March 2008
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**El Salvador: 2007 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 2007 Article IV consultation with El Salvador, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 5, 2007, 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 November 5, 2007. 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 November 19, 2007 discussion of the staff report that concluded the Article IV consultation.

- 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

EL SALVADOR

**Staff Report for the 2007 Article IV Consultation**

Prepared by the Staff Representatives for the 2007 Consultation with El Salvador

Approved by David J. Robinson and Adnan Mazarei

November 5, 2007

**Discussions.** A staff team held discussions in San Salvador during September 24–October 5, 2007. The mission comprised Messrs. Desruelle (head), Samuel, and Roache (all WHD). The team met with Technical Secretary of the Presidency Eduardo Ayala, 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. Mr. Schipke, the regional resident representative, assisted the mission, and Mr. Guerra, Senior Advisor (OED), attended the concluding meeting.

**Focus of the Consultation.** In view of El Salvador's economic and policy performance, this Article IV consultation is streamlined. The discussions focused on the growth outlook, fiscal policy, and the financial system.

**Past Fund Advice.** The thrust of the authorities' economic policies has been consistent with Fund advice. In the last consultation completed on July 24, 2006, Executive Directors stressed the need to pursue a reform agenda to improve growth and social prospects, reduce vulnerabilities, and maximize the benefits from dollarization. In particular, they encouraged up front fiscal consolidation to help improve the debt dynamics. Over the last year, the authorities have *inter alia* reduced further the fiscal deficit, strengthened banking norms, and continued their program to improve competitiveness.

**Exchange Arrangement**. 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. The U.S. dollar has been legal tender since January 1, 2001.

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## EXECUTIVE SUMMARY

**Background**: Economic growth has remained around 4 percent, its fastest pace in a decade. Growth is expected to slow down slightly in 2008 in light of U.S. developments, before rebounding in 2009 and later years. In recent years, the real effective exchange rate has remained broadly stable; it does not appear to be out of line with fundamentals.

**Key policy issues**: The central challenge is to sustain the recent improved growth performance over the medium term, improve the resilience of the dollarized economy to external shocks, and bring down poverty. While macroeconomic and structural policies have generally been well-oriented, it will be essential to maintain the reform momentum, including in the forthcoming pre-electoral period.

- **Fiscal policy is appropriately focused on reducing public debt and reorienting spending toward priority areas.** To secure the authorities' 2008 and 2009 fiscal objectives, additional measures will likely be required, including further improvements in tax administration and reform of subsidies.

- **The internationalization of the banking system offers an ideal opportunity to accelerate financial sector reforms**. Financial sector vulnerabilities have diminished with the internationalization of the banking system and implementation of stronger prudential norms. Early approval of pending legislation and implementation of additional steps to raise regulatory and supervisory standards are necessary.

- To strengthen competitiveness in the dollarized economy and help sustain high growth, the authorities rightly emphasize **improvements in the business climate and productivity enhancing reforms** (e.g., improvements in public infrastructure and labor skills).

## I. Recent Developments

1. **The Salvadoran economy has continued to grow at its fastest pace in a decade.** After several years of sluggish activity in the early 2000s, growth started improving in 2005, and has remained between 4 and 4¼ percent (annual rate) since the first quarter of 2006, despite slower growth in the United States since mid-2006 (Figure 1 and Table 1). The recovery in growth has been driven mainly by remittance-financed consumption and investment, while, on the supply side, nontraditional agriculture, tourism, and other services have been the most dynamic sectors. Inflation peaked at 5½ percent in January 2007, due to a spike in food prices, and has moderated recently.

2. **The current account deficit was stable in 2006, at about 5 percent of GDP. It widened somewhat in the first half of 2007, reflecting robust domestic demand.** During the latter period, imports of consumer, intermediate, and capital goods grew at annual rates slightly exceeding 10 percent. Export growth lagged behind that of imports, as buoyant nontraditional exports, rising at a 16 percent at annual rate, were offset by stagnant exports of the maquila sector.[1] Remittances remain the most important source of external financing; they have kept growing so far this year, albeit more slowly than in previous years (Figure 2 and Table 2). The other main sources of external financing in 2007 will be foreign direct investment, partly related to domestic bank acquisitions, and grants to the public sector.

3. **The real effective exchange rate has remained broadly stable in the last year, as it had during the previous decade.** Modest real appreciation against the U.S. dollar was compensated by the weakness of the dollar against third-country currencies. Based upon the current real effective exchange rate level and the baseline scenario (reflecting current policies for 2007–08 and a further improvement in the primary fiscal balance of ½ percent of GDP in 2009), medium-term projections show a sustainable current account position: the current account deficit would fall to 3½–4 percent of GDP toward the end of the five-year projection period, and external debt would decline steadily from 50 percent of GDP to below 40 percent of GDP by 2012 (Tables 2 and 6).[2] Staff analysis also suggests that the actual level of the real effective exchange rate is well within its estimated equilibrium range (Figure 3).[3] Staff's model indicates that the equilibrium exchange rate level appreciated substantially in the 1990s following the end of the civil war (a period marked by recovery of domestic activity and a swift rise in remittances), and has moved little since. Furthermore,

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[1] The maquila sector has been seriously affected by increased competition from Asian producers following the termination of the Multi-Fibre Agreement.

[2] The literature suggests that the impact of external debt on growth becomes nonsignificant when debt falls below a threshold between 35 and 40 percent.

[3] According to the staff model, the current exchange rate level is 10 percent below (under-valuation) the point estimate of the equilibrium exchange rate. Given the large standard error of this country-specific model, this estimate of the exchange rate is not significantly different from the equilibrium.

robust nontraditional export growth, particularly to Central American partners, suggests that the export sector remains competitive. There are also signs that the restructuring of the maquila sector is yielding tangible results, with the establishment of new product lines and a marked deceleration in total output decline. Balancing these various elements, staff considers that the exchange rate is not out of line with fundamentals.

4. **Public finances have been improving in line with budget projections.** Revenue rose by about ¾ percent of GDP in 2006, reflecting in part tax administrative measures and cyclically higher economic activity (each accounting for about ¼ percent of GDP). Higher capital outlays related to tropical storm Stan and rising subsidies on petroleum products (¼ percent of GDP) kept the fiscal deficit close to the budgeted figure of 3 percent of GDP (Table 3 and Figure 4). Continued strong tax revenue performance during the first half of 2007, coupled with under execution of some programs, resulted in a lower-than-forecast deficit. Seasonal acceleration in the implementation of the public sector investment program should bring the deficit close to the budgeted 2.3 percent of GDP for the year as a whole. The 2007 fiscal deficit will be financed primarily by domestic resources raised by the recently established trust funds and autonomous bodies.[4]

5. **Private sector credit has expanded, reflecting higher consumption and investment demand and greater availability of loanable funds**. Faster deposit growth, partly augmented by the proceeds from the sale of the three largest domestic banks, has funded increases in credit (9 percent in 2006 and 2007) (Table 4 and Figure 5). Lending and deposit rates have shown limited movements, broadly tracking U.S. interest rates. While sovereign spreads have risen a bit since July, reflecting tighter liquidity in international credit markets, they remain below the Latin America regional average. The three largest banks have been recently acquired by foreign financial groups, raising the participation of foreign banks in the financial system to 95 percent.

6. **Poverty has markedly fallen in the past fifteen years, but remains high** (Figure 6). The proportion of the population below the nationally defined poverty line has declined by 30 percentage points since 1991, but still stands at 31 percent of households (35 percent of total population).

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[4] Key program loans from the World Bank and IDB to finance social and infrastructure spending were not approved by congress. To secure alternative financing, the government has recently established a trust for priority spending on security and education, and has sought additional financing for two autonomous bodies (road repairs, national registry). A trust fund to finance the transition cost of the 1998 pension reform began operating last year.

7. **Preparations for the 2009 legislative and presidential elections have started.** The main opposition party, the FMLN, recently announced its candidates for the presidential elections. The media expect the ruling party, ARENA, to follow suit in the first semester of 2008.

## II. Policy Discussions

8. **The 2007 consultation discussions focused on the growth outlook, fiscal policy, and financial sector developments**. In particular, the discussions centered on (i) spillovers from the United States to El Salvador and the associated risks; (ii) the short-term fiscal stance and its consistency with medium-term fiscal objectives; and (iii) the internationalization of the Salvadoran banking system.

### A. Growth Outlook and Risks

9. **The staff expects growth to remain around 4 percent this year and to slow down to 3¾ percent in 2008, as an improved underlying growth trend would be temporarily compensated by the impact of the U.S. slowdown.** The Salvadoran economy is expected to feel the effect of lower U.S. growth: as discussed in Box 1, staff's empirical analysis suggests that business cycle spillovers from the U.S. economy have been large and rapid in the past. At the same time, the resilience of Salvadoran growth in the last four quarters is encouraging. Further indicators of a better growth trend include output and export diversification, with robust expansion stemming from increased capacity in emerging activities like tuna canning, tourism, and services to enterprises. In addition, the drag of the maquila sector on growth is expected to come to an end in the next few years. Consumption and investment remain supported by remittances, abundant financial sector liquidity, and low interest rates. The authorities place greater weight on the positive internal factors, including higher investment, and maintain a growth estimate for 2007 of at least 4½ percent.

10. **The baseline medium-term scenario envisages growth to be sustained in the range of 4 to 4½ percent from 2009 on.** Sustained growth at this level, which is similar to the experience of the last 18 months, would represent a long-awaited payoff from the wide range of growth-oriented reforms adopted during the last decade. It would reflect higher investment and nontraditional exports, linked to the further integration of the Salvadoran economy into the global economy and continued output diversification. Assuming labor force growth close to the recent trend of 2 percent and a pick-up in the level of investment to 20 percent of GDP (Table 1), the baseline projection would require annual productivity growth of around 1 percent, close to the levels achieved in the 1990s.[5] The authorities assume higher levels of investment and are confident that growth could exceed 5 percent

[5] See Chapter II, *Economic Growth and Integration in Central America*, IMF Occasional Paper No. 257. Staff analysis has also pointed to the growth benefits of CAFTA-DR – see Chapter II, *Central America: Global Integration and Regional Cooperation*, IMF Occasional Paper No. 243.

over the medium term. Under this baseline scenario, assuming full implementation of the authorities' fiscal strategy, public debt would gradually fall to about 35 percent of GDP. In parallel, the current account deficit would decline to 3½ percent of GDP, with the share of FDI financing rising to 3 percent of GDP, helping to reduce the external debt-to-GDP ratio and lower the economy's presently high external financing requirement (text table below).

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

| | | Projections | | | | | |
|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
| Real GDP growth (percent) | 4.2 | 4.2 | 3.8 | 4.5 | 4.5 | 4.5 | 4.5 |
| Inflation (percent, end period) | 4.9 | 4.0 | 3.5 | 3.0 | 3.0 | 3.0 | 3.0 |
| Overall public sector balance | -2.9 | -2.2 | -1.9 | -1.5 | -1.3 | -1.2 | -1.2 |
| Public sector primary balance | -0.5 | 0.3 | 0.6 | 1.0 | 1.2 | 1.3 | 1.3 |
| Public sector debt | 41.9 | 40.8 | 39.8 | 38.6 | 37.1 | 35.7 | 34.3 |
| External current account balance | -4.7 | -5.9 | -5.6 | -4.9 | -4.2 | -3.8 | -3.5 |
| Total gross external financing needs | 15.4 | 16.8 | 16.4 | 15.1 | 14.5 | 15.4 | 12.7 |

11. **There are two key downside risks to this scenario, which underscore the importance of being conservative in the design of fiscal policy, enhance buffers to absorb economic and financial shocks, and pursue efforts to improve competitiveness.**

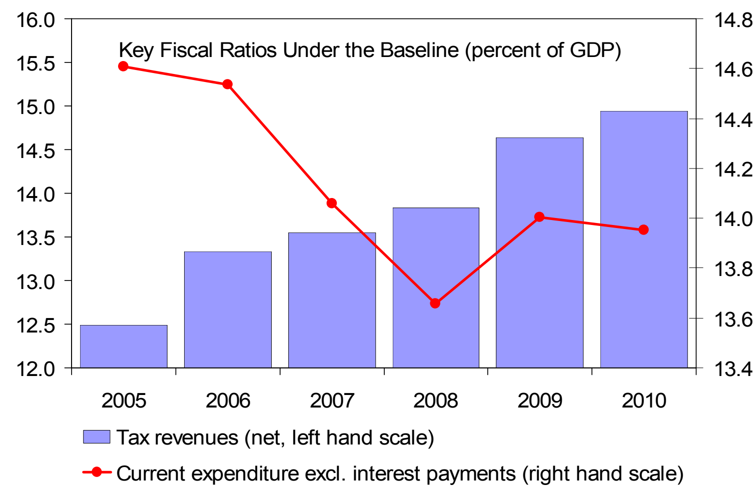
- **In the near term, a greater-than-expected U.S. economic slowdown would have a direct impact on exports and possibly remittances**. It would also reduce external demand from El Salvador's Central American trading partners given strong regional linkages to the U.S. economy. Reduced capital market access could make it more difficult to refinance the substantial stock of short term, private sector external debt, which could amplify the effects on investment from a U.S. downturn. Under such a scenario, assuming lower fiscal revenue in 2008 but no expenditure cut (see paragraph 16) and subsequently a gradual adjustment to a primary surplus of 1 percent of GDP, public debt would rise to 42 percent of GDP in 2008 and decline thereafter to 38 percent of GDP by 2012.

- **Over the medium term, the underlying favorable growth trend mentioned above might not take hold due to a shortfall in investment and exports or further exogenous shocks**. Should investment and productivity improvements remain at the levels seen during 2001–05, growth would fail to exceed 3 percent. Under this alternative, with growth being less externally driven, the current account deficit might turn out higher than projected and the composition of its financing less favorable. Gross external financing needs would also likely remain high if the private sector continues to maintain a substantial stock of short-term liabilities.

## B. Fiscal Policy

12. **The authorities reaffirmed their commitment to achieving a primary surplus of 1 percent of GDP in 2009, and plan to undertake about half of the needed adjustment in 2008. Staff supports this adjustment path**. A surplus of 1 percent of GDP, if reached in 2009 and subsequently maintained, would put public debt firmly on a downward path (as shown above in the baseline scenario). The draft 2008 budget envisages a primary surplus of 0.6 percent of GDP, an improvement of 0.3 percent of GDP over the projected 2007 outcome; it would thus leave progress of a similar magnitude to be accomplished in 2009.

13. **The staff welcomed the planned reallocation of spending toward priority areas in the draft 2008 budget, but raised questions about the composition of adjustment in 2008 and fulfillment of the authorities' 2009 tax revenue target.** In the draft 2008 budget, capital expenditure is projected to increase by 0.3 percent of GDP, with a focus on projects in public safety, health, and education as well as on the development of the poorest regions of the country.[6] Social outlays are projected to increase by 0.2 percent of GDP. However, the staff observed that the proposed adjustment for 2008 envisages a 0.4 percent of GDP reduction in noninterest current expenditure (mainly on goods and services), which might be difficult to sustain. It also noted that the draft budget only envisages raising revenue by 0.3 percent in 2008 to 13.8 percent of GDP, leaving a gap of 0.7 percent compared to the authorities' 2009 objective. Furthermore, staff suggested taking into account the possibility that part of the recent improvement in tax revenue was related to cyclical factors (see paragraph 4). The authorities indicated that tax revenue might well exceed expectations in 2008, as it had done in recent years. They also counted on passage of a bill currently in parliament to help fight abuse of tax incentives granted to firms operating in free trade zones.




14. **In light of these concerns, the staff suggested various possible additional fiscal measures to secure the needed adjustment and ensure continued progress on the revenue front.** Building on successful actions in recent years, further steps to enhance tax

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[6] The growth in capital expenditure (excluding reconstruction) includes outlays financed by grants from the Millennium Challenge Account, aimed at opening up the Northern Region, home to the majority of the poor.

administration and reduce tax evasion could include enhancing auditing capacity, tightening control over large taxpayers, and improving further cross-checking systems and customs valuation procedures. The staff also recommended tackling energy and water subsidies, which, as currently designed, are expensive and poorly targeted. Furthermore, the staff encouraged the authorities to avoid granting new tax incentives for investment, as a first step toward the eventual implementation of a regional code of conduct on such incentives.

15. **Beyond 2009, the main medium-term challenge will be to keep raising fiscal revenue to accommodate further capital and social spending, and hence help reduce poverty.** While sustaining a fiscal surplus of 1 percent of GDP over the medium term would reduce debt to sustainable levels (as envisaged by 2009), more will need to be done on the revenue side to allow higher spending in social areas to help achieve the Millennium Development Goals and in public infrastructure to enhance the country's competitiveness.[7]

16. **The authorities and the staff discussed fiscal responses should short-term downside risks materialize.** Under such a scenario, the staff suggested that the authorities might have room not to compensate a short-term fall in revenue by corresponding expenditure cuts, but should avoid undertaking additional discretionary spending. This response, which would be contingent on the authorities' ability to secure the needed financing, would lower the risk of undermining the emerging underlying higher growth trend. As noted in paragraph 11, the public debt path would be higher in this scenario, but would still remain within manageable limits. The authorities and staff agreed on the importance of preserving priority expenditure in such a scenario, which would require careful planning.

17. **The staff and the authorities saw merit in strengthening fiscal institutions to buttress efforts to consolidate public finances and reorient spending toward social and other priorities.** Priorities include the development of a medium-term expenditure framework linking sectoral objectives within a sustainable fiscal plan[8]; the establishment of a tax expenditure budget to enhance information on induced revenue losses and facilitate evaluation of alternative policy options; and dissemination of information on structural fiscal balances to avoid a deficit bias over the business cycle. Strengthening the legal framework for public-private partnerships (PPPs) and the administrative capacity to manage them is also of great importance, given the administration's intention to use PPPs for electricity generation and road construction.

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[7] El Salvador is on track to achieve most of the MDGs, while the goal of halving extreme poverty has already been achieved. However, the goal of halving malnutrition looks unlikely to be met.

[8] At a recent regional workshop on MTEFs held in Honduras, country representatives expressed great interest in the development of MTEFs. Subsequently, the Council of Finance Ministers of Central America, Panama, and the Dominican Republic agreed to set up a working group to take this process forward.

18. **The staff also pointed out that alternative financing vehicles (e.g., trust funds, borrowing by autonomous bodies) were not optimal sources of finance for budget expenditure**, **as they result in higher costs**. The authorities stressed that they had recourse to such vehicles in 2007 only because they found themselves unable to secure parliamentary approval for World Bank and IDB loans designed to finance priority spending. They also emphasized that all spending to be financed from these alternative sources next year was fully and transparently recorded in the draft 2008 budget.

19. **Further pension reform is needed.** Changes done to the financing of the pension system in the last year have yielded some reduction in the transition costs stemming from the 1998 switch to a private pension system. Nevertheless, the recommendations for pension reform proposed in recent FAD technical assistance reports (including reducing the replacement rates and increasing the retirement age) remain essential to reduce unfunded liabilities of the residual public pension system and to limit contingent fiscal liabilities in the private pension system. Low returns on private pension portfolios increase the probability that the minimum pension guarantees extended to participants in the private pension system will be activated.[9]

## C. The Financial Sector

20. **The banking system appears to be profitable, well-capitalized and highly liquid,** making it well-positioned to weather modestly tighter liquidity conditions in international capital markets. The return on assets was 1.3 percent at end-June 2007 slightly lower than December 2006, while the ratio of capital to risk-weighted assets reached 14 percent at end-June 2007 compared with a 12 percent regulatory minimum (Table 5). However, while nonperforming loans remain at a low level (2 percent of total loans), an increasing proportion of these loans are to the consumer sector, which has experienced rapid credit growth, driven in large part by expansion of the credit card business. The staff and the authorities agreed on the importance of maintaining vigilance over this trend.

21. **The authorities and the staff agreed that the recent internationalization of the banking system creates a propitious environment for pressing ahead with financial sector reforms** aligning the regulatory and supervisory frameworks with international best practice (Box 2).

[9] For a detailed analysis of pension systems in Central America, including El Salvador, see Chapter III in *Economic Growth and Integration in Central America,* Occasional Paper No. 257.

**Banking System Indicators**

(In percent unless otherwise stated)

| | 2003 | 2004 | 2005 | 2006 | June 2007 |
|---|---|---|---|---|---|
| Number of banks | 12 | 12 | 12 | 13 | 13 |
| *Of which:* public banks | 2 | 2 | 2 | 2 | 2 |
| Share of public banks in total assets | 4.2 | 4.0 | 3.8 | 4.5 | 4.5 |
| Capital to risk-weighted assets | 12.8 | 13.4 | 13.5 | 13.8 | 14.0 |
| NPLs to total loans 1/ | 2.8 | 2.4 | 2.0 | 2.0 | 2.1 |
| Provisions to NPLs | 130 | 132 | 127 | 116 | 121 |
| Return on equity | 11.5 | 10.9 | 11.8 | 14.6 | 12.5 |
| Return on assets | 1.1 | 1.0 | 1.2 | 1.5 | 1.3 |
| Liquid asset to deposits | 35.7 | 36.1 | 33.5 | 32.3 | 36.5 |

1/ Official definition based upon past-due loans.

- **Pending legislation to strengthen supervision and deepen the financial system requires urgent attention.** The authorities are pressing for approval by the end of the year of three laws that have been under consideration for some time. These laws, respectively, seek to merge the superintendencies of banks, pensions, and the stock market into a single unit; develop a framework for the securitization of financial assets; and provide a legal structure for collective investment schemes, including mutual funds.

- **Other gaps in the legal and regulatory framework need to be filled**. The mission also emphasized the need to move ahead with several recommendations of the 2004 FSAP update that remain relevant, including enhancing the autonomy of the supervisory authorities and providing legal protection for their staff; strengthening the balance sheet of the central bank; and bolstering deposit insurance.

- **Regional efforts to enhance cross-border supervision are underway.** The staff welcomed the recent signing of a regional memorandum of understanding to improve consolidated cross-border supervision in Central America, Panama, and the Dominican Republic. It supported further regional harmonization efforts.

- **Other steps to reassess the local supervisory framework are also in train.** The authorities and the mission agreed on the need to gain a fuller understanding of the business model (e.g., risk and liquidity management) of the international banks that are now major players in the country. The authorities indicated that they have engaged a consultant to review the supervisory framework in light of the entry of foreign banks, and make recommendations for improvement where necessary.

### D. Competitiveness

22. **The authorities and staff concurred that, in a dollarized economy, productivity-enhancing structural reforms are key to improving competitiveness and sustaining high growth over the medium term.** To complement trade integration, the authorities have been implementing a strategy to improve the business climate and reduce the cost of doing business, which has resulted in a steady improvement in relevant international rankings. This strategy includes:[10]

- **Improving transportation networks and power generation.** The authorities are undertaking public investment in ports, roads, and power generation to ease bottlenecks and better integrate the northern zone with the rest of El Salvador. These projects are partly financed by grants and soft loans.

- **Fighting crime**. To help reduce the sizable economic cost of crime, the authorities have appropriately focused on security-related initiatives, including programs targeting poor municipalities and youths at risk.

- **Enhancing the quality of the labor force**. With their long-term educational plan (*Plan 2021*), the authorities are seeking to expand basic education and improve specialized training in English and technical fields. This would foster investment in higher-technology activities.

- **Cutting red tape**. The authorities have progressively streamlined bureaucratic procedures, including reducing the time needed to open a business and establishing one-stop windows for customs procedures and tax payments. They are considering legislation to improve bankruptcy procedures.

## III. Staff Appraisal

23. **Growth appears to be on an improved trend, but the short-term outlook could be affected by external developments**. Staff projects that growth will decline slightly in 2008 and rebound to above 4 percent in 2009, while inflation will remain contained. A key risk is a larger-than-expected U.S. slowdown, which would have a rapid and substantial impact.

24. **The real effective exchange rate does not appear to be out of line with fundamentals.** Medium-term projections show a sustainable current account position; the exchange rate level is well within its estimated equilibrium range; and the evolution of

[10] Further information on these initiatives can be found in the staff report for the 2006 Article IV Consultation with El Salvador (IMF Country Report No. 06/410).

exports, including the diversification of products and markets, suggests that the export sector remains competitive.

25. **The central policy challenge is to maintain the reform momentum to sustain the recent revival of growth, make a strong dent in poverty, and enhance the resiliency of the dollarized economy to shocks.** Policies have generally been well oriented in recent years. It is crucial to make further progress in the next 18 months, prior to the national elections scheduled for early 2009.

26. **Fiscal policy appropriately focuses on putting public debt on a firm downward path, and raising revenue to address social and other needs.** The staff supports the authorities' 2009 targets of a primary balance of 1 percent of GDP and tax revenue of 14½ percent of GDP. It sees scope for further actions to secure these objectives, including additional steps to enhance tax administration, eliminate tax loopholes, and target subsidies. The staff also recommends developing a plan to protect social spending in the event that downside risks materialize.

27. **Various institutional reforms could help maintain strong public finances over the medium term**, including the development of a medium-term expenditure framework and of a tax expenditure budget. In this regard, the staff is concerned about the efficacy of financing significant budget outlays through trusts and autonomous bodies. Forging broad support for a further reform of the pension system will also be needed to minimize actual and contingent fiscal liabilities.

28. **The purchases of the three largest domestic banks by large foreign banks offer an ideal opportunity to spur financial sector reforms.** Rapid passage of the three laws on the merger of supervisory institutions, the securitization of financial assets, and collective investment schemes would be a good initial step. Other priorities include measures to raise regulatory and supervisory practices to international standards, foster consolidated cross-border supervision, strengthen the balance sheet of the central bank, and build close relations with the new bank owners. While the financial system appears to be highly liquid, well-capitalized, and profitable, it will be important to keep watching closely the evolution of global financial conditions and the recent rapid rise in consumer credit in the domestic market.

29. **The authorities' strategy to improve competitiveness has been yielding dividends, and deserves to be pursued**. The current focus on fighting crime, improving public infrastructure, enhancing labor skills, and simplifying business regulations seems appropriate.

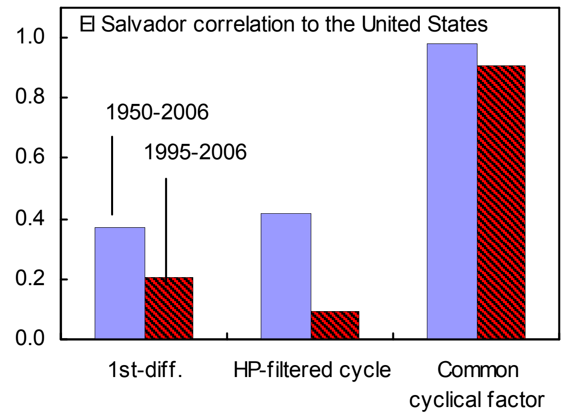
30. **It is proposed that the next Article IV consultation be held on the standard 12-month cycle**.

## Box 1. External Business Cycle Linkages

*The business cycle in El Salvador is highly sensitive to external conditions. New research indicates that spillovers from the U.S. economy are large and rapid.*

The business cycle is defined as the process of transient upswings and downturns in GDP growth, relative to some measure of the underlying trend. While the definition is clear-cut, a wide variety of possible trend-cycle decompositions mean that actual measurement of the cycle, and cyclical links between economies, is more difficult.

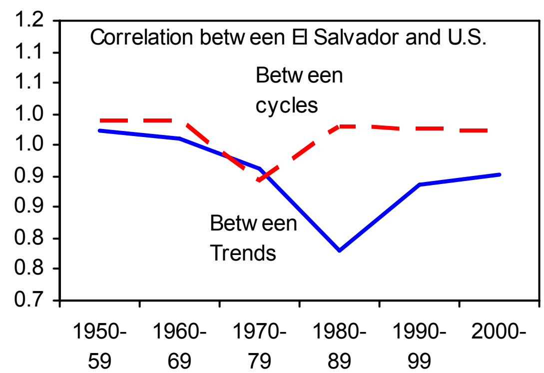
Correlations of El Salvador's economic cycle with the U.S. cycle were calculated using three decompositions: the first difference in annual GDP growth rates; the cyclical component from the Hodrick-Prescott filter; and the common cycle method.




Source: Fund staff estimates.

The common cycle methodology of Vahid and Engle (1993)[1] extends the intuition of cointegration methods to estimate long-run linkages to the analysis of short-run linkages (known as codependence in growth rates).

Correlations were much higher using the common cycle methodology, particularly with the U.S. This suggests that comovements between growth in El Salvador and other Central American countries are largely driven by a shared cycle with the U.S.




Source: Fund staff estimates.

The common cycle method also suggests that periods in which El Salvador growth decoupled from the U.S. were largely the results of country-specific structural shocks that had a long-lasting impact; for example, the end of the civil war in the early 1990s.

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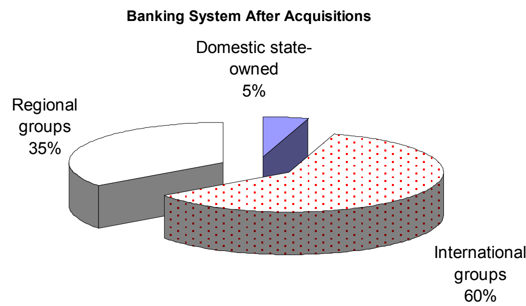
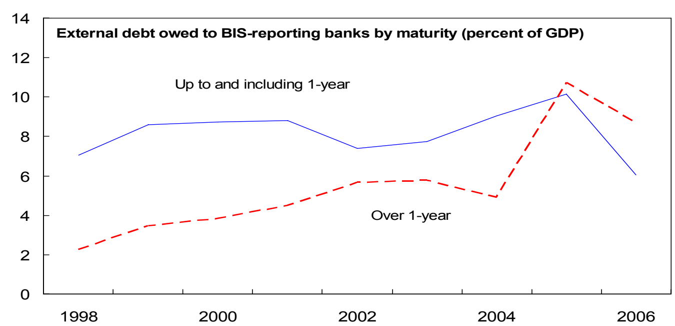
[1] Vahid, F., and R. F. Engle, 1993, "Common Trends and Common Cycles," *Journal of Applied Econometrics*,

## Box 2. Managing Transition in the Banking Sector

**Recent foreign acquisitions have reconfigured the Salvadoran financial sector.** El Salvador's three largest banks have been recently acquired by international and regional banking groups. When all transactions are concluded, around 95 percent of the banking system will be foreign-owned and 60 percent will be owned by large international banks. The associated financial institutions, insurance companies, pension funds, and stockbrokers have also been acquired.



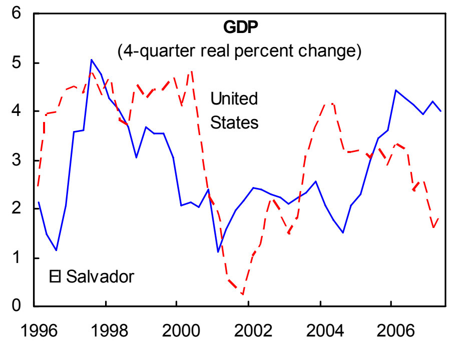

**The new configuration could help reduce financial sector vulnerabilities.** The capital base of the banks would be improved particularly in cases where the banks become branches of larger foreign entities. Access to a larger resource pool would also provide additional resources for lending. The localization of liabilities could also help improve external vulnerability indicators. Some loans to Salvadoran private entities which were on the books of the head offices of the foreign banks have been moved to local subsidiaries, reducing private external debt by about 5 percentage points of GDP.



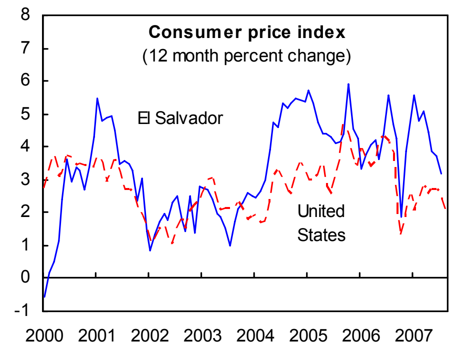

**International experiences suggest that a number of regulatory and supervisory changes may be required on the entry of large foreign banks.** In countries where the central bank has limited capacity to provide liquidity to the market, clear procedures need to be established for dealing with liquidity problems in an individual bank (foreign or domestic) and also for the system as a whole. The method of supervising these foreign institutions will differ from domestic banks, and it might be useful to execute memoranda of understanding with the home supervisors. Marked differences in the regulatory framework between the domestic market and headquarters of the institutions could increase the regulatory burden and reduce efficiency. Regulators should therefore try to move the regime closer to international best practice. Large foreign banks may tend to ignore small savers and borrowers who do not fit into their business model. Thus regulatory authorities need to be vigilant to such trends and devise strategies to ensure that there is no loss of access.

## Figure 1. El Salvador: Real Sector

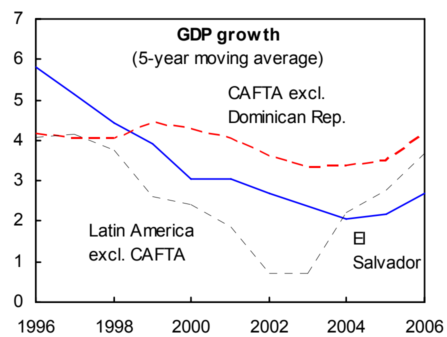
*Growth remains at a relatively high level compared to recent years.*



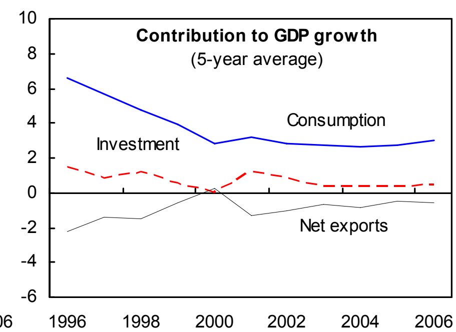

*Inflation has declined from the peak of early 2007, but has stayed above U.S. inflation.*



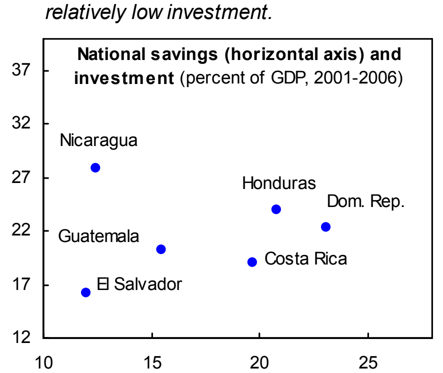

*Growth has lagged behind that of regional neighbors since the late 1990s.*



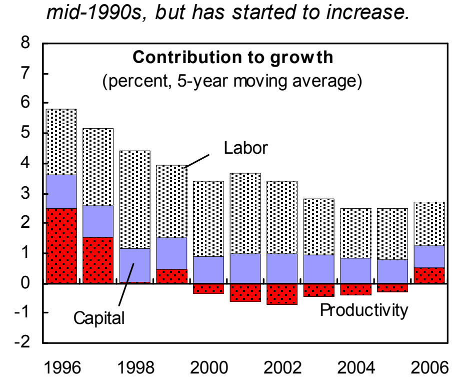

*Growth has been mainly driven by consumption.*




*Low savings may be one factor leading to relatively low investment.*



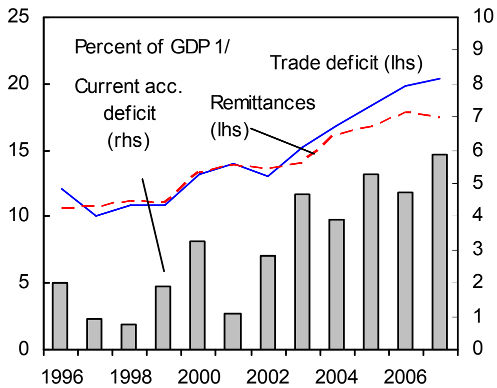

*Productivity declined sharply following the mid-1990s, but has started to increase.*



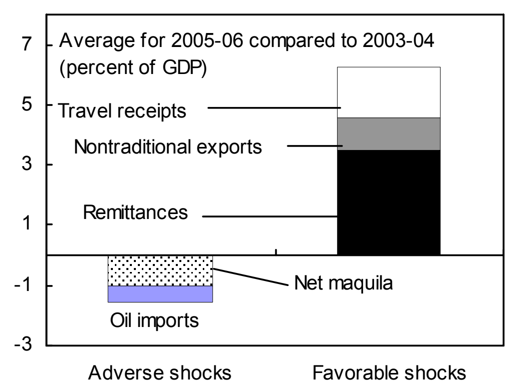

Sources: Central Bank of El Salvador; International Financial Statistics; and Fund staff estimates.

## Figure 2. El Salvador: External Sector

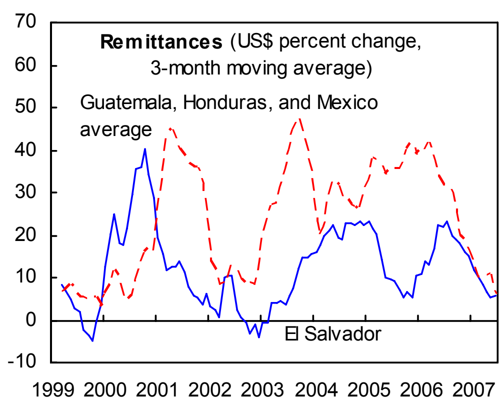
*The current account deficit has increased to the 5–6 percent range.*



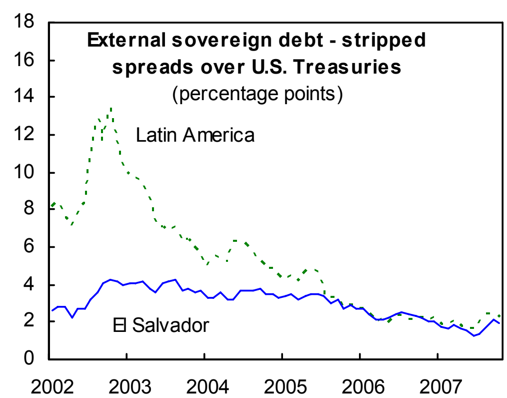

*The balance of shocks has been favorable, particularly related to remittance flows.*



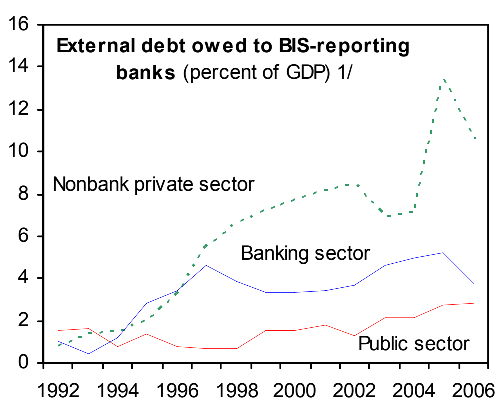

*Remittance growth has begun to slow, as in some other countries.*



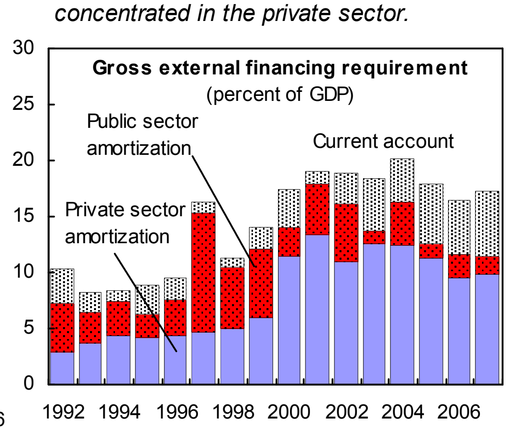

*The external El Salvador risk premium has remained low.*




*External short-term debt of the nonbank private sector has marginally risen.*




*Financing needs remain high and are concentrated in the private sector.*



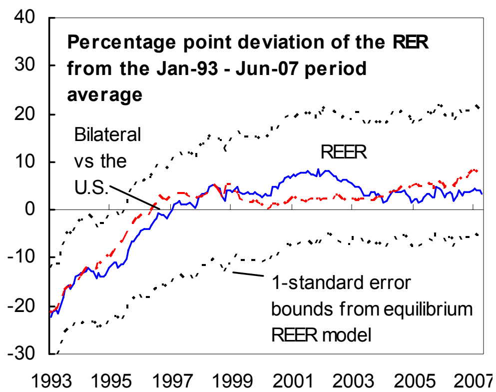

Sources: Central Bank of El Salvador; International Financial Statistics; J.P. Morgan; Bank for International Settlements; and Fund staff estimates.

1/ Final datapoint is for the first half of 2007 at an annual rate.

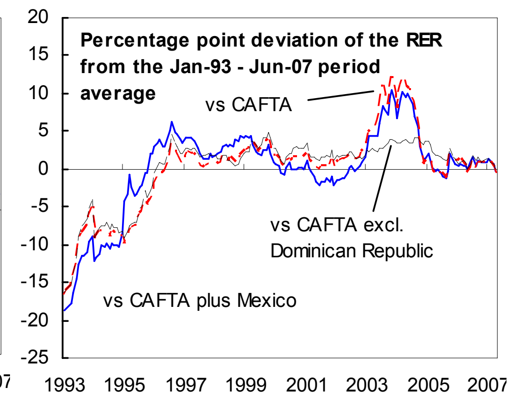
2/ Declines recorded at the end of 2006 were largely due to reclassifications related to the acquisitions of major local banks by foreign banks.

## Figure 3. El Salvador: Competitiveness Indicators

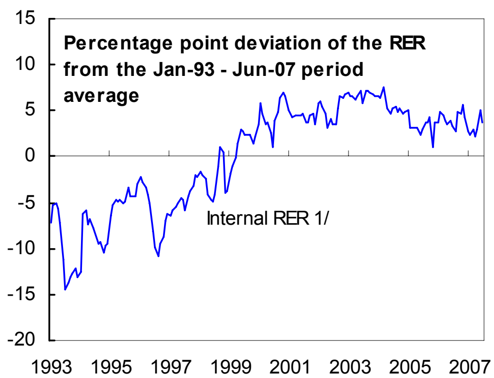
*El Salvador's broad REER has been stable, but modestly appreciated versus the U.S.*



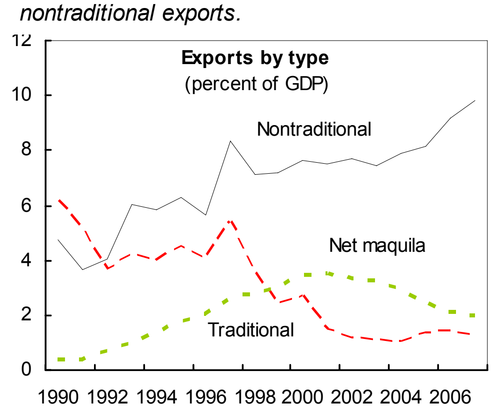

*Competitiveness has not been lost relative to other CAFTA countries.*



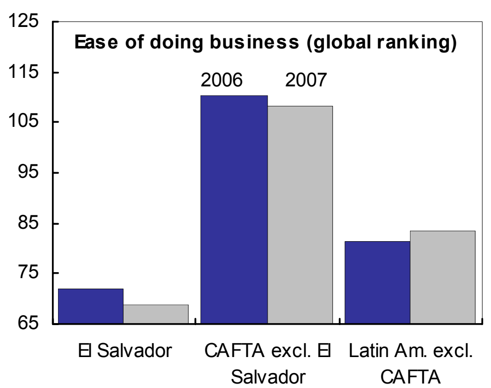

*The internal REER has also been stable in recent years.*



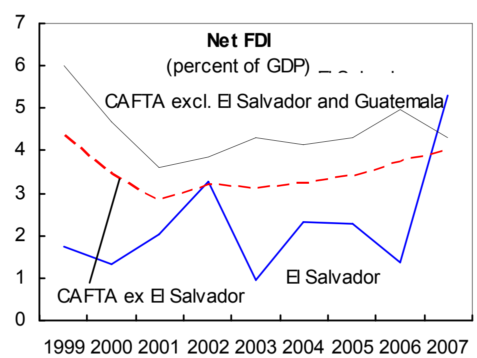

*The fall in maquila exports was offset by nontraditional exports.*




*The investment climate has improved in recent years and compares well in the region.*



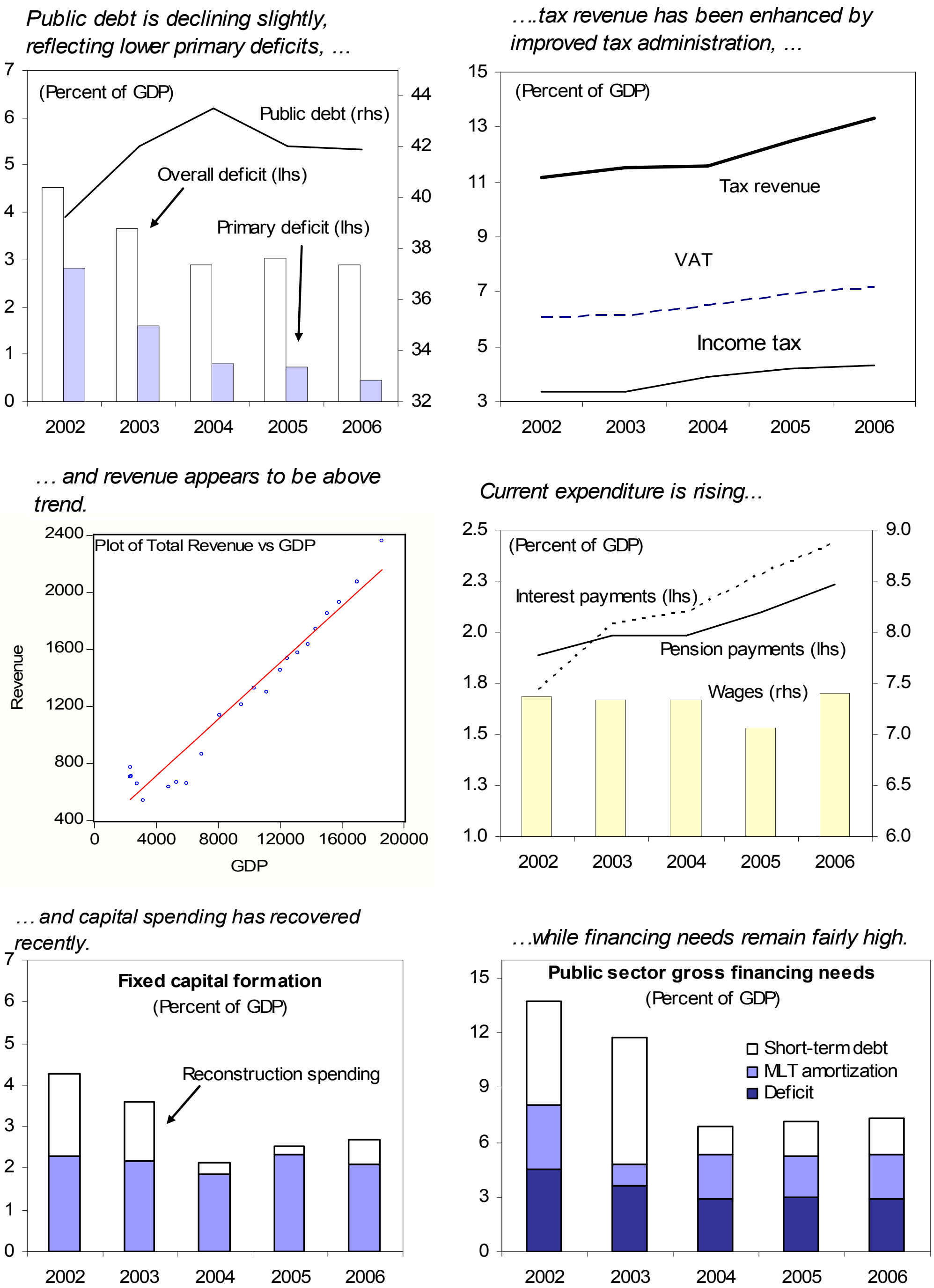

*FDI inflows have been low in recent years, but have begun to pick up.*




Sources: National authorities; International Financial Statistics; and the World Bank.

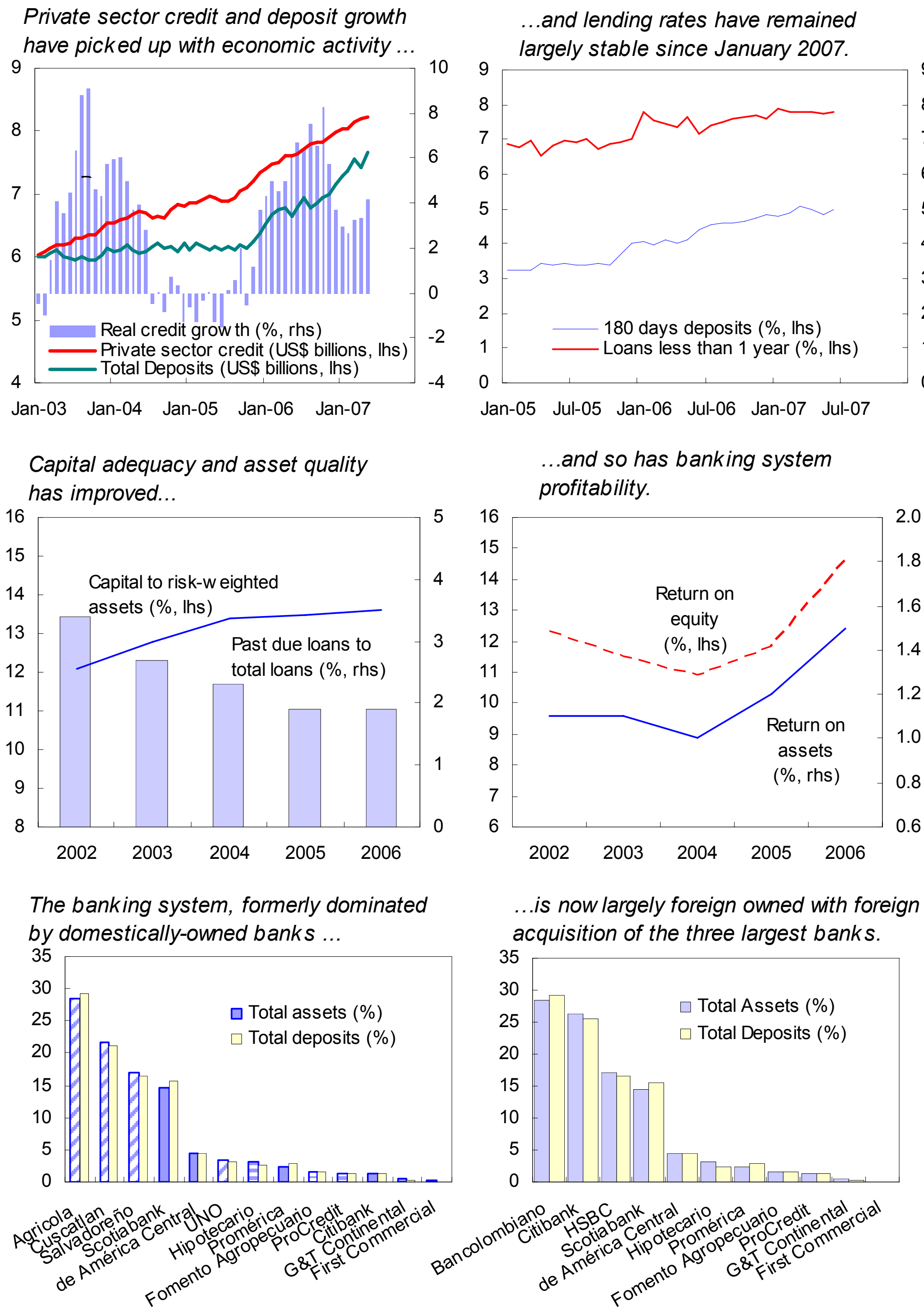
1/ The price of nontradables relative to tradables in the consumer price index, excluding transport, energy, and utilities. Both categories used together account for 67 percent of the index.

**Figure 4. El Salvador: Fiscal Sector**



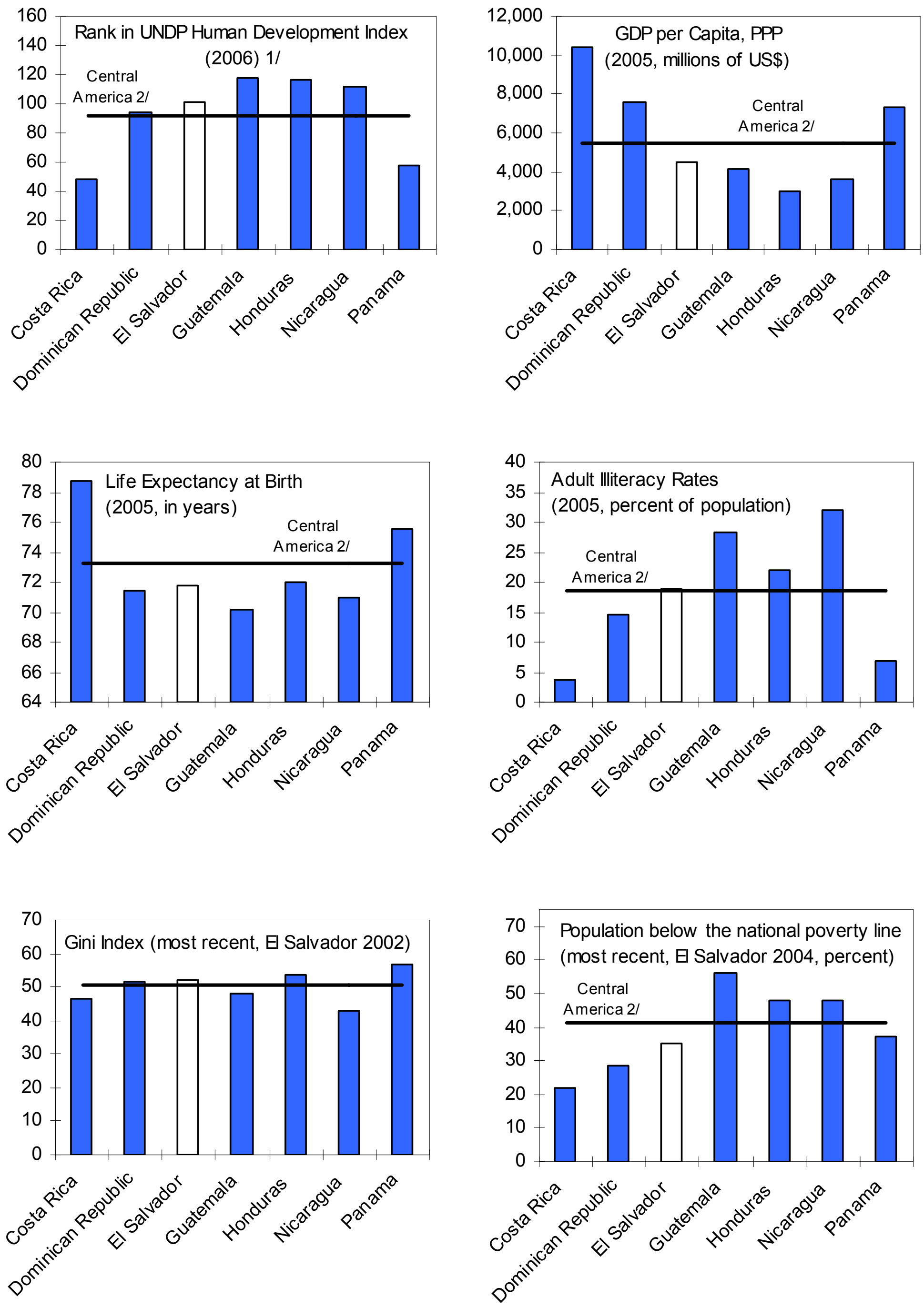

Sources: Salvadoran authorities; and Fund staff calculations.

**Figure 5. El Salvador: Financial Sector Developments**




Sources: Salvadoran authorities; and Fund staff calculations.

## Figure 6. El Salvador: Social Indicators




Sources: UNDP Human Development Report; ECLAC; World Economic Outlook; World Development Indicators; and Fund staff calculations.
1/ Rank in 2004. Out of 177 countries.
2/ Simple (unweighted) average.

## Table 1. El Salvador: Selected Economic and Social Indicators

I. Social Indicators

| | | | |
|---|---|---|---|
| Population (millions) | 7.1 | Infant mortality (2004, per 1,000 live births) | 28 |
| Per capita income (2006, U.S. dollars) | 2,661 | Percent of pop. below poverty line (2004) | 35 |
| Rank in UNDP Development Index 2006 (out of 177) | 101 | Gini index (2002) | 52 |
| Life expectancy at birth in years (2004) | 71 | Oil imports 2006 (millions of U.S. dollars) | 375 |

II. Economic Indicators

| | 2002 | 2003 | 2004 | 2005 | Est. 2006 | Proj. 2007 | Proj. 2008 |
|---|---|---|---|---|---|---|---|
| | (Annual percent change, unless otherwise stated) | | | | | | |
| **Income and prices** | | | | | | | |
| Real GDP | 2.3 | 2.3 | 1.9 | 3.1 | 4.2 | 4.2 | 3.8 |
| Real GDP per capita | 0.4 | 0.4 | 0.0 | 1.3 | 2.3 | 2.5 | 2.1 |
| Unemployment rate | 6.2 | 6.9 | 6.8 | 7.8 | 7.0 | 7.0 | … |
| Consumer prices (end of period, e.o.p.) | 2.8 | 2.5 | 5.4 | 4.3 | 4.9 | 4.0 | 3.5 |
| **External sector** | | | | | | | |
| Export f.o.b. volume (including maquila sector) | 3.3 | 2.0 | 2.6 | -2.6 | 0.8 | 5.0 | 7.4 |
| Import f.o.b. volume (including maquila sector) | -0.6 | 7.7 | 4.1 | 1.4 | 5.2 | 5.2 | 4.6 |
| Terms of trade | -0.7 | -1.0 | -2.5 | -1.8 | -2.3 | -0.8 | -1.5 |
| Real effective exchange rate (e.o.p., + appreciation) 1/ | -1.4 | -3.0 | -0.7 | 2.4 | -0.2 | -0.8 | … |
| External sovereign bond (average spread, basis points) 2 | 325 | 386 | 348 | 298 | 209 | 169 | … |
| | (In percent of GDP, unless otherwise indicated) | | | | | | |
| **Money and credit** | | | | | | | |
| Credit to the private sector | 42.3 | 43.5 | 43.1 | 43.1 | 42.9 | 43.4 | 44.3 |
| Broad money | 43.7 | 43.3 | 41.3 | 41.2 | 42.5 | 46.4 | 46.7 |
| Interest rate (annual, time deposits, eop) 1/ | 3.4 | 3.4 | 3.3 | 3.4 | 4.9 | 4.5 | 5.5 |
| **External sector** | | | | | | | |
| Current account balance | -2.8 | -4.7 | -3.9 | -5.2 | -4.7 | -5.9 | -5.6 |
| Trade balance | -13.0 | -15.2 | -16.8 | -18.2 | -19.8 | -20.0 | -19.8 |
| Exports (f.o.b. including maquila) | 21.1 | 21.0 | 21.1 | 20.1 | 19.1 | 19.0 | 19.3 |
| Imports (f.o.b. including maquila) | 34.1 | 36.1 | 38.0 | 38.3 | 38.9 | 39.0 | 39.1 |
| Services and income (net) | -3.9 | -3.5 | -3.3 | -3.8 | -2.9 | -3.7 | -3.4 |
| Transfers (net) | 14.0 | 14.0 | 16.2 | 16.7 | 17.9 | 17.7 | 17.5 |
| **Public finances** | | | | | | | |
| Combined public sector balance | -4.4 | -3.6 | -3.0 | -3.0 | -2.9 | -2.2 | -1.9 |
| Combined primary balance | -2.7 | -1.6 | -0.8 | -0.8 | -0.5 | 0.2 | 0.6 |
| *Of which: tax revenue* | 11.2 | 11.5 | 11.5 | 12.5 | 13.3 | 13.5 | 13.8 |
| **National Savings and Investment** | | | | | | | |
| Gross domestic investment | 16.4 | 17.0 | 16.2 | 15.7 | 16.1 | 20.4 | 19.0 |
| Public sector 3/ | 3.6 | 3.3 | 1.9 | 2.3 | 2.2 | 2.9 | 2.7 |
| Private sector | 12.8 | 13.7 | 14.3 | 13.4 | 14.0 | 17.5 | 16.3 |
| *Of which: foreign direct investment* | 3.3 | 0.9 | 2.3 | 3.5 | 1.1 | 5.1 | 3.0 |
| Gross domestic saving | 13.6 | 12.3 | 12.3 | 10.5 | 11.4 | 14.5 | 13.4 |
| Public sector | 0.8 | -0.4 | -0.4 | -0.8 | -0.5 | 0.0 | 0.3 |
| Private sector | 12.7 | 12.7 | 12.7 | 11.3 | 11.9 | 14.5 | 13.1 |
| **Total public debt** | 39.3 | 42.1 | 43.5 | 42.0 | 41.9 | 40.8 | 39.8 |
| *Of which: external public debt* | 27.9 | 31.4 | 30.2 | 29.2 | 29.3 | 26.8 | 24.4 |
| External public debt service (percent of exports of goods and services) | 16.8 | 11.3 | 21.8 | 16.6 | 15.7 | 15.2 | 11.8 |
| **Net foreign assets of the banking system** | | | | | | | |
| Millions of U.S. dollars | 1,294 | 1,044 | 1,050 | 1,104 | 1,459 | 2,079 | 1829.4 |
| Percent of deposits | 21.6 | 17.0 | 16.9 | 17.3 | 20.4 | 22.0 | 18.1 |
| **Memorandum items:** | | | | | | | |
| Net maquila exports | 3.3 | 3.3 | 2.9 | 2.4 | 2.1 | 2.0 | 1.9 |
| Nominal GDP (billions of U.S. dollars) | 14.3 | 15.0 | 15.8 | 17.1 | 18.7 | 20.2 | 21.8 |

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

1/ For 2007, the REER shows the percentage change through July and the interest rate the average through July.

2/ The figure for 2007 shows the average spread through August 20.

3/ Includes reconstruction outlays after the earthquakes in 2001 and tropical storm Stan in 2005.

## Table 2. El Salvador: Balance of Payments

(In US$ millions)

| | 2004 | 2005 | Prel. 2006 | Proj. 2007 | Proj. 2008 | Proj. 2009 | Proj. 2010 | Proj. 2011 | Proj. 2012 |
|---|---|---|---|---|---|---|---|---|---|
| **Current account** | **-616** | **-894** | **-877** | **-1,185** | **-1,222** | **-1,140** | **-1,063** | **-1,044** | **-1,018** |
| Trade balance | -2,660 | -3,105 | -3,688 | -4,043 | -4,310 | -4,418 | -4,623 | -4,920 | -5,230 |
| Export of goods (f.o.b.) | 3,339 | 3,429 | 3,568 | 3,840 | 4,192 | 4,534 | 4,913 | 5,200 | 5,538 |
| General merchandise | 1,416 | 1,614 | 1,966 | 2,237 | 2,527 | 2,802 | 3,111 | 3,363 | 3,630 |
| Goods for processing | 1,923 | 1,815 | 1,602 | 1,602 | 1,665 | 1,732 | 1,802 | 1,837 | 1,908 |
| Import of goods (f.o.b.) | -5,999 | -6,534 | -7,257 | -7,883 | -8,502 | -8,952 | -9,536 | -10,120 | -10,768 |
| General merchandise | -4,540 | -5,131 | -6,053 | -6,679 | -7,251 | -7,650 | -8,182 | -8,739 | -9,335 |
| Goods for processing | -1,458 | -1,403 | -1,204 | -1,204 | -1,251 | -1,301 | -1,354 | -1,380 | -1,433 |
| Services | -64 | -82 | 19 | -67 | -37 | -11 | 25 | 65 | 108 |
| Income | -460 | -571 | -553 | -677 | -704 | -790 | -810 | -831 | -853 |
| Current transfers | 2,568 | 2,865 | 3,346 | 3,603 | 3,830 | 4,079 | 4,345 | 4,641 | 4,957 |
| **Financial and capital account** | **218** | **893** | **1,135** | **1,629** | **1,347** | **1,270** | **1,203** | **1,194** | **1,168** |
| Capital account | 100 | 94 | 94 | 120 | 111 | 212 | 214 | 152 | 145 |
| Public sector | 242 | 329 | 497 | -57 | -98 | 14 | 15 | 15 | 15 |
| Private sector | -126 | 470 | 511 | 1,566 | 1,333 | 1,044 | 974 | 1,027 | 1,008 |
| Foreign direct investment | 366 | 388 | 254 | 1,070 | 694 | 703 | 756 | 814 | 876 |
| Commercial banks | 191 | -51 | -209 | -142 | 375 | 150 | 150 | 150 | 150 |
| **Currency substitution** | **-6** | **-5** | **0** | **0** | **0** | **0** | **0** | **0** | **0** |
| **Errors and omissions** | **352** | **-52** | **-187** | **0** | **0** | **0** | **0** | **0** | **0** |
| **Change in net reserves (- = increase)** | **53** | **59** | **-72** | **-445** | **-125** | **-130** | **-140** | **-150** | **-150** |
| | | | | (Annual percentage change) | | | | | |
| Exports (fob, volume) | 2.6 | -2.6 | 0.8 | 5.0 | 7.4 | 6.4 | 6.5 | 4.1 | 4.7 |
| Import (fob, volume) | 4.1 | 1.4 | 5.2 | 5.2 | 4.6 | 5.0 | 4.7 | 4.4 | 4.7 |
| Terms of Trade | -2.5 | -1.8 | -2.3 | -0.8 | -1.5 | 1.4 | 0.0 | 0.0 | 0.0 |
| | | | | (In percent of GDP) | | | | | |
| **Current account** | **-3.9** | **-5.2** | **-4.7** | **-5.9** | **-5.6** | **-4.9** | **-4.2** | **-3.8** | **-3.5** |
| Export of goods (f.o.b.) | 21.1 | 20.1 | 19.1 | 19.0 | 19.3 | 19.4 | 19.5 | 19.2 | 19.0 |
| Import of goods (f.o.b.) | -38.0 | -38.3 | -38.9 | -39.0 | -39.1 | -38.2 | -37.8 | -37.3 | -36.9 |
| Net maquila exports | 2.9 | 2.4 | 2.1 | 2.0 | 1.9 | 1.8 | 1.8 | 1.7 | 1.6 |
| Remittances | 16.1 | 16.6 | 17.8 | 17.6 | 17.4 | 17.2 | 17.0 | 16.9 | 16.8 |
| **Financial and Capital account** | **1.4** | **5.2** | **6.1** | **8.1** | **6.2** | **5.4** | **4.8** | **4.4** | **4.0** |
| Public sector capital | 1.5 | 1.9 | 2.7 | -0.3 | -0.4 | 0.1 | 0.1 | 0.1 | 0.1 |
| Private sector capital | -0.8 | 2.8 | 2.7 | 7.7 | 6.1 | 4.5 | 3.9 | 3.8 | 3.5 |
| Foreign direct investment | 2.3 | 2.3 | 1.4 | 5.3 | 3.2 | 3.0 | 3.0 | 3.0 | 3.0 |
| Commercial banks | 1.2 | -0.3 | -1.1 | -0.7 | 1.7 | 0.6 | 0.6 | 0.6 | 0.5 |
| **Memorandum items** | | | | | | | | | |
| Gross international reserves (US$ mln) | 1,880 | 1,820 | 1,898 | 2,158 | 2,283 | 2,413 | 2,553 | 2,703 | 2,854 |
| in months of imports (excluding maquila) | 3.0 | 2.7 | 2.6 | 3.0 | 3.0 | 3.0 | 3.0 | 2.9 | 2.9 |
| in percent of total short-term external debt | 114 | 122 | 161 | 171 | 162 | 163 | 168 | 174 | 182 |
| External debt (in percent of GDP) | 56.0 | 53.4 | 51.7 | 50.6 | 49.1 | 46.8 | 43.8 | 41.2 | 38.3 |
| *Of which*: public sector debt | 30.2 | 29.2 | 29.5 | 26.7 | 25.0 | 23.3 | 21.7 | 20.2 | 19.0 |
| External public debt servicing (US$ mln) | 918 | 727 | 760 | 793 | 673 | 671 | 820 | 1,311 | 851 |
| percent of exports of goods and services | 21.8 | 16.6 | 15.7 | 15.2 | 11.8 | 10.9 | 12.3 | 18.4 | 11.1 |
| Gross external financing requirement (US$m) | 3,063 | 3,214 | 2,881 | 3,399 | 3,566 | 3,545 | 3,660 | 4,173 | 3,698 |
| percent of GDP | 19.4 | 18.8 | 15.4 | 16.8 | 16.4 | 15.1 | 14.5 | 15.4 | 12.7 |

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

(In percent of GDP)

| | | | | Proj. 1/ | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
| **Revenues and grants** | **16.0** | **16.5** | **17.2** | **17.3** | **17.5** | **18.3** | **18.8** | **18.4** | **18.3** |
| Current revenue | 15.7 | 16.2 | 16.9 | 17.0 | 17.0 | 17.8 | 18.0 | 18.1 | 18.0 |
| Tax revenue | 11.5 | 12.5 | 13.3 | 13.5 | 13.8 | 14.6 | 14.9 | 14.9 | 14.9 |
| Nontax revenue | 3.5 | 3.2 | 3.0 | 2.9 | 2.8 | 2.8 | 2.8 | 2.7 | 2.7 |
| *Of which:* pension revenue | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 |
| Operating surplus of the public enterprises | 0.6 | 0.5 | 0.6 | 0.5 | 0.4 | 0.3 | 0.3 | 0.4 | 0.4 |
| Operating surplus of the central bank | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Capital revenue | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Official grants | 0.3 | 0.3 | 0.2 | 0.3 | 0.4 | 0.5 | 0.8 | 0.3 | 0.3 |
| **Expenditure** | **18.9** | **19.5** | **20.1** | **19.5** | **19.4** | **19.8** | **20.1** | **19.5** | **19.5** |
| Current expenditure | 16.7 | 16.8 | 17.0 | 16.4 | 16.1 | 16.5 | 16.5 | 16.5 | 16.4 |
| Wages and salaries | 7.3 | 7.1 | 7.1 | 6.9 | 7.0 | 7.2 | 7.1 | 7.1 | 7.1 |
| Goods and services | 3.7 | 4.0 | 3.9 | 3.7 | 3.4 | 3.6 | 3.7 | 3.7 | 3.7 |
| Interest | 2.1 | 2.2 | 2.4 | 2.4 | 2.5 | 2.5 | 2.5 | 2.5 | 2.4 |
| Current transfers | 3.5 | 3.6 | 3.6 | 3.5 | 3.2 | 3.2 | 3.2 | 3.2 | 3.2 |
| Nonpension payments | 1.4 | 1.3 | 1.8 | 1.7 | 1.6 | 1.6 | 1.6 | 1.5 | 1.5 |
| Pension payments | 2.2 | 2.2 | 1.9 | 1.8 | 1.6 | 1.6 | 1.6 | 1.6 | 1.6 |
| Capital expenditure | 2.2 | 2.7 | 3.1 | 3.0 | 3.2 | 3.3 | 3.6 | 3.1 | 3.1 |
| Fixed capital formation | 2.1 | 2.5 | 2.7 | 2.6 | 3.0 | 3.0 | 3.4 | 2.8 | 2.8 |
| Capital transfers | 0.1 | 0.2 | 0.4 | 0.4 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 |
| **Primary balance** | **-0.8** | **-0.8** | **-0.5** | **0.2** | **0.6** | **1.0** | **1.2** | **1.3** | **1.3** |
| **Overall balance** | **-3.0** | **-3.0** | **-2.9** | **-2.2** | **-1.9** | **-1.5** | **-1.3** | **-1.2** | **-1.2** |
| **Financing** | **3.0** | **3.0** | **2.9** | **2.2** | **1.9** | **1.5** | **1.3** | **1.2** | **1.2** |
| **External** | **1.5** | **2.0** | **2.7** | **-0.3** | **-0.4** | **-0.5** | **-0.8** | **-3.2** | **0.2** |
| Disbursements | 4.0 | 4.3 | 4.8 | 1.4 | 0.7 | 0.7 | 0.2 | 0.2 | 1.6 |
| Amortization | -2.4 | -2.3 | -2.2 | -1.6 | -1.2 | -1.2 | -1.1 | -3.4 | -1.4 |
| **Domestic** | **1.4** | **1.0** | **0.3** | **2.5** | **2.4** | **2.1** | **2.1** | **4.3** | **1.0** |
| Central bank | -0.4 | 0.5 | -0.3 | 0.3 | -0.1 | -0.1 | 0.2 | -0.1 | -0.3 |
| Banking system | 0.1 | -0.1 | 0.4 | 0.6 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 |
| Private sector | 0.0 | 0.7 | 0.4 | 1.6 | 2.3 | 1.9 | 1.8 | 4.2 | 1.1 |
| Privatization proceeds 2/ | 1.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other 3/ | 0.5 | -0.1 | -0.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Memorandum items:** | | | | | | | | | |
| Current account balance | -1.0 | -0.6 | 0.0 | 0.5 | 0.9 | 1.2 | 1.6 | 1.6 | 1.6 |
| Pension balance | -1.9 | -2.0 | -1.8 | -1.6 | -1.6 | -1.6 | -1.5 | -1.6 | -1.6 |
| Reconstruction expenditure | 0.3 | 0.2 | 0.9 | 0.9 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Gross financing needs | 6.9 | 7.2 | 7.0 | 5.6 | 4.8 | 4.3 | 3.8 | 5.9 | 3.8 |
| Implicit interest rate (in percent) | 5.3 | 5.5 | 6.3 | 6.2 | 6.6 | 6.9 | 7.0 | 7.2 | 7.3 |
| Total public sector debt 4/ | 43.5 | 42.0 | 41.9 | 40.8 | 39.8 | 38.6 | 37.1 | 35.7 | 34.3 |
| *Of which:* nonfinancial public debt | 40.5 | 39.7 | 39.6 | 38.7 | 37.9 | 36.7 | 35.4 | 34.1 | 32.8 |

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

1/ Projections prepared by the staff based on authorities strategy.
2/ Includes the sale of shares in the telephone company (CTE) for 2004.
3/ Comprises discrepancies from above- and below-the-line items. The overall balance is measured above the line.
4/ Comprises nonfinancial public sector debt and nonmonetary net liabilities of the central bank.

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

| | 2003 | 2004 | 2005 | 2006 | Proj. 2007 | Proj. 2008 |
|---|---|---|---|---|---|---|
| | (End of period stocks; millions of U.S. dollars) | | | | | |
| | I. Central Bank | | | | | |
| **Net foreign assets** | **1,709** | **1,763** | **1,709** | **1,880** | **2,329** | **2,454** |
| Net international reserves | 2,003 | 1,985 | 1,926 | 2,004 | 2,449 | 2,574 |
| *Of which* : disposable NIR | 153 | 303 | 187 | 191 | 186 | 199 |
| **Net domestic assets** | **653** | **485** | **523** | **412** | **445** | **432** |
| Nonfinancial public sector | 345 | 287 | 367 | 315 | 384 | 371 |
| Commercial banks | 85 | 0 | 0 | 0 | 0 | 0 |
| Nonbank financial institutions | 427 | 434 | 388 | 363 | 355 | 355 |
| Nonfinancial private sector | 0 | 0 | 0 | 0 | 0 | 0 |
| Other items (net) | -205 | -236 | -232 | -265 | -294 | -294 |
| **Central bank backed liabilities** | **2,361** | **2,248** | **2,232** | **2,293** | **2,774** | **2,886** |
| Currency issue | 42 | 36 | 34 | 34 | 34 | 34 |
| Liabilities to other depositary corporations | 1,688 | 1,596 | 1,644 | 1,694 | 2,028 | 2,181 |
| Other liabilities | 630 | 615 | 553 | 565 | 713 | 672 |
| | II. Commercial Banks | | | | | |
| **Net foreign assets** | **-598** | **-682** | **-526** | **-392** | **-250** | **-625** |
| **Net domestic assets** | **7,287** | **7,417** | **7,623** | **8,392** | **9,533** | **10,570** |
| Net claims on nonfinancial public sector | -141 | -250 | -238 | -285 | -173 | -149 |
| Net claims on the financial system | 1,817 | 1,851 | 1,692 | 1,791 | 2,159 | 2,322 |
| Claims on the private sector | 6,541 | 6,809 | 7,353 | 7,986 | 8,784 | 9,635 |
| Other items (net) | -929 | -993 | -1,184 | -1,100 | -1,238 | -1,238 |
| **Liabilities to the private sector** | **6,689** | **6,735** | **7,097** | **8,001** | **9,283** | **9,945** |
| Deposits | 6,020 | 6,166 | 6,328 | 7,069 | 8,202 | 8,788 |
| Other | 669 | 569 | 769 | 931 | 1,080 | 1,157 |
| | III. Financial System | | | | | |
| **Net foreign assets** | **1,044** | **1,050** | **1,104** | **1,459** | **2,079** | **1,829** |
| **Net domestic assets** | **5,475** | **5,475** | **5,927** | **6,477** | **7,304** | **8,325** |
| Nonfinancial public sector | 209 | 43 | 135 | 30 | 211 | 222 |
| Credit to private sector | 6,548 | 6,817 | 7,361 | 7,993 | 8,784 | 9,635 |
| Other | -1,282 | -1,385 | -1,569 | -1,547 | -1,692 | -1,532 |
| **Liabilities to the private sector** | **6,519** | **6,525** | **7,031** | **7,936** | **9,383** | **10,155** |
| *Of Which* : | | | | | | |
| Money | 1,073 | 1,203 | 1,292 | 1,488 | 1,759 | 1,904 |
| Quasi-money | 5,406 | 5,462 | 5,699 | 6,393 | 7,559 | 8,181 |
| | (Percent changes relative to previous year's broad money) | | | | | |
| Net domestic assets | 8.3 | 0.0 | 6.9 | 7.8 | 10.4 | 10.9 |
| Nonfinancial public sector | 4.2 | -2.6 | 1.4 | -1.5 | 2.3 | 0.1 |
| Credit to the private sector | 8.0 | 4.1 | 8.3 | 9.0 | 10.0 | 9.1 |
| Liabilities to the private sector | 4.3 | 0.1 | 7.8 | 12.9 | 18.2 | 8.2 |
| | (Percent of GDP) | | | | | |
| Credit to the private sector | 43.5 | 43.1 | 43.1 | 42.9 | 43.4 | 44.3 |
| Liabilities to the private sector | 43.3 | 41.3 | 41.2 | 42.5 | 46.4 | 46.7 |
| | (Annual percent change, unless otherwise stated) | | | | | |
| **Memorandum items:** | | | | | | |
| Credit to the private sector | 8.2 | 4.1 | 8.0 | 8.6 | 9.9 | 9.7 |
| Deposits in commercial banks | 0.9 | 2.4 | 2.6 | 11.7 | 16.5 | 8.2 |
| Commercial bank liquidity deposits at central bank percent of total deposits | 28.2 | 26.5 | 26.7 | 26.6 | 23.8 | 22.0 |

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

**Table 5. El Salvador: Selected Vulnerability Indicators**
(In percent of GDP, unless otherwise indicated)

| | 2003 | 2004 | 2005 | 2006 | Proj. 2007 | Proj. 2008 |
|---|---|---|---|---|---|---|
| **Fiscal indicators** | | | | | | |
| Overall balance of the public sector | -3.6 | -3.0 | -3.0 | -2.9 | -2.2 | -1.9 |
| Public sector primary balance | -1.6 | -0.8 | -0.8 | -0.5 | 0.3 | 0.6 |
| Gross public sector financing requirement | 11.7 | 6.9 | 7.2 | 7.0 | 5.6 | 4.8 |
| Public sector debt | 42.1 | 43.5 | 42.0 | 41.9 | 40.8 | 39.8 |
| Public sector external debt | 31.4 | 30.2 | 29.2 | 29.5 | 26.7 | 25.0 |
| External interest payments to total fiscal revenue (percent) | 11.2 | 12.2 | 11.6 | 10.7 | 12.9 | 10.6 |
| External amortization payments to total fiscal revenue (percent) | 7.2 | 15.2 | 13.7 | 12.6 | 9.6 | 6.8 |
| **Financial indicators 1/** | | | | | | |
| Broad money (percent change, 12-month basis) | 4.3 | 0.1 | 7.8 | 12.9 | 18.2 | 8.2 |
| Private sector credit (percent change, 12-month basis) | 8.2 | 4.1 | 8.0 | 8.6 | 9.9 | 9.7 |
| Ratio of capital to risk-weighted assets | 12.8 | 13.4 | 13.5 | 13.8 | 14.0 | … |
| Ratio of loans more than 90 days past due | | | | | | |
| to total loans 2/ | 2.8 | 2.4 | 2.0 | 2.0 | 2.1 | … |
| Provision coverage | | | | | | |
| Ratio of provisions to total loans | 3.6 | 3.1 | 2.4 | 2.2 | 2.4 | … |
| Ratio of provisions to loans more than 90 days past due 2/ | 130 | 132 | 127 | 116.4 | 116.5 | … |
| Ratio of real estate loans to total loans | 22.0 | 23.7 | 23.4 | 23.4 | 24.0 | … |
| Ratio of consumption loans to total loans | 14.2 | 17.3 | 20.1 | 20.9 | 22.9 | … |
| Return to average equity | 11.5 | 10.9 | 11.8 | 14.6 | 12.9 | … |
| Return to average total assets | 1.1 | 1.0 | 1.2 | 1.5 | 1.4 | … |
| Ratio of liquid assets to total deposits | 35.7 | 36.1 | 33.5 | 32.3 | 35.5 | … |
| **External indicators** | | | | | | |
| Exports of goods and services (percent change, 12-month basis) | 7.9 | 2.6 | 4.2 | 10.5 | 7.8 | 9.1 |
| Imports of goods and services (percent change, 12-month basis) | 10.0 | 6.8 | 9.2 | 12.5 | 9.6 | 7.6 |
| Current account balance | -4.7 | -3.9 | -5.2 | -4.7 | -5.9 | -5.6 |
| Capital and financial account balance | 7.9 | 1.4 | 5.2 | 6.1 | 8.1 | 6.2 |
| Gross official reserves (millions of U.S. dollars ) | 1,910 | 1,880 | 1,820 | 1,898 | 2,158 | 2,283 |
| Months of imports of goods and services, excluding maquila | 3.1 | 2.8 | 2.6 | 2.5 | 2.7 | 2.7 |
| Percent of short-term debt 3/ | 116 | 107 | 115 | 152 | 135 | 129 |
| Percent of gross external financing requirements | 68 | 61 | 57 | 65 | 65 | 65 |
| Percent of broad money | 29.3 | 28.8 | 25.9 | 23.9 | 23.0 | 22.5 |
| Total public external debt service | 3.1 | 5.8 | 4.3 | 4.4 | 3.9 | 3.0 |
| Total external debt to exports of goods and services (percent) | 209 | 210 | 208 | 199 | 190 | 181 |
| External interest payments to exports of goods and services (percent) | 12.4 | 13.3 | 13.8 | 14.1 | 15.1 | 14.1 |
| External amortization payments to exports of goods and services (percent) | 11.5 | 16.6 | 16.8 | 17.6 | 13.4 | 11.6 |
| REER 12-month basis (depreciation -) 4/ | -3.0 | -0.7 | 2.4 | -0.2 | -0.8 | … |

Sources: Central Bank of El Salvador; Ministry of Finance; and Fund staff estimates and projections.
1/ As of June 2007.
2/ Based on past-due loans.
3/ Refers to total external debt. Maturity less than one year, defined on a residual maturity basis.
4/ As of July 2007.

**Table 6. El Salvador: External Debt Sustainability Framework, 2002-2012**

(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | **Debt-stabilizing non-interest current account 5/** |
| **Baseline: External debt** | 50.9 | 57.0 | 56.0 | 53.4 | 51.7 | **50.6** | **49.1** | **46.8** | **43.8** | **41.2** | **38.3** | **-3.1** |
| Change in external debt | 7.0 | 6.1 | -1.0 | -2.6 | -1.7 | -1.1 | -1.5 | -2.3 | -3.0 | -2.7 | -2.8 | |
| Identified external debt-creating flows (4+8+9) | -0.1 | 3.1 | -0.3 | -1.8 | -1.6 | -0.6 | 0.2 | -0.9 | -1.4 | -1.6 | -1.7 | |
| Current account deficit, excluding interest payments | 0.2 | 1.3 | 0.4 | 1.7 | 1.0 | 2.0 | 1.9 | 1.0 | 0.5 | 0.4 | 0.2 | |
| Deficit in balance of goods and services | 14.7 | 15.9 | 17.2 | 18.7 | 19.7 | 20.3 | 20.0 | 18.9 | 18.2 | 17.9 | 17.5 | |
| Exports | 26.6 | 27.3 | 26.6 | 25.7 | 26.0 | 25.8 | 26.2 | 26.4 | 26.6 | 26.3 | 26.2 | |
| Imports | 41.3 | 43.2 | 43.9 | 44.4 | 45.7 | 46.1 | 46.2 | 45.3 | 44.8 | 44.2 | 43.7 | |
| Net non-debt creating capital inflows (negative) | -1.4 | 0.9 | -1.5 | -2.8 | -1.7 | -4.5 | -3.7 | -3.4 | -3.4 | -3.4 | -3.3 | |
| Automatic debt dynamics 1/ | 1.1 | 0.9 | 0.8 | -0.6 | -0.9 | 1.9 | 1.9 | 1.5 | 1.4 | 1.4 | 1.5 | |
| Contribution from nominal interest rate | 2.6 | 3.4 | 3.5 | 3.6 | 3.7 | 3.9 | 3.7 | 3.6 | 3.4 | 3.2 | 3.2 | |
| Contribution from real GDP growth | -1.0 | -1.1 | -1.0 | -1.6 | -2.0 | -2.0 | -1.8 | -2.1 | -2.0 | -1.8 | -1.7 | |
| Contribution from price and exchange rate changes 2/ | -0.5 | -1.4 | -1.7 | -2.6 | -2.5 | -2.0 | -1.8 | -1.4 | -1.4 | -1.3 | -1.2 | |
| Residual, incl. change in gross foreign assets (2-3) 3/ | 7.1 | 3.0 | -0.7 | -0.8 | -0.1 | 1.6 | 0.1 | 0.0 | -0.2 | 0.2 | 0.1 | |
| External debt-to-exports ratio (in percent) | 191.4 | 209.0 | 210.0 | 207.7 | 198.9 | 196.0 | 187.4 | 177.5 | 164.9 | 156.4 | 146.5 | |
| **Scenario with key variables at their historical averages 4/** | | | | | | **50.6** | **48.9** | **47.1** | **45.1** | **43.6** | **41.8** | **-2.1** |
| **Key Macroeconomic Assumptions Underlying Baseline** | | | | | | | | | | | | |
| Real GDP growth (in percent) | 2.3 | 2.3 | 1.9 | 3.1 | 4.2 | 4.2 | 3.8 | 4.5 | 4.5 | 4.5 | 4.5 | |
| GDP deflator in U.S. dollars (change in percent) | 1.2 | 2.8 | 3.1 | 4.8 | 4.9 | 4.1 | 3.6 | 3.0 | 3.0 | 3.0 | 3.0 | |
| Nominal external interest rate (in percent) | 6.1 | 7.0 | 6.5 | 6.9 | 7.5 | 8.2 | 7.9 | 7.8 | 7.8 | 7.9 | 8.4 | |
| Growth of exports (U.S. dollar terms, in percent) | 5.7 | 7.9 | 2.6 | 4.2 | 10.5 | 7.8 | 9.1 | 8.3 | 8.5 | 6.6 | 7.1 | |
| Growth of imports (U.S. dollar terms, in percent) | 2.2 | 10.0 | 6.8 | 9.2 | 12.5 | 9.6 | 7.6 | 5.5 | 6.5 | 6.2 | 6.4 | |
| Current account balance, excluding interest payments | -0.2 | -1.3 | -0.4 | -1.7 | -1.0 | -2.0 | -1.9 | -1.0 | -0.5 | -0.4 | -0.2 | |
| Net non-debt creating capital inflows | 1.4 | -0.9 | 1.5 | 2.8 | 1.7 | 4.5 | 3.7 | 3.4 | 3.4 | 3.4 | 3.3 | |

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate.

e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

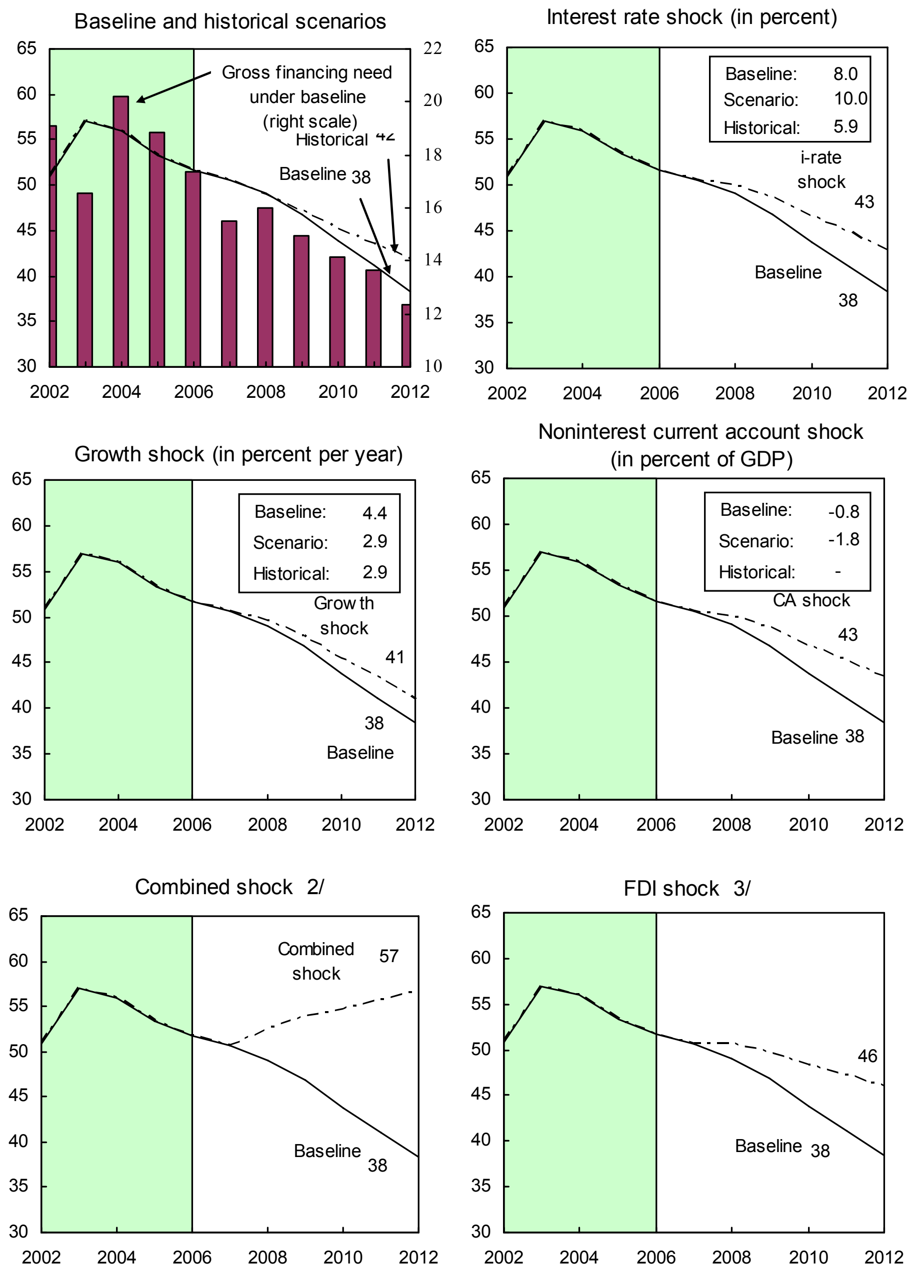
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

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

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

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

Figure 7. El Salvador: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)




Sources: International Monetary Fund, Country desk data, and Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks, except the interest rate which is a 200 basis point shock. 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/ Real interest rate higher by 200bps, historical GDP growth rate, a one-half standard deviation shock to the current account balance and FDI 1.5 percentage point of GDP lower from 2008–2012.
3/ FDI averages 1.5 percent of GDP rather than 3.0 percent of GDP from 2008–2012.

## Table 7. El Salvador: Public Sector Debt Sustainability Framework, 2002-2012

(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | Debt-stabilizing primary balance 9/ |
| 1 **Baseline: Public sector debt 1/** | 39.3 | 42.1 | 43.5 | 42.0 | 41.9 | **40.8** | **39.8** | **38.6** | **37.1** | **35.7** | **34.3** | **-0.1** |
| o/w foreign-currency denominated | 39.3 | 42.1 | 43.5 | 42.0 | 41.9 | 40.8 | 39.8 | 38.6 | 37.1 | 35.7 | 34.3 | |
| 2 Change in public sector debt | 4.9 | 2.8 | 1.5 | -1.5 | -0.1 | -1.1 | -0.9 | -1.3 | -1.4 | -1.5 | -1.4 | |
| 3 Identified debt-creating flows (4+7+12) | 3.3 | 1.7 | 2.3 | -0.2 | -0.6 | -1.1 | -0.9 | -1.3 | -1.4 | -1.5 | -1.4 | |
| 4 Primary deficit | 2.7 | 1.6 | 0.8 | 0.8 | 0.5 | -0.2 | -0.6 | -1.0 | -1.2 | -1.3 | -1.3 | |
| 5 Revenue and grants | 15.5 | 16.5 | 16.0 | 16.5 | 17.2 | 17.3 | 17.5 | 18.3 | 18.8 | 18.4 | 18.3 | |
| 6 Primary (noninterest) expenditure | 18.2 | 18.1 | 16.8 | 17.3 | 17.6 | 17.1 | 16.9 | 17.3 | 17.6 | 17.1 | 17.1 | |
| 7 Automatic debt dynamics 2/ | 0.5 | 0.1 | 0.1 | -1.0 | -1.1 | -0.9 | -0.4 | -0.3 | -0.2 | -0.2 | -0.1 | |
| 8 Contribution from interest rate/growth differential 3/ | 0.5 | 0.1 | 0.1 | -1.0 | -1.1 | -0.9 | -0.4 | -0.3 | -0.2 | -0.2 | -0.1 | |
| 9 Of which contribution from real interest rate | 1.3 | 1.0 | 0.9 | 0.2 | 0.5 | 0.7 | 1.1 | 1.4 | 1.4 | 1.4 | 1.4 | |
| 10 Of which contribution from real GDP growth | -0.8 | -0.9 | -0.7 | -1.2 | -1.6 | -1.6 | -1.4 | -1.7 | -1.6 | -1.6 | -1.5 | |
| 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 | 1.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 13 Privatization receipts (negative) | 0.1 | 0.0 | 1.3 | 0.0 | 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/ | 1.6 | 1.1 | -0.8 | -1.3 | 0.5 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Public sector debt-to-revenue ratio 1/ | 252.8 | 255.2 | 272.1 | 254.8 | 244.2 | 236.0 | 228.3 | 210.6 | 197.6 | 193.9 | 187.1 | |
| **Gross financing need 6/** | 13.6 | 11.7 | 6.9 | 7.2 | 7.0 | 5.6 | 4.8 | 4.3 | 3.8 | 5.9 | 3.8 | |
| in billions of U.S. dollars | 222.0 | 201.9 | 124.8 | 140.2 | 149.7 | 129.5 | 118.3 | 114.2 | 109.5 | 181.8 | 126.5 | |
| **Scenario with key variables at their historical averages 7/** | | | | | | **40.8** | **41.8** | **42.8** | **43.9** | **44.9** | **45.9** | **-0.3** |
| **Scenario with no policy change (constant primary balance) in 2007-2012** | | | | | | **40.8** | **40.2** | **39.7** | **39.3** | **38.9** | **38.6** | **-0.1** |
| **Key Macroeconomic and Fiscal Assumptions Underlying Baseline** | | | | | | | | | | | | |
| Real GDP growth (in percent) | 2.3 | 2.3 | 1.9 | 3.1 | 4.2 | 4.2 | 3.8 | 4.5 | 4.5 | 4.5 | 4.5 | |
| Average nominal interest rate on public debt (in percent) 8/ | 5.2 | 5.5 | 5.3 | 5.5 | 6.3 | 6.2 | 6.6 | 6.9 | 7.0 | 7.2 | 7.3 | |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | 4.0 | 2.7 | 2.2 | 0.7 | 1.5 | 2.1 | 3.0 | 3.9 | 4.0 | 4.2 | 4.3 | |
| Nominal appreciation (increase in U.S. dollar value of local currency, in percent) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | ... | ... | ... | ... | ... | ... | |
| Inflation rate (GDP deflator, in percent) | 1.2 | 2.8 | 3.1 | 4.8 | 4.9 | 4.1 | 3.6 | 3.0 | 3.0 | 3.0 | 3.0 | |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 1.4 | 1.5 | -5.1 | 6.0 | 6.2 | 0.9 | 2.6 | 7.1 | 6.3 | 1.4 | 4.5 | |
| Primary deficit | 2.7 | 1.6 | 0.8 | 0.8 | 0.5 | -0.2 | -0.6 | -1.0 | -1.2 | -1.3 | -1.3 | |

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; $\pi$ = growth rate of GDP deflator; g = real GDP growth rate; $\alpha$ = share of foreign-currency denominated debt; and $\varepsilon$ = 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.

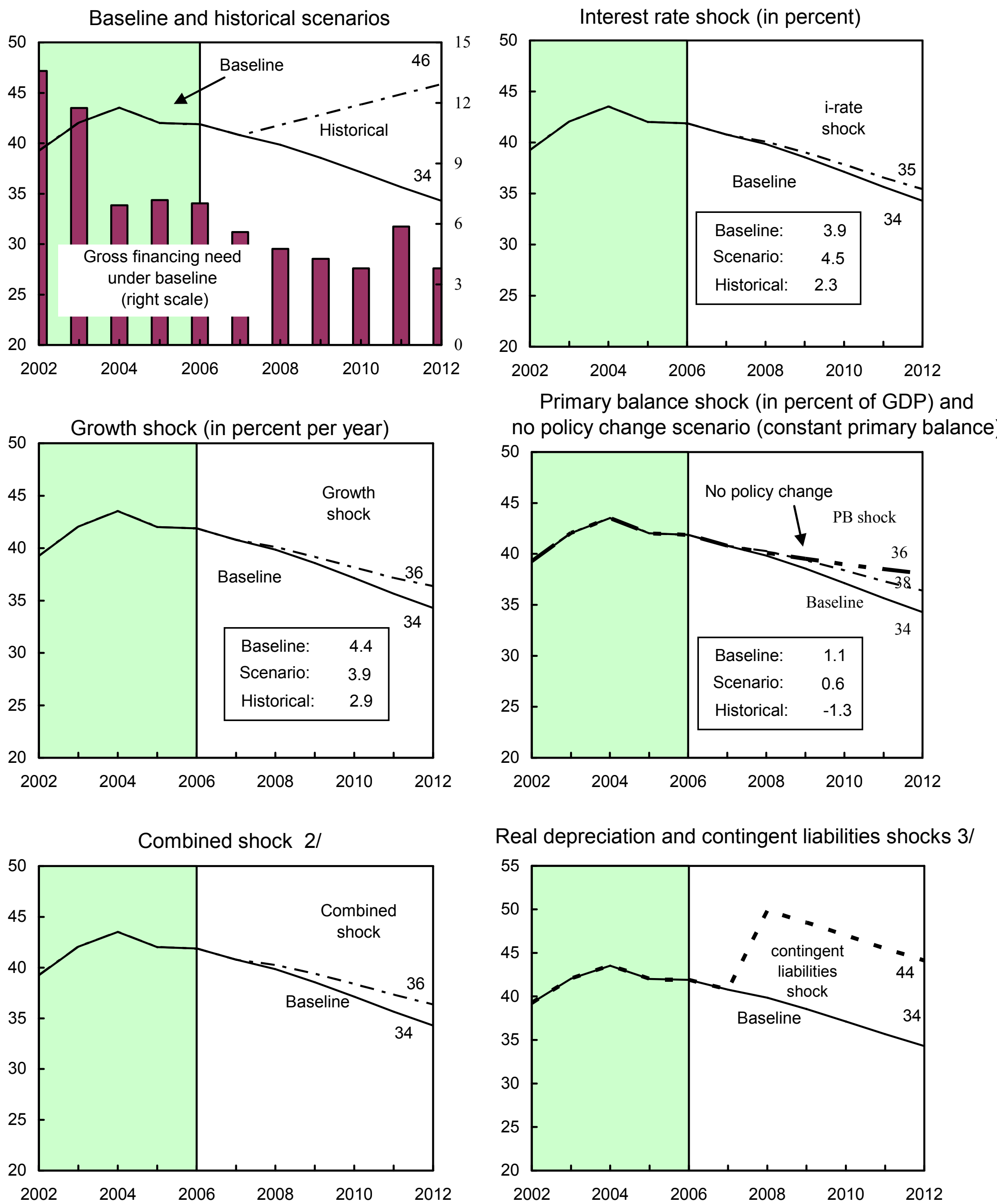
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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 8. El Salvador: Public Debt Sustainability: Bound Tests 1/
(Public 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 primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

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# IMF Executive Board Concludes 2007 Article IV Consultation with El Salvador

On November 19, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with El Salvador.[1]

**Background**

Real output growth has been maintained at around 4 percent (annually) since the first quarter of 2006, its fastest pace in a decade. The main drivers of growth on the demand side were remittance-financed consumption, investment, and nontraditional exports, while on the supply side agriculture, tourism, and services were the most dynamic sectors. Inflation peaked at 5½ percent in January 2007, due to a spike in food prices, and has moderated recently. The current account deficit, stable in 2006, has widened somewhat in the first half of 2007, reflecting robust domestic demand and still weak maquila exports. Higher foreign direct investment, partly related to the sale of the three largest banks, and government grants facilitated the financing of the larger current account deficit. The real effective exchange rate has remained broadly stable in the last year, as it had during the previous decade.

Public finances have continued to improve, in line with budget projections. The overall public sector deficit fell to less than 3 percent of GDP in 2006, and is projected to come down to 2¼ percent of GDP for 2007. Strong revenue performance in 2006 and thus far this year, due in part to improved tax administration and broadening the tax rolls, have contributed to these

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[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.

positive results. The projected improvement in 2007 also reflects a significant reduction in current expenditure, mainly on goods and services and current transfers. In parallel with the improvement in the fiscal deficit, public debt is projected to decline to 41 percent of GDP by the end of the year.

The banking sector experienced robust growth in deposits and domestic assets during the last 18 months. The rapid growth in deposits has boosted liquidity levels, and the banking systems profitability and overall asset quality have been maintained. Private sector credit has expanded to finance higher economic activity, particularly in response to increased consumption and investment demand. The increase in credit was mostly financed by deposit increases, partly related to the sales of the three largest banks. Meanwhile domestic interest rates remained stable reflecting improved liquidity in the banking system. During the period, the three largest banks were acquired by foreign financial groups, raising the participation of foreign banks in the financial system to 95 percent.

The authorities continue to focus on improving the business climate to enhance competitiveness in the dollarized economy. Recent modernization of land registration and simplification of customs procedures have aided El Salvador's advancement in world rankings in this area.

**Executive Board Assessment**

Directors commended the authorities for the increase in growth observed over the last two years, which owed much to the continued implementation of sound economic policies, the strong track record of structural reforms, and favorable global conditions. Directors encouraged the authorities to maintain the reform momentum during the next eighteen months and beyond, so as to boost El Salvador's growth potential, enhance the resiliency of the dollarized economy to external shocks, and further reduce poverty levels and achieve the Millennium Development Goals.

Directors noted that growth could moderate in 2008 on account of external developments, and to rebound in later years. They encouraged the authorities to be vigilant to short-term downside risks, particularly those stemming from a sharper-than-expected slowdown of growth in the United States, its main economic partner.

Directors agreed that the real effective exchange rate appears broadly in line with fundamentals and that the current account position is projected to be sustainable over the medium term. They also pointed to the good performance of non-traditional exports, including product and market diversification, which suggests that the export sector remains competitive.

Directors noted that fiscal policy is appropriately focused on placing the public debt firmly on a downward path and raising the tax/GDP ratio to permit higher social and infrastructure expenditures. They supported the authorities' medium-term fiscal target of improving the primary surplus to 1 percent of GDP by 2009. Directors saw scope for further measures in 2008 to secure these objectives, including additional efforts to improve tax administration, eliminate tax loopholes, and reform poorly targeted subsidies.

Directors saw merit in strengthening public financial management, including through the development of a medium-term expenditure framework and a tax expenditure budget, and expressed concerns about the efficacy of financing government expenditure through trusts and autonomous bodies. They encouraged the authorities to build broad support for the reform of the pension system to lower contingent fiscal liabilities.

Directors considered the recent foreign acquisition of the three largest domestic banks as an opportunity to press ahead with financial sector reforms, and to align the regulatory and supervisory frameworks with international best practice. They supported the authorities' intention to make further improvements in these areas, welcomed the recent passage of the law on securitization of financial assets, and urged expeditious passage of other pending financial legislation. Directors also called for fostering cross-border supervision and strengthening the central bank's balance sheet. They noted that financial soundness indicators point to a healthy situation in the financial sector, and recommended that the authorities remain vigilant to changes in global financial conditions and to the recent rapid increase in consumer credit extended by domestic banks.

Directors supported the authorities' strategy to improve competitiveness of the dollarized economy, which has been yielding positive results. They also considered that the focus on fighting crime, improving public infrastructure, enhancing labor market skills, and streamlining business regulations remains appropriate.

***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.

## El Salvador: Selected Economic and Social Indicators

| | 2003 | 2004 | 2005 | Est. 2006 | Proj. 2007 | Proj. 2008 |
|---|---|---|---|---|---|---|
| **Real economy (change in percent)** | | | | | | |
| Real GDP | 2.3 | 1.9 | 3.1 | 4.2 | 4.2 | 3.8 |
| Consumer prices (end of period) | 2.5 | 5.4 | 4.3 | 4.9 | 4.0 | 3.5 |
| National savings (percent of GDP) | 12.3 | 12.3 | 10.5 | 11.4 | 14.5 | 13.4 |
| Gross domestic investment (percent of GDP) | 17.0 | 16.2 | 15.7 | 16.1 | 20.4 | 19.0 |
| **Public finances (percent of GDP)** | | | | | | |
| Consolidated public sector deficit | -3.6 | -3.0 | -3.0 | -2.9 | -2.2 | -1.9 |
| Consolidated primary deficit | -1.6 | -0.8 | -0.8 | -0.5 | 0.2 | 0.6 |
| Public sector debt (percent of GDP, end of period) | 42.1 | 43.5 | 42.0 | 41.9 | 40.8 | 39.8 |
| *Of which* | | | | | | |
| Nonfinancial public sector | 40.3 | 40.5 | 39.7 | 39.6 | 38.7 | 37.9 |
| **Money and credit (end-year, percent change)** | | | | | | |
| Net domestic assets | 8.3 | 0.0 | 6.9 | 7.8 | 10.4 | 10.9 |
| Of which | | | | | | |
| Nonfinancial public sector | 4.2 | -2.6 | 1.4 | -1.5 | 2.3 | 0.1 |
| Private sector | 8.0 | 4.1 | 8.3 | 9.0 | 10.0 | 9.1 |
| Liabilities to private sector | 4.3 | 0.1 | 7.8 | 12.9 | 18.2 | 8.2 |
| **Interest rates (average)** | | | | | | |
| Deposit rate (six months) 1/ | 3.4 | 3.3 | 3.4 | 4.9 | 4.5 | … |
| Lending rate (more than one year) 1/ | 8.0 | 7.7 | 8.2 | 9.0 | 9.3 | … |
| **External sector** | | | | | | |
| Trade balance (percent of GDP) | -15.2 | -16.8 | -18.2 | -19.8 | -20.0 | -19.8 |
| Current account balance (percent of GDP) | -4.7 | -3.9 | -5.2 | -4.7 | -5.9 | -5.6 |
| | - | | | | - | |
| Change in net international reserves (millions of U.S. dollars, increase -) | 316.2 | 52.5 | 58.9 | -71.6 | 444.9 | -125.0 |
| Terms of trade | -1.0 | -2.5 | -1.8 | -2.3 | -0.8 | -1.5 |
| Real effective exchange rate (end of period) 1/ | -3.0 | -0.7 | 2.4 | -0.2 | -0.8 | … |
| **Net foreign assets of the banking system** | | | | | | |
| Millions of U.S. dollars | 1,044 | 1,050 | 1,104 | 1,459 | 2,079 | 1829.4 |
| Percent of deposits | 17.0 | 16.9 | 17.3 | 20.4 | 22.0 | 18.1 |

Sources: Central Reserve Bank of El Salvador; Ministry of Finance; and IMF staff estimates.
1/ For 2007, the REER shows the percentage change through July and interest rates are the average through July.

**Statement by Ramón Guzmán, Alternate Executive Director for El Salvador and Alvaro Umaña, Senior Advisor to Executive Director November 19, 2007**

On behalf of our authorities, we would like to thank staff for their policy advice and for the constructive discussions held within the framework of the Article IV consultation. El Salvador´s authorities broadly agree with the staff appraisal.

The economic and social performance of El Salvador during the last decade has been strong, supported by prudent policy management and a solid forward-looking strategy. The process of consolidating macroeconomic stability has advanced and structural reforms in a broad array of sectors have taken place, making the country one of the reform leaders in the region while at the same time improving the country's social conditions. Poverty reduction has been impressive. In 1991 poverty level was at 60% and dropped by almost half to 31% in 2006. The country is committed to continue reducing poverty and meet the Millennium Development Goals (MDG´s) with innovative social programs such as Red Solidaria (solidarity network), Health Fund and the 2021 Education Plan, among others.

El Salvador´s proven track record of structural reforms is paying off. The economy has strong fundamentals and the country presents a sound investment environment. In 2007, the economy is expected to grow at an annual rate above 4.5 percent, the highest rate in a decade, and my authorities expect it to remain around 5 percent in the next few years. This growth is the consequence of good governance, well-designed economic policies including negotiation and implementation of free trade agreements (with United Stated, Mexico and Chile, among others), improvement in the business environment and many other successful government programs. Economic policies in recent years have resulted in increases in the share of nontraditional exports, agriculture, tourism and services. Remittance-financed consumption and higher private and public investment levels in high-impact infrastructure projects have also played an important role. Inflation, which peaked at 5.5 percent at the beginning of 2007 and fell back to around 4 percent recently, remains the lowest in the Central American region and among the lowest in Latin America. Consequently, the real effective exchange rate has remained broadly stable, in line with its fundamentals.

El Salvador´s current account deficit remained stable at 5 percent of GDP and it is expected to fall over the next years due to continued improvements in the fiscal growth of remittances, higher foreign direct investment and grants from the Millennium Challenge Account.

Our authorities are aware of the external risks related to a slowdown in the United States economy and continued higher oil prices in the international markets. Several internal factors favor the continuous strong performance of the economy, including a record level of both, public and private sector investment levels, the strong expansion of the tourism sector, increase in agricultural production, and the strong economic growth in the neighboring countries. Several new large-scale and broad-impact infrastructure projects will begin construction in 2008 such as public hydroelectric plants, private electric plants fueled by coal and gas in the eastern part of El Salvador, the conclusion of the construction and concession of La Union Port, the implementation of the Millennium Challenge Account grant in the northern part of El Salvador, which covers nearly one third of the country, among others.

As a result of the government's commitment to fiscal discipline, the fiscal stance has improved in the last three years. Tax revenues to GDP have increased by 2.0 percentage points of GDP since 2004, which has permitted my authorities to expand public investment, to reduce the deficit from 4.4% of GDP in 2002 to 2.2% in 2007 and to reduce the total debt of the nonfinancial public sector from 40.6% of GDP in 2004 to 38.8% in 2007. For 2008, the budget presented to Congress envisages a further reduction of the deficit to 1.9 percent of GDP, a record level of public investment, and a further reduction of nonfinancial public sector debt to 37.7% of GD, without relying on any new financing from international markets.

In the future, the authorities will remain committed to fiscal consolidation while at the same time focusing on the poor. For that matter, the tax-to-GDP ratio will further increase in the next two years, placing debt on a firmly downward trend over the medium term. Further steps to enhance tax revenues and reduce evasion include enhancing auditing capacity, tightening control over large taxpayers, and improving further cross-checking systems and customs valuation procedures.

Private sector credit expanded by 9 percent in 2006 and 2007, participation of foreign banks in the financial system increased to 95 percent as a result of the sale of the three largest domestic banks. Our authorities are committed to accelerate financial sector reform, including the approval of new financial legislation. On this line, it is expected that this week Congress will approve a new securitization law.

The authorities will continue focusing on improving competitiveness through higher power generation and reduction of transportation costs to increase the economy resilience to external shocks, sustain economic growth and continue reducing poverty. Efforts will also continue to improve the business climate by reducing transaction costs and red tape and fighting crime and delinquency, and by enhancing the quality of the labor force and investing in people through higher allocations to education and health.