November 2006
IMF Country Report No. 06/410

El Salvador: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for El Salvador

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with El Salvador, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 19, 2006, 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 July 10, 2006. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 24, 2006 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for El Salvador.

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

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with El Salvador

Approved by Markus Rodlauer and Adnan Mazarei

July 10, 2006

- **Discussions.** A staff team held discussions in San Salvador during May 8–19, 2006. The team met with Vice-President of the Republic Ana Vilma de Escobar, Technical Secretary of the Presidency Eduardo Zablah, Finance Minister William Hándal, Economy Minister Yolanda de Gavidia, Central Bank President Luz María de Portillo, other senior government officials, legislators, labor unions, and private sector representatives.

- **Staff team.** The staff team comprised M. Garza (Head), O. Hendrick, M. Rodriguez, W. Samuel, and G. Tolosa (EP) (all WHD). D. Desruelle (WHD) and N. Conrado (OED) participated in the final discussion.

- **Last consultation** (January 31, 2005). Directors praised El Salvador for its long record of sound macro policies and reforms. They noted that the challenges were to boost growth, improve social conditions, and deal with adverse shocks in the dollarized regime. Directors stressed the need for a stronger fiscal stance, further banking reform, and improved business climate to foster private investment.

- **Fund relations.** El Salvador has accepted the obligations of Article VIII, sections 2, 3, and 4 and maintains an exchange system free of restrictions on the making of payments and transfers for current transactions. The U.S. dollar has been the legal tender since January 2001. El Salvador subscribes to the SDDS, participated in an FSAP update and ROSCs by FAD and STA in 2004–05, and has no outstanding obligations to the Fund. It is on the standard 12-month cycle for Article IV consultations.

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EXECUTIVE SUMMARY

Background

- **El Salvador has adopted a wide range of reforms since the early 1990s.** The government that took office in June 2004 has continued the reform effort, with actions to strengthen tax revenue, improve debt management, and adopt CAFTA-DR (the free-trade agreement of Central America and Dominican Republic with the United States) to deepen integration with the global and regional economy.

- **The near-term outlook has strengthened, although challenges remain.** After several years of sluggish growth, economic activity has picked up and growth is expected to reach 3½ percent this year, supported by the authorities' policies and favorable global conditions. Strengthening medium-term growth prospects requires reforms to improve the debt dynamics, address banking fragilities, and bolster private investment and exports through improved competitiveness and higher savings.

- **The authorities are planning further policy actions.** They intend to limit tax exemptions and subsidies, raise priority spending, and obtain passage of banking reforms this year. Their fiscal framework would keep public debt steady through 2008 (42 percent of GDP) and bring it down thereafter.

Key issues and staff recommendations

- **Discussions focused on policies to enhance growth and social progress within the framework of formal dollarization.** Staff supported plans to strengthen the economy's resiliency to shocks and improve competitiveness, and encouraged the authorities to reinforce the fiscal framework. Supportive global conditions provide a good opportunity to advance the reform process.

- **Fiscal policy.** The staff recommended placing the public debt on a firm downward path, while protecting priority spending. It supported the authorities' medium-term strategy to strengthen tax revenue and contain pension costs to provide more room for investment and social spending. To achieve these objectives, the staff recommended more fundamental tax and pension reforms.

- **Banking reform.** The staff supported plans to consolidate financial stability through steps to strengthen the prudential and supervisory framework, deepen intermediation, and improve the safety net. To solidify the dollarization regime, the staff encouraged the authorities to strengthen the lender-of-last-resort function and restructure the central bank's balance sheet, as provided by the dollarization law of 2001.

- **Competitiveness.** Improving competitiveness is key to boosting productivity and investment. The staff supported the authorities' strategy to boost infrastructure and human capital, reduce red tape, tackle crime, and create new trade opportunities, which would help lower the cost of doing business in El Salvador.

I. Overview

1. **El Salvador has made major strides on several fronts since the peace accords of 1992.** Political stability and democracy have become firmly rooted. Social conditions have improved, with a substantial decline in poverty. Wide-ranging reforms have been adopted, which were capped by formal dollarization in 2001 (Table 1). As a result, El Salvador maintains macroeconomic stability, has an investment grade rating (the only such country in Central America), and is often considered to be the second-best performer on reforms in Latin America, after Chile.

2. **Building upon this progress, President Saca has pursued an outward-oriented policy strategy to enhance growth and social prospects.** Mr. Saca, who began his 5-year term in June 2004, has focused economic policies on developing new sources of growth and reducing poverty through greater integration with the global and regional economy, investment and social reforms, consolidation of financial stability, and stabilization of the public debt level. Thus far, the government has put into effect CAFTA-DR, increased tax revenue, and improved debt management.

3. **Supported by this policy strategy and broadly favorable global conditions, the Salvadoran economy has strengthened somewhat since the last Article IV consultation.** Output growth has picked up. Inflation has slowed despite the pass-through of a sharp increase in oil prices. Sovereign spreads have remained among the lowest in Latin America. The coverage of bank deposits with short-term foreign assets has remained at a comfortable level (Figures 1–2 and Table 2).

4. **The main policy challenge is to place the economy on a path of faster growth and social progress.** Despite strong reforms, per capita income has stagnated since 2000, while poverty stands at 35 percent (60 percent in 1992). The growth performance has also been disappointing partly because the economy has been hit by adverse shocks (external factors, natural disasters, and the political cycle), and structural weaknesses have limited the growth potential. Factors behind the weak growth record also include:

- ***Low investment.*** Low investment and productivity growth reflect low national savings and the constraints on infrastructure and human capital, high crime, and weaknesses in governance (IMF country report 05/270).

- ***Fiscal weaknesses.*** Fiscal pressures arise from large pension outlays, rising interest payments, and the need to boost priority spending. Lowering the public debt would reduce the vulnerability to financing risks, while providing more room to respond to shocks and help catalyze private investment.

- ***Vulnerable external position.*** With exports concentrated in coffee and textiles, high dependence on workers' remittances, a large oil import bill, and low FDI, the high gross external financing needs (17 percent of GDP) make the economy susceptible to changes in the terms of trade, foreign competition, migration patterns, and investor sentiment.

- ***Banking system fragilities.*** While the banking system is among the strongest in the region, it still has some weaknesses. Its capacity to withstand shocks would be bolstered by efforts to improve prudential and supervision norms, enhance the financial safety net, and strengthen the lender-of-last-resort (LOLR) function.

5. **The policies needed to remove obstacles to growth will require the support of Congress.** The March 2006 legislative election resulted in a divided congress, as the governing party *ARENA* and the left-wing *FMLN* each won 40 percent of seats. President Saca has created a blue-ribbon committee to help build consensus on fiscal reforms and is seeking to broaden the policy dialogue with the *FMLN*. Passage of proposed constitutional amendments to reform the political framework and strengthen policy making will need approval by a qualified majority.[1] The next presidential and legislative elections are due in March 2009.

6. **Over the years, the authorities' policy thrust has been in line with Fund advice.** Since the last Article IV consultation, the authorities have drawn on Fund advice to reduce vulnerability by strengthening tax policy, deepening banking reform, and improving statistics. While the authorities agreed on the need to improve the public debt dynamics, they have emphasized the importance of boosting investment and social spending, and noted the challenge of approving difficult reforms in a fragmented congress.

7. **The 2006 consultation discussions focused on how best to achieve the government's growth and social objectives, taking advantage of the stability brought by dollarization and the opportunities offered by CAFTA-DR.** A key theme was how to reinforce the fiscal framework to improve the debt dynamics further while providing room for priority spending. A second focus was on policies to enhance the resiliency of the dollarized economy against shocks and to improve competitiveness.

II. Recent Economic Developments

8. **The economy has benefited from favorable global conditions and has weathered well the adverse oil price shock and last year's tropical storm Stan.**

- **Growth has picked up moderately while inflation slowed.** Output grew by 2¾ percent in 2005, spurred by private consumption. So far in 2006, growth is running at 3½ percent, led by investment and exports. After a brief increase to 6 percent in October 2005, largely due to temporary food price hikes caused by tropical storm Stan, year-on-year inflation fell to 3½ percent in May 2006, the lowest level in the region.

- **The external current account deficit widened slightly during this period, to 4½ percent of GDP.** Strong remittances, favorable commodity export prices (mainly coffee), and a recent surge in nontraditional exports have mostly offset rising oil imports and higher interest payments (Table 3). El Salvador's real exchange rate has remained broadly stable in recent years. However, low FDI, intensified global textile

[1] The amendments would extend the tenure of congress from 3 to 5 years (same as the president) starting with the 2009 election, and shift from qualified to simple majority the approval by congress of the budget financing.

competition, and declining terms of trade suggest that external competitiveness needs to be strengthened to fully reap the benefits from CAFTA-DR (Box 1).

- **Bank credit growth has supported the economic expansion.** Credit to the private sector grew by 4 percent in real terms in 2005 and picked up to 7 percent in May 2006 (year-on-year). An increase in bank deposits has supported the credit expansion and led to a build up of short-term foreign assets, while keeping foreign liabilities broadly unchanged. Domestic interest rates have risen at a slower pace than those abroad, with the average lending rate at 8¾ percent and the deposit rate at 4 percent in May 2006 (Figure 3 and Table 4).

- **Access to international capital markets remains solid, supported by high global liquidity and an investment grade rating.**[2] In April 2006, the government reopened the 30-year sovereign bond issued in 2005, placing US$400 million (over 2 percent of GDP) with a yield of 7.6 percent (same level as in 2005). Spreads have remained stable, hovering at around 200 basis points in recent weeks, among the lowest in Latin America.

9. **The government's policy strategy has been implemented as planned.**

- **The public debt has been stabilized at 42 percent of GDP.**[3] Fiscal performance has been consistent with a budgeted fiscal deficit of 3 percent of GDP for 2006 and a primary deficit of 0.7 percent (same level as in 2005). The effect of earlier revenue actions and recent steps to broaden the taxpayer base have boosted tax revenue by 0.5 percent of GDP through June 2006.[4] As budgeted, this gain has been offset by higher energy subsidies, wages, interest payments, and pension outlays.[5] The 2006 budget envisages maintaining capital spending at the level attained in 2005 (Figure 4 and Tables 5–6).

- **Debt management has strengthened.** The authorities continued to lengthen debt maturities (17 years on average), diversify financing sources, and lower costs with the above-mentioned issue of 30-year bonds and greater use of multilateral loans.[6] A relatively low share of floating-rate debt (one-third of total debt) has also helped

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[2] Moody's rated El Salvador investment grade in 1997. Standard & Poor's and Fitch IBCD rate El Salvador one notch below investment grade, as the country's sluggish growth, public debt, and poverty levels are considered important sources of vulnerability.

[3] Nonfinancial public sector debt, which excludes the central bank's net liabilities, stabilized at 40 percent of GDP.

[4] In 2005, the authorities broadened the income and value-added tax bases, raised excise taxes, and reinforced the tax office. As a result, tax revenue rose by 1 percent of GDP, to 12½ percent in 2005.

[5] Subsidies on energy, public transportation, water, and nontraditional exports amounted to 0.8 percent of GDP in 2005. The budgeted wage increase (6 percent on average) granted for 2006 is the first increase since 1999.

[6] The World Bank approved policy loans for US$200 million (1¼ percent of GDP) in 2005 to support the authorities' growth strategy. The Inter-American Development Bank (IDB) also approved a policy loan (US$100 million) for basic education in 2005.

mitigate the impact of higher interest rates. However, sizable gross financing needs (6 percent of GDP) still make public finances vulnerable to refinancing risks.

- **Banking regulations improved, while banks' liquidity remained comfortable.** The authorities issued stricter prudential norms and improved bank resolution practices, although some aspects of the dollarization regime have not been completed yet due to fiscal constraints (¶21 and ¶23). Banks' net foreign assets currently cover 30 percent of deposits (above the statutory level of 26 percent), although slightly below the level observed in other fully and partially dollarized economies in the region.

- **CAFTA-DR came into effect in March 2006.** As prior steps, congress improved the regulatory framework to enhance competition (mainly in government procurement and telecommunications) and to strengthen protection of intellectual property rights. It also passed anti-trust legislation, upgraded customs procedures, and stiffened penalties for corruption by public officers.

III. Report on Policy Discussions

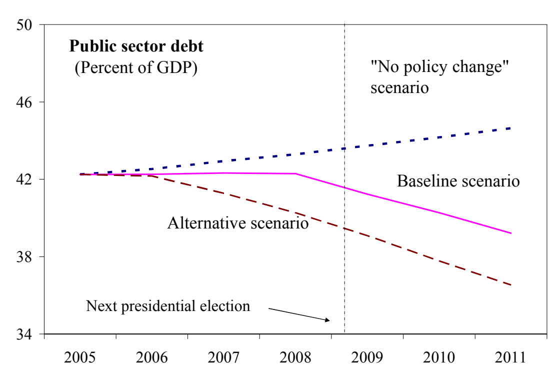
A. Near-term Outlook

10. **Growth is projected to reach to 3½ percent in 2006.** The pick up would continue to be led by investment and exports. Inflation would stay at 4 percent, reflecting high oil prices, and the external current account deficit at around 4½ percent of GDP. The economy appears well positioned to manage the risks from the global external environment (mainly, volatile oil prices and interest rates), given that the government's financing needs for 2006 have been already covered and the strong foreign asset position of the banking system. [7]

B. Medium-Term Outlook

11. **Full implementation of the authorities' policy framework would strengthen the medium-term outlook, but would nevertheless leave important vulnerabilities.**

- **The policy framework should support growth of 3½ percent over the medium term**, aided by the favorable impact of CAFTA-DR and related reforms efforts on exports and investment. The envisaged primary surplus would keep the public debt ratio at current levels until 2008, followed by a gradual decline thereafter. (Tables 7 and 8).



- **The public debt dynamics would remain sensitive to shocks and policy slippages**

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[7] An oil price increase of US$10 per barrel raises oil imports by 0.8 percent of GDP, while an interest rate increase of 100 basis points raises external interest payments by 0.3 percent of GDP, both on an annual basis.

(Appendix I). For instance, should the primary balance remain at the same level as in 2005 (a “no policy change” scenario), public debt would rise to 45 percent of GDP by 2011. Stress tests also show that the debt dynamics is sensitive to an adverse combined shock to the primary balance, the real interest rate, and economic growth.

- **The economy’s external financing needs would remain high.** The economy would be susceptible to sudden changes in remittances, terms of trade, and investor sentiment. For instance, a reduction of one standard deviation in remittances would increase external financing needs by nearly 2 percent of GDP per year.

Key Macroeconomic Indicators under Baseline Scenario
(In percent of GDP, unless otherwise noted)

	Prel.	Projections					
	2005	2006	2007	2008	2009	2010	2011
Real GDP growth (percent)	2.8	3.5	3.5	3.5	3.5	3.5	3.5
Inflation (percent, end period)	4.3	4.0	3.0	3.0	3.0	3.0	3.0
Overall public sector balance	-3.0	-2.8	-2.6	-2.3	-1.4	-1.3	-1.3
Public sector primary balance	-0.7	-0.4	-0.2	0.1	1.0	1.0	1.0
Public sector debt	42.3	42.3	42.3	42.3	41.2	40.3	39.2
External current account balance	-4.6	-4.5	-4.6	-4.4	-4.0	-3.8	-3.9
Total gross external financing needs	18.7	17.6	17.0	16.3	15.9	15.9	16.4

12. **An alternative scenario with stronger up-front fiscal consolidation and continued reforms illustrates the benefits of additional policy efforts (Table 9 and 10).** Under this scenario, more front-loaded progress toward the medium-term primary surplus target of 1 percent of GDP by 2009, together with growth-oriented reforms, would lower the public debt ratio to under 36 percent by 2011 and help sustain growth rates of at least 4 percent (the authorities’ medium-term objective). A stronger fiscal stance would also increase national savings to support higher private investment while strengthening the external position (Box 2). With improved debt management, this effort would also help contain the economy’s external financing needs.

Key Macroeconomic Indicators under Alternative Scenario
(In percent of GDP, unless otherwise noted)

	Prel.	Projections					
	2005	2006	2007	2008	2009	2010	2011
Real GDP growth (percent)	2.8	3.5	4.0	4.0	4.0	4.0	4.0
Inflation (percent, end period)	4.3	4.0	3.0	3.0	3.0	3.0	3.0
Overall public sector balance	-3.0	-2.8	-1.9	-1.7	-1.3	-1.3	-1.3
Public sector primary balance	-0.7	-0.4	0.5	0.6	1.0	1.0	1.0
Public sector debt	42.3	42.2	41.3	40.3	38.9	37.6	36.4
External current account balance	-4.6	-4.5	-4.1	-3.9	-3.7	-3.4	-3.1
Total gross external financing needs	18.7	17.1	16.4	14.7	13.4	12.1	11.1

C. Improving Growth and Social Prospects

Fiscal policy: improving debt dynamics and supporting priority spending

13. **The authorities plan to keep the public debt ratio stable through 2008 and bring it down thereafter, while raising priority spending.** This would involve achieving primary balance in 2007–08 and a surplus of 1 percent of GDP starting in 2009. Key envisaged fiscal policies are as follows:

- **Raising tax revenue, limiting subsidies, and containing pension outlays.** Given substantial progress on expenditure reform in the past, the authorities have set a tax revenue target of 14½ percent of GDP for 2009 (12½ percent in 2005), which they expect to attain by reducing tax evasion. They also plan to improve the targeting of subsidies to the poor and are exploring options to reduce/spread out costs of the 1998 pension reform.
- **Improving infrastructure and alleviating poverty.** The investment plan focuses on developing social infrastructure, especially in the northern region (the poorest in the country), completion of a seaport (*Cutuco*), and major electricity projects, with a cost of nearly 2 percent of GDP per year over the next five years (¶25–26).
- **Financing.** The bulk of the government's gross financing needs would be covered through sovereign bond issues and multilateral borrowing. The investment plan would be financed mostly with grants (including from the U.S. millennium challenge account), concessional loans, and public-private partnerships (PPP).

14. **Consistent with these plans, the authorities intend to introduce fiscal measures in the coming months.** With assistance from the Fund, they plan to limit income tax exemptions on export regimes and energy subsidies, including for transportation, with an expected annual yield of 1 percent of GDP.[8] On this basis, the fiscal deficit is projected at 2¾ percent of GDP for 2006, with a primary deficit of 0.5 percent of GDP (keeping the public debt/GDP ratio at around 42 percent).

15. **To achieve the target for tax revenue, the authorities also plan to further reduce tax evasion and bring informal activities into the tax base.** Besides the planned reduction of tax exemptions on export regimes, they will implement tax code reforms approved in 2004 to raise penalties for tax delinquency, use bank records to enforce taxation, and fight smuggling. These actions are expected to strengthen an action plan initiated last year to tighten control over larger taxpayers and VAT rebates to exporters, and improve cross-checking of tax payments. The authorities estimate that this strategy would lead to revenue gains of some 0.5 percent of GDP per year in 2006–09.

16. **The staff recommended a more ambitious approach to lowering public debt, while protecting priority spending.** The staff noted that achieving a primary surplus of

[8] Export regimes are subject to abuse and fraud, including by nonexporting firms. Limiting tax exemptions should have no effect on export performance. The electricity subsidy is to be limited to consumption of up to 100 kilowatts hours (kwh) per month, instead of granting the subsidy regardless of total consumption.

0.5 percent of GDP in 2007 would set a strong basis to reach the medium-term primary surplus target, and improve the debt dynamics starting in 2007. The authorities explained that the fiscal priorities were still consistent with a primary balance for 2007–08. On the basis of their reform agenda, they also felt that some factors could have a positive impact on the debt dynamics in 2007–08, such as faster growth than projected in the staff's baseline scenario, which would help achieve a stronger fiscal consolidation.

17. **The staff agreed that the fiscal effort should focus first on reducing subsidies, tax exemptions, and tax evasion, although it also encouraged the authorities to consider additional measures.** In particular, the staff noted the following options: increasing the VAT rate (currently at 13 percent, compared to an average of 14 percent in Latin America), introducing a property tax, and raising gradually excise taxes on petroleum products to levels elsewhere in the region (as oil market conditions permit). The authorities noted that they preferred to intensify the fight against tax evasion before considering further tax measures. They saw a large revenue potential in this area, given that evasion on income tax and VAT is estimated at 1½ to 2 percent of GDP.

18. **The staff supported actions to contain nonpriority spending and saw additional room to further reorient spending to foster the authorities' priorities.** The staff welcomed plans to improve the targeting of energy subsidies in 2006, maintain the wage bill/GDP stable at the 2006 level, and limit local governments' borrowing. The staff also proposed removing subsidies on water (except for the poor) and nontraditional exports (6 percent of value) this year. In line with the 2004 fiscal ROSC, the staff advised the authorities to (i) further improve budgeting and control of the local governments, which are taking up a growing role in implementing priority spending, and (ii) enhance the PPP framework to ensure proper selection of projects and recording in the fiscal accounts, and to minimize contingency fiscal costs, as the use of PPP for investment projects increases over the medium term.

19. **The staff noted that parametric pension reforms could contribute to fiscal consolidation.**[9] The staff suggested addressing the issue of generous pension benefits and advised against actions that would increase the present value of unfunded pension liabilities for the government. This could be done through (i) raising the retirement age and contribution period; (ii) lowering replacement rates; (iii) applying income tax on pension benefits at upper income levels; and (iv) limiting future pension increases. The authorities noted that political support for parametric pension reforms would be difficult to achieve. They saw a need to foster a broad public debate over pension costs and their implications for taxation, priority spending, and debt dynamics. As noted, the authorities are also looking at ways to spread out the pension reform costs over time, which they plan to discuss with staff once these options have been developed.

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[9] The pay-as-you-go (PAYG) system was replaced by a fully-funded system of individual pension accounts in 1998. Net pension costs to the government are projected at 2 percent of GDP per year during 2006–11, mainly due to generous pension benefits and the shift of contributors to the new system. The SIP provides a fuller description of the main features of the pension reform.

20. **Skillful debt management is vital to reduce vulnerability to financing risks.** The authorities plan further issuance of 30-year sovereign bonds (shifting from bullet to amortized bonds), develop the domestic bond market, and seek support on softer terms (grants, concessional loans, and debt swaps) for their social agenda.[10] The staff concurred that this debt strategy, combined with further fiscal consolidation, would significantly lower the government's financing needs over the medium term.

Central bank operations: strengthening liquidity buffers

21. **The staff encouraged the implementation of remaining aspects of the dollarization law (2000), with a view to enhancing financial stability and firming up the monetary regime.** Strengthening the LOLR function and shifting the central bank's net liabilities to the government (2½ percent of GDP) would provide added flexibility to deal with systemic liquidity shocks and remove the central bank's exposure to liquidity mismatches.[11]

- **Strengthening the LOLR function.** The authorities agreed to keep the central bank's disposable foreign reserves at current levels (2 percent of deposits) and consider using a small portion of the current liquidity requirement (3 percent of deposits) to add to the cushion of liquid foreign assets, available for potential systemic liquidity operations. Such a cushion, together with the remaining liquidity requirement (23 percent), would protect banks adequately against liquidity shocks.
- **Restructuring the balance sheet.** The central bank plans to issue long-term bills to reduce liquidity mismatches to under 2 percent of GDP and to net out operations with the public sector to contract its balance sheet gradually, before seeking approval by congress to shift remaining liabilities to the government. The staff suggested eliminating liquidity mismatches as much as possible, and noted that the assumption of these liabilities by the government would permanently remove central bank liquidity risks and enhance fiscal transparency, without changing the overall fiscal position.

Financial system: improving risk management, deepening intermediation

22. **The banking system has been strengthened, although there is room for further improvement.** Since 2000, banks' capital adequacy has improved and the bank resolution framework has been strengthened. Banks appear well positioned to withstand temporary

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[10] The World Bank has provided assistance to strengthen debt management and the local bond market. The authorities are also discussing IDB policy loans for US$300 million (1.7 percent of GDP) for 2007–09 in support of their social agenda.

[11] Disposable foreign reserves of the central bank currently cover one-third of its short-term nonmonetary liabilities. Conversely, the excess of these liabilities over disposable reserves amounts to 2 percent of GDP.

liquidity shocks. However, the quality of bank assets may be overstated, while stress tests show vulnerability to credit risk. The system also faces pockets of weakness in supervision and limited reserves in the deposit insurance system.

Banking System Indicators

(In percent unless otherwise stated)

	2003	2004	2005	March 2006
Number of banks	12	12	12	11
Of which: public banks	2	2	2	2
Share of public banks in total assets	4.2	4.0	3.8	4.4
Capital to risk-weighted assets	12.8	13.0	13.5	13.5
NPLs to total loans 1/	12.3	11.1	8.8	8.8
Provisions to NPLs	130	142	126	126
Return on equity	11.5	9.8	10.1	11.6
Return on assets	1.1	1.0	1.1	1.3
Liquid asset to short-term liabilities	36.3	29.5	32.1	27.2

1/ Includes contingencies. Nonperforming loans are defined as the sum of the three lowest loan categories.

23. **The staff supported the authorities' banking reform plans.** Along the lines of the 2004 FSSA, the authorities have framed reforms to address remaining fragilities and consolidate financial stability. Priorities are as follows:

- **Prudential norms.** New norms to tighten provisioning rules and loan classification aim to strengthen asset quality and lower credit risk. The rules introduce a generic provision (1 percent of loans) and shift to provisioning on the basis of net loans (after collateral). They provide banks a grace period to adjust accounting systems to the new rules and assess related provision shortfalls. The authorities plan to announce a 5-year schedule in December 2006 to phase in the new rules.

- **Supervision.** The authorities plan to submit a draft bill to congress this year to: (i) enhance the autonomy of the superintendency of banks, including by providing legal protection to its staff in discharging tasks; (ii) strengthen consolidated supervision by reducing equity participation from 50 to 20 percent for consolidation of accounts into a financial group; and (iii) merge the superintendencies of banks, securities, and pensions, with the central bank in charge of regulating the financial system.

- **Financial deepening.** With a view to fostering private investment through deeper intermediation, the authorities intend to secure passage by congress of a framework for securitization and investment funds this year. Their objective is to broaden the access of small-and medium-size enterprises to financial services and promote a more efficient allocation of credit risk among borrowers, intermediaries, and investors.

- **Safety net.** The authorities are taking steps to strengthen the financial safety net. New bank resolution guidelines issued recently clarify the roles of the central bank, the deposit insurance fund, and the superintendency of banks in resolving failed banks. To strengthen the reserves of the deposit insurance fund, the authorities will propose to congress this year to raise the ceiling on the fund's reserves from 1 to 5 percent of deposits. The staff recommended raising gradually banks' deposit insurance premia to achieve the proposed new ceiling over the medium term.

Competitiveness: Removing Impediments To Investment

24. **The authorities and staff agreed on the need to strengthen external competitiveness.** Given the dollarized regime, the goal is to improve productivity and lower the cost of doing business to foster investment. Supported by the World Bank and the IDB, the authorities seek to improve infrastructure, enhance skilled labor, lower red tape, and reduce crime.

25. **The staff supported the envisaged actions to improve the investment climate (Box 3).**

- **Infrastructure and human capital.** The plan is to alleviate infrastructure constraints (electricity, ports, water, and roads) and upgrade human capital. The authorities agreed on the need to foster private participation in these areas to avoid placing an undue burden on the public finances and protect other social spending.

- **Red tape and crime.** The authorities are taking steps to lower transaction costs and reduce crime (related costs are estimated at 6 percent of GDP per year by the United Nations). The staff encouraged the authorities to enhance as well the legal basis for commercial dispute resolution, corporate insolvency, and creditor rights.

- **Integration.** The authorities seek to reach new free-trade agreements (including with the European Union, Canada, and Colombia) to create additional trade opportunities, a steping stone toward multilateral trade liberalization. They plan to abolish subsidies to nontraditional exports by end-2007 and export regimes by end-2009, in line with WTO obligations. The staff noted that pursuing multilateral trade negotiations would avoid a multiplication of free-trade agreements that could generate complexity in trade. The authorities also support the development of a regional code to avoid excessive tax competition in attracting foreign investment, and are moving to strengthen cross-border supervision and harmonize regulatory practices to facilitate financial integration within the region.

Poverty-reduction strategy

26. **Poverty alleviation remains on top of the authorities' agenda.** Consistent with the social objectives of the MDGs, the authorities aim to reduce poverty to 29 percent and rural extreme poverty to 15 percent by 2015.[12] Based on a poverty map, the authorities are targeting priority areas to develop social infrastructure. Key programs are as follows:

- **Solidarity network ("Red Solidaria").** The network provides social infrastructure (education, health, water, electricity, and rural roads) to the poorest municipalities; and extends cash transfers to families who meet basic education and healthcare requirements. The program now covers 16 out of 36 targeted municipalities and is partly financed by multilateral and bilateral agencies.

- **Development of the northern region.** The program seeks to integrate the northern region with the rest of the economy and provide development opportunities (about one-half of the poor are located in this region). It entails construction of a transnational highway, feeding roads, and social infrastructure over the period 2007–11. It has an estimated cost of US$1 billion (over 5 percent of GDP), and is expected to be mostly financed with grants.

[12] Presently, extreme poverty stands at 15 percent (31 percent in 1992). While the MDG for extreme poverty on urban areas has been met, rural poverty stands at about 20 percent.

Statistics

27. **El Salvador's macroeconomic statistics are adequate for surveillance purposes.** As recommended by the 2004 data ROSC, the authorities are conducting economic censuses and surveys to improve source data and the quality of statistics. With STA assistance, they are improving the national accounts and short-term economic indicators, and plan to strengthen the quality of private external debt data.

IV. Staff Appraisal

28. **The Salvadoran authorities have made further progress in the implementation of their outward-oriented growth strategy.** They should be particularly commended for their strenuous efforts to secure the entry into force of CAFTA-DR in a timely manner and for their success in raising tax revenue significantly, which is making it possible to increase investment and social spending.

29. **Thanks to this strategy and to generally favorable global conditions, growth started to pick up in 2005 and is expected to strengthen further in 2006.** A good performance of exports, a rise in investment, and strong workers' remittances helped the economy weather well the sharp rise in oil prices and the impact of last year's tropical storm Stan. The economy appears well positioned to absorb potential shifts in global market sentiment, given the present full coverage of the government's financing needs for 2006 and the strong foreign asset position of the banking system.

30. **Building on these achievements, the fundamental policy challenge is to place the economy on a path of high sustainable growth and faster social progress, taking advantage of the opportunities opened up by CAFTA-DR and the stability brought by dollarization.** To meet this challenge, policy priorities include additional fiscal consolidation, financial sector reform, and measures to enhance competitiveness. Implementation of these policies will enhance the resiliency of the dollarized economy to adverse shocks and remove existing obstacles to growth. Staff also notes that current global conditions and a favorable election calendar provide a good opportunity to move this agenda forward.

31. **The authorities' fiscal strategy aims to keep the public debt steady through 2008 and bring it down thereafter, while raising priority spending.** The staff supports the authorities' medium-term target of a primary surplus of 1 percent of GDP (from a deficit of 0.7 percent in 2005). The staff welcome plans to limit tax exemptions to export regimes and subsidies in 2006, and supports the goal of increasing tax revenue by 2 percentage points GDP by 2009, which would be achieved through further reduction in tax evasion. The staff also welcome the authorities' support to a regional code of conduct to limit tax competition in attracting investment. With planned increases in investment and social spending, however, the primary balance would improve only modestly during 2007–08. In turn, the public debt ratio would stabilize at current levels, leaving the public finances vulnerable to shocks and slippages in policy implementation.

32. **The staff recommends a more ambitious approach to reducing public debt, while protecting priority spending.** In particular, the staff suggests a more up-front fiscal consolidation. Efforts to reduce tax evasion and subsidies envisaged by the authorities should be reinforced by further fiscal measures, which could include an increase in the VAT rate, parametric pension reforms, removal of subsidies on nontraditional exports and water, and improved control over local government spending. The staff notes the importance of fostering a broad public debate over the need to strengthen the fiscal policy framework, with focus on the trade offs among taxation, priority spending, pension costs, and debt dynamics. It also supports the authorities' debt management objectives of lengthening maturities and reducing costs, which combined with the proposed fiscal effort, should help reduce the vulnerability from large gross financing needs.

33. **The staff supports the planned financial sector reforms to underpin financial stability and strengthen the system's capacity to withstand shocks**. Envisaged reforms include tightening provisioning rules, strengthening supervisory capacity, enhancing the safety net, and deepening financial intermediation. The staff also recommends to strengthen the lender-of-last-resort function, through the creation of a pool of liquid assets, and to complete the restructuring of the balance sheet of the central bank. These actions would provide additional liquidity buffers to absorb system-wide shocks or to minimize the risks of contagion.

34. **Given the need to strengthen competitiveness over the medium term, the authorities are appropriately focusing on improving productivity and reducing costs in the dollarized economy.** The staff endorses the authorities' plans to upgrade infrastructure and human capital, lower red tape, tackle crime, and create new trade opportunities. To avoid fiscal pressures and further improve the investment climate, the staff encourages the authorities to bolster private sector participation in infrastructure projects, and improve procedures for corporate insolvency, business dispute resolution, and creditor's rights.

35. **El Salvador's economic statistics are adequate for surveillance purposes**. The staff supports ongoing efforts to improve the quality of national accounts and short-term economic indicators.

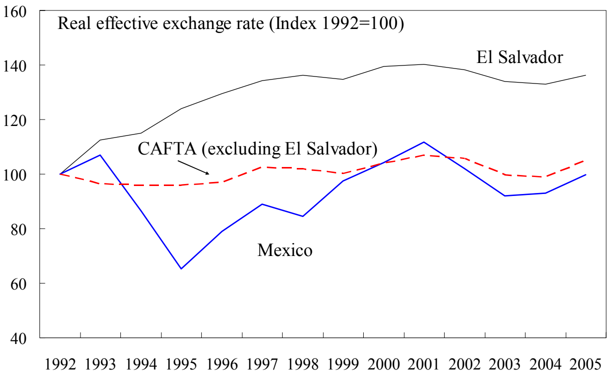
36. **It is proposed that the next Article IV consultation be held on the standard 12-month cycle.**

Box 1. External Competitiveness

External competitiveness needs to be strengthened in light of the importance of continued growth of nontraditional exports, low foreign direct investment, intensified foreign textile competition, and declining terms of trade.

- ***El Salvador's REER appreciated in the 1990s and has been stable this decade.*** The real appreciation partly reflected the sharp increase in workers' remittances. Since 2000, El Salvador's external competitiveness position has evolved in parallel to that of other countries in the region.

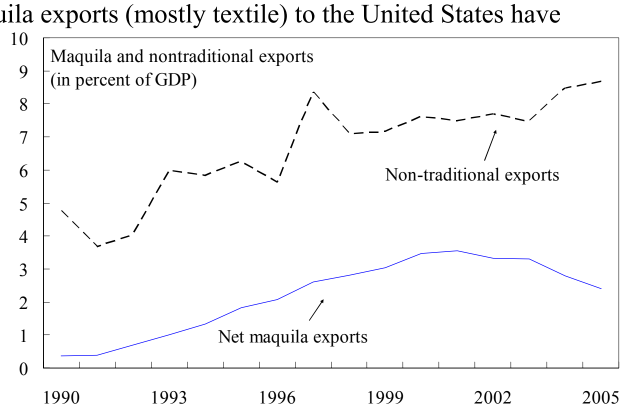
- ***The rise in nontraditional exports in the last few years mainly reflected favorable prices, although volumes have also picked up since 2005.***



Source: IMF, Information Notice System.

- ***Foreign textile competition from China has intensified since 2000, leading to a decline in maquila exports.*** After rapid growth in the 1990s, maquila exports (mostly textile) to the United States have declined to 2½ percent of GDP in 2005. The phasing out of quotas under the agreement of textiles and clothing in January 2005 has further increased competition, although El Salvador still enjoys improved market access under CAFTA-DR and a proximity advantage in the United States relative to China.

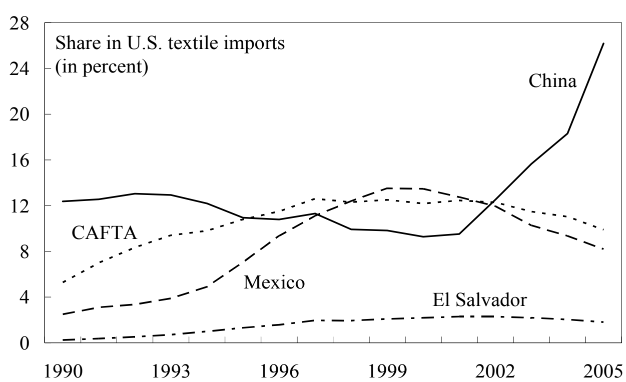
- ***Foreign direct investment has been low, averaging 2.1 percent of GDP since 1999,*** despite a liberal investment regime. This ratio is the second lowest in the region, after Guatemala.



Source: Banco Central de Reservas de El Salvador.

- ***The terms of trade have declined steadily by 10 percent since 1998,*** mostly reflecting weakening traditional export prices (mainly, coffee and sugar) through 2002 and rising oil prices since that year.

- ***Sizable workers' remittances have affected external competitiveness.*** The related expansion in domestic demand has raised the relative price of nontradable relative to tradable goods and put upward pressure on wages. This trend has encouraged consumption of tradables and dampened their production, resulting in a widening of the trade balance.



Source: U.S. Department of Commerce, Office of Textiles and Apparel.

Box 2. Savings and Growth

Supported by CAFTA-DR, the authorities seek to bolster new areas of growth and make investment and exports the leading sources of higher growth. Achieving this goal would require a substantial increase in national savings.

The authorities foresee comparative advantage and growth potential in the following areas: (i) ***Agro-business:*** there is potential in food processing and pharmaceuticals; (ii) ***Call centers:*** government programs are providing training in English; (iii) ***Textiles:*** incoming firms are to produce higher value-added and promote vertical integration; (iv) ***Tourism:*** a new tourism framework facilitates expansion of convention tourism and spending by returning nationals; and (v) ***Regional distribution:*** the new port (*Cutuco*) is to provide a logistical and distribution center for the region.

For years, consumption has been the driving force for growth. Over the last 5 years, growth has averaged 2¼ percent per year. The contribution of consumption to growth was 3 percentage points, while the combined contribution of investment and net exports was negative (see Figure 1). Relative to GDP, consumption reached over 100 percent, supported by strong worker remittances (16 percent). Domestic investment amounted to only 16½ percent while national savings averaged 13 percent.

Raising growth would require a substantial increase in national savings and investment, while maintaining external balance. Assuming a constant incremental capital output ratio ICOR and stable external debt dynamics, a sensitivity analysis shows the following:

- ***Sustaining growth at 3½ percent.*** Domestic investment would need to rise to 17½ percent of GDP (from 15½ percent in 2005) while national savings would need to increase to 13½ percent (nearly 11 percent in 2005); and

- ***Sustaining growth of at least 4 percent (the authorities' forecast).*** Domestic investment would need to rise to at least 20 percent of GDP while national savings would need to increase to 16 percent, well above historical levels.

Box 3. Reforms to the Investment Climate

While some competitiveness indicators are strong in El Salvador by regional standards, the authorities' reforms seek to remove key obstacles to investment and take advantage of the new opportunities opened up by CAFTA-DR (Figure 6).

What is good about the Salvadorean business climate? El Salvador ranks 56 out of 117 countries, close to Costa Rica and Mexico, in the global competitiveness indicators prepared by the World Economic Forum (WEF). Strengths include the macroeconomic environment, public institutions, and competition in information technology. The labor market is one of the most flexible, especially in hiring/dismissal practices (13) and hiring of foreign labor (38).

What areas could be improved to foster investment? Main weaknesses are in basic infrastructure, human capital, and crime.

The implementation of CAFTA-DR has helped improve the business climate. CAFTA-DR has provided incentives for customs reform, enforcement of important norms (anti-corruption, labor, environment, intellectual property rights, and e-commerce), and competition (telecoms and government procurement). The 2004 anti-trust law has also strengthened competition practices.

The authorities' reform agenda to improve the investment climate includes:

- ***Easing infrastructure constraints.*** Priority areas are electricity, highways, and ports. The authorities will review this year the electricity regulatory framework to improve pricing rules and allow for long-term contracts for investors. This should help alleviate supply constraints in power generation, which have become tighter in recent years.

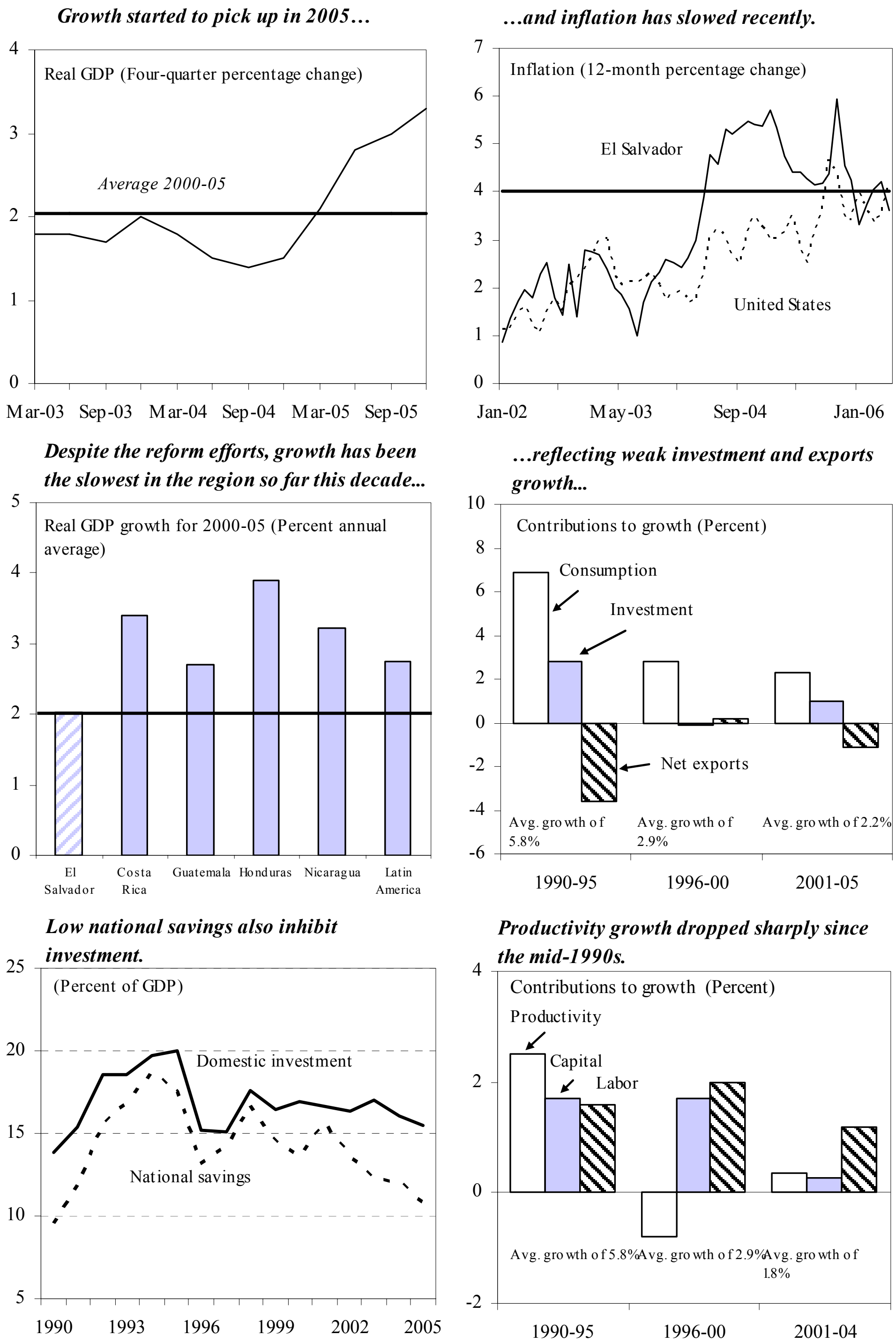
- ***Enhancing skilled labor.*** *Education Plan 2021*, launched in 2005 and supported by the IDB, aims to achieve full enrollment in schools up to 9th grade, make students fluent in English, and broaden 2-year programs for specialized training. The plan is designed to support investment in technology activities over the next few years.

- ***Reducing crime.*** With World Bank assistance, the authorities are developing special (preventive and corrective) programs targeting poor municipalities and youths at risk.

- ***Lowering transaction costs.*** Competitiveness programs, including "*El Salvador Eficiente*", seek to reduce red tape and support small firms. So far, these programs have centralized customs procedures, lowered the time to open new businesses through a one-stop window, and provided market intelligence for small exporters.

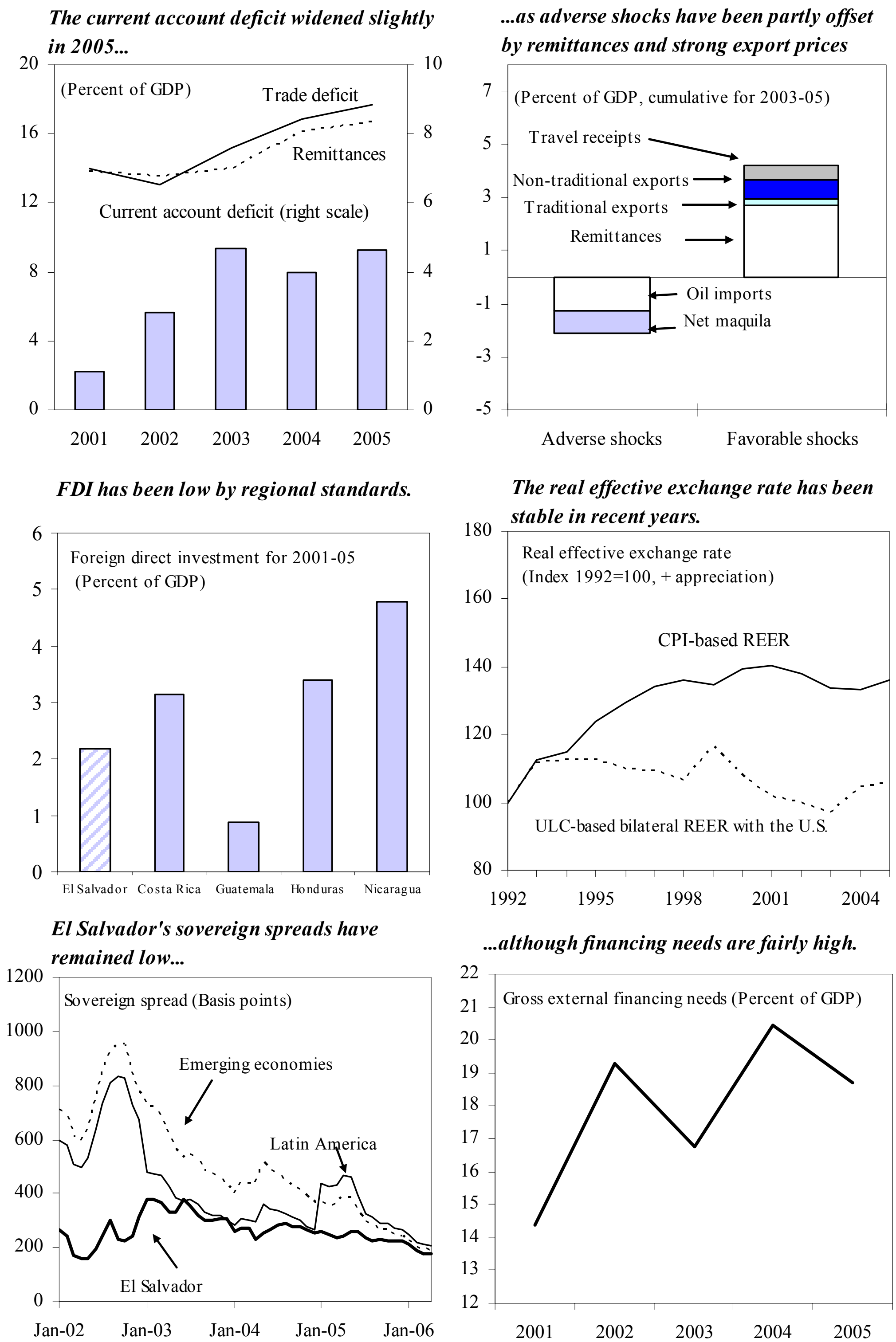
- ***New trade opportunities.*** Following the adoption of CAFTA-DR, the authorities are seeking free-trade arrangements with Canada and the European Union by 2007 and with CARICOM, Colombia, and Taiwan, Province of China by 2009. The ultimate objective is to move toward multilateral trade liberalization.

Figure 1. El Salvador: Real Sector



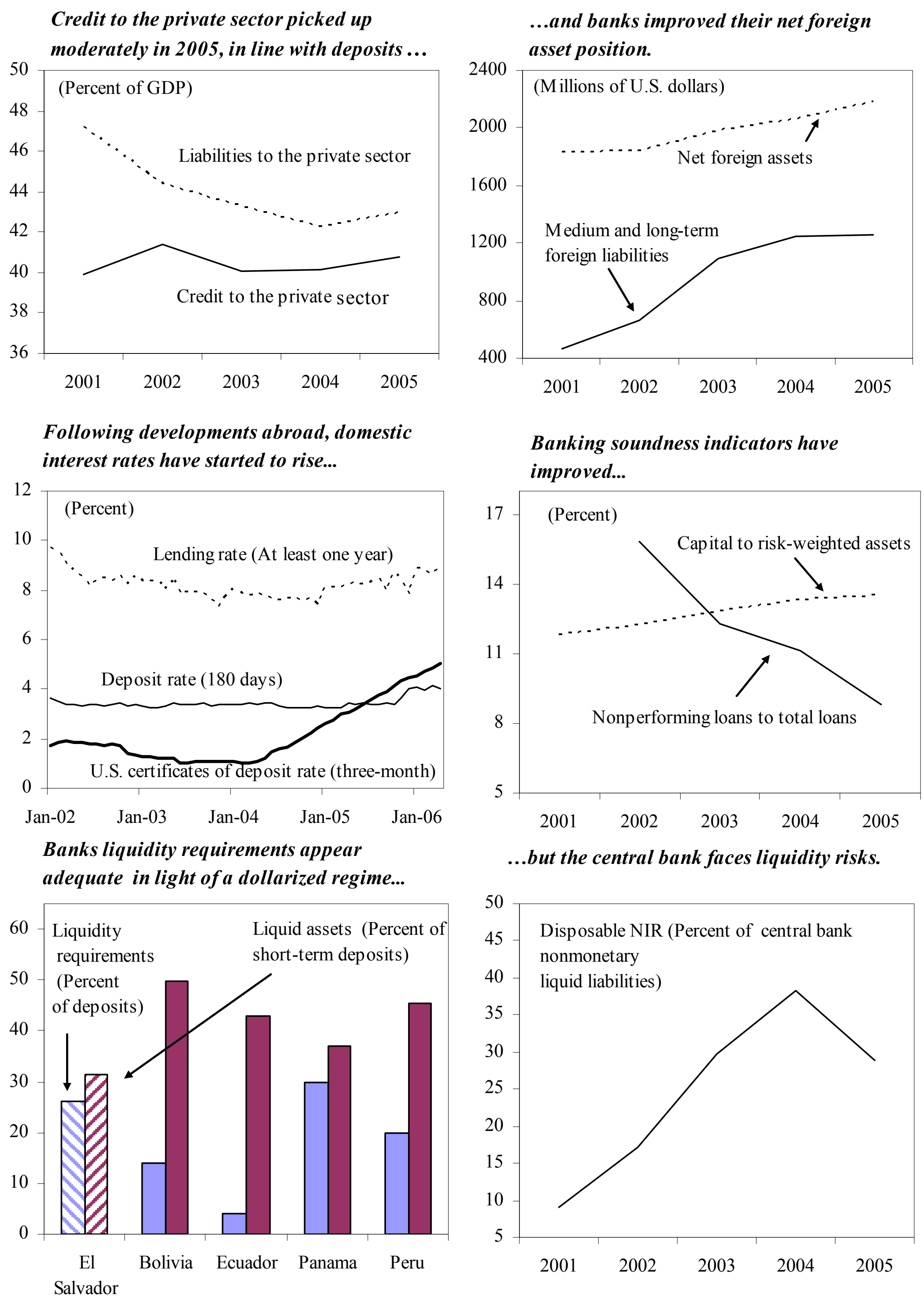
Sources: Central Bank of El Salvador; and Fund staff estimates.

Figure 2. El Salvador: External Sector



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

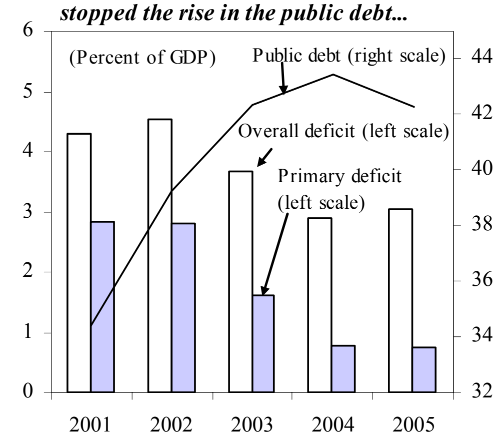
Figure 3. El Salvador: Monetary and Financial Sector



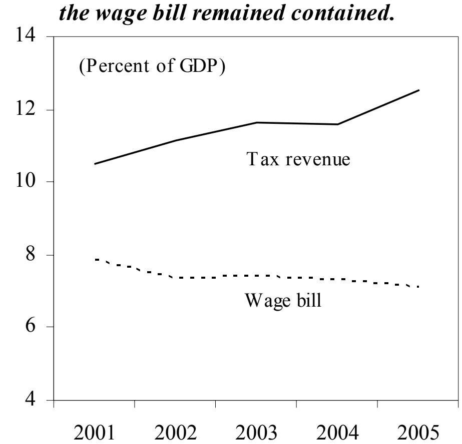
Source: Central Bank of El Salvador; and Fund staff estimates.

Figure 4. El Salvador: Fiscal Sector

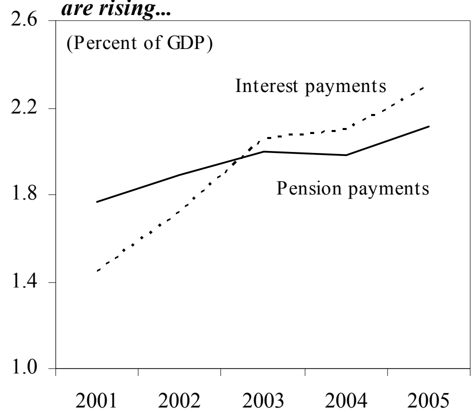
A decline in the primary deficit has stopped the rise in the public debt...



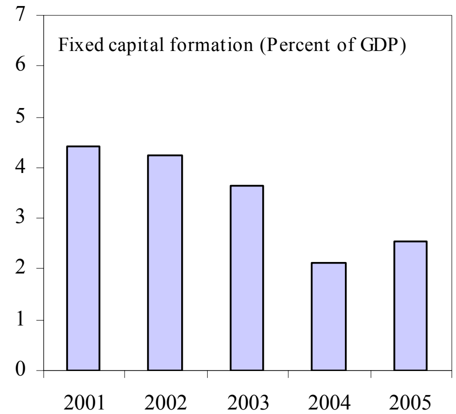
….as tax revenue strengthened and the wage bill remained contained.



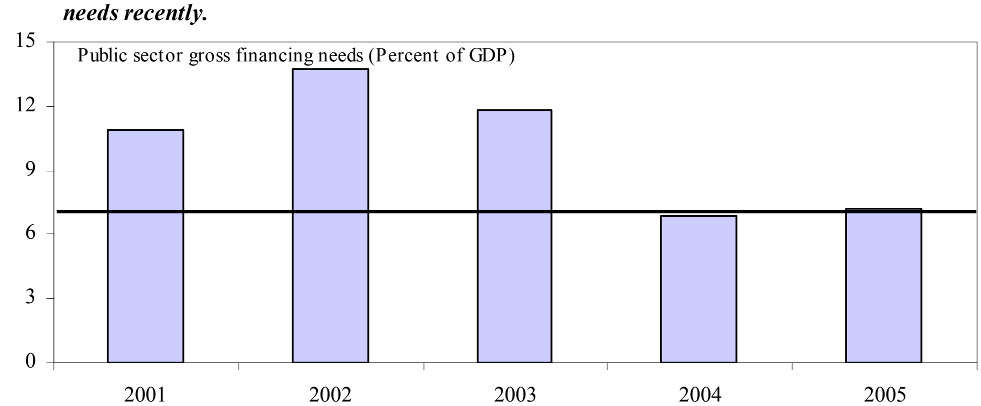
However, pension and interest payments are rising...



…while capital spending recovered in 2005.

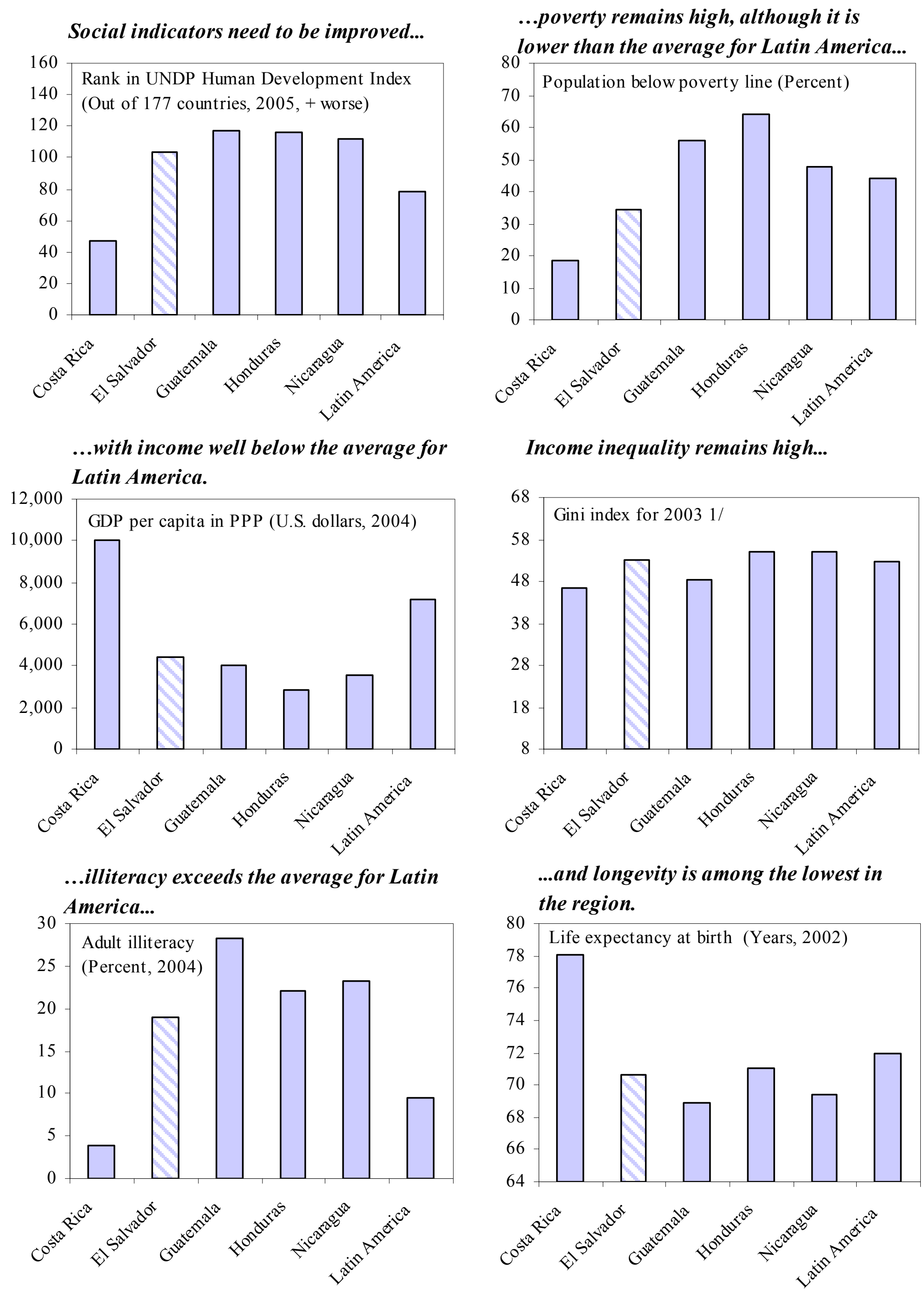


Financing needs remain fairly high, although skillful debt management has lowered these needs recently.



Sources: Country authorities; and Fund staff estimates.

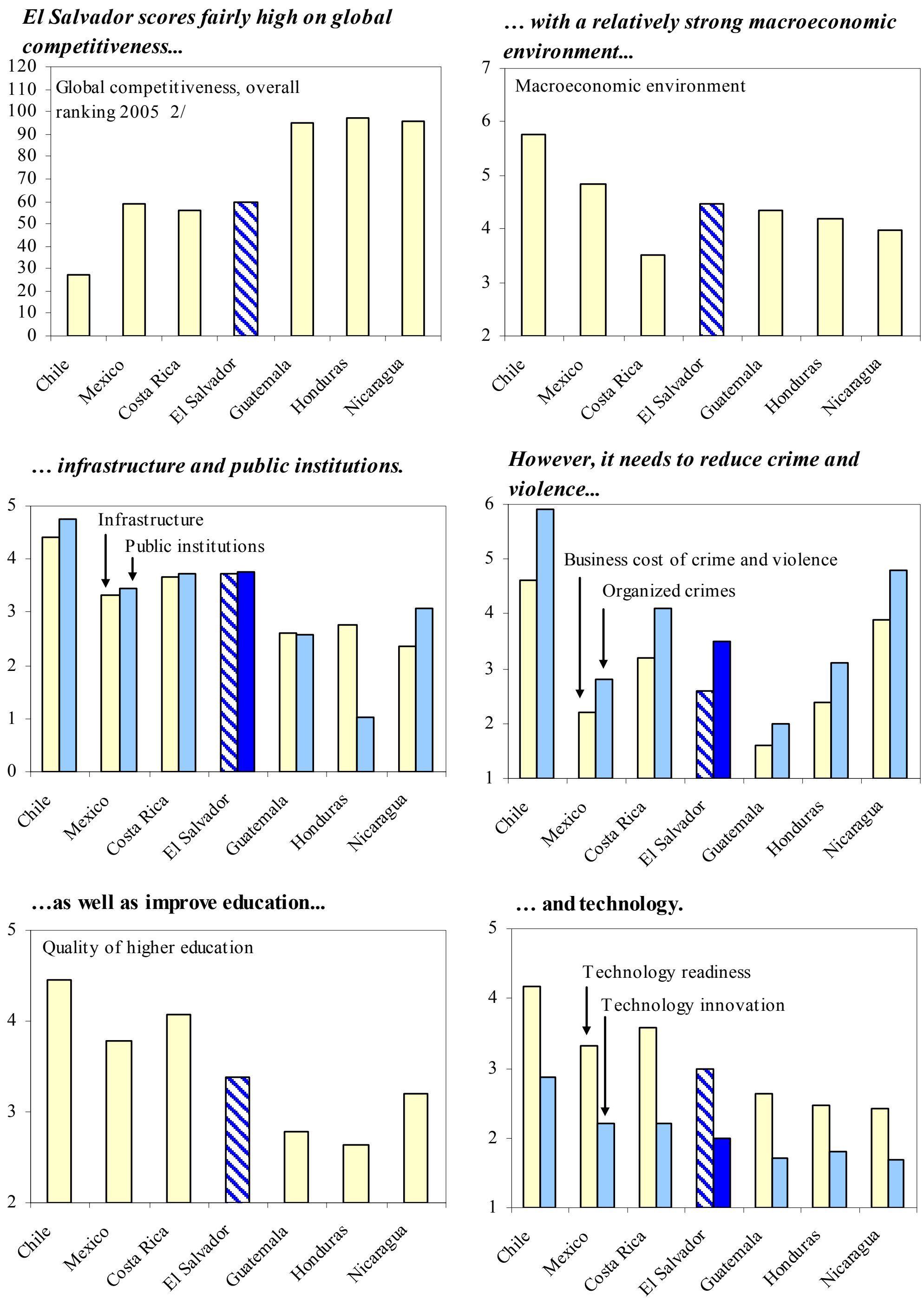
Figure 5. El Salvador: Social Indicators



Sources: UNDP Human Development Report 2005.

1/ A value of 0 represents perfect equality, a value of 100 represents perfect inequality.

Figure 6. El Salvador: Business Environment 1/



Source: World Economic Forum, Global Competitiveness Report.
1/ Scores are based on a scale of 0 to 7, with a value of 7 representing the best score and 0 the worst.
2/ Global Competitiveness ranking out of 104 countries, with 1 being the best and 104 the worst.

Table 1. El Salvador: Key Structural Reforms 1992–2006

Scope and Key Elements	Implementation Period
I. Public Finances	
Tax policy	
Valued-added tax (VAT) adopted	1992
VAT rate raised from 10 to 13 percent	1995
VAT base broadened	2001–03
Wage policy	
Modernization of state and payroll cuts	1995 & 2001
Ethics code for civil servants introduced and civil service law reformed	2001–02
Nominal salaries for most civil servants maintained broadly stable	1999–04
Privatization	
Laws for privatization of telecommunication and electricity company	1996
Sale of four regional electricity distribution companies (75 percent) and three thermal generating plants	1998–99
Break-up and partial sale of the state telecoms monopoly (ANTEL)	1998
Pension system	
Approval for reforming the public social security and pension system	1996
Transition from pay-as-you-go pension system to fully-funded private accounts initiated	1998
Provision for early retirement phased out	2004
Debt management	
Replacing of short-term public debt for longer-term bonds intensified	2002
II. Monetary and Exchange Rate Systems	
Central bank recapitalized	1993
De facto exchange rate peg adopted	1994
Approval of central bank autonomy law	1996
Introduction of U.S. dollar as legal tender initiated	2001
III. Trade policy	
Preferential access to U.S. textile market under Caribbean Basin Initiative	Early 1990s
Trade liberalization, further reducing tariffs and non-tariff barriers	1992–95
External tariffs from Central American Common Market (CACM) adopted	1996
Free-trade agreements with Chile, Dominican Republic, Mexico, and Panama	1998–2001
Liberal regime for FDI introduced	1999–2000
Central America Free Trade Agreement with the United States implemented	2006
IV. Banking System	
Privatization of banks (nationalized in 1980)	1992–94
Public bank (two-tier) created to assume development lending from central bank	1994
Banking law to strengthen the supervisory powers of regulators and tighten prudential regulations, including gradual increase in capital adequacy ratios (9.2 percent in 1999 to 12 percent in 2005)	1999
Reforms to banking law to strengthen protection of depositors, improve supervisory powers to take preventive and corrective measures against banks, and introduce consolidated supervision	2002
Liquidity buffers further strengthened and prudential regulations moved closer to international standards	2003–05
V. Investment Climate	
Labor code reformed to ease rules on fringe benefits and hiring/firing of workers	1994
Minimum wage maintained stable	1998–2002 & 2004
VI. Political System	
Peace accord and demobilization of FMLN and paramilitary forces, accompanied by a reconstruction program	1992
FMLN becomes a political party and participates in presidential, legislative, and municipal elections	1994
Constitutional change to limit duties of army and creation of new civilian police	1992–94

Sources: Authorities of El Salvador; and Fund staff.

Table 2. El Salvador: Selected Economic and Social Indicators

I. Social Indicators

Population (millions)	6.7	Infant mortality (per 1,000 live births)	33
Per capita income (U.S. dollars)	2,189	Percent of pop. below poverty line (2004)	35
Rank in UNDP Development Index 2005 (out of 177)	104	Gini index (2003)	53
Life expectancy at birth in years (2002)	71	Oil imports (millions of U.S. dollars)	874

II. Economic Indicators

					Prel.	Proj. 1/	
	2001	2002	2003	2004	2005	2006	2007
			(Annual percent change)				
Income and prices							
Real GDP	1.7	2.2	2.3	1.8	2.8	3.5	3.5
Real GDP per capita	-0.2	0.3	0.0	-0.4	0.7	1.2	1.2
Unemployment	7.0	6.2	6.9	6.8	7.8	…	…
Consumer prices (end of period, e.o.p.)	1.4	2.8	2.5	5.4	4.3	4.0	3.0
External sector							
Export f.o.b. volume (including *maquila* sector)	-4.1	3.3	2.1	2.8	-2.1	5.4	5.4
Import f.o.b. volume (including *maquila* sector)	0.7	-0.5	8.6	6.4	2.7	7.1	4.7
Terms of trade	-0.1	-0.6	-0.3	-0.7	0.5	-1.3	-0.6
Real effective exchange rate (e.o.p., + appreciation) 2/	1.2	-2.3	-5.1	0.8	2.3	-0.8	…
			(In percent of GDP, unless otherwise indicated)				
Money and credit							
Credit to the private sector	39.9	41.4	40.1	41.5	42.0	42.8	42.8
Broad money	47.2	44.4	43.3	42.0	41.0	42.2	42.2
Interest rate (annual, time deposits) 2/	5.5	3.4	3.4	3.2	3.4	4.0	…
External sector							
Current account balance	-1.1	-2.8	-4.7	-4.0	-4.6	-4.5	-4.6
Trade balance	-14.0	-13.0	-15.2	-16.8	-17.7	-18.9	-18.9
Exports (f.o.b. including *maquila*)	20.9	21.1	21.0	21.1	20.2	20.3	20.4
Of which : main export products 3/	4.9	4.4	4.3	3.9	3.8	3.6	3.3
Imports (f.o.b. including *maquila*)	34.9	34.1	36.1	37.9	37.9	39.2	39.3
Services and income	-3.7	-3.9	-3.5	-3.4	-3.8	-3.5	-3.7
Transfers	16.6	14.1	14.1	16.2	16.9	17.9	18.0
Public finances							
Combined public sector balance	-4.3	-4.5	-3.7	-2.9	-3.0	-2.8	-2.7
Combined primary balance	-2.8	-2.8	-1.6	-0.8	-0.7	-0.4	-0.2
Of which: tax revenue	10.5	11.2	11.5	11.6	12.5	13.2	13.5
Gross domestic investment	16.7	16.2	17.0	16.0	15.4	16.5	17.0
Public sector 4/	4.5	4.3	3.3	1.9	2.2	2.9	3.6
Private sector	12.2	11.9	13.7	14.2	13.2	13.6	13.4
Of which: foreign direct investment	2.1	3.5	0.8	2.7	1.8	1.8	2.0
National savings	15.6	13.4	12.3	12.0	10.8	12.0	12.4
Public sector	-0.2	0.0	-0.5	-0.9	-0.5	-0.2	0.3
Private sector	15.8	13.4	12.8	12.9	11.3	12.2	12.1
Total public debt	34.4	39.3	42.1	43.5	42.3	42.6	42.7
Of which: external public debt	22.8	27.9	31.4	30.2	29.3	30.1	30.8
nonfinacial public sector debt	33.5	38.6	40.3	40.5	39.9	40.3	40.3
External public debt service (percent of exports of goods and services)	14.8	16.8	11.3	20.8	12.7	15.5	14.3
Net foreign assets of the banking system							
Millions of U.S. dollars	1,827	1,839	1,982	2,059	2,178	2,276	2,426
Percent of deposits	29.2	29.2	30.9	31.2	31.4	29.7	29.7
Memorandum items:							
Net *maquila* exports	3.5	3.3	3.3	2.9	2.4	2.3	2.2
Oil import bill	3.5	3.3	3.9	4.2	5.0	5.7	5.8
Petroleum price (U.S. dollars per barrel)	24.5	23.9	30.7	37.8	50.1	62.5	65.5
Nominal GDP (millions of U.S. dollars)	13,813	14,307	15,047	15,822	16,974	18,218	19,421

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

1/ Projections prepared by the staff, including envisaged measures to limit tax exemptions and subsidies in 2006.
2/ As of May 2006.
3/ Comprises coffee, sugar, and net *maquila.*
4/ Includes reconstruction outlays after the earthquakes in 2001 and tropical storm Stan in 2005.

Table 3. El Salvador: Balance of Payments

	2001	2002	2003	2004	Prel. 2005	Proj. 2006
(In millions of U.S. dollars)						
Current account balance	**-150**	**-405**	**-702**	**-632**	**-786**	**-827**
Trade balance	-1,933	-1,865	-2,287	-2,662	-3,008	-3,446
Export of goods (f.o.b.)	2,892	3,020	3,153	3,337	3,432	3,694
General merchandise	1,241	1,262	1,280	1,416	1,614	1,844
Goods for processing	1,650	1,757	1,873	1,921	1,818	1,850
Import of goods (f.o.b.)	-4,824	-4,885	-5,439	-5,999	-6,440	-7,140
General merchandise	3,664	3,602	4,060	4,542	5,036	5,711
Goods for processing	1,161	1,283	1,379	1,457	1,404	1,429
Services	-250	-240	-107	-77	-72	-97
Income	-266	-323	-423	-460	-571	-546
Of which						
Interest on external public debt (net)	-35	-64	-199	-276	-291	-253
Interest on external private debt (net)	-181	-170	-204	-226	-245	-305
Current transfers	2,298	2,023	2,114	2,568	2,865	3,262
Financial and capital account [1/]	**716**	**1,101**	**1,187**	**205**	**821**	**929**
Capital account	199	209	113	100	93	92
Foreign direct investment	289	496	123	430	300	321
Public sector capital	578	1233	715	255	459	433
Private sector capital	-350	-837	236	-580	-31	83
Currency substitution	**-286**	**-204**	**-25**	**-6**	**-5**	**0**
Errors and omissions	**-457**	**-615**	**-143**	**380**	**-89**	**0**
Change in net reserves (- = increase)	**178**	**124**	**-316**	**53**	**59**	**-102**
(Annual percentage change)						
Exports (fob)						
Value	-2.4	4.4	4.4	5.8	2.9	7.6
Volume	-4.1	3.3	2.1	2.8	-2.1	5.4
General merchandise						
Value	-8.4	1.7	1.4	10.6	14.0	14.2
Volume	-10.5	0.0	-0.7	7.8	10.9	11.6
Import (fob)						
Value	2.6	1.3	11.4	10.3	7.4	10.9
Volume	0.7	-0.5	8.6	6.4	2.7	7.1
General merchandise						
Value	3.2	-1.7	12.7	11.9	10.9	13.4
Volume	0.8	-3.4	10.5	9.0	7.9	10.8
Terms of Trade	-0.1	-0.6	-0.3	-0.7	0.5	-1.3
(In percent of GDP)						
Current account	**-1.1**	**-2.8**	**-4.7**	**-4.0**	**-4.6**	**-4.5**
Export of goods (f.o.b.)	20.9	21.1	21.0	21.1	20.2	20.3
Import of goods (f.o.b.)	-34.9	-34.1	-36.1	-37.9	-37.9	-39.2
Net maquila exports	3.6	3.3	3.3	2.9	2.4	2.3
Current transfers	16.6	14.1	14.1	16.2	16.9	17.9
Foreign direct investment	2.1	3.5	0.8	2.7	1.8	1.8
Public sector capital	4.2	8.6	4.7	1.6	2.7	2.4
Private sector capital	-2.5	-5.8	1.6	-3.7	-0.2	0.5
Memorandum items:						
Gross international reserves (GIR, millions of U.S. dollars)	1,712	1,591	1,910	1,893	1,833	1,931
GIR in months of imports, excluding maquila	5.7	4.7	5.0	4.5	3.9	3.8
External public sector debt	22.8	27.9	31.4	30.2	29.3	29.8
External public debt servicing (millions of U.S. dollars)	532	638	464	918	579	760
Public sector debt service to exports of goods and services (percent)	14.8	16.8	11.3	20.8	12.7	15.5
Of which: Interest	4.0	5.1	6.8	7.0	7.5	7.1

Sources: Central Reserve Bank; and Fund staff estimates.

1/ Includes conversion of colones into U.S. dollars under the dollarization law from 2001.

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

	2001	2002	2003	2004	2005	Proj. 2006
(End-of-period stocks; in millions of dollars)						
I. Central Reserve Bank						
Net international reserves, NIR	**1,710**	**1,589**	**1,906**	**1,888**	**1,829**	**1,931**
Of which: Disposable net international reserves 1/	86	170	165	256	151	127
Net domestic assets	**-86**	**-170**	**-165**	**-256**	**-151**	**-127**
Nonfinancial public sector	113	24	247	187	266	278
Central Government	124	32	250	191	268	282
Rest of public sector	-11	-7	-3	-4	-2	-4
Commercial banks	103	86	85	0	0	0
Nonbank financial institutions	262	221	101	133	93	56
Liquidity operations	-641	-567	-486	-538	-467	-453
Medium- and long-term foreign liabilities	-125	-101	-267	-195	-191	-177
Other	202	166	156	158	149	168
Base money	**1,623**	**1,419**	**1,741**	**1,632**	**1,679**	**1,804**
Currency issue	270	67	42	36	34	34
Liquidity requirements	1,353	1,352	1,699	1,596	1,644	1,770
II. Financial System						
Net foreign assets	**1,827**	**1,839**	**1,982**	**2,059**	**2,178**	**2,276**
Net domestic assets	**4,696**	**4,516**	**4,482**	**4,581**	**4,787**	**5,419**
Nonfinancial public sector	207	-87	135	154	223	218
Central Government	551	247	493	536	489	510
Rest of public sector	-344	-334	-358	-382	-266	-292
Credit to private sector	5,516	5,921	5,984	6,565	7,123	7,800
Medium- and long-term foreign liabilities	-470	-659	-1,092	-1,249	-1,261	-1,260
Other	-556	-659	-544	-890	-1,297	-1,339
Liabilities to the private sector	**6,523**	**6,355**	**6,464**	**6,640**	**6,966**	**7,695**
Of which:						
Money	1,171	1,056	1,069	1,202	1,293	1,453
Quasi-money	5,030	4,960	4,980	4,989	5,061	5,441
(Percent changes in relation to previous year's liabilities to the private sector)						
Net domestic assets	**2.4**	**-2.8**	**-0.5**	**1.5**	**3.1**	**9.1**
Of which:						
Nonfinancial public sector	2.4	-4.5	3.5	0.3	1.0	-0.1
Credit to private sector	-1.6	6.2	1.0	9.0	8.4	9.7
Liabilities to the private sector	**2.6**	**-2.6**	**1.7**	**2.7**	**4.9**	**10.5**
(In percent of GDP)						
Credit to the private sector	39.9	41.4	40.1	41.5	42.0	42.8
Liabilities to the private sector	47.2	44.4	43.3	42.0	41.0	42.2
Of which:						
Currency in circulation	2.4	1.0	0.3	0.2	0.2	0.2
Money	8.3	7.8	7.1	7.2	7.3	7.5
Quasi-money	36.0	34.9	33.3	31.5	29.6	28.8
Memorandum items:						
Credit to the private sector (12-month percentage change)	-1.8	7.3	1.1	9.7	8.5	9.5
Liquidity requirements (percent of deposits) 2/	26.0	26.0	35.0	32.0	29.0	26.0
Net foreign assets (percent of deposits)	29.2	29.2	30.9	31.2	31.4	29.7
Disposable NIR (percent of central bank nonmonetary liabilities) 3/	7.2	13.7	17.4	24.2	16.5	14.4
Disposable NIR (percent of central bank liquid nonmonetary liabilities) 4/	9.0	17.1	29.7	38.3	29.0	29.2

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

1/ NIR in excess of base money

2/ Comprises requirements on short-term (25 percent) and medium-term deposits (20 percent), and an additional deposit requirement of 3 percent. A special liquidity requirement (9 percent of deposits) was introduced in 2003, which was phased out in three annual steps.

3/ Nonmonetary liabilities include government deposits at the central bank.

4/ Excludes privatization-related government deposits and medium-term liquidity bills.

Table 5. El Salvador: Operations of the Consolidated Public Sector
(In percent of GDP)

	2001	2002	2003	2004	Prel. 2005	Proj. 1/ 2006
Revenues and grants	**15.5**	**16.0**	**16.5**	**16.0**	**16.6**	**17.2**
Current revenue	15.1	15.2	16.0	15.7	16.2	17.0
Tax revenue	10.5	11.2	11.5	11.6	12.5	13.2
Nontax revenue	4.1	4.0	3.8	3.5	3.2	3.2
Of which: pension revenue	0.5	0.7	0.3	0.2	0.2	0.1
Operating surplus of the public enterprises	0.4	0.0	0.6	0.6	0.5	0.5
Operating surplus of the central bank	0.1	0.1	0.0	0.0	0.0	0.0
Capital revenue	0.0	0.5	0.0	0.0	0.0	0.0
Official grants	0.4	0.3	0.5	0.3	0.3	0.3
Expenditure	**18.4**	**18.0**	**18.7**	**18.6**	**19.4**	**19.6**
Current expenditure	15.2	15.6	16.5	16.6	16.8	17.1
Wages and salaries	7.9	7.4	7.3	7.3	7.1	7.4
Goods and services	3.0	3.2	3.6	3.7	4.0	3.8
Interest	1.4	1.7	2.0	2.1	2.3	2.4
Current transfers	2.9	3.3	3.5	3.5	3.4	3.5
Non-pension payments	1.2	1.4	1.5	1.5	1.3	1.3
Pension payments	1.8	1.9	2.0	2.0	2.1	2.3
Capital expenditure	3.1	2.3	2.2	2.1	2.6	2.5
Fixed capital formation	3.0	2.3	2.2	1.8	2.3	2.1
Capital transfers	0.1	0.0	0.1	0.2	0.3	0.4
Underlying overall balance	**-2.9**	**-1.9**	**-2.2**	**-2.6**	**-2.8**	**-2.4**
Reconstruction expenditure	1.4	2.0	1.4	0.3	0.2	0.4
Other 2/	0.0	0.6	0.0	0.0	0.0	0.0
Primary balance	**-2.8**	**-2.8**	**-1.6**	**-0.8**	**-0.7**	**-0.4**
Overall balance	**-4.3**	**-4.5**	**-3.7**	**-2.9**	**-3.0**	**-2.8**
Financing	**4.3**	**4.5**	**3.7**	**2.9**	**3.0**	**2.8**
External	**4.5**	**8.9**	**2.9**	**1.5**	**2.1**	**2.8**
Disbursements	7.0	12.4	4.1	4.0	4.4	5.4
Amortization	-2.5	-3.5	-1.2	-2.4	-2.3	-2.6
Domestic	**-0.2**	**-4.4**	**0.7**	**1.4**	**0.9**	**0.0**
Central bank	0.2	-0.6	1.5	-0.4	0.5	0.1
Banking system	0.9	-1.4	0.0	0.5	-0.1	-0.1
Private sector	-0.9	-0.6	0.0	0.0	0.7	0.0
Privatization proceeds 3/	0.1	0.1	0.0	1.7	0.0	0.0
Other 4/	-0.4	-1.7	-0.8	-0.4	-0.2	0.0
Memorandum items:						
Current account balance	-0.2	-0.4	-0.5	-0.9	-0.5	-0.2
Pension balance	-1.2	-1.2	-1.7	-1.7	-1.9	-2.2
Gross financing needs	10.9	13.7	11.8	6.8	7.2	7.3
Implicit interest rate (in percent)	5.0	5.2	5.5	5.2	5.7	6.0
Total public sector debt 5/	34.4	39.3	42.1	43.5	42.3	42.6
Of which: nonfinancial public debt	33.5	38.6	40.3	40.5	39.9	40.3

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

1/ Projections prepared by the staff, including envisaged measures to limit tax exemptions and subsidies in 2006.

2/ One-time fine paid in 2002 by the state electricity company (CEL) to cancel an energy contract.

3/ Includes the sale of shares in the telephone company (CTE) for 2004.

4/ Comprises discrepancies from above- and below-the-line items. The overall balance is measured above the line.

5/ Comprises nonfinancial public sector debt and nonmonetary net liabilities of the central bank.

Table 6. El Salvador: Selected Vulnerability Indicators
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	Prel. 2005	Proj. 2006
Fiscal indicators						
Overall balance of the public sector	-4.3	-4.5	-3.7	-2.9	-3.0	-2.8
Public sector primary balance	-2.8	-2.8	-1.6	-0.8	-0.7	-0.4
Gross public sector financing requirement	10.9	13.7	11.8	6.8	7.2	7.3
Public sector debt	34.4	39.3	42.1	43.5	42.3	42.6
Public sector external debt	22.8	27.9	31.4	30.2	29.3	30.1
External interest payments to total fiscal revenue (percent)	1.6	2.8	8.0	10.9	10.3	8.1
External amortization payments to total fiscal revenue (percent)	18.1	23.6	7.5	24.0	8.9	8.9
Financial indicators						
Broad money (percent change, 12-month basis)	2.6	-2.6	1.7	2.7	4.9	10.5
Private sector credit (percent change, 12-month basis)	-1.8	7.3	1.1	9.7	8.5	9.5
Credit to nonresidents (millions of U.S. dollars)	247	358	304	…	…	…
Ratio of capital to risk-weighted assets	11.8	12.2	12.8	13.0	13.5	…
Ratio of loans more than 90 days past due						
to total loans 1/	4.3	3.5	2.8	2.1	1.9	…
Ratio of nonperforming loans to total loans 2/	...	15.8	12.3	11.1	8.8	…
Provision coverage						
Ratio of provisions to total loans	4.3	3.9	3.6	3.6	3.6	…
Ratio of provisions to loans more than 90 days past due 1/	103	115	130	142	126	…
Ratio of real estate loans to total loans	18.1	18.9	22.0	24.0	23.6	…
Ratio of consumption loans to total loans	11.1	12.4	14.2	17.8	20.6	…
Return to average equity	10.7	12.2	11.5	9.8	10.1	…
Return to average total assets	0.9	1.1	1.1	1.0	1.1	…
Ratio of liquid assets to total assets	34.6	30.0	31.7	30.8	30.3	…
Ratio of liquid assets to total short-term liabilities	36.3	33.0	36.3	29.5	32.1	…
External indicators						
Exports of goods and services (percent change, 12-month basis)	-2.4	4.4	4.4	5.8	2.9	7.6
Imports of goods and services (percent change, 12-month basis)	2.6	1.3	11.4	10.3	7.4	10.9
Current account balance	-1.1	-2.8	-4.7	-4.0	-4.6	-4.5
Capital and financial account balance	5.2	7.7	7.9	1.3	4.8	5.1
Gross official reserves (millions of U.S. dollars)	1,712	1,591	1,910	1,893	1,833	1,931
Months of imports of goods and services, excluding maquila	5.7	4.7	5.0	4.5	3.9	3.8
Percent of short-term debt 3/	266	278	687	253	628	359
Percent of gross external financing requirements	86.1	57.7	75.8	58.5	57.7	60.1
Percent of broad money	26.2	25.0	29.5	28.5	26.3	26.2
Total public external debt service	3.8	5.1	3.1	5.8	3.5	4.6
Total external debt to exports of goods and services (percent)	170	192	210	201	206	206
External interest payments to exports of goods and services (percent)	7.5	7.8	12.8	15.0	15.6	15.1
External amortization payments to exports of goods and services (percent)	13.4	14.7	5.9	18.3	6.9	11.1
REER 12-month basis (depreciation -) 4/	1.2	-2.3	-5.1	0.8	2.3	-0.8

Sources: Central Bank of El Salvador; Ministry of Finance; and Fund staff estimates and projections.
1/ Based on past-due loans.
2/ Includes contingencies. Nonperforming loans are defined as the sum of the three lowest loan categories.
3/ Refers to public external debt. Maturity less than one year, defined on a residual maturity basis.
4/ As of May 2006.

Table 7. El Salvador: Balance of Payments

	Prel. 2005	Proj. 2006	2007	2008	2009	2010	2011
	(In millions of U.S. dollars)						
Current account balance	**-786**	**-827**	**-895**	**-915**	**-872**	**-897**	**-986**
Trade balance	-3,008	-3,446	-3,679	-3,750	-3,871	-4,091	-4,387
Export of goods (f.o.b.)	3,432	3,694	3,956	4,285	4,655	5,067	5,391
General merchandise	1,614	1,844	2,069	2,305	2,579	2,883	3,147
Goods for processing	1,818	1,850	1,887	1,980	2,075	2,183	2,244
Import of goods (f.o.b.)	-6,440	-7,140	-7,635	-8,035	-8,525	-9,157	-9,778
General merchandise	5,036	5,711	6,167	6,501	6,923	7,486	8,071
Goods for processing	1,404	1,429	1,469	1,535	1,602	1,671	1,707
Services	-72	-97	-92	-103	-119	-134	-150
Income	-571	-546	-628	-789	-851	-899	-963
Of which							
Interest on external public debt (net)	-291	-253	-335	-369	-403	-421	-441
Interest on external private debt (net)	-245	-305	-317	-408	-435	-463	-494
Current transfers	2,865	3,262	3,506	3,726	3,969	4,227	4,514
Financial and capital account [1/]	**821**	**929**	**1,010**	**1,040**	**1,002**	**1,037**	**1,136**
Capital account	93	92	90	108	108	108	108
Foreign direct investment	300	321	397	414	441	471	502
Public sector capital	459	433	492	507	312	342	324
Private sector capital	-31	83	43	24	154	129	215
Currency substitution	**-5**	**0**	**0**	**0**	**0**	**0**	**0**
Errors and omissions	**-89**	**0**	**0**	**0**	**0**	**0**	**0**
Change in net reserves (- = increase)	**59**	**-102**	**-115**	**-125**	**-130**	**-140**	**-150**
	(Annual percentage change)						
Exports (fob)							
Value	2.9	7.6	7.1	8.3	8.6	8.9	6.4
Volume	-2.1	5.4	5.4	6.7	6.8	7.0	4.4
General merchandise							
Value	14.0	14.2	12.2	11.4	11.9	11.8	9.2
Volume	10.9	11.6	10.0	9.2	9.7	9.6	7.0
Import (fob)							
Value	7.4	10.9	6.9	5.2	6.1	7.4	6.8
Volume	2.7	7.1	4.7	3.4	4.2	5.4	4.8
General merchandise							
Value	10.9	13.4	8.0	5.4	6.5	8.1	7.8
Volume	7.9	10.8	5.9	3.3	4.4	6.0	5.7
Terms of Trade	0.5	-1.3	-0.6	-0.3	-0.1	-0.1	0.0
	(In percent of GDP)						
Current account	**-4.6**	**-4.5**	**-4.6**	**-4.4**	**-4.0**	**-3.8**	**-3.9**
Export of goods (f.o.b.)	20.2	20.3	20.4	20.7	21.1	21.5	21.5
Import of goods (f.o.b.)	-37.9	-39.2	-39.3	-38.8	-38.6	-38.9	-39.0
Net maquila exports	2.4	2.3	2.2	2.2	2.1	2.2	2.1
Current transfers	16.9	17.9	18.0	18.0	18.0	18.0	18.0
Foreign direct investment	1.8	1.8	2.0	2.0	2.0	2.0	2.0
Public sector capital	2.7	2.4	2.5	2.4	1.4	1.5	1.3
Private sector capital	-0.2	0.5	0.2	0.1	0.7	0.5	0.9
Memorandum items:							
Gross international reserves (GIR, In millions of U.S. dollars)	1,833	1,931	2,046	2,171	2,301	2,441	2,591
GIR in months of imports, excluding maquila	3.9	3.8	3.8	3.8	3.7	3.6	3.6
External public sector debt	29.3	29.8	30.5	31.0	30.5	30.1	29.5
External public debt servicing (In millions of U.S. dollars)	579	760	752	735	761	777	805
Public sector debt service to exports of goods and services (percent	12.7	15.5	14.3	13.0	12.5	11.8	11.5
Of which: Interest	7.5	7.1	8.4	8.5	8.5	8.3	8.2

Sources: Central Reserve Bank; and Fund staff estimates.

1/ Includes conversion of colones into US dollars under the dollarization law from 2001.

Table 8. El Salvador: Medium-Term Operations of the Consolidated Public Sector
(In percent of GDP)

	Prel.	Proj. 1/					
	2005	2006	2007	2008	2009	2010	2011
Revenues and grants	**16.6**	**17.2**	**17.9**	**18.3**	**18.9**	**18.9**	**18.6**
Current revenue	16.2	17.0	17.1	17.6	18.2	18.2	18.2
Tax revenue	12.5	13.2	13.5	14.0	14.6	14.6	14.6
Nontax revenue	3.2	3.2	3.0	3.0	3.0	3.0	3.0
Of which: pension revenue	0.2	0.1	0.1	0.1	0.1	0.1	0.0
Operating surplus of the public enterprises	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Operating surplus of the central bank	0.0	0.0	0.0	0.1	0.1	0.1	0.0
Official grants	0.3	0.3	0.7	0.7	0.7	0.6	0.3
Expenditure	**19.4**	**19.6**	**20.5**	**20.7**	**20.3**	**20.2**	**19.9**
Current expenditure	16.8	17.1	16.9	16.9	16.8	16.7	16.7
Wages and salaries	7.1	7.4	7.4	7.4	7.4	7.4	7.4
Goods and services	4.0	3.8	3.8	3.8	3.8	3.8	3.8
Interest	2.3	2.4	2.4	2.4	2.4	2.4	2.3
Current transfers	3.4	3.5	3.3	3.2	3.2	3.2	3.1
Non-pension payments	1.3	1.3	1.1	1.1	1.1	1.1	1.1
Pension payments	2.1	2.3	2.1	2.1	2.1	2.0	2.0
Capital expenditure 2/	2.6	2.5	3.6	3.8	3.5	3.5	3.2
Fixed capital formation	2.3	2.1	3.2	3.5	3.2	3.2	2.9
Capital transfers	0.3	0.4	0.4	0.3	0.3	0.3	0.3
Underlying overall balance	**-2.8**	**-2.4**	**-2.7**	**-2.3**	**-1.4**	**-1.3**	**-1.3**
Reconstruction expenditure	0.2	0.4	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.2	0.0	0.0	0.0	0.0	0.0
Primary balance	**-0.7**	**-0.4**	**-0.2**	**0.1**	**1.0**	**1.0**	**1.0**
Overall balance	**-3.0**	**-2.8**	**-2.7**	**-2.3**	**-1.4**	**-1.3**	**-1.3**
Financing	**3.0**	**2.8**	**2.7**	**2.3**	**1.4**	**1.3**	**1.3**
External	**2.1**	**2.8**	**2.6**	**2.5**	**1.4**	**1.5**	**1.3**
Disbursements	4.4	5.4	4.1	3.7	2.5	3.1	4.8
Amortization	-2.3	-2.6	-1.5	-1.2	-1.0	-1.6	-3.4
Domestic	**0.9**	**0.0**	**0.1**	**-0.2**	**0.0**	**-0.1**	**0.0**
Central bank	0.5	0.1	0.0	0.0	0.0	0.0	0.0
Banking system	-0.1	-0.1	0.1	-0.1	0.0	0.0	0.0
Private sector	0.7	0.0	0.0	0.0	0.0	-0.1	0.0
Other 3/	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Current account balance	-0.5	-0.2	0.3	0.8	1.4	1.5	1.5
Pension balance	-1.9	-2.2	-2.1	-2.0	-2.0	-2.0	-2.0
Gross financing needs	7.2	7.3	6.0	5.2	4.1	4.5	6.2
Implicit interest rate (in percent)	5.7	6.0	6.1	6.2	6.2	6.2	6.2
Total public sector debt 4/	42.3	42.6	42.7	42.6	41.6	40.6	39.6
Of which: nonfinancial public debt	39.9	40.3	40.3	40.3	39.2	38.3	37.2

Sources: Central reserve bank; Ministry of Finance; and Fund staff estimates.

1/ Projections prepared by the staff, including envisaged measures to limit tax exemptions and subsidies in 2006.

2/ Incorporates the authorities' investment plan described in ¶13.

3/ Comprises discrepancies from above- and below-the-line items. The overall balance is measured above the line.

4/ Comprises nonfinancial public sector debt and nonmonetary net liabilities of the central bank.

Table 9. El Salvador: Illustrative Medium-Term Scenarios

	Prel	Proj					
	2005	2006	2007	2008	2009	2010	2011
Baseline Scenario 1/							
(Annual percentage changes)							
Macroeconomic parameters							
Real GDP	2.8	3.5	3.5	3.5	3.5	3.5	3.5
Nominal GDP	7.3	7.3	6.6	6.6	6.6	6.6	6.6
Average consumer prices	3.7	4.1	3.5	3.0	3.0	3.0	3.0
(In percent of GDP, unless otherwise indicated)							
Public							
Public sector revenue	16.6	17.2	17.9	18.3	18.9	18.9	18.6
Public sector expenditure	19.6	20.0	20.5	20.6	20.3	20.2	19.8
Of which: interest	2.3	2.4	2.4	2.4	2.4	2.3	2.3
Overall public sector	-3.0	-2.8	-2.6	-2.3	-1.4	-1.3	-1.3
Of which: primary balance	-0.7	-0.4	-0.2	0.1	1.0	1.0	1.0
Public sector	42.3	42.3	42.3	42.3	41.2	40.3	39.2
External							
Current account	-4.6	-4.5	-4.6	-4.4	-4.0	-3.8	-3.9
Gross international reserves (in millions of U.S. dollars)	1,820	1,922	2,037	2,162	2,292	2,432	2,582
Gross external financing requirements	18.7	17.6	17.0	16.3	15.9	15.9	16.4
Gross domestic	15.4	16.5	17.0	17.5	17.5	17.5	17.5
Public	2.2	2.9	3.6	3.8	3.5	3.5	3.2
Private	13.2	13.5	13.3	13.7	14.0	14.0	14.3
Of which: foreign direct investment	1.8	1.8	2.0	2.0	2.0	2.0	2.0
National	10.8	11.9	12.4	13.1	13.5	13.7	13.6
Public	-0.5	-0.2	0.3	0.8	1.4	1.5	1.6
Private	11.3	12.1	12.1	12.3	12.1	12.2	12.0
Alternative Scenario							
(Annual percentage changes)							
Macroeconomic parameters							
Real GDP	2.8	3.5	4.0	4.0	4.0	4.0	4.0
Nominal GDP	7.3	7.3	7.1	7.1	7.1	7.1	7.1
Average CPI	3.7	4.1	3.5	3.0	3.0	3.0	3.0
(In percent of GDP, unless otherwise indicated)							
Budget and public debt							
Public sector revenue	16.6	17.2	18.2	18.8	19.3	19.7	19.7
Public sector expenditure	19.6	20.0	20.1	20.5	20.5	20.9	20.9
Of which: interest	2.3	2.4	2.4	2.4	2.3	2.3	2.2
Overall public sector	-3.0	-2.8	-1.9	-1.7	-1.3	-1.3	-1.3
Of which: primary balance	-0.7	-0.4	0.5	0.6	1.0	1.0	1.0
Public sector	42.3	42.2	41.3	40.3	38.9	37.6	36.4
External							
Current account	-4.6	-4.5	-4.1	-3.9	-3.7	-3.4	-3.1
Gross international reserves (in millions of U.S. dollars)	1,820	1,922	2,045	2,176	2,317	2,467	2,628
Gross external financing requirements	18.7	17.1	16.4	14.7	13.4	12.1	11.1
Gross domestic	15.4	16.5	19.4	20.0	20.0	20.0	20.0
Public	2.2	2.9	3.5	3.9	4.0	4.0	4.1
Private	13.2	13.6	15.9	16.1	16.0	16.0	15.9
Of which: foreign direct investment	1.8	1.8	2.5	2.5	2.5	2.5	2.5
National	10.8	11.9	15.3	16.1	16.3	16.6	16.9
Public	-0.5	-0.2	0.9	1.5	2.0	2.1	2.5
Private	11.3	12.1	14.4	14.6	14.3	14.5	14.4

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

1/ Prepared by staff based on the authorities' envisaged policy framework.
2/ Prepared by staff based on proposed fiscal consolidations and reforms of Table

Table 10. El Salvador: Enhanced Structural Reforms

Measures	Sector
I. Measures Implemented (July 2004–June 2006)	
Increase in selected excise taxes	Fiscal
Reduce evasion further and bring informal activities into the tax base	Fiscal
Approval of anti-trust law prior to CAFTA-DR	Investment climate
Approval of CAFTA-DR and enabling legislation, including intellectual property rights,	Trade
enhancing competition in telecomunications, and improving transparency and competitive	
bidding for government procurement	
Issue regulations to bring prudential norms closer to best practice	Banking
Improve bank resolution practice.	Banking
II. Immediate Measures (Next 12 months)	
Target gas and electricity subsidies only to the poor	Fiscal
Phase out income tax exemptions to export regimes	Fiscal
Further improve debt management to reduce government's financing needs	Fiscal
Net out operations of the public sector to shrink central bank's balance sheet	Monetary/Fiscal
Phase out subsidies on water and for nontraditional exports 1/	Monetary
Set timetable for gradual improvement in prudential requirements	Banking
Reinforce consolidated supervision and enhance the autonomy and powers of the	Banking
superintendency of banks	Banking
Secure passage of framework for securitization and investment funds	
III. Near-Term Measures (Next 1–2 years)	Fiscal
Raise value-added tax rate 1/	Fiscal
Introduce a property tax 1/	Fiscal
Align excise taxes on petroleum products with those in the region (as world oil market	
conditions permit) 1/	Fiscal
Increase gradually the minimum retirement age and adopt other parametric pension reforms 1/	Fiscal
Transfer expenditure tasks to local governments (in line with recent rise in revenue-sharing	
from 6 to 7 percent) 1/	Monetary/Fiscal
Restructure balance sheet of the central bank as envisaged in dollarization law	Banking
Shift supervision toward risk management and develop early-warning signal system	Investment climate
Increase private sector participation in infrastructure (ports, power generation, water, roads)	Trade
Approval of improvements to the insolvency and credit rights' framework 1/	Trade
IV. Medium-Term Measures (Next 2–3 years)	
	Monetary
Conclude restructuring of public financial institutions	Banking
Strengthen the lender-of-last-resort function and the deposit insurance scheme	Banking
Complete trade agreements with Canada, Colombia, European Union, CARICOM, and Taiwan,	
province of China	Investment climate
Enhance labor market flexibility, including by allowing for hourly wages and reducing	
overtime costs 1/	Investment climate

Source: The Salvadorean authorities.

1/ As recommended by staff.

Table 11. El Salvador: Millennium Development Goals

(In percent, unless otherwise noted)

	1990 Benchmark	2015 Goal	2003 Estimate	2004 Estimate	Status
1. Poverty					
Halve extreme poverty	32.6	16.3	16.7	15.2	Achieved
Halve malnutrition 1/	11.2	5.6	10.3	...	Unlikely
2. Education					
Achieve full enrollment in primary education education to 100 percent	78.0	100.0	88.4	88.4	On track
3. Gender equality					
Raise girls/boys ratio in primary and secondary	101.0	100.0	96.0	94.0	On track
4. Child mortality 2/					
Reduce child mortality under 5 years of age by two...thirds	52.0	17.0	31.0	...	On track
5. Maternal health					
Reduce maternal mortality rate (for each 100,000 live births) by three-fourths	91-223	23-56	106-239	...	Unlikely
Raise the contraceptive prevalence rate (percent of women ages 15-49)	47.0	n/a	67.0	...	On track
6. Environment					
Halve the proportion of individuals without access to improved water source	33.0	16.0	14.0	15.0	On track
Halt forest degradation (percent of total land) 2/	9.3	4.7	5.8	...	Off track
7. Global partnership for development 3/					
Develop and implement strategies for youth employment (youth unemployment rate in percent of total labor force ages 15/24)	14.0	n/a	11.4	11.5	On track
Make available the benefits of new information technologies (Use of internet - per 100 people)	0.3	n/a	8.3	8.9	On track

Sources: Official information; and World bank, World Development Indicators database, April 2005.
1/ Refers to the indicator of weight for age. Benchmark data is for 1993
2/ Benchmark data is for 1988-1993 and the estimate is for 1997-2002
3/ Benchmark data is for 1983-1993 and the estimate is for 1993-2002

Table 12. Comparative Social Indicators

	Costa Rica	**El Salvador**	Guatemala	Honduras	Nicaragua	Average for Latin America and the Caribbean
Rank in UNDP Human Development Index (out of 177 countries) (2005)	47	**104**	117	116	112	79
GDP per capita in PPP, U.S. dollars (2004)	10,049	**4,391**	4,028	2,835	3,515	7,223
People not expected to survive to age 40 (in percent of population) (2000–05)	3.7	**9.9**	14.1	13.8	10.3	n.a.
Life expectancy at birth (years) (2002)	78.1	**70.6**	68.9	71.0	69.4	71.9
Infant mortality (per 1,000 live births) (2002)	9	**33**	36	32	32	27
Population without access to safe water (2000)	5	**23**	8	12	23	14
Per capita health exp. in PPP, U.S. dollars (2001)	562	**376**	199	153	158	n.a.
Physicians per 100,000 people (1990–2003)	160	**126**	109	87	62	n.a.
Adult illiteracy (2004)	3.8	**18.9**	28.2	22.0	23.3	9.5
Primary school net enrollment (2001–02) (percent of relevant age of the population) 1/	91	**89**	85	87	82	94
Secondary school net enrollment (2001/02) (percent of relevant age of the population) 1/	51	**46**	28	...	37	61
Share of income or consumption (in percent) 2/						
Poorest 10 percent	1.4	**0.9**	0.9	0.9	1.2	n.a.
Richest 10 percent	34.8	**40.6**	48.3	42.2	45.0	n.a.
Gini index (Human Development Report, 2003) 3/	46.5	**53.2**	48.3	55.0	55.1	n.a.
Percentage of population below the poverty line 3/	18.5	**34.5**	56.0	63.9	47.9	44.2

Sources: UNDP Human Development Report 2005; CEPAL, Indicators of Economic and Social Development in Latin America and the Caribbean.

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

2/ Survey based on income.

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

Table 1. El Salvador: Public Sector Debt Sustainability Framework, 2001–2011
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	Projections 2006	2007	2008	2009	2010	2011	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	34.4	39.3	42.1	43.5	42.3	**42.3**	**42.3**	**42.3**	**41.2**	**40.3**	**39.2**	**-0.2**
2 Change in public sector debt	3.6	4.9	2.8	1.4	-1.2	0.0	0.1	0.0	-1.1	-1.0	-1.1	
3 Identified debt-creating flows (4+7+12)	2.9	3.4	1.7	2.5	0.1	-0.1	0.0	-0.3	-1.2	-1.2	-1.2	
4 Primary deficit	2.8	2.8	1.6	0.8	0.7	0.4	0.2	-0.1	-1.0	-1.0	-1.0	
5 Revenue and grants	15.5	16.0	16.5	16.0	16.6	17.2	17.9	18.3	18.9	18.9	18.6	
6 Primary (noninterest) expenditure	18.3	18.9	18.1	16.8	17.3	17.6	18.1	18.2	17.9	17.8	17.6	
7 Automatic debt dynamics 2/	-0.1	0.5	0.1	0.0	-0.7	-0.5	-0.2	-0.2	-0.2	-0.2	-0.2	
8 Contribution from interest rate/growth differential 3/	-0.1	0.5	0.1	0.0	-0.7	-0.5	-0.2	-0.2	-0.2	-0.2	-0.2	
9 Of which contribution from real interest rate	0.4	1.3	1.0	0.8	0.5	0.9	1.2	1.2	1.2	1.1	1.1	
10 Of which contribution from real GDP growth	-0.5	-0.8	-0.9	-0.7	-1.1	-1.4	-1.4	-1.4	-1.4	-1.4	-1.3	
11 Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.1	0.0	0.0	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.1	0.0	0.0	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 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	
15 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	
16 Residual, including asset changes (2-3) 5/	0.7	1.5	1.1	-1.1	-1.3	0.1	0.0	0.3	0.2	0.3	0.2	
Public sector debt-to-revenue ratio 1/	221.7	244.8	255.2	271.0	255.3	245.0	237.1	230.6	218.3	213.6	211.3	
Gross financing need 6/	10.9	13.7	11.8	6.8	7.2	7.3	6.0	5.2	4.1	4.5	6.2	
in billions of U.S. dollars	172.5	224.4	202.4	123.8	140.0	152.2	133.7	123.6	102.3	119.7	176.7	
Scenario with key variables at their historical averages 7/						**42.3**	**43.7**	**45.3**	**46.8**	**48.5**	**49.9**	**-0.3**
Scenario with no policy change (constant primary balance) in 2005-2010						**42.3**	**42.9**	**43.3**	**43.7**	**44.2**	**44.6**	**-0.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	1.7	2.3	2.3	1.8	2.8	3.5	3.5	3.5	3.5	3.5	3.5	
Average nominal interest rate on public debt (in percent) 8/	5.0	5.2	5.5	5.2	5.7	6.0	6.1	6.1	6.1	6.1	6.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.6	4.0	2.7	2.0	1.3	2.3	3.1	3.1	3.1	3.1	3.1	
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)	3.4	1.2	2.8	3.3	4.4	3.7	3.0	3.0	3.0	3.0	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	5.6	5.2	-1.9	-5.3	5.7	5.6	6.1	4.3	1.5	3.2	1.9	
Primary deficit	2.8	2.8	1.6	0.8	0.7	0.4	0.2	-0.1	-1.0	-1.0	-1.0	

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.

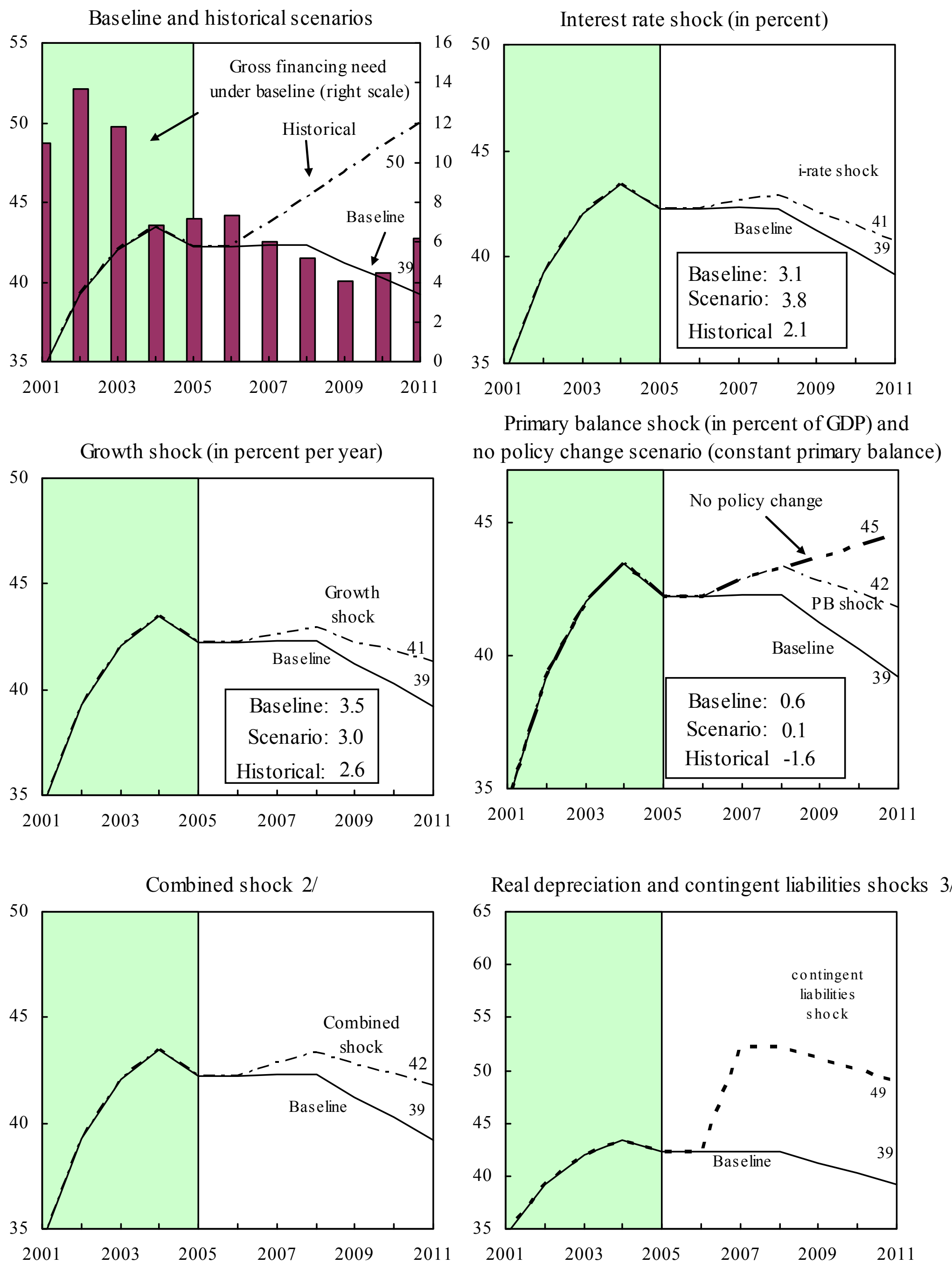
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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



Sources: 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 primary balance.

3/ 10 percent of GDP shock to contingent liabilities occur in 2006.

Table 2. Country: External Debt Sustainability Framework, 2001–2011
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing non-interest current account 6/**
1	**Baseline: External debt**	44.1	50.9	57.2	56.1	55.4	**55.6**	**56.3**	**56.9**	**56.4**	**55.9**	**55.4**	**-0.8**
2	Change in external debt	2.3	6.8	6.3	-1.1	-0.6	0.2	0.7	0.6	-0.5	-0.4	-0.6	
3	Identified external debt-creating flows (4+8+9)	-2.1	-0.1	3.1	-0.2	-1.5	1.0	0.8	1.1	0.5	0.4	0.5	
4	Current account deficit, excluding interest payments	-1.3	0.3	1.5	0.4	1.0	0.7	0.4	0.1	-0.4	-0.5	-0.3	
5	Deficit in balance of goods and services	15.8	14.7	15.9	17.3	18.1	15.0	16.5	16.3	15.4	14.9	15.2	
6	Exports	26.0	26.6	27.3	27.9	26.9	27.0	27.0	27.3	27.6	28.0	27.9	
7	Imports	41.9	41.3	43.2	45.2	45.1	42.0	43.5	43.6	43.1	42.9	43.1	
8	Net non-debt creating capital inflows (negative)	-1.1	-1.4	0.9	-1.4	-2.3	-1.7	-2.0	-1.5	-1.5	-1.6	-1.6	
9	Automatic debt dynamics 1/	0.3	1.0	0.7	0.8	-0.2	2.1	2.4	2.4	2.5	2.4	2.4	
10	Contribution from nominal interest rate	2.4	2.5	3.2	3.6	3.6	3.9	4.2	4.3	4.3	4.3	4.3	
11	Contribution from real GDP growth	-0.7	-1.0	-1.1	-1.0	-1.4	-1.8	-1.8	-1.8	-1.9	-1.9	-1.8	
12	Contribution from price and exchange rate changes 2/	-1.4	-0.5	-1.4	-1.8	-2.4	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	4.4	6.9	3.2	-0.9	0.9	-0.8	-0.1	-0.5	-1.0	-0.8	-1.1	
	External debt-to-exports ratio (in percent)	169.6	191.6	209.8	201.1	205.7	206.3	208.2	208.3	204.0	199.7	198.5	
	Gross external financing need (in billions of US dollars) 4/	2.0	2.8	2.5	3.2	3.2	3.2	3.3	3.4	3.5	3.7	4.1	
	in percent of GDP	14.4	19.3	16.7	20.5	18.7	17.6	17.0	16.3	15.9	15.9	16.4	
	Scenario with key variables at their historical averages 5/						**55.6**	**55.7**	**55.5**	**54.6**	**54.0**	**53.2**	**-1.7**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	1.7	2.3	2.3	1.8	2.8	3.5	3.5	3.5	3.5	3.5	3.5	
	GDP deflator in US dollars (change in percent)	3.4	1.2	2.8	3.3	4.4	3.7	3.0	3.0	3.0	3.0	3.0	
	Nominal external interest rate (in percent)	5.9	6.0	6.6	6.6	7.0	7.5	8.1	8.1	8.1	8.1	8.1	
	Growth of exports (US dollar terms, in percent)	-1.8	5.7	7.9	7.6	3.6	7.4	6.9	7.6	7.9	8.0	6.2	
	Growth of imports (US dollar terms, in percent)	2.5	2.2	10.0	10.1	7.0	0.0	10.5	6.7	5.3	6.1	7.2	
	Current account balance, excluding interest payments	1.3	-0.3	-1.5	-0.4	-1.0	-0.7	-0.4	-0.1	0.4	0.5	0.3	
	Net non-debt creating capital inflows	1.1	1.4	-0.9	1.4	2.3	1.7	2.0	1.5	1.5	1.6	1.6	

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, ε = nominal appreciation (increase in dollar value of domestic currency), and α = 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).

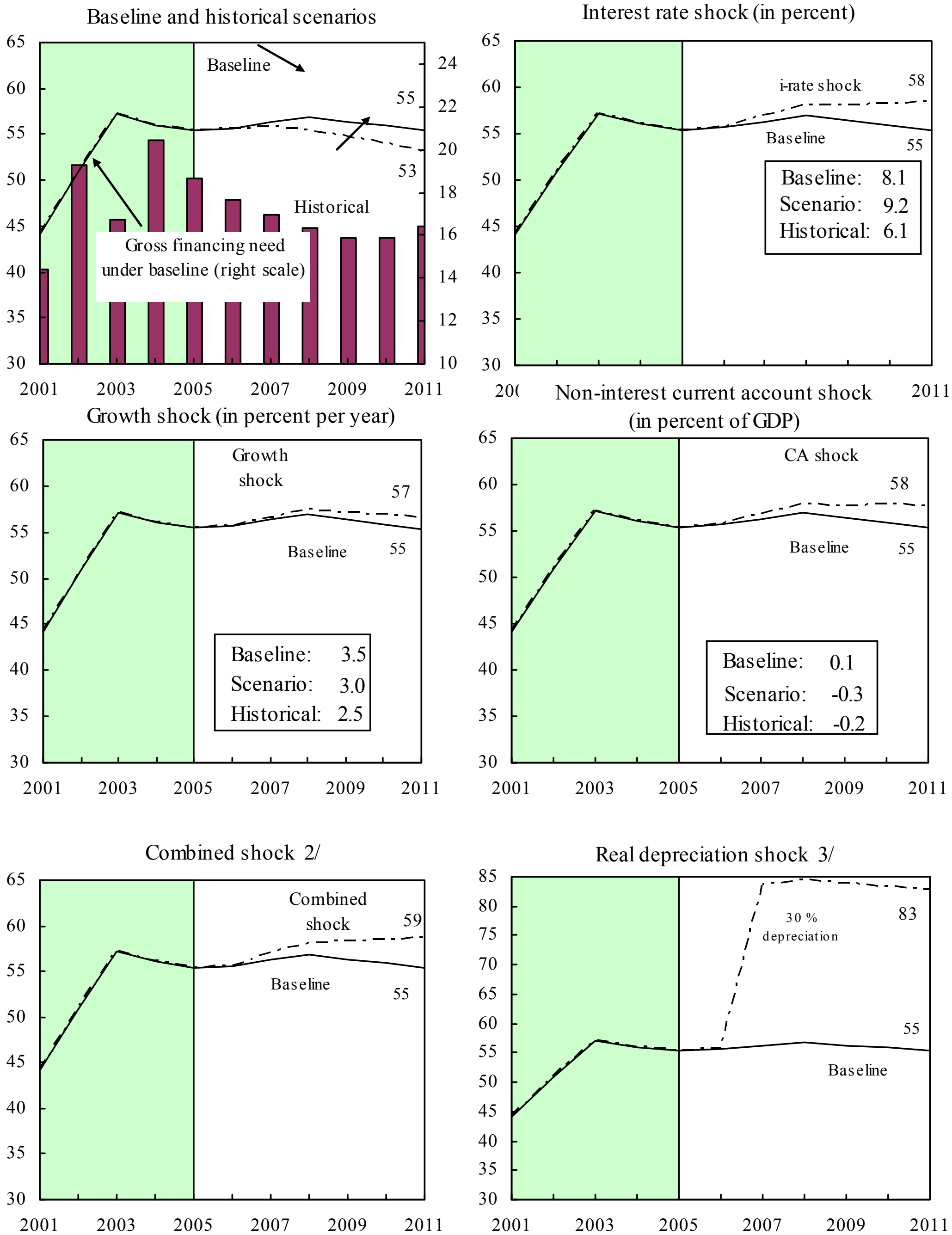
3/ For projection, line includes the impact of price and exchange rate changes.

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.

Figure 2. El Salvador. External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and 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.

3/ One-time real depreciation of 30 percent occurs in 2006.

EL SALVADOR: FUND RELATIONS
(As of May 31, 2006)

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

II. **General Resources Account:**

	SDR Million	Percent of Quota
Quota	171.30	100.00
Fund holdings of currency	171.30	100.00
Reserve position in Fund	0.00	0.00

III. **SDR Department:**

	SDR Million	Percent of Allocation
Net cumulative allocation	24.99	100.00
Holdings	24.98	99.98

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

V. **Financial Arrangements:**

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

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

VII. **Safeguards Assessments:**

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

VIII. **Exchange Arrangement**:

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

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

IX. **Article IV Consultation:**

The last Article IV consultation was concluded on January 31, 2005 (see Country Report No. 05/271 and www.imf.org). El Salvador is under the standard 12-month cycle.

X. **FSAP Participation and ROSCs:**

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

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

Department	**Dates**	**Purpose**
FAD	October 2000	Tax and customs administration
	June 2001	Install a regional expert
	July 2002	Tax administration inspection visit
	April 2004	Tax reform
	March 2006	Strategy for strengthening public finances
INS	February 2002	Course on trade and exchange rate policies
STA	May 2001	Money and banking statistics
	August 2001	Regional visit on data template
	February and November 2004	National Accounts
	November 2005	National Accounts

XII. **Resident Representative:** None

WORLD BANK GROUP RELATIONS WITH EL SALVADOR

RECENT AND PLANNED IBRD ACTIVITIES

A Country Assistance Strategy (CAS) covering the period (FY 05–08) was approved by the Board in January 2005. The CAS proposed a strategic program of lending and nonlending services to support the three main pillars of the government's development plan, "Safe Country 2004–2009: (i) accelerate broad-based, equitable economic growth and increase employment; (ii) improve equity through building human capital and expanding access to socioeconomic infrastructure, assets and markets; and (iii) enhance security and reduce vulnerability.

The Bank Group's assistance over the period FY 05–FY 08 include: support for implementation of the existing loan portfolio; new IBRD lending, including a program of Development Policy Loans (DPLs) of up to US$400 million (high lending scenario) and investment operations in selective areas for US$185 million; analytical and advisory work; technical assistance and capacity development programs; and targeted private sector assistance provided by IFC and MIGA. The DPLs would provide quick-disbursing budget support in line with policy performance and would allow the Government to reduce its external financing costs by partially replacing higher cost bonds issued in the international capital markets.

The DPLs are intended to contribute to the Government's objectives of reigniting growth, reinforcing macroeconomic stability and fiscal sustainability, and increasing the efficiency and transparency of public sector management. Following the medium term framework laid out in DPL1 (US$100 million disbursed in September 2005), the design of key prior actions, triggers and indicators for the subsequent loans will support actions in each of the areas. While the second DPL focuses mostly on addressing fiscal issues and strengthening the international trade and business environment, the third DPL will focus on actions to strengthen the financial system, improve the investment climate, address infrastructure investment and services, promote innovation and technology and further progress in the modernization of public financial management.

The Bank's current lending portfolio in El Salvador includes the first DPL (US$100 million) and six investment projects (US$424 million), totaling US$524 million, of which US$114.1 million has been disbursed as of March 30, 2006. The Second Broad-Based Growth DPL (US$100 million) was approved by the Board in December 2005 and is waiting for the approval of Salvadorean Assembly prior to signing and disbursement. The Education Project on Excellence and Innovation in Secondary Education (US$83 million); the Land Administration and Protected Areas loan (US$40.2 million); the Social Protection and Local Development loan (US$21 million); and the Environmental Services (US5 million) have been approved by the Board in 2005 and are scheduled to be signed by September 2006.

During FY 05 the Bank completed four core diagnostic studies for El Salvador: (i) A poverty assessment (PA) focusing on recent poverty and inequality trends; (ii) a public expenditure review (PER) focusing on fiscal trends and sustainability, the public expenditure management system, and social sector expenditures; (iii) a country financial accountability assessment (CFAA) that addresses the public expenditure management framework and offers recommendations for a more efficient use of the public funds; and (iv) a country procurement assessment (CPAR). This analytic work has underpinned the design of the Development Policy Loan program.

Finally, in support of accelerating broad-based equitable economic growth, the Bank is giving technical assistance to develop and implement a debt management strategy. In July 2005 the Bank completed the Investment Climate Assessment (ICA), and in January 2006 finalized a Recent Economic Developments in Infrastructure Report (REDI), which focuses on assessing El Salvador's electricity, telecommunications, transport, and water and sanitation sectors.

El Salvador: Relations with the World Bank Group

I. Financial Relations
(in millions of U.S. dollars as of March 30, 2006)

Active IBRD Operations by Sector	Committed [1]	Disbursed	Undisbursed
Education	173.0	83.0	90.0
Environment	5.0	0.0	5.0
Judicial Reform	18.2	2.3	15.9
Land Administration	40.2	0.0	40.2
Public Sector Management	24.0	19.4	4.6
Health and Social Services	163.6	9.4	154.2
Development Policy Lending	100.0	0.0	100.0
TOTAL	**524.0**	**114.1**	**409.9**

IBRD Loan Disbursements (US$ millions, as of March 30, 2006)	2000	2001	2002	2003	2004	2005	2006
Gross disbursements	34.4	49.5	63.2	38.1	16.3	128.7	4.3
Principal Repayments (-)	18.2	25.1	28.0	37.9	41.5	41.2	5.4
Total Net Disbursements	**16.2**	**24.4**	**35.2**	**0.2**	**-25.1**	**87.5**	**-1.2**
Interests and Fees (-)	0.0	23.6	18.7	17.3	12.3	14.2	3.3
Total Net Cash Flows	**16.2**	**0.8**	**16.5**	**-17.1**	**-37.4**	**73.2**	**-4.4**
Debt Outstanding (end of period) [2]	**325.4**	**349.3**	**385.1**	**385.7**	**360.5**	**448.0**	**446.8**

1/ Net of cancellations.
2/ Includes exchange rate adjustments at end of period.

EL SALVADOR: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

V. FINANCIAL RELATIONS

(In millions of US dollars)

A. Operations (as of March 23, 2006)

Loans	**Total**	**Disbursed**	**Undisbursed**
Agriculture	24.8	5.1	19.7
Education	157.9	57.5	100.4
Energy	40.0	0.9	39.1
Environment	67.2	33.0	34.2
Social Investment, local development, emergency	126.8	57.4	69.4
Reform and public sector modernization	120.8	42.8	78.0
Health and Sanitation	63.9	18.7	45.2
Transport	113.1	49.2	63.9
Housing	69.3	10.8	58.5
Total	**783.9**	**275.3**	**508.5**

B. Loan Disbursements

	2002	**2003**	**2004**	**2005**	**2006 (*)**
Gross disbursements	143.6	97.4	52.0	91.6	100.19
Amortization	54.3	73.6	96.2	97.3	88.9
Net disbursements	89.3	23.8	-44.2	-5.7	11.29

(*) Projections

VI. PLANNED ACTIVITIES (2006)

Project Name	**Projected loan**
Strengthening of University of San Salvador (UES)	25.0
Social Sector Reform Program	100.0
Total	**125.0**

VII. FUTURE PLANS

The IDB's country strategy paper for El Salvador was approved in October 2005, and a program review mission took place in June 2006.

El Salvador: Statistical Issues

El Salvador is in observance with the Special Data Dissemination Standards. While macroeconomic statistics are adequate for surveillance, a number of weaknesses remain. The Central Bank (CB) makes data available to the public through regular official publications and its website (http://www.bcr.gob.sv/).

VIII. Money and Banking Statistics

Several financial institutions have yet to distinguish transactions using the residency criterion. With Salvadoran banks actively lending in the region, the lack of reliable information on transactions by residency status and on foreign branch activity is complicating interpretation of the monetary and credit aggregates. Following the adoption of the U.S. dollars as legal tender, the use of the principle of residence acquired more relevance, since all accounts are denominated in U.S. dollars. In addition, there is a need to improve estimates of M1 by incorporating a reliable measure of dollars circulating in the economy, and of broad money by including all financial intermediaries in the financial system.

IX. Public Sector Statistics

The principal outstanding issue is the compilation of reliable data on the operations of the local governments. The ministry of finance conducts a quarterly survey of 50 local governments, including the largest municipalities. However the reporting of the survey is not consistent, as some local governments provide information with a lag or do not report at all.

Real sector and prices statistics

The CB produces both current and constant price (base 1990) annual national accounts following the *1968 SNA*, with a lag of around nine months. Also, it produces quarterly national accounts, using the production approach and disseminates these data three months after the end of the reference period. Recognizing the efforts to improve source data, the 2003 ROSC mission stressed the need for modernizing the statistical system. The Central Bureau of Statistics and Census conducted during August–November 2005 various surveys to improve data sources on industry, trade and services.

The consumer price index has a sound methodological basis and its coverage is confined to the San Salvador metropolitan area and the three largest departmental capitals representing 85 percent of the urban population. The weights were derived from the National Urban Household Income and Expenditure Survey of 1991/92 and require updating. The authorities also compile a producer price index (January 1998=100), which is confined to the San Salvador metropolitan area and the departments of La Libertad and Santa Ana and uses weights from the 1992 economic census.

External sector statistics

The compilation of external trade statistics follows the fifth edition of the *Balance of Payments Manual (BPM5),* but does not include estimates of informal/illegal transactions.

There has been a significant improvement in the coverage and timeliness of balance of payments data in recent years. In particular, the CB has made significant progress in obtaining information on services, foreign direct investment, private external debt, and goods for processing, as well as for the international investment position statistics. There is scope for improving the quality and consistency of the customs declaration, processed electronically. Also, a few weaknesses remain in the measurement of cross-border capital flows. El Salvador compiles the data template on international reserves and foreign currency liquidity.

External vulnerability indicators

The central bank compiles information about the external indebtedness of the nonbank private sector.

EL SALVADOR: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of June 20, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	Feb 06	Mar 06	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April 06	May 06	M	M	M		
Reserve/Base Money	Mar 06	May 06	W	W	W	O, LO, LO, LO	LO, O, O, O, LO
Broad Money	Mar 06	May 06	W	W	W		
Central Bank Balance Sheet	Mar 06	May 06	W	W	M		
Consolidated Balance Sheet of the Banking System	Mar 06	May 06					
Interest Rates[2]	May 06	Jun 06	W	W	W		
Consumer Price Index	May 06	Jun 06	M	M	M	O, O,LNO, O	LNO, LO, O, O, LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar 06	May 06	Q	Q	Q	LO, LO, LNO, LO	LO, O, LO, LO, NO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Mar 06	May 06	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar 06	May 06	Q	Q	Q		
External Current Account Balance	Mar 06	May 06	M	M	M	O, LO, LNO, LO	LO, LO, O, O, LO
Exports and Imports of Goods and Services	2005	May 06	A	A	A		
GDP/GNP	Dec 05	Feb 06	A,Q	A, Q	A	LO, LNO, LNO, LO	LNO, LNO, LO, O, LO
Gross External Debt	Mar 06	May 06	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC or the Substantive Update (published on December 2004 and based on the findings of the mission that took place during August 12–28, 2003) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

Public Information Notice (PIN) No. 06/84
FOR IMMEDIATE RELEASE
July, 31, 2006

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

IMF Executive Board Concludes 2006 Article IV Consultation with El Salvador

On July, 24, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with El Salvador.[1]

Background

Since taking office in 2004 the government has pursued an outward-oriented strategy to boost growth and improve social conditions. The policy agenda focuses on developing new sources of growth and reducing poverty through further integration with the global and regional economy, investment and social reforms, and stabilization of the public debt level. Early achievements of this strategy include an increase in tax revenue, improved debt management, and the CAFTA-DR.

Since the last Article IV consultation, the economy has strengthened. Growth has picked up and is running at 3½ percent thus far in 2006 (2 percent per year in 2000–05), spurred by investment and exports. Despite the full pass-through of higher oil prices, year-on-year inflation fell to 3½ percent in May 2006, the lowest level in the region. The external current account deficit widened slightly to 4½ percent of GDP in 2005. Sovereign spreads have remained among the lowest in the Latin America region.

Fiscal policy has aimed at stabilizing the public debt/GDP ratio and strengthening debt management. The 2006 budget limits the deficit to 3 percent of GDP, which implies a primary deficit of some 0.7 percent and will maintain public debt at around 42 percent of GDP, with the nonfinancial public sector debt at 40 percent. Tax revenue has been strengthened by tax measures approved in late 2004/early 2005, as well as recent

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

efforts to broaden the taxpayer base. As budgeted, this revenue gain is largely offset by higher energy subsidies, wages, interest, and pension outlays. The increase in capital spending achieved in 2005 has been maintained in the 2006 budget.

The banking system has been strengthened and appears well positioned to withstand temporary liquidity shocks. Banks' capital adequacy has improved and their net foreign asset position has remained at a comfortable level, covering 30 percent of deposits (above the statutory level of 26 percent). Meanwhile, stricter prudential norms and improved bank resolution practices have been issued, although some aspects of the dollarization regime are yet to be adopted.

To secure the implementation of CAFTA-DR in March 2006, congress approved legislation to enhance competition (mainly in government procurement and telecoms), upgrade customs procedures, and protect intellectual property rights. Congress also passed anti-trust legislation and stiffened penalties for corruption by public officers.

Looking ahead, the authorities plan to strengthen the fiscal stance in 2006 by limiting income tax exemptions and subsidies; as well as secure passage of banking reforms to underpin financial stability and deepen intermediation. Over the medium term, the strategy is to keep the public debt/GDP ratio stable through 2008 and reduce it gradually thereafter. This would be achieved by increasing the revenue effort through further reductions in tax evasion and controlling pension costs, while creating space for priority infrastructure and social spending.

Executive Board Assessment

Executive Directors commended the continued progress made by the Salvadorian authorities in implementing their outward-oriented growth strategy, which has already helped bring about strong growth based on a solid export performance, rising investment, and robust workers' remittances. Looking ahead, Directors observed that the main policy challenge for El Salvador is to place the economy on a path of sustained rapid growth and social progress, that will help the country achieve the Millennium Development Goals. This will involve continued progress on the fiscal sector, financial system, and structural reform agendas. Directors urged the authorities to take advantage of current global conditions and the benefits of the liberalized trade regime under the recently implemented CAFTA-DR, and noted that a national dialogue will be important to obtain broad-based consensus on the reforms.

Directors supported the authorities' medium-term fiscal strategy based on an increase in tax revenue, an improved targeting of tax exemptions and subsidies, and planned increases in investment and social spending. In the near term, however, these policies imply only a modest improvement in the primary balance and, as a result, the public debt ratio would remain roughly unchanged in the next few years. In light of this, Directors encouraged the authorities to build consensus in favor of a more front-loaded fiscal effort, while protecting priority spending. In this context, they recommended additional measures, which could include tightening pension parameters, reducing subsidies, including on nontraditional exports, and improving control over local government spending. To complement the authorities’ efforts to reduce tax evasion, many Directors also encouraged consideration of additional tax measures, such as raising the VAT rate. Directors welcomed the authorities’ support for a regional code of conduct to limit tax competition in attracting investment.

Directors commended the authorities for already securing the government’s financing needs for 2006. They also supported the authorities’ debt management objective of lengthening maturities and seeking external support on concessional terms.

Directors noted the strong foreign asset position of commercial banks, which limits the economy’s vulnerability to potential shifts in global market sentiment. They supported the planned financial system reforms, which will underpin financial stability and strengthen the system’s resilience to shocks. Directors endorsed the authorities’ focus on implementing the recently issued stricter prudential norms, enhancing consolidated supervision, fostering intermediation with the passage of a securitization framework, and reinforcing the financial safety net. They also supported the authorities’ regional strategy to enhance financial sector stability. Directors recommended implementing pending elements of the dollarization law of 2001 by restructuring the balance sheet of the central bank and strengthening its lender-of-last-resort function to provide an additional cushion against system-wide shocks and minimize contagion risks.

Directors supported the authorities’ medium-term agenda to strengthen the economy’s competitiveness through improvements in productivity and cost reductions in the dollarized economy. They endorsed the authorities’ plans to upgrade basic infrastructure and human capital, eliminate red tape, tackle crime, and create new trade opportunities. To limit fiscal pressures and further improve the investment climate, Directors encouraged the authorities to enhance the framework for private sector participation in infrastructure projects, and to improve procedures for corporate insolvency, business dispute resolution, and creditor’s rights.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the Article IV consultation with El Salvador may be made available at a later stage if the authorities consent.

El Salvador: Selected Economic and Financial Indicators

	2002	2003	2004	Prel. 2005	Proj. 2006
Real economy (change in percent)					
Real GDP	2.2	2.3	1.8	2.8	3.5
Consumer prices (end of period)	2.8	2.5	5.4	4.3	4.0
National savings (percent of GDP)	13.4	12.3	12.0	10.8	11.9
Gross domestic investment (percent of GDP)	16.2	17.0	16.0	15.4	16.5
Public finances (percent of GDP)					
Consolidated public sector deficit	-4.5	-3.7	-2.9	-3.0	-2.8
Consolidated primary deficit	-2.8	-1.6	-0.8	-0.7	-0.4
Public sector debt (percent of GDP, end of period)	39.3	42.1	43.5	42.3	42.6
Of which					
Nonfinancial public sector	38.6	40.3	40.5	39.9	40.3
Money and credit (end-year, percent change)					
Net domestic assets	-2.8	-0.5	1.5	3.1	9.1
Of which					
Nonfinancial public sector	-4.5	3.5	0.3	1.0	-0.1
Private sector	6.2	1.0	9.0	8.4	9.7
Liabilities to private sector	-2.6	1.7	2.7	4.9	10.5
Interest rates (average)					
Deposit rate (six months)	3.4	3.4	3.3	3.4	4.1
Lending rate (more than one year)	8.7	8.0	7.7	8.2	8.8
External sector					
Trade balance (percent of GDP)	-13.0	-15.2	-16.8	-17.7	-18.9
Current account balance (percent of GDP)	-2.8	-4.7	-4.0	-4.6	-4.5
Change in net international reserves					
(millions of U.S. dollars, increase -)	123.5	-316.2	52.5	58.9	-102.0
Terms of trade	-0.6	-0.3	-0.7	0.5	-1.3
Real effective exchange rate (end of period) 1/	-2.3	-5.1	0.8	2.3	-0.8
Net foreign assets of the banking system					
Millions of U.S. dollars	1,839	1,982	2,059	2,178	2,276
Percent of deposits	29.2	30.9	31.2	31.4	29.7

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

1/ As of May 2004.

Statement by Moises Schwartz, Executive Director for El Salvador and Nina Conrado, Senior Advisor to Executive Director
July 24, 2006

On behalf of the authorities of El Salvador, we would like to thank staff for their valuable policy advice and for the constructive discussions in the framework of the Article IV consultation. The authorities broadly agree with the thrust of the staff appraisal.

The economic and social performance of El Salvador during the last decade has been outstanding, supported by a prudent policy management and a solid forward looking strategy. The process of consolidating macroeconomic stability has advanced, and major structural reforms in a broad array of sectors, including pension reform, the adoption of official dollarization and trade liberalization have taken place, making the country a leading reformer in the region and in Latin America.

Despite the important progress in macroeconomic stability and in reducing poverty, challenges in the short and medium-term include the need to promote economic growth, to make the economy more resilient to shocks, and to mitigate risks associated with natural disasters. To advance towards these objectives, the government strategy has included the consolidation of the fiscal stance, efforts to improve the business climate and continue opening the economy towards globalization.

Macroeconomic performance during 2005 and the first half of 2006 has been strong. GDP growth has started to accelerate, reaching 3.2 percent during the first quarter of 2006, consistent with the annual projection of 3.5 percent. The export sector is being more dynamic, and is expected to continue with this trend, especially as the economic agents seize the opportunities of the CAFTA-DR, which began its implementation in March, being El Salvador the first country in the region to do so. Growth has also reflected an increase in investment, which in a context of acceleration of credit growth, favorable commodity prices and strong remittances, may reflect positive signs in the economy's medium-term resilience towards shocks and better growth perspectives. Additionally, even in the context of high and volatile international oil prices, the annual inflation rate as of June 2006 was 4.4 percent, one of the lowest in the region, mainly supported by the dollarization framework.

Fiscal policy has included an integral approach, strengthening revenues, improving the quality of public expenditures and making efforts to improve debt management. In terms of tax policy, in 2005 the government undertook probably the most comprehensive reform of the last decade. Important progress was made in terms of strengthening tax administration and raising selected excise taxes; however, the authorities are aware that more needs to be done, and are planning to continue improving tax administration and broadening the taxpayer base, through limiting tax exemptions and fighting tax evasion. In the area of improving the quality of public expenditures, efforts are being made in maintaining a stable wage bill, prioritizing public investment projects, expanding the solidarity network and rationalizing subsidies to better target the poor. In this last area, for example, a subsidy given to the transport sector was eliminated in June.

The stabilization of public debt is a high priority in the government's agenda and has become an issue of discussion at the national level. The authorities are aware of the importance of further reducing the deficit to improve debt dynamics, especially considering the medium-term challenge of financing the pension reform. They are making efforts to reconcile this objective with the need to increase public expenditure to continue reducing poverty, to reach the MDG's and improve infrastructure to support long term growth. The authorities agree with the staff's recommendation for a stronger up front fiscal consolidation and the need to increase national saving, nevertheless, they think that a similar debt reduction path could be obtained through the promotion of economic growth and a 2 percent of GDP increase in revenues through the reduction in tax evasion.

El Salvador's debt management strategy has included the lengthening of debt maturity, the diversification of the investor's base, and contracting debt at fixed interest rates during the period of lowest rates in the USA. As part of these efforts, the country has continued to successfully issue long term bonds, benefiting from its access to international capital markets and investment grade rating. As of July 2006 the government has completed the year's financing needs, with the placement of Eurobonds. In April the government raised US$400 millions through a bond due in 2035, with the lowest yield since the bonds were first issued, and in July it raised an additional US$ 225 millions at a slightly higher spread, in a context of market volatility and expectations of further increases in international interest rates.

With regard to the financial sector, important efforts have been made in consolidating the prudential and supervisory framework. Further steps are planned. The government is drafting proposal bills aimed at enhancing the autonomy of superitendency of banks, strengthening consolidated supervision, merging supervisory agencies and fostering financial deepening. It is important to mention that some of these efforts are being discussed with neighboring countries, as part of a regional strategy intended at strengthening cross border supervision and harmonizing regulatory practices. Additionally, the authorities are planning to press forward with measures to protect banks against liquidity shocks and to advance in the complete implementation of the Monetary Integration Law, including the needed restructuring of the central bank's balance sheet and improving the function of the lender of last resort. For this last point, the authorities have solicited technical assistance to the IMF.

The authorities agree with staff on the importance of improving competitiveness, and to obtain this goal, an integral strategy is being carried out. In terms of commercial strategy, the main policy is to improve access to the world's most important markets, for which the government plans to continue with its integration efforts, and is now in negotiation of other free trade agreements. Additionally, the government is conscious of the importance of investment in physical and in human capital. In terms of public investment, as part of the prioritization efforts, the government has prepared an important project geared to the development of the northern region of the country, and is actively seeking financing from the Millennium Challenge Corporation. In relation to human capital, for example, this year the government launched for the period 2006-009 a program called “Triennium of Alphabetization”, aimed at doubling the goal of reducing analphabetism. The authorities are also making progress in improving other aspects of the business climate, for example, the government launched the program “El Salvador Eficiente”, as an alliance between the government and the private sector to streamline procedures, it also launched a new web page containing a Guide of Public Services, and is making important efforts to increase security.

The authorities welcomed the analyzes included as Selected Issues, which covered important benchmarks in terms of structural reforms in El Salvador, and are thankful to the IMF´s Staff for their hard work and accurate advice.