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Breaking the Cycle of Low Growth in El Salvador

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El Salvador has benefited significantly from the stimulus provided by the external conditions. The economic recovery in the United States, together with lower oil prices, helped push growth to 2.5 percent in 2015, up from 1.8 percent in the previous four years. Large savings from lower oil imports, estimated at about 3 percent of GDP, have raised the real income of families, lowered costs for companies, strengthened the external position, and led to further social progress.

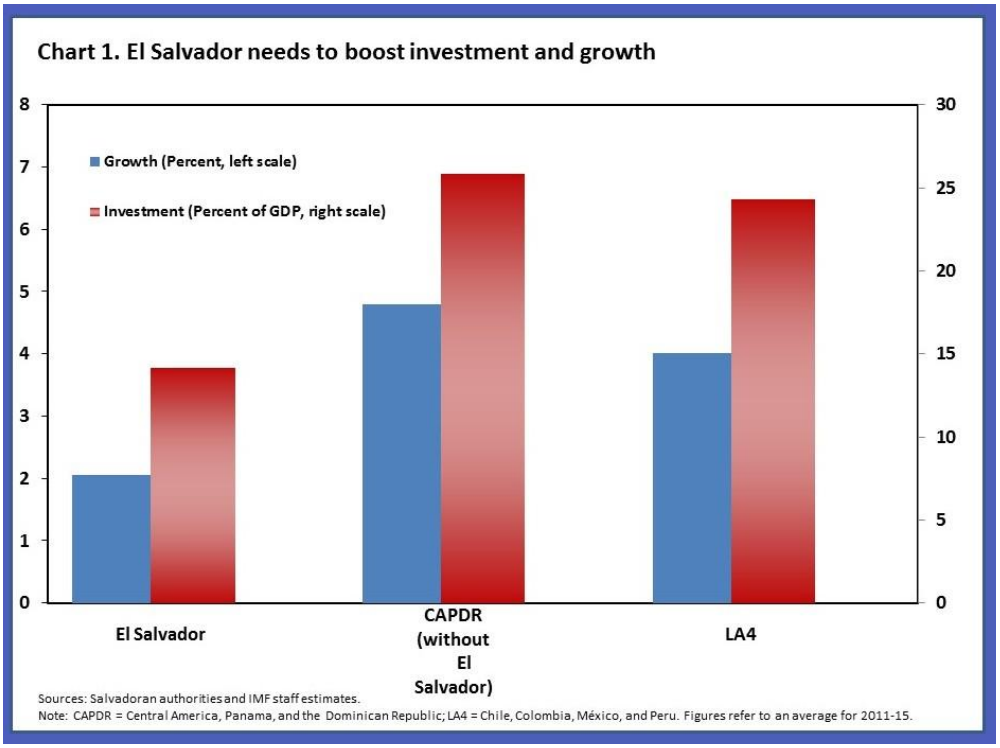


Chart 1. El Salvador needs to boost investment and growth

Sources: Salvadoran authorities and IMF staff estimates.
Note: CAPDR = Central America, Panama, and the Dominican Republic; LA4 = Chile, Colombia, México, and Peru. Figures refer to an average for 2011-15.

Yet, El Salvador's growth rate is the slowest in Central America, largely reflecting a level of investment that is among the lowest in Latin America (see Chart 1). There is a complex web of fundamental factors related to history, institutions, and policies behind the low investment. On top of this, fiscal pressures, together with a deep political gridlock, have led to sizable fiscal deficits, rising public debt, and large financing needs. These vulnerabilities inhibit investors' confidence, elevate the risk of a future disorderly adjustment, and ultimately weaken the country's prospects for growth.

The challenge for El Salvador is how to exit this vicious cycle of low growth and rising debt. Our latest report on El Salvador warns that, without a resolution to the political stalemate, it will be difficult to carry out much-needed supply-side reforms and a balanced fiscal correction that protects social programs. This strategy is indispensable to ignite investment and jobs, and place public debt on a declining path. Certainly, the external windfalls—namely, the U.S.

recovery and lower oil prices—have provided the Salvadoran society with a unique opportunity to work together and change course.

Boosting growth

The Salvadoran economy is expected to keep growing at just below 2.5 percent in 2016–18 and slow to its trend rate of 2 percent thereafter, owing mostly to some reversal in oil prices and expected completion of large investment projects. We expect the vicious cycle of low growth to continue: low growth hinders efforts to ease crime and upgrade education, which deters investment, jobs, and, in turn, growth. This outlook will make it harder to increase the standards of living of lower-income families.

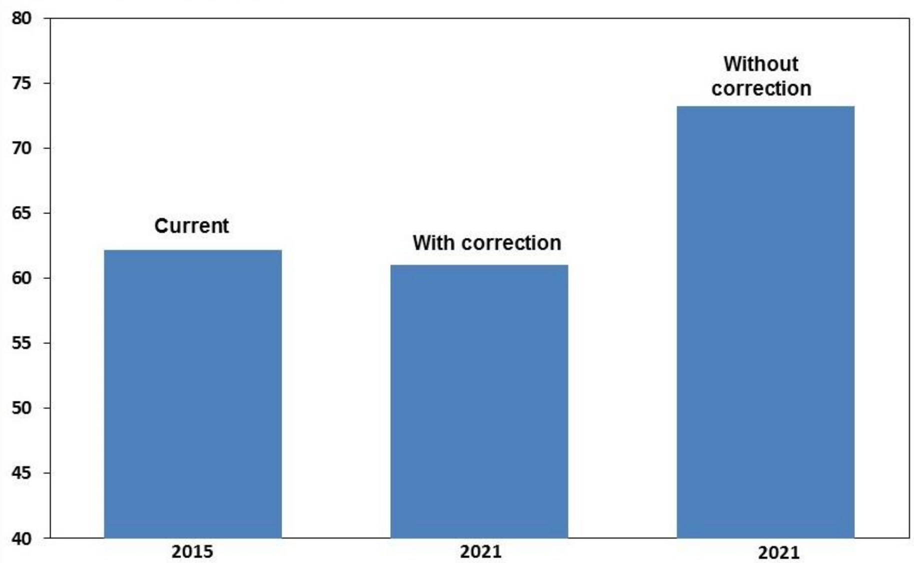
The causes behind sluggish growth are multiple and complex and include crime and emigration, high logistics costs, low competitiveness, and adverse exposures (including to natural disasters and fiscal risks). The recent appreciation of the U.S. dollar has also emerged as a new drag on competitiveness and growth, given the fully dollarized economy. A broad political and social agreement is clearly needed to open the door for needed growth reforms.

The government rightly targets a rate of growth of 3 percent per year. This target calls for higher competitiveness and productivity, which could be achieved by lowering barriers to entry in many sectors, improving the quality of education, reducing crime through active security enforcement and broader preventive measures, and linking wages more closely to productivity. Additionally, improving labor markets would help boost job opportunities for the Salvadorans, thereby slowing the pace of outward migration. Financial inclusion could also contribute to growth. Such reforms could go a long way toward raising investment closer to levels in neighboring countries. But the viability of many of these reforms will also require building fiscal space (room in the budget for productive investment and priority spending).

Declining debt

The report cautions that public debt will exceed 70 percent of GDP by 2021 and rise further in later years (see Chart 2). This unsustainable path calls for assertive action. The priority is to lift an impasse in congress to access long-term external financing and lessen the risk of an imminent liquidity crunch for the budget that

Chart 2. An adjustment of 3 percent of GDP stabalizes the public debt
(Public debt, percent of GDP)



Sources: Salvadoran authorities and IMF staff estimates and projections.

could result in a disorderly adjustment. This action would buy time to design a fiscal correction of 3 percent of GDP that could be executed over 2017–19 to reverse the upward trend in the debt ratio and contain financing needs to manageable levels. Although this adjustment strategy may seem ambitious, we believe now is the time for such a bold goal given the rising fiscal risks. While the fiscal tightening will have a near-term impact on growth, a more solid fiscal position, together with vigorous structural reforms, would create the conditions for a rebound in growth toward 3 percent over the medium term.

The fiscal plan needs to protect growth and be socially friendly to secure the buy-in of society. This entails two basic ingredients:

- First, the budget needs to do its part and contain pressures from nonpriority spending (affecting the wage bill, subsidies, and other areas) and create space for security (a major bipartisan priority requiring significant increases in public resources), programs for the poor, and growth-enhancing reforms.
- Second, the government needs to make the tax system more growth-friendly, with measures that remove or reduce distortionary taxes that inhibit growth, raise the value-added tax rate (but offset any adverse effect on lower-income families), and set up a property tax.

Beyond this correction, there is a need for pension reform to reduce the large unfunded pension liabilities (estimated at 100 percent of GDP) and expand provision of a sustainable basic pension. There is also room to strengthen fiscal responsibility initiatives that are currently debated to help entrench fiscal discipline in years to come.

The right choice now is to engage into an active dialogue across political parties and the Salvadoran society to enable a strong corrective strategy. The tailwinds from abroad offer an invaluable opportunity to act. Doing so will allow El Salvador to enter into a virtuous cycle of higher, inclusive growth and declining debt.

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