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# El Salvador: Selected Issues—Background Notes

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EL SALVADOR

# Background Notes on Selected Issues

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Approved by Western Hemisphere Department

January 14, 2005

Contents | Page

# I. INTRODUCTION

1. This paper presents background notes on economic growth, national savings, and implications of the Central American Free-Trade Agreement with the United States (CAFTA). These notes were prepared by the staff team for the 2004 Article IV consultation discussions.

2. **A key challenge for the authorities is to place the economy on a path of sustained higher growth.** Despite an impressive reform effort, growth in El Salvador has been sluggish in recent years. Chapter II describes possible factors behind this performance and suggests that the medium-term growth outlook hinges on further structural reforms, including steps to improve competitiveness and further strengthen the public finances. The chapter presents the authorities' planned growth strategy, which seeks to gain from new trade opportunities, remove obstacles to productivity, and redirect workers' remittances to investment.

3. **Increasing domestic savings is key to supporting higher investment and growth.** Chapter III highlights the factors behind the sharp decline in domestic savings in recent years, suggesting a possible Dutch-disease phenomenon. The note concludes that along with further fiscal consolidation, private sector savings should be raised by strengthening incentives for shifting family remittances to be invested, rather than consumed, thus supporting higher investment and growth.

4. **El Salvador's congress recently ratified CAFTA, which, once in effect, will have important macroeconomic implications.** Chapter IV describes the possible beneficial effects of CAFTA (which still needs to be ratified by the U.S. Senate), as well as the policy requirements for taking full advantage from this agreement. The chapter stresses the need to strengthen domestic rules and institutions, and to implement other reforms to improve the investment climate and boost productivity.

# II. Economic Growth [1]

## A. Background

5. **Growth in El Salvador has slowed sharply since the mid-1990s and per capita output has stagnated since 2000.** From 1960 to 2004, annual real GDP growth averaged about 3 percent, albeit with wide fluctuations. Real GDP contracted by 2 percent a year during the 1980s, reflecting the effects of the civil war. Growth rebounded in the early 1990s (6 percent per year) with the post-war reconstruction period. However, it then decelerated in the second half of the 1990s and slowed further during 2000–04 (to 2 percent per year). The slowdown reflected a combination of factors, including adverse external conditions (including a slowdown in the U.S. economy, and unfavorable changes in oil and coffee prices), major earthquakes, and election-related uncertainties.

6. **Total factor productivity (TFP) growth has averaged close to zero during 1960–2004.** The contribution of TFP to overall growth increased to nearly 1 percent in the 1990s, from minus 2 percent per year in the previous two decades. However, TFP growth turned negative in the second half of the decade, notwithstanding implementation of a wide range of reforms including trade liberalization, privatization, increased labor market flexibility, strengthened banking system, and fiscal reforms. Historically, TFP has contributed less to growth in El Salvador than in neighboring countries.

El Salvador: Sources of Growth 1/

| | Real GDP | Contribution from | | |
|---|---|---|---|---|
| | Growth | TFP | Capital | Labor |
| 1960-69 | 5.6 | 2.2 | 1.5 | 1.9 |
| 1970-79 | 3.8 | -1.3 | 2.4 | 2.7 |
| 1980-89 | -2.1 | -3.2 | 0.3 | 0.8 |
| 1990-95 | 5.8 | 2.5 | 1.7 | 1.6 |
| 1996-00 | 2.9 | -0.8 | 1.7 | 2.0 |
| 2001-04 | 1.8 | 0.3 | 1.2 | 0.3 |
| Memorandum item | | | | |
| 1960-2004 | 3.0 | -0.3 | 1.4 | 1.8 |

Sources: FUSADES (2003); and Fund staff estimates.

1/ Estimates are subject to weakenesses in the national accounts, including methodological shortcomings and poor sources of data.

[1] Prepared by Michael Papaioannou.

## B. Stylized Views

7. **The disappointing long–term growth performance could be attributed to a variety of factors.** While there is no agreement among observers and analysts on the specific factors underlying sluggish productivity and weak capital formation, a stylized summary of views (which are not mutually exclusive) is as follows:

- **Competitiveness.** A weakening of external competitiveness is likely to have contributed to low growth. Factors that have affected competitiveness include: (i) high wage costs, locked in by the dollarization regime (dollar wages in El Salvador are relatively high, despite a prudent minimum wage and public sector wage policy and a relatively flexible labor market); (ii) Dutch-disease type effects of large family remittances (which have been channeled mainly to consumption, boosting the price of nontradeables); (iii) problems related to lack of innovation, slow licensing of foreign technology, weak research and development, and product design; and (iv) low quality of education, resulting in weak labor force skills.[2]

- **Savings:** Gross national savings are low and declining, which constrain the level of investment required to achieve a higher sustained growth rate. Since 2000, public sector savings have been negative, while private domestic savings have declined reflecting the impact of external shocks on income levels and rising consumption partly spurred by family remittances (see Chapter III).

- **Structural:** The World Bank has identified obstacles related to: (i) infrastructure deficiencies, including poor telecommunications, roads, and ports, as well as high energy prices; (ii) weak governance and institutions reflecting poor regulatory and property rights enforcement, inefficiencies in the judicial system, problems from anti-competitive practices, and widespread perceptions of corruption; (iii) an underdeveloped financial system, high banking concentration, and scarce long-term credit; and (iv) high crime rate and violence.

- **Innovation and technology.** Some analysts (e.g., Hausmann 2003)[3] have emphasized the structural and microeconomic bottlenecks as factors that have inhibited innovation and entrepreneurship, particularly in small- and medium-sized companies. El Salvador's companies have been lacking sophistication and innovation, allocating low

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[2] El Salvador ranked at an intermediate level in INCAE's 1999 Report on Competitiveness for Central America. It also ranked 53rd out of 104 countries in the World Economic Forum's 2004 index of global competitiveness, a deterioration over its previous ranking of 48th out of 102 countries in 2003.

[3] FUSADES, 2003, *Estrategia económica y social 2004–09, Oportunidades, seguridad y legitimidad: bases para el desarrollo (San Salvador).*

resources for research and development, suffering from excessive red-tape, and adapting slowly to state-of-the-art technology. It is argued that a more active (albeit well-focused and targeted) government policy is needed to help overcome these barriers.

## C. Policy Implications

8. **Boosting productivity, investment, and growth prospects hinges on fiscal consolidation and structural reforms.**

- Fiscal consolidation would contribute to higher savings, supporting increased investment (including in infrastructure and education). It would also underpin a stable macroeconomic environment by reducing vulnerabilities associated with high public debt and a large external current account deficit.

- Structural policies should aim to improve the investment climate, with steps to: (i) upgrade basic infrastructure, information technology networks, human capital and security,[4] to maximize investment opportunities emerging from CAFTA and other FTAs; (ii) promote FDI and technological transfer; (iii) encourage private sector participation in ports, airports, water, and rural electrification; (iv) enhance labor market flexibility, combat crime, and improve institutions (mainly the rule of law and corruption); and (v) use technical assistance from international organizations to improve administrative and technical expertise, including for treasury operations and financial hedging.

## D. Sources of Growth

9. The authorities' development strategy for 2005–09 seeks to gain from new trade opportunities, remove obstacles to productivity, and direct workers remittances to investment. Recent experience in banking and airline services suggests that El Salvador is well positioned to develop logistical and distribution centers for the region. Areas with comparative advantage and growth potential include:

- **Agriculture.** New crops (including cotton) could help attain vertical integration with textiles and agro business. Productivity is to be boosted with steps to promote: (i) contracts between producers and buyers to lower market uncertainty; (ii) leasing of small farms (cooperatives) to allow the use of large-scale technology; and (iii) joint ventures to ease transfer of technology and management.

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[4] Legislation passed by congress in July 2004 has provided for crime prevention and rehabilitation programs, while significantly tightening penalties for crime.

- **Agro business.** Further trade opening should bolster production of processed foods for the region; gourmet coffee; pharmaceuticals; and native food products for Salvadorans living abroad. Recently, a foreign company began production of processed foods.

- **Textiles.** The goal is to shift away from exports facing stiff competition from Asia into higher value-added products, taking advantage of increased vertical integration and close distance to the United States. Two foreign companies intend to start operating in El Salvador shortly.

- **Construction.** Family remittances could support housing and other construction for recipient families and retiring workers. As remittances have become a more stable source of income, they have the potential to fund mortgage lending and working capital for small businesses.

- **Services.** Insurance, distribution, and storage services would be boosted by development of the Cutuco port (Pacific Ocean) and a connecting highway to a Honduran port (Atlantic Ocean), providing an alternative to the Panama Canal. Prospects are also favorable for tourism (especially for Salvadorans living abroad), call centers (a major computer company will start operations shortly), and software development

Table 1. El Salvador: Gross Domestic Product by Expenditure and Sector

(In percent of GDP)

| | 1999 | 2000 | 2001 | 2002 | 2003 | Est. 2004 |
|---|---|---|---|---|---|---|
| | | | I. By Expenditure | | | |
| **Consumption** | **95.9** | **98.1** | **99.1** | **98.6** | **99.7** | **101.3** |
| Private | 85.9 | 87.9 | 88.6 | 88.1 | 89.3 | 91.1 |
| Public | 10.0 | 10.2 | 10.5 | 10.5 | 10.4 | 10.2 |
| **Investment** | **16.4** | **16.9** | **16.7** | **16.2** | **16.6** | **15.8** |
| Gross fixed capital formation | 16.1 | 16.9 | 16.4 | 16.4 | 16.6 | 15.8 |
| Private | 13.2 | 14.2 | 13.5 | 13.0 | 13.4 | 13.4 |
| Public | 2.9 | 2.7 | 2.9 | 3.4 | 3.2 | 2.4 |
| Change in inventories | 0.4 | 0.0 | 0.2 | -0.3 | 0.0 | 0.0 |
| **Net exports** | **-12.3** | **-15.0** | **-15.8** | **-14.8** | **-16.4** | **-17.1** |
| Exports of goods and services | 24.9 | 27.4 | 25.8 | 26.4 | 26.7 | 25.8 |
| Imports of goods and services | 37.3 | 42.4 | 41.6 | 41.1 | 43.0 | 42.9 |
| | | | II. By Sector | | | |
| **Primary production** | **10.9** | **10.2** | **9.8** | **9.0** | **8.9** | **8.9** |
| Agriculture | 10.5 | 9.8 | 9.4 | 8.5 | 8.5 | 8.4 |
| Mining | 0.4 | 0.4 | 0.4 | 0.5 | 0.5 | 0.5 |
| **Secondary production** | **28.9** | **29.1** | **29.5** | **29.8** | **29.5** | **29.2** |
| Manufacturing | 22.6 | 23.1 | 23.1 | 23.2 | 23.0 | 22.8 |
| Utilities | 2.0 | 1.7 | 1.7 | 1.8 | 1.7 | 1.7 |
| Construction | 4.3 | 4.4 | 4.7 | 4.8 | 4.9 | 4.6 |
| **Services** | **60.2** | **60.7** | **60.7** | **61.3** | **61.5** | **61.3** |
| Commerce, restaurants, and hotels | 19.0 | 19.4 | 19.3 | 19.2 | 18.9 | 18.7 |
| Transport and communications | 8.3 | 8.5 | 8.7 | 9.0 | 9.0 | 9.0 |
| Financial services | 4.2 | 4.3 | 4.4 | 4.3 | 4.3 | 4.3 |
| Professional goods and services | 4.1 | 4.1 | 4.1 | 4.2 | 4.2 | 4.1 |
| House rentals | 7.9 | 7.9 | 7.5 | 7.7 | 7.6 | 7.7 |
| Community services | 6.6 | 6.7 | 6.9 | 7.2 | 7.3 | 7.2 |
| Government services | 7.6 | 7.4 | 7.2 | 7.0 | 6.9 | 6.9 |
| Less bank taxes | -4.0 | -4.1 | -4.2 | -4.1 | -4.0 | -4.0 |
| Plus customs duties | 6.5 | 6.6 | 6.9 | 6.8 | 7.2 | 7.4 |

Source: Central Reserve Bank of El Salvador.

Table 2. El Salvador: Real Gross Domestic Product by Expenditure and Sector

(Annual percentage change)

| | 1999 | 2000 | 2001 | 2002 | 2003 | Est. 2004 |
|---|---|---|---|---|---|---|
| | | | I. By Expenditure | | | |
| **Gross domestic product** | **3.4** | **2.2** | **1.7** | **2.2** | **1.8** | **1.5** |
| **Consumption** | **3.4** | **3.7** | **3.2** | **1.7** | **1.9** | **2.6** |
| Private | 3.7 | 3.9 | 3.1 | 1.8 | 2.1 | 2.8 |
| Public | 0.4 | 0.9 | 4.6 | 1.5 | 0.2 | 0.4 |
| **Gross fixed investment** | **-4.0** | **2.7** | **5.1** | **-3.9** | **6.7** | **-2.6** |
| Gross fixed capital formation | -0.8 | 5.2 | 1.5 | 2.6 | 3.4 | -2.6 |
| Private | 2.2 | 7.5 | 0.4 | -1.0 | 4.6 | 1.5 |
| Public | -14.9 | -7.6 | 8.3 | 23.7 | -2.3 | -23.7 |
| **Net exports** | **-4.1** | **10.7** | **12.3** | **-5.2** | **6.6** | **3.1** |
| Exports of goods and services | 7.1 | 16.8 | -0.2 | 5.9 | 3.8 | -0.3 |
| Imports of goods and services | 2.7 | 14.5 | 4.2 | 1.7 | 4.8 | 0.9 |
| | | | II. By Sector | | | |
| **Primary production** | **7.4** | **-3.2** | **-2.2** | **0.3** | **0.3** | **1.8** |
| Agriculture | 7.7 | -3.1 | -2.6 | 0.1 | 0.1 | 1.8 |
| Mining | 0.4 | -4.7 | 11.7 | 5.5 | 4.0 | 2.0 |
| **Secondary production** | **2.9** | **2.9** | **4.8** | **3.5** | **2.6** | **0.7** |
| Manufacturing | 3.7 | 4.1 | 4.0 | 2.9 | 2.3 | 1.3 |
| Utilities | 2.7 | -2.3 | 4.7 | 7.3 | 3.1 | 2.9 |
| Construction | -1.8 | -3.4 | 9.6 | 6.7 | 4.7 | -3.1 |
| **Services** | **2.9** | **3.0** | **1.1** | **2.0** | **1.8** | **1.8** |
| Commerce, restaurants, and hotels | 2.0 | 3.6 | 1.9 | 1.5 | 1.2 | 1.4 |
| Transport and communications | 9.5 | 6.1 | 4.3 | 5.0 | 2.5 | 2.5 |
| Financial services | 12.0 | 7.7 | 1.6 | 0.7 | 1.8 | 2.2 |
| Professional goods and services | 0.2 | 1.5 | 1.9 | 2.6 | 1.5 | 1.0 |
| House rentals | 0.5 | 1.5 | -2.9 | 3.8 | 3.1 | 2.8 |
| Community services | 0.3 | 1.4 | -1.1 | 1.8 | 1.3 | 0.9 |
| Government services | 1.6 | 0.9 | 0.6 | -3.5 | 0.0 | 1.3 |
| Less bank taxes | 7.2 | 6.2 | 2.3 | 0.9 | 0.0 | 1.5 |
| Plus customs duties | 2.6 | 2.2 | 1.8 | 2.2 | 1.8 | 1.8 |

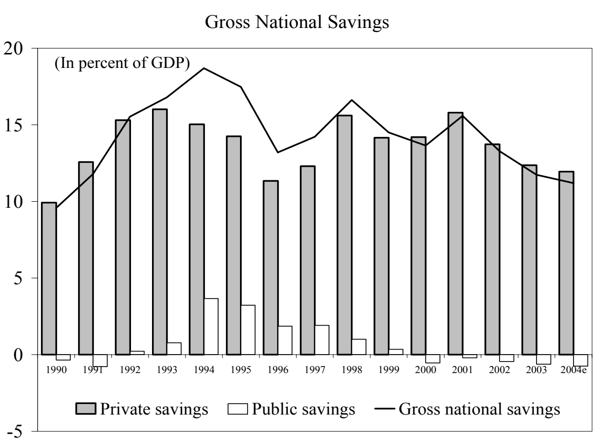
Source: Central Reserve Bank of El Salvador.

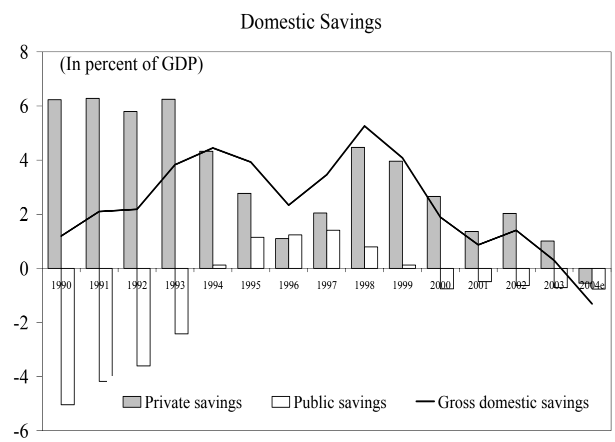
## III. Savings Trends—Evidence of a Dutch Disease? [5]

*Growing family remittances and external borrowing in recent years have been accompanied by rising consumption and a sizable decline in national savings. El Salvador needs to shift family remittances away from consumption and achieve further fiscal consolidation to raise national savings and support increased investment and growth.*

10. **El Salvador's internal and external balances have weakened since 2000.** While domestic investment has remained relatively stable during 2000–04 (at about 16 percent of GDP), national savings have declined steadily, and the external current account deficit has doubled (to nearly 5 percent of GDP in 2003–04). This behavior was accompanied by sluggish output growth (under 2 percent per year) and rising consumption. While income levels have been affected by adverse external conditions, these trends could reflect Dutch-disease type effects created by family remittances and external borrowing.

11. **The private sector has largely led the decline in national savings during 2000–04.** Private savings fell to an estimated 12 percent of GDP in 2004 (15.8 percent in 2001), one of its lowest levels since 1990. Public sector savings remained negative (0.5 percent of GDP per year), after reaching 1.4 percent of GDP in 1997. At the same time, total domestic savings (excluding net transfers from abroad) turned negative, declining to an estimated minus 1.3 percent of GDP in 2004 (positive 5 percent in 1998).



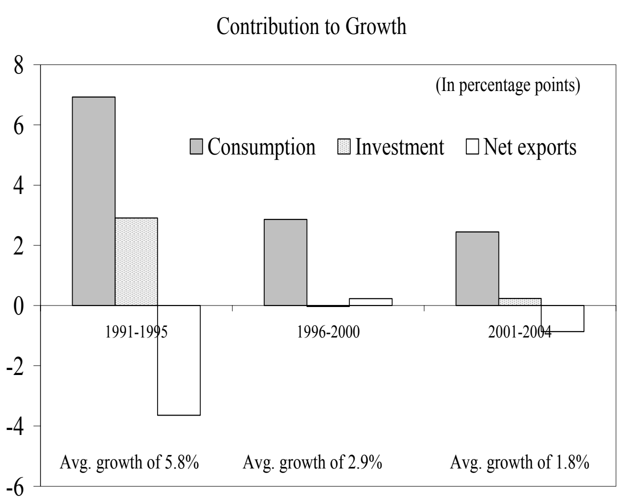

12. **Mirroring the decline in savings, consumption has grown steadily.** Consumption climbed to an estimated 101 percent of GDP in 2004 (an average of 96 percent in 1993–99), with the private sector explaining some three-fifths of this increase. Indeed, consumption has

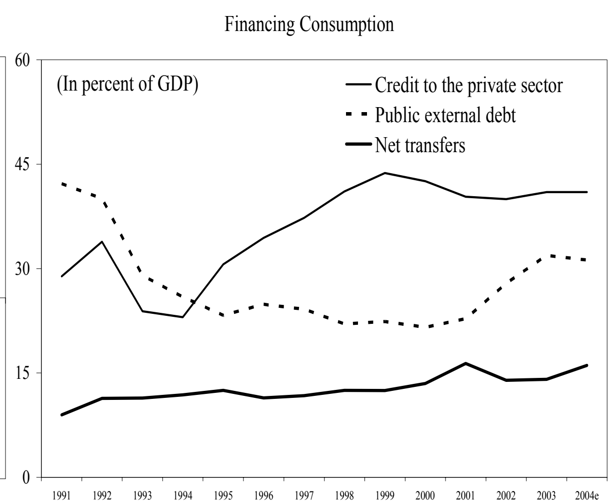
[5] Prepared by Cem Karacadag.

been by far the main contributor to growth since 1990. The surge in consumption has been associated with a rapid expansion of private sector credit in the late 1990s, and with rising family remittances and public external borrowing since 2000. During 2000–04, family remittances have risen by 3 percentage points of GDP (to 16 percent of GDP), while public external borrowing averaged 4 percent of GDP (1 percent per year in 1997–99). As a result, public external debt increased to 31 percent of GDP.

13. **The deterioration in macroeconomic balances may be symptomatic of a Dutch-disease phenomenon.** A high share of family remittances (some 70 percent) is spent on consumption, while external borrowing has supported an increase in public consumption (mainly pension payments). Rising consumption has put upward pressure on prices and wages in the nontradable sector, and led to increased imports, contributing to the weakening of the external balance. The related loss in external competitiveness has also inhibited export growth. Net exports have contributed negatively to growth during 2000–04.

14. **Boosting savings is critical to support higher investment and growth, while safeguarding external sustainability.** Further fiscal consolidation should play a key role in raising national savings. In particular, higher consumption taxes could discourage private consumption and raise savings. Also, productivity-enhancing reforms, together with policies to increase flexibility in the labor and goods market could help improve the economy's competitiveness and channel resources to the export sector. The combined effect of higher savings and reforms would provide for higher investment and growth.




**To maximize the benefits of remittances for growth, the focus should be on strengthening the environment and incentives for investing a larger share of remittance flows.** Workers remittances will, and should, continue to play a major role in supporting incomes, and social conditions, and the balance of payments in El Salvador. The key to maximizing the benefits of these flows lies in increasing the share of remittances channeled through the domestic financial system, which in turn can invest these resources in productive ventures, education, and other sustained improvements in living conditions. Therefore, efforts should be made to increase the "bankable" El Salvadorans at home and abroad, expand available savings instruments, and lower the cost of transferring remittances.

Table 3. El Salvador: Savings and Investment Flows

(In percent of GDP)

| | 1999 | 2000 | 2001 | 2002 | 2003 | Est. 2004 |
|---|---|---|---|---|---|---|
| **Domestic investment** | **16.4** | **16.9** | **16.7** | **16.2** | **16.6** | **15.8** |
| Private | 13.2 | 14.2 | 13.5 | 13.0 | 13.4 | 13.4 |
| Public | 2.9 | 2.7 | 2.9 | 3.4 | 3.2 | 2.4 |
| National savings | 14.5 | 13.6 | 15.6 | 13.3 | 11.7 | 11.2 |
| Private | 14.2 | 14.2 | 15.8 | 13.7 | 12.4 | 11.9 |
| Public | 0.3 | -0.5 | -0.2 | -0.5 | -0.6 | -0.7 |
| | | | | | | |
| **Foreign savings** | **1.6** | **3.3** | **0.8** | **3.2** | **4.9** | **4.6** |
| | | | | | | |
| **Memoranda items:** | | | | | | |
| Domestic savings 1/ | 4.1 | 1.9 | 0.9 | 1.4 | 0.3 | -1.3 |
| Private | 4.0 | 2.7 | 1.4 | 2.0 | 1.0 | -0.5 |
| Public | 0.1 | -0.8 | -0.5 | -0.6 | -0.7 | -0.8 |
| Domestic savings-investment | -12.3 | -15.0 | -15.8 | -14.8 | -16.4 | -17.1 |
| Private | -9.2 | -11.5 | -12.2 | -11.0 | -12.4 | -13.9 |
| Public | -2.8 | -3.5 | -3.4 | -4.1 | -3.9 | -3.2 |
| Consumption | 95.9 | 98.1 | 99.1 | 98.6 | 99.7 | 101.3 |
| Private | 85.9 | 87.9 | 88.6 | 88.1 | 89.3 | 91.1 |
| Public | 10.0 | 10.2 | 10.5 | 10.5 | 10.4 | 10.2 |

Sources: Central Reserve Bank of El Salvador, and Fund staff estimates.

1/ Excluding net factor payments and net transfers.

Table 4. El Salvador: Contribution to Real Gross Domestic Product by Expenditure and Sector

(Percentage points)

| | 1999 | 2000 | 2001 | 2002 | 2003 | Est. 2004 |
|---|---|---|---|---|---|---|
| I. By Expenditure | | | | | | |
| **Gross domestic product** | **3.4** | **2.2** | **1.7** | **2.2** | **1.8** | **1.5** |
| **Consumption** | **3.2** | **4.3** | **3.8** | **1.9** | **2.0** | **2.7** |
| Private | 3.1 | 4.2 | 3.4 | 1.8 | 2.0 | 2.7 |
| Public | 0.0 | 0.1 | 0.4 | 0.1 | 0.0 | 0.0 |
| **Investment** | **-0.8** | **0.6** | **1.1** | **-0.8** | **1.3** | **-0.5** |
| Gross fixed capital formation | -0.2 | 1.1 | 0.3 | 0.5 | 0.7 | -0.5 |
| Private | 0.3 | 1.4 | 0.1 | -0.2 | 0.7 | 0.3 |
| Public | -0.5 | -0.3 | 0.3 | 0.7 | -0.1 | -0.8 |
| Change in inventories | -0.6 | -0.5 | 0.8 | -1.3 | 0.6 | 0.0 |
| **Net exports** | **0.8** | **-2.4** | **-3.0** | **1.3** | **-1.4** | **-0.7** |
| II. By Sector | | | | | | |
| **Primary production** | **0.9** | **-0.5** | **-0.3** | **0.0** | **0.0** | **0.2** |
| Agriculture | 0.9 | -0.5 | -0.4 | 0.0 | 0.0 | 0.2 |
| Mining | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 |
| **Secondary production** | **0.7** | **0.9** | **1.5** | **1.0** | **0.8** | **0.2** |
| Manufacturing | 0.8 | 1.1 | 1.1 | 0.7 | 0.5 | 0.3 |
| Utilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Construction | -0.1 | -0.2 | 0.4 | 0.3 | 0.2 | -0.1 |
| **Services** | **1.6** | **2.1** | **0.8** | **1.3** | **1.1** | **1.1** |
| Commerce, restaurants, and hotels | 0.4 | 0.8 | 0.4 | 0.3 | 0.2 | 0.3 |
| Transport and communications | 0.7 | 0.6 | 0.4 | 0.5 | 0.2 | 0.2 |
| Financial services | 0.4 | 0.3 | 0.1 | 0.0 | 0.1 | 0.1 |
| Professional goods and services | 0.0 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 |
| House rentals | 0.0 | 0.1 | -0.3 | 0.3 | 0.3 | 0.2 |
| Community services | 0.0 | 0.1 | -0.1 | 0.1 | 0.1 | 0.0 |
| Government services | 0.1 | 0.1 | 0.0 | -0.2 | 0.0 | 0.1 |
| Less bank taxes | -0.2 | -0.2 | -0.1 | 0.0 | 0.0 | 0.0 |
| Plus customs duties | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |

Source: Central Reserve Bank of El Salvador.

## IV. Some Macroeconomic Implications from CAFTA [6]

*The main impact of the Central American Free Trade Agreement (CAFTA) for El Salvador is expected from increased foreign investment and the strengthening of domestic rules and institutions. El Salvador needs to implement reforms to reduce barriers to investment and growth in order to fully benefit from CAFTA.*

15. **CAFTA—signed by Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua in May 2004 —provides these countries with permanent access to the U.S. market**. While the Central American countries already have strong trade and investment relations with the United States and enjoy preferential trade arrangements in the context of the Caribbean Basin Initiative (CBI), CAFTA is substantially more comprehensive and changes the form of trade relations from the unilateral preferential arrangement defined under the CBI to a negotiated bilateral agreement. For Central America, the agreement is important since it provides enhanced and permanent access to its largest export market.

16. **For most goods, CAFTA eliminates all tariffs and substantially reduces nontariff barriers, while agricultural goods and textiles retain some protection.** Immediately after CAFTA enters into force, tariffs on all non-agricultural and non-textile exports from Central America to the United States and on about 80 percent of nonagricultural and non-textile exports from the United States to Central America will be reduced. In the case of agriculture and textiles, CAFTA provides some enhanced market access but its extent is much smaller than for other goods. For these goods, there are long transition periods (up to 20 years), and relatively high import tariffs on sensitive items (sugar and corn) will remain during this transition period.

17. **CAFTA includes provisions that will strengthen policies in the Central American countries and promote further reforms, although it may also weaken fiscal revenues.** The agreement includes provisions on investment and financial services, antitrust, government purchases, protection of intellectual property rights and labor. The commitments made in these areas will compel the governments in the region to move forward with reforms and will promote the institutional development required to put these policies in place. An immediate concern for the Central American economies is the potential impact of CAFTA on their fiscal balances. Since a significant fraction of the Central American economies' imports are sourced from the United States, CAFTA might lead to a fall in customs revenue and deterioration of their fiscal positions.[7]

18. **CAFTA provides El Salvador with opportunities to boost exports, investment and growth.** Specialization and higher productivity could lead to a substantial increase in trade

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[6] Prepared by Carla Macario.

[7] For El Salvador, the revenue loss from CAFTA is projected to be relatively small, reaching about 0.3 percent of GDP after several years.

flows and to export diversification. Permanent access to the U.S. market and stronger rules (anti-trust, intellectual property and dispute resolution) should increase FDI flows and therefore enhance growth.[8]

19. **For CAFTA's potential benefits to fully materialize, El Salvador must address the constraints that are presently hindering investment and growth.** In contrast to Mexico before NAFTA, El Salvador has had preferential access to the U.S. market since 1983. Despite this access, exports, investment and growth have been sluggish in recent years.

In particular, progress is needed in the following areas:

- **Upgrading productivity**. Reducing the "skills gap" by improving education is key for reversing the poor productivity performance. A significant productivity increase is needed to preserve and expand the share in export markets in light of the competition from Asian countries (with much lower wage levels).[9]

- **Strengthening institutional development and governance**, in particular regarding the rule of law and securities/crime.

- **Boosting infrastructure investment**, particularly in lagging regions, with strong participation of the private sector.

- **Diversifying exports**, to increase the share of non-garment exports. Garment exports are threatened by the end of quotas in the global textile industry and the phasing out of the special incentives for export-processing zones, which are highly concentrated on manufacturing garments. Providing assistance for adapting export products to demand on international markets, following the example of Chile and Colombia, would facilitate export diversification. The provision of technical assistance for dealing with sanitary and phytosanitary standards would help promote agricultural exports and create jobs in rural areas.

- **Developing further trade opportunities**, multilateral as well as bilateral, by moving ahead with trade negotiations (Canada and the European Union).

- **Strengthening the fiscal position** to provide scope for higher infrastructure investment and social expenditure, and offsetting the revenue loss from CAFTA.

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[8] The GDP of the Central American countries could increase by as much as 1.5 percent as a result of the agreement, according to some studies (see Hilaire and Yang, 2003).

[9] See World Bank's draft Country Assistance Strategy for El Salvador (expected to be approved in February 2005).