February 2009
IMF Country Report No. 09/71

El Salvador: Request for Stand-By Arrangement—Staff Report; Staff Supplement and Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for El Salvador

In the context of the request for a Stand-By Arrangement for El Salvador, the following documents have been released and are included in this package:

- The staff report for the Request for Stand-By Arrangement prepared by a staff team of the IMF, following discussions that ended on December 22, 2008, 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 9, 2009. 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 supplement of January 9, 2009, on the assessment of the risks to the Fund and the Fund's liquidity position.

- A staff statement of January 16, 2009, updating information on recent developments.

- A Press Release summarizing the views of the Executive Board as expressed during its January 16, 2009 discussion of the staff report that approved the request.

- A statement by the Executive Director for El Salvador.

The documents listed below have been separately released.

Letter of Intent sent to the IMF by the authorities of El Salvador*
Memorandum of Economic and Financial Policies by the authorities of El Salvador*
Technical Memorandum of Understanding*
*Also included in Staff Report

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

EL SALVADOR

Request for Stand-By Arrangement

Prepared by the Western Hemisphere Department in Consultation with Other Departments

Approved by Miguel A. Savastano and Alan MacArthur

January 9, 2009

Discussions. Discussions were held in San Salvador during December 15–22, 2008. The mission met with the Technical Secretary of the Presidency Eduardo Ayala Grimaldi, Minister of Finance William Handal, Central Bank President Luz María Serpas de Portillo, other senior government officials, and the leading presidential candidates.

Staff team. The mission comprised Messrs. Schipke (Head), Bannister, Prat, Swiston (all WHD) and Ms. Martin (SPR). An MCM TA mission on financial sector preparedness (including on the ability of the central bank to inject liquidity) took place concurrently. Two FAD TA missions (on tax administration, energy subsidies, and social spending) also overlapped with the start of the mission.

Context. Despite solid macroeconomic fundamentals, during 2009 El Salvador could be adversely affected by the global financial crisis, the U.S. recession, and election-related uncertainty. The authorities are requesting a Stand-By Arrangement through March 31, 2010, with access of SDR 513.9 million (300 percent of quota), as part of their strategy to maintain adequate bank liquidity in the officially dollarized economy. The high-access arrangement is expected to play a catalytic role in strengthening investor and depositor confidence by reducing uncertainty about macroeconomic policies in the run-up to the elections, and during the first few months of the new administration. The authorities' intention is to treat the arrangement as precautionary and consent to the publication of the Staff Report.

The program. The Fund-supported program will focus on crisis preparedness, continued prudent fiscal policies, and financial sector reforms.

- Financial contingency measures, including closely monitoring bank liquidity and short-term borrowing. The authorities have concrete action plans to deal with stress in the banking system.
- Short-term fiscal policy. Maintain fiscal restraint by keeping the nonfinancial public sector deficit below 2.8 percent of GDP in 2009. The authorities could increase social and infrastructure spending by $50 million, if additional external financing becomes available.
- Structural reforms. Further strengthen financial sector regulation and supervision and enhance the banking system's ability to weather shocks.

Political situation. Congressional elections are scheduled to take place on January 18, 2009, while the first round of the presidential elections will take place in March.

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I. Background

1. **El Salvador's macroeconomic fundamentals are solid and have improved in recent years**. Fiscal consolidation led to a reduction in the public debt-to-GDP ratio, and in 2006–07 the country experienced the highest growth rates in a decade. In the recently concluded Article IV consultation, Directors highlighted the strength of El Salvador's macroeconomic fundamentals following years of prudent policies, well-oriented structural reforms, and a favorable external environment.[1]

2. **Political polarization may increase as the 2009 elections draw closer**. In recent years, a split congress and an intermittent political dialogue between the two main parties has delayed passage of important economic legislation requiring a two-thirds majority, including authorization of government borrowing (although agreement was reached in December 2008 to approve a budget support loan from the IADB). The political focus has now shifted to the congressional/municipal and presidential elections, slated for January and March 2009, respectively.[2] Even though the opposition, left-of-center, candidate has been ahead in the polls since the start of the campaign, most analysts expect the presidential elections to be closely contested.

3. **The impact of the global financial crisis on El Salvador's dollarized economy has been broadly as envisaged during the Article IV consultation**. Real GDP growth is projected to slow to 3.2 percent in 2008 (compared to 4.7 percent in 2007), reflecting lower growth in remittances, a tightening of external financing conditions, and a decline in investment. Exports, however, have remained buoyant despite weaker external demand. Twelve-month inflation has been slowing from almost 10 percent in August to 5.5 percent by year-end, reflecting lower commodity prices. The external current account deficit is projected at 6 percent of GDP in 2008, fully financed by net capital inflows.

4. **The banking system remains liquid and well-capitalized, although nonperforming loans have increased and profitability is declining**. Even though linkages to global financial markets are strong (the three largest banks were acquired by foreign banks in the last two years and the share of foreign-owned bank assets is now above 90 percent) the impact of the financial turmoil has been limited and banks' holdings of toxic assets appear to be limited. Moreover, unlike other countries in the region, credit growth in recent years remained moderate and there is no evidence of asset bubbles. While some banks have been instructed not to increase their exposure, banks' external credit lines have remained broadly unchanged. As of end-November 2008, banks maintained a liquidity ratio of about 42 percent (of which more than half were held in highly liquid assets) and capital adequacy of about

[1] See http://www.imf.org/external/np/sec/pn/2008/pn08151.htm

[2] If none of the presidential candidates attains 50 percent of the votes, there will be a run-off in mid-April. The new government assumes office on June 1, 2009.

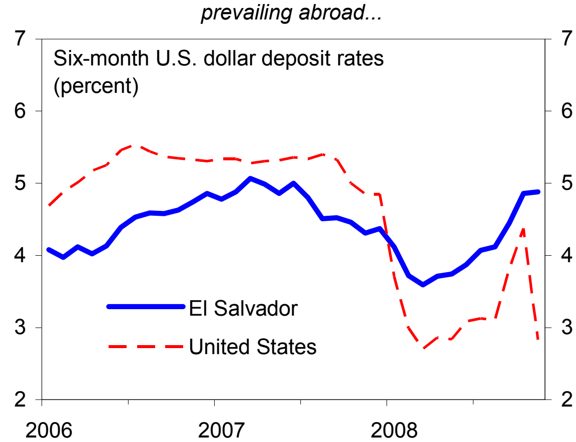
14½ percent, with both indicators comfortably above prudential requirements. At the same time, banks' financial margins have fallen reflecting: (i) higher deposit rates; (ii) a higher share of low-return liquid assets; (iii) lower credit growth; and (iv) provisioning against rising nonperforming loans.

Financial Soundness Indicators

	Average 2003–06	Dec. 2007	Jun. 2008	Nov. 2008
Capital Adequacy				
Regulatory capital to risk-weighted assets	13.4	13.8	14.5	14.6
Asset Quality and Provisioning				
NPLs to gross loans	2.3	2.1	2.3	3.1
Total provision to NPLs	126.3	120.0	113.3	100.1
Profitability				
Return over average assets	1.2	1.2	1.4	1.0
Return over average equity	12.2	11.3	13.2	8.8
Liquidity				
Liquid assets to deposits	46.7	39.9	40.1	42.3
Leverage				
Loans in percent of deposits	96.1	97.4	102.2	103.5

Source: Superintendency of the Financial System.

Banks have raised deposit rates above those prevailing abroad...



...but with deposit growth stalling, banks have turned to debt issuance to fund lending.

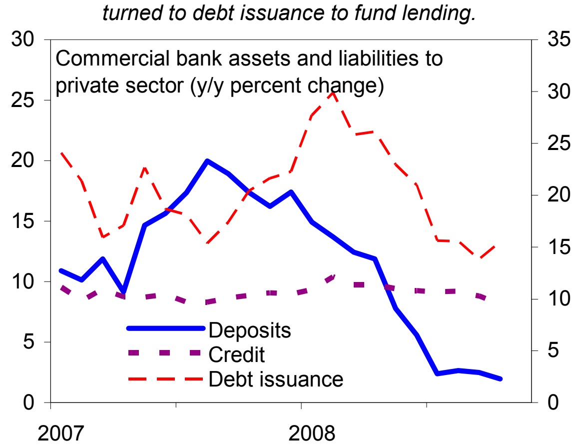
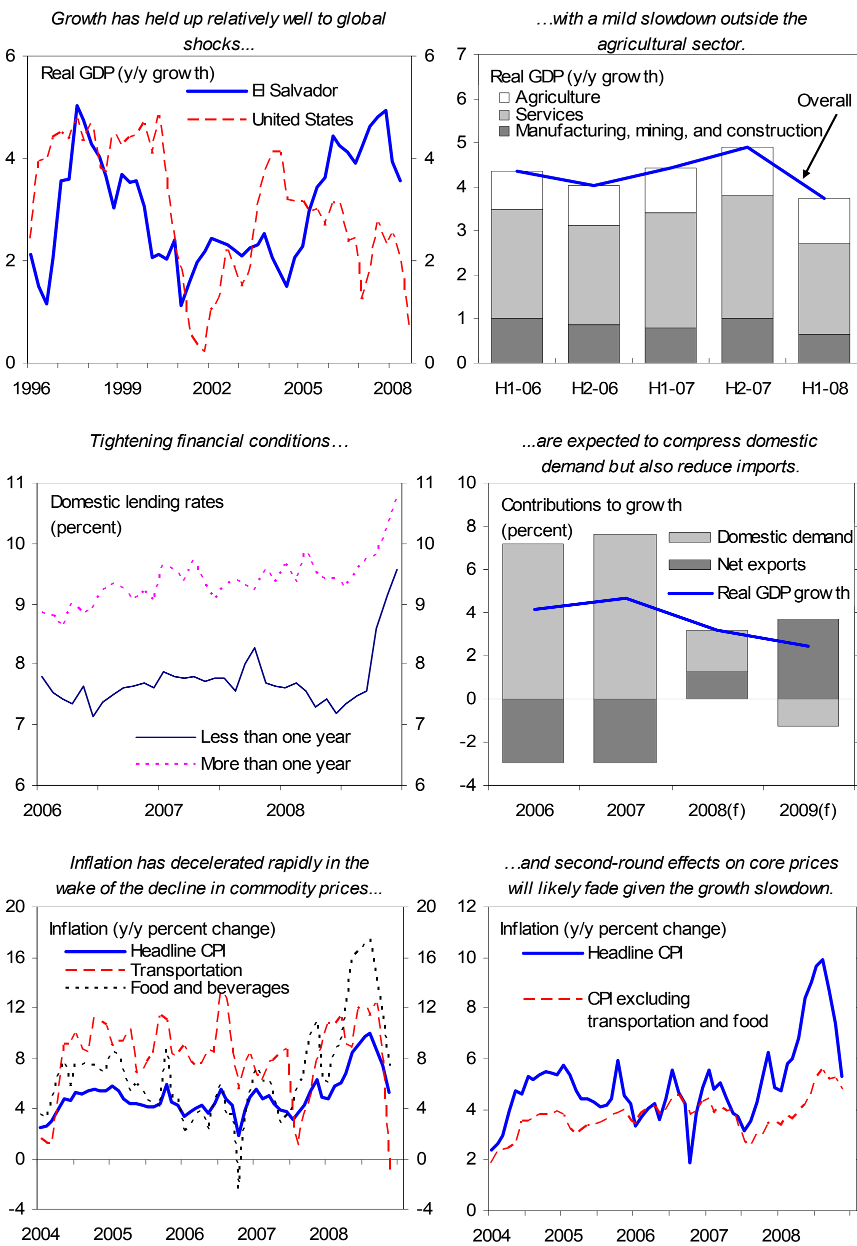
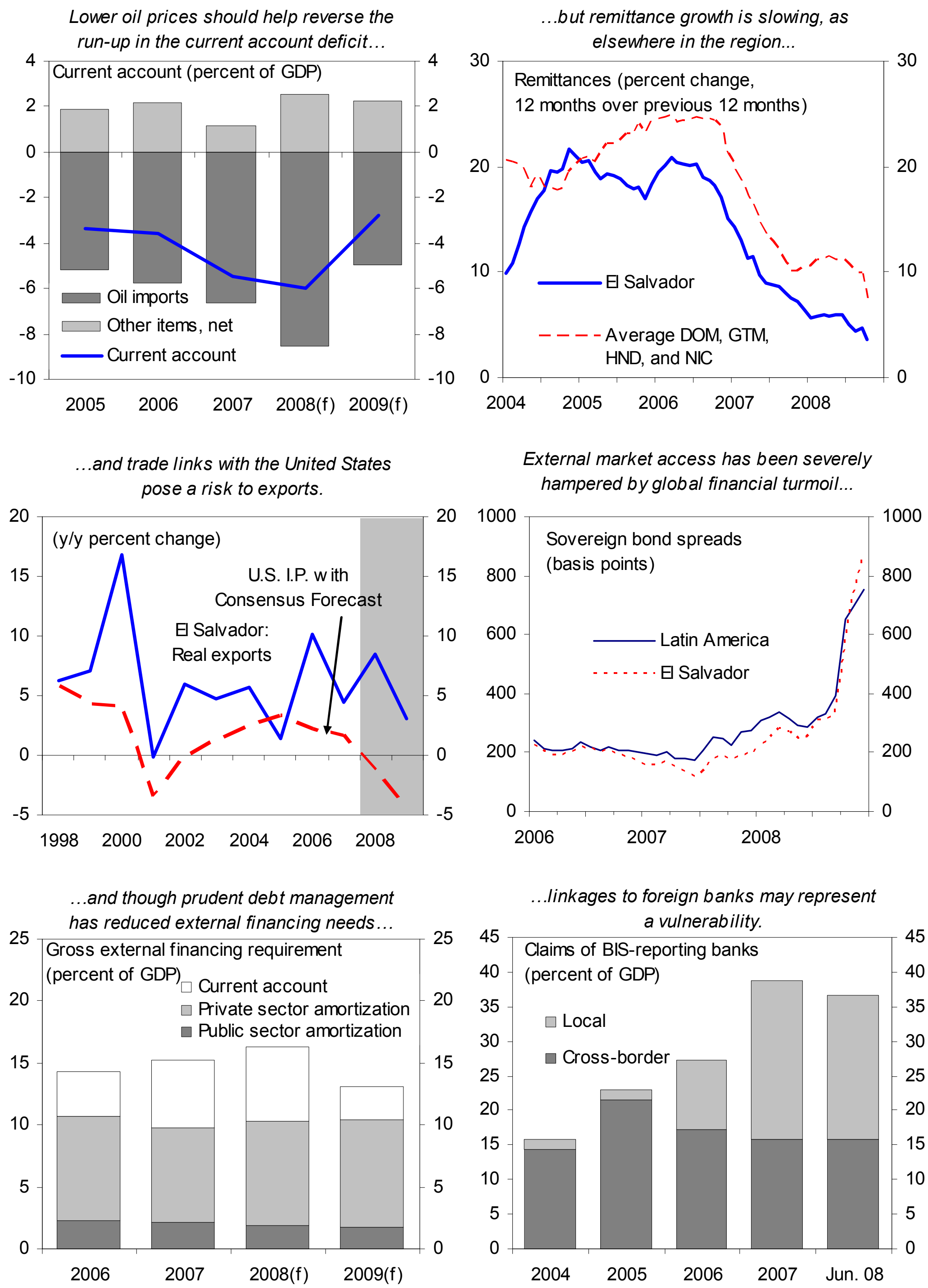


Figure 1. El Salvador: Economic Activity and Inflation



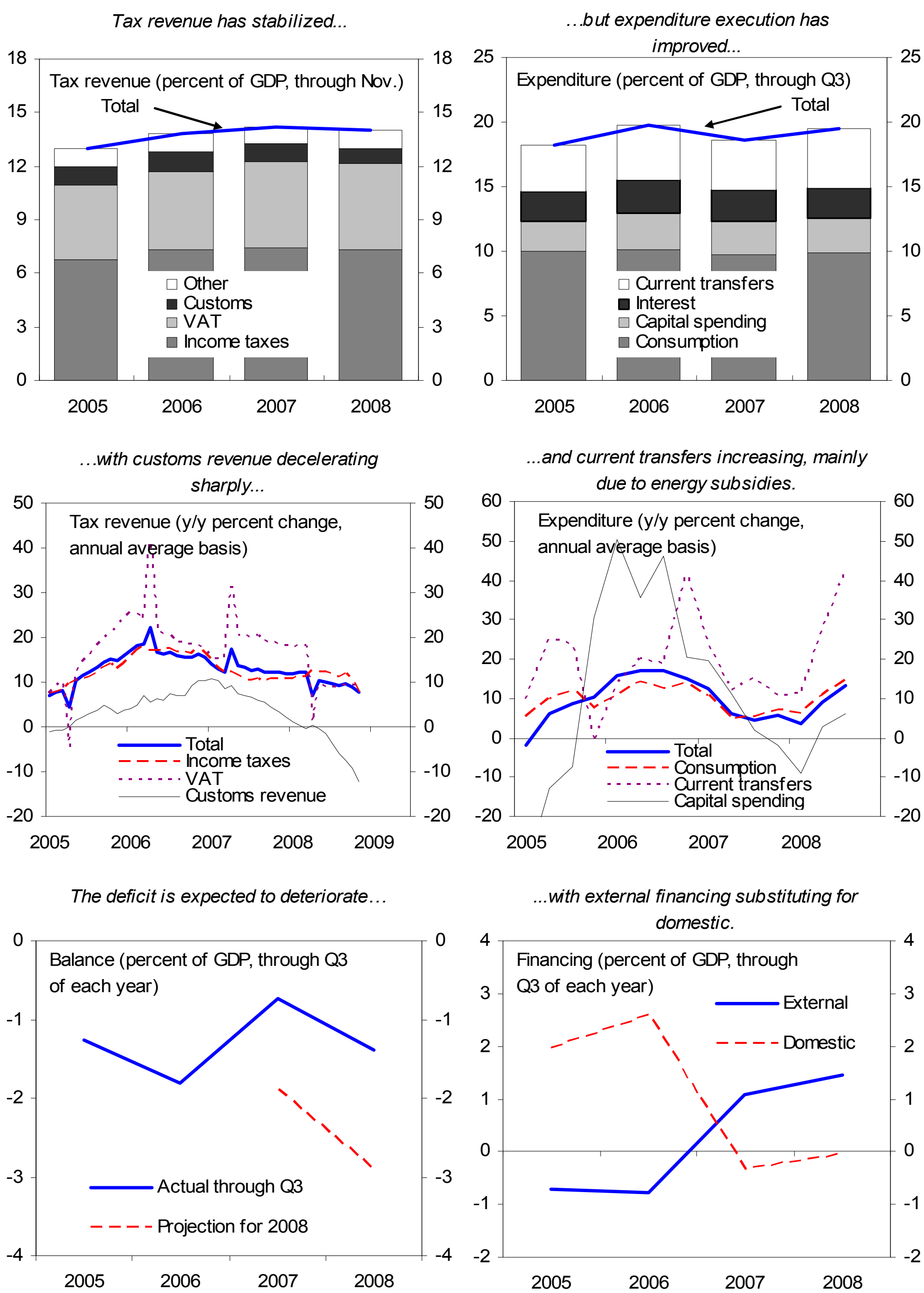
Sources: Central Reserve Bank of El Salvador; and Fund staff calculations.

Figure 2. El Salvador: Trade and the Balance of Payments



Sources: Central Reserve Bank of El Salvador; Haver Analytics; Consensus Forecasts; J.P. Morgan; Bank for International Settlements; and Fund staff calculations.

Figure 3. El Salvador: Fiscal Indicators



Sources: Ministry of Finance; and Fund staff calculations.

5. **The overall public sector deficit in 2008 is projected to reach 2.9 percent of GDP, one percentage point higher than in 2007 and slightly above the level envisaged during the Article IV consultation**. The weaker fiscal position reflects increased social spending, lower revenue growth and, to a lesser extent, higher capital expenditure on a new hydroelectric power plant. El Salvador's sovereign debt is rated investment grade by Moody's and one notch below investment grade by S&P and Fitch (although the last two agencies revised their outlooks to negative recently). Since March 2008, the government started facing difficulties placing domestic debt with maturities beyond the presidential election of March 2009. Nonetheless, as noted, the government recently managed to forge a consensus in congress to authorize borrowing from two multilateral development banks (MDBs), the first such authorization in three years. These loans would improve the liquidity position of the government.

II. Outlook and Policies for 2009

6. **The U.S. recession is likely to continue having a significant impact on El Salvador**. The country has strong economic and financial links with the United States through remittances, trade, and capital flows. With official dollarization, the central bank is severely constrained in its ability to ease domestic monetary conditions or provide liquidity support to individual banks; as a result, banks have to self-insure by maintaining high levels of liquidity. Fiscal policy is the main policy lever, but has very limited room for maneuver due to financing constraints.

7. **Electoral uncertainty could exacerbate financial stress**. Prospects of a strong showing by the left-leaning opposition party (FMLN) could exacerbate concerns among foreign and domestic investors about policy continuity, and trigger capital and deposit outflows.

8. **To mitigate these risks, the authorities have taken measures to strengthen banks' resilience**. In late June, liquid asset requirements were increased by 3 percentage points to 6 percent (total prudential requirements—reserve and liquidity—now amount to 28 percent of deposits, effectively). Additionally, banks have been required to submit contingency liquidity plans to the Superintendency of the Financial System (SSF), including on the availability of foreign credit lines. Moreover, the SSF and the central bank have upgraded their monitoring capabilities and are now able to follow key banking indicators (including the level and composition of liquid assets, deposits and other liabilities, and interbank market rates) on a daily basis. In addition, the central bank will use a US$400 million loan from the IADB to purchase high quality loans from banks in order to sustain the growth of credit to the private sector.[3]

[3] This loan is different from the US$950 million combined from the IADB and the World Bank approved for the central government.

9. **To further enhance the resilience of the financial sector, the authorities plan to seek congressional approval of the Financial Sector Supervision and Regulation Law**. This draft bill, which benefited from MCM technical assistance, proposes merging the supervisory entities for the financial system, pension funds, and the stock market; increasing the autonomy of the new institution; providing legal protection for supervisors; and strengthening cross-border consolidated supervision.

Macroeconomic Framework

10. **Economic growth in 2009 is projected to slow further to 2½ percent owing to the difficult external and domestic environment, but the risks are tilted to the downside.** Exports have continued to increase (by some 17 percent over the previous year) despite the U.S. recession, lending some momentum to growth in 2009. The strong export performance appears related to the implementation of the CAFTA-DR, as Salvadoran producers are regaining some of their share of the U.S. market, though shipments to other destinations have also remained buoyant. While some of this increase may continue in 2009, the global slowdown is likely to cause export growth to slow. Remittance growth has decelerated sharply in recent months, and is expected to remain low throughout 2009, despite weak historical linkages to the U.S. business cycle. Domestic demand is expected to contract, constrained by tight financial conditions and the stagnation of remittances. Inflation is projected to fall to 3¾ percent and the current account deficit to narrow to 2¾ percent of GDP, due to slower credit and import growth, and the full-year effect of significantly lower petroleum prices.

11. **To mitigate the decline in domestic demand, the authorities have revised their fiscal deficit target for 2009 to 2.8 percent—0.4 percentage points above their earlier target**. Higher capital expenditure on social infrastructure, financed with the loans recently secured from the IADB, fully explains the revised deficit target. Weaker than envisaged output growth would have a small effect on the fiscal balance. El Salvador's tax revenue base is low at 13.2 percent of GDP and relies heavily on ad-valorem taxes, with a tax elasticity close to one. Additionally, automatic stabilizers are not very strong. The externally-financed increase in capital expenditures envisaged for 2009 seeks to mitigate weak domestic demand, while keeping the pubic debt-to-GDP ratio on a sustainable path.

12. **The authorities have adopted measures to improve revenue administration**. These include, among others, modernizing customs administration and border procedures, strengthening collection procedures on tax arrears, and improving tax auditing and enforcement. These measures are expected to yield some 0.2 percent of GDP, despite the weak growth outlook. In addition, the authorities are considering the elimination of certain tax exemptions, including on nontraditional exports.

13. **On the expenditure side, the authorities intend to proceed with their plans to fully eliminate the remaining nonresidential subsidy on electricity, and create fiscal**

space to increase social spending. The authorities expect to generate space of up to 0.3 percent of GDP, which could be used to expand the coverage of *Red Solidaria* (a cash transfer program) to the 100 poorest municipalities in the country and implement targeted programs for health, education, and mitigation of damages from tropical storms.

III. Program Discussions on a Stand-By Arrangement (SBA)

14. **The main goals of a Fund SBA with El Salvador would be to signal policy continuity in the face of electoral uncertainty, help sustain investor confidence, and boost the economy's resilience to shocks**. The Fund's financial support would help reinforce the commitment from the authorities and the leading presidential candidates to maintaining macroeconomic stability derived from official dollarization, and enhance the capacity of the financial sector to withstand shocks by strengthening its liquidity buffers. Both leading presidential candidates have sought a dialogue with the Fund and committed publicly to continue maintaining sound macroeconomic policies and official dollarization, as well as respecting El Salvador's international commitments, including CAFTA-DR.

15. **Program discussions covered the various shocks that could jeopardize macroeconomic stability, and the scope for preventive policies to mitigate their effects**. The authorities were concerned about the possibility of a slowdown in capital flows, deposit outflows, or increases in interest rates, given the proximity of the elections and the financial crisis in advanced countries. They also were concerned that a sharp decline in exports or remittances would further tighten domestic liquidity conditions.

16. **The authorities were confident that popular support for official dollarization and macroeconomic stability, the economy's proven resilience, and the measures recently adopted, would allow them to successfully absorb most shocks without drawing on Fund resources**. They pointed to earlier episodes of election-related uncertainty, when deposit outflows were moderate and deposits returned in a matter of weeks. They also noted that the low public debt and their success in securing financing from MDBs would help reduce vulnerabilities. The loans from MDBs comprise the US$400 million financial sector loan from the IADB, mentioned earlier, plus loans to the central government totaling US$950 million to be disbursed over three years. Part of the US$950 million will be used to amortize a US$650 million Eurobond balloon payment maturing in 2011, while the remainder will be allocated to investment and social programs.

Tentative MDBs Disbursement Schedule
(million U.S. dollars)

	2008	2009	2010/11	Total
Total	237	863	250	1350
Central government (IADB/WB)	200	500	250	950
Financial system (IADB)	37	363	0	400

17. **Discussions also covered the size and possible use of the economy's liquidity buffer**. Banking system liquid assets held abroad, about 25 percent of private banking system deposits (about US$8.5 billion by end-2008), would be the first line of defense against deposit outflows. Since banks are highly liquid, the authorities were confident that individual banks would be able to redeem moderate withdrawals with their own resources. However, as of end–November, the BCR had "free" net international reserves (NIR) of only US$136 million (2 percent of deposits), which hampers its ability to inject or reallocate liquidity into the banking system.[4] In the case of unexpectedly large shocks to bank liquidity that cannot be met through existing buffers, the central bank would draw Fund resources to provide liquidity and prevent a bank run. The central bank (which is not allowed to lend to the government) would only be able to use Fund resources to provide dollar liquidity to banks via repo transactions or through the outright purchase of bank assets.

Banking System Liquidity
(liquid asset holdings; in percent of private sector deposits)

	Dec-07	Jun-08	Nov-08
Most liquid	**21.1**	**22.0**	**24.7**
Deposits at BCR	15.1	13.8	15.7
Deposits abroad	2.8	4.3	2.8
Securities abroad	3.3	4.0	6.2
Subject to funding constraints	**16.1**	**16.1**	**15.3**
Central government securities	4.3	4.5	3.8
Central Bank securities	11.8	11.6	11.5
Operational liquidity (cash)	**2.8**	**2.0**	**2.3**
Total	**39.9**	**40.1**	**42.3**
Potential Fund support (300% of quota)			9.3
Most liquid plus Fund support			34.0
Memo items (million U.S. dollars)			
Total private sector deposits	8,641	8,527	8,536
Total liquidity	3,450	3,421	3,608
Most liquid	1,825	1,879	2,110
Potential Fund support (300% of quota)			795

Sources: Central Reserve Bank of El Salvador; and Fund staff calculations.

18. **The possibility of extremely large shocks was also discussed**. The authorities considered that those events were very unlikely, particularly if a Fund arrangement were in place. Nevertheless, the authorities agreed that if such a shock were to materialize, the rapid implementation of El Salvador's bank resolution framework would be critical. In this context, it was agreed that the proposed SBA would contain a consultation clause under which Fund staff and the authorities would discuss policy responses and options to mitigate the effects of such a shock.

IV. Program Access, Conditionality, and Capacity to Repay the Fund

Access

19. **The proposed SBA would involve frontloaded and exceptional access**. The goal of increasing El Salvador's liquidity buffer and sending a strong signal to investors and depositors is not likely to be attained with access within the current access limits—which would allow a first purchase equal to a fraction of El Salvador's quota of SDR 171.3 million (US$265.14 million). With total banking system deposits of almost US$9 billion, staff

[4] In El Salvador, free NIR are defined as the difference between the central bank's net international reserves and its liquid liabilities with domestic residents, mainly private bank and government deposits held at the BCR.

considers that an initial access of about US$530 million (200 percent of quota) would provide a reasonable increase in the country's liquidity buffer to help forestall large deposit withdrawals (Box 1). Total access under the program is thus proposed to be 300 percent of quota; 200 percent of quota (SDR 342.6 million, or US$530.28 million) to be made available upon approval, and the remaining 100 percent of quota phased evenly following quarterly reviews (Table 9).[5] [6]

20. **Even under scenarios of moderate financial stress the program would be fully financed**. In the absence of large deposit withdrawals or cancellations of external credit lines, the authorities may not need to make purchases under the SBA, even under more conservative assumptions about FDI and other balance of payment flows (Tables 2 and 8).

21. **In the case of large deposit outflows, exceptional balance of payments pressures in the capital account would arise**. In the absence of new external financing, those outflows would produce a severe liquidity crunch and a large contraction in capital flows and require a significant adjustment in domestic demand. In this scenario, the resources provided under the SBA would help alleviate the burden of adjustment—a key justification for the staff request for exceptional access (Box 2). If the outflows were too large or persistent, however, the authorities would have to adopt corrective measures, in consultation with Fund staff.

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[5] The arrangement falls within the exceptional access policy because the annual 100 percent of quota would be exceeded. However, the cumulative amount of exactly 300 percent of quota is within normal limits under the policy.

[6] The Executive Board was informed of negotiations involving exceptional access for El Salvador in an informal Board session held on December 19, 2008.

Box 1. Assessing the Adequate Access Level

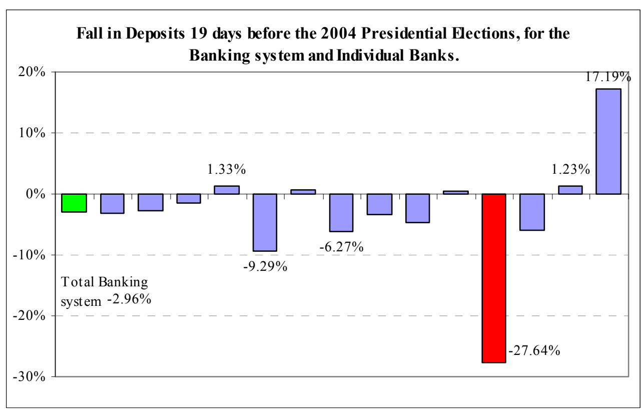
With highly liquid assets at 25 percent, El Salvador can withstand large, system-wide deposit withdrawals. However, being a fully dollarized economy, most reserves in El Salvador are backing bank deposits; free reserves of the central bank amount to only US$136 million. As a result, the central bank is severely constrained from providing liquidity support to individual banks that experience unexpectedly large deposit outflows.

At the time of the 2004 presidential elections, system-wide deposit outflows amounted to about 3 percent of deposits, although some banks lost up to 28 percent of their deposits. A similar phenomenon has been observed during elections in other dollarized economies in Latin America in which system-wide deposits fell by around 5 percent, but individual banks suffered larger outflows.

A number of metrics suggest that a liquidity buffer of about US$800 million, or 300 percent of El Salvador's quota, would be appropriate. The speed with which deposit outflows could occur in the current environment suggests the need for significant frontloading.

- A 5 percent deposit withdrawal (consistent with past electoral episodes in El Salvador and other dollarized economies) and a 50 percent rollover of short-term external credit lines reflecting global financial conditions, would jointly generate liquidity needs of close to US$800 million.

- A common central bank practice is to have intrenational reserves covering about 10–15 percent of total deposits as a liquidity buffer. In the case of El Salvador, and with coverage of 10 percent of deposits, this would amount to about US$870 million.



- Central bank liquidity support is often linked to bank capital.[1] In the case of El Salvador, total bank capital amounts to US$1.2 billion. With the recently approved financial sector loan from the IADB for US$400 million, access to about US$800 million from the Fund would give the central bank access to resources roughly equal to the total capital of banks.

1/ Common practice in Latin American countries is for liquid assets to cover between 50 and 100 percent of total bank capital.

Box 2. Exceptional Access Criteria

Under the policy on exceptional access, in cases like El Salvador where the member is not experiencing a capital account crisis, the four criteria for exceptional access are not expected to be met, but requests for access above the limits still need to be justified in light of the four criteria. The total access under the proposed SBA would equal SDR 513.9 (US$795 million, 300 percent of quota), only the annual access under the program would exceed the normal access limit; the cumulative access of 300 percent of quota is within normal access limits under the policy. The staff's evaluation of the case for exceptional access based on the four substantive criteria under the exceptional access framework is as follows:

Criterion 1—exceptional balance of payments pressures on the capital account. This criterion is not met as balance of payments pressures on the capital account have not yet materialized and the program is to be treated as precautionary. However, there is a significant risk that, due to the unfavorable external environment and election uncertainty, a sudden withdrawal of deposits from the banking system, and a corresponding capital outflow, could materialize and cause exceptional balance of payments pressures.

Criterion 2—sustainable debt position. Preliminary calculations by staff indicate that debt will remain sustainable in the absence of extremely large deposit withdrawals that could jeopardize the solvency of the banking system. El Salvador's public debt is relatively low, at 40 percent of GDP, and the government has been undertaking a fiscal consolidation effort in recent years that should continue in the medium term. The drawdown of the full amount of the proposed SBA and the pre-emptive borrowing from MDBs would increase the debt-to-GDP ratio in 2009, but under a baseline scenario of prudent policies the ratio would decline to about 35 percent in the medium term. Staff debt sustainability analysis concludes that external debt remains sustainable in the medium term.

Criterion 3—access to private capital markets. While access to capital markets by the private sector and the government is currently limited, El Salvador has good prospects of regaining access as the global financial crisis eases and election year uncertainty is resolved, given its investment grade rating by Moody's and a rating one notch below investment grade by S&P and Fitch.

Criterion 4—strong policy reforms and implementation capacity. El Salvador's adherence to dollarization since 2001 has required a good track record in pursuit of solid policies and structural reforms, providing confidence in the authorities' ability to implement the program. The policies contained in the SBA provide a reasonably strong prospect for success. Up-front commitment by political parties to the program also demonstrates the authorities' capacity to deliver the proposed policies.

Program conditionality

22. **The conditionality of the proposed SBA takes into account El Salvador's monetary regime and sound track record of policy implementation**. In particular, program conditionality is focused on maintaining a prudent fiscal stance and strengthening the financial system. The specific conditions and benchmarks are listed below:

- **Prior action**: Adopt a regulation to enhance the functioning of the interbank market, which would facilitate the allocation of liquidity among banks by making the central bank a clearing house for interbank transactions.[7]

- **Quantitative performance criteria**: Quarterly ceilings on the deficit of the nonfinancial public sector resulting in a deficit of 2.8 percent of GDP for 2009 (quarterly targets), with an adjuster,[8] and a zero ceiling on the accumulation of net external payments arrears.

- **Structural benchmarks**:

    - Maintain reserve requirements on banks at current levels (about 22 percent).

    - Approval by congress of the bill to further strengthen financial supervision.[9] In addition, the Fund would be willing to continue providing technical assistance to enhance the banking system's resilience to shocks, in line with recommendations from the Article IV consultation. Some of the TA recommendations could become structural benchmarks after the first review.

- **Consultation clause**: Standard monetary performance criteria (including a floor on NIR) are not particularly useful in an officially dollarized economy, and a floor on NIR could constrain the BCR's ability to provide liquidity to banks experiencing problems in redeeming withdrawals. In view of this, the program contains a clause (triggered if the sum of total deposits in commercial banks, plus external short-term bank liabilities of commercial banks with an original maturity of up to one year, falls by 10 percent with respect to its level at end–November 2008) under which the

[7] Approved in late 2008.

[8] The adjuster could be for a maximum of US$50 million (0.2 percent of GDP), if additional resources from external multilateral or official bilateral creditors become available. If external financing were to exceed this amount, additional resources should be used to substitute for short-term domestic financing. Staff analysis concludes that this temporary increase in the fiscal deficit would not jeopardize public debt sustainability.

[9] Prior to submission to congress, the authorities would provide staff the opportunity to review and comment on the draft law.

authorities commit to consult with Fund staff and reach understandings on corrective measures for consideration by the Fund at the next scheduled review.[10]

Capacity to Repay the Fund

23. **El Salvador's capacity to repay the Fund is strong**. The government is committed to macroeconomic stability and prudent fiscal policies, public debt is relatively low (about 40 percent of GDP), and medium-term growth prospects are good. In addition, the main presidential candidates have expressed their support to the proposed program (direct quotes or other expression of support will be circulated prior to the Board meeting). When financial turmoil subsides and global growth rebounds, El Salvador is well positioned to return to a high growth path reaping the benefits of trade agreements (including CAFTA-DR and a potential Association Agreement with the European Union), its geographical position, and strong economic fundamentals.

24. **El Salvador's growth should recover as world growth conditions normalize, and fiscal policy will ensure that its public debt remains sustainable**. Over the medium-term fiscal policy should focus on enhancing the economy's growth potential while creating space to respond to shocks and address priority spending needs. This would require raising the primary surplus of the public sector by about 1¾ percent of GDP between 2010 and 2014, through tax measures and reductions in nonpriority spending. In particular, staff recommended strengthening tax administration through streamlining of tax incentives, including on nontraditional exports, the modernization of customs, strengthening of collection procedures on tax arrears, and improvements in tax auditing and enforcement. On the expenditure side, additional savings could be achieved through further improving the efficiency and targeting of public spending, e.g. on energy and transportation subsidies.

25. **The consultation clause would also be a key safeguard**. If stress in the financial sector results in a significant loss in deposits and/or external credit lines and triggers the consultation clause, the authorities, in consultation with Fund staff, would design additional policy actions to strengthen El Salvador's external position and enhance the prospects of fulfilling its financial obligations. While the program is designed to both instill confidence and withstand shocks to the banking system, a full blown domestic banking crisis remains a tail risk; if such an event were to occur, El Salvador's macroeconomic strategy would have to be reassessed, in consultation with Fund staff.

26. **An updated safeguards assessment of the central bank has been initiated and will be completed no later than the first review**. Staff monitoring since the previous safeguards assessment (2002) indicates that the central bank continues to comply with key

[10] The authorities will provide, on a daily basis, bank-level data on total deposits, and the liquidity position of the banking system. In addition, they will provide on a weekly basis, bank-level data on outstanding short-term external liabilities of the banking system.

safeguards requirements, including publishing IFRS-based financial statements that have been externally audited in accordance with international standards. The update would aim to confirm the findings of the off-site monitoring and identify any emerging safeguards issues.

V. Staff Appraisal

27. **El Salvador's macroeconomic fundamentals are solid and have improved in recent years, but there are significant risks to the near-term outlook**. Reaping the benefits of prudent macroeconomic policies and sustained structural reforms, El Salvador has seen its fiscal position improve, its public debt-to-GDP ratio decline, and growth reach its highest level in a decade in 2006–07. While the economy is in a relatively good position to weather the global financial turmoil, the U.S. recession, and electoral uncertainty entail significant risks for the 2009 outlook.

28. **In light of these risks, the main objective of the proposed program is to preserve macroeconomic stability and to boost the economy's resilience to shocks**. The program aims at bolstering confidence by maintaining sound macroeconomic policies, further strengthening the regulatory and supervisory framework of the banking system, and increasing the liquidity buffer of the financial system.

29. **Continued fiscal prudence is the cornerstone of the program**. While the fiscal deficit target for 2009 is slightly higher than expected during the 2008 Article IV consultation, the authorities are firmly committed to keeping the deficit at 2.8 percent of GDP. To meet this target, they have adopted measures in the areas of tax policy and administration, and electricity subsidies, and are committed to strictly control central government expenditures. The projected deficit is expected to be financed in full with resources secured from the MDBs. Weaker-than-expected output growth poses a risk to meeting the fiscal deficit target, but staff considers medium-term prospects for fiscal sustainability to be strong, given the country's track record of implementing sound policies.

30. **The proposed program would give the central bank greater room to provide liquidity to banks in the case of temporary shortfalls**. With a capital adequacy ratio of 14½ percent and a liquidity ratio of 42 percent (of which more than half are held in highly liquid assets), El Salvador's banking system is well-positioned to withstand significant deposit outflows or cuts in external credit lines. However, being a fully dollarized economy, the central bank's ability to use its free reserves to provide liquidity support to individual banks that experience unexpectedly large deposit outflows is limited. A liquidity buffer of US$800 million from the Fund would significantly increase the central bank's lender-of-last-resort capability.

31. **The prospects for policy continuity are reasonably high**. The support given by the leading presidential candidates to the main elements of the proposed program provide important assurances that the new government will maintain macroeconomic stability, respect international trade agreements, and pursue policies that are consistent with official

dollarization. Their public pronouncements should bolster market confidence and minimize the risk of deposit outflows. Staff will seek an early understanding with the new administration soon after the election, in the context of the first program review.

32. **El Salvador's capacity to repay the Fund is strong**. When the global financial crisis subsides and world growth starts to rebound, El Salvador will be well poised to return to a high growth path reaping the benefits of its strong economic fundaments, geographical position, and openness. The consultation clause contained in the program provides an additional safeguard to Fund resources, as it would trigger policy discussions on actions to strengthen El Salvador's external position and enhance the prospects of fulfilling its financial obligations to the Fund if large shocks materialize.

33. **In light of these considerations, staff recommends the approval of the requested SBA**.

Table 1. El Salvador: Selected Economic and Social Indicators

	2003	2004	2005	2006	2007	Est.. 2008	Proj. 2009
	(Annual percent change, unless otherwise stated)						
Income and prices							
Real GDP	2.3	1.9	3.1	4.2	4.7	3.2	2.5
Consumer prices (end of period, e.o.p.)	2.5	5.4	4.3	4.9	4.9	5.5	3.8
GDP deflator (period average)	2.8	3.1	4.8	4.9	4.4	5.6	3.6
External sector							
Exports of goods and services, volume	4.7	5.7	1.4	10.2	4.5	8.4	3.1
Imports of goods and services, volume	4.8	4.1	3.1	11.3	7.3	3.4	-3.5
Terms of trade	-4.4	-6.1	-2.9	-0.9	-5.7	-6.6	6.0
Real effective exchange rate (e.o.p., + is appreciation) 1/	-3.0	-0.7	2.4	-0.2	-0.8	8.0	…
External sovereign bond (average spread, basis points)	325	267	248	200	163	388	…
	(Percent of GDP, unless otherwise stated)						
Money and credit							
Credit to the private sector	41.8	41.8	42.9	43.0	42.8	41.7	41.2
Broad money	43.9	43.3	42.6	43.8	47.1	45.8	42.6
Interest rate (annual, time deposits, e.o.p.)	3.4	3.3	4.0	4.9	4.4	4.9	4.1
External sector							
Current account balance	-4.7	-4.0	-3.3	-3.6	-5.5	-6.0	-2.7
Trade balance	-15.2	-16.8	-17.2	-19.0	-20.0	-19.9	-16.5
Exports (f.o.b. including *maquila*)	21.0	21.1	20.2	20.2	19.8	21.3	21.1
Imports (f.o.b. including *maquila*)	-36.1	-38.0	-37.4	-39.1	-39.8	-41.2	-37.6
Services and income (net)	-3.5	-3.3	-3.9	-3.3	-4.0	-3.6	-3.1
Transfers (net)	42.2	16.2	17.8	18.6	18.5	17.5	16.9
Public finances							
Combined public sector balance	-3.6	-3.0	-3.0	-2.9	-1.9	-2.9	-2.8
Combined primary balance	-1.6	-0.8	-0.8	-0.5	0.5	-0.5	-0.5
Of which: tax revenue	11.5	11.5	12.5	13.3	13.4	13.2	13.6
Total public debt	42.1	43.5	42.0	41.9	38.3	40.0	41.5
Of which: external public debt	28.1	27.7	26.3	27.5	24.3	23.9	24.0
External public debt service							
(percent of exports of goods and services)	11.1	15.7	15.6	14.4	11.5	8.7	12.5
National Savings and Investment							
Gross domestic investment	17.0	16.2	15.7	16.1	16.1	15.4	15.3
Public sector 2/	3.3	1.9	2.3	2.2	2.0	2.2	2.2
Private sector	13.7	14.3	13.4	13.9	14.1	13.2	13.0
Of which: foreign direct investment	0.8	2.3	2.3	1.3	7.0	1.9	1.4
Gross domestic saving	12.3	12.2	12.4	12.4	10.6	9.4	12.5
Public sector	1.0	0.9	-0.5	-0.3	0.5	-0.2	0.0
Private sector	11.3	11.3	12.9	12.7	10.1	9.6	12.5
Net foreign assets of the banking system							
Millions of U.S. dollars	1,051	1,063	1,115	1,441	2,173	2,348	1,871
Percent of deposits	14.7	14.2	14.6	17.3	22.9	24.8	19.8
Memorandum items:							
Net *maquila* exports	3.3	2.9	3.6	3.3	2.8	3.1	3.2
Nominal GDP (billions of U.S. dollars)	15.0	15.8	17.1	18.7	20.4	22.2	23.6

Sources: Central Reserve Bank of El Salvador; Ministry of Finance; and Fund staff estimates.

1/ The figure for 2008 shows the end-period change through November.

2/ Includes reconstruction outlays after tropical storm Stan in 2005.

Table 2. El Salvador: Balance of Payments

(In US$ millions)

	2005	2006	2007	2008	2009	2010	Proj. 2011	2012	2013	2014
Current account	**-569**	**-675**	**-1,119**	**-1,331**	**-645**	**-836**	**-858**	**-884**	**-933**	**-987**
Merchandise trade balance	-2,938	-3,540	-4,073	-4,407	-3,889	-4,171	-4,362	-4,661	-5,023	-5,412
Export of goods (f.o.b.)	3,447	3,760	4,035	4,727	4,965	5,166	5,557	5,966	6,398	6,864
General merchandise	1,625	1,982	2,234	2,701	2,858	2,986	3,224	3,473	3,729	4,006
Goods for processing	1,821	1,777	1,801	2,026	2,107	2,181	2,333	2,493	2,669	2,858
Import of goods (f.o.b.)	-6,385	-7,299	-8,108	-9,133	-8,854	-9,337	-9,919	-10,626	-11,421	-12,275
General merchandise	-5,180	-6,143	-6,871	-7,800	-7,495	-7,931	-8,429	-9,034	-9,716	-10,450
Goods for processing	-1,205	-1,157	-1,237	-1,333	-1,359	-1,406	-1,490	-1,592	-1,705	-1,825
Services	-87	-79	-242	-268	-234	-208	-157	-132	-121	-107
Income	-579	-528	-579	-533	-505	-568	-671	-733	-807	-893
Of which: Interest on public debt	-328	-342	-315	-253	-255	-276	-303	-301	-294	-282
Current transfers	3,035	3,472	3,776	3,877	3,983	4,110	4,332	4,642	5,017	5,424
Financial and capital account	**875**	**1,129**	**750**	**1,208**	**568**	**960**	**1,015**	**1,080**	**1,174**	**1,246**
Capital account	94	97	150	129	162	256	153	153	156	159
Public sector financial flows	343	497	-115	350	339	28	-24	-136	-234	-271
Of which : disbursements	727	901	205	653	918	465	540	301	161	111
Of which : amortization	-385	-404	-320	-303	-578	-437	-564	-436	-395	-382
Private sector financial flows	439	535	715	729	67	676	886	1,063	1,252	1,359
Foreign direct investment	398	245	1,426	431	323	462	619	801	862	928
Commercial banks	-51	-209	-498	435	-85	105	127	55	69	69
Other	92	498	-213	-137	-172	109	141	206	321	363
Currency substitution	**-5**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Errors and omissions	**-360**	**-382**	**649**	**522**	**0**	**0**	**0**	**0**	**0**	**0**
Change in net reserves (- = increase)	**59**	**-72**	**-280**	**-398**	**77**	**-124**	**-157**	**-196**	**-241**	**-259**
					(In percent of GDP)					
Current account	**-3.3**	**-3.6**	**-5.5**	**-6.0**	**-2.7**	**-3.4**	**-3.3**	**-3.2**	**-3.1**	**-3.0**
Merchandise trade balance	-17.2	-19.0	-20.0	-19.9	-16.5	-16.8	-16.6	-16.6	-16.7	-16.7
Export of goods (f.o.b.)	20.2	20.2	19.8	21.3	21.1	20.8	21.2	21.3	21.2	21.2
Net maquila exports	3.6	3.3	2.8	3.1	3.2	3.1	3.2	3.2	3.2	3.2
Import of goods (f.o.b.)	-37.4	-39.1	-39.8	-41.2	-37.6	-37.6	-37.8	-37.9	-37.9	-37.9
Petroleum and products	-5.2	-5.8	-6.7	-8.6	-5.0	-5.5	-5.8	-5.9	-6.0	-6.0
Services	-0.5	-0.4	-1.2	-1.2	-1.0	-0.8	-0.6	-0.5	-0.4	-0.3
Income	-3.4	-2.8	-2.8	-2.4	-2.1	-2.3	-2.6	-2.6	-2.7	-2.8
Current transfers	17.8	18.6	18.5	17.5	16.9	16.5	16.5	16.6	16.7	16.8
Financial and Capital account	**5.1**	**6.0**	**3.7**	**5.4**	**2.4**	**3.9**	**3.9**	**3.9**	**3.9**	**3.8**
Capital account	0.5	0.5	0.7	0.6	0.7	1.0	0.6	0.5	0.5	0.5
Public sector financial flows	2.0	2.7	-0.6	1.6	1.4	0.1	-0.1	-0.5	-0.8	-0.8
Private sector financial flows	2.6	2.9	3.5	3.3	0.3	2.7	3.4	3.8	4.2	4.2
Foreign direct investment	2.3	1.3	7.0	1.9	1.4	1.9	2.4	2.9	2.9	2.9
Commercial banks	-0.3	-1.1	-2.4	2.0	-0.4	0.4	0.5	0.2	0.2	0.2
Other	0.5	2.7	-1.0	-0.6	-0.7	0.4	0.5	0.7	1.1	1.1
Merchandise trade (f.o.b.)					(annual percent change)					
Exports (nominal)	3.2	9.1	7.3	17.1	5.0	4.1	7.6	7.3	7.2	7.3
Volume	-1.5	5.3	4.7	11.5	4.0	2.5	5.6	5.5	5.4	5.4
Price	4.8	3.6	2.5	5.1	1.0	1.5	1.9	1.8	1.8	1.8
Imports (nominal)	6.4	14.3	11.1	12.6	-3.1	5.5	6.2	7.1	7.5	7.5
Volume	-1.3	9.5	2.2	0.1	1.8	2.6	3.6	4.8	5.3	5.3
Price	7.9	4.4	8.6	12.6	-4.7	2.8	2.6	2.2	2.1	2.1
Terms of trade	-2.9	-0.9	-5.7	-6.6	6.0	-1.2	-0.7	-0.5	-0.3	-0.3
Memorandum items										
Gross international reserves (US$ mln)	1,833	1,908	2,199	2,597	2,520	2,644	2,802	2,998	3,239	3,498
in months of imports (excluding maquila) 1/	3.6	3.3	3.4	4.2	3.8	3.8	3.7	3.7	3.7	3.7
in percent of total short-term external debt	101	148	174	189	180	182	187	197	210	222
External debt (in percent of GDP)	51.3	51.4	44.5	44.4	42.8	41.9	41.0	39.0	36.9	34.9
Of which : public sector debt	26.3	27.5	24.3	23.9	24.0	22.8	21.5	19.7	17.5	15.5
Of which : private sector debt	25.0	23.9	20.1	20.5	18.8	19.1	19.5	19.3	19.3	19.4
External public debt servicing (US$ mln)	713	746	635	556	833	713	867	738	689	664
percent of exports of goods and services	15.6	14.4	11.5	8.7	12.5	10.2	11.5	9.1	8.0	7.1
Gross external financing requirement (US$mln)	2,876	3,194	3,120	3,243	2,982	3,046	3,275	3,261	3,326	3,445
percent of GDP	16.8	17.1	15.3	14.6	12.7	12.3	12.5	11.6	11.0	10.6

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

1/ Expressed in terms of following year's imports.

Table 3. El Salvador: Operations of the Consolidated Public Sector

(In percent of GDP)

	2005	2006	2007	Proj. 1/ 2008	2009	2010	2011	2012	2013	2014
Revenues and grants	**16.5**	**17.2**	**17.1**	**17.0**	**17.2**	**18.6**	**18.4**	**18.5**	**18.5**	**18.4**
Current revenue	16.2	16.9	16.8	16.7	16.7	17.8	18.1	18.2	18.2	18.1
Tax revenue	12.5	13.3	13.4	13.2	13.6	14.3	14.6	14.7	14.7	14.7
Nontax revenue	3.2	3.0	2.9	2.8	2.6	2.8	2.8	2.8	2.8	2.8
Of which: pension revenue	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Operating surplus of the public enterprises	0.5	0.6	0.5	0.7	0.5	0.7	0.7	0.7	0.6	0.6
Operating surplus of the central bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Official grants	0.3	0.2	0.3	0.3	0.5	0.8	0.3	0.3	0.3	0.3
Expenditure	**19.5**	**20.1**	**19.0**	**19.8**	**20.1**	**20.2**	**20.0**	**19.8**	**19.5**	**19.3**
Current expenditure	16.8	17.0	16.3	16.9	16.7	16.5	16.4	16.2	16.0	15.8
Wages and salaries	7.1	7.1	6.9	6.9	7.2	7.2	7.2	7.2	7.2	7.2
Goods and services	4.0	3.9	3.6	3.7	3.5	3.3	3.2	3.1	3.1	3.1
Interest	2.2	2.4	2.5	2.4	2.3	2.3	2.4	2.4	2.2	2.0
Current transfers	3.6	3.6	3.3	4.0	3.7	3.6	3.6	3.5	3.5	3.5
Nonpension payments	1.3	1.8	1.7	2.5	2.1	1.9	1.9	1.9	1.9	1.9
Pension payments	2.2	1.9	1.6	1.5	1.5	1.6	1.6	1.5	1.5	1.5
Capital expenditure	2.7	3.1	2.8	2.9	3.4	3.8	3.6	3.6	3.5	3.4
Primary balance	**-0.8**	**-0.5**	**0.5**	**-0.5**	**-0.5**	**0.7**	**0.8**	**1.1**	**1.1**	**1.2**
Overall balance	**-3.0**	**-2.9**	**-1.9**	**-2.9**	**-2.8**	**-1.7**	**-1.6**	**-1.3**	**-1.0**	**-0.8**
Financing	**3.0**	**2.9**	**1.9**	**2.9**	**2.8**	**1.7**	**1.6**	**1.3**	**1.0**	**0.8**
External	**2.0**	**2.7**	**-0.6**	**1.4**	**-0.1**	**0.1**	**-0.1**	**0.0**	**-0.3**	**-0.4**
Disbursements	4.3	4.8	1.0	2.8	2.4	1.9	2.1	1.1	0.5	0.3
Amortization	-2.3	-2.2	-1.6	-1.4	-2.5	-1.8	-2.2	-1.1	-0.9	-0.8
Domestic	**1.0**	**0.3**	**2.5**	**1.5**	**2.9**	**1.6**	**1.7**	**1.3**	**1.4**	**1.3**
Central bank	0.5	-0.3	0.7	-0.4	1.1	0.0	0.2	-0.1	0.0	-0.1
Banking system	-0.1	0.4	0.2	0.3	0.1	0.2	0.2	0.2	0.2	0.2
Private sector 2/	0.7	0.1	1.6	1.6	1.7	1.4	1.3	1.2	1.3	1.2
Other	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Current account balance	1.3	0.0	0.5	-0.2	0.0	1.3	1.7	2.0	2.2	2.3
Pension balance	-1.5	-1.7	-1.4	-1.4	-1.5	-1.6	-1.6	-1.5	-1.5	-1.5
Gross financing needs	6.6	7.0	5.3	5.9	6.8	4.9	5.1	3.7	3.1	2.7
Implicit interest rate (in percent)	5.5	6.3	6.5	6.8	6.1	5.9	6.3	6.4	6.0	5.8
Total public sector debt	42.0	41.9	38.3	40.0	41.5	40.7	39.7	38.5	36.5	34.4

Sources: Central Reserve Bank of El Salvador; Ministry of Finance; and Fund staff estimates.

1/ Projections after 2009 prepared by Fund staff.

2/ Includes financing for education, health, and pension trust funds.

Table 4. El Salvador: Summary Accounts of the Financial System

	2004	2005	2006	2007	Proj. 2008	Proj. 2009
	(End of period stocks; millions of U.S. dollars)					
	I. Central Bank					
Net foreign assets	**1,763**	**1,709**	**1,880**	**2,206**	**2,324**	**1,847**
Net international reserves	1,888	1,829	1,907	2,198	2,558	2,482
Of which: "Free" NIR 1/	206	91	94	50	136	129
Net domestic assets	**485**	**523**	**412**	**540**	**362**	**695**
Nonfinancial public sector	287	367	315	465	367	622
Commercial banks	0	0	0	0	0	0
Nonbank financial institutions	434	388	363	355	256	231
Nonfinancial private sector	0	0	0	0	37	400
Other items (net)	-236	-232	-265	-280	-298	-558
Central bank backed liabilities	**2,248**	**2,232**	**2,293**	**2,745**	**2,686**	**2,542**
Currency issue	36	34	34	33	33	33
Liabilities to other depositary corporations	1,596	1,644	1,694	2,044	2,085	2,091
Other liabilities	615	553	565	668	568	418
	II. Commercial Banks					
Net foreign assets	**-682**	**-535**	**-415**	**39**	**24**	**24**
Net domestic assets	**7,614**	**7,907**	**8,705**	**9,681**	**9,956**	**9,993**
Net claims on nonfinancial public sector	7	-37	-85	-36	35	70
Net claims on the financial system	2,099	2,050	2,111	2,504	2,380	2,440
Claims on the private sector	6,502	7,211	7,907	8,617	9,125	9,225
Other items (net)	-993	-1,317	-1,228	-1,404	-1,584	-1,743
Liabilities to the private sector	**6,931**	**7,372**	**8,289**	**9,719**	**9,980**	**10,017**
Deposits	6,342	6,606	7,360	8,641	8,754	8,780
Other	589	766	929	1,078	1,227	1,237
	III. Financial System					
Net foreign assets	**1,063**	**1,115**	**1,441**	**2,173**	**2,348**	**1,871**
Net domestic assets	**5,432**	**5,886**	**6,491**	**7,147**	**7,518**	**7,872**
Nonfinancial public sector	323	369	261	464	484	778
Credit to private sector	6,602	7,317	8,022	8,726	9,249	9,716
Other	-1,493	-1,801	-1,791	-2,044	-2,215	-2,622
Liabilities to the private sector	**6,495**	**7,001**	**7,932**	**9,320**	**9,866**	**9,743**
Broad money	6,841	7,269	8,172	9,601	10,163	10,037
Money	1,220	1,314	1,510	1,765	1,868	1,845
Quasi-money	5,621	5,956	6,662	7,836	8,295	8,192
	(Percent changes relative to previous year's broad money)					
Net domestic assets	3.3	6.6	8.3	8.0	3.9	3.5
Nonfinancial public sector	0.2	0.7	-1.5	2.5	0.2	2.9
Credit to the private sector	4.8	10.5	9.7	8.6	5.4	4.6
Liabilities to the private sector	3.5	7.4	12.8	17.0	5.7	-1.2
	(Percent of GDP)					
Credit to the private sector	41.8	42.9	43.0	42.8	41.7	41.2
Liabilities to the private sector	41.1	41.0	42.5	45.7	44.5	41.3
	(Annual percent change, unless otherwise stated)					
Memorandum items:						
Financial system credit to the private sector	5.1	10.8	9.6	8.8	6.0	5.0
Private sector deposits in commercial banks	3.2	4.2	11.4	17.4	1.3	0.3
Commercial bank liquidity deposits at central bank (percent of total deposits)	25.2	24.9	22.9	23.5	24.4	24.4

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

1/ Free NIR are defined as the difference between the central bank's net international reserves and its liquid liabilities with domestic residents.

Table 5. El Salvador: Selected Vulnerability Indicators

(In percent of GDP, unless otherwise indicated)

	2004	2005	2006	2007	2008	Proj. 2009
Fiscal indicators						
Overall balance of the public sector	-3.0	-3.0	-2.9	-1.9	-2.9	-2.8
Public sector primary balance	-0.8	-0.8	-0.5	0.5	-0.5	-0.5
Gross public sector financing requirement	6.9	7.1	7.0	5.3	5.9	5.6
Public sector debt	43.5	42.0	41.9	38.3	40.0	41.5
Public sector external debt	27.7	26.3	27.5	24.3	23.9	24.0
External interest payments to total fiscal revenue (percent)	11.9	11.6	10.7	12.9	8.2	7.9
External amortization payments to total fiscal revenue (percent)	14.8	13.6	12.6	9.2	8.0	14.2
Financial indicators 1/						
Broad money (percent change, end-of-period)	3.6	6.3	12.4	17.5	5.9	-1.2
Private sector credit (percent change, end-of-period)	5.1	10.8	9.6	8.8	6.0	5.0
Ratio of capital to risk-weighted assets	13.4	13.5	13.8	13.8	14.6	…
Ratio of loans more than 90 days past due to total loans 2/	2.4	2.0	1.9	2.1	3.1	…
Provision coverage						
Ratio of provisions to total loans	3.2	2.5	2.2	2.5	3.1	…
Ratio of provisions to loans more than 90 days past due 2/	132.3	126.7	116.4	120.0	100.1	…
Return to average equity	10.9	11.8	14.6	11.3	8.8	…
Return to average total assets	1.0	1.2	1.5	1.2	1.0	…
Ratio of liquid assets to total deposits	51.2	46.0	38.7	39.9	41.9	…
External indicators						
Exports of goods and services (percent change, 12-month basis)	8.0	3.3	13.4	6.6	16.1	3.7
Imports of goods and services (percent change, 12-month basis)	10.1	6.2	15.9	11.8	12.7	-2.8
Current account balance	-4.0	-3.3	-3.6	-5.5	-6.0	-2.7
Capital and financial account balance	1.4	5.1	6.0	3.7	5.4	2.4
Gross international reserves (millions of U.S. dollars)	1,893	1,833	1,908	2,199	2,597	2,520
Months of imports of goods and services, excluding maquila	5.0	4.2	3.7	3.8	4.0	4.0
Percent of short-term debt 3/	114	101	148	174	189	180
Percent of gross external financing requirements	66	64	60	70	80	84
Percent of broad money	27.7	25.2	23.4	22.9	25.5	25.1
Total public external debt service	4.4	4.2	4.0	3.1	2.5	3.5
Total external debt to exports of goods and services (percent)	185	192	185	164	153	151
External interest payments to goods and services exports (percent)	12.9	15.9	14.2	15.2	12.1	12.0
External amortization to goods and services exports (percent)	14.9	14.7	14.0	13.3	10.5	14.9
REER, depreciation is negative (percent change, end-of-period) 4/	-0.7	2.4	-0.2	-0.8	8.0	…

Sources: Central Bank of El Salvador; Ministry of Finance; Financial System Superintendency; and Fund staff estimates.

1/ Values for 2008 are as of November, except for broad money and private sector credit growth, which are projections.

2/ Based on past-due loans.

3/ Refers to total external debt. Maturity less than one year, defined on a residual maturity basis.

4/ Value for 2008 is as of November.

Table 6. El Salvador: External Debt Sustainability Framework, 2004-2014
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						Debt-stabilizing non-interest current account 6/
		2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	
1	**Baseline: External debt**	52.0	51.3	51.4	44.5	44.4	**42.8**	**41.8**	**40.7**	**38.5**	**36.4**	**34.4**	**-2.7**
2	Change in external debt	-0.6	-0.6	0.1	-6.9	-0.1	-1.6	-1.0	-1.1	-2.1	-2.1	-2.0	
3	Identified external debt-creating flows (4+8+9)	-0.1	-3.0	-2.4	-5.4	-0.8	-1.2	-0.8	-1.3	-2.4	-2.6	-2.5	
4	Current account deficit, excluding interest payments	0.9	-0.2	0.4	2.1	3.2	0.0	0.6	0.3	0.2	0.2	0.2	
5	Deficit in balance of goods and services	17.2	17.7	19.4	21.2	21.1	17.5	17.6	17.1	16.9	16.8	16.8	
6	Exports	28.0	26.8	27.8	27.1	28.9	28.2	27.9	28.4	28.5	28.4	28.2	
7	Imports	45.3	44.5	47.2	48.3	50.0	45.7	45.5	45.5	45.4	45.2	45.0	
8	Net non-debt creating capital inflows (negative)	-1.5	-2.4	-1.6	-6.5	-3.1	-1.3	-1.8	-2.2	-2.9	-2.8	-2.8	
9	Automatic debt dynamics 1/	0.6	-0.4	-1.1	-1.0	-0.8	0.1	0.4	0.5	0.2	0.1	0.2	
10	Contribution from nominal interest rate	3.1	3.5	3.2	3.4	2.8	2.7	2.7	2.9	2.9	2.8	2.8	
11	Contribution from real GDP growth	-0.9	-1.5	-2.0	-2.2	-1.3	-1.0	-1.0	-1.2	-1.5	-1.6	-1.5	
12	Contribution from price and exchange rate changes 2/	-1.6	-2.4	-2.4	-2.1	-2.4	-1.6	-1.3	-1.2	-1.2	-1.2	-1.1	
13	Residual, incl. change in gross foreign assets (2-3) 3/	-0.6	2.3	2.4	-1.5	0.7	-0.4	-0.2	0.2	0.3	0.4	0.5	
	External debt-to-exports ratio (in percent)	185.4	191.5	184.8	163.9	153.4	151.4	149.6	143.3	135.3	128.2	121.6	
	Gross external financing need (in millions of US dollars) 4/	2,859	2,876	3,194	3,120	3,243	2,982	3,046	3,275	3,261	3,326	3,445	
	in percent of GDP	18.1	16.8	17.1	15.3	14.6	12.7	12.2	12.4	11.5	10.9	10.5	
	Scenario with key variables at their historical averages 5/						**42.8**	**41.5**	**40.6**	**39.8**	**39.1**	**38.5**	**-2.0**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	1.9	3.1	4.2	4.7	3.2	2.5	2.5	3.0	4.0	4.5	4.5	
	GDP deflator in US dollars (change in percent)	3.1	4.8	4.9	4.4	5.6	3.6	3.2	3.0	3.0	3.1	3.1	
	Nominal external interest rate (in percent)	6.1	7.3	6.9	7.1	6.9	6.5	6.8	7.4	7.6	7.9	8.2	
	Growth of exports (US dollar terms, in percent)	8.0	3.3	13.4	6.6	16.1	3.7	4.6	7.8	7.5	7.3	7.3	
	Growth of imports (US dollar terms, in percent)	10.1	6.2	15.9	11.8	12.7	-2.8	5.2	6.0	6.9	7.3	7.3	
	Current account balance, excluding interest payments	-0.9	0.2	-0.4	-2.1	-3.2	0.0	-0.6	-0.3	-0.2	-0.2	-0.2	
	Net non-debt creating capital inflows	1.5	2.4	1.6	6.5	3.1	1.3	1.8	2.2	2.9	2.8	2.8	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

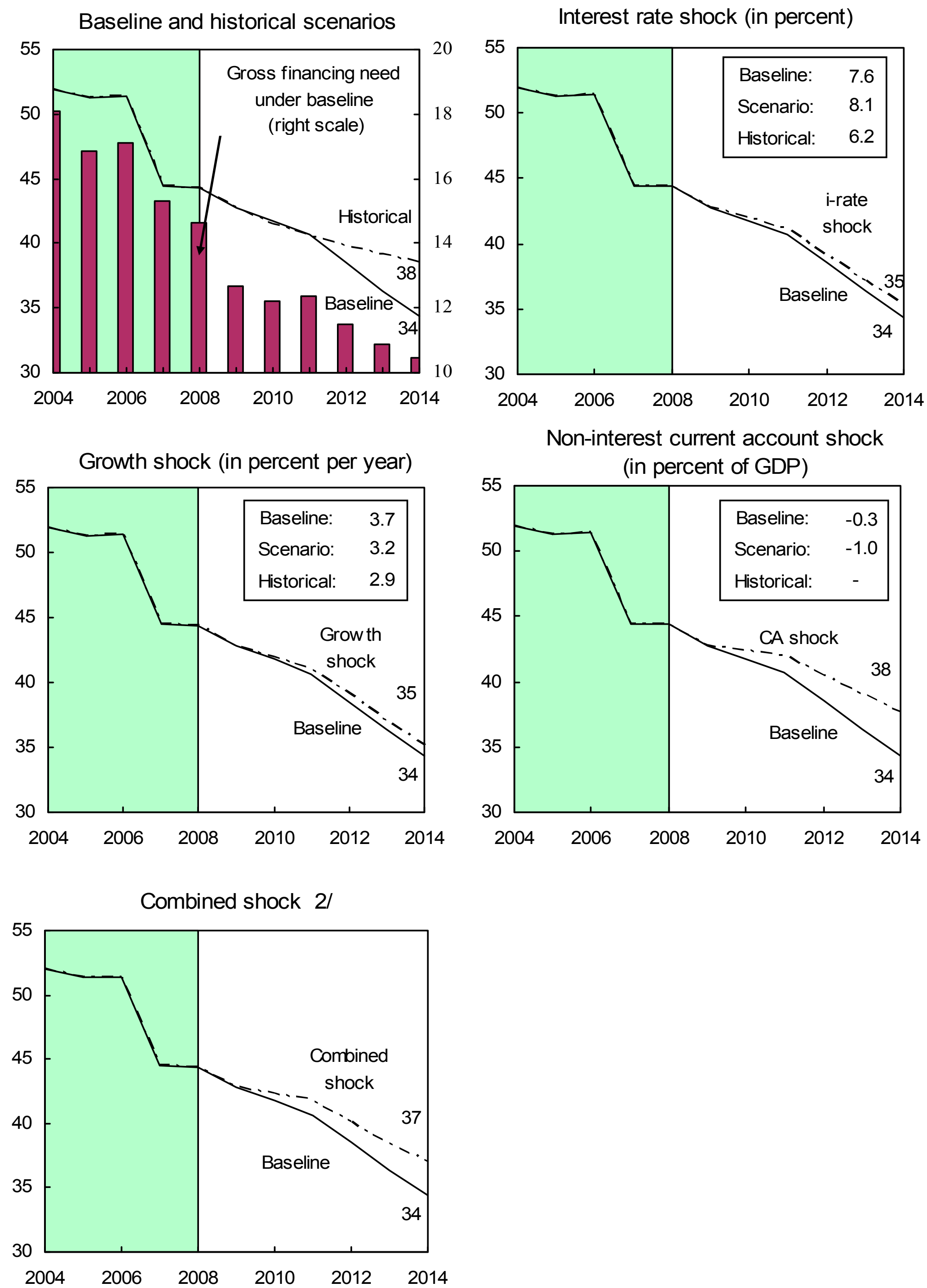
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 7. El Salvador: Public Sector Debt Sustainability Framework, 2004-2014
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	43.5	42.0	41.9	38.3	40.0	**41.5**	**40.7**	**39.8**	**38.5**	**36.9**	**35.2**	**-0.6**
o/w foreign-currency denominated	40.1	40.3	38.5	38.3	36.4	41.5	40.7	39.8	38.5	36.9	35.2	
Change in public sector debt	1.5	-1.5	-0.1	-3.6	1.8	1.5	-0.8	-1.0	-1.3	-1.6	-1.7	
Identified debt-creating flows (4+7+12)	2.3	-0.2	-0.6	-1.6	-0.3	0.5	-0.6	-0.7	-1.3	-1.7	-1.8	
Primary deficit	0.8	0.8	0.5	-0.5	0.5	0.5	-0.7	-0.8	-1.1	-1.1	-1.2	
Revenue and grants	16.0	16.5	17.2	17.1	17.0	17.2	18.6	18.4	18.5	18.5	18.4	
Primary (noninterest) expenditure	16.8	17.3	17.6	16.6	17.5	17.8	17.9	17.6	17.4	17.3	17.3	
Automatic debt dynamics 2/	0.1	-1.0	-1.1	-1.0	-0.8	0.0	0.0	0.1	-0.3	-0.6	-0.7	
Contribution from interest rate/growth differential 3/	0.1	-1.0	-1.1	-1.0	-0.8	0.0	0.0	0.1	-0.3	-0.6	-0.7	
Of which contribution from real interest rate	0.9	0.2	0.5	0.7	0.3	0.9	1.0	1.2	1.2	1.0	0.9	
Of which contribution from real GDP growth	-0.7	-1.2	-1.6	-1.8	-1.1	-0.9	-1.0	-1.2	-1.5	-1.6	-1.5	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-0.8	-1.3	0.5	-2.0	2.0	1.0	-0.2	-0.2	0.0	0.1	0.1	
Public sector debt-to-revenue ratio 1/	272.1	254.8	244.2	223.7	236.1	241.2	219.6	215.7	207.6	199.7	190.9	
Gross financing need 6/	6.6	6.8	7.0	5.3	5.9	6.8	4.9	5.1	3.7	3.1	2.7	
in millions of U.S. dollars	1040.7	1161.9	1310.7	1077.2	1303.0	1608.3	1217.3	1344.8	1033.3	937.5	883.7	
Scenario with key variables at their historical averages 7/						**41.5**	**41.4**	**41.1**	**41.2**	**41.4**	**41.5**	**-0.9**
Scenario with no policy change (constant primary balance) in 2009-2014						**41.5**	**41.9**	**42.3**	**42.6**	**42.6**	**42.5**	**-0.8**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	1.9	3.1	4.2	4.7	3.2	2.5	2.5	3.0	4.0	4.5	4.5	
Average nominal interest rate on public debt (in percent) 8/	5.3	5.5	6.3	6.5	6.8	6.1	5.9	6.3	6.4	6.0	5.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.2	0.7	1.5	2.1	1.2	2.4	2.7	3.3	3.4	2.9	2.7	
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	3.1	4.8	4.9	4.4	5.6	3.6	3.2	3.0	3.0	3.1	3.1	
Growth of real primary spending (deflated by GDP deflator, in percent)	-4.7	5.6	9.5	-1.8	8.8	4.2	2.9	0.9	2.7	3.7	3.7	
Primary deficit	0.8	0.8	0.5	-0.5	0.5	0.5	-0.7	-0.8	-1.1	-1.1	-1.2	

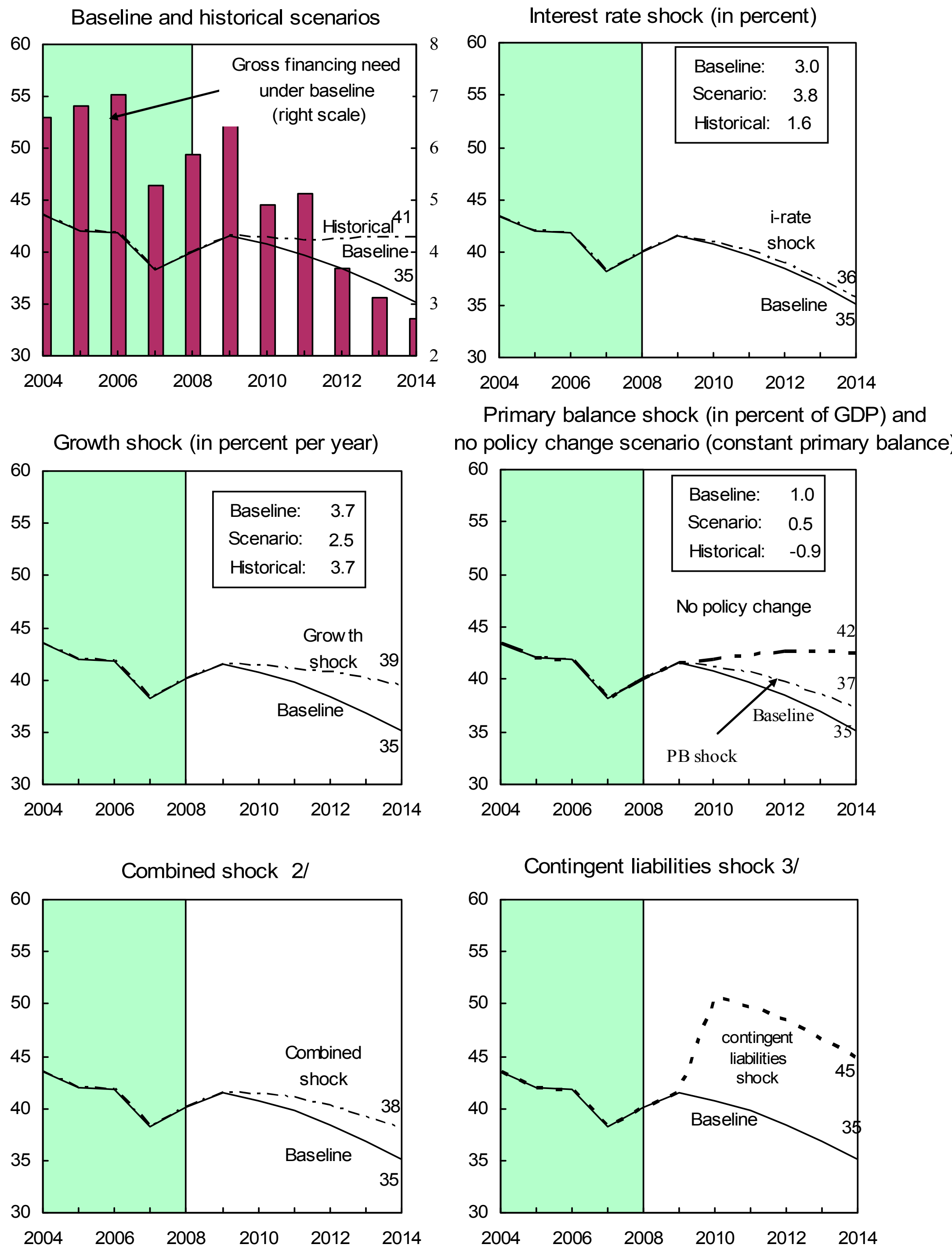
1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi\ (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 4. El Salvador: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Figure 5. El Salvador: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and IMF staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ Ten percent of GDP shock to contingent liabilities occurs in 2009.

Table 8. El Salvador: External Financing Requirements and Sources

(In US$ millions)

	2006	2007	Proj. 2008	2009	2010	2011	2012	2013	2014
Gross financing requirements	**-3,194**	**-3,120**	**-3,243**	**-2,982**	**-3,046**	**-3,275**	**-3,261**	**-3,326**	**-3,445**
Current account deficit	-675	-1,119	-1,331	-645	-836	-858	-884	-933	-987
Debt amortization	-2,447	-1,721	-1,514	-2,414	-2,085	-2,260	-2,181	-2,152	-2,199
Public sector	-404	-320	-303	-578	-437	-564	-436	-395	-382
Private sector	-2,043	-1,401	-1,212	-1,836	-1,649	-1,696	-1,745	-1,757	-1,817
GIR accumulation	-72	-280	-398	77	-124	-157	-196	-241	-259
Gross financing sources	**3,194**	**3,120**	**3,243**	**2,982**	**3,046**	**3,275**	**3,261**	**3,326**	**3,445**
Public sector disbursements	901	205	653	918	465	540	301	161	111
Private sector net inflows	2,293	2,915	2,590	2,065	2,581	2,735	2,961	3,165	3,334
Foreign direct investment	245	1,426	431	323	462	619	801	862	928
Other	2,047	1,489	2,160	1,741	2,119	2,116	2,159	2,302	2,406
Financing gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**

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

Table 9. El Salvador: Purchase Schedule and Terms Under the Stand-By Arrangement

Date	Conditions for purchase	Purchase: Million SDR	Million US$ 1/	Percent of Quota	Percent of Total Access
January 16, 2009	Board approval of the SBA	342.60	530.28	200.00	66.67
May 29, 2009	First review, based on end-March 2009 performance criteria	42.825	66.28	25.00	8.33
September 15, 2009	Second review, based on end-June 2009 performance criteria	42.825	66.28	25.00	8.33
December 15, 2009	Third review, based on end-September 2009 performance criteria	42.825	66.28	25.00	8.33
March 15, 2010	Fourth review, based on end-December 2009 performance criteria	42.825	66.28	25.00	8.33
Total		513.90	795.42	300.00	100.00

Source: Fund staff estimates.

Table 10. El Salvador: Quantitative Performance Measures for 2009

	2009 Program (In millions of U.S. Dollars)			
	end-March	end-June	end-September	end-December
Performance criterion				
Overall balance of the non-financial public sector (cumulative floor)	-150	-201	-427	-669
Continuous performance criterion				
Standard continuous performance criteria on zero-ceiling on non-accumulation of external debt service arrears by the non-financial public sector. 1/				
Indicative target				
Total bank deposits plus external short-term bank liabilities (floor)	8,303	8,303	8,303	8,303

1/ For the purpose of the program ceiling, external non-financial public sector debt-service arrears are defined as unpaid debt service payments by the non-financial public sector to nonresidents beyond 30 days after the due date.

Table 11. El Salvador: Structural Measures for 2009

Prior action

Implement regulation to increase effectiveness of central bank intervention in interbank lending market.

Structural benchmarks

Maintain prudential reserve requirements of banking system, currently at about 22 percent in effective terms (continuous).

May 15

Pass financial supervision bill containing following elements:

i) Merge the supervisory entities for banks, pensions and the stock market
ii) Enhance the autonomy of the merged supervisory institution
iii) Strengthen legal protection for supervisors
iv) Strengthen cross-border consolidated supervision.

Table 12. El Salvador: Indicators of Fund Credit, 2005-2014

(In units indicated)

		Projections					
	2008	2009	2010	2011	2012	2013	2014
Existing and prospective Fund credit 1/							
In millions of SDRs	0.0	471.1	513.9	513.9	369.4	117.8	5.4
In percent of exports of goods and services	0.0	11.0	11.4	10.6	7.1	2.1	0.1
In percent of public sector external debt	0.0	12.9	14.0	14.1	10.4	3.5	0.2
In percent of gross reserves	0.0	28.9	30.1	28.4	19.1	5.6	0.2
In percent of quota	0.0	275.0	300.0	300.0	215.6	68.8	3.1
Repurchases and charges due from existing and prospective drawings 2/ 3/							
In millions of SDRs	0.0	8.9	12.2	12.6	156.0	257.5	113.7
In percent of exports of goods and services	0.0	0.2	0.3	0.3	3.0	4.6	1.9
In percent of public sector external debt service	0.0	1.6	2.6	2.3	32.7	57.8	26.5
In percent of gross reserves	0.0	0.5	0.7	0.7	8.1	12.3	5.0
In percent of quota	0.0	5.2	7.1	7.4	91.0	150.3	66.4

Sources: Central Reserve Bank of El Salvador; Ministry of Finance; and Fund staff estimates.

1/ End of period.
2/ Under obligation schedule, assuming a constant 2.2 percent rate of charge.
3/ Excluding commitment charges.

Table 13. El Salvador: Proposed Access, 2009-2010

		High Access Cases 1/				Normal Access Cases			
	Proposed Arrangement	Proposed Arrangement (Percentile)	20th Percentile (Ratio)	80th Percentile (Ratio)	Average (Ratio)	Proposed Arrangement (Percentile)	20th Percentile (Ratio)	80th Percentile (Ratio)	Average (Ratio)
Access									
In millions of SDRs	513.9	6	2,147	12,943	8,404	87	36	409	353
Average annual access (percent of quota)	240	52	119	458	283	100	21	50	39
Total access in percent of: 2/									
Actual quota	300	18	305	901	652	100	30	75	63
Gross domestic product	2.2	6	3	10	11	69	1	3	2
Gross international reserves	20.4	11	27	91	89	62	5	41	41
Exports of goods and nonfactor services	7.7	8	12	43	33	82	2	7	6
Imports of goods and nonfactor services	4.7	2	13	57	34	66	2	7	5
Total debt stock									
Public 3/	5.6	14	7	33	22	…	…	…	…
External	5.2	16	7	17	13	75	2	6	4
Short-term	37.4	54	20	110	96	…	…	…	…
M2	5.1	23	5	24	26	61	1	12	102

Sources: Executive Board documents; MONA database; and Fund staff estimates.

1/ High access cases include all available data at approval and on augmentation for the [33] requests to the Board since 1994 which involved the use of the exceptional circumstances clause or SRF resources. Exceptional access augmentations are counted as separate observations. For the purpose of measuring access as a ratio of different metrics, access includes augmentations and previously approved and drawn amounts.

2/ The data used to calculate ratios is the actual value for the year prior to approval for public, external, and short-term debt, and the projection at the time of program approval in which the program was approved for all other variables.

3/ Defined as debt of the central government and debt guaranteed by the central government

INTERNATIONAL MONETARY FUND

El Salvador—Assessment of the Risks to the Fund and the Fund's Liquidity Position

Prepared by the Finance and Strategy, Policy, and Review Departments

In consultation with other Departments

Approved by Andrew Tweedie and Alan MacArthur

January 9, 2009

1. **This note assesses the risks to the Fund arising from the proposed Stand-By Arrangement (SBA) for El Salvador and its effects on the Fund's liquidity, in accordance with the policy on exceptional access**.[1] The authorities are requesting a 15-month SBA with access of SDR 513.9 million (300 percent of quota). While an amount equivalent to SDR 342.6 million (200 percent of quota) would be made available upon approval of the arrangement, this would be followed by four quarterly purchases of an amount equivalent to SDR 42.8 million (25 percent of quota) each; the authorities intend to treat the arrangement as precautionary. The last purchase is scheduled to be made available in March 2010 (Table 1).

Table 1. El Salvador: Proposed SBA—Access and Phasing

			Percent of quota	
Availability	Date 1/	SDR mn.	Purchase	Cumulative
2009	January (approval)	342.600	200	200
	May	42.825	25	225
	September	42.825	25	250
	December	42.825	25	275
2010	March	42.825	25	300
	Total	513.900	300	300

Source: Finance Department
1/ Starting in May 2009, purchases will depend on the completion of a review and on performance criteria for the end of the previous quarter.

[1] See *The Acting Chair's Summing Up of the Review of Access Policy Under the Credit Tranches and the Extended Fund Facility, and Access Policy in Capital Account Crises—Modifications to the Supplemental Reserve Facility and Follow-Up Issues Related to Exceptional Access Policy* (3/5/03).

I. BACKGROUND

2. **El Salvador has had several Fund Arrangements but has not drawn on Fund resources since the early 1980s**. El Salvador has had four SBAs during the period May 1993 and February 2000, and treated all of them as precautionary arrangements (Table 2). These programs supported reconstruction and the resumption of economic growth in the context of macroeconomic stability following the peace accords in 1992. Each of these arrangements was for a relatively small amount of resources, with the first in May 1993 for an amount of SDR 47.11 million (38 percent of quota), and each of the last three SBA's was for SDR 37.68 million (30 percent of quota).The last arrangement was for 17 months, beginning September 1998 and ending February 2000, and it was requested to help the authorities maintain macroeconomic discipline and the momentum of structural reforms. Economic performance under the program was broadly on track in the period through 1998, but there were significant deviations toward the end of the program period. El Salvador has had no outstanding Fund credit since end-1991.

3. **El Salvador's total external debt burden, as well as its public external debt burden, are moderate and have been on a declining trend in recent years**. El Salvador's external debt-to-GDP ratio is expected to continue its decline to below 45 percent of GDP at end-2008, from a level of 52 percent of GDP in 2004 (Table 3). Likewise, public and publicly guaranteed external debt, which accounts for just slightly over half of total external debt, is expected to fall to 24 percent of GDP at the end of 2008, from a level of 28 percent of GDP in 2004. In terms of both total external debt and public external debt, El Salvador falls close to the middle of the range of earlier and newly approved exceptional access cases at time of approval (Table 4).[2] Compared with the four earlier exceptional access cases, its total external debt and public external debt to GDP ratios are larger than those of Brazil and Turkey; while compared with the six newly approved cases, its total external debt to GDP ratio is larger than those of Georgia and Pakistan, and its public external debt to GDP ratio is larger than those of Georgia, Latvia, and Ukraine.[3] The composition of El Salvador's external debt is different from that of most of the earlier and newly approved exceptional access cases. El Salvador's external debt service is relatively low, reflecting that nearly 60 percent of public external debt is owed to bilateral and multilateral creditors.

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[2] The recent exceptional access cases used as comparators in this paper are those approved since the exceptional access procedures were put in place. In contrast to the newly approved arrangements, El Salvador's authorities intend to treat the arrangement as precautionary, as balance of payments pressures have not materialized. The 2008 extended arrangement for Liberia also involved exceptional access. However, Liberia is excluded since this arrangement was different from other exceptional access cases in that exceptional access was granted in the context of Liberia's clearance of arrears to the Fund.

[3] The earlier exceptional access cases are those approved from 2003 to 2005.

Table 2. El Salvador: IMF Financial Arrangements, Purchases and Repurchases, 1984–2015
(In millions of SDR)

Year	Type of New Arrangement	Date of Arrangement	Date of Expiration or Cancellation	Amount of New Arrangement	Amount Drawn	Purchases	Repurchases	Fund Exposure 1/ GRA	Fund Exposure 1/ Trust Fund	Fund Exposure 1/ Total
1984 2/						0.00	5.38	107.50	19.70	127.20
1985 2/						0.00	26.58	80.92	19.70	100.62
1986 2/						0.00	49.76	35.08	15.78	50.86
1987 2/						0.00	35.12	3.88	11.87	15.75
1988 2/						0.00	7.79	0.00	7.96	7.96
1989 2/						0.00	3.91	0.00	4.05	4.05
1990 2/	SBA	27-Aug-1990	26-Aug-1991	35.60	-	0.00	3.91	0.00	0.13	0.13
1991 2/						0.00	0.13	0.00	0.00	0.00
1992	SBA	06-Jan-1992	05-Mar-1993	41.50	-	0.00	0.00	0.00	0.00	0.00
1993	SBA	10-May-1993	31-Dec-1994	47.11	-	0.00	0.00	0.00	0.00	0.00
1994					-	0.00	0.00	0.00	0.00	0.00
1995	SBA	21-Jul-1995	20-Sep-1996	37.68	-	0.00	0.00	0.00	0.00	0.00
1996						0.00	0.00	0.00	0.00	0.00
1997	SBA	28-Feb-1997	30-May-1998	37.68	-	0.00	0.00	0.00	0.00	0.00
1998	SBA	23-Sep-1998	22-Feb-2000	37.68	-	0.00	0.00	0.00	0.00	0.00
1999						0.00	0.00	0.00	0.00	0.00
2000						0.00	0.00	0.00	0.00	0.00
2001						0.00	0.00	0.00	0.00	0.00
2002						0.00	0.00	0.00	0.00	0.00
2003						0.00	0.00	0.00	0.00	0.00
2004						0.00	0.00	0.00	0.00	0.00
2005						0.00	0.00	0.00	0.00	0.00
2006						0.00	0.00	0.00	0.00	0.00
2007						0.00	0.00	0.00	0.00	0.00
2008 3/						0.00	0.00	0.00	0.00	0.00
2009 4/	*SBA*	*16-Jan-2009*	*15-Apr-2010*	*513.90*		*471.08*	*0.00*	*471.08*	*0.00*	*471.08*
2010 4/						*42.83*	*0.00*	*513.90*	*0.00*	*513.90*
2011 4/						*0.00*	*0.00*	*513.90*	*0.00*	*513.90*
2012 4/						*0.00*	*144.53*	*369.37*	*0.00*	*369.37*
2013 4/						*0.00*	*251.60*	*117.77*	*0.00*	*117.77*
2014 4/						*0.00*	*112.42*	*5.35*	*0.00*	*5.35*
2015 4/						*0.00*	*5.35*	*0.00*	*0.00*	*0.00*

Source: Finance Department

1/ As of end December, unless otherwise stated.
2/ Include repurchases under credit tranches and Trust Fund.
3/ Projected as of end December.
4/ Figures under the proposed program in italics. They include the projected payments under obligation basis.

Table 3. El Salvador: Total External Debt, 2004–2008

		2004	2005	2006	2007	2008
		(In millions of U.S. dollars)				
Total External Debt		8,211	8,761	9,584	9,060	9,845
of which :	Public	4,372	4,491	5,125	4,956	5,306
	Multilateral	2,455	2,621	2,525	2,516	2,615
	Private	3,838	4,270	4,459	4,103	4,538
		(In percent of GDP)				
Total External Debt		52.0	51.3	51.4	44.5	44.4
of which :	Public	27.7	26.3	27.5	24.3	23.9
	Multilateral	15.5	16.6	16.0	15.9	16.6
	Private	24.3	25.0	23.9	20.1	20.5

Source: El Salvador authorities, World Economic Outlook, and IMF staff estimates.

Table 4. Debt Ratios in Earlier and Newly Approved Exceptional Access Cases 1/
(In percent of GDP)

	Total External Debt	Public External Debt	Total Public Debt	Debt to IMF
A. Earlier arrangements, 2003-05:				
Argentina (2003)	129.0	82.5	149.4	12.2
Brazil (2003)	38.6	21.5	85.9	5.1
Turkey (2005)	35.0	17.8	71.6	3.0
Uruguay (2005)	82.0	60.8	75.8	13.8
B. Newly approved arrangements (2008):				
Georgia	34.6	21.0	25.1	2.8
Hungary	106.4	37.6	67.4	4.2
Iceland	165.0	99.9	108.9	5.1
Latvia	129.2	10.2	14.3	2.8
Pakistan	31.4	29.5	54.6	3.5
Ukraine	54.3	10.4	10.6	2.5
El Salvador (2009) 2/	*44.4*	*23.9*	*40.0*	*2.4*

Source: Board Documents and IMF staff estimates.

1/ Ratios for the year indicated in parenthesis. Year in parenthesis corresponds to the year of approval of the last IMF arrangement with each country.
2/ Ratios for total external debt, public external debt, and total public debt are end-2008 estimates. The Debt to IMF ratio is calculated as the first purchase under the proposed arrangement divided by the 2008 GDP (both in U.S. dollars), although El Salvador's authorities have expressed their intention to treat the arrangement as precautionary, as balance of payments pressures have not materialized.

II. The New SBA—Risks and Impact on the Fund's Finances

A. Risks to the Fund

4. **Access under the proposed arrangement would far exceed that in previous arrangements for El Salvador, and would surpass the annual access limit and reach exactly the cumulative access limit**.[4] If all purchases were to be made according to the schedule, El Salvador's total outstanding use of GRA resources would reach 200 percent of quota with the first purchase, and peak at 300 percent of quota from March 2010 to March 2012. In terms of SDRs, this access would be nearly four times higher than El Salvador's previous peak of Fund credit outstanding reached during 1983–84. However, in terms of quota, this peak exposure would be lower than those of all earlier and newly approved exceptional access cases (Figure 1).

5. **While the authorities plan to treat the proposed arrangement as precautionary, if the SBA is fully disbursed, GRA credit outstanding to El Salvador would exceed 3 percent of GDP by end-2009** (Table 6). Upon approval of the arrangement, and drawing of the first purchase, El Salvador would become the eighth largest exposure in the GRA, just below Latvia and Liberia, and above the Dominican Republic (Table 5).

6. **Under the proposed SBA, if all purchases were fully made, El Salvador's debt to the Fund as a share of its public external debt would increase significantly**. El Salvador's outstanding use of Fund GRA resources would rise from zero to account for about 13 percent of public external debt by end-2009 (Table 6). El Salvador's projected repayments to the Fund would rise from 1.6 percent of public external debt service in 2009, to reach 33 percent in 2012, and to about 58 percent in 2013.[5] In terms of exports of goods and services, El Salvador's external debt service to the GRA would amount to about 3 percent in 2012 and about 4.6 percent in 2013, closer to the ratios projected for the recently approved arrangements for Georgia and Hungary from among the newly approved exceptional access cases.

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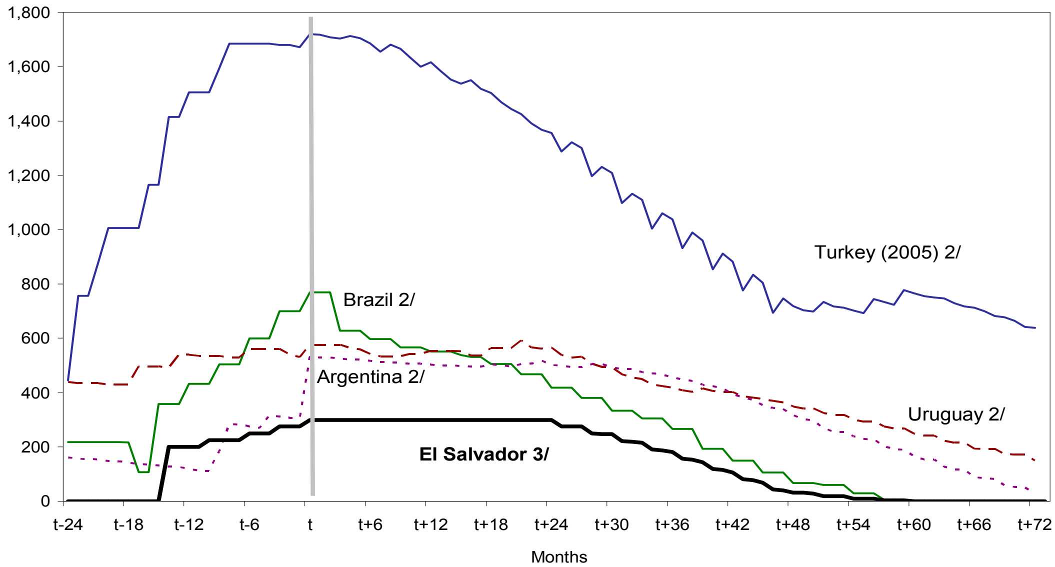
[4] It should be noted that even if the newly proposed access limits (200 percent of quota for annual and 500 percent of quota for cumulative purchases) were approved, the SBA for El Salvador would still be exceptional access, reflecting that the available purchases in 2009 would exceed 200 percent.

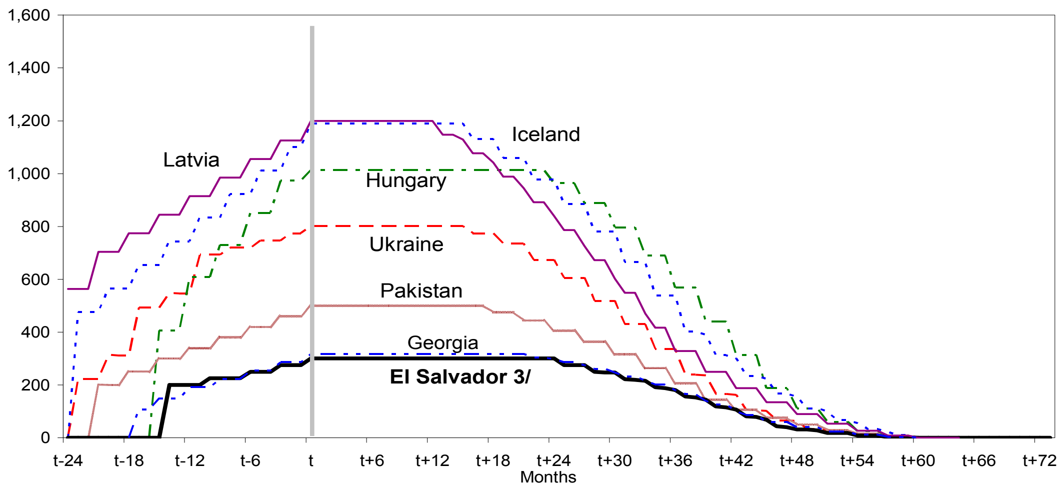
[5] The figures on debt service used in this report correspond to the schedule on an obligations basis, in line with the guidelines stipulated in *Review of Fund Facilities—Proposed Decisions and Implementation Guidelines* (11/3/00). Under the obligations schedule, the first repurchase should take place in April 2012, 3¼ years after the first purchase under the arrangement. Under the policy on time-based repurchase expectations, there is an expectation that repurchases of holdings resulting from the purchases in the credit tranches and the EFF, including under exceptional access, will adhere to the expectations schedule, and an extension from the expectations to the obligations schedule would require a decision by the Executive Board.

Figure 1. Fund Credit Outstanding in the GRA around Peak Borrowing 1/
(In percent of quota)

A. Earlier Exceptional Access Cases



B. Approved or Forthcoming Exceptional Access Cases since September 2008



Source: IFS, Finance Department, and IMF staff estimates.

1/ Peak borrowing is defined as the highest level of credit outstanding for a member, in percent of quota. Month t represents the month of the highest historical credit outstanding (in percent of quota). For Argentina, t is September 2001; for Brazil, September 2003; for Turkey, April 2003; and for Uruguay, August 2004. For the countries in Panel B, t would be reached in February 2010 for Georgia, in February 2010 in the case of Hungary, and in October 2010 in the cases of Iceland and Ukraine. For comparability, projected repurchases are assumed to be on an obligations basis.
2/ Projected repurchases (on an obligation basis) as of May 2005. Schedules do not show large early repurchases made by Argentina, Brazil, and Uruguay in 2005-06.
3/ El Salvador's authorities have expressed their intention to treat the arrangement as precautionary, as balance of payments pressures have not materialized.

Table 5. Fund GRA Exposure

		In Percent of			
				Total GRA Credit	
	SDR Millions	Quota	GDP 3/	As of end-December, 2008	After approval of forthcoming arrangement 4/
Top five borrowers 1/					
Turkey	5,534.4	464.6	1.1	31.6	31.0
Hungary	4,215.0	405.9	4.1	24.1	23.6
Ukraine	3,057.3	222.8	2.5	17.4	17.1
Pakistan	2,072.1	200.5	2.1	11.8	11.6
Iceland	560.0	476.2	4.7	3.2	3.1
El Salvador 2/	342.6	200.0	2.4	2.0	1.9

Sources: Finance Department and IMF staff estimates.

1/ Fund credit outstanding as of end-December, 2008.
2/ Fund credit outstanding after the first purchase of the proposed SBA, although El Salvador's authorities have expressed their intention to treat the arrangement as precautionary, as balance of payments pressures have not materialized.
3/ Staff projections to end-2008 for all countries except Pakistan, where projections are for end-June 2009.
4/ Numerator is Fund credit outstanding as of end-December, 2008 or the first purchase under the proposed forthcoming SBA. Denominator is the sum of total Fund GRA credit outstanding as of end-December, 2008 and the first purchase of the proposed arrangement.

B. Impact on the Fund's Liquidity Position and Risk Exposure

7. **The proposed arrangement for El Salvador, if fully drawn, would reduce Fund liquidity by about 0.5 percent** (Table 6).[6] Commitments under the proposed arrangement would reduce the one-year forward commitment capacity (FCC) by SDR 513.9 million—from an estimated level of SDR 97.6 billion at the time of program approval.

8. **After the first purchase, Fund GRA credit to El Salvador as a share of total Fund credit from the GRA would be about 2 percent**. This share takes into account the initial purchase under the newly approved arrangements for Ukraine, Hungary, Iceland, Pakistan, and Latvia. Concentration of Fund credit among the top five borrowers would fall by about 2 percentage points to about 86 percent.

[6] The FCC is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of GRA resources available for new financing over the next 12 months. See *The Fund's Liquidity Position—Review and Outlook* (10/14/02). Following the creation of the Short-term Liquidity Facility (SLF), the calculation of the FCC will exclude the repurchases falling due under the SLF—See *A New Facility for Market Access Countries—The Short-Term Liquidity Facility—Proposed Decision* (Supplement 1, 10/27/08).

Table 6. El Salvador—Impact on GRA Finances

(In millions of SDRs, at end of period unless otherwise noted)

	Jan-2009	2009	2010	2011	2012	2013	2014
Exposure							
Fund GRA credit outstanding to El Salvador 1/	342.6	471.1	513.9	513.9	369.4	117.8	5.4
Fund GRA credit outstanding to El Salvador (percent of quota) 1/	200.0	275.0	300.0	300.0	215.6	68.8	3.1
Fund GRA credit outstanding to El Salvador (percent of total GRA credit outstanding) 2/	1.9	…	…	…	…	…	…
Fund GRA credit outstanding to five largest debtors (percent of total GRA credit outstanding) 2/	86.4	…	…	…	…	…	…
Liquidity							
One-year Forward Commitment Capacity (FCC) 3/	97,603.9	…	…	…	…	…	…
El Salvador's impact on FCC 4/	(513.9)	…	…	…	…	…	…
Prudential measures							
Fund GRA credit outstanding to El Salvador (percent of current precautionary balances) 5/	4.9	…	…	…	…	…	…
Debt and Debt Service Ratios 6/							
El Salvador's GRA credit outstanding (percent of total public external debt)	10.0	12.9	14.0	14.1	10.4	3.5	0.2
El Salvador's GRA credit outstanding (percent of GDP)	2.4	3.1	3.2	3.1	2.1	0.6	0.0
El Salvador's GRA credit outstanding (percent of gross international reserves)	20.4	28.9	30.1	28.4	19.1	5.6	0.2
El Salvador's GRA debt service to the Fund (percent of exports of goods and services)	0.0	0.2	0.3	0.3	3.0	4.6	1.9
El Salvador's GRA debt service to the Fund (percent of total public external debt service)	0.5	1.6	2.6	2.3	32.7	57.8	26.5
Memorandum items							
Fund's precautionary balances 5/	6,938.6						
Fund's residual burden sharing capacity 7/	40.0						
Projected payment of charges to the Fund on GRA credit outstanding 8/	1.7	8.9	12.2	12.6	10.9	5.6	1.2
Projected debt service payments to the Fund on GRA credit outstanding 8/	1.7	8.9	12.2	12.6	156.0	257.5	113.7

Source: El Salvador authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

1/ Repurchases follow obligation schedule.
2/ Reflects total GRA credit oustanding as of end-December, 2008, plus the first purchase of El Salvador.
3/ As of end-December, 2008. The Forward Commitment Capacity is a measure of the resources available for new financial commitments in the coming year, equal to usable resources plus repurchases one-year forward minus the prudential balance.
4/ A single country's negative impact on the FCC is defined as the country's sum of Fund credit and undrawn commitments minus repurchases one-year forward.
5/ As of end-April 2008 for precautionary balances. The numerator for credit outstanding includes the first purchase upon approval of the program.
6/ Staff projections for total public external debt, GDP, gross international reserves, and exports of goods and services, as used in the staff report that requests the proposed SBA. For Jan-2009, staff projections of these variables relate to 2008.
7/ Estimated based on end-December, 2008 data. Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being utilized to offset deferred charges and takes into account the loss in capacity due to nonpayment of burden sharing adjustments by members in arrears.
8/ Includes surcharges and service charge.

9. **Potential GRA exposure to El Salvador would be modest in relation to the Fund's precautionary balances (the general and special reserves and the SCA-1)**. Outstanding GRA credit to El Salvador following the first purchase would be equivalent to 5 percent of the Fund's current stock of precautionary balances.

10. **In the event that El Salvador were to fully draw on resources available under the proposed SBA, and to incur arrears on the charges accruing to its GRA obligations, the Fund's burden sharing mechanism would be put under some strain**.[7] Charges on the GRA obligations would exceed SDR 10 million in each of the years from 2010 to 2012. This would amount to over half of the Fund's estimated residual burden-sharing capacity, taking into account the newly approved arrangements (see Table 6). However, the impact on the Fund's burden sharing capacity of potential arrears from this arrangement would be expected to decline if there is a sustained pick up in lending.

III. Assessment

11. **The authorities plan to treat the proposed SBA as precautionary, and the main goals would be to signal policy continuity, help sustain investor confidence, and boost the economy's resilience to shocks**. However, in the event of significant balance of payments pressures, they are likely to draw on the available resources which would entail some financial risk for the Fund. The proposed level of access is nearly four times higher than the previous peak Fund exposure to El Salvador, but not excessively large in terms of most relevant metrics, including the size of the country's economy and its debt servicing capacity.

12. **The possibilities of large and sudden deposit outflows and unwinding of cross border bank loans remain risks, which if they materialize, would call for additional policy responses**. If stress in the financial system triggered the consultation clause, the authorities, in consultation with the Fund, would design additional policy actions to strengthen El Salvador's external position and enhance the prospects of fulfilling its financial obligations. Moreover, a continuation of global financial turmoil and the prospects of continued slowdown in the real economy of the United States, and their related impacts through remittances, trade, and capital flows to El Salvador, suggest that a further deterioration of the balance of payments, despite the Fund's financial support, cannot be ruled out.

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[7] Under the burden-sharing mechanism, the financial consequences for the Fund that stem from the existence of overdue financial obligations are shared between creditors and debtors through a decrease in the rate of remuneration and an increase in the rate of charge, respectively. The mechanism is used to accumulate precautionary balances in the special contingent account (SCA-1) and to compensate the Fund for a loss in income when debtors do not pay charges. The Executive Board has set a floor for remuneration at 85 percent of the SDR interest rate. No corresponding ceiling applies to the rate of charge. The adjustment for the SCA-1 was suspended, effective November 1, 2006, by the Executive Board (adopted January 3, 2007).

13. **Realization of the above risks would adversely affect El Salvador's capacity to repay the Fund**, **notwithstanding that the proposed access is modest in terms of the Fund's resources, as well as compared to other recent exceptional access cases**. Drawing on the resources would generate an increased debt service burden. A sustained and forceful implementation of the program by the new administration, and a prompt response to changes in underlying conditions and deviations from program assumptions are essential to mitigating these risks and safeguarding Fund resources. El Salvador's track record of implementing sustainable macroeconomic policies provides confidence in this regard.

Statement by the IMF Staff Representative
January 16, 2009

1. This statement reports on developments since the issuance of the staff report and does not change the thrust of the staff appraisal.

2. Some leading indicators of U.S. economic activity released during this week point to a possible further deterioration in U.S. prospects for 2009. El Salvador's outlook for 2009 and 2010 would be negatively impacted, in line with the downside risks highlighted in the staff report.

3. Financial indicators have been broadly stable. Total deposits at end-December stood at US$8,815 million, around one percent above their end-November level. Sovereign spreads have fallen by 100 basis points since end-2008, compared to a decline of only 30 basis points of the regional composite.

4. Both leading presidential candidates have endorsed publicly the main elements of the program, including on macroeconomic stability, fiscal sustainability, and dollarization. Below please find the respective hyperlinks (please also see attachment).

Rodrigo Avila (ARENA):
http://www.rodrigopresidente.com/nota275.php

Mauricio Funes (FMLN):
http://www.mauriciofunestv.com/comunicadodeprensa.doc

ATTACHMENT

Rodrigo Ávila Seeks IMF's Final Approval for $800 Million Loan

"As president of COENA [Consejo Ejecutivo Nacional, National Executive Council] and candidate for president, I believe that this loan and all its associated economic elements will help preserve the macroeconomic stability of our country."
Rodrigo Ávila, President of ARENA [Alianza Republicana Nacionalista, Nationalist Republican Alliance]

Rodrigo Ávila, president of the ARENA party and candidate for president nominated by this political institution, today requested IMF authorities to approve the final allocation for a loan of $800 million that will provide "economic security" to the country in the face of the global financial crisis that has shaken the world's major economies and is threatening the emerging economies.

Although a preliminary agreement was reached between the government and the IMF on December 22, disbursement of the funds depends on the approval of the IMF's Executive Board. A decision is to be taken tomorrow, and that is why the president of the foremost national political institution considers it prudent to call for a definitive commitment.

"As president of COENA [Consejo Ejecutivo Nacional, National Executive Council] and candidate for president, I believe that this loan and all its associated economic elements will help preserve the macroeconomic stability of our country, which is crucial for supporting a favorable investment climate, protecting jobs, and preventing the crisis from hitting us with full force and affecting the financial circumstances of Salvadoran families," the candidate for president explained.

Ávila said that obtaining this loan is crucial for preserving the liquidity of the national financial sector and maintaining a sound economy. "The purpose of this loan is to enhance confidence in the economy and provide a liquidity cushion for the financial sector that will allow it to shield itself from the global financial crisis and protect the country from its effects. That is why we once again stress the importance of obtaining this loan," he added.

Ávila committed to respecting agreements with the IMF

Ávila also made a commitment that, once the agreement comes into effect, he will respect the terms agreed on with the financial institution and the spirit of the loan agreement.

The funds, which would be available within one month and remain so for a period of 15 months, would improve the country's economic security. On various occasions, Rodrigo Ávila has stated that one of his main goals is to maintain the economic stability of the country.
In this context, the candidate for president has stated that the economic policies of his government program, called "A More Just Country," will focus on firmly establishing the official dollarization policy, establishing strict preventive regulations for the financial sector,

and a prudent fiscal policy in line with the budget approved by the Legislative Assembly, which provides for expanded social spending to mitigate the impact of the global economic crisis on the poorest sectors of the population.

Rodrigo Ávila finished by expressing his confidence that the decision of the IMF Executive Board would be favorable for his country, and he affirmed that the measures he has taken to support this agreement will soon bear fruit. "When I met with the IMF authorities for the first time last June 17th to discuss this subject, we were certain that these measures would bring great benefits to the Salvadoran people," he said.

Peace, Progress, and Development

San, Salvador, January 15, 2009

Statement by F.M.L.N. Presidential Candidate Mauricio Funes on the Agreement between the International Monetary Fund and the Government of El Salvador

Since the financial crisis began in the USA, I have been concerned about the potential fallout on El Salvador. For this reason, in recent weeks, I have been working hard to study the crisis, to propose specific measures to counteract its repercussions and prevent more serious problems in future, and to identify external political, technical, and financial assistance. Furthermore, and in light of the seriousness and complexity of the international economic and financial situation, I have emphasized that the only way to address the crisis successfully is through national unity, as I believe that El Salvador's destiny is our shared responsibility.

In November I traveled to Washington, where I met with staff of the Inter-American Development Bank (IDB), the World Bank (IBRD), and the International Monetary Fund (IMF). At these meetings I reaffirmed my commitment to maintaining and consolidating macroeconomic stability, preserving dollarization, and implementing a sound fiscal policy geared toward increasing social spending and investment in infrastructure. In addition, I presented my proposals for addressing the crisis, including the establishment of the special strategic reserve fund. In addition, my proposals include other measures designed to strengthen the domestic financial system and to make timely loans to support productive sectors—in particular, the agriculture sector and micro-enterprises and SMEs.

As a candidate for the presidency of the Republic of El Salvador, I repeat my willingness to maintain good relations with international financial institutions and with multilateral banks. Moreover, I am committed to supporting all programs aimed at ensuring macroeconomic stability, increasing social and infrastructure investment, safeguarding the stability of the financial system and curbing the fiscal deficit.

On December 22, the IMF issued a press release announcing that agreement had been reached, in principle, on a program that could be supported by an amount in the equivalent of SDR 513.9 million (about US$800 million), under a 15-month Stand-By Arrangement (SBA). This press release goes on to say that the Salvadorian authorities intend to treat the arrangement as precautionary and do not intend to draw on it.

I share the general principles underpinning this agreement, especially those having to do with preserving macroeconomic stability, maintaining dollarization, and ensuring prudent fiscal management. Moreover, I wish to express my satisfaction at the inclusion of measures to increase social spending and investment in infrastructure as well as efforts to strengthen the domestic financial system. These are essential elements for generating a climate conducive to domestic and foreign private investment and for achieving greater economic growth for the benefit of the Salvadoran people.

San Salvador, January 15, 2009

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 09/10
FOR IMMEDIATE RELEASE
January 16, 2009

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves Precautionary Stand-By Arrangement for El Salvador of About $800 Million

The Executive Board of the International Monetary Fund today approved a 14½ month SDR 513.9 million (about US$800 million) precautionary Stand-By Arrangement for El Salvador to support the country's economic strategy to cope with the adverse effects of the global financial crisis. The Salvadorian authorities do not intend to draw on the funds.

As El Salvador is not facing any immediate balance of payment needs, the authorities' program supported by the Fund is a precautionary measure that forms part of an overall strategy to strengthen the country's financial defenses. The program's main goal is to help provide adequate liquidity to the country's economy. Despite its solid macroeconomic fundamentals, the authorities are taking these preventive measures to stave off any adverse effects El Salvador could be facing in 2009 as a result of the global financial turmoil, the U.S. recession and uncertainties related to the Salvadorian electoral cycle.

As part of this strategy, El Salvador has also negotiated loans with the World Bank and the Inter-American Development Bank for a total of US$950 million. The Fund arrangement is designed to foster investor and depositor confidence by reducing uncertainty about macroeconomic policies in the run-up to the elections, and during the first few months of the new administration.

Following the Executive Board discussion on El Salvador, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, said:

"El Salvador's macroeconomic fundamentals are solid following years of prudent policies and structural reforms. However, the global financial turmoil and the recession in the United States entail risks to the outlook in 2009. The authorities' program, supported by the precautionary Stand-By Arrangement with the Fund, aims to reduce these risks by strengthening the financial system, maintaining a prudent fiscal stance, and increasing the economy's liquidity buffers.

"The authorities' fiscal program aims to safeguard medium-term sustainability, while raising public investment and sheltering the most vulnerable groups in society from the effects of the slowdown. These objectives will be supported by measures to increase government revenue and improve spending efficiency, including improvements in tax administration and lower electricity subsidies to create additional space for better-targeted social spending.

"The authorities have responded proactively to the global financial turmoil by taking action to enhance monitoring of bank liquidity and borrowing, maintain prudential requirements for bank reserves and liquid assets at current levels, and improve the functioning of the interbank market. They plan to seek congressional approval of a law to strengthen financial sector supervision and regulation.

"El Salvador's banking system is well positioned to withstand a significant temporary shortfall of liquidity in situations of stress. Access to substantial Fund resources will increase further the economy's liquidity buffer and bolster confidence in the financial system.

"The two main presidential candidates have publicly endorsed the main elements of the program, and reiterated their commitment to macroeconomic stability, official dollarization, and prudent fiscal policy. This endorsement will contribute to policy continuity and strengthen confidence during the political transition," Mr. Portugal said.

ANNEX

Recent Economic Developments

El Salvador's macroeconomic fundamentals are solid and have improved in recent years thanks to prudent policies, well-oriented structural reforms, and a favorable external environment. Fiscal consolidation led to a reduction in the public debt-to-GDP ratio, and in 2006–07, the country experienced the highest growth rates in a decade.

However, the global financial crisis has significantly affected the country's dollarized economy. Real GDP growth is projected to slow to 3.2 percent in 2008, compared to 4.7 percent in 2007, reflecting lower growth in remittances, a tightening of external financing conditions, and a decline in investments. Exports, however, have remained buoyant despite weaker external demand. The banking system remains liquid and well-capitalized, although nonperforming loans have increased and profitability is declining. While the country's linkages to global financial markets are strong, the impact of the financial turmoil has, so far, been moderate.

The U.S. recession is likely to continue having an adverse effect on El Salvador. The U.S. is El Salvador's main export market, and there are also strong financial sector linkages. Remittances from the U.S. amount to about 18 percent of GDP.

Program Summary

The authorities' economic program will focus on crisis preparedness, continued prudent fiscal policies, and financial sector reforms:

- **Financial contingency measures:** Including closely monitoring bank liquidity and short-term borrowing.

- **Short-term fiscal policy:** Maintain fiscal restraint by keeping the nonfinancial public sector deficit not exceeding 2.8 percent of GDP in 2009.

- **Structural reforms:** Further strengthening of financial sector regulation and supervision and enhancing the banking system's ability to weather shocks.

El Salvador joined the IMF on March 14, 1946, and its quota is SDR 171.3 million (about US$258.8 million). El Salvador has had no outstanding IMF credits since 1991.

Statement by Ramon Guzmán, Executive Director for El Salvador
and Alvaro Umaña, Senior Advisor
January 14, 2009

Given that the Article IV consultation for El Salvador was recently concluded, this statement can be brief. In the Summing-Up of the consultation, Directors highlighted the fact that El Salvador has strong macroeconomic fundamentals, the result of several years of sound policies, well-oriented structural reforms and a favorable external environment. However, the present international crisis (the U.S. recession in particular), and the food and fuel prices increases of 2008, have had an impact on the economy with growth slowing down to 3.2 percent last year. Inflation, which had risen in the earlier part of the year, slowed down and closed at 4.5 percent by year's end.

The main downside risks include the difficult external environment and potential impact of inadequate financing due to the global crisis, as well as electoral uncertainty that could impact the capital account as the 2009 elections approach. All this has resulted in some tightening in domestic financial conditions, but the banking system remains resilient and well capitalized, although profitability has decreased.

The government has taken important steps to strengthen the banking system, including raising liquidity asset requirements by three percentage points to 6 percent in June 2008 (total prudential requirements—liquidity and reserves—now amount to 28 percent of deposits). Banks have also been required to submit contingency liquidity plans, including availability of external credit lines. Monitoring capabilities for key banking indicators have been upgraded and are updated daily. The central bank, with Interamerican Development Bank (IADB) resources, will purchase high quality loans to sustain credit growth in the private sector.

Linkages to global financial markets are strong since the three largest banks were acquired by foreign banks and foreign-owned banks assets are now above 90 percent, providing an additional anchor the financial system. Liquidity ratios for the banking system are about 42 percent (more than half highly liquid assets) and capital adequacy is 14.5 percent, with both indicators above prudential requirements.

The Salvadoran authorities will seek congressional approval of a Financial Sector Supervision and Regulation Law to increase the resilience of the financial sector. This law, drafted with MCM technical assistance, proposes to merge supervisory entities in the financial system, pension fund and stock market; increasing autonomy and providing legal protection for supervisor. The law also provides for cross-border consolidated supervision.

The overall public sector deficit is projected to be one percentage point higher than 2007, reaching 2.9 percent. This weaker fiscal position reflects increased social spending to shield the impact of fuel and food price increases on the poor, lower revenue growth and higher capital spending on a new hydroelectric plant. Although there have been difficulties in placing domestic debt with maturities beyond March 2009, the recent agreement to authorize loans from the World Bank and IADB, the first such authorization in three years, will improve the liquidity position of the government.

Although exports continued to increase (17 percent) in 2008 despite the U.S. recession, the global slowdown is likely to cause export growth to stagnate. Remittances growth had decelerated and is expected to remain low throughout 2009. Domestic demand is expected to decrease this yea as well. To mitigate the drop in domestic demand, the fiscal deficit target for 2009 has been revised to 2.8 percent, 0.4 percent above the earlier target. The authorities are also expected to increase revenues by 0.2 percent of GDP and to eliminate nonresidential subsidies for electricity, as well as creating additional space for social spending (0.3 percent of GDP to expand the *Red Solidaria*).

The main goals for the Fund SBA is to provide for stability and policy continuity in the face of electoral uncertainty, sustain investor confidence and increase the economy's resilience to shocks. The level of access (300 percent of quota) has been clearly justified by staff using a variety of metrics. It also has one of the lowest multipliers of quota among the recent SBA's approved by the Fund, as shown in Figure 1-B of the risk assessment Supplement 1.

The staff's evaluation of the exceptional access criteria clearly shows that El Salvador meets three of the four criteria, namely: sustainable debt position, access to private capital markets and strong policy reform and implementation capacity. El Salvador does not presently have exceptional pressures on the capital account and it intends to treat the program as precautionary, in case that these pressures should materialize.

Given its strong economic fundamentals, location and openness of the economy, El Salvador is well positioned to renew growth once the global crisis subsides. Years of responsible policies have also resulted in a decrease in total debt, so El Salvador has a strong capacity to repay the Fund. In light of the country's strong track record, its unique present situation and its potential needs, we request you support for the proposed SBA.