Trip Notes

Latin America Trip 2024

Aktia

Latin America Trip Overview

Aktia's EMD team participated in an investor trip in Latin America during the second week of September 2024, with a group of other international EM investors and analysts.

We visited Ecuador, Panama and El Salvador in five days, had 27 meetings in total with Ministers, Central Banks, congress members, IMF & multilateral bank representatives, consultants, and independent local researchers/strategists. The discussions were very valuable and gave further inside on the current economic situations, political environment and shed more light for the near-term future.

Despite being countries at various stages of development, all three share a common challenge in improving the sustainablity and level of future growth. During 2024 growth has been rather lackluster in all three countries, driven by negative climate effects (drought) and tight domestic liquidity environment. Policy makers are now seeking ways to kick-start growth in their respective countries. Given post-pandemic higher debt levels and debt servicing costs, growth or fiscal consolidation is needed to ensure stabilising debt levels.

View from the Central Bank of Ecuador offices

Ecuador

Ecuador – 9-10.9.2024

Ecuador has gone through a volatile period during the last 12-18 months, both in terms of the political landscape and security situation within the country. Economic growth has remained quite subdued with 2024 estimates hovering around 0-1%. The current administration appears to be successfully implementing the fiscal adjustments according to the IMF program, which in part is a drag on growth along with a challenging structural picture within the electricity production sector.

In May 2023 former President Lasso decided to both step down and dissolve the parliament. This led to both presidential and legislative elections which were held in August / October 2023 and saw current President Daniel Noboa claim victory. However, in the National Assembly, the Correistan RC party claimed most seats, leading to a coalition government being formed between the RC (47 seats), Social Christian Party (16 seats) and Noboas National Democratic Action (14 seats).

Forward to September 2024 and the country is again preparing for general elections in February 2025, as this would have marked the end of President Lassos original term. At the time of our visit, the election campaigns were already gathering pace, with a total of 17 candidates having so far declared themselves available as presidential candidates. Based on polls, the main candidates appear again to be President Noboa and the Correista candidate Luisa Gonzáles.

Polling results have, however, been quite volatile with Noboa's support ranging between 32-48% while the Correistan candidate has hovered around 25-28%. A potential third main candidate, that came up in multiple meetings, is Jan Topic who finished fourth in the 2023 presidential elections and currently polling below 10%. To win the election in the first round, a candidate needs to obtain either 50% of votes or 40% and a 10% difference to the runner-up.

The country's internal security situation is still the main topic of the political scene. Despite declaring a national state of emergency in January 2024, President Noboa's efforts in stopping a wave of criminal violence appear not to have been fully successful yet. Gang and drug related crime is still a large problem especially around coastal areas. The second most important election theme appears to be increasing the number of formal jobs, as only approx. 1/3 of working age population has a formal job.

In May 2024, the IMF approved a 48-month EFF worth USD 4bn for Ecuador, of which USD 1bn was disbursed immediately. Economic growth has been quite lacklustre during 2024, with the most optimistic estimates at around 1% YoY and the IMF estimate at around 0.1%. We understand that the IMF will look more closer at the growth dynamics in the up-and-coming World Economic Outlook update in October 2024.

Ecuador

The government fiscal position has improved during 2024, in line with the IMF program expectations. Overall budget balance for January-July 2024 was just above USD 41m, an improvement of over USD 2bn from the corresponding period in 2023. Tax revenues have improved due to changes in periodisation of income tax withholding, a successful VAT hike (12->15%), cuts to petrol subsidies, and temporary gains via corporate/bank taxes, central bank dividends etc. Oil revenues are down versus 2023 but better than expected due to the Yasuni-ITT oil field still operating at higher capacity than expected. Government arrears have been reduced from USD 4.6bn at the start of 2024 to USD 4bn as of August 2024. The IMF program requires a USD 500m reduction in arrears for 2024.

Growth has been supported by the external sector, with an increase in both non-oil (+7.4%) and oil (+20%) exports during the first seven months of 2024, compared to the same period of 2023. In dollar terms, exports of fishing and agricultural related goods exceeded oil exports (USD 8.14bn vs 5.8). Overall Ecaudor posted a positive trade surplus of USD 4.2bn during January-July 2024 (USD 1.4bn Jan-Jul 2023). As an additional positive, international reserves grew to USD 8.4bn at the end of August 2024 (vs USD 4.45bn December 2023).

As stated, so far, the implementation of the IMF program has been successful by the government. The program also opened up for funding via multilateral funding from the IDB (USD 1.3bn) and CAF (USD 1.25bn) during 2024. The IDB loan was direct budget support, directed to energy investments and a special development loan (housing and microbusinesses). Challenges lie ahead, as the IMF program assumes a USD 1.5bn Eurobond issuance in 2025. Given the current questionable market access of Ecuador, with credit spreads trading at distressed (>1000bps) levels, a contingency plan could involve the IMF providing incremental financing in the form of a RSF (Resilience and Sustainability Facility). Another challenge is the incremental 1.4% fiscal consolidation planned for 2026, as agreed with the

View in central Quito

Ecuador

IMF. This would involve cutting current diesel subsidies, which are politically much more difficult to implement compared to petrol subsidies, which only affected private car owners.

The long-term prospects of Ecuador are hindered by lack of reform on especially three areas: labour code, international arbitration and electricity supply. President Noboa has tried to bring about reform on the issues related to labour code and international arbitration, but these were rejected in the constitutional referendum held on April 21, 2024. The current labour code is from 1938 and would need modernisation to today's needs, including hourly contracts for example. International arbitration is needed in order to attract more FDI investments. The third area which needs reform is electricity supply. Currently electricity demand is already exceeding electricity supply, in addition to the negative drought effects that have hurt the supply side during 2024. The constitution does not allow for any privitisation of strategic assets and any electricity project with capacity in excess of 50 Mwh needs to be in PP format.

View: Ecuador has been one of few CCC rated exposures in our Hard currency strategy during recent years. The position was reduced in connection to the debt-for-nature swap transaction which took place during 2023. Ecuador uses the US Dollar as legal tender, and hence local currency investments are not relevant.

The "Image of the Homeland" mural inside the National Assembly building in Ecuador

Panama

Panama – 11-12.9.2024

Key topics during our visit to Panama was to learn how the new President Mulino administration will tackle pension reform, potential reopening of the Cobre mine, sufficient water supply to the Panama Canal and fiscal adjustment.

Relative to Ecuador and El Salvador, Panama is still one of the most developed countries in Latin-American which is also reflected in its current credit rating (BBB). Historically the country has benefitted from a well diversified economy and enjoyed higher growth rates than in the rest of the LATAM region. Without doubt, growth was strongly supported by the real estate boom during the previous low interest rate environment.

2023 and 2024 have been somewhat difficult years for Panama in a number of ways. First, the country experienced a period of exceptional drought which directly affected the operations of the Panama Canal. As the water in the Panama Canal is also used to drinking water, low water levels affected political opinions and played its own part in the strong protests against and closure of the Cobre mine, the second challenge during 2023. With hindsight most speakers confirmed that the anti-mining protests of 2023 were in part, if not fully, a protest against the highly unpopular previous administration of outgoing president Laurentino Cortizio. The resulting closure of the Cobre Panama copper mine (approx. 4-5% of GDP) in late 2023, led to the loss of 8000 jobs directly and approx. 30 000 indirectly. Due to these two shocks, the IMF estimates that GDP growth will decrease to 2.5% in 2024.

The new president José Raul Mulino has enjoyed solid approval ratings since taking office on July 1, 2024. Mulino has now laid out a plan and sequencing on how and when to tackle the countries main challenges.

Panama

First, Mulino will attempt to tackle the pension system and its deficits. The current pension system involves an old defined benefit scheme and a new mixed scheme of which, the old defined benefit scheme is in severe deficit. In addition, the old pension system suffers from poor governance, as there currently is no annual audit produced. The Mulino administration has set-out to tackle the pension issue through parametric reform, i.e. adjusting pension age and contribution rates. The timeline is ambitious, with indications that this will be dealt with during extraordinary parliamentary sessions during Q4 2024. Given the ambitious timeline, implementation risks are evident.

The second item on the Mulino administrations agenda is the re-opening of the Cobre mine. This message was quite clear and shared by both government officials and representatives of the companies operating the mine, Minerva Panama / First Quantum Minerals. Since his initial “re-open to close” remarks in relation to the mine, president Mulino has somewhat toned down the “close” term perhaps indicating a more long-term solution. Reading between the lines, the government was open to renegotiate the contract with First Quantum Minerals, but only if the company dropped its arbitration against the country. Handing the concession to another operator is possible if a agreement with First Quantum cannot be reached.

Despite improving approval for the mining sector among the people, overturning the decision to close the mine could demand significant political capital. Given the sequencing laid out by Mulino, any setbacks to the pension reform could prove costly when tackling the mining issue.

Mulinos third agenda point is the new Panama Canal reservoir along the Indio River. The project will be implemented by the state owned Panama Canal company and total costs are estimated at around USD 2.4bn. Securing sufficient water supply is important both for the canal operations and securing drinking water for the population.

Street view within historic district of Panama City

Panama

In terms of current operations, canal capacity has been normalised after an approx. 30% reduction in daily transits during late 2023 and H1 2024. While LNG ship transits have somewhat been reduced, other forms of energy transport has made up for this loss. The canal company remains an important source of funding for the government, paying an USD 2.5-2.7 bn annual dividend in addition to a monthly tonnage linked transfer.

The final key topic for the Mulino administration is addressing the countries fiscal imbalances, given a lower growth trend in coming years compared to previous years (IMF estimates 4% long-term real growth). Preserving the countries Investment Grade rating is key to the administration and its implications well understood. Government revenue collection has been clearly below budget during 2024. This implies that the 2024 deficit will be at least 4.0%, with some analysts projecting closer to 5.5%. The new administration has been reducing arrears, but still has some USD 800m on balance. The Mulino administration conveyed a commitment to fiscal adjustment although with a relatively slow pace, targeting a 2.5% deficit in 5 years. Despite a low tax revenue / GDP ratio, no immediate tax hikes are expected but rather maximising revenue under current tax rules. In terms of financing, the government has shunned away from tapping the Eurobond market and relied on issuing bonds on the local market at a higher interest rate cost. While market participants have observed somewhat meager demand for these local bills / bonds in terms of standard auction success rates, local banks conveyed appetite to invest in these when asked. For 2025 Panama does have outstanding Eurobond maturities, meaning they are expected to refinance these as well via Eurobond issuances.

View: We are currently invested in Panama in our Hard Currency strategy, although reduced our exposure during late 2023. The coherent message with regards re-opening of the mine and hence, most likely, avoiding arbitration is a clear positive take-away from the trip. Panama is a fully dollarized economy and hence local currency investments are not relevant.

El Salvador

El Salvador – 13.9.2024

Discussions during our visit to El Salvador focused on the potential IMF program, its details and timing as well as the governments planned fiscal adjustment.

El Salvadors president Nayib Bukele has now been in power since June 2019 and was sworn in for a second term on June 1, 2024. Bukele's popularity is still strong, with almost 85% of votes in the presidential election, and his party Nuevas Ideas controls 54 out of 60 seats in the Legislative Assembly. Bukele's popularity is rooted in the significant improvement in the security situation, that his administration has achieved.

Despite the high popularity in elections, some independent analysts pointed out Bukele's reluctance to implement any radical reforms as the administration seems very sensitive to any social media critic. However, political capital should be sufficient to push through reforms needed for structural improvement.

International relationships, especially with the US, seem to have improved thanks to the new US Ambassador William Duncan who was sworn in on January 24, 2023. Since taking office, the relationship has taken more pragmatic path and become much closer. Given geopolitical sensitivities, the US is committed to El Salvador and we understood that the current US administration would support IMF involvement in the country. The US presidential election outcome is not seen as an issue, as interest are more broad based.

Compared to previous communication, the Bukele administration conveyed a more detailed picture of the ongoing IMF discussions. For example, the fiscal adjustment needed has been agreed and expected to be part of the 2025 budget, which is to be submitted in October 2024.

El Salvador

The fiscal adjustment plan is quite ambitious, with a 3.5% deficit adjustment over 3 years (the length of the IMF program discussed).

Our understanding is that the 2025 adjustment will focus on increasing tax revenue via digitalisation, cutting intra-governmental transfers and freezing remuneration for government workers, while subsidies (gas) would not be touched. In terms of debt levels, the government targets a reduction below 80% of GDP by the end of the 3 year adjustment period (from 84.4% now).

As stated above, the administration appears committed to fiscal adjustment. The IMF program was viewed as an opportunity to kickstart growth and investment, which have been sluggish, through securing funding for much needed infrastructure. Securing an IMF program would most likely open-up for additional multilateral funding.

Bitcoin and its status as legal tender in El Salvador has publicly been the greatest hurdle for any IMF program. Based on the August 6, 2024 IMF statement and meetings during the trip, it seems as if both parties have softened their stance with regards to Bitcoin. The administration is working on a reform of the Bitcoin law. The use of Bitcoin as means of payment in the economy is marginal, with a total transaction volume of USD 6-7m during over 3 years. The government though still has Bitcoin holdings of some USD 400m.

El Salvador does not have any Eurobond redemptions until 2027. Herein, perhaps, lies the risk to any potential IMF program as the current liquidity situation is not urgent enough to force Bukele’s hand. The alternative to the IMF program would entail draining domestic financing (banks / pension funds) sources once more, which most likely would have a negative effect on growth and investment. Fiscal deficits would also have to be cut, but without the external financing to boost growth.

View: We have recently opened a position in El Salvador in our Hard Currency strategy. We see a high probability of an IMF program and believe the following market reaction should have positive impact on El Salvadorean bond prices. El Salvador is also a dollarized economy, and therefore local currency bonds are not relevant currently.

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