

Panama has had strong foreign investment flows (FDI) and there are USD 16bn worth of investments in the pipeline during the next five years.

Panama has the Energy Transition Agenda for 2020-2030 in place and a strong emphasis to increase the share of renewables in electricity production (currently 80%) and even more in the coming years. In 2020 only 20% of electricity consumption was produced with fossil fuels. Electricity has a significant role for the country as mining has become the main export sector during the past 10+ years.

Unfortunately, there are currently major challenges related to the mining sector. Panama has one of the world's largest and most advanced copper mines, Cobre, which produces currently over 350,000t of copper per year (mainly copper but also gold and silver). The government and the mine operator First Quantum have been trying to find an operating agreement for a long time as the old one was determined unconstitutional already back in 2018. Negotiations have been extremely difficult and have gone back and forth. However, the time for the agreement is running out. The

original agreement was very unfair from Panama's point of view. Now the question is how to find an agreement where both sides are satisfied and that the financial incentives are fair and in line with global market conventions. The next step would be arbitration if an agreement cannot be found. This would clearly be the worst-case scenario for both sides (extremely expensive, time consuming with high uncertainty regarding the outcome). However, according to local experts, the agreement is expected to be reached in the coming weeks, which of course would remove a cloud of uncertainty, and would also help to attract new investments in the future. Mining has an enormous influence on the economy, as it represents more than 4% of GDP and has more than 2000 local companies linked to it based on the value chain. Furthermore, the Cobre mine is not the only one with operation agreement issues, there is also another gold mine where the situation is very similar to Cobre. With the Panama

Panama

Canal, the mining sector is by far the most important driver for the economy.

Another concern is the social security program and more precisely the pension program. There are currently two different pension schemes running side-by-side, the old one and the new one. The issue is that the old one is weighing heavily on the deficit (and the deficit is growing all the time) and the cost of financing could be as high as 2% of GDP (USD 11bn for next 5-6 years). Currently, the government has no political capital to solve the problem as general elections are scheduled for next year. Regarding elections, the situation is very fragmented and there is no strong leader candidate currently. However, now it seems that whoever will be the new president, there will be no major regime changes

In Panama, the general premise is that the new president and government will have a large number of tough decisions to make. Issues related to social security, pension program and

subsidy cutbacks must be dealt with promptly and in decisive manner.

Finally, Panama has been listed on FATF's (Financial Action task Force) "grey list" but has been working intensely lately to get out of it. The country has answered and fulfilled 12 out of 15 questions raised and is determined to get the rest of the issues solved too. Panama has taken steps to improve transparency on beneficiary ownership information on companies (and SPVs = Special Purpose Vehicles) by improving databases and reporting requirements. These actions have been taken to improve anti-money laundering (AML) and counter-terrorist financing (CFT) issues and there is significant development in the area.

View: We have moderate position in our HC strategy but have started to increase the position over time due to positive developments on several fronts.



Palacio de las Garzas in Panama City

Costa Rica

Costa Rica 24.-25.1.2023

Costa Rica has been a prime example how to execute an efficient fiscal rule. It was approved already back in 2018 but due to the pandemic, the first full year with the rule in use was 2022. The fiscal rule combined with the IMF agreement has provided a solid foundation for strong fiscal numbers. Most importantly, the savings component in the fiscal rule has been a public salary freeze. The expectation is that it will continue until the end of 2023 (the budget for this year is locked). GDP growth has been on a solid path, 2022 growth was 4.3% and the expectation for 2023 is 2.7%. Recent growth has been reliant mainly on activity in free trade zones, as local business activity has stagnated. The administration and President Chavez are fully committed to the IMF agreement and fiscal consolidation. However, the fiscal rule was designed during a low inflation period, so due to the current situation modest tweaks could be applied. Inflation is running currently just below 8% but is expected to reach a target of 3% by the end of the year according to the Central Bank.

The former Finance Minister expressed a favourable outlook; Costa Rica's macro story is stable compared to many peers. The primary balance is running at a surplus, the current account deficit target for 2023 is 3.5% according to the Central Bank. Financing needs for this year are less than 10% of GDP. Congress has approved a total of USD 3bn eurobond issuance for 2023 (1.5bn for H1 and 1.5bn for H2) and USD 1.2bn financing from multilaterals. Currently multilaterals are a cheaper financing option for the country and it could mean that the Central Bank will not issue the maximum amount of eurobonds. Debt levels have increased during the past years but metrics are now stabilising, and the debt-to-GDP level is just above 60% with a downward trending path. One issue has been very low CB reserves (USD 6.7bn July 2022) but that has been improving rapidly lately. Reserves are currently running at USD 10bn. The Central Bank is committed to increase reserve levels but there is no explicit target. However, the Governor of the Central Bank communicated that levels of 11-15% of GDP are comfortable (currently around 12%). On the positive side, Costa Rica, just like

Panama, is also enjoying nearshoring with new investments from large companies like Intel (production facility) and others.



Recent growth has been reliant mainly on activity in free trade zones as local business activity has stagnated. Current, the administration and President Chavez are fully committed with the IMF agreement and fiscal consolidation.

Costa Rica

On the political side things are a bit complicated. President Rodrigo Chavez Robles was elected in May 2022 and came as an outsider to Costa Rica's politics after spending 37 years abroad. The issue is that Chavez only has 10 seats (of 57) in Congress. The president is considered to be a confrontational person and the complexity related to governance can be seen in disputes with the legislature, judiciary and press for example. These issues could call for early congress elections in 2023. President Chavez has been criticised for not executing any significant reforms and bringing anything new on the table. However, he is very popular among the people and currently has a popularity rate of 74%.

There is a new law approved which should help international investors gain access to local bond markets in Costa Rica in the future. The goal is to increase the share of international investors in local markets and improve liquidity by unifying bond jurisdictions, tax treatment, and facilitate settlements for example.



Central Bank of Costa Rica

View: Small underweight in our HC strategy, no plans to add. Costa Rica was one of the strongest performers last year. We have around 3% of investments in local government bonds in the Frontier strategy. The local market is still fairly illiquid and that is one reason why the position has been kept small.

El Salvador

El Salvador – 26.1.2023

Moving away from a solid macroeconomic environment, predictability on reforms and transparency (Panama & Costa Rica) to El Salvador. However, against expectations, El Salvador delivered one of greatest surprises of the trip in the form of strong fiscal numbers from last year. Revenues were up more than anticipated (+12% vs 2021), expenditures were kept at healthy levels and most importantly, the country made its 2023 eurobond payment. To be honest, we did not give too high of a probability for making the payment a year ago. But we are happy to be proven wrong here. Now it seems that El Salvador could muddle through the next bond payment 2025 (USD 350m), but the real challenge will be 2027 expiry of USD 800m. This could be too big of a hurdle to pass. According to local political analysts, President Bukele will stop servicing debt if, and when it compromises his popularity, so at least for now there is a commitment to continue debt payments.

The case for El Salvador is straight forward if one takes away some of the more complicated nuances. The government is

running out of money and fast. Debt payments and day-to-day cash needs are covered through a tape and gum approach. All pockets have been turned inside out to keep the financing side afloat. Some actions taken are at least questionable and non-transparent. For example, income transfers from local municipalities to the central government and pension reform where pension liabilities are moved from the government balance sheet to non-finance institutions (this way the country's debt metrics will improve significantly) would not survive scrutiny in the western world. The pension reform was widely discussed, and evidently not even local officials have a clear picture of what the outcome will be. From a bond investors point of view government could also save on interest expenses (but it is unclear how much if any) and debt metrics will improve as mentioned. The reform included a 30% increase for pensions (it is unclear how this ~230m expenditure will be financed) and liabilities are even in the best case just pushed forward to the future. These actions do not change the fact that there is a severe deficit in the pension system, and it must be financed eventually. The threat in the end is that the deficit will fall on salvadorians to pay.

President Nayib Bukele has been in power since June 2019. After a very short honeymoon, things have taken steps towards a wrong direction and quickly. Bukele has concentrated more power to himself and his inner circle, and is controlling congress, local municipalities, legislative institutions, the press and so on. Similarly, international relationships with the western world and especially with the US very quickly turned sour. Also tendering Bitcoin as an official currency in El Salvador was from Bukele's playbook. The government is committed to its bitcoin strategy, although there are no transactions or activity with the crypto currency at the moment. The common view among locals is that Bukele will be in power for the next 20 years. He currently has a very high popularity rate (80%) and the perception of him is that he is a populist who is resolving peoples' issues. For example, Bukele has gained more popularity with fuel subsidies (despite the USD 50m cost per month which is causing pressure on government finances). In the political playing field he is described as a political animal and as a negotiator and high stake poker player.

El Salvador

From a democracy point of view El Salvador is missing an opposition. Or there is an opposition but people are too afraid to support it. And as the government is controlling the press, there is no public voice or channel for the opposition to express their opinions. There are general elections coming in 2024. It is clear that Bukele will continue (although it is against the constitution, but this will be solved) as president. If, and only if, the congressional election will be legitimate, there is a possibility that the ruling party (Nuevas Ideas) could lose a few seats but nothing that would make a big difference.

El Salvador, as many other lower-rated countries, can currently only dream about getting external financing through bond markets. Financing needs are deteriorating but the picture is not all that worrisome for El Salvador. For now, it seems that the country could fulfill their USD 4bn financing needs for this year from local markets (issuing Cetes 1.3bn + Letes 1.3bn, mainly for local banks to absorb) and tapping loans from multilaterals like CABI (Central American Bank

for Economic Integration) and CAF (development bank of Latin America).

One interesting topic is El Salvador's relationship with the IMF and US. Although it seems like somewhat of a surprise, it seems that relationships are warmer than they may appear on the surface. The new US ambassador started a few weeks ago. The Biden administration has been more active to initiate dialogue with El Salvador and the main reason is probably the threat of the immigration crises if risks should materialise in the country. There is a population of 6m in El Salvador, but estimates are that 2.5-3.5m Salvadorans are migrants in the US. Better US relationships would also mean positive steps with IMF. According to the World Bank, authorities have ongoing discussions with the IMF and on a pure numbers level, potential support from the IMF is not actually so large. However, for the IMF, the major issue is Bitcoin and the lack of transparency around it. At the same time, it seems that the government sees the IMF as a last resort of financing. But, with the IMF onboard, the World

Bank would also increase its support (currently supporting in form of project finance only).

Lastly, the security situation was very troublesome in the country not too long ago. Crime gangs were violent and the security issues were real. But President Bukele announced a State law of Emergency and the situation is much better now, and he gained popularity among population with decisive actions. After the operation, more than 1% of the population is in jail and not all of them for reason. This translates to human rights issues that could have a price tag later on president's popularity.

View: No position. Although fiscals from last year have surprised, we see that governance side is still deteriorating due to Bukele's actions. Also, longer-term financing will be one of the key issues and we are sceptical how the country will solve this issue.

Guatemala

Guatemala – 27.1.2023

Guatemala achieved a very strong recovery after the pandemic as GDP growth was 8% in 2021. Official numbers are not yet confirmed for 2022 but growth is expected to land at around 4%. For the current year, the outlook is similar with growth expectation of 3.5-4%. The economy has proven to be very resilient against these shocks, and a possible US slowdown should not pose significant risks to the economy according to the Central Bank. Authorities have continued with the same economic model as before the pandemic which provides stability to the macroeconomic environment.

One area where Guatemala shines is with remittances, as growth has been strong (+18% 2022) and the positive development is expected to continue this year too (6-9% growth). These figures are the strongest in the region. Also in this case, US slowdown is not expected to cause significant risks for remittances as Guatemalans are working in varied



Guatemala City

sectors in the US according to the Central Bank. Guatemala is strongly positioned from a reserves point of view, and has USD 20bn reserves currently, which equals more than 8 months of imports. Strong growth in remittances have been the main driver for reserves growth. Regarding Foreign Direct Investments (FDI), the development has been more stable (around USD 1.5bn per year) with the exception of 2021 when FDIs reached USD 3.4bn but this was due the selling of a local telecommunication firm to a foreign investor.

More on the encouraging side is the increasing tax base, which is up from 10% to 12% of GDP. The government is committed to increase it further. Reforms related to the revenue side are improvements in income tax collection, VAT and customs. Authorities emphasised that reforms are structural and more institutionalised. Guatemala has an active dialogue with the IMF and World Bank, which are providing technical assistance in various areas. Co-operation has resulted in several improvements in taxation and has helped launch electronic invoicing, which already covers 90% of the formal business side.

Guatemala

Guatemala differs from many peers with its low debt-to-GDP levels. For 2023 total public debt is expected to be 29.1% of GDP. The fiscal deficit has been on average 1.8% for past 18 years. Expectation for 2023 fiscal deficit is 2.5%. According to authorities, with a higher tax burden, there could be room to increase debt levels moderately, but the Central Bank has no intentions of doing so. Guatemala is one of the first smaller economies adopting an inflation targeting regime. Current inflation is running at 9.2% but Central Bank's expectation is that the target (4%, +/- 1%) is achieved by the end of 2023.

Challenges in Guatemala are related in many aspects to poverty, inequality, social security and living conditions. According to some estimates, 25% or even 30% of people are living under extreme poverty. One factor is that around 50% of locals are still living in rural areas where income levels are extremely low. This level of poverty accompanied with very large share of informal economy (even 70%) is a clear constraint to the economy. These issues will be key focus areas for the IMF going forward.

There will be general elections this year and there are some fears that elections could be influenced by organised crime and corruption. The former finance minister expressed concerns that there could be acts of violence related to elections, and that these could trigger even more severe security issues in the country. Mexican and Columbian narcotics traffickers have penetrated into Guatemala, some parts of the country are dominated by organised crime, and it is said that there are more guns today than during civil war times.

On a more positive end note, Guatemala has a long history of macroeconomic stability and successful bond issuances. Debt management has been sensible and currently reserves provide buffers. The Guatemalan currency (quetzal) has been quite stable as there is a rule that an over 0.9% fluctuation (daily, moving average) triggers a rule, which gives the Central Bank consent to intervene in FX markets via daily auctions. There is a limit of a maximum five auctions per day, USD 20m each with a cumulative USD 1bn use of

reserves a year. According to the Central Bank, daily turnover is FX in roughly USD 130-150m. The IMF expressed their view that wider band for FX could be beneficial to have additional flexibility against external shocks. However, the IMF does not see Guatemala moving towards a floating FX regime any time soon.

View: We have position (roughly 1,6%) in USD bonds in Guatemala but will be carefully monitoring how especially security situation continues to develop as elections are getting closer (June 2023). Our Frontier strategy also has a small position through Development Finance Institution bonds linked to the quetzal.

This presentation is produced by Aktia Bank plc (“Aktia”) for investors. The information has been collected from available public sources, considered by Aktia to be trustworthy. However, Aktia cannot guarantee that the information is correct or all-inclusive. The presentation is meant as a tool, among others, to help the investor to make decisions. The investor’s investment decision is his own, and it should always be founded on information and analyses that the investor himself deems to be sufficient. The investor should observe that there may be swift changes on the market, affecting this presentation. Aktia, its subsidiaries and associated companies, co-operation partners, or employees of said companies are not responsible for direct or indirect losses or damage caused by the use of this presentation, or parts of it, in investment operations. The presentation is meant to be shown in conjunction to a spoken presentation given by Aktia, and it should not be used without the presentation. The contents of this presentation is aimed for the target group it was presented to, and it shall not be made available to any other recipients. Copying or quoting the presentation, or parts of it, is not allowed without the permission of Aktia.

Investments always involve financial risks. The customer bears the responsibility for the financial impact of his investment decisions. The investment may fail to yield a profit, or the invested capital may even be lost. The customer may be debited the costs for financial services irrespective of the investment results. It is always advisable to study the investment market and alternative investments in detail before making the decision to invest. Aktia cannot give assurance to the materialisation of the expected yield presented. The information is based on assumptions based on the historic yield from different financial instruments, but it is no guarantee for future development of yield or value. This presentation is part of Aktia’s marketing material, and therefore not necessary put together in accordance with the rules for independent investment analysis. Trade restrictions concerning investment analysis is not applied on the financial instruments presented. This presentation is not based on the customer’s individual data, and it is not intended to be investment advice. The aim is to present the financial instruments, and their characteristics, included in the quotation. We would be happy to set a date for preparation of an individual investor profile and to give you individual investment advice. The customer may be obliged also to pay taxes and official charges other than those debited by Aktia. The customer should be aware that investments and investment property are subject to taxation, the impact of which was not necessarily taken into consideration in this presentation. Future performance is subject to taxation which depends on the personal situation of each investor, and which may change in the future. The customer is responsible for the gathering of necessary information regarding taxation of his investments and his decisions concerning these.

Aktia