Moving El Salvador to a Path of Higher Growth and Declining Debt

By Mario Garza and Bogdan Lissovolik
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El Salvador has made important strides in reducing poverty and income inequality since the global crisis of 2008–09. Poverty declined from 40 percent of the population to 30 percent over the past five years—that is over 600,000 people no longer living below the poverty line. And prices have remained stable, helped by the dollarized regime.

But the Salvadoran economy has been growing at the slowest pace in Central America, high fiscal deficits persist, and public debt has been rising. Public debt—at 60 percent of GDP in 2014—is the highest in Central America. These vulnerabilities hurt macroeconomic stability and inhibit the continued progress needed to raise living standards for all Salvadorans. El Salvador’s key challenge ahead is to exit from the trap of low growth and high debt.

As discussed in our recent annual report on El Salvador, improving the country’s economy will require a two-pronged strategy: an ambitious fiscal adjustment to reduce public debt (with spending measures to protect the poor) and supply-side measures to raise growth and create more jobs. The success of this strategy hinges on an active public debate across all political parties and the Salvadoran society to determine the right steps to achieve both these goals.

A strategy for growth

Over the past four years, the Salvadoran economy grew by only 1.8 percent a year, about 3 percentage points below the growth in the rest of Central America. Under current policies, growth is expected to increase only modestly—to 2½ percent in 2014–15 and possibly 2½ percent in 2016–18. Such an uninspiring growth path is simply not enough to create the jobs and improve the livelihoods of the population that the government aspires to. Also,

Sources: National authorities and Fund staff calculations.
1/ Simple average of Costa Rica, Guatemala, Honduras, Nicaragua, Panama, and the Dominican Republic.
with relatively weak growth outcomes, the fiscal deficit would persist at an unacceptably high level—rising steadily from 4 percent of GDP over the past four years to 5½ percent by 2019. This combination of low growth and high fiscal deficits would lead public debt to exceed 70 percent of GDP by 2019, limiting the fiscal space to lessen income inequalities further and generating substantial financing risks for the government.

But these outcomes are not inevitable and there is an alternative. Ambitious and aggressive steps on the supply-side could raise longer-term growth closer to 3 percent, as targeted by the government. This must include steps to encourage private investment, enhance productivity, and boost the competitiveness of the export sector.

What should be the priorities? At the top of our list would be measures that promote economic diversification, ease red-tape, improve public safety and security, lower energy costs, and upgrade physical infrastructure. To broaden economic opportunities and foster social inclusion, emphasis should be given to strengthening primary education, broadening the coverage of health programs, and providing incentives to reduce labor market informality. Adoption of the authorities’ development plan, together with the FOMILENIO II investment grant from the United States, provides a strong basis to advance such essential reforms.

**Reining in public debt**

The second leg of the road ahead should be to reduce fiscal imbalances and restore debt sustainability. Fortunately, there is broad social consensus in this area but views differ on the size, pace, and composition of the necessary fiscal adjustment.

The solution certainly entails difficult social choices and we don’t have all the answers—it will be for the Salvadoran people and their political representatives to decide this question. However, we believe that a gradual adjustment of 3½ percent of GDP spread over the next 3 years will bring public debt back down below 50 percent of GDP over the next 10 years. This will significantly reduce fiscal risks and help ensure El Salvador maintains access to market financing on favorable terms. Certainly, this is a more ambitious fiscal plan than will be discussed in Congress in the coming months, in the context of the fiscal responsibility law. However, we believe, given the current global nexus and risks, now is the time for a bolder objective.
The right composition of revenue and expenditure measures to generate this adjustment should be part of the public debate and decided after a broad consultation with the Salvadoran society. Fortunately, there are several options. For instance, El Salvador could aim to align its tax system with the region by raising the value-added tax rate and introducing a property tax. An important contribution could come from reversing the upward trend in the government’s wage bill and ensuring that all public subsidies are directed toward supporting the poor.

Beyond this gradual adjustment, a plan is also needed to reduce the large unfunded pension liabilities that currently amount to over 90 percent of GDP. Inevitably this will imply difficult decisions to raise contributions and lessen pension benefits over time. This will need to be combined with an effort to ensure that the security of old-age pensions is expanded to cover the entire population.

The government has a fresh opportunity after the 2015 March congressional election to act audaciously and decisively. Doing so will ensure a future of better growth and job security, improve living standards, and bring public debt down to safer levels.

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