© 2005 International Monetary Fund

August 2005
IMF Country Report No. 05/271

# El Salvador: 2004 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for El Salvador

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with El Salvador, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 10, 2004, with the officials of El Salvador on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 14, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of January 31, 2005 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 31, 2005 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for El Salvador.

The document listed below has been or will be separately released.

Selected Issues—Background Notes Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

**To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.**

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

**International Monetary Fund**
**Washington, D.C.**

INTERNATIONAL MONETARY FUND

EL SALVADOR

**Staff Report for the 2004 Article IV Consultation**

Prepared by the Staff Representatives for the 2004 Consultation with El Salvador

Approved by Markus Rodlauer and Anthony R. Boote

January 14, 2005

- **Discussions.** Article IV consultation discussions were held in San Salvador during October 25–November 10, 2004. The staff team met with Vice-President of the Republic Ana Vilma de Escobar, Technical Secretary of the Presidency Eduardo Zablah, Finance Minister Guillermo López Suárez, Central Bank President Luz María de Portillo, other senior government officials, legislators, labor unions, and private sector representatives.
- **Staff team.** The team comprised M. Garza (Head), C. Karacadag, C. Macario, and M. Papaioannou (all WHD). Ms. P. Brenner (MFD) conducted discussions on the 2004 FSAP update. M. Rodlauer (WHD) and G. Peraza (OED) participated in the final discussions.
- **Last Article IV consultation** (July 18, 2003). Directors praised El Salvador for its record of fiscal prudence and reforms since the early 1990s, while noting a recent fiscal deterioration and sluggish growth. They called for a stronger fiscal stance, a larger cushion of international reserves, further banking reforms, and improved central bank operations to underpin the monetary regime and deal with adverse shocks. Directors supported the continued wage discipline and efforts to make the labor market more flexible.
- **Fund relations.** El Salvador has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system free of restrictions on payments and transfers for current international transactions. It adopted the U.S. dollar as a legal tender in January 2001. El Salvador subscribes to the SDDS and has no outstanding obligations to the Fund. It is on the standard 12-month cycle for Article IV consultations.
- **Background Notes (BN).** The BN includes notes on growth, national savings, and the implications of CAFTA.

Contents Page

Contents Page

## EXECUTIVE SUMMARY

### Background

- **El Salvador has implemented a wide range of structural reforms over the last decade.** The reform effort encompassed important fiscal reforms, trade opening, and pension reform, and was capped with the adoption of official dollarization in 2001. This strategy brought rapid growth initially, an investment-grade rating, and substantial improvements in social conditions. Nevertheless, growth has been sluggish in recent years, the fiscal and external current account deficits have widened, and public debt has increased to over 45 percent of GDP, and the debt of the nonfinancial public sector to nearly 41 percent of GDP.

- **Although growth is expected to pick up slightly in 2005, important challenges remain.** Growth is expected at 2½ percent in 2005 mainly due to higher private consumption. The medium-term growth outlook hinges critically on reforms to entrench prudent fiscal policies, strengthen the banking system, and boost investment and productivity—reforms needed to make sure that El Salvador can compete successfully under its dollarization regime.

- **The new government that took office in June 2004 is strengthening economic policies to address these challenges.** A tax package has been adopted, CAFTA was ratified by congress, and banking reforms are continuing. Further measures are needed, however, to fully address El Salvador's vulnerabilities, and ensure sustained rapid growth and social progress.

### Key staff recommendations

- **The staff supports the authorities' efforts to strengthen the policy framework, and recommends that it be broadened into a comprehensive reform agenda** to improve growth prospects and enhance the economy's resilience to shocks.

- **Fiscal consolidation.** The primary fiscal surplus should be raised to about 1 percent of GDP by 2006 (from a deficit of 0.7 percent in 2004) to place the public debt on a downward path. Further reforms are needed on tax policy, expenditure control, and the pension system.

- **Central bank operations.** Staff supported the authorities' plans to fully implement the dollarization law. In particular, the government should assume the central bank's non-monetary liabilities, while the central bank would develop its lender of last resort function.

- **Banking reforms.** The authorities intend to deepen banking reforms along the lines of staff recommendations, with focus on strengthening prudential norms, supervision, and bank resolution practices.

- **Structural reforms.** Strengthening competitiveness is key to boosting medium-term growth prospects. Staff endorsed the authorities' plans to deepen trade reform and alleviate infrastructure constraints, and recommended further enhancing labor market flexibility.

# I. Background

## A. A Brief Medium-Term Perspective

1. **Since the peace agreements of 1992, El Salvador has made major progress on several fronts.** Peace, democracy, and political stability have been firmly rooted. Social conditions have improved, with a substantial decline in poverty. Wide-ranging economic reforms—including trade opening, privatization, tax policy, civil service, and pension system—have been supported by a broad national consensus. As a result, El Salvador has the second-highest income level in Central America (after Costa Rica), maintains an investment grade rating (the only country in the region), and is often considered to be the second-best performer on reforms in Latin America (after Chile).[1]

2. **The reform efforts of the 1990s were capped by official dollarization in 2001.** The authorities view the official dollarization as a milestone in El Salvador's reform efforts, anchoring its stability-oriented policy framework. The new regime eliminated the scope for monetary policy, and has helped reduce interest rates and consolidate low inflation (see ¶9).

3. **While the reforms have brought important benefits, growth has slowed over the course of the past decade and the policy framework remains vulnerable.** After a strong expansion during the post-war reconstruction period, growth has been on a declining trend reflecting falling productivity and low investment. Several studies have looked at El Salvador's growth performance in recent years, which can be attributed to declining national savings; weakening external competitiveness, particularly through the 1990s; and constraints on infrastructure, human capital, and weaknesses in governance.[2] More recently, adverse external cyclical factors, major earthquakes, and election-related uncertainties have also inhibited growth.[3]

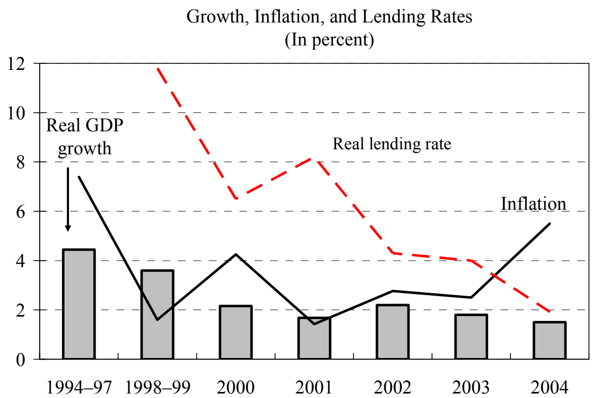
4. **Dollarization is now firmly entrenched, but it is a demanding policy framework and further efforts are needed to ensure its sustainability in an environment of rapid growth and financial stability.** Vulnerabilities remain, particularly in the areas of the public finances, the financial sector, and the labor market. These vulnerabilities could impair the economy's capacity to respond to shocks and inhibit its growth potential.

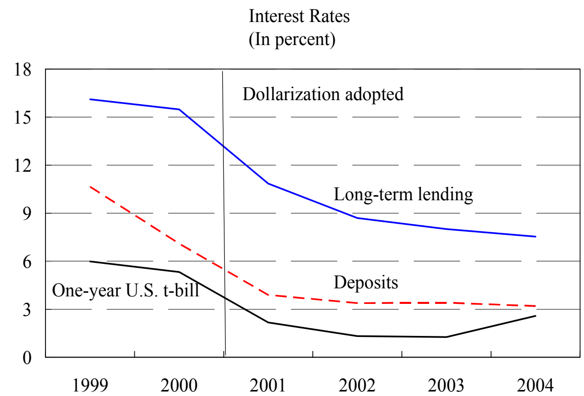
---

[1] See the index of economic freedom (2004), compiled by The Heritage Foundation and The Wall Street Journal. This index ranks El Salvador 24th out of 155 countries.

[2] For a useful summary see World Bank's Country Economic Memorandum (December 2003).

[3] Chapter II of the BN describes the factors behind El Salvador's growth performance.




## B. Recent Developments

### Political and social environment

5. **Policymaking has recently been constrained by a divided congress.** After fourteen years of political dominance, the right-wing governing party (*ARENA*) lost its majority in congress to the left-wing opposition (*FMLN*) in 2003. Although *ARENA* won the presidential election in April 2004, the change in the balance of power created substantial uncertainty and has limited the government's ability to implement its reform agenda, as the *FMLN* has opposed key reforms.[4]

6. **President Saca began his five-year term in June 2004 with a market-oriented reform agenda.** He has sought to broaden consensus with small parties, the *FMLN*, and business sector, and recently secured approval of key tax measures and ratification of CAFTA. While the next few months may offer an opportunity to pass additional reforms (mainly banking) through congress, this window may close again with the approach of legislative elections in March 2006.

7. **While social indicators have improved significantly, important challenges remain.** Poverty fell to under 40 percent in 2002 (60 percent in 1992) while extreme poverty declined to 15 percent (31 percent in 1992). Education and health levels have also improved. Despite this progress, crime remains a source of concern, and indicators on education, health, and access to sanitation and safe water are below the average for Latin America.

Social Indicators

| | El Salvador | Other CA Avg. | LA Avg. |
|---|---|---|---|
| Rank in UNDP Human Development Index, out of 177 countries (2004) | 103 | 100 | 79 |
| GDP per capita in PPP, U.S. dollars (2002) | 4,890 | 4,498 | 7,223 |
| Life expectancy at birth (years) (2002) | 71 | 70 | 71 |
| Infant mortality (1,000 live births) (2002) | 33 | 27 | 27 |
| Access to safe water (2000) | 77 | 35 | 86 |
| Adult illiteracy (2002) | 20 | 19 | 11 |
| Secondary school net enrollment (2002) | 46 | 39 | 61 |
| Poverty rate (2004) | 37 | 44 | . . . |

---

[4] *ARENA* holds only one-third of seats in congress, while *FMLN* controls nearly 40 percent. The next presidential election is scheduled for April 2009.

**Recent economic developments**

8. **After growth decelerated in the second half of the 1990s, it slowed further in 2000–03.** Buffeted by earthquakes, falling terms of trade (coffee and oil), and the slowdown in the United States, real GDP growth declined to 2 percent per year in 2000–03 (implying stagnant per capita income), the external current account deficit widened, and national savings declined.[5] Public debt rose rapidly to 46 percent of GDP by end-2003 and the debt of the nonfinancial public sector to nearly 41 percent of GDP, reflecting earthquake reconstruction and pension reform costs.[6] Despite the higher fiscal and external current account deficits, net international reserves (NIR) increased (to over 30 percent of M2 by end-2003), owing mainly to higher prudential liquidity requirements in 2003.

9. **Despite the global and regional recovery in 2004, growth in El Salvador continued to be sluggish and economic vulnerabilities remained.**

- ***Growth was dampened in 2004 by shocks and election-related uncertainty.*** Through September 2004, output grew by about 1.5 percent (y/y), owing to weak investment and export growth. Investment was affected by uncertainties related to the April 2004 elections, as well as delays in public investment due to late approval of the 2004 budget.[7] National savings continued to decline while unemployment stayed high at 7 percent. Inflation rose to 5.4 percent (y/y) in November 2004 (2½ percent in 2003), reflecting mainly higher world oil prices and, to a lesser extent, a minimum wage increase in 2003 (frozen since 1998).

- ***Although fiscal deficits have come down, the primary balance is still negative.*** The overall public sector deficit is estimated to have declined to 3 percent of GDP in 2004 (4½ percent in 2002), owing to lower reconstruction outlays. To finance the overall deficit in 2004, the government has placed international bonds and sold the remaining shares in a telephone company (almost 2 percent of GDP).[8]

- ***After rising rapidly during 1999–2003, public debt declined slightly to 45 percent of GDP at end-2004.*** The decline reflected the sale of government shares noted above. Meanwhile, the structure of the public debt has improved with the issue of long-term

---

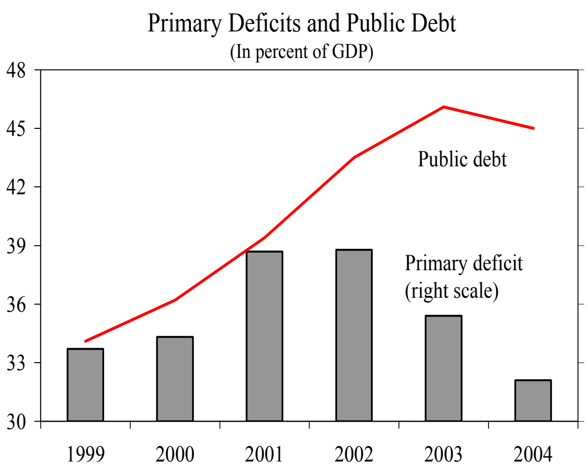
[5] While real per capita GDP did not grow in 2000–03 (reflecting in part the impact of external shocks), income (GNP) per capita rose by 3 percent a year during this period reflecting the strong increase in family remittances (see Chapter III of BN).

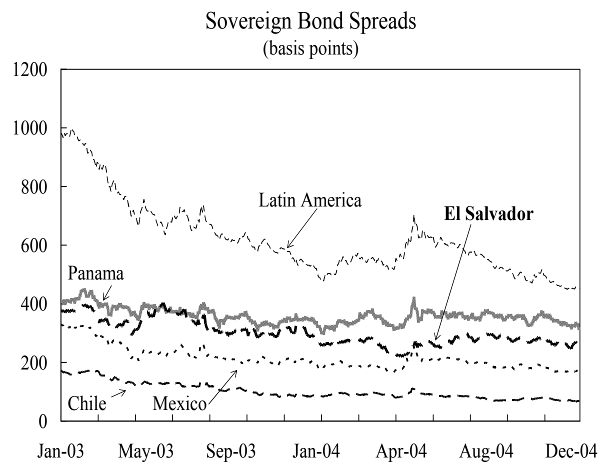
[6] Since 1998 the pay-as-you-go system is being replaced by a fully-funded system of individual pension accounts. Pension costs are projected to reach about 2¼ percent of GDP per year during 2005–09, mainly reflecting the shift of participants to the new system.

[7] The budget was only approved in July 2004; until then, the spending ceilings of the previous budget applied, with no new projects being started.

[8] The bonds (US$286 million or 1.8 percent of GDP) were issued for 30 years at a fixed interest rate of 7.6 percent (270 basis points over comparable U.S. treasury bills, one of the lowest sovereign spreads in Latin America).

sovereign bonds (10- and 30-year issues) and replacement of most short-term debt (6 percent of GDP) in late 2002. As a result, gross borrowing of the public sector fell in 2004.




➢ ***The restructuring of the central bank remains to be completed, as envisaged in the dollarization law (Box 1).*** The central bank has replaced most domestic currency with U.S. dollar notes and holds prudential liquidity requirements of individual banks. However, some important aspects of the dollarization law still need to be implemented, such as developing a lender-of-last-resort (LOLR) function (see ¶30) and the transfer of central bank nonmonetary liabilities to the government. These liabilities (mainly short-term paper) are not sufficiently backed by NIR and constitute a source of liquidity risk for the central bank.

➢ ***In this context, the central bank continued to roll over its own paper and maintained its NIR cushion in 2004.*** The margin of NIR over base money remained at around US$150 million. Pending the transfer of nonmonetary liabilities to the government, the central bank began to issue three-year paper in 2003 to replace maturing paper and reduce liquidity risk. The central bank also implemented a scheduled reduction in a special liquidity requirement (from 9 to 6 percent of deposits) during 2004.[9]

➢ ***Banks stepped up their medium-term external borrowing during 2003–04.*** With deposits declining in real terms (2 percent per year), increased borrowing helped banks sustain a moderate expansion of real credit (2 percent per year). The decline in deposits partly reflected the increasing share of savings being invested in private pension funds (their resources had risen to 11 percent of GDP at end-2003, since their creation in 1998). Cross-border lending by Salvadoran banks to the region picked up in 2004, but stricter country-risk

[9] This requirement was introduced in mid-2003 against potential systemic liquidity pressures before the presidential election. Including the special requirement, prudential liquidity requirements cover 29 percent of banks' deposits.

**Box 1. Implementation of the Monetary Integration Law**

**Key Features of the Law** (November 2000)

- *Legal tender.* On January 1, 2001, the U.S. dollar became legal tender and all financial system accounts were converted from colones to U.S. dollars at the exchange rate of C 8.75 per U.S. dollar. Prices, wages, and salaries were denominated in colones or in U.S. dollars.

- *Conversion*. The central bank no longer prints new currency notes nor issues coins, but it may issue currency from its inventory of colón notes. The law did not set a deadline for the conversion of existing currency notes in colones into U.S. dollar notes.

- *Credit operations.* The central bank cannot extend direct credit to financial institutions, but it retained the power to issue bonds and conduct transactions in securities and portfolio investments.

- *Lender of last resort (LOLR).* This function was restructured: (i) the reserve requirement (20 percent of deposits) was converted into a remunerated prudential liquidity requirement (effectively 23 percent of deposits) that banks can access to cover short-term needs; (ii) use of the first 25 percent of this requirement is free of interest, the second 25 percent can be drawn at a market interest rate (LIBOR + 250 basis points), while the remainder is only available in consultation with the superintendency of banks and under intervention; (iii) banks that exhaust the requirement are to be liquidated, and the deposit insurance fund (IGD) would pay out up to US$7,060 per depositor starting in January 2004 (US$6,250 earlier); and (iv) the central bank may conduct repurchase operations of U.S. treasury bills or central bank securities, in the event of systemic liquidity problems.

- *Transfer of liabilities*. The government will assume all other central bank liabilities.

**Implementation of the Law** (as of end-2004)

- *Conversion.* Over 94 percent of currency in circulation at end-2000 has been converted into U.S. dollar notes.

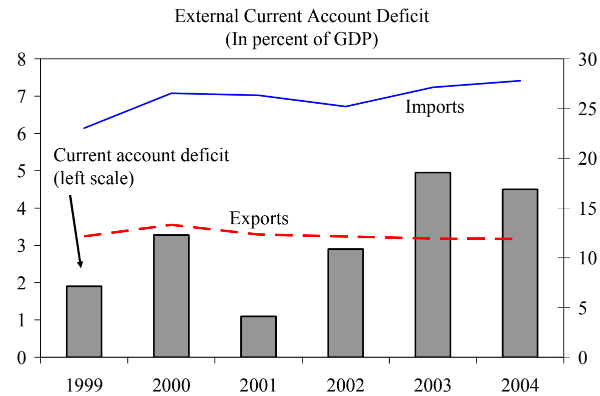
- *Credit operations.* The central bank has refrained from intervening in the interbank market and has unwound 15 percent of the outstanding stock of liquidity paper at end-2000.

- *LOLR.* In mid-2003, the central bank introduced a special requirement of 9 percent of deposits (which was lowered to 6 percent by September 2004) that banks can access in the event of liquidity problems. The special and liquidity requirements now account for a combined 29 percent of deposits. These resources, however, can not be used to manage systemic liquidity. The authorities need to develop this capacity, including by building NIR.

*Transfer of liabilities.* The government has not yet assumed the central bank’s liabilities. Excess of NIR over base money does not adequately back short-term non-monetary domestic liabilities of the central bank (mainly, government deposits and open market bills). This situation constrains LOLR capacity and constitutes a liquidity risk for the central bank.

provisions are tempering the growth.[10] During 2004, bank lending rates (one year or more) declined by 90 basis points, to 7½ percent, while deposit rate were stable at about 3¼ percent.[11]

➢ ***The external current account deficit is estimated to have narrowed slightly to 4½ percent of GDP in 2004 (5 percent in 2003).*** A sharp pick up in family remittances would more than offset an increase in oil imports (which rose by 1 percent of GDP) and a decline in net maquila exports (mainly textiles), attributable to intensified competition from East Asia. NIR declined by US$170 million in 2004 to US$1.7 billion (about 4½ months of imports), mainly reflecting the scheduled decline in banks' reserve requirements at the central bank.




➢ ***While the real exchange rate has depreciated recently, other indicators suggest that external competitiveness needs to be strengthened (Box 2).*** The CPI-based real exchange rate has depreciated by almost 6½ percent since end-2001, mainly reflecting the fall of the U.S. dollar. However, the recent sluggish export growth, relatively low FDI, heightened competition from East Asia, and relatively high dollar wages, suggest that external competitiveness needs to be strengthened. This will be particularly important in preparation for CAFTA and expiration of textile quotas under the agreement on textiles and clothing in 2005.

## C. Fund Policy Advice and Implementation

10. **Policy implementation in El Salvador has been broadly consistent with Fund advice, although the pace of implementation has slowed recently.** In recent Article IV consultations, Directors praised El Salvador's record of fiscal prudence and impressive reforms since the early 1990s. More recently, Directors called for a stronger fiscal stance, a larger international reserve cushion, further banking reforms, and improved central bank operations to underpin the dollarized regime and help deal with adverse shocks. While progress has been made on many of these areas, the pace of policy implementation slowed during the election period, especially in the fiscal area. Implementation of technical assistance has picked up recently, especially in the areas of tax policy, the banking system, and statistics.

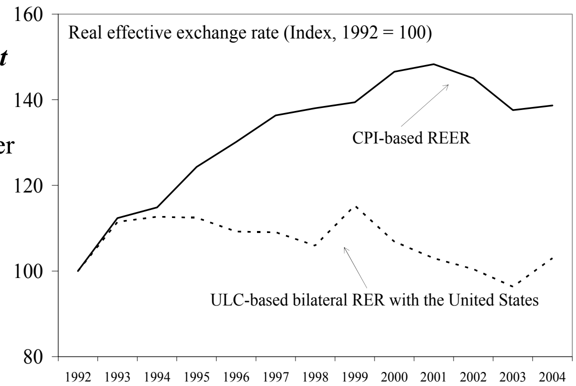
---

[10] Provisions range from 1 to 40 percent on investments with moderate risk (as assessed by international rating agencies) and up to 100 percent for noninvestment-grade risk.

[11] The compression of intermediation spreads reflects mainly greater competition among banks for creditworthy borrowers in an effort to maintain market share.

**Box 2. External Competitiveness**

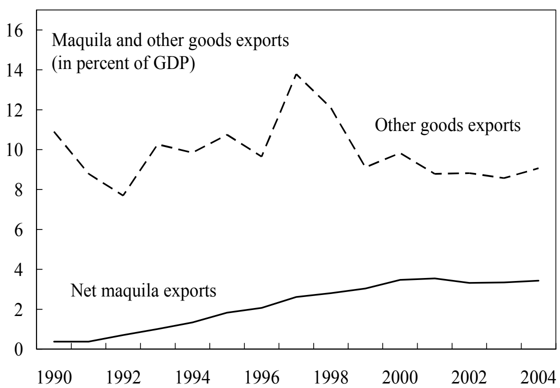
**While the real exchange rate has depreciated recently, external competitiveness appears to require further strengthening as export growth has been sluggish, foreign direct investment has remained low, and competition from Asia has intensified.**




- ***The CPI-based real effective exchange rate (REER) has depreciated by about 6½ percent since 2002,*** after a large appreciation in 1992–2001 (48 percent). The recent depreciation reflects the decline of the U.S. dollar vis-à-vis other major currencies and lower domestic inflation than in trading partners.

- ***In contrast, the UCL-based bilateral real exchange rate against the U.S. has appreciated in 2004,*** after a slight depreciation over 1992–2003 (4 percent). A prudent wage policy in the 1990s supported the initial expansion of exports and employment in the maquila and nontraditional sectors. Nevertheless, the recent trend reflects an increase in the minimum wage (5 percent) in 2003 in excess of inflation and productivity growth.

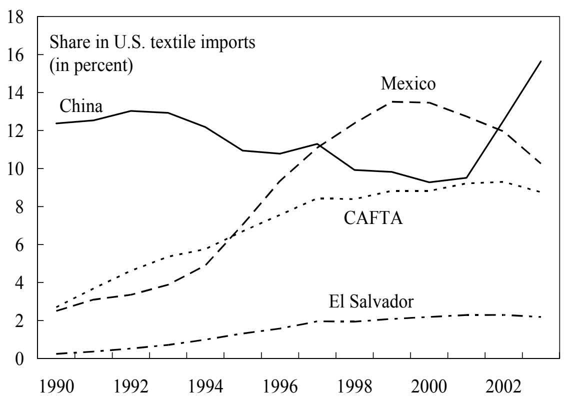
**Other indicators suggest a weakening in external competitiveness:**




- ***Maquila and other goods exports have stagnated since 199 at about 3 percent of GDP.*** Moreover, after rapid growth in the 1990s, the share of maquila exports (mostly textile) in the United States remained relatively low (2 percent).

- ***Foreign direct investment has only averaged 1½ percent of GDP since 1999,*** despite a liberal investment regime. This ratio is the lowest in the region.

- ***The nontradable sector remains attractive relative to the tradable sector,*** as sizable workers remittances have raised demand for nontradables. This situation has maintained employment and real wages relatively higher in the nontradable sector relative to the tradable sector (see Figure 2).




- ***Competition from Asia (mainly China) has intensified in recent years.*** This could stifle further growth of textile and nontraditional exports, which account for four-fifths of El Salvador's total exports. With the phasing out of textiles quotas under the agreement of textiles and clothing in January 2005, textile exports could suffer further, although El Salvador will continue to enjoy a significant tariff and proximity advantage in the United States relative to China.

11. The authorities have generally agreed with the thrust of Fund policy advice, while noting the challenge of approving often difficult reforms in a fragmented congress. Nevertheless, the authorities indicated their strong commitment to addressing existing vulnerabilities and regaining the reform momentum in the fiscal, trade, banking, and central bank areas. They also expressed their appreciation for the Fund's technical assistance and their intention to request further assistance in the future, mainly on macroeconomic statistics.

## II. Outlook and Risks

### A. Near-Term Outlook

12. **Growth is expected to recover to 2½ percent in 2005.** The pick-up would be supported by strong private consumption, and moderate increases in investment and non-maquila exports. Inflation is projected to slow to 2½ percent, reflecting oil price developments and plans to keep the minimum and public sector wages unchanged for 2005. The external current account deficit is projected to narrow to about 4 percent of GDP, reflecting an expected decline in oil prices and rising family remittances. NIR are projected to remain broadly unchanged.

El Salvador: Macroeconomic Framework
(In percent of GDP, unless otherwise noted)

| | 2004 | 2005 |
|---|---|---|
| Real GDP growth (percent) | 1.5 | 2.5 |
| Inflation (percent, end period) | 5.5 | 2.5 |
| Overall public sector balance | -2.9 | -3.1 |
| Public sector primary balance | -0.7 | -0.7 |
| Public sector debt | 44.8 | 46.2 |
| External current account balance | -4.4 | -4.0 |
| NIR (months of imports) | 4.5 | 4.3 |

13. **The overall public sector deficit is projected to rise slightly to over 3 percent of GDP.** A tax package recently approved by congress (see ¶20) will be more than offset by a budgeted increase in public investment and social spending, and further increases in interest and pension payments. As a result, the public debt is projected to rise to 46 percent of GDP by end-2005.

### B. Medium-Term Outlook

14. **The authorities' strategy for the next five years aims to improve growth prospects and social conditions.** The new government has begun to strengthen the policy stance to deepen the process of integration with the global and regional economy. The main elements of this strategy are:

- ***Strengthen the fiscal stance.*** Key goals are to raise tax revenue by 3 percentage points of GDP by 2009, to 14½ percent, and to achieve the social objectives of the Millennium Development Goals (MDG) by 2012 (Table 14). Increased social spending would focus on health, education, water, rural electrification, and rural roads.

- ***Move forward with structural reforms.*** The priorities are to broaden trade opening, consolidate the stability of the financial system, and alleviate infrastructure constrains. These actions are expected to tap new sources of growth, mainly from agriculture, agro-business, textiles, and services sectors (see Chapter II of BN).

15. **The medium-term outlook would improve under this strategy.** A baseline scenario prepared by staff, assuming implementation of the authorities' strategy and including the impact of CAFTA, projects an increase in real GDP growth to 3 percent over the medium term—while this is still slower than in the mid-1990s (4 percent), it is higher than the average growth rates in 2000–04 (2 percent). With a prudent wage policy, inflation would remain at 2½ percent per year, in line with major trading partners. The tax effort would shift the primary balance into a small surplus (¼ of 1 percent of GDP), stabilizing the public sector debt at about 47 percent of GDP. Under these policies, the external current account deficit would stay at over 4 percent of GDP per year over the medium term, and NIR would remain broadly unchanged at around four months of imports.

Key Macroeconomic Indicators under Baseline Scenario
(Percent of GDP, unless otherwise indicated)

| | Est. | Projection | | | | |
|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| Growth (percent) | 1.5 | 2.5 | 3.0 | 3.0 | 3.0 | 3.0 |
| Inflation (percent, eop) | 5.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Overall public sector balance | -2.9 | -3.1 | -3.3 | -2.8 | -2.3 | -2.6 |
| Public sector primary balance | -0.7 | -0.7 | -0.6 | 0.0 | 0.5 | 0.2 |
| Public sector debt | 44.8 | 46.2 | 47.1 | 47.4 | 47.2 | 47.4 |
| External current account balance | -4.4 | -4.0 | -4.2 | -4.3 | -4.3 | -4.2 |
| NIR (months of imports) | 4.5 | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 |
| External debt | 43.5 | 43.8 | 44.4 | 45.2 | 45.9 | 46.5 |

16. **Despite the improved outlook resulting from these policies, important vulnerabilities would remain:**

- ***The public finances would remain vulnerable to shocks, as the public debt would remain relatively high.*** Staff simulations show that a temporary shock combining slower growth, a lower primary balance, and higher interest rates would push the public debt up to 52 percent of GDP by 2009 (47 percent in the baseline—Annex).

- ***The external position would remain fragile to external shocks.*** An important downside risk is associated with competition from East Asia, which could raise the external current account deficit by some 1 percent of GDP per year over the medium term. This would raise external debt to 52 percent of GDP by 2009 (46½ percent in the baseline). (Table 10 sumarizes the impact of other shocks.)

- ***The economy is also vulnerable to policy slippages.*** Given the lack of majority in congress, marshalling the necessary consensus for the government's reform agenda will be a challenge. Under an alternative scenario that keeps the tax/GDP ratio and the primary deficit at the levels projected for 2005—the public debt ratio could approach 55 percent by 2009. Rising fiscal and external deficits and slower structural reforms would undermine investment and productivity, and leave growth at the moderate pace of 2000–04 (see Annex).

## III. Policy Discussions

17. **Against this background, the policy discussions centered on the challenge of boosting El Salvador's growth prospects and its resilience to shocks, thereby maximizing the benefits of the dollarization regime**. The main challenge for El Salvador is to boost investment and productivity, while reducing public debt and building up liquidity cushions. There was broad agreement between staff and the authorities that the strategy to achieve these goals should be centered on policies to reverse the recent deterioration in national savings

(through additional fiscal measures), improve competitiveness, further strengthen the banking system, and upgrade the investment environment. The staff emphasized the importance of policies to raise growth and reduce vulnerabilities in the context of the dollarization regime—the measures recommended by staff and the proposed sequence are summarized in Table 15.

18. **To anchor the policy discussions, the staff prepared an "active-policy scenario," based on a comprehensive reform effort.** Under that scenario, the primary fiscal surplus would increase to 1 percent of GDP from 2006; as a result, the public debt would decline to 43 percent of GDP by 2009. The stronger fiscal stance would reduce the external current account deficit, while higher domestic savings and the structural reforms indicated above would support higher investment and productivity. Provided that this comprehensive reform agenda is implemented, the staff considered that growth could accelerate to, and be maintained at, 4 percent a year over the medium term in the context of macro-stability and the dollarization regime.

Key Macroeconomic Indicators under Reinforced Policies
(Percent of GDP, unless otherwise indicated)

| | Est. | Projection | | | | |
|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| Growth (percent) | 1.5 | 3.0 | 3.5 | 4.0 | 4.0 | 4.0 |
| Inflation (percent, eop) | 5.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Overall public sector balance | -2.9 | -2.3 | -1.7 | -1.7 | -1.6 | -1.6 |
| Public sector primary balance | -0.7 | 0.1 | 1.0 | 1.0 | 1.0 | 1.0 |
| Public sector debt | 44.8 | 45.9 | 46.1 | 44.9 | 43.7 | 42.6 |
| External current account balance | -4.4 | -3.5 | -3.3 | -3.2 | -3.0 | -3.0 |
| NIR (months of imports) | 4.6 | 4.6 | 4.6 | 4.6 | 4.6 | 4.6 |
| External debt | 43.5 | 44.3 | 43.6 | 42.7 | 41.5 | 40.3 |

## A. Fiscal Policy

19. **The staff recommended further fiscal consolidation to place the public debt on a downward path.** As noted, raising the primary surplus to about 1 percent of GDP from 2006 would lower the public debt to 43 percent of GDP by 2009.[12] Recent tax measures (see below) should be followed by further reforms in the areas of tax policy, tax administration, and expenditure to yield an additional 0.7–1 percent of GDP. The authorities shared the staff's view from a medium-term perspective, but also stressed the more immediate need to address social and investment priorities, which would lead to a primary deficit of 0.7 percent of GDP in 2005–06 (the same as in 2004). They expected that political conditions should become more conducive to further strengthen the fiscal stance after the congressional elections in March 2006. They also saw a chance that, on the basis of the reforms implemented and planned, growth could pick up faster than projected in the staff's baseline scenario, which would help support revenue and fiscal consolidation.

[12] In outer years, these evolution would bring the debt ratio within the "safe" range (25–40 percent of GDP) observed in emerging countries with relatively strong growth and low incidence of financial crises (WEO, October 2003).

20. **The authorities are taking important tax measures for 2005.** Congress recently passed a package of measures to strengthen the income and value-added (VAT) taxes, eliminate tax loopholes, and raise selected excise taxes (beer, liquor, and cigarettes). These measures, which were prepared with assistance from FAD, are expected to yield 1.2 percent of GDP. To reach the revenue target of 14½ percent of GDP by 2009, the authorities would need to develop a strategy to further reduce tax evasion and bring informal activities into the tax base, which they view as areas with large revenue potential—evasion on income tax and VAT is estimated at 2½–3 percent of GDP.

Recent Tax Measures

| | Percent of GDP |
|---|---|
| **Total** | **1.2** |
| **Income tax** | 0.3 |
| Advance payment of 1.5 percent on gross income of individuals | |
| Include services by nonresidents and interest income from cross-border lending | |
| Phase out deductions for loan provisioning | |
| **Value-added tax** | 0.3 |
| Tighten crediting rules for exempt activities | |
| Withhold 1 percent of suppliers' sales to large taxpayers | |
| **Excise taxes** (mainly, beer, liquor, and cigarettes) | 0.2 |
| **Tax administration** | 0.4 |
| Eliminate bank secrecy for taxation purposes | |
| Strengthen tax enforcement | |

21. **A series of steps are underway to improve tax administration.** Reforms to the tax code (October 2004) have enabled the authorities to tighten penalties for tax delinquency, phase out bank secrecy for tax purposes, and fight import smuggling. Following FAD recommendations, the authorities are adopting an action plan to tighten control over large taxpayers and VAT rebates to exporters, improve cross-checking of tax payments, and strengthen the tax agency, including by hiring additional tax auditors.

22. **Staff welcomed these initiatives, and encouraged additional revenue reforms.** To attain the fiscal consolidation proposed by staff, the authorities could implement additional measures as recommended by FAD, including an increase in the VAT rate, adoption of a property tax, and a gradual increase in excise taxes on petroleum products to levels elsewhere in the region (as oil market conditions permit).[13] The authorities indicated that they prefer to intensify their strategy to reduce tax evasion before considering further tax measures.

23. **On the expenditure side, the authorities intend to increase priority social and infrastructure spending.** This increase, combined with rising interest and pension outlays, will result in a substantial increase in total expenditure to about 19½ percent of GDP in 2005–06 (18 percent in 2004). The authorities emphasized that the higher spending would be focused on key priority programs, while other spending (such as public sector wages—¶12) would be strictly contained. They also noted their plans for a substantial increase in private sector participation in infrastructure projects (power generation, roads, ports, and an airport cargo terminal).

24. **While progress has been made on expenditure reform, there is room to further reorient spending toward social and investment priorities.** Staff recommended a gradual

[13] Staff estimates that raising the VAT rate from 13 to 15 percent would yield about 0.7 percent of GDP, while raising excise taxes on petroleum products to the average in the region would yield 0.4 percent of GDP. The excise tax now amounts to 31 percent for gasoline (37 percent in the region) and 24 percent for diesel (45 percent in the region).

increase in the retirement age by five years (to 60 years for women and 65 years for men), and the transfer of expenditure responsibilities to local governments (following last year's increase in the tax-revenue sharing ratio from 6 to 7 percent). Subsidies for water services and liquefied gas should be better targeted, while the subsidy for nontraditional exports (6 percent of value) should be eliminated. The authorities agreed with most of these suggestions (which could yield savings of about ½ of 1 percent of GDP), although they indicated that further pension reform and decentralization measures would need legislation and a political consensus that may be difficult to obtain in the near future.

25. **Staff encouraged the authorities to improve public expenditure management, as recommended by the 2004 ROSC.** While many best practices for transparency are being met, the ROSC recommended the introduction of a multiyear budget and better control of local governments which are assuming a growing role in implementing social and investment projects. The authorities are developing a poverty map to improve the targeting of the poorest areas and the allocation of resources among priorities envisaged in the MDGs.[14]

26. **The authorities intend to further improve public debt management.** They plan further issuance of 30-year sovereign bonds (3 percent of GDP for 2005), and have requested new policy loans from the World Bank and the Inter-American Bank (IDB).[15] Staff supported these plans as they will further lengthen debt maturity and diversify financing sources.

## B. Central Bank Operations

27. **The authorities intend to implement the pending elements of the dollarization law, to firmly consolidate the monetary regime.**

- ***The authorities plan to restructure the balance sheet of the central bank, to make it fully consistent with dollarization.*** They intend to submit a restructuring plan to congress in 2005, in order to: (i) replace central bank paper and illiquid claims on the government with treasury bills; and (ii) transfer other assets and liabilities to the government, as recommended by the 2004 FSSA. This would remove the liquidity mismatch, leaving the central bank only with the task of managing prudential liquidity reserves (and the LOLR function, as explained below). The authorities noted that the restructuring plan may need to be carried out gradually,

---

[14] The World Bank's public expenditure review of June 2004 found that El Salvador has the basic foundations of a well-functioning expenditure management system. The report also identified areas of improvement, including in the process of external audit, internal controls, and quality of financial data. It recommended to integrate financial management systems and improve selection and performance indicators for public investment projects.

[15] The World Bank's draft country assistance strategy (expected to be approved in February 2005) envisages policy loans of US$300 million (1.8 percent of GDP) over 2005–08 in support of the authorities' growth strategy, while the IDB recently approved a policy loan (US$100 million for 2005) for basic education.

as outstanding central bank paper matures.[16] Staff supported the restructuring plan, noting that the transfer of central bank net liabilities (2½ percent of GDP) to the government—while not changing the consolidated fiscal position—would enhance fiscal transparency and contribute to financial stability.[17]

- ***After restructuring, the central bank will focus on a few core tasks.*** It will continue to act as fiscal agent of the government, hold liquid reserves of banks, publish macroeconomic statistics, and conduct macro prudential research. The authorities agreed with staff that over the longer term some of these tasks could be efficiently performed by other public agencies or the private sector; the staff encouraged them to undertake a cost-benefit analysis as a basis for further reforms in these areas.

28. **Since the restructuring process will take time to implement, staff suggested near-term steps to improve the conduct of the monetary regime.** Guidelines for central bank credit operations should be set to formalize most practices followed thus far—for example, setting a floor for government deposits in the central bank and a ceiling on the stock of central bank paper, and avoiding intervention in the interbank market. Government deposits should be gradually built up to avoid the need for further placements of central bank paper. The authorities agreed with these suggestions, although they were not sure that formal guidelines were needed.

29. **Staff recommended to maintain the current level of liquidity requirements.** The authorities saw some scope for lowering the special liquidity requirement (from 6 to 3 percent), in light of reduced political uncertainty and upcoming banking reforms. They noted that the requirement could be tightened again whenever necessary. In staff's view, the cushion provided by the current liquidity requirements (about 30 percent of deposits) should remain in place at least until the central bank is restructured and the LOLR function strengthened.[18]

30. **The staff encouraged the authorities to strengthen the LOLR function over the medium term.** The authorities agreed with staff that, once the restructuring was complete, the central bank could conduct limited systemic liquidity operations as a lender of last resort. These operations could take place in the amount of excess NIR (over liquidity requirements). To this end, the government should bolster further the NIR cushion, possibly by issuing long-term external debt. The staff noted that Fund technical assistance could help in developing the function of lender of last resort.

---

[16] For 2005, the central bank will broadly maintain its NIR position as outstanding central bank paper will rise slightly to offset maturing medium- and long-term external liabilities.

[17] The consolidated public sector includes the central bank, whose debt is included in public debt statistics.

[18] The coverage of bank deposits in El Salvador compares favorably to other fully and partially dollarized economies in the region (Table 16).

## C. Banking System

31. **The banking system appears relatively sound, although there are some areas for further strengthening (Box 3).** Since the 2000 FSAP, steps have been taken to improve capital adequacy and reinforce the bank resolution framework. However, reported prudential indicators may still overstate the quality of bank assets, reflecting shortcomings in provisioning and loan classification rules, including on impaired assets.[19] The system also faces credit and cross-border risks, weaknesses in supervision, and limited reserves in the deposit insurance system. Nonetheless, banks appear well positioned to withstand temporary liquidity shocks.

Banking System Indicators

(In percent unless otherwise stated)

| | 2002 | 2003 | Sep 2004 |
|---|---|---|---|
| Number of banks | 12 | 12 | 12 |
| *Of which:* public banks | 2 | 2 | 2 |
| Share of public banks in total assets | 4.5 | 4.2 | 4.0 |
| Capital to risk-weighted assets | 12.2 | 12.8 | 13.0 |
| NPLs to total loans | 3.5 | 2.8 | 2.7 |
| Provisions to NPLs | 115 | 130 | 129 |
| Return on equity | 12.2 | 11.5 | 9.8 |
| Return on assets | 1.1 | 1.1 | 1.0 |
| Liquid asset to short-term liabilities | 33.0 | 36.3 | 36.2 |

32. **The authorities plan to deepen banking reforms, along the lines of the recommendations made by staff.** Priorities include strengthening prudential and supervisory rules, the safety net, and state-owned banks.

- ***Prudential norms.*** The authorities plan to issue regulations in early 2005 to align current norms with best-practice standards, over a period of four years. Specifically, they will raise provisioning requirements, tighten loan classification, and improve valuation of non-loan assets (repossessed and other fixed assets). The required CAR was also raised from 11½ to 12 percent starting in 2005—the final step of a schedule that raised the CAR from 9 percent in 1999.

Loan-Loss Provisioning

(In percent of loan value)

| Category | Old | New |
|---|---|---|
| A | 0 | 1 |
| B | 1 | 5 |
| C | 10 | 25 |
| D | 50 | 60 |
| E | 100 | 100 |

- ***Supervision.*** Reforms to be submitted to congress in early 2005 seek to strengthen consolidated supervision, enhance autonomy of the superintendency of banks (providing legal protection to the superintendent and superintendency's staff when they are performing their duties in good faith, and clarifying the powers of the board and the superintendent), and integrate the supervisory agencies (banks, stock market, and pensions). The authorities intend to develop an early-warning system and shift supervision toward risk management, taking into account the growing reliance on external borrowing by banks.

---

[19] The application of best-practice prudential standards could result in capital shortfalls, particularly for the state banks. Under these standards, staff estimates that the average capital adequacy ratio (CAR) could fall to an adjusted 7½ percent, compared with the reported average CAR of 13 percent.

**Box 3. Summary of Staff Recommendations on Financial Sector Reform**

***The authorities have stated their intention to address virtually all of the staff recommendations on financial sector reform.***

**Main findings**

- Indicators of bank soundness suggest that the system has weathered well the recent sluggishness in economic growth.
- The central bank holds the liquidity reserves of banks, but has no commitment to act as lender of last resort, except as an agent of the government in bank resolution. Dollarization has had a positive impact on financial sector stability by eliminating exchange rate risk and lowering interest rates.
- Supervision of the financial system has been strengthened since 2000, notably the framework for bank resolution, consolidated supervision, and money laundering.
- Prudential norms have been strengthened with an increase in the required capital asset ratios (from 9 percent in 1999 to 12 percent in 2005), and with higher country-risk provisioning to address the risks of increased cross-border lending.

**Main recommendations**

- *Central bank operations.* Replace central bank paper and illiquid claims on the government with treasury bills, transfer other liabilities to the government, and improve the lender-of-last-resort function.
- *Supervision*. Strengthen capacity to conduct consolidated supervision, provide legal protection to supervisory staff, and implement risk-based supervision.
- *Prudential norms.* Align current norms on provisioning requirement, loan classification, and valuation of non-loan assets with best-practice standards.
- S*afety net.* Improve bank resolution practices by clarifying the roles of, and coordination among, the central bank, the superintendency of banks, and the deposit insurance fund. Strengthen the reserves of the deposit insurance fund.
- *Public sector banks.* Further restructure the two state banks, including by reducing costs, raising provisions, cutting bad loans, and tightening lending criteria.
- *Legal environment.* Approve a new Securitization Law to stimulate access to credit and allow for the efficient allocation of credit risk among borrowers, first and second floor financial intermediaries, and investors. Enhance the legal basis for commercial dispute resolution, corporate insolvency, and creditor's rights.

- ***Safety net.*** In an effort to improve bank resolution practices, the authorities are developing a framework to clarify the roles of, and coordination among, the central bank, the superintendency of banks, and the deposit insurance fund in addressing failed banks. On the deposit insurance fund, the staff recommended to raise bank premia to increase its reserves over the medium term.[20] The authorities agreed with this recommendation, while noting that it would take time to implement as banks first need to absorb the impact of ongoing reforms (such as tighter prudential norms, adoption of international accounting standards, and elimination of tax deduction of provisions).

33. ***Public sector banks.*** The two state banks[21] are among the weakest in the banking system, while the social housing fund has issued large amounts of its own bonds that constitute a potential future drain to the budget. Along the lines of staff recommendations, the authorities intend to further restructure these institutions (reducing costs, raising provisions, cutting nonperforming loans, and tightening lending criteria), although they considered that their privatization would be politically feasible only over the medium term. In the near term, they will assess whether these banks could be converted into second-tier banks to support lending to small businesses.

## D. Competitiveness and Other Issues

34. **Staff and the authorities agreed that external competitiveness needs to be strengthened (see ¶9, Box 2 and Figure 2).** The authorities seek to bolster competitiveness and remove obstacles to productivity and private investment. Their strategy is intended to create new trade opportunities, alleviate constraints on infrastructure and human capital, and build upon the reform process already made. The staff supported the authorities' strategy to rebuild competitiveness under the dollarization regime and stressed, in particular, the need for measures to improve the investment climate and enhance labor market flexibility.

35. **The authorities recently secured ratification of CAFTA by congress, and are working toward free-trade agreements with Canada and the European Union.** These agreements will further deepen the economy's openness and provide access to new markets. CAFTA will make permanent the benefits of the Caribbean Basin Initiative and further reduce the average tariff (now 6½ percent), although a few agricultural products will enjoy long transition periods (up to 20 years). Potential fiscal costs are expected to be relatively small (less than 0.3 percent of GDP), given already low tariff rates. CAFTA will also provide incentives for customs reform and enforcement of important norms (anti-corruption, labor, environment, property rights, and e-commerce). The recently adopted anti-trust law (November 2004) should strengthen competition practices and complement the reform of government procurement (Chapter IV of BN).

---

[20] The staff recommends to raise the fund's reserves gradually to the equivalent of 5 percent of deposits, from a current level of 1 percent.

[21] *Banco de Fomento Agropecuario* and *Banco Hipotecario,* together accounting for about 2½ percent of GDP in deposits.

36. **The authorities are pursuing several other reforms to improve the investment climate.** They plan to encourage private participation in infrastructure (electricity, ports, airport concessions, water, and roads), upgrade human capital to support higher-technology companies, and enhance the legal basis for commercial dispute resolution, corporate insolvency, and creditor rights. To further improve the investment climate, the authorities are also taking steps to reduce violence and crime (viewed as a problem in the business community), lower the cost of doing business in El Salvador, strengthen the rule of law, and upgrade the information technology network.

37. **Staff supported these reforms and encouraged the authorities also to seek further improvements in the labor market.** While the labor market is relatively flexible, further reforms are needed to allow for hourly wages and reduce overtime costs.[22] The authorities agreed with the staff's recommendations, but indicated that political support for these actions would be feasible only over the medium term.

38. **Economic statistics are adequate for surveillance purposes, and improvements along the lines of the 2003 ROSC data module are being implemented.** The ROSC identified poor source data and inadequate compilation techniques as major impediments to improving the quality of statistics. With STA assistance, the authorities have developed a timetable to improve the national accounts and government finance statistics. They also plan to adopt a new framework law to enhance interagency coordination for data sharing, which would help improve the quality of source data.

## IV. Staff Appraisal

39. **El Salvador has implemented a wide range of structural reforms over the past decade.** The reform effort culminated in the adoption of official dollarization in 2001, which the authorities view as a cornerstone of their market and stability-oriented policy framework. This strategy brought rapid growth initially, an investment-grade rating, and substantial improvements in social conditions. In recent years, however, growth has been sluggish and new economic vulnerabilities have emerged, such as those related to the rising public debt. While the slow growth is attributable to adverse shocks and election-related uncertainties—suggesting a sound basis for stronger growth when the external conditions improve—it will be crucial for El Salvador to continue on its reform path in the coming years, with focus on addressing economic vulnerabilities and removing the remaining barriers to growth. This agenda is, in a nutshell, what is needed to solidify and make the best of dollarization, a most demanding monetary regime.

40. **Economic conditions remained subdued in 2004, despite the global and regional recovery.** Growth was under 2 percent, owing to sluggish export and investment growth, and inflation rose due to higher world oil prices. The fiscal deficit declined due to lower earthquake reconstruction outlays, although the public debt ratio stayed at a relatively high 45 percent of GDP. Increased family remittances helped support incomes and the external

[22] According to the World Bank's 2003 World Development Indicators, El Salvador's labor laws are among the most flexible in the region (after Costa Rica).

position, but national savings declined further, with possible implications for investment and future growth prospects.

41. **The new government that took office in June 2004 has adopted a reform agenda to improve growth and social prospects.** The staff welcomes the recent approval by congress of a revenue package and CAFTA, and supports planned initiatives to improve the banking system, alleviate investment constraints, and achieve the MDGs goals. These actions are critical to enhance growth prospects and foster social cohesion, and the staff welcomes the broad consensus achieved to support them.

42. **Looking ahead, the staff encourages the authorities to broaden the reform agenda to meet the challenge of reviving growth in a lasting way, reducing vulnerabilities, and maximizing the benefits from dollarization.** There is a need to boost investment and productivity, reduce public debt and external vulnerability, and build liquidity buffers. To this end, the policy strategy should focus on raising national savings, improving competitiveness, further reforming the public sector, strengthening the banking system, and improving the investment climate.

43. **The staff supports the authorities' medium-term plans to substantially increase revenues and priority spending.** In particular, the staff endorses the authorities' aim to raise tax revenues by 3 percentage points of GDP over the medium term. The implementation of revenue measures already in train, including ongoing efforts to improve tax administration, will contribute to this goal, but additional measures would be needed to fully accomplish it. Moreover, because the authorities also plan to increase substantially social and infrastructure spending, the staff projects only modest improvements in the primary fiscal balance. In turn, the public debt ratio would stabilize at a relatively high level, leaving the public finances vulnerable to shocks and slippages in policy implementation.

44. **The staff therefore recommends further measures to place the public debt firmly on a downward path while raising priority spending.** The authorities' medium-term fiscal program should aim at raising the primary surplus to about 1 percent of GDP. To this end, recent revenue measures should be buttressed by further steps to strengthen the tax effort, including a possible increase in the VAT rate, and expenditure reforms should include further pension reform, improved control over local governments' expenditure, and better targeting of subsidies. The staff supports the authorities' debt management objectives of further lengthening of maturities and reducing financing costs, which would also be helped by the recommended strengthening of the overall fiscal position.

45. **The staff supports the authorities' commitment to restructuring the central bank, consistent with the dollarization regime.** The planned transfer of central bank liabilities to the government will eliminate central bank liquidity risks and contribute to fiscal transparency. Once this restructuring is complete, the central bank should develop further its lender-of-last-resort function, and the government should provide for a larger cushion of NIR over the medium term. Meanwhile, the authorities should maintain prudential liquidity requirements at current levels to mitigate potential systemic liquidity risks.

46. **The authorities' strategy for banking reforms is appropriate.** The staff endorses the gradual alignment of prudential rules with best-practice standards, as recommended by the

staff. The envisaged strategy to strengthen consolidated supervision, the autonomy of the superintendency of banks, and bank resolution practices is commendable. Staff recommends to continue efforts to strengthen public financial institutions and the deposit insurance fund over the medium term.

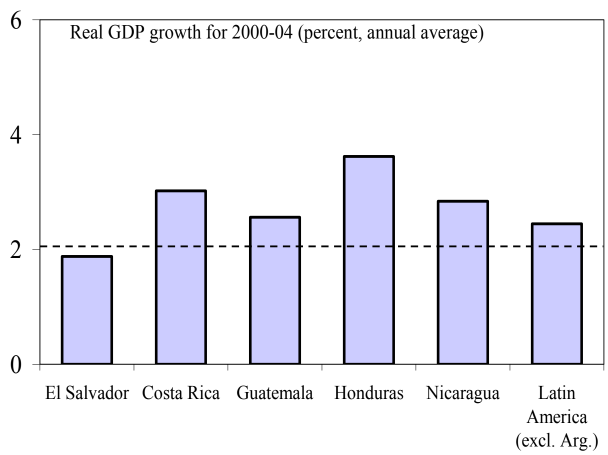
47. **The staff welcomes the recent ratification by congress of CAFTA and the plans to secure free-trade agreements with Canada and the European Union.** To take full advantage of trade and investment opportunities, policies need to focus on strengthening competitiveness. In this regard, the staff supports the authorities' plans to alleviate infrastructure constraints, upgrade the investment climate, and improve human capital. Moreover, staff recommends to pursue further trade integration within the framework of multilateral trade negotiations. Staff also encourages the authorities to further enhance labor market flexibility and improve the procedures for corporate insolvency, business dispute resolution, and creditors rights.

48. **El Salvador's economic statistics are adequate for surveillance purposes**, and the staff welcomes the ongoing efforts to improve them further in line with Fund recommendations.

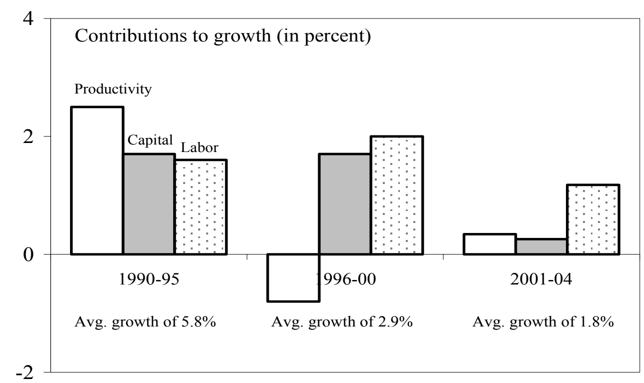
49. **It is recommended that the next Article IV consultation with El Salvador be held on the standard 12-month cycle.**

## Figure 1. El Salvador—Growth Performance and Obstacles

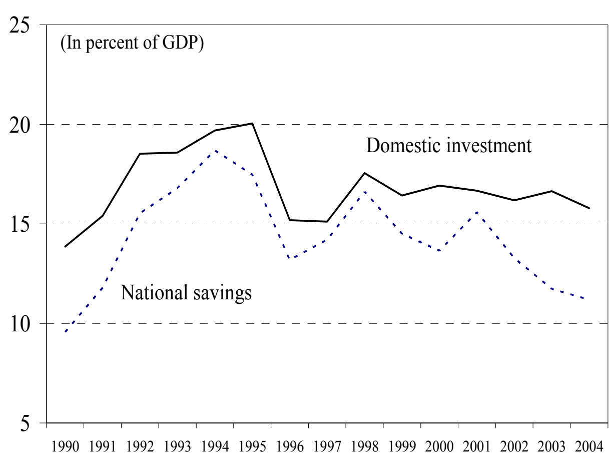
***Growth in El Salvador has been weak compared to the region.***



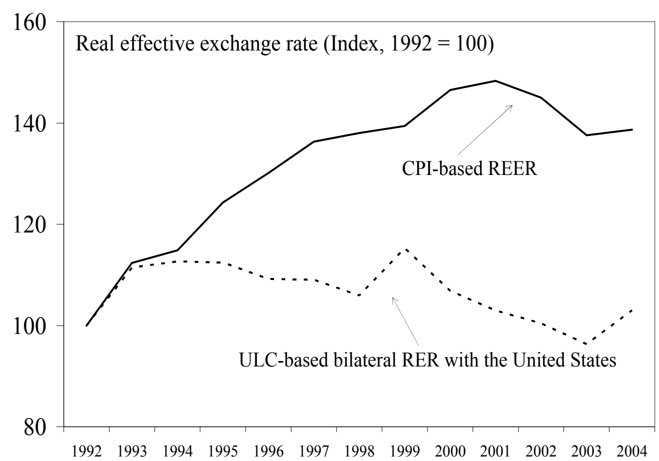

***Productivity growth dropped sharply since the mid-1990s.***




***Savings have declined while investment has stagnated recently.***

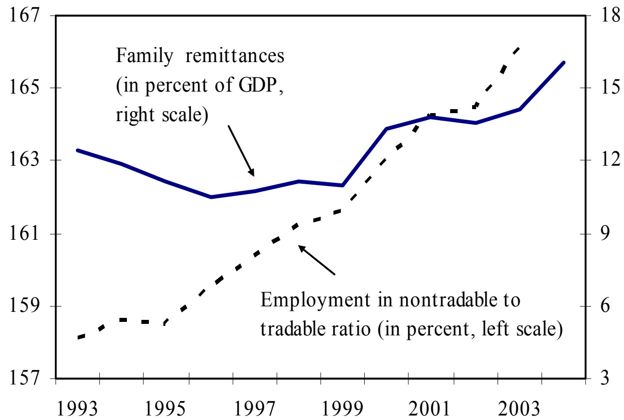



***The CPI-based REER has depreciated recently, after a long period of appreciation.***

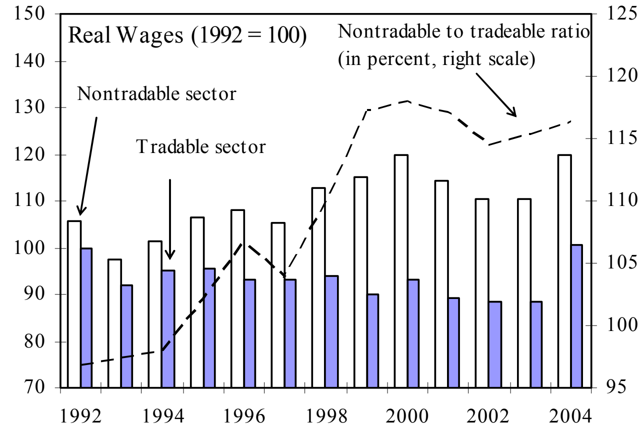


## Figure 2. El Salvador—Indicators of Competitiveness

***Buoyant workers' remittances are raising demand for and employment in nontradables...***

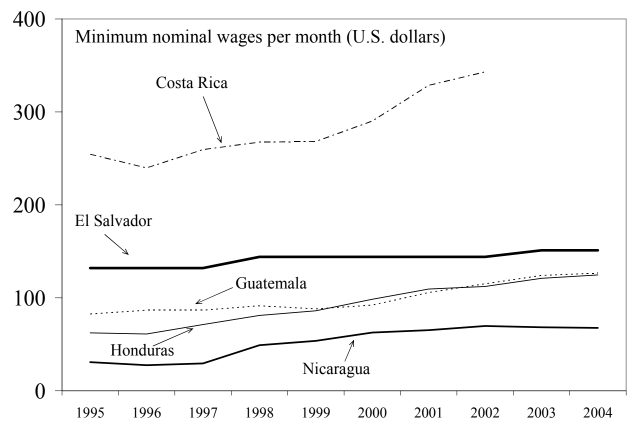



***...pushing real wages up in non-tradables...***




***and limiting the decline in real manufacturing wages.***


***Minimum wages remain the highest in the region after Costa Rica...***




***...as a result, export growth and FDI have been the lowest in the region.***

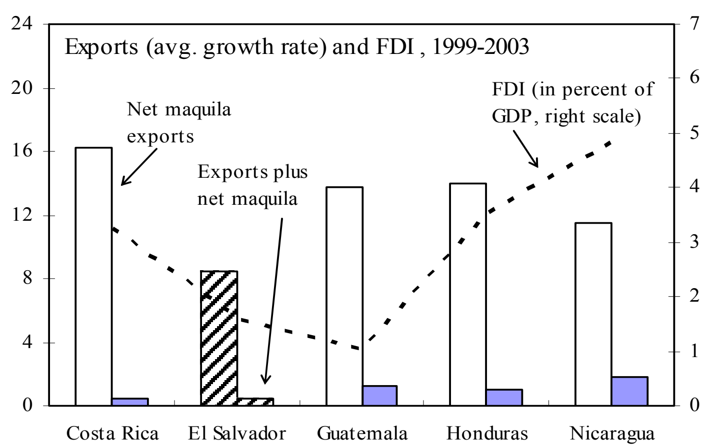


Table 1. El Salvador: Selected Economic and Financial Indicators

| | 1999 | 2000 | 2001 | 2002 | Prel. 2003 | Proj. 1/ 2004 | Proj. 1/ 2005 |
|---|---|---|---|---|---|---|---|
| | (Annual percent change) | | | | | | |
| **Income and prices** | | | | | | | |
| Real GDP | 3.4 | 2.2 | 1.7 | 2.2 | 1.8 | 1.5 | 2.5 |
| Real GDP per capita | 1.4 | 0.2 | -0.2 | 0.3 | -0.1 | -0.4 | 0.7 |
| GDP deflator | 0.3 | 3.2 | 3.4 | 1.4 | 2.5 | 4.2 | 2.5 |
| Consumer prices (end of period) | -1.0 | 4.3 | 1.4 | 2.8 | 2.5 | 5.5 | 2.5 |
| Unemployment rate | 7.5 | 7.0 | 7.0 | 6.2 | 6.9 | 7.0 | … |
| **External sector** | | | | | | | |
| Export f.o.b. volume (including maquila) | -5.2 | 16.5 | -2.9 | 4.4 | 2.2 | -0.9 | -1.2 |
| Import f.o.b. volume (including maquila) | -6.4 | 15.9 | 1.5 | 0.3 | 8.6 | 1.5 | 0.7 |
| Terms of trade | -4.6 | -3.7 | -0.1 | -0.6 | 0.1 | -1.0 | 0.1 |
| Real effective exchange rate (end of period) 2/ | 1.0 | 5.1 | 1.2 | -2.2 | -5.1 | 0.8 | … |
| | (In percent of GDP, unless otherwise indicated) | | | | | | |
| **Money and credit** | | | | | | | |
| Credit to the private sector | 43.7 | 42.8 | 39.9 | 41.4 | 42.3 | 42.0 | 42.0 |
| Broad money | 49.2 | 48.4 | 47.2 | 44.4 | 43.3 | 41.9 | 40.9 |
| Interest rate (180-day time deposits) 2/ | 10.7 | 9.3 | 5.5 | 3.4 | 3.4 | 3.2 | … |
| **External sector** | | | | | | | |
| Current account balance | -1.9 | -3.3 | -1.1 | -2.9 | -4.9 | -4.4 | -4.0 |
| Trade balance | -10.9 | -13.2 | -14.0 | -13.1 | -15.2 | -15.8 | -16.0 |
| Exports (f.o.b. including maquila) | 19.8 | 22.1 | 20.7 | 21.1 | 21.2 | 20.4 | 19.6 |
| Imports (f.o.b. including maquila) | 30.7 | 35.3 | 34.7 | 34.2 | 36.4 | 36.2 | 35.6 |
| Services and income | -3.7 | -3.7 | -3.7 | -3.9 | -3.9 | -4.7 | -4.7 |
| Transfers | 12.7 | 13.7 | 16.6 | 14.1 | 14.2 | 16.1 | 16.6 |
| **Public finances** | | | | | | | |
| Combined public sector balance | -2.6 | -3.0 | -4.3 | -4.6 | -3.8 | -2.9 | -3.1 |
| Consolidated primary balance | -1.2 | -1.4 | -2.9 | -2.9 | -1.8 | -0.7 | -0.7 |
| *Of which* : tax revenues | 10.2 | 10.2 | 10.5 | 11.1 | 11.6 | 11.5 | 12.8 |
| **Gross domestic investment 3/** | **16.4** | **16.9** | **16.7** | **16.2** | **16.6** | **15.8** | **16.7** |
| Public sector 4/ | 3.1 | 2.9 | 4.4 | 4.3 | 3.6 | 2.3 | 3.1 |
| Private sector | 13.3 | 14.0 | 12.3 | 11.9 | 13.0 | 13.5 | 13.7 |
| **National savings** | **14.5** | **13.6** | **15.6** | **13.3** | **11.7** | **11.4** | **12.7** |
| Public sector | 0.3 | -0.5 | -0.2 | -0.5 | -0.6 | -0.7 | -0.3 |
| Private sector | 14.2 | 14.2 | 15.8 | 13.7 | 12.4 | 12.1 | 13.0 |
| **Total public debt** | **34.1** | **36.2** | **39.4** | **43.5** | **46.1** | **44.8** | **46.2** |
| *Of which:* nonfinancial public debt (eop) | 28.1 | 29.5 | 33.8 | 38.7 | 40.7 | 40.7 | 40.0 |
| external public debt (eop) | 22.4 | 21.6 | 22.8 | 27.9 | 31.6 | 31.4 | 33.1 |
| External public debt service (in percent of exports of goods and services) | 19.3 | 10.3 | 15.1 | 16.9 | 13.3 | 23.8 | 16.8 |
| **Gross international reserves** | | | | | | | |
| In millions of U.S. dollars | 2,035 | 1,942 | 1,736 | 1,590 | 1,909 | 1,739 | 1,745 |
| In months of imports | 7.0 | 6.4 | 5.8 | 4.7 | 5.2 | 4.5 | 4.3 |
| In percent of short-term debt 5/ | 195.9 | 168.7 | 187.4 | 186.2 | 134.1 | 157.4 | 150.3 |
| Nominal GDP (in millions of U.S. dollars) | 12,465 | 13,134 | 13,813 | 14,312 | 14,941 | 15,802 | 16,602 |

Sources: Central reserve bank; ministry of finance; and Fund staff estimates.

1/ Baseline projections based on the authorities' policies.
2/ As of September 2004.
3/ Investment includes inventories.
4/ Includes reconstruction expenditure after the earthquakes in 2001.
5/ Includes banking and corporate debt on a remaining maturity basis.

Table 2. El Salvador: Operations of the Consolidated Public Sector

(In percent of GDP)

| | | | | | Prel. | Proj. 1/ | |
|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
| **Revenues and grants** | **15.0** | **15.7** | **14.8** | **15.3** | **16.1** | **15.8** | **16.6** |
| Current revenue | 14.8 | 14.8 | 14.4 | 14.5 | 15.6 | 15.3 | 16.1 |
| Tax revenue | 10.2 | 10.2 | 10.5 | 11.1 | 11.6 | 11.5 | 12.8 |
| Nontax revenue | 3.6 | 4.0 | 3.5 | 3.3 | 3.5 | 3.2 | 2.8 |
| *Of which:* pension revenue | 0.4 | 0.5 | 0.5 | 0.7 | 0.3 | 0.2 | 0.2 |
| Operating surplus of the public enterprises | 0.8 | 0.6 | 0.3 | 0.0 | 0.5 | 0.6 | 0.4 |
| Operating surplus of the central bank | 0.2 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 |
| Capital revenue | 0.0 | 0.1 | 0.0 | 0.5 | 0.0 | 0.0 | 0.1 |
| Official grants | 0.3 | 0.8 | 0.4 | 0.3 | 0.5 | 0.5 | 0.4 |
| **Expenditure** | **17.7** | **18.7** | **17.7** | **17.3** | **18.5** | **18.2** | **19.3** |
| Current expenditure | 14.4 | 15.4 | 14.6 | 15.0 | 16.3 | 16.0 | 16.4 |
| Wages and salaries | 8.3 | 8.4 | 7.8 | 7.4 | 7.4 | 7.3 | 7.4 |
| Goods and services | 2.7 | 2.8 | 3.0 | 3.2 | 3.7 | 3.3 | 3.2 |
| Interest | 1.4 | 1.5 | 1.4 | 1.7 | 2.1 | 2.2 | 2.5 |
| Current transfers | 2.0 | 2.6 | 2.4 | 2.7 | 3.2 | 3.2 | 3.4 |
| Non-pension payments | 1.2 | 1.7 | 0.6 | 0.8 | 1.2 | 1.2 | 1.1 |
| Pension payments | 0.8 | 0.9 | 1.8 | 1.9 | 2.0 | 2.0 | 2.3 |
| Capital expenditure | 3.2 | 3.3 | 3.1 | 2.3 | 2.2 | 2.2 | 2.9 |
| Fixed capital formation | 3.1 | 2.9 | 3.0 | 2.3 | 2.2 | 1.9 | 2.7 |
| Capital transfers | 0.1 | 0.4 | 0.1 | 0.0 | 0.1 | 0.3 | 0.2 |
| **Underlying overall balance** | **-2.6** | **-3.0** | **-2.9** | **-2.0** | **-2.4** | **-2.5** | **-2.8** |
| Reconstruction expenditure | 0.0 | 0.0 | 1.4 | 2.0 | 1.4 | 0.4 | 0.3 |
| Other 2/ | 0.0 | 0.0 | 0.0 | 0.6 | 0.0 | 0.0 | 0.0 |
| **Primary balance** | **-1.2** | **-1.4** | **-2.9** | **-2.9** | **-1.8** | **-0.7** | **-0.7** |
| **Overall balance** | **-2.6** | **-3.0** | **-4.3** | **-4.6** | **-3.8** | **-2.9** | **-3.1** |
| **Financing** | **2.6** | **3.0** | **4.3** | **4.6** | **3.8** | **2.9** | **3.1** |
| **External** | **1.4** | **1.5** | **4.5** | **8.9** | **3.0** | **1.6** | **3.1** |
| Disbursements | 4.8 | 3.1 | 7.0 | 12.4 | 4.2 | 3.9 | 4.8 |
| Amortization | -3.4 | -1.6 | -2.5 | -3.5 | -1.2 | -2.3 | -1.7 |
| **Domestic** | **1.2** | **1.5** | **-0.1** | **-4.3** | **0.9** | **1.3** | **0.1** |
| Central bank | 0.0 | 0.1 | 0.2 | -0.6 | 1.5 | 0.0 | 0.0 |
| Banking system | 0.6 | 1.5 | 0.9 | -1.4 | -0.4 | -0.2 | -0.1 |
| Private sector | -0.1 | -0.6 | -0.9 | -0.2 | 0.0 | -0.3 | 0.1 |
| Privatization proceeds 3/ | 1.3 | 0.0 | 0.1 | 0.0 | 0.0 | 1.9 | 0.0 |
| Other 4/ | -0.7 | 0.5 | -0.4 | -2.1 | -0.2 | 0.0 | 0.0 |
| **Memorandum items:** | | | | | | | |
| Current account balance | 0.3 | -0.5 | -0.2 | -0.5 | -0.6 | -0.7 | -0.3 |
| Pension balance | -0.5 | -0.4 | -1.2 | -1.2 | -1.7 | -1.8 | -2.1 |
| Gross financing needs | 11.7 | 6.4 | 10.3 | 13.7 | 5.4 | 6.3 | 5.5 |
| Implicit interest rate (in percent) | 4.4 | 4.7 | 4.2 | 4.5 | 4.8 | 5.0 | 5.7 |
| Total public sector debt 5/ | 34.1 | 36.2 | 39.4 | 43.5 | 46.1 | 44.8 | 46.2 |
| *Of which:* nonfinancial public debt | 28.1 | 29.5 | 33.8 | 38.7 | 40.7 | 40.7 | 40.0 |
| Public sector external debt | 22.4 | 21.6 | 22.8 | 27.9 | 31.6 | 31.4 | 33.1 |

Sources: Central reserve bank; ministry of finance; and Fund staff estimates.

1/ Baseline projections prepared by staff.
2/ One-time fine paid by the state electricity company (CEL) to cancel an energy contract.
3/ Includes the sale of shares in the telephone company (CTE) for 2004.
4/ Comprises discrepancies from above- and below-the-line items. The overall balance is measured above the line.
5/ Comprises nonfinancial public sector debt, central bank paper, and medium- and long-term external liabilities of the central bank, and state banks.

Table 3. El Salvador: Summary Accounts of the Banking System

| | 1999 | 2000 | 2001 | 2002 | 2003 | Proj. 2004 | Proj. 2005 |
|---|---|---|---|---|---|---|---|
| (End-of-period stocks, in millions of U.S. dollars) | | | | | | | |
| I. Central Reserve Bank | | | | | | | |
| **Net international reserves** | **1,934** | **1,891** | **1,710** | **1,589** | **1,906** | **1,736** | **1,746** |
| **Net domestic assets** | **35** | **-47** | **-86** | **-170** | **-165** | **-150** | **-126** |
| Nonfinancial public sector | 74 | 84 | 113 | 24 | 247 | 248 | 255 |
| Commercial banks | 148 | 117 | 103 | 86 | 85 | 0 | 0 |
| Nonbank financial institutions | 325 | 326 | 262 | 221 | 101 | 132 | 135 |
| Open market operations | -572 | -629 | ... | ... | ... | ... | ... |
| Liquidity operations | ... | ... | -641 | -567 | -486 | -533 | -561 |
| *Of which:* medium- and long-term securities | ... | ... | 0 | 0 | -108 | -144 | ... |
| Medium- and long-term foreign liabilities | -165 | -150 | -125 | -101 | -267 | -196 | -151 |
| Other | 225 | 204 | 202 | 166 | 156 | 200 | 197 |
| **Base money** | **2,004** | **1,844** | **1,623** | **1,419** | **1,741** | **1,586** | **1,620** |
| Currency issue | 652 | 557 | 270 | 67 | 42 | 33 | 28 |
| Liquidity requirements | 1,352 | 1,287 | 1,353 | 1,352 | 1,699 | 1,553 | 1,592 |
| II. Financial System | | | | | | | |
| **Net foreign assets** | **1,814** | **1,812** | **1,827** | **1,839** | **1,982** | **1,866** | **1,861** |
| **Net domestic assets** | **4,324** | **4,546** | **4,696** | **4,516** | **4,482** | **4,757** | **4,929** |
| Nonfinancial public sector | -145 | 57 | 207 | -87 | 135 | 96 | 85 |
| Credit to private sector | 5,558 | 5,618 | 5,516 | 5,921 | 6,326 | 6,638 | 6,973 |
| Medium- and long-term foreign liabilities | -490 | -521 | -470 | -659 | -1,096 | -1,071 | -1,071 |
| Other | -599 | -608 | -556 | -659 | -884 | -906 | -1,058 |
| **Liabilities to the private sector** | **6,138** | **6,358** | **6,523** | **6,355** | **6,463** | **6,623** | **6,790** |
| Money | 1,140 | 1,117 | 1,171 | 1,056 | 1,068 | 1,133 | 1,193 |
| Quasi-money | 4,756 | 4,913 | 5,030 | 4,960 | 4,980 | 5,044 | 5,096 |
| Investment certificates | 236 | 328 | 323 | 340 | 416 | 446 | 501 |
| (Percentage changes) | | | | | | | |
| **Net domestic assets** | **2.4** | **3.6** | **2.4** | **-2.8** | **-0.5** | **4.1** | **2.6** |
| *Of which* | | | | | | | |
| Nonfinancial public sector | 1.3 | 3.3 | 2.4 | -4.5 | 3.5 | -0.6 | -0.2 |
| Credit to the private sector | 3.8 | 1.0 | -1.6 | 6.2 | 6.4 | 4.8 | 5.1 |
| **Liabilities to the private sector** | **6.5** | **3.6** | **2.6** | **-2.6** | **1.7** | **2.5** | **2.5** |
| (In percent of GDP) | | | | | | | |
| Credit to the private sector | 43.7 | 42.8 | 39.9 | 41.4 | 42.3 | 42.0 | 42.0 |
| Liabilities to the private sector | 49.2 | 48.4 | 47.2 | 44.4 | 43.3 | 41.9 | 40.9 |
| *Of which* | | | | | | | |
| Currency in circulation | 3.8 | 3.4 | 1.6 | 0.4 | 0.2 | 0.2 | 0.2 |
| Money | 8.6 | 8.5 | 8.5 | 7.4 | 7.1 | 7.2 | 7.2 |
| Quasi-money | 37.4 | 37.4 | 36.4 | 34.7 | 33.3 | 31.9 | 30.7 |
| **Memorandum items:** | | | | | | | |
| Credit to the private sector (12-month percentage change) | 4.1 | 1.1 | -1.8 | 7.3 | 6.9 | 4.9 | 5.0 |
| Credit to nonresidents (US$ million) | 33 | 82 | 247 | 358 | 304 | 380 | ... |
| Total liquidity requirements (percent) 1/ | 24.7 | 22.2 | 21.6 | 21.5 | 26.5 | 23.6 | 23.5 |
| NIR in excess of base money (US$ million) 2/ | -35 | 47 | 86 | 170 | 165 | 150 | 126 |
| Excess NIR less nonmonetary liabilities (US$ million) 3/ | ... | ... | -1,119 | -1,070 | -780 | -838 | -883 |
| Excess NIR less liquid nonmonetary liabilities (US$ million) 4/ | ... | ... | -981 | -609 | -425 | -448 | ... |

Sources: Central reserve bank; ministry of finance; and Fund staff estimates.

1/ Total liquidity requirement as a percent of liabilities to the private sector in commercial banks.
2/ Net international reserves in excess of base money.
3/ Nonmonetary liabilities include government deposits at the central bank.
4/ Exclude privatization-related government deposits (US$247 million) and medium-term liquidity bills (US$144 million).

Table 4. El Salvador: Balance of Payments

| | 1999 | 2000 | 2001 | 2002 | 2003 | Proj. 1/ 2004 | 2005 |
|---|---|---|---|---|---|---|---|
| (In millions of U.S. dollars, unless otherwise indicated) | | | | | | | |
| **Current account balance** | **-237** | **-431** | **-151** | **-411** | **-734** | **-702** | **-671** |
| Trade balance | -1,356 | -1,740 | -1,933 | -1,871 | -2,274 | -2,508 | -2,644 |
| Export of goods (f.o.b.) | 2,469 | 2,900 | 2,864 | 3,021 | 3,162 | 3,220 | 3,262 |
| General merchandise | 1,136 | 1,291 | 1,214 | 1,263 | 1,281 | 1,433 | 1,564 |
| Goods for processing | 1,333 | 1,609 | 1,650 | 1,758 | 1,881 | 1,787 | 1,698 |
| Import of goods (f.o.b.) | -3,825 | -4,640 | -4,797 | -4,892 | -5,436 | -5,728 | -5,906 |
| General merchandise | 2,871 | 3,487 | 3,637 | 3,609 | 4,055 | 4,387 | 4,633 |
| Goods for processing | 955 | 1,153 | 1,161 | 1,283 | 1,381 | 1,340 | 1,273 |
| Services | -183 | -235 | -250 | -240 | -169 | -176 | -196 |
| Income | -280 | -253 | -266 | -323 | -408 | -562 | -578 |
| *Of which* | | | | | | | |
| Interest on external public debt (net) | -32 | -14 | -35 | -64 | -238 | -333 | -351 |
| Interest on external private debt (net) | -157 | -170 | -181 | -160 | -91 | -144 | -158 |
| Current transfers | 1,582 | 1,797 | 2,298 | 2,023 | 2,117 | 2,544 | 2,748 |
| **Financial and capital account** | **671** | **535** | **497** | **1,369** | **1,186** | **538** | **686** |
| Capital account | 79 | 109 | 198 | 209 | 113 | 119 | 121 |
| Foreign direct investment | 162 | 178 | 289 | 496 | 68 | 150 | 149 |
| Public sector capital | 177 | 200 | 620 | 1,270 | 444 | 247 | 511 |
| Private sector capital | 290 | 57 | -566 | -575 | 418 | 27 | -147 |
| **Currency substitution** | **0** | **0** | **-286** | **-204** | **-25** | **-6** | **-5** |
| **Errors and omissions** | **-227** | **-150** | **-238** | **-878** | **-110** | **0** | **0** |
| **Change in net reserves (- = increase)** | **-208** | **46** | **178** | **124** | **-316** | **170** | **-10** |
| (Annual percentage change) | | | | | | | |
| **Exports (f.o.b.)** | | | | | | | |
| Value | -6.4 | 17.5 | -1.3 | 5.5 | 4.7 | 1.8 | 1.3 |
| Volume | -5.2 | 16.5 | -2.9 | 4.4 | 2.2 | -0.9 | -1.2 |
| General merchandise | | | | | | | |
| Value | -21.8 | 13.7 | -6.0 | 4.1 | 1.4 | 11.8 | 9.1 |
| Volume | -23.8 | 11.3 | -8.2 | 2.4 | -0.4 | 9.3 | 6.4 |
| **Imports (f.o.b.)** | | | | | | | |
| Value | -3.0 | 21.3 | 3.4 | 2.0 | 11.1 | 5.4 | 3.1 |
| Volume | -6.4 | 15.9 | 1.5 | 0.3 | 8.6 | 1.5 | 0.7 |
| General merchandise | | | | | | | |
| Value | -7.3 | 21.5 | 4.3 | -0.8 | 12.4 | 8.2 | 5.6 |
| Volume | -9.6 | 18.9 | 1.8 | -2.4 | 10.3 | 5.7 | 2.9 |
| **Terms of trade** | -4.6 | -3.7 | -0.1 | -0.6 | 0.1 | -1.0 | 0.1 |
| (In percent of GDP) | | | | | | | |
| **Current account balance** | **-1.9** | **-3.3** | **-1.1** | **-2.9** | **-4.9** | **-4.4** | **-4.0** |
| Export of goods (f.o.b.) | 19.8 | 22.1 | 20.7 | 21.1 | 21.2 | 20.4 | 19.6 |
| Import of goods (f.o.b.) | -30.7 | -35.3 | -34.7 | -34.2 | -36.4 | -36.2 | -35.6 |
| Net maquila exports | 3.0 | 3.5 | 3.5 | 3.3 | 3.3 | 2.8 | 2.6 |
| Current private transfers | 12.7 | 13.7 | 16.6 | 14.1 | 14.2 | 16.1 | 16.6 |
| Foreign direct investment | 1.3 | 1.4 | 2.1 | 3.5 | 0.5 | 1.0 | 0.9 |
| **Memorandum items:** | | | | | | | |
| Gross international reserves (US$ million) | 2,035 | 1,942 | 1,736 | 1,590 | 1,909 | 1,739 | 1,745 |
| In months of imports, excluding maquila | 7.0 | 6.4 | 5.8 | 4.7 | 5.2 | 4.5 | 4.3 |
| External public sector debt | 22.4 | 21.6 | 22.8 | 27.9 | 31.6 | 31.4 | 33.1 |
| Public sector debt service to exports of goods and services ratio | 19.3 | 10.3 | 15.1 | 16.9 | 13.3 | 23.8 | 16.8 |
| *Of which:* interest | 3.8 | 3.7 | 4.1 | 5.1 | 7.9 | 8.7 | 9.3 |

Sources: Central reserve bank; and Fund staff estimates.

1/ Baseline projections.

Table 5. El Salvador: Indicators of the Banking Sector

| | 1999 | 2000 | 2001 | 2002 | 2003 | Sep. 2004 |
|---|---|---|---|---|---|---|
| **I. Financial Sector** | | | | | | |
| **Number of banks** | | | | | | |
| Private banks | 15 | 11 | 10 | 10 | 10 | 10 |
| Private commercial | 10 | 6 | 6 | 6 | 5 | 5 |
| Foreign-owned subsidiaries | 5 | 5 | 4 | 4 | 5 | 5 |
| Total assets of private banks (millions of U.S. dollars) | 7,395 | 7,739 | 8,493 | 8,717 | 9,560 | 9,795 |
| (as percentage of GDP) | 59.3 | 58.9 | 61.5 | 60.9 | 64.0 | 62.0 |
| Public banks | 2 | 2 | 2 | 2 | 2 | 2 |
| Total assets of public banks (millions of U.S. dollars) | 469.2 | 446.3 | 382.5 | 406.0 | 422.6 | 409.9 |
| (as percentage of GDP) | 3.8 | 3.4 | 2.8 | 2.8 | 2.8 | 2.6 |
| **Number of other financial institutions** | | | | | | |
| Branches of foreign banks | 1 | 2 | 2 | 2 | 2 | 2 |
| Securities companies | 15 | 18 | 18 | 18 | 20 | 20 |
| Other credit institutions | 5 | 6 | 6 | 11 | 11 | 11 |
| Pension funds | 5 | 3 | 3 | 3 | 3 | 3 |
| Total assets of other financial institutions | | | | | | |
| (in millions of U.S. dollars) | 1,530 | 1,958 | 2,374 | 2,806 | 3,222 | … |
| (as percentage of GDP) | 12.3 | 14.9 | 17.2 | 19.6 | 21.6 | … |
| *Of which:* | | | | | | |
| Pension funds | | | | | | |
| (in millions of U.S. dollars) | 225 | 497 | 787 | 1,099 | 1,598 | … |
| (as percentage of GDP) | 1.8 | 3.8 | 5.7 | 7.7 | 10.7 | … |
| **II. Banking Sector** | | | | | | |
| **Capital** | | | | | | |
| Ratio of capital to risk-weighted assets | 10.4 | 11.5 | 11.8 | 12.2 | 12.8 | 13.0 |
| **Asset quality** | | | | | | |
| Ratio of loans more than 90 days past due | | | | | | |
| to total loans 1/ | 7.7 | 5.2 | 4.3 | 3.5 | 2.8 | 2.7 |
| Ratio of nonperforming loans to total loans 2/ | ... | ... | ... | 15.8 | 12.3 | 12.0 |
| Provision coverage | | | | | | |
| Ratio of provisions to total loans | 5.9 | 4.3 | 4.3 | 3.9 | 3.6 | 3.5 |
| Ratio of provisions to loans more than 90 days past due 1/ | 80.6 | 84.9 | 103.1 | 115.1 | 129.8 | 128.6 |
| Ratio of real estate loans to total loans | 14.5 | 15.2 | 18.1 | 18.9 | 22.0 | 23.4 |
| Ratio of consumption loans to total loans | 10.6 | 11.5 | 11.1 | 12.4 | 14.2 | 16.8 |
| **Management** | | | | | | |
| Ratio of personnel expenses to average total assets | 1.9 | 1.9 | 1.6 | 1.6 | 1.5 | ... |
| Ratio of other noninterest expenses | | | | | | |
| to average total assets | 2.3 | 2.5 | 2.3 | 2.2 | 2.2 | ... |
| **Profitability** | | | | | | |
| Return to average equity | -3.5 | 3.2 | 10.7 | 12.2 | 11.5 | 9.8 |
| Return to average total assets | -0.1 | 0.3 | 0.9 | 1.1 | 1.1 | 1.0 |
| **Liquidity** | | | | | | |
| Ratio of liquid assets to total assets | 26.1 | 28.3 | 34.6 | 30.0 | 31.7 | 31.6 |
| Ratio of liquid assets to total short-term liabilities 3/ | 28.8 | 31.3 | 36.3 | 33.0 | 36.3 | 36.2 |

Source: Superintendency of the financial system.

1/ Based on past-due loans.
2/ Includes contingencies. Nonperforming loans are defined as the sum of the three lowest loan categories.
3/ Official definition of liquid assets.

Table 6. El Salvador: Indicators of External Vulnerability

| | 1999 | 2000 | 2001 | 2002 | Prel. 2003 | Proj. 2004 |
|---|---|---|---|---|---|---|
| Merchandise exports (12-month percent change) 1/ | -6.4 | 17.5 | -1.3 | 5.5 | 4.7 | 1.8 |
| Merchandise imports (12-month percent change) 1/ | -3.0 | 21.3 | 3.4 | 2.0 | 11.1 | 5.4 |
| Terms of trade (percentage change) | -4.6 | -3.7 | -0.1 | -0.6 | 0.1 | -1.0 |
| Current account balance (in percent of GDP) | -1.9 | -3.3 | -1.1 | -2.9 | -4.9 | -4.4 |
| Central bank gross international reserves (in US$ million) | 2,035 | 1,942 | 1,736 | 1,590 | 1,909 | 1,739 |
| In months of next year's imports of goods and services 1/ | 5.3 | 4.9 | 4.3 | 3.5 | 4.0 | 3.6 |
| In months of next year's imports of goods and services 2/ | 7.0 | 6.4 | 5.8 | 4.7 | 5.2 | 4.5 |
| In percent of base money | 101.5 | 105.3 | 106.9 | 112.1 | 109.6 | 109.6 |
| In percent of M2 | 33.2 | 30.5 | 26.6 | 26.4 | 31.6 | 28.2 |
| In percent of short-term debt on a remaining maturity basis 3/ | 195.9 | 168.7 | 187.4 | 186.2 | 134.1 | 157.4 |
| Public sector external debt (in percent of GDP) | 22.4 | 21.6 | 22.8 | 27.9 | 31.6 | 31.4 |
| Public sector external debt to exports of goods and services ratio | 89.7 | 78.7 | 88.4 | 104.8 | 118.3 | 120.1 |
| Public sector external debt amortization to exports of goods and services ratio | 14.5 | 6.8 | 10.9 | 11.8 | 5.3 | 15.1 |
| Public sector external debt interests to exports of goods and services ratio | 3.8 | 3.7 | 4.1 | 5.1 | 7.9 | 8.7 |
| REER appreciation (+) (12-month percentage change) 4/ | 1.0 | 5.1 | 1.2 | -2.2 | -5.1 | 0.8 |

Sources: Central Reserve Bank; and Fund staff estimates.

1/ Includes maquila.
2/ Excludes maquila imports.
3/ Includes banking and corporate debt.
4/ As of September 2004.

Table 7. El Salvador: Operations of the Consolidated Public Sector

(In percent of GDP)

| | Prel. | Projections 1/ | | | | | |
|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| **Revenues and grants** | **16.1** | **15.8** | **16.6** | **16.4** | **16.8** | **17.2** | **17.7** |
| Current revenue | 15.6 | 15.3 | 16.1 | 16.1 | 16.5 | 16.9 | 17.4 |
| Tax revenue | 11.6 | 11.5 | 12.8 | 13.0 | 13.5 | 14.0 | 14.6 |
| Nontax revenue | 3.5 | 3.2 | 2.8 | 2.7 | 2.6 | 2.5 | 2.5 |
| *Of which:* pension revenue | 0.3 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 |
| Operating surplus of the public enterprises | 0.5 | 0.6 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| Capital revenue | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Official grants | 0.5 | 0.5 | 0.4 | 0.3 | 0.3 | 0.3 | 0.2 |
| **Expenditure** | **18.5** | **18.2** | **19.3** | **19.7** | **19.6** | **19.5** | **20.3** |
| Current expenditure | 16.3 | 16.0 | 16.4 | 16.7 | 16.5 | 16.0 | 15.6 |
| Wages and salaries | 7.4 | 7.3 | 7.4 | 7.4 | 7.2 | 6.8 | 6.5 |
| Goods and services | 3.7 | 3.3 | 3.2 | 3.2 | 3.1 | 3.0 | 3.0 |
| Interest | 2.1 | 2.2 | 2.5 | 2.7 | 2.8 | 2.8 | 2.8 |
| Current transfers | 3.2 | 3.2 | 3.4 | 3.4 | 3.4 | 3.3 | 3.3 |
| Non-pension payments | 1.2 | 1.2 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 |
| Pension payments | 2.0 | 2.0 | 2.3 | 2.3 | 2.2 | 2.2 | 2.2 |
| Capital expenditure | 2.2 | 2.2 | 2.9 | 3.0 | 3.1 | 3.5 | 4.7 |
| Fixed capital formation | 2.2 | 1.9 | 2.7 | 2.9 | 3.0 | 3.4 | 4.5 |
| Capital transfers | 0.1 | 0.3 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 |
| **Underlying overall balance** | **-2.4** | **-2.5** | **-2.8** | **-3.3** | **-2.8** | **-2.3** | **-2.6** |
| Reconstruction expenditure | 1.4 | 0.4 | 0.3 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Primary balance** | **-1.8** | **-0.7** | **-0.7** | **-0.6** | **0.0** | **0.5** | **0.2** |
| **Overall balance** | **-3.8** | **-2.9** | **-3.1** | **-3.3** | **-2.8** | **-2.3** | **-2.6** |
| **Financing** | **3.8** | **2.9** | **3.1** | **3.3** | **2.8** | **2.3** | **2.6** |
| **External** | **3.0** | **1.6** | **3.1** | **3.3** | **2.8** | **2.3** | **2.6** |
| Disbursements | 4.2 | 3.9 | 4.8 | 5.6 | 4.5 | 3.8 | 4.0 |
| Amortization | -1.2 | -2.3 | -1.7 | -2.3 | -1.7 | -1.5 | -1.4 |
| **Domestic** | **0.9** | **1.3** | **0.1** | **0.0** | **0.0** | **0.0** | **0.0** |
| Central bank | 1.5 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Banking system | -0.4 | -0.2 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Private sector | 0.0 | -0.3 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Privatization proceeds 2/ | 0.0 | 1.9 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other 3/ | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Memorandum items:** | | | | | | | |
| Current account balance | -0.6 | -0.7 | -0.3 | -0.6 | 0.0 | 0.9 | 1.8 |
| Pension balance | -1.7 | -1.8 | -2.1 | -2.2 | -2.2 | -2.2 | -2.1 |
| Gross financing needs | 5.4 | 6.3 | 5.5 | 5.6 | 4.5 | 3.8 | 4.0 |
| Implicit interest rate (in percent) | 4.8 | 5.0 | 5.7 | 6.2 | 6.3 | 6.3 | 6.4 |
| Total public sector debt 4/ | 46.1 | 44.8 | 46.2 | 47.1 | 47.4 | 47.2 | 47.4 |
| Public sector external debt | 31.6 | 31.4 | 33.1 | 34.7 | 35.7 | 36.2 | 36.9 |

Sources: Central reserve bank; ministry of finance; and Fund staff estimates.

1/ Baseline projections prepared by staff.
2/ Includes the sale of shares in the telephone company (CTE) for 2004.
3/ Comprises discrepancies from above and below-the-line items. The overall balance is measured above the line.
4/ Includes debt of the central bank and public banks.

Table 8. El Salvador: Balance of Payments

| | Prel. | Projections 1/ | | | | | |
|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| | (In millions of U.S. dollars, unless otherwise indicated) | | | | | | |
| **Current account balance** | **-734** | **-702** | **-671** | **-743** | **-799** | **-831** | **-876** |
| Trade balance | -2,274 | -2,508 | -2,644 | -2,767 | -2,949 | -3,077 | -3,217 |
| Export of goods (f.o.b.) | 3,162 | 3,220 | 3,262 | 3,461 | 3,633 | 3,867 | 4,120 |
| General merchandise | 1,281 | 1,433 | 1,564 | 1,678 | 1,762 | 1,905 | 2,062 |
| Goods for processing | 1,881 | 1,787 | 1,698 | 1,783 | 1,871 | 1,962 | 2,058 |
| Import of goods (f.o.b.) | -5,436 | -5,728 | -5,906 | -6,228 | -6,582 | -6,943 | -7,337 |
| General merchandise | 4,055 | 4,387 | 4,633 | 4,897 | 5,192 | 5,491 | 5,820 |
| Goods for processing | 1,381 | 1,340 | 1,273 | 1,331 | 1,391 | 1,452 | 1,517 |
| Services | -169 | -176 | -196 | -332 | -350 | -376 | -393 |
| Income | -408 | -562 | -578 | -599 | -633 | -683 | -746 |
| *Of which:* | | | | | | | |
| Interest on external public debt, net | -238 | -333 | -351 | -383 | -407 | -442 | -479 |
| Interest on external private debt, net | -91 | -144 | -158 | -124 | -123 | -127 | -138 |
| Current transfers | 2,117 | 2,544 | 2,748 | 2,955 | 3,133 | 3,305 | 3,480 |
| **Financial and capital account** | **1,186** | **538** | **686** | **838** | **919** | **951** | **996** |
| Capital account | 113 | 119 | 121 | 70 | 70 | 70 | 70 |
| Foreign direct investment | 68 | 150 | 149 | 254 | 268 | 283 | 299 |
| Public sector capital | 587 | 242 | 563 | 587 | 526 | 450 | 543 |
| Private sector capital | 418 | 27 | -147 | -72 | 56 | 149 | 85 |
| **Currency substitution** | **-25** | **-6** | **-5** | **0** | **0** | **0** | **0** |
| **Errors and omissions** | **-110** | **0** | **0** | **0** | **0** | **0** | **0** |
| **Change in net reserves (- = increase)** | **-316** | **170** | **-10** | **-95** | **-120** | **-120** | **-120** |
| | (Annual percentage change) | | | | | | |
| **Exports (f.o.b.)** | | | | | | | |
| Value | 4.7 | 1.8 | 1.3 | 6.1 | 5.0 | 6.4 | 6.6 |
| Volume | 2.2 | -0.9 | -1.2 | 4.0 | 2.9 | 4.3 | 4.4 |
| General merchandise | | | | | | | |
| Value | 1.4 | 11.8 | 9.1 | 7.3 | 5.0 | 8.1 | 8.2 |
| Volume | -0.4 | 9.3 | 6.4 | 5.1 | 3.0 | 6.0 | 6.1 |
| **Import (f.o.b)** | | | | | | | |
| Value | 11.1 | 5.4 | 3.1 | 5.4 | 5.7 | 5.5 | 5.7 |
| Volume | 8.6 | 1.5 | 0.7 | 3.6 | 3.8 | 3.6 | 3.8 |
| General merchandise | | | | | | | |
| Value | 12.4 | 8.2 | 5.6 | 5.7 | 6.0 | 5.8 | 6.0 |
| Volume | 10.3 | 5.7 | 2.9 | 3.6 | 3.9 | 3.7 | 3.9 |
| **Terms of trade** | **0.1** | **-1.0** | **0.1** | **0.2** | **0.2** | **0.2** | **0.2** |
| | (In percent of GDP) | | | | | | |
| **Current account balance** | **-4.9** | **-4.4** | **-4.0** | **-4.2** | **-4.3** | **-4.3** | **-4.2** |
| Export of goods (f.o.b.) | 21.2 | 20.4 | 19.6 | 19.7 | 19.6 | 19.8 | 20.0 |
| Import of goods (f.o.b.) | -36.4 | -36.2 | -35.6 | -35.5 | -35.6 | -35.5 | -35.6 |
| Net maquila exports | 3.3 | 2.8 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 |
| Current private transfers | 14.2 | 16.1 | 16.6 | 16.9 | 16.9 | 16.9 | 16.9 |
| Foreign direct investment | 0.5 | 1.0 | 0.9 | 1.5 | 1.5 | 1.5 | 1.5 |
| **Memorandum items:** | | | | | | | |
| Gross international reserves (US$ million) | 1,909 | 1,739 | 1,745 | 1,840 | 1,960 | 2,080 | 2,200 |
| In months of imports excluding maquila | 5.2 | 4.5 | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 |
| External public sector debt | 31.6 | 31.4 | 33.1 | 34.7 | 35.7 | 36.2 | 36.9 |
| Public sector debt service to exports of goods and services ratio | 13.3 | 23.8 | 16.8 | 19.6 | 17.7 | 16.9 | 16.6 |
| *Of which:* interest | 7.9 | 8.7 | 9.3 | 10.5 | 10.8 | 10.9 | 11.1 |

Sources: Central reserve bank; and Fund staff estimates.

1/ Baseline projection prepared by staff.

Table 9. El Salvador: Public Debt Sustainability Framework
(In percent of GDP, unless otherwise stated)

| | Actual | | Prel. | Projections | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2003 | | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| | | | | **I. Baseline Projections** | | | | |
| **Public sector debt 1/** | 46.1 | | 44.8 | 46.2 | 47.1 | 47.4 | 47.2 | 47.4 |
| Primary deficit | 1.8 | | 0.7 | 0.7 | 0.6 | 0.0 | -0.5 | -0.2 |
| Public sector debt-to-revenue ratio | 286.0 | | 285.8 | 278.7 | 287.2 | 282.5 | 274.2 | 267.5 |
| Gross financing need 2/ | 5.4 | | 6.3 | 5.5 | 5.6 | 4.5 | 3.8 | 4.0 |
| In billions of U.S. dollars | 0.8 | | 1.0 | 0.9 | 1.0 | 0.8 | 0.7 | 0.8 |
| **Key macroeconomic and fiscal assumptions** | | 10-Year Historical Average | | | | | | |
| Real GDP growth (in percent) | 1.8 | 3.3 | 1.5 | 2.5 | 3.0 | 3.0 | 3.0 | 3.0 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | 2.4 | 2.2 | 0.8 | 3.2 | 3.7 | 3.8 | 3.8 | 3.9 |
| Inflation rate (GDP deflator, in percent) | 2.5 | 2.5 | 4.2 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | -0.1 | 4.6 | -6.7 | 7.5 | 1.7 | 1.8 | 2.2 | 7.9 |
| | | | | **II. Reinforced Policy Projections** | | | | |
| **Public sector debt 1/** | 46.1 | | 45.0 | 45.9 | 46.1 | 44.9 | 43.7 | 42.6 |
| Primary deficit | 1.8 | | 0.7 | -0.1 | -1.0 | -1.0 | -1.0 | -1.0 |
| Public sector debt-to-revenue ratio | 286.0 | | 285.8 | 265.0 | 255.6 | 251.9 | 247.1 | 230.4 |
| Gross financing need 2/ | 5.4 | | 6.3 | 4.7 | 4.6 | 3.4 | 2.9 | 2.8 |
| In billions of U.S. dollars | 0.8 | | 1.0 | 0.8 | 0.8 | 0.6 | 0.6 | 0.6 |
| **Key macroeconomic and fiscal assumptions** | | | | | | | | |
| Real GDP growth (in percent) | 1.8 | | 1.5 | 3.0 | 3.5 | 4.0 | 4.0 | 4.0 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | 2.4 | | 0.8 | 3.2 | 3.7 | 3.8 | 3.8 | 3.9 |
| Inflation rate (GDP deflator, in percent) | 4.2 | | 4.2 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | -0.1 | | -6.7 | 8.0 | 2.2 | 2.8 | 3.2 | 8.9 |
| | | | | **III. Debt Dynamics under Various Shocks** | | | | |
| 1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006 | | | | 46.9 | 48.3 | 48.6 | 48.5 | 48.6 |
| 2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 | | | | 46.7 | 48.7 | 49.5 | 49.7 | 50.2 |
| 3. Primary balance is at historical average minus two standard deviations in 2005 and 2006 | | | | 49.1 | 53.0 | 53.4 | 53.2 | 53.4 |
| 4. Combination of 1-3 using one standard deviation shocks | | | | 48.3 | 51.5 | 51.9 | 51.7 | 51.9 |
| 5. Alternative (adverse) scenario 4/ | | | | 46.4 | 48.0 | 49.5 | 51.0 | 53.4 |

Sources: Central reserve bank; ministry of finance; and Fund staff projections.

1/ Gross public sector includes general government, the central bank, public financial institutions, and nonfinancial public enterprises.
2/ Defined as public sector deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.
3/ Nominal interest rate is derived as nominal interest expenditure divided by the previous period debt stock.
4/ Assumes tax revenue stays at 12¾ percent of GDP as projected for 2005 and a primary fiscal deficit of 0.7 percent of GDP during the projection period.

Table 10. El Salvador: External Debt Sustainability Framework

(In percent of GDP, unless otherwise stated)

| | Actual | 10-Year Historical Average | Prel. | Projections | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2003 | | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| | | | | **I. Baseline Projections** | | | | |
| **External debt** | **44.2** | | **43.5** | **43.8** | **44.4** | **45.2** | **45.9** | **46.5** |
| Change in external debt | 6.1 | | -0.7 | 0.3 | 0.6 | 0.8 | 0.7 | 0.6 |
| External debt-to-exports ratio (in percent) | 165.8 | | 166.5 | 171.5 | 172.5 | 176.5 | 177.8 | 179.4 |
| Gross external financing need (in billions of U.S .dollars) 1/ | 1.7 | | 2.1 | 2.0 | 2.1 | 2.1 | 2.1 | 2.2 |
| In percent of GDP | 11.2 | | 13.5 | 12.1 | 12.2 | 11.5 | 11.0 | 10.8 |
| **Key macroeconomic assumptions** | | | | | | | | |
| Real GDP growth (in percent) | 1.8 | 3.3 | 1.5 | 2.5 | 3.0 | 3.0 | 3.0 | 3.0 |
| GDP deflator in U.S. dollars (change in percent) | 2.5 | 3.8 | 4.2 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Nominal external interest rate (in percent) | 6.9 | 5.1 | 7.6 | 8.0 | 8.2 | 8.1 | 8.1 | 8.2 |
| Current account balance, excluding interest payments | -2.4 | -0.4 | -1.3 | -0.7 | -0.8 | -0.9 | -0.8 | -0.7 |
| Net non-debt creating capital inflows | 0.0 | 0.7 | 2.2 | 0.7 | 1.4 | 1.4 | 1.4 | 1.4 |
| | | | | **II. Reinforced Policy Projections** | | | | |
| **External debt** | **44.2** | | **43.5** | **44.3** | **43.6** | **42.7** | **41.5** | **40.3** |
| Change in external debt | 6.1 | | -0.7 | 0.8 | -0.7 | -0.9 | -1.2 | -1.2 |
| External debt-to-exports ratio (in percent) | 165.8 | | 166.5 | 166.4 | 160.3 | 155.2 | 147.9 | 141.7 |
| Gross external financing need (in billions of U.S.dollars) 1/ | 1.7 | | 2.1 | 2.0 | 1.9 | 1.9 | 1.8 | 1.7 |
| In percent of GDP | 11.2 | | 13.5 | 12.1 | 10.6 | 10.3 | 8.9 | 8.0 |
| **Key macroeconomic assumptions** | | | | | | | | |
| Real GDP growth (in percent) | 1.8 | | 1.5 | 3.0 | 3.5 | 4.0 | 4.0 | 4.0 |
| GDP deflator in U.S. dollars (change in percent) | 2.5 | | 4.2 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Nominal external interest rate (in percent) | 6.9 | | 7.6 | 7.2 | 7.3 | 7.2 | 7.2 | 7.3 |
| Current account balance, excluding interest payments | -2.4 | | -1.3 | -1.1 | -0.8 | -0.9 | -0.6 | -0.5 |
| Net non-debt creating capital inflows | 0.0 | | 2.2 | 1.7 | 2.6 | 2.6 | 2.6 | 2.5 |
| | | | | **III. Debt Dynamics under Various Shocks** | | | | |
| 1. Nominal interest rate is baseline plus two standard deviations of historical average in 2005 and 2006 | | | 43.5 | 45.1 | 47.1 | 47.9 | 48.7 | 49.3 |
| 2. Real GDP growth is baseline minus two standard deviations of historical average in 2005 and 2006 | | | 43.5 | 45.3 | 47.6 | 48.4 | 49.1 | 49.7 |
| 3. Change in U.S. dollar GDP deflator is baseline minus two standard deviations of historical average in 2005 and 2006 | | | 43.5 | 45.9 | 48.7 | 49.5 | 50.2 | 50.8 |
| 4. Non-interest current account is baseline minus two standard deviations of historical average in 2005 and 2006 | | | 43.5 | 46.1 | 48.9 | 49.9 | 50.6 | 51.4 |
| 5. Lower world output and export demand in 2005 and 2006 2/ | | | 43.5 | 44.7 | 48.0 | 49.1 | 50.2 | 51.2 |
| 6. Combination of 1-4 using one standard deviation shocks | | | 43.5 | 46.4 | 49.7 | 50.6 | 51.4 | 52.1 |

Sources: Central reserve bank; ministry of finance, and Fund staff projections.

1/ Defined as external current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

2/ The potential negative impact is estimated by assuming zero export growth, which would worsen the current account and external debt in 2005 and 2006.

Table 11. El Salvador: Key Structural Reforms 1992-2004

| Scope and Key Elements | Implementation Period |
|---|---|
| **I. Public Finances** | |
| **Tax policy** | |
| Valued-added tax (VAT) adopted | 1992 |
| VAT rate raised from 10 to 13 percent | 1995 |
| VAT base broadened | 2001-03 |
| **Wage policy** | |
| Modernization of state and payroll cuts | 1995 & 2001 |
| Ethics code for civil servants introduced and civil service law reformed | 2001-02 |
| Nominal salaries for most civil servants maintained broadly stable | 2000-04 |
| **Privatization** | |
| Laws for privatization of telecommunication and electricity company | 1996 |
| Sale of four regional electricity distribution companies (75 percent) and three thermal generating plants | 1998-99 |
| Break-up and partial sale of the state telecoms monopoly (ANTEL) | 1998 |
| **Pension system** | |
| Approval for reforming the public social security and pension system | 1996 |
| Transition from pay-as-you-go pension system to fully-funded private accounts initiated | 1998 |
| Provision for early retirement phased out | 2004 |
| **Debt management** | |
| Replacing of short-term public debt for longer-term bonds intensified | 2002 |
| **II. Monetary and Exchange Rate Systems** | |
| Central bank recapitalized | 1993 |
| De facto exchange rate peg adopted | 1994 |
| Approval of central bank autonomy law | 1996 |
| Introduction of U.S. dollar as legal tender initiated | 2001 |
| **III. Trade policy** | |
| Preferential access to U.S. textile market under Caribbean Basin Initiative | Early 1990s |
| Trade liberalization, further reducing tariffs and non-tariff barriers | 1992-95 |
| External tariffs from Central American Common Market (CACM) adopted | 1996 |
| Free-trade agreements with Chile, Dominican Republic, Mexico, and Panama | 1998-2001 |
| Liberal regime for FDI introduced | 1999-2000 |
| Central America Free-Trade Agreement with the United States ratified | 2004 |
| **IV. Banking System** | |
| Privatization of banks (nationalized in 1980) | 1992-94 |
| Public bank (two-tier) created to assume development lending from central bank | 1994 |
| Banking law to strengthen the supervisory powers of regulators and tighten prudential regulations, including gradual increase in capital adequacy ratios (9.2 percent in 1999 to 12 percent in 2005) | 1999 |
| Reforms to banking law to strengthen protection of depositors, improve supervisory powers to take preventive and corrective measures against banks, and introduce consolidated supervision | 2002 |
| Liquidity buffers further strengthened and prudential regulations moved closer to international standards | 2003-04 |
| **V. Investment Climate** | |
| Labor code reformed to ease rules on fringe benefits and hiring/firing of workers | 1994 |
| Minimum wage maintained stable | 1998-2002 & 2004 |
| **VI. Political System** | |
| Peace accord and demobilization of FMLN and paramilitary forces, accompanied by a reconstruction program | 1992 |
| FMLN becomes a political party and participates in presidential, legislative, and municipal elections | 1994 |
| Constitutional change to limit duties of army and creation of new civilian police | 1992-94 |

Sources: Authorities of El Salvador; and Fund staff.

Table 12. Comparative Social Indicators

| | Costa Rica | **El Salvador** | Guatemala | Honduras | Nicaragua | Average for Latin America and the Caribbean |
|---|---|---|---|---|---|---|
| Rank in UNDP Human Development Index (out of 177 countries) (2004) | 45 | **103** | 121 | 115 | 118 | 79 |
| GDP per capita in PPP, U.S. dollars (2002) | 8,840 | **4,890** | 4,080 | 2,600 | 2,470 | 7,223 |
| People not expected to survive to age 40 (in percent of population) (2000–05) | 3.7 | **9.9** | 14.1 | 13.8 | 10.3 | n.a. |
| Life expectancy at birth (years) (2002) | 78.0 | **70.6** | 65.7 | 68.8 | 69.4 | 70.5 |
| Infant mortality (per 1,000 live births) (2002) | 9 | **33** | 36 | 32 | 32 | 27 |
| Population without access to safe water (2000) | 5 | **23** | 8 | 12 | 23 | 14 |
| Per capita health exp. in PPP, U.S. dollars (2001) | 562 | **376** | 199 | 153 | 158 | n.a. |
| Physicians per 100,000 people (1990–2003) | 160 | **126** | 109 | 87 | 62 | n.a. |
| Adult illiteracy (2002) | 4.2 | **20.3** | 30.1 | 20.0 | 23.3 | 11.4 |
| Primary school net enrollment (2001–02) (percent of relevant age of the population) 1/ | 91 | **89** | 85 | 87 | 82 | 94 |
| Secondary school net enrollment (2001/02) (percent of relevant age of the population) 1/ | 51 | **46** | 28 | ... | 37 | 61 |
| Share of income or consumption (in percent) 2/ | | | | | | |
| Poorest 10 percent | 1.4 | **0.9** | 0.9 | 0.9 | 1.2 | n.a. |
| Richest 10 percent | 34.8 | **40.6** | 48.3 | 42.2 | 45.0 | n.a. |
| Gini index (Human Development Report, 2003) 3/ | 46.5 | **53.2** | 48.3 | 55.0 | 55.1 | n.a. |
| Percentage of population below the poverty line 3/ | 18.5 | **37.2** | 56.0 | 63.9 | 47.9 | 44.7 |

Source: UNDP Human Development Report 2004.

1/ Data of net enrollment ratios are based on the new International Standard Classification of Education, adopted in 1997 (UNESCO 1997), and may not be strictly comparable with those for earlier years. Data for some countries may refer to national or UNESCO Institute for Statistics estimates. For details, see http://www.uis.unesco.org/. Because data are from different sources, comparisons across countries should be made with caution.

2/ Survey based on income.

3/ Data refer to the most recent year available during the period specified. The average is for Central America.

Table 13. Central America: Comparative Governance Indicators 1/

| | Voice and Accountability | Political Stability | Government Effectiveness | Regulatory Quality | Rule of Law | Control of Corruption |
|---|---|---|---|---|---|---|
| **Costa Rica** | | | | | | |
| 2002 | 84.8 | 86.5 | 66.5 | 72.7 | 72.2 | 79.4 |
| 1997/98 | 87.8 | 81.2 | 73.5 | 90.9 | 71.5 | 76.6 |
| **El Salvador** | | | | | | |
| **2002** | **51.5** | **56.8** | **35.6** | **56.2** | **39.7** | **36.6** |
| **1997/98** | **49.4** | **48.1** | **44.5** | **99.4** | **29.7** | **41.6** |
| **Guatemala** | | | | | | |
| 2002 | 35.4 | 32.4 | 32.0 | 52.1 | 21.6 | 30.9 |
| 1997/98 | 33.1 | 22.1 | 45.8 | 66.7 | 10.3 | 18.8 |
| **Honduras** | | | | | | |
| 2002 | 46.0 | 38.4 | 27.3 | 41.8 | 23.7 | 27.3 |
| 1997/98 | 51.2 | 36.4 | 36.1 | 43.6 | 17.0 | 11.0 |
| **Nicaragua** | | | | | | |
| 2002 | 52.0 | 47.6 | 17.5 | 39.7 | 32.0 | 39.7 |
| 1997/98 | 57.6 | 37.7 | 29.7 | 37.0 | 25.5 | 18.2 |
| **Average for Central America** | | | | | | |
| 2002 | 53.9 | 52.3 | 35.8 | 52.5 | 37.8 | 42.8 |
| 1997/98 | 55.8 | 45.1 | 45.9 | 67.5 | 30.8 | 33.2 |
| **Average for Latin America and the Caribbean** | | | | | | |
| 2002 | 61.2 | 51.2 | 53.3 | 58.4 | 53.2 | 54.9 |
| 1997/98 | 59.1 | 45.0 | 48.3 | 66.4 | 43.9 | 46.7 |

Source: Kaufmann, Kraay, and Mastruzzi (2003), http://info.worldbank.org/governance/kkz/

1/ Percentile rank with a higher number denoting better governance.

# Table 14. El Salvador: Millennium Development Goals

(In percent, unless otherwise noted)

| | 1990 Benchmark | 2015 Goal | 2002 Estimate | Status 1/ |
|---|---|---|---|---|
| **1. Poverty** | | | | |
| Halve extreme poverty | 31.0 | 15.5 | 15.0 | Achieved |
| Halve malnutrition 2/ | 23.3 | 11.6 | 19.6 | Unlikely |
| **2. Education** | | | | |
| Achieve full enrollment in primary education education to 100 percent | 74.0 | 100.0 | 85.0 | On track |
| **3. Gender equality** | | | | |
| Raise girls/boys ratio in primary and secondary | 100.0 | 100.0 | 101.0 | Completed |
| **4. Child mortality** | | | | |
| Reduce child mortality under 5 years of age by two-thirds | 60.0 | 20.0 | 39.0 | On track |
| **5. Maternal health** | | | | |
| Reduce maternal mortality rate (for each 100,000 live births) by three-fourths 2/ | 158.0 | 40.0 | 172.0 | Unlikely |
| **6. Environment** | | | | |
| Halve the proportion of individuals without access to improved water source | 34.0 | 17.0 | 23.0 | On track |
| Halt forest degradation (percent of total land) 3/ | 9.3 | 9.3 | 5.8 | Off track |
| **7. Global partnership for development 4/** | | | | |
| Develop and implement strategies for youth employment employment (youth unemployment rate in percent of total labor force ages 15/24) | 14.7 | n/a | 12.0 | On track |
| Make available the benefits of new information technologies (Use of internet - per 100 people) 5/ | 0.3 | n/a | 1.3 | On track |

Sources: Official information; and Country Assistance Strategy of the World Bank.

1/ As reported by the World Bank.
2/ Benchmark data is from 1993.
3/ Estimate data is from 2001.
4/ The objective has various qualitative targets.
5/ Benchmark data is from 1996.

Table 15. El Salvador: Sequence of Structural Reforms

| Measures | Sector | Implementation prospects |
|---|---|---|
| **I. Immediate Measures (Next 6 months)** | | |
| Increase in selected excise taxes | Fiscal | Implemented (December 2004) |
| Reduce evasion further and bring informal activities into the tax base | Fiscal | High. Reforms to tax code and tax administration underway to support this effort |
| Target subsidies on water and liquefied gas only to the poor | Fiscal | High. To be implemented in 2005 |
| Make permanent a special liquidity requirement (6 percent of deposits) | Monetary | High. Requirement to be retained |
| Restructure balance sheet of the central bank as envisaged in dollarization law | Monetary/Fiscal | High. Proposal to be submitted to congress in 2005, and carried out over a 2-3 year period |
| Formalize current practices for central bank operations, while restructuring is carried out | Monetary | Authorities agreed in principle. Actions would entail setting a floor for government deposits and keep stock of central bank paper stable |
| Align prudential norms to best-practice standards | Banking | High. Regulations to be issued in early 2005 will provide for a 4-year implementation period |
| Reinforce consolidated supervision and enhance the autonomy and powers of the superintendency of banks | Banking | High. Reforms to the banking law to be submitted to congress by April 2005 |
| Secure approval of CAFTA | Trade | Implemented (December 2004) |
| Secure approval of anti-trust law to support CAFTA | Trade | Implemented (November 2004). Law provides a legal framework for competition |
| **II. Near-Term Measures (Next 1-2 years)** | | |
| Raise value-added tax rate | Fiscal | Medium |
| Introduce a property tax | Fiscal | High. A property registy has been created and legislation would need to be prepared |
| Align excise taxes on petroleum products with those in the region (as world oil market conditions permit) | Fiscal | Medium |
| Increase gradually the minimum retirement age | Fiscal | Low. Authorities agree with measure, but political support unlikely |

Table 15. El Salvador: Sequence of Structural Reforms

| Measures | Sector | Implementation prospects |
|---|---|---|
| Transfer expenditure tasks to local governments (in line with recent rise in revenue-sharing from 6 to 7 percent) | Fiscal | Medium. Authorities agree with this measure and legislation would need to be prepared |
| Phase out subsidies for nontraditional exports | Fiscal | High. To be implemented by end-2005 |
| Shift supervision toward risk management and develop early-warning signal system | Banking | High. Preparatory work to be done in 2005 |
| Improve bank resolution practices | Banking | High. To be implemented in 2005-06 |
| Increase private sector participation in infrastructure (ports, power generation, water, roads) | Investment climate | High. A top priority in the authorities' agenda |
| **III. Medium-Term Measures (Next 2-3 years)** | | |
| Conclude restructuring of public financial institutions | Monetary | These institutions will focus on lending for small businesses while political support for privatization is developed |
| Strengthen the lender-of-last-resort function and the deposit insurance scheme | Banking | The authorities agreed in principle with this measure; in the meantime, current liquidity requirement will provide a cushion against systemic liquidity shocks |
| Approval of improvements to the insolvency and credit rights' framework | Banking | Legislation will be prepared for this purpose during 2005 |
| Approval of the free-trade agreement with Canada and European Union | Trade | Progress expected during 2005-06 |
| Enhance labor market flexibility, including by allowing for hourly wages and reducing overtime costs | Investment climate | Political support will be needed; labor sector may resist reform without proper social safeguards |
| Continue to make progress on security and governance (i.e., rule of law) | Investment climate | Ongoing |
| Improve transparent and competitive bidding for government procurement | Investment climate | Ongoing |

Table 16. El Salvador: Comparison of Selected Financial Soundness Indicators with Other Highly Dollarized Economies 1/

(In percent; end-September 2004, unless specified otherwise)

| | El Salvador | Bolivia | Ecuador 2/ | Panama | Peru |
|---|---|---|---|---|---|
| Liquidity requirements (in percent of deposits) | 29.0 | 10.0 | 0.0 | 30.0 | 8 3/<br>20 4/ |
| Liquid assets to short-term liabilities (or short-term deposits) | 36.2 | 18.1 | 29.3 | 28.4 | 43.7 |
| NPLs to total loans 5/ | 2.7 | 16.9 | 8.3 | 2.0 | 4.6 |
| NPLs to total loans 6/ | 12.0 | 25.5 | ... | ... | 10.8 |
| Total provisions to NPLs 5/ | 128.6 | 76.5 | 101.7 | 163.6 | 154.7 |
| Total provisions to NPLs 6/ | 28.4 | 41.9 | ... | ... | 55.4 |
| Capital to risk-weighted-assets ratio | 13.0 | 15.0 | 12.2 | 18.8 | 14.3 |
| Return on average assets | 1.0 | -0.1 | 1.6 | 2.1 | 1.1 |

Sources: El Salvador's 2004 FSSA update; and Fund Occasional Paper No. 230 (pages 16-17).

1/ Different definitions across countries imply that the numbers may not be strictly comparable.
2/ Data on capital adequacy as of end-March 2004.
3/ On domestic currency.
4/ On foreign currency.
5/ NPLs are defined as overdue loans.
6/ NPLs are defined as the sum of the lowest three loan classification categories.

## EL SALVADOR—PUBLIC DEBT SUSTAINABILITY

### A. Background

1. **El Salvador's public sector debt has risen rapidly since 1999, although its structure has improved.** Public debt is projected to reach 45 percent of GDP in 2004 compared to 34 percent in 1999. In contrast, gross financing needs have declined recently, owing to the substitution of most short-term debt with long-term sovereign bonds in 2002. Prudent debt management has doubled the average maturity of the public debt to nearly ten years over the period 1999–2004.

2. **The increase in debt reflects sizable primary fiscal deficits.** Primary deficits averaged nearly 2 percent of GDP per year during 1999–2004, driven in part by post-earthquake reconstruction outlays and pension reform costs. Despite low real interest rates, the interest burden climbed in 2002-03 owing to the rising debt level. The use of privatization proceeds (nearly 2 percent of GDP) to cover the fiscal deficit is expected to slightly reduce the debt ratio in 2004.

Table 1. El Salvador: Public Sector Debt 1/

(In percent of GDP)

| | 1999 | 2000 | 2001 | 2002 | 2003 | Est. 2004 |
|---|---|---|---|---|---|---|
| Public sector debt | 34.1 | 36.2 | 39.4 | 43.5 | 46.1 | 44.8 |
| Identified debt-creating flows (net) | 0.1 | 1.2 | 2.5 | 3.3 | 2.0 | -1.5 |
| Primary deficit | 1.2 | 1.4 | 2.9 | 2.9 | 1.8 | 0.7 |
| Automatic debt dynamics | 0.2 | -0.2 | -0.3 | 0.3 | 0.2 | -0.3 |
| Real interest rate | 1.3 | 0.5 | 0.3 | 1.2 | 1.0 | 0.3 |
| Real GDP growth | -1.1 | -0.7 | -0.6 | -0.8 | -0.8 | -0.7 |
| Privatization proceeds | -1.3 | 0.0 | -0.1 | 0.0 | 0.0 | -1.9 |
| Residual, including asset changes | 1.1 | 0.9 | 0.7 | 0.8 | 0.5 | 0.3 |
| **Memorandum items** | | | | | | |
| Combined public sector deficit | 2.6 | 3.0 | 4.3 | 4.6 | 3.8 | 2.9 |
| Public sector debt to revenue (in percent) | 226.8 | 230.1 | 266.8 | 283.7 | 286.0 | 284.5 |
| Gross financing need | 11.7 | 6.4 | 10.3 | 13.7 | 5.4 | 6.3 |
| In billions of U.S. dollars | 1.5 | 0.8 | 1.4 | 2.0 | 0.8 | 1.0 |
| Real GDP growth (in percent) | 3.4 | 2.2 | 1.7 | 2.2 | 1.8 | 1.5 |
| Average real interest rate (in percent) | 4.1 | 1.6 | 0.8 | 3.2 | 2.4 | 0.8 |

1/ Includes nonfinancial public sector debt, central bank paper, and medium- and long-term external liabilities of the central bank and state banks.

### B. Baseline Scenario

3. **Under the authorities' planned policies, staff project public debt to stabilize at about 47 percent of GDP over the medium term.** The projection is based on:

- A shift in the primary balance from a deficit of 0.7 percent of GDP per year in 2005-06 to a small surplus thereafter;

- An increase in the real interest rate to 3¾ percent over the period (2.4 percent in 2003), in line with WEO projections; and

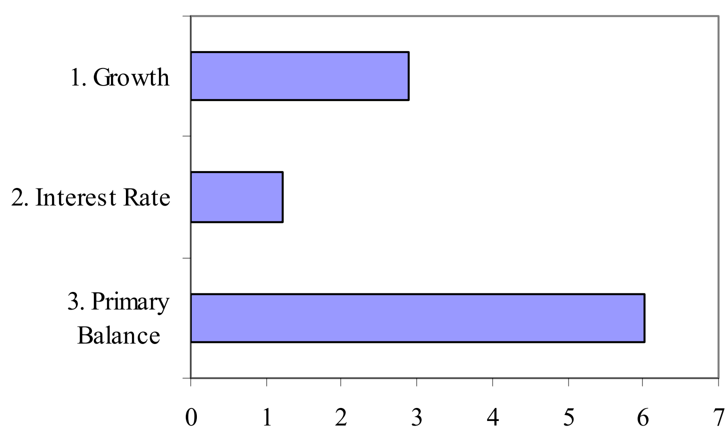
- Real GDP growth of 3 percent per year, due to improved investment and productivity.

Table 2. El Salvador: Public Sector Debt
(In percent of GDP)

| | Projection | | | | |
|---|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 | 2009 |
| Public sector debt | 46.2 | 47.1 | 47.4 | 47.2 | 47.4 |
| Primary deficit | 0.7 | 0.6 | 0.0 | -0.5 | -0.2 |
| Public sector debt to revenue (in percent) | 278.7 | 287.2 | 282.5 | 274.2 | 267.5 |
| Gross financing needs | 5.5 | 5.6 | 4.5 | 3.8 | 4.0 |
| **Memorandum item** | | | | | |
| Real interest rate (in percent) | 3.3 | 3.3 | 3.7 | 3.8 | 3.8 |

4. **Under this scenario, the public finances would remain vulnerable to shocks.** While relatively low gross financing needs would provide some protection against adverse shocks, a shift in market sentiment could heighten funding costs and shorten average maturity over time. Standard sensitivity tests indicate that the debt dynamics are sensitive to fiscal shocks and output growth volatility. Using 2004 as a starting point and two-standard deviation shocks for 2005–06, a higher primary deficit (or lower GDP growth) would increase the debt ratio by 6 percentage points (or 3 percentage points) of GDP by 2009, compared to the baseline scenario (Figure 1)

Figure 1. Sensitivity Test on Public Debt
(In percentage points of GDP)



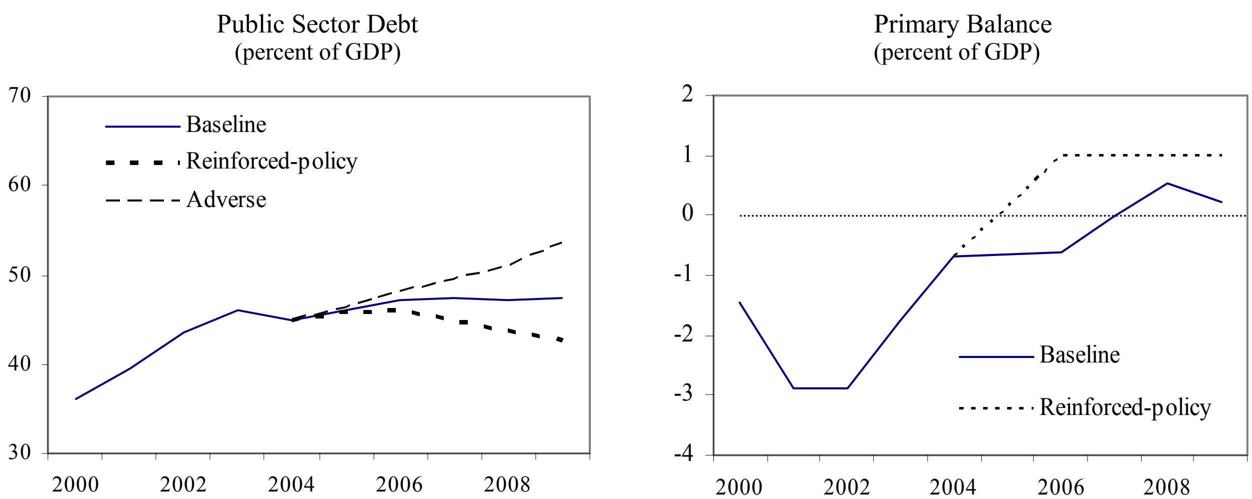

Shocks to baseline projection (two-standard deviations from historical levels in 2005–06 for output growth, interest rate, and primary balance):
1. Real GDP grows by 0.8 percent, compared to 3 percent in the baseline.
2. Real interest rate increases to 4.9 percent from 3.5 percent in the baseline.
3. The primary deficit reaches 3.2 percent of GDP from a small surplus in the baseline.

## C. Other Scenarios

5. **Reinforced-policy scenario.** Further fiscal consolidation and structural reforms as recommended by staff would improve debt dynamics. This scenario assumes a recovery in growth to levels in the 1990s (4 percent) and a primary surplus of 1 percent of GDP over the medium term, mainly as a result of further tax and expenditure reform. This would lead to a steady decline in the public debt to under 43 percent of GDP by 2009 (Figure 2), or 230 percent of government revenue (compared to nearly 270 percent in the baseline). External indebtedness would fall to under 140 percent of exports by 2009 (nearly 170 percent in 2004).

6. **Alternative (adverse) scenario.** The main downside risks to the baseline scenario stem from fiscal slippages. Public debt would rise to nearly 55 percent of GDP by 2009 under the assumption that: (i) the primary deficit remains at 0.7 percent of GDP over the period, and (ii) growth is the same as in the baseline scenario.

Figure 2. El Salvador: Alternative Scenarios



## EL SALVADOR: FUND RELATIONS
(As of November 30, 2004)

I. **Membership Status:** Joined March 14, 1946; Article VIII

| II. **General Resources Account:** | **SDR Million** | **Percent of Quota** |
|---|---|---|
| Quota | 171.30 | 100.00 |
| Fund holdings of currency | 171.30 | 100.00 |
| Reserve position in Fund | 0.00 | 0.00 |

| III. **SDR Department:** | **SDR Million** | **Percent of Allocation** |
|---|---|---|
| Net cumulative allocation | 24.99 | 100.00 |
| Holdings | 24.98 | 99.99 |

IV. **Outstanding Purchases and Loans:**
None

V. **Financial Arrangements:**

| **Type** | **Approval Date** | **Expiration Date** | **Amount Approved (SDR million)** | **Amount Drawn (SDR million)** |
|---|---|---|---|---|
| Stand-By | 09/23/98 | 02/22/00 | 37.68 | 0.00 |
| Stand-By | 02/28/97 | 05/30/98 | 37.68 | 0.00 |
| Stand-By | 07/21/95 | 09/20/96 | 37.68 | 0.00 |

VI. **Projected Obligations to the Fund:**
None

VII. **Safeguards Assessments:**

FIN completed the off-site safeguards assessment of the central reserve bank (BCR) in 2002. The BCR's safeguards were generally adequate, and a stage two (on-site) assessment was not needed. Based on the recommendations of the safeguards assessment, the BCR (i) has agreed to publish the audited general balance sheet, income statement, and the opinion on the financial statements; (ii) is adopting International Accounting Standards (IAS), with the expectation that the 2004 financial statements will be fully compliant with IAS; and (iii) restructured its audit committee in January 2003 to have a majority representation of independent directors to ensure objectivity on the audit process.

VIII. **Exchange Arrangement**:

Effective January 1, 2001, the dollar became legal tender and circulates freely. The dollar is used as a unit of account and a medium of exchange, with no limitations. All payments may be made in either dollars or colones. The BCR has the obligation to exchange colones in circulation for dollars upon request from banks, at a fixed and unalterable exchange rate of C 8.75 per U.S. dollar. As a result, El Salvador has an exchange rate arrangement with no separate legal tender category.

El Salvador has accepted the obligations of Article VIII, Sections 2, 3 and 4 and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

IX. **Article IV Consultation:**

The last Article IV consultation was concluded on July 18, 2003. El Salvador is under the standard 12-month cycle.

X. **FSAP Participation and ROSCs:**

FSAP conducted in 2000, FSSA report considered by the Executive Board on July 23, 2001. FSAP update conducted in February-March and October-November 2004. FAD ROSC conducted in May-June 2002. STA ROSC data module conducted in August 2003.

XI. **Technical Assistance (since October 2000):**

| **Department** | **Dates** | **Purpose** |
|---|---|---|
| FAD | October 2000 | Tax and customs administration |
| | June 2001 | Install a regional expert |
| | July 2002 | Tax administration inspection visit |
| | April 2004 | Tax reform |
| INS | February 2002 | Course on trade and exchange rate policies |
| STA | May 2001 | Money and banking statistics |
| | August 2001 | Regional visit on data template |
| | February and November 2004 | National Accounts |

XII. **Resident Representative:** None

## El Salvador: Relations with the World Bank Group
(As of November 30, 2004)[1/]

### I. Financial Relations

#### A. IBRD Lending Operations by Sector
(In millions of U.S. dollars)

| | Disbursed | Undisbursed |
|---|---|---|
| **IBRD active portfolio** | | |
| Education | 116.9 | 29.2 |
| Health infrastructure | 3.0 | 139.6 |
| Environment | 46.1 | 3.9 |
| Public sector management | 18.2 | 24.0 |
| Fully disbursed operations | 585.5 | 0.0 |
| **Total** | **769.7** | **196.7** |
| IBRD | 741.7 | 196.7 |
| IDA | 28.0 | 0.0 |
| *Of which* | | |
| Repaid | 406.8 | |
| IDA | 15.2 | |
| IBRD | 391.6 | |
| **Debt outstanding** [2/] | **358.5** | |

#### B. IBRD Loan Disbursements

| | 2000 | 2001 | 2002 | 2003 | 2004 [3/] |
|---|---|---|---|---|---|
| Gross disbursements | 34.4 | 49.5 | 63.2 | 38.1 | 10.7 |
| Amortization (cash) | 17.4 | 24.2 | 27.2 | 37.0 | 36.9 |
| **Net disbursements** | **17.0** | **25.3** | **36.0** | **1.1** | **-26.3** |
| Interest and charges | 23.7 | 23.5 | 18.6 | 18.1 | 11.4 |
| **Total net flows** | **-6.7** | **1.8** | **17.4** | **-17.0** | **-37.7** |

Source: World Bank.

1/ Net of cancellations.
2/ Includes amounts sold to third parties and exchange rate adjustment for US$-4.4 million.
3/ As of November 30, 2004.

## II. Recent and Planned IBRD Activities

The last Country Assistance Strategy (CAS) was discussed by the Board in November 2001. The CAS covered the FY02–04 period and supported three interrelated development objectives: (i) sustaining efforts to reduce poverty and promoting social development; (ii) accelerating growth and developing new opportunities; and (iii) fine tuning the role of the public sector. It proposed lending of US$270 million over FY02–04, with a base case of five planned operations. Only two of the five planned projects were delivered during FY02–04: the Earthquake Emergency Reconstruction for US$142.6 million and Judicial Modernization for US$18.2 million. This was largely because some of the projects were postponed by the government as it faced severe fiscal constraints in the aftermath of the earthquakes. As a result, the Bank's current lending portfolio in El Salvador includes six investment projects in the areas of education, land administration, public sector management and health infrastructure totaling US$381 million, of which US$184 million (48 percent) had been disbursed as of November 30, 2004.

The Bank Group's assistance will be elaborated in a new Country Assistance Strategy covering FY05–08 which will propose a strategic program of lending and nonlending services to support the three main pillars of the government's development plan "Safe Country 2004–2009": (i) to accelerate broad-based, equitable economic growth and increase employment; (ii) to improve equity through building human capital and expanding access to socioeconomic infrastructure, assets and markets; and (iii) to enhance security and reduce vulnerability. In this context, Bank assistance would include: (i) support for implementation of the existing loan portfolio; (ii) new IBRD lending, including a Program of Development Policy Loans as the central component of the strategy, and investment operations in selective areas where the Bank has global expertise and comparative advantage and which complement the activities of other key development partners; (iii) analytical and advisory work, technical assistance, and facilitation of access by El Salvador to grants administered by the World Bank; (iv) learning and capacity development programs through the World Bank Institute (WBI) and the Global Distance Learning Center (GDLN) and (v) targeted private sector assistance provided by IFC and MIGA. The new CAS is scheduled for Bank Board presentation in January 2005.

In June 2004, the Bank completed five core diagnostic studies for El Salvador: a Country Economic Memorandum (CEM), focusing on sources of growth; a Poverty Assessment (PA) focusing on recent poverty and inequality trends; a Public Expenditure Review (PER) focusing on broad fiscal issues, the public expenditure management system and social sector expenditures; a Country Financial Accountability Assessment (CFAA) assessing the public expenditure management framework; and a Country Procurement Assessment (CPAR). In nonformal economic and sector work, the Corporate Social Responsibility Group worked with the government on strategies to stimulate dialogue around appropriate stakeholder roles in strengthening the implementation of an education-focused Corporate Social Responsibility Strategy.

# El Salvador: Relations with the Inter-American Development Bank

## I. Financial Relations

(In millions of U.S. dollars)

### A. Operations (as of December 1, 2004)

| **Loans** | **Total** | **Disbursed** | **Undisbursed** |
|---|---|---|---|
| Energy | 40.0 | 0.0 | 40.0 |
| Transportation | 57.7 | 32.2 | 25.6 |
| Education | 143.7 | 112.2 | 31.6 |
| Health and sanitation | 63.9 | 12.0 | 51.9 |
| Environment | 81.2 | 28.8 | 52.4 |
| Housing | 69.3 | 1.4 | 67.9 |
| Social investment, local development, and emergency | 69.8 | 42.1 | 27.7 |
| Public sector reform and modernization | 129.5 | 22.1 | 107.4 |
| Agriculture | 24.8 | 1.2 | 23.5 |
| **Total** | **679.9** | **251.9** | **428.0** |

### B. Loan Disbursements

| | **2000** | **2001** | **2002** | **2003** | **Prel. 2004** |
|---|---|---|---|---|---|
| Net disbursements | 73.1 | 107.2 | 85.8 | 18.9 | -23.9 |
| Gross disbursements | 115.6 | 169.6 | 143.7 | 96.2 | 56.1 |
| Amortization | 42.5 | 62.4 | 57.9 | 77.3 | 80.0 |

## II. Planned Activities (2005)[1]

| **Project Name** | **Projected Loan** |
|---|---|
| Rural Roads Program, Phase II | 49.0 |
| Census support | 25.0 |
| Social Safety Net | 50.0 |
| Higher Education (University of El Salvador) | 25.0 |
| Basic Education | 100.0 |
| **Total** | **249.0** |

## III. Future Plans

The policy dialogue with the new administration took place in August 2004. The new strategy paper (Estrategia del Banco para el País—EBP) will be prepared by early 2005 and is expected to be approved by the Board in the first quarter of 2005.

[1] Preliminary.

El Salvador: Core Statistical Indicators

(As of December 31, 2004)

| | Exchange Rates | International Reserves | Reserve/ Base Money | Central Bank Balance Sheet | Broad Money | Interest Rates | Consumer Price Index | Exports/ Imports | Current Account Balance | Overall Government Balance | GDP/ GNP | External Debt/ Debt Service |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Date of Latest Observation | 12/04 | 10/04 | 10/04 | 10/04 | 10/04 | 12/04 | 11/04 | 10/04 | 10/04 | 10/04 | 10/04 | 10/04 |
| Date Received | 12/04 | 12/04 | 12/04 | 12/04 | 12/04 | 12/04 | 12/04 | 12/04 | 12/04 | 12/04 | 12/04 | 12/04 |
| Frequency of Data 1/ | D | W | W | W | W | W | M | M | Q | M | AQ | Q |
| Frequency of Reporting 2/ | D | W | W | W | W | W | M | M | Q | M | AQ | Q |
| Source of Update 3/ | A | A | A | A | A | A | A | A | A | A | A | A |
| Mode of Reporting 4/ | T/E | T/E | T/E | T/E | T/E | T/E | T/E | T/E | T/E | T/E | T/E | T/E |
| Confidentiality 5/ | C | C | C | C | C | C | C | C | C | C | C | C |
| Frequency of Publication 2/ | D | W | W | M | W | W | M | M | Q | M | A | M |

1/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annual, or O-other.
2/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, V-irregularly in conjunction with staff visits, or O-other irregular basis.
3/ A-direct reporting by central bank, ministry of finance, or other official agency, N-official publication or press release, P-commercial publication, C-commercial electronic data provider, E-EIS, or O-other.
4/ E-electronic data transfer, C-cable or facsimile, T-telephone, M-mail, V-staff visits, or O-other.
5/ A-for use by the staff only, B-for use by the staff and the Executive Board, C-for unrestricted use, D-embargoed for a specified period and thereafter for unrestricted use, or E-subject to other use restrictions

**Statement by the IMF Staff Representative**
**January 31, 2005**

1. The information on recent developments presented below has become available since the staff report was issued. It does not affect the thrust of the staff appraisal.

2. **Inflation rose to 5.4 percent (year-on-year) in December.** The increase reflected mainly higher oil prices, and was in line with the projection in the staff report. Core inflation (excluding food and oil prices) was 4 percent.

3. **Preliminary data indicate a stronger fiscal performance for 2004 than estimated earlier.** The overall public sector deficit is now estimated at 2.6 percent of GDP in 2004 (3 percent in the staff report), with the primary deficit amounting to 0.3 percent of GDP. The improvement reflected mainly stronger tax collections and lower capital spending, and led to a build up in public sector deposits at the central bank.

4. **As a result, the net international reserves position was also stronger than anticipated.** Net international reserves (NIR) reached US$1.9 billion at end-2004, some US$150 million higher than originally projected.

5. **Congress is expected to approve the 2005 budget shortly.** It has already approved the limit on public sector borrowing proposed by the authorities. The budget coming out of congress is expected to be broadly in line with the draft submitted by the authorities.

INTERNATIONAL MONETARY FUND
*Public Information Notice*
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/21
FOR IMMEDIATE RELEASE
February 14, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

# IMF Executive Board Concludes 2004 Article IV Consultation with El Salvador

On January 31, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with El Salvador.[1]

**Background**

El Salvador has implemented a wide range of structural reforms over the last decade. Impressive reforms—including trade opening, privatization, and tax policy, civil service, and pension reform—have been supported by a broad national consensus. The reform effort was capped with official dollarization in 2001, which helped reduce interest rates and consolidated low inflation. This strategy has contributed to considerable improvements in per capita income and social conditions.

Nevertheless, economic growth in recent years has been dampened by adverse external conditions (including high oil prices), major earthquakes, and election-related uncertainties. Real GDP growth is estimated at about 1½ percent in 2004, while inflation picked up to over 5 percent, owing to higher oil prices. The public sector deficit is expected to decline to 3 percent of GDP in 2004 (from nearly 4 percent in 2003), although public debt remained at 45 percent of GDP and the debt of the nonfinancial public sector at 40.7 percent of GDP. A strong pick-up in family remittances more than offset the increase in oil imports, contributing to a decline in the external current account deficit to an estimated 4½ percent of

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of the Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the January 31, 2005 Executive Board discussion based on the staff report.

GDP in 2004 (from 5 percent in 2003). International reserves remained around US$1.7 billion, covering close to 30 percent of bank deposits.

The new government that took office in 2004 has embarked on a renewed reform effort to improve growth prospects and social conditions. A recently approved package of tax measures, including steps to improve tax administration, is projected to raise revenue by about 1 percent of GDP. Because of budgeted increases in social spending and investment, however, the fiscal position in 2005 will remain about the same as in 2004 (i.e., a primary deficit of about 0.7 percent of GDP). Planned banking reforms (including tighter prudential norms and improved supervision) are aimed at further strengthening the banking system. congress recently ratified a free-trade agreement with the United States (CAFTA).

**Executive Board Assessment**

Executive Directors praised El Salvador's long-standing record of structural reform and commitment to sound macroeconomic policies, and considered that official dollarization has served El Salvador well. Prudent policies and political stability have underpinned economic growth, significant poverty reduction, low inflation, and increased market confidence as reflected in El Salvador's investment-grade credit rating. Directors noted, however, that major challenges remain. Central among these is the need to revive economic growth, which has been sluggish as a result of natural disasters, declining terms of trade, and the economic slowdown in the United States. In addition, Directors stressed that dollarization still presents significant challenges, and that additional efforts are required to ensure its sustainability. These efforts should focus on strengthening the public finances and achieving debt sustainability.

Against this background, Directors welcomed the new government's reform agenda designed to consolidate the economic gains and maximize the benefits of dollarization, improve growth and social prospects, reduce external vulnerabilities, and achieve the Millennium Development Goals. They supported the agenda's focus on fiscal consolidation and structural reforms to raise national savings and improve productivity and competitiveness. They put particular emphasis on efforts to deepen trade reform, address infrastructure bottlenecks, increase labor market flexibility, and improve incentives for private investment. Above all, Directors observed that it will be important to build society's support for the reform agenda.

Directors considered that moderate primary fiscal surpluses will be required to place the public debt firmly on a downward path. In this context, they endorsed the authorities' medium-term plans to substantially increase tax revenues, including by strengthening tax administration to reduce tax evasion, and welcomed congress' recent approval of a package of revenue measures. Most Directors considered that additional measures may be needed in light of plans to boost social and infrastructure spending. Apart from further steps to strengthen the revenue side, Directors also encouraged the authorities to improve public expenditure management—including through further pension reform, improved control over local government expenditure, better targeting of subsidies, and other measures recommended in the 2004 Fiscal Report on the Observance of Standards and Codes. At the same time, they welcomed the planned increase in social and infrastructure spending, while containing non-productive spending and the wage bill, noting that well-targeted social investment is crucial for building human capital. They also supported plans to involve the private sector in infrastructure projects. Directors welcomed recent reforms to the pension system, stressing at the same time the need for increases in the retirement age. Directors endorsed the authorities' debt management strategy, which aims at further lengthening maturities and reducing financing costs.

Directors welcomed the authorities' plans to make financial sector strengthening a priority in the coming years, including the restructuring of the central bank. They encouraged the authorities to push ahead with the planned transfer of the central bank's non-monetary liabilities to the government, in order to eliminate central bank liquidity risks and enhance fiscal transparency. Some Directors also recommended that the central bank develop further its lender of last resort function and raise net international reserves over the medium term.

Directors welcomed the findings of the 2004 Financial System Stability Assessment (FSSA) update, which indicate that the financial sector generally is in good health and that dollarization has strengthened financial stability. They commended the authorities' strategy for banking sector reform and the envisaged alignment of prudential rules with international best practice, in line with the FSSA recommendations. They stressed, in particular, the importance of plans to strengthen consolidated supervision—especially for cross-border activities—as well as the autonomy of the superintendency of banks and bank resolution practices. Directors also called for a strengthening of the two state-owned banks and the deposit insurance fund. They also considered enhanced access to financial services and financial literacy programs to be essential for raising the national savings rate and channeling El Salvador's significant remittance inflows into investment rather than consumption.

Directors welcomed congress' recent ratification of the Central American Free Trade Agreement. They supported plans to secure free-trade agreements with other important trading partners, but also stressed the importance of pursuing further trade integration within the framework of multilateral trade negotiations. They emphasized that enhanced competitiveness and productivity will be needed to enable El Salvador to take full advantage of trade and investment opportunities arising from these agreements. In this regard, Directors welcomed the steps being taken to maintain a prudent wage policy, while stressing that further labor market flexibility will be important to keep labor costs competitive. It will be important also to improve the environment for private investment, including by reducing crime and corruption, strengthening the legal and regulatory environment, and improving governance and transparency.

Directors welcomed the authorities' ongoing efforts to improve macroeconomic statistics in line with Fund recommendations. In particular, they commended plans to improve the national accounts and government finance statistics within a framework of strengthened inter-agency coordination and data sharing.

***Public Information Notices (PINs)*** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

**El Salvador: Selected Economic and Financial Indicators**

| | | | Prel. | Proj. | |
|---|---|---|---|---|---|
| | 2001 | 2002 | 2003 | 2004 | 2005 |
| **Real economy (change in percent)** | | | | | |
| Real GDP | 1.7 | 2.2 | 1.8 | 1.5 | 2.5 |
| Consumer prices (end of period) | 1.4 | 2.8 | 2.5 | 5.5 | 2.5 |
| National savings (percent of GDP) | 15.6 | 13.3 | 11.7 | 11.4 | 12.7 |
| Gross domestic investment (percent of GDP) | 16.7 | 16.2 | 16.6 | 15.8 | 16.7 |
| **Public finances (percent of GDP)** | | | | | |
| Consolidated public sector deficit | 4.3 | 4.6 | 3.8 | 2.9 | 3.1 |
| Consolidated primary deficit | 2.9 | 2.9 | 1.8 | 0.7 | 0.7 |
| Public sector debt (percent of GDP, end of period) | 39.4 | 43.5 | 46.1 | 44.8 | 46.2 |
| *Of which* | | | | | |
| Nonfinancial public sector | 33.8 | 38.7 | 40.7 | 40.7 | 40.0 |
| **Money and credit (end-year, percent change)** | | | | | |
| Net domestic assets | 2.4 | -2.8 | -0.5 | 4.1 | 2.6 |
| *Of which* | | | | | |
| Nonfinancial public sector | 2.4 | -4.5 | 3.5 | -0.6 | -0.2 |
| Private sector | -1.6 | 6.2 | 6.4 | 4.8 | 5.1 |
| Liabilities to private sector | 2.6 | -2.6 | 1.7 | 2.5 | 2.5 |
| **Interest rates (average)** | | | | | |
| Deposit rate (six months) | 5.5 | 3.4 | 3.4 | 3.3 | … |
| Lending rate (more than one year) | 10.8 | 8.7 | 8.0 | 7.7 | … |
| **External sector** | | | | | |
| Trade balance (percent of GDP) | -14.0 | -13.1 | -15.2 | -15.8 | -16.0 |
| Current account balance (percent of GDP) | -1.1 | -2.9 | -4.9 | -4.4 | -4.0 |
| Change in net international reserves (millions of U.S. dollars, increase -) | 178 | 124 | -316 | 170 | -10 |
| Net international reserves | 1,710 | 1,589 | 1,906 | 1,736 | 1,746 |
| Gross international reserves (months of non-maquila imports of goods and services) | 5.8 | 4.7 | 5.2 | 4.5 | 4.3 |
| Terms of trade | -0.1 | -0.6 | 0.1 | -1.0 | 0.1 |
| Real effective exchange rate (end of period) 1/ | 1.2 | -2.2 | -5.1 | 0.8 | ... |

Sources: Central reserve bank; ministry of finance; and IMF staff estimates and projections.

1/ As of September 2004.

**Statement by Moises Schwartz, Executive Director for El Salvador and Gerardo Peraza, Senior Advisor to Executive Director January 31, 2005**

On behalf of the Salvadoran authorities, we thank staff for its constructive policy advice during the Article IV consultation discussions. We would like also to convey the authority's appreciation for a very professional and timely technical assistance particularly on tax reform and financial sector issues. The authorities broadly agree with the thrust of the staff appraisal.

Over more than 12 years, El Salvador has embarked on a path of market-oriented reforms that have brought in macroeconomic stability and a substantial improvement in socioeconomic conditions. As reported by staff, El Salvador "is often considered to be the second-best performer on reforms in Latin America [only after Chile]" while it is the only country in Central America with an investment grade.

In 2001, El Salvador capped the reform effort by officially adopting the U.S. dollar as a legal tender. So far, the dollarization has proven very helpful in anchoring expectations by lowering interest rates and consolidating low inflation. As this Chair indicated during the 2003 Article IV Consultation, the dollarization in the case of El Salvador "makes sense" given the close ties to the U.S. economy. Nonetheless, the Salvadoran authorities recognize that the regimen choice places great demand on a policy framework that needs to rely solely on sound and thorough economic reform as the only viable alternative to achieve sustainable and faster economic growth.

Moreover, El Salvador still faces important challenges. In this context, the government of President Saca that took office in June 2004 is confident that the proposed reform agenda (nicely summarized on table 15 of the staff report) will reinforce the dollarization regime while reinvigorate growth and facilitate a more effective reduction in poverty. Core elements of the authorities' agenda for the next five years are: (i) maintaining fiscal sustainability while promoting social equity, (ii) strengthening the financial system, and (iii) pursuing structural reforms to raise productivity. The authorities strongly believe that a successful implementation of their plans hinges on building the necessary domestic consensus around key policy issues.

***Recent developments and prospects***

After experiencing strong economic growth in the first half of the 90's, El Salvador's economy decelerated reflecting an adverse external environment, weak productivity, and two powerful earthquakes in 2001. In 2004, authorities' latest estimates put output growth at 1.8 percent (y/y) despite the negative impact of higher oil prices, uncertainty related to the Presidential elections, and the holdup of new investment projects due to delay in passing the 2004 fiscal budget. Inflation closed at 5.4 percent reflecting mostly higher oil prices while the external current account narrowed thanks to a sharp pick up in family remittances. Preliminary fiscal data also indicate a better fiscal balance on account of lower than projected capital spending and tax buoyancy toward the end of the year. The financial sector remains sound and the banks well capitalized with the capital adequacy ratio (CAR) at 12.8 in November 2004, with none of the banks reporting a CAR below the minimum requirement.

Looking forward, authorities are optimistic about growth and employment prospects. Strong capital inflows (in telecommunication, financial and manufacturing sectors) later last year signal an important backing to the authorities' policies. In addition, several projects will start operations during the first half of 2005 including a call center for Dell Computers and two textiles companies specialized in higher value-added products. Traditional agricultural products are already showing a strong rebound spurred by new business opportunities. Lastly, this week passage of the 2005 budget also bodes well for a timing execution of public investment program.

***Achieving fiscal sustainability with social equity***

The Salvadoran authorities are fully committed to ensure the sustainability of public debt. They are also trying to strike the right balance between public debt dynamics and higher social and capital spending. This is the same dilemma faced by several developing nations where addressing social inequalities is central to garner needed domestic support for reforms. Against this backdrop, the authorities moved quickly (within the first six months in office) to secure the passage of a comprehensive fiscal reform expected to yield about 1.3 percent of GDP (on annual basis) in additional revenue. Thus, in 2005, they plan to accommodate higher public investment (almost 1 percent of GDP) at the same time they maintain the primary deficit at last year level. Investment priorities for this year include the reconstruction of regional hospitals, rural electrification, water and basic infrastructure, and the beginning of the Cutuco port. This port facility will reduce cost and increase the capacity to export and the attractiveness of El Salvador for private investment. In addition, the 2005 budget already reflects the new social priorities of the government by reorienting public spending to expand the coverage and quality of health and education. The government has designed a social safety net program to be launched in the first quarter of 2005, with the assistance of the World Bank and the IADB, to direct public spending toward the most vulnerable municipalities.

On public debt management, the Salvadoran authorities have succeeded in lengthening the maturity of the debt by issuing long-term sovereign bonds and replacing a significant portion of short-term debt. A recent example is the placement of US$287 million in 30-year bonds at a fixed interest rate of 7.6 percent (270 basis points over comparable U.S. treasury bills, one of the lowest in Latin America). As a result, by end-2004, about 75 percent of nonfinancial public sector debt had a maturity of more than 10 years.

Looking forward, the authorities are confident that greater emphasis on tax administration will raise tax revenue by 3 percent of GDP in the period 2005-09 while stabilizing the nonfinancial public sector debt at around 38½ percent of GDP by 2009. Despite this fiscal constraint, the authorities plan to increase gradually over the next five years social spending as a percentage of GDP. The authorities will pursue a close monitoring of the fiscal position and be ready to adopt further fiscal reforms if necessary to achieve the debt objective.

***Strengthening financial sector***

Further strengthening of the financial sector remains a central priority in the authorities' agenda. Since 2000, the authorities have made important progress toward strengthening the regulation and supervision of the financial system. Most notably, policy actions include issuance of provisions for bank regularization and restructuring; improvements in onsite- and offsite-bank examinations; introduction of anti-money laundering procedures; and adoption of a plan to converge to International Financial Reporting Standards. In addition, as the financial sectors in Central America become more integrated and with conglomerates controlling an important share of the Salvadoran banks, the authorities have issued supervisory guidelines and improved communication with other regional supervisors to begin implementing consolidated supervision.

The government's financial sector agenda for the next coming years aims to restructure the central bank, strengthen further bank regulation and supervision, reinforce micro-lending, and enhance the insolvency and creditor rights system. Specific policy actions are in line with Fund staff recommendations. The authorities plan to request technical assistance in some of the key areas.

***Trade and competitiveness***

The authorities are determined to bolster the economy competitiveness by opening new trade opportunities, improving the investment climate, and enhancing domestic security. A faster growing economy is essential, along targeted public policy, to cause a significant dent in poverty.

In this context, El Salvador has pursued a very active and ambitious trade agenda. The country has already signed a number of bilateral agreements (México, Chile, Panamá and the Dominican Republic). At the same time, it continues to promote greater integration with neighboring countries marked more recently with the elimination of physical customs post between at the Guatemala-El Salvador borders. Honduras is expected to join in later this year. Regional trade is more diversified than extra-regional trade and benefit directly a larger number of small- and medium-size enterprises.

In 2004, El Salvador was the first country in Central America to ratify CAFTA. Full ratification of the trade agreement will cement the benefits under the Caribbean Basin Initiative and open up new business opportunities. CAFTA could bring lasting benefits in terms of the modernization of the institutional and legal framework, prior conditions for a more attractive investment climate. The Central American countries are negotiating a free trade agreement with Canada and are preparing the groundwork to start negotiations with the European Union.

On business environment, last November, the authorities secured passage of key anti-trust legislation to strengthen competition practices and protect trade and commerce from unfair practices. The Judicial Branch is also undergoing a process of modernization to enhance private security of individuals and for the protection of contracts and of investors' rights—

both key conditions of a well functioning market economy. In addition, President Saca has promoted a series of initiatives to tackle crime and violence while preserving human rights and civil liberties. Finally, the authorities have reiterated their commitment to strengthening anti-corruption and transparency initiatives to improve El Salvador's overall investment climate and a more effective public sector.