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El Salvador: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for El Salvador

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with El Salvador, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 11, 2008, with the officials of El Salvador on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 29, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of November 12, 2008, updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 12, 2008 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 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with El Salvador

Approved by David J. Robinson and Adnan Mazarei

October 29, 2008

Executive Summary

Discussions. The discussions were held in San Salvador during September 1–11. The mission met with Technical Secretary of the Presidency Eduardo Ayala Grimaldi, Minister of Finance William Hándal, Central Bank President Luz María Serpas de Portillo, other senior government officials, members of Congress, labor union representatives, the private sector, think tanks, and the economic teams of the leading presidential candidates.

Staff team. The mission comprised A. Schipke (head), M. Albino-War, R. Cubero, and J. Prat (all WHD). L. Cortavarría (MCM) and D. Desruelle joined the mission on September 8 and A. Umaña (OED) participated in the final discussions.

Context. As a result of sustained economic reforms over the last couple of years, El Salvador's macroeconomic fundamentals are relatively solid. Like in other Central American countries, however, economic growth has decelerated in recent months on the back of the U.S. slowdown and still high commodity prices. The global financial turmoil and, possibly, electoral uncertainty, have led to some tightening in domestic financial conditions.

Key policy recommendations. Policies need to focus on crisis preparedness and structural reforms.

- Financial contingency measures. Monitor banks' liquidity and their short- term borrowing closely, draw up concrete action plans to deal with stress in the banking system, and negotiate contingent credit lines.

- Short-term fiscal policy. Maintain fiscal restraint and seek a political agreement to access long-term financing from multilateral development banks (MDBs).

- Structural reforms. Further strengthen financial sector regulation and supervision and the sector's ability to confront shocks; reduce public debt to about 30 percent of GDP through tax revenue measures and cuts in nonpriority spending; improve the efficiency and targeting of subsidies; and implement a parametric reform of the pension system.

Authorities' views. There was agreement between the authorities and staff on the policy challenges and on most of the required measures.

2007 Surveillance Decision. The level of the real effective exchange rate is broadly in line with fundamentals and standard competitiveness indicators suggest that the export sector remains competitive.

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I. Recent Developments

1. **As a result of sustained economic reforms, El Salvador's macroeconomic fundamentals are relatively solid.** In 2007, the fiscal position improved, the public debt-to-GDP ratio declined, and economic growth reached its highest level in a decade.

2. **Like in other Central American countries, however, economic growth has decelerated in recent months on the back of the U.S. slowdown and still high commodity prices.** Growth in the monthly economic activity indicator has slowed to 3.6 percent in the 12 months to July. Demand has been squeezed by the increase in food and fuel prices. The impact of the U.S. slowdown has also started to show: remittance growth has fallen to 4.4 percent in the 12 months to August and, while export growth (particularly from coffee, maquila, and nontraditional sectors) has shown a marked upturn this year (accelerating to 16 percent y/y in August), it has started to falter in q/q terms. Moreover, imports have also grown fast (16 percent in the year to August), driven by oil prices. The external current account deficit widened to 5.5 percent of GDP in 2007, and reached 6 percent of 2008 GDP in the 12 months to June 2008**.**

3. **The rise in global commodity prices has also generated substantial inflationary pressures.** Headline inflation increased from 4.9 percent (y/y) in December 2007 to 8.7 percent in September. The main contributor was food inflation, which rose from 6.5 percent to 14.3 percent during the same period. Rising food prices are also considered to have been a major factor behind the 4 percentage point increase in the poverty rate in 2007 (to 35 percent), a development likely to have worsened in 2008. Several alternative measures of core inflation are trending up, suggesting some transmission of external price shocks to domestic prices, though there is no clear sign of overheating or cyclical demand pressures, in contrast to other countries in the region.

El Salvador: Consumer Price Inflation Measures

(In percent, last 12 months)

	2005	2006	2007	Sep. 2008
Headline Inflation	4.3	4.9	4.9	8.7
Core Inflation Measures				
Trimming method				
Monthly frequency				
Ten-percent window 1/	2.3	2.5	2.1	4.6
Annual frequency				
Ten-percent window 12-month	3.3	3.0	3.1	5.4
Noncore inflation measures				
Food	4.7	5.3	6.5	14.3
Nonfood	4.0	4.7	4.0	5.7

Sources: Central bank of El Salvador; and Fund staff estimates.
1/ Excludes items with inflation in the 10-percent tails of the distribution.

4. **Political uncertainty and polarization have intensified in the run-up to the 2009 elections.** Since the advent of democracy in the early 1990s, Salvadoran politics have remained polarized between the two main parties—the governing ARENA and the FMLN. Over the past few years, a split congress and a difficult political dialogue between the two parties have effectively prevented passage of legislation requiring a two-thirds majority, including on long-term domestic and external financing. With congressional and presidential elections scheduled for January and March 2009, respectively, the political focus has shifted to the elections. Even though the FMLN candidate has been ahead in the polls since the start of the campaign, most analysts expect the outcome of the presidential elections to be close.

5. **The global financial turmoil, and possibly, electoral uncertainty, have led to some tightening in domestic financial conditions.** The stock of bank deposits has stagnated relative to end-2007, while deposit rates have increased slightly. Interbank repo rates have also risen recently, reflecting tighter funding conditions, and banks have increased their external borrowing, in part to build up liquidity. Credit growth has slowed down. The central government has found it difficult to place its short-term debt instruments (especially those with maturities beyond the presidential election) in local markets, despite the relatively solid fiscal position. In mid-September, Standard & Poor's revised down the outlook on El Salvador's sovereign debt rating from stable to negative (the rating itself was maintained at BB+), based on the adverse impact of external shocks on growth, inflation, and the fiscal deficit, as well as political uncertainty. However, sovereign spreads (after rising considerably in July) have recently fluctuated in line with those of other Latin American emerging markets.

6. **The banking system—mainly foreign-owned—remains well-capitalized and liquid, and has so far shown resilience to the global financial turmoil.** Over the last two years, the three largest banks were acquired by foreign banks; about 95 percent of bank assets in El Salvador are now foreign owned. The banking system shows capital adequacy above the regulatory minima of 12 and is relatively liquid (with net liquid assets to short-term liabilities of 34.4 percent). Much of this liquidity is held at the central bank, which in turn invests it conservatively. However, with a rising share of consumer and housing loans in total credit, nonperforming loans (NPLs) have been on an upward trend since 2006. The impact of high commodity prices and slower remittance growth on borrowers' income may also have played a role. Profitability levels fell in 2007, mainly on account of acquisition-related restructuring costs, and remain subdued due to rising NPLs.

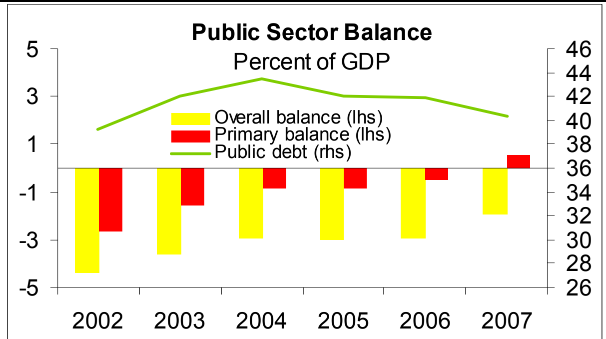
Selected Financial Soundness Indicators for the Banking Sector, 2003–08

	2003	2004	2005	2006	2007	2008 1/
Capital Adequacy						
Regulatory capital to risk-weighted assets	12.8	13.4	13.5	13.8	13.8	14.5
Asset quality and Provisioning						
NPLs to gross loans	2.8	2.4	2.0	1.9	2.1	2.7
Total provision to NPLs	129.8	132.3	126.7	116.4	120.0	104.3
Profitability						
Return over average assets	1.1	1.0	1.2	1.5	1.2	1.3
Return over average equity	11.5	10.9	11.8	14.6	11.3	12.0
Liquidity						
Net liquid assets to total short-term liabilities	35.7	36.1	33.5	32.3	34.0	34.4

Source: Superintendencia del Sistema Financiero
1/ Data for 2008 correspond to August 2008.

7. **The fiscal position improved substantially in 2007, but is being undermined in 2008 by the impact of high fuel prices on energy subsidies:**

- At 1.9 percent of GDP, the 2007 fiscal deficit was 0.3 percent of GDP better than the budget target, on account of continued strong revenue growth and some expenditure restraint. The 2007 primary balance, estimated at ½ percent of GDP, improved by 1 percent of GDP relative to 2006, leading to a further decline in public debt.



Source: Ministry of Finance of El Salvador.

- The public sector fiscal deficit for the seven months to July 2008 increased relative to the same period a year earlier, driven by higher spending on energy subsidies and government actions to mitigate the impact of food prices (see below). Strong revenue performance, particularly regarding income tax and VAT receipts, cuts in nonpriority spending, and some government measures to rationalize energy subsidies, have partly offset the deterioration in the operating surplus of public enterprises and the rapid increase in spending (see Box 1).

Public Sector Operations: January–July
(In million of dollars)

	2007	2008	Percent change 08/07
Revenues and grants	**2,162.3**	**2,330.2**	**7.8**
Current revenue	2,128.0	2,298.7	8.0
Of which			
Tax revenue	1,771.5	1,931.5	9.0
Operating surplus of public enterprises	61.3	56.4	-8.0
Expenditure	**2,287.4**	**2,536.5**	**10.9**
Current expenditure	1,963.6	2,191.5	11.6
Capital expenditure	324.2	345.2	6.4
Primary balance	**201.1**	**139.2**	**-30.8**
Overall balance	**-125.1**	**-206.3**	**64.9**

Sources: Central Reserve Bank; and Ministry of Finance.

8. **The government has actively responded to high commodity prices.** Key measures include expanding *Red Solidaria* (a well-targeted conditional cash transfer program), increasing allowances for a tax credit program for middle-income families, eliminating import tariffs on wheat and agricultural inputs, delivering seeds and fertilizers for agricultural production, and granting a selective increase in wages of low-income public servants, with an estimated impact of about 0.2 percent of GDP in 2008. The cost of these measures and of energy subsidies has been met mainly through expenditure cuts on nonpriority spending and continued tax administration improvements. Additional measures were introduced in July; namely, a tax amnesty (with an estimated one-off fiscal impact of about 0.15 percent of GDP this year); a new tax on incoming international phone calls (which would yield about 0.2 percent of GDP per year); and the gradual elimination, in three steps starting in August 2008 and finishing in October 2009, of the electricity subsidy for the corporate sector, expected to improve the operational surplus of the public electricity company (CEL) by 0.2 percent of GDP in 2009 and 0.4 percent of GDP per year thereafter.

Box 1. Energy Subsidies in El Salvador

Rising oil prices have led the cost of energy subsidies to almost double since end-2007 to an estimated 2½ percent of GDP in 2008.

Energy subsidies are funded mainly by profits of the state-owned electricity company (CEL) and the general budget. About half of the energy subsidies are associated with electricity consumption, one-third with liquid gas, and the rest with public transport:

- **Lack of adjustment of electricity tariffs has provided a subsidy to final consumers, funded by CEL.** The tariff is currently US$91 MWH, compared to a market price of US$141 MWH. Since half of the electricity generation is fuel-based, the profits of CEL have been quickly eroding with rising oil prices.
- **Basic residential electricity consumption is also subsidized by the central government.** For consumption below 99 KWH per month the central government's budget covers 70 percent of the electricity bill. This subsidy is relatively inexpensive.
- **An administered price for liquid gas (LPG) by the government is in place for residential consumers.** Though recently increased to US$0.491 per gallon, the market price is US$1.50 per gallon. Fund staff has estimated that only one-fifth of this subsidy goes to low-income households, and there are concerns about undue use of this subsidy by businesses and smuggling to neighboring countries.
- **Ceilings on tariffs for public transport are also established.** To cover the difference between operating costs and bus fares, the government grants a subsidy to bus owners, which was doubled in June 2008 to US$800 per bus and US$400 per microbus per month. To partially fund this increase, the government passed a new tax on incoming international phone calls.

Initially, the government committed to maintaining energy subsidies until the March 2009 elections, but their increasing cost prompted the adoption of offsetting measures.

- It increased the price of liquid gas by 23 percent last April, the first increase in 13 years.
- It announced in July that the electricity subsidy for the nonresidential sector would be gradually phased out by October 2009.

A comprehensive reform strategy for energy subsidies, however, is needed to improve their efficiency and targeting. Such a strategy should eliminate the residential electricity subsidy beyond the basic consumption threshold and improve the targeting of LPG and public transport subsidies. This could lead to savings of about 0.8 percent of GDP.

II. Short-Term Outlook and Risks

9. **Despite relatively solid macroeconomic fundamentals, the outlook for 2008–09 is clouded by a combination of external and domestic shocks.**

- **The external environment is likely to remain difficult.** Continued global financial turmoil is leading to tighter external financing conditions for banks and corporations[1], which could further constrain domestic investment and consumption. The continued U.S. slowdown projected throughout 2009 (and with serious downside risks in light of the worsening financial crisis), will negatively impact growth, given strong linkages between the two economies through exports, remittances, and financial flows.[2] Global fuel and basic grain prices are projected to stabilize above their 2007 average levels, resulting in a deterioration in the terms of trade. These shocks might lead to further increases in banks' NPLs, yet another channel for slowing credit and domestic economic activity.

- **On the domestic front, the main concern is political uncertainty,** which could trigger financial volatility (such as a slowdown in capital flows, deposit withdrawals, and an increase in interest rates) as the elections draw closer.[3]

10. **The near-term outlook will be marked by adjustment to these shocks.** In this officially dollarized economy, the balance of payments is self-stabilizing: if the supply of foreign currency falls, the adjustment will be borne through squeezed purchasing power and higher interest rates. Real GDP growth would slow down to about 3 percent in 2008 and 2.6 percent in 2009. While official dollarization serves as a strong nominal anchor for price expectations, inflation is projected to increase in 2008 on account of the shocks, before subsiding in 2009, as the impact of commodity prices dissipates.[4] The fiscal deficit—driven by higher spending on subsidies and wages—would rise to 2.3 percent of GDP in 2008, but improve slightly in 2009, reflecting the recent

Near-term Macroeconomic Outlook

(In percent of GDP, unless otherwise noted)

		Projections	
	2007	2008	2009
Real GDP growth (percent)	4.7	3.0	2.6
Inflation (percent, end period)	4.9	9.0	6.0
Overall public sector balance	-1.9	-2.3	-2.2
Public sector debt	40.8	40.5	40.4
External current account balance	-5.5	-6.1	-5.4
Total external debt	45.3	46.6	45.9

Source: Country authorities; and Fund staff estimates.

[1] Information provided by the authorities suggests that the direct exposure of the financial system to distressed foreign assets is limited.

[2] The elasticity of El Salvador's economic cycle with respect to the U.S. cycle is estimated to be close to one, with a lag of 2–3 quarters.

[3] In the months before the 2004 general elections, which were also tight but in which the left-wing party did not have a clear lead in the polls, there was a moderate decline in term deposits (a fall of 4 percent y/y in February 2004). This was generally attributed to electoral factors.

[4] Though there are no formal data on wage levels, public and private sector representatives, as well as independent analysts, confirmed that there are no signs of generalized wage pressures yet.

elimination of the electricity subsidy for the corporate sector. The widening of the current account deficit in 2008—financed by FDI inflows (likely to halve after their 2007 peak) and commercial banks' net foreign assets—would begin to reverse in 2009 as commodity prices stabilize and the public and private sectors adjust their savings accordingly**.**

11. **A key risk to the short-term outlook is a domestic liquidity crisis triggered by a deteriorating external environment and growing political uncertainty.** These shocks could hamper the public sector's ability to meet its short-term financing needs, which competes with banks for an increasingly tight pool of liquidity. The central government has to roll over or place a total of about US$250 million of debt (including from public trust funds) by end-2008. In the absence of legislative approval for long-term financing, the government has increased its reliance on short-term debt instruments (LETES). However, it could face significant difficulties in placing LETES at maturities that go beyond the presidential election. Political uncertainty coupled with the external financial turbulence could also lead to a sustained loss of bank deposits, a cut-off of external credit for banks, and systemic liquidity shortages. Given the prominent local presence of international financial institutions such as HSBC, Scotiabank, and Citibank, stress in a parent bank could also have an adverse impact on deposits or reduce the availability of external credit for the local subsidiaries.

III. External Stability and Medium-Term Outlook

12. **Under current policies, GDP growth would recover slowly to reach 4 percent and public debt would stabilize at about 40 percent of GDP through 2013.** The absence of further fiscal consolidation would erode growth via higher interest rates and lower productivity-enhancing spending. Based on the strong nominal anchor provided by official dollarization, inflation would gradually fall to about 3 percent by 2010. The current account deficit would narrow slowly, leading to a mild reduction in external debt. Given the absence of structural fiscal and financial reforms, the economy would be more vulnerable to negative shocks, the room for policy action would be more limited, and the risk of a financial crisis would be higher.

13. **In the baseline scenario, premised on the policy recommendations described in section IV, growth would reach 4½ percent and public debt decline to about 30 percent of GDP by 2013**.[5] On account of a subdued domestic demand, but stronger net exports than in recent years, growth is projected to converge to its potential rate of 4½ percent. This rate is underpinned by structural reforms adopted during the last decade, further integration of the Salvadoran economy into the global economy, continued output diversification, and an increase in public spending on infrastructure. Inflation is expected to fall to 3 percent, as the inflationary impact of commodity prices subsides and domestic demand adjusts to restore external equilibrium.[6] The public sector primary surplus would gradually improve to

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[5] The baseline scenario encompasses policy actions that are deemed to be feasible and realistic.

[6] The projected inflation path would be the same under current policies, as the inflationary pressure exerted by a higher fiscal deficit would be offset, *ceteris paribus*, by a compression in private demand through higher interest rates. Also, the complete elimination of energy subsidies under the baseline may have a one-off effect on prices that would be absent in the current policies scenario.

1.9 percent of GDP by 2013 and public debt would fall to about 30 percent of GDP, mostly driven by revenue efforts.[7] [8]

Key Macroeconomic Indicators under Baseline Scenario

(In percent of GDP, unless otherwise noted)

			Projections					
	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP growth (percent)	4.2	4.7	3.0	2.6	3.0	3.5	4.0	4.5
Inflation (percent, end period)	4.9	4.9	9.0	6.0	4.0	3.0	3.0	3.0
Overall public sector balance	-2.9	-1.9	-2.3	-2.2	-1.3	-1.1	-0.5	-0.5
Public sector primary balance	-0.5	0.5	0.0	0.2	1.1	1.4	1.9	1.9
Primary balance excluding grants	-0.7	0.2	-0.4	-0.3	0.4	1.0	1.5	1.6
Public sector debt	41.9	40.8	40.5	40.4	38.8	37.1	34.9	32.7
External current account balance	-3.6	-5.5	-6.1	-5.4	-5.3	-4.8	-4.3	-4.0
Total external debt	51.7	45.3	46.6	45.9	44.9	43.9	42.3	40.6

Source: Fund staff estimates, based on data from country authorities.

[7] Sensitivity analyses suggest that, were key variables to remain at their historical average—GDP growth at 2.9 percent, real interest rates at 2.9 percent, and primary deficit at 1.2 percent—public sector debt would increase to 44 percent by the end of the projection period.

[8] It is assumed that external financing from multilateral development banks would become available through a political agreement between the two main parties.

GDP Contributions by Demand Component

(In percent of GDP unless otherwise stated)

	2006	2007	2008	2009	2010	2011	2012	2013
Real growth	**4.2**	**4.7**	**3.0**	**2.6**	**3.0**	**3.5**	**4.0**	**4.5**
Consumption	4.8	5.7	1.4	2.1	0.5	1.1	1.3	2.4
Private consumption	4.6	5.6	0.2	1.8	0.4	0.9	1.2	2.0
Government consumption	0.2	0.1	1.2	0.3	0.1	0.2	0.1	0.4
Investment	2.1	1.4	-3.1	-1.3	1.2	1.0	1.7	1.5
Private investment	2.1	1.5	-3.8	-1.3	0.7	1.1	1.6	1.5
Government investment	0.0	-0.1	0.7	0.0	0.5	-0.1	0.1	0.0
Net exports	-2.0	-2.5	4.7	1.8	1.3	1.4	1.0	0.6
Exports	3.4	2.2	3.9	0.5	2.0	2.4	2.1	1.9
Imports	-5.4	4.7	-0.8	-1.3	0.7	1.0	1.1	1.3

Sources: Salvadoran authorities; and Fund staff estimates.

14. **In the absence of a crisis scenario, the medium-term external position of El Salvador remains sustainable.**

- **A continued strengthening of public and private savings will lead to a gradual narrowing of the current account deficit to about 4 percent of GDP by 2013.** This level is, according to staff research, broadly in line with the underlying deficit consistent with structural current account determinants. This would allow total external debt to fall to 41 percent in 2013.[9]

[9] The debt-stabilizing noninterest current account deficit is estimated to be about 3 percent of GDP (with net interest payments averaging about 2–2½ percent of GDP).

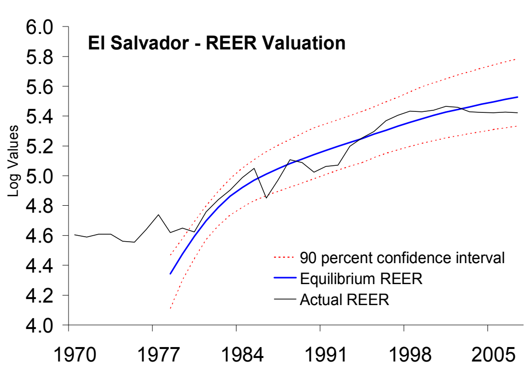
Savings-Investment Balance under Baseline Scenario

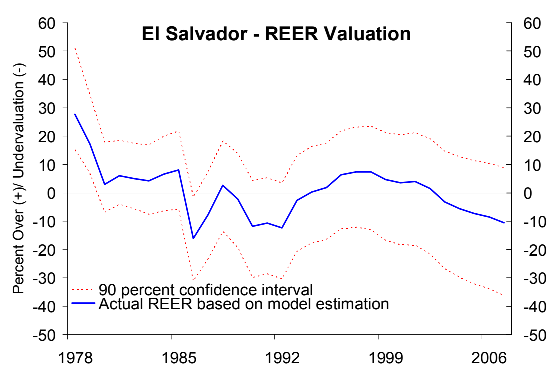
(In percent of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP growth	**4.2**	**4.7**	**3.0**	**2.6**	**3.0**	**3.5**	**4.0**	**4.5**
Gross domestic investment	**16.1**	**16.3**	**16.2**	**14.6**	**15.3**	**15.8**	**16.8**	**17.6**
Public sector	2.2	2.0	2.6	2.6	3.1	2.9	2.9	2.8
Private sector	14.0	14.3	13.6	11.9	12.2	12.8	13.9	14.7
National savings	**12.6**	**10.8**	**10.1**	**9.2**	**10.0**	**11.0**	**12.5**	**13.5**
Public sector	0.0	0.5	0.1	0.1	1.2	1.7	2.3	2.3
Private sector	12.6	10.3	10.1	9.1	8.8	9.3	10.3	11.3
External savings	**3.6**	**5.5**	**6.1**	**5.4**	**5.3**	**4.8**	**4.3**	**4.0**

Sources: Salvadoran authorities and Fund staff estimates.

- **The real effective exchange rate (REER) appears broadly in line with fundamentals**. [10] The REER depreciated from early 2007 to the first quarter of 2008, as the continued weakening of the U.S. dollar vis-à-vis the weighted average of El Salvador's trading partners' currencies offset the increase in local inflation during the period (though this trend reversed more recently given a stronger dollar and higher domestic inflation) (see Box 2). Despite this REER depreciation, higher GDP growth and strong remittance and FDI inflows more than offset a worsening of the terms of trade in 2007, leading to both an appreciation of the equilibrium REER and a widening of the current account deficit.



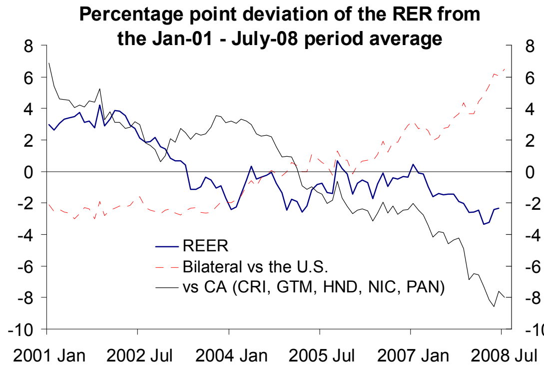


- **Standard competitiveness indicators suggest that the export sector remains competitive** (see Box 2). The solid export performance in recent months confirms that the sector is well positioned to contribute to the external adjustment process.

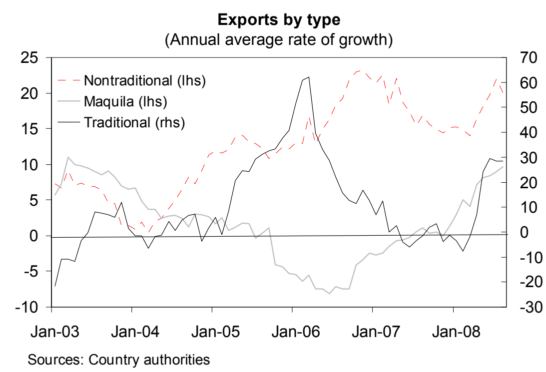
[10] To assess the REER level, staff used a fundamental equilibrium approach, linking the actual path of the REER with the level predicted by the trend values of the fundamentals.

Box 2. External Competitiveness

Dollar weakness favored price competitiveness up to the first quarter of 2008, but the spike in local inflation has reversed the trend since. The pick-up in domestic inflation in El Salvador triggered a real appreciation vis-à-vis the U.S. However, the fall of the dollar vis-à-vis the currencies of other trading partners pushed down the nominal and real effective exchange rates up to March 2008. The REER has appreciated thereafter on the back of continued high local inflation, but it is still below its level 12 months before.



Export performance has been very strong in 2008. Several years of modest export growth, mainly as a result of the rise of China and a decline in the maquila sector, led to a loss of share in the U.S. and world markets. However, maquila export growth bottomed out in 2006 and reached positive territory by the end of last year. Traditional (mainly coffee) and nontraditional exports have also had a strong rebound this year. As a result, exports have been growing at over 16 percent in the year to August.



El Salvador compares well with Central American countries in competitiveness rankings, but continues to be affected by crime. It ranks second in the region in the World Bank's *Doing Business Report*, which focuses on regulatory costs for starting and operating a business, and third in the *Global Competitiveness Index*, which considers a broader set of factors. The country does well in infrastructure, goods and factors market efficiency, and macro stability, but is hindered by low human capital (health and education), poor technological sophistication and innovation, and high and rising crime.

Competitiveness Rankings

	Ease of Doing Business, 2008		Global Comp. Index 2007-08	
	2006	2007	2006	2007
Costa Rica	105	115	68	63
Dominican Republic	117	99	93	96
El Salvador	**71**	**69**	**53**	**67**
Guatemala	118	114	91	87
Honduras	111	121	90	83
Nicaragua	67	93	101	111
Panama	81	65	60	59

Sources: World Bank, Doing Business Report 2007–08; and World Economic Forum, Global Competitiveness Report 2007–08.

15. **The main risks to the medium-term outlook are associated with the global financial turmoil as well as with the level of commitment of the new administration to macro stability and structural reforms.** If the global financial turmoil were to persist beyond 2009, leading the global growth slowdown to be more protracted than currently projected, the Salvadoran economic performance would be affected through exports, remittances, and the flows of foreign finance. Risks could also arise from a major change in policies by the next administration or lower-than-projected remittance inflows (which account for about 18 percent of GDP).

IV. Policy Discussions

16. **Discussions focused on fiscal and financial policies to prepare for potential risks associated with the external shocks and election-related uncertainty, and address key medium-term macroeconomic and social challenges.** In particular, the discussions centered on:

- Government policies in the run-up to the 2009 elections to smooth adjustments to external shocks and political uncertainty.
- The roadmap of policies and reforms that the next administration would need to adopt to enhance the resilience of the macroeconomy and the financial sector to shocks, and create the conditions for higher growth and a faster reduction in poverty.

A. Short-Term Policies to Address Global Shocks and Political Uncertainty

17. **For the short term, the focus of discussions was on policies to support macro stability and contain potential risks from external and domestic shocks:**

- **Design contingency measures to reduce risks in the run-up to the elections:**

  ► **Enhance financial sector crisis preparedness.** In line with previous staff recommendations, the authorities introduced in July a temporary 3 percent liquid asset requirement on banks, to buttress liquidity levels ahead of the elections. They are also negotiating external credit lines for the central bank, and are drawing up action plans on how to deal with situations of stress in the banking system. There was agreement on the need to closely monitor banks (e.g., their short-term borrowing, deposits, and liquidity levels) and cooperate more closely with their home supervisors.

  ► **Improve the access to, and the profile of, budget financing.** There was agreement on the need to allow for higher interest rates on short-term debt instruments (LETES) to lengthen their maturity beyond the elections and the changeover in government. Staff noted that the reliance on LETES has worsened the term structure of public debt and increased vulnerabilities. There was agreement on the urgent need to reach a political agreement with the opposition to restore government's access to long-term finance (which requires approval by a 2/3 majority in congress), including financing by multilateral development banks (MDBs). The government is working to reach such an agreement, and has secured a credit line with a regional development bank (CABEI).

- **Maintain fiscal restraint.** The mission commended the authorities for the strong fiscal performance in 2007, and agreed with them on the need to maintain fiscal restraint, while expanding social programs to mitigate the impact of high commodity prices on the poor. Maintaining fiscal restraint is particularly important in light of the tightness of liquidity.[11] Therefore, staff recommended that increases in well-targeted social programs (such as *Red Solidaria*) be accommodated within a public sector deficit target of 2.3 percent of GDP for 2008.[12] This would require further improvements in tax administration and cutting nonpriority primary expenditure, including through enhanced controls of energy subsidies, specifically in the cases of gas and public transport. To reduce the risk of a wage-price spiral, the mission noted the need to limit public wage increases. There was agreement that the 2009 budget should target a deficit of 2.2 percent of GDP: higher spending in 2009 due to the impact of increases in public wages and the transportation subsidy would be offset by the newly adopted tax on incoming international calls, grants from the Millennium Challenge Corporation, and savings that will kick in from the recent reform of electricity subsidies.

18. **The authorities expressed their willingness to continue adopting administrative measures ahead of the elections**. These would include measures on the fiscal revenue and spending sides to provide additional room for expanding well-targeted programs and reduce the cost of subsidy abuse.[13]

B. Medium-Term Policies to Enhance the Economy's Resilience and Growth Potential

19. **The key policy challenges for El Salvador over the medium term are:** to build up the economy's resilience to shocks and create the conditions for counter-cyclical policies; and to boost the trend growth rate of real GDP. Staff suggested, and the authorities agreed, that the medium-term issues be discussed in a seminar with the new economic team and the IFIs following the elections.

Fiscal policy

20. **There was agreement that medium-term fiscal policy be geared toward creating the fiscal space necessary to respond to shocks and address priority spending needs.** A stronger medium-term fiscal position will increase the ability of fiscal policy (the main policy lever under official dollarization) to react in cases of external or domestic shocks (including

[11] While in principle the solid fiscal position should allow for some fiscal easing, particularly in case of a sharper-than-expected growth slowdown, the lack of financing would place a tight limit on the deficit. Additionally, allowing the deficit to expand might exacerbate liquidity shortages for banks.

[12] Due to slower projected growth, the baseline deficit projection is slightly higher than the one discussed during the mission of 2.2 percent of GDP.

[13] The authorities have requested Fund technical assistance to improve the targeting of energy subsidies.

natural disasters) and adopt counter-cyclical policies. It was agreed that continued fiscal consolidation should be achieved while enabling higher spending on well-targeted social programs and productivity-enhancing public infrastructure.

21. **A fiscal strategy anchored on reducing public debt to about 30 percent of GDP by 2013 would help achieve these objectives.**[14] The strategy would imply an improvement of about 1¾ percent of GDP in the public sector primary surplus between 2009 and 2013.[15] Much of this improvement (1 percent of GDP) would be achieved through tax revenue measures, and the rest through reductions in spending.

22. **To ensure the success of this strategy, staff recommended:**

- **Strengthening tax policy and administration**, with the aim of raising the tax-to-GDP ratio by 1 percent of GDP to 15 percent by 2013. This would require additional efforts to improve the administration's auditing capacity, cross-checking information systems and customs valuation procedures. It may also require a streamlining of tax incentives and, possibly, an increase in the VAT rate.[16] The authorities requested Fund TA to assess the potential yield of measures other than raising tax rates.

- **Improving the efficiency and targeting of public spending.** Eliminating the electricity subsidy for the nonresidential sector should yield about 0.4 percent of GDP per year. To build up on this achievement, staff recommended to (i) limit the electricity subsidy to low-income groups (which would save a further 0.2 percent of GDP per year); and (ii) improve the targeting and the pricing of public transport and gas subsidies, with an estimated yield of 0.6 percent of GDP per year. The government could redirect these savings toward well-targeted social programs (0.4 percent of GDP) and public investment (0.2 percent of GDP), while the public electricity company (CEL) would also be able to expand its investment program (0.3 percent of GDP).

- **Reducing other current spending by about ½ percent of GDP by 2013**, mainly through restraint on wages and purchases of goods and services (0.5 percent of GDP) and the envisaged pension reform (0.1 percent of GDP), discussed below.[17]

- **Further reforming the pension system.** Staff stressed the need for further parametric reforms to the pension system (such as reducing replacement rates and increasing the retirement age) with a view to reducing the still-high transition costs (from the pay-as-

[14] For emerging markets, a range between 25–50 percent of GDP is usually deemed as reasonable.

[15] Grants are expected to increase moderately during the projection period, reflecting financial assistance totaling about 2.3 percent of GDP from the Millennium Challenge Corporation.

[16] An increase of 1 percentage point in the VAT rate would yield about ½ percent of GDP.

[17] Specific measures to support cuts in nonpension current spending would be identified in the context of the Public Expenditure Review to be prepared jointly by the WB and the IDB, expected to be completed in 2009.

- you-go system to privately managed individual accounts) and minimizing contingent liabilities.[18] The authorities are opposed to implementing a parametric pension reform.

Medium-term Fiscal Framework under Baseline Scenario

(In percent of GDP)

			Proj. 1/					
	2006	2007	2008	2009	2010	2011	2012	2013
Revenues and grants	**17.2**	**17.1**	**17.5**	**17.7**	**18.6**	**18.6**	**18.7**	**18.7**
Tax revenue	13.3	13.4	14.1	14.1	14.5	14.9	15.1	15.1
Nontax revenue	3.0	2.9	2.8	2.8	2.7	2.7	2.7	2.7
Operating surplus of the public enterprises	0.6	0.5	0.2	0.3	0.6	0.6	0.7	0.6
Official grants	0.2	0.3	0.5	0.5	0.8	0.3	0.3	0.3
Expenditure	**20.1**	**19.0**	**19.8**	**19.9**	**20.0**	**19.6**	**19.3**	**19.2**
Current expenditure	17.0	16.3	17.0	17.1	16.7	16.5	16.2	16.1
Of which nonpension current transfers	1.8	1.7	2.7	2.7	2.5	2.5	2.5	2.5
Capital expenditure	3.1	2.8	2.8	2.8	3.3	3.1	3.1	3.0
Primary balance excluding grants	**-0.7**	**0.2**	**-0.4**	**-0.3**	**0.4**	**1.0**	**1.6**	**1.6**
Primary balance	**-0.5**	**0.5**	**0.0**	**0.2**	**1.1**	**1.4**	**1.9**	**1.9**
Overall balance	**-2.9**	**-1.9**	**-2.3**	**-2.2**	**-1.3**	**-1.1**	**-0.5**	**-0.5**

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

Financial sector

23. **The authorities and staff agreed that the internationalization of the banking system entails benefits as well as challenges for macro-financial stability.** The increased presence of large international banks should help deepen financial intermediation, introduce superior risk management and corporate governance practices, and provide easier access to international capital markets. However, it also exposes the local economy to events from abroad, could introduce more volatility in capital inflows, and poses a challenge for domestic supervision.

24. **The mission welcomed the financial sector reforms undertaken since the last Article IV Consultation.** In particular, it noted the internal restructuring of the financial system superintendency, intended to underpin the move toward risk-based supervision; the ongoing contacts with the home supervisors of foreign-owned banks; and the passage of a bill that provides a legal framework for the securitization of financial assets. On this latter issue, staff recommended strict regulations to prevent asset originators from fully passing on credit risks to third parties.

25. **There was consensus on the need to implement key structural reforms in the** financial **sector.** These include: (i) passage of the bill to strengthen financial supervision; (ii) strengthening the central bank's liquidity management and lender-of-last-resort functions, including through a recapitalization by the treasury, a reform enabling it to pool commercial

[18] 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 (2007).

bank reserves to transfer liquidity to banks in distress (at present, an individual bank can only access its own reserves); (iii) bolstering the deposit insurance fund to 5 percent of total deposits (from the current 1 percent) by increasing the premium paid by banks; and (iv) approving the existing bill to enhance the legal basis for mutual funds.

V. Staff Appraisal

26. **Economic fundamentals are solid, but the economy is entering a downturn and there are significant risks to the near-term outlook**. As a result of sustained economic reforms over the last few years, the fiscal position improved, the public debt-to-GDP ratio declined, and, in 2007, economic growth reached its highest level in a decade. However, the current turmoil in world financial markets, a global growth slowdown, and electoral uncertainty entail considerable risks to the outlook.

27. **Against the background of these developments, crisis preparedness and contingency measures are paramount.** In the financial sector, these include monitoring banks' liquidity and their short-term borrowing closely, drawing up concrete action plans to deal with stress in the banking system, and negotiating contingent credit lines. Staff welcomes the steps the authorities have already taken, including the introduction of a temporary 3 percent liquid asset requirement on banks, but continued efforts are necessary. In the public sector, the authorities should allow for higher interest rates to lengthen the maturity of short-term debt beyond the election and seek a political agreement to access long-term financing from MDB's.

28. **Faced with increased risks, the authorities' main challenge is to maintain macroeconomic stability.** A critical component is the need to exercise fiscal restraint. Staff recommends a public sector deficit target of 2.3 percent of GDP in 2008; increases in well-targeted social programs should be accommodated within this envelope. Also, staff welcomes the authorities' 2009 budget deficit target of 2.2 percent of GDP, which reflects increases in public wages and transportation subsidies as well as the impact of the recent reform of electricity subsidies and a newly adopted tax on international calls.

29. **The authorities and staff agree on the need to move structural reforms in the financial sector forward.** These include passage of the bill to strengthen financial supervision, improvements in the central bank's liquidity and its ability to act as lender-of-last-resort, bolstering the deposit insurance fund to 5 percent of total deposits, and passage of a bill to enhance the legal basis for mutual funds.

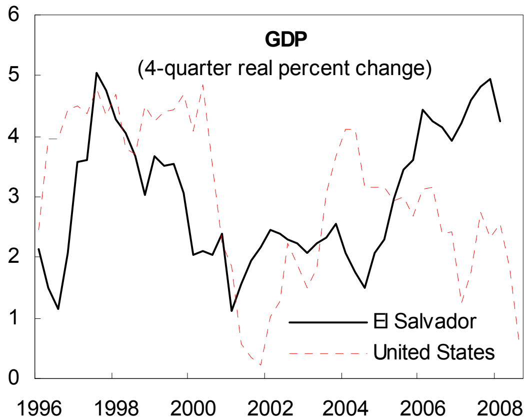
30. **In the medium term, the authorities need to continue reforms aimed at enhancing the economy's resilience and growth potential.** Priorities include: reducing public debt to about 30 percent of GDP through tax revenue measures and cuts in nonpriority spending, improving the efficiency and targeting of subsidies, and implementing a parametric reform of the pension system.

31. **Staff analysis indicates that the REER is broadly in line with fundamentals.** Solid export performance in 2008 and standard competitiveness indicators suggest that the export sector remains competitive.

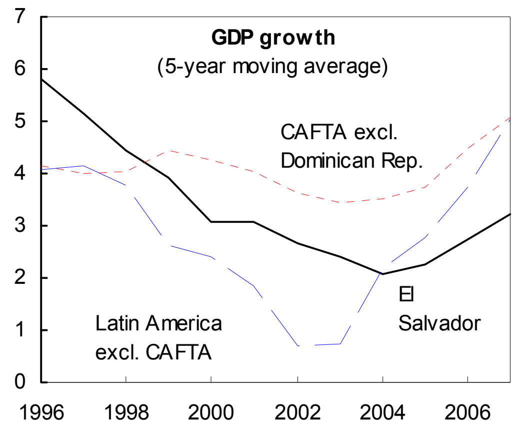
32. **It is proposed that the next Article IV consultation be held on the standard 12-month cycle.**

Figure 1. El Salvador: Real Sector

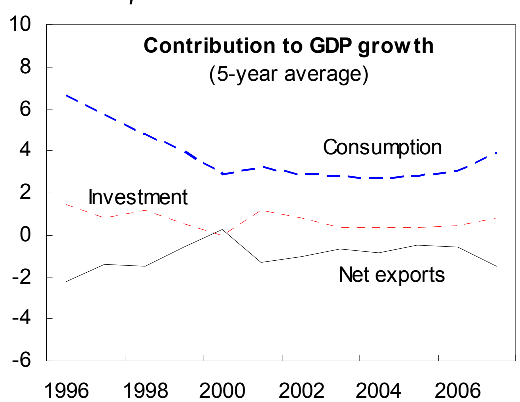
Despite global shocks, growth performance has remained favorable ...



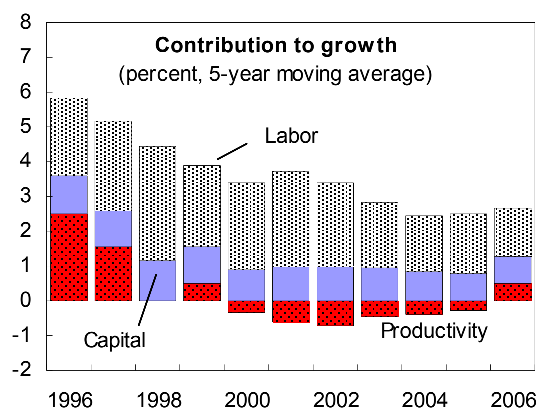
...but lags still behind that of regional neighbors



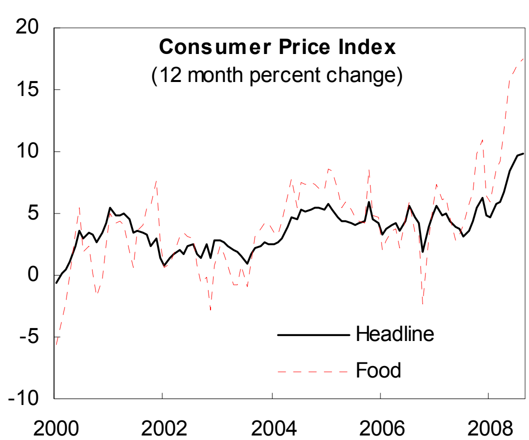
Growth has been mainly driven by consumption.



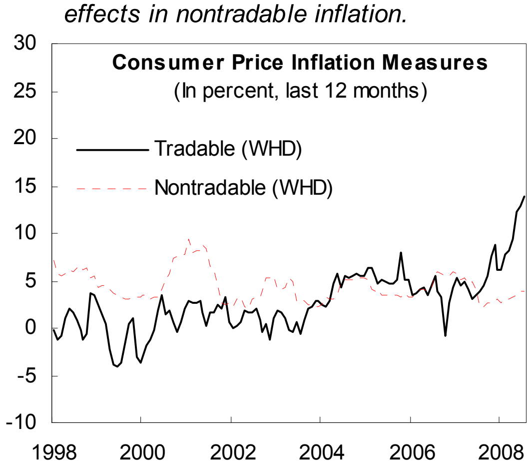
...and an increase in productivity.



Inflation has increased sharply on account of higher food prices...

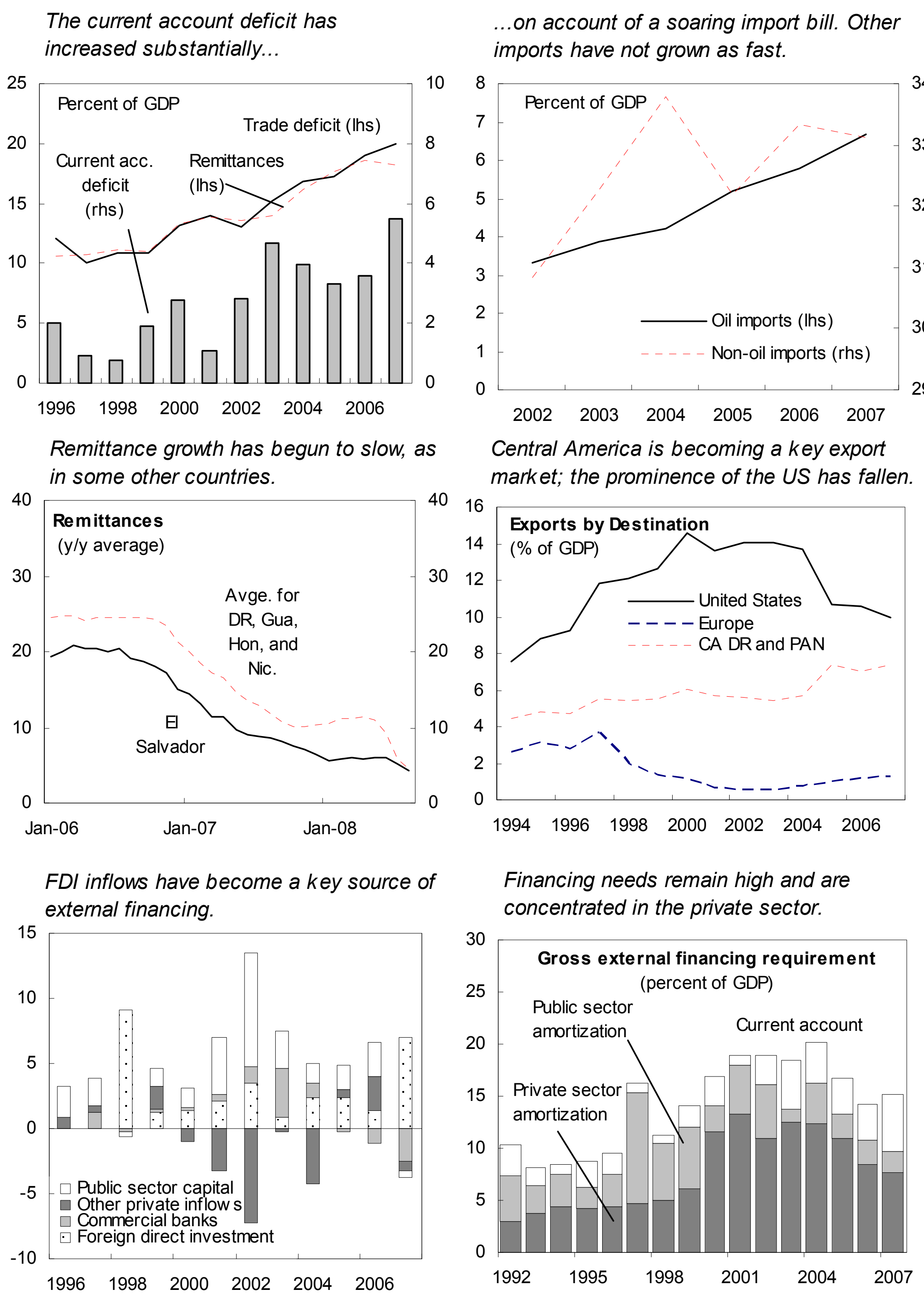


...without evidence yet of second round effects in nontradable inflation.



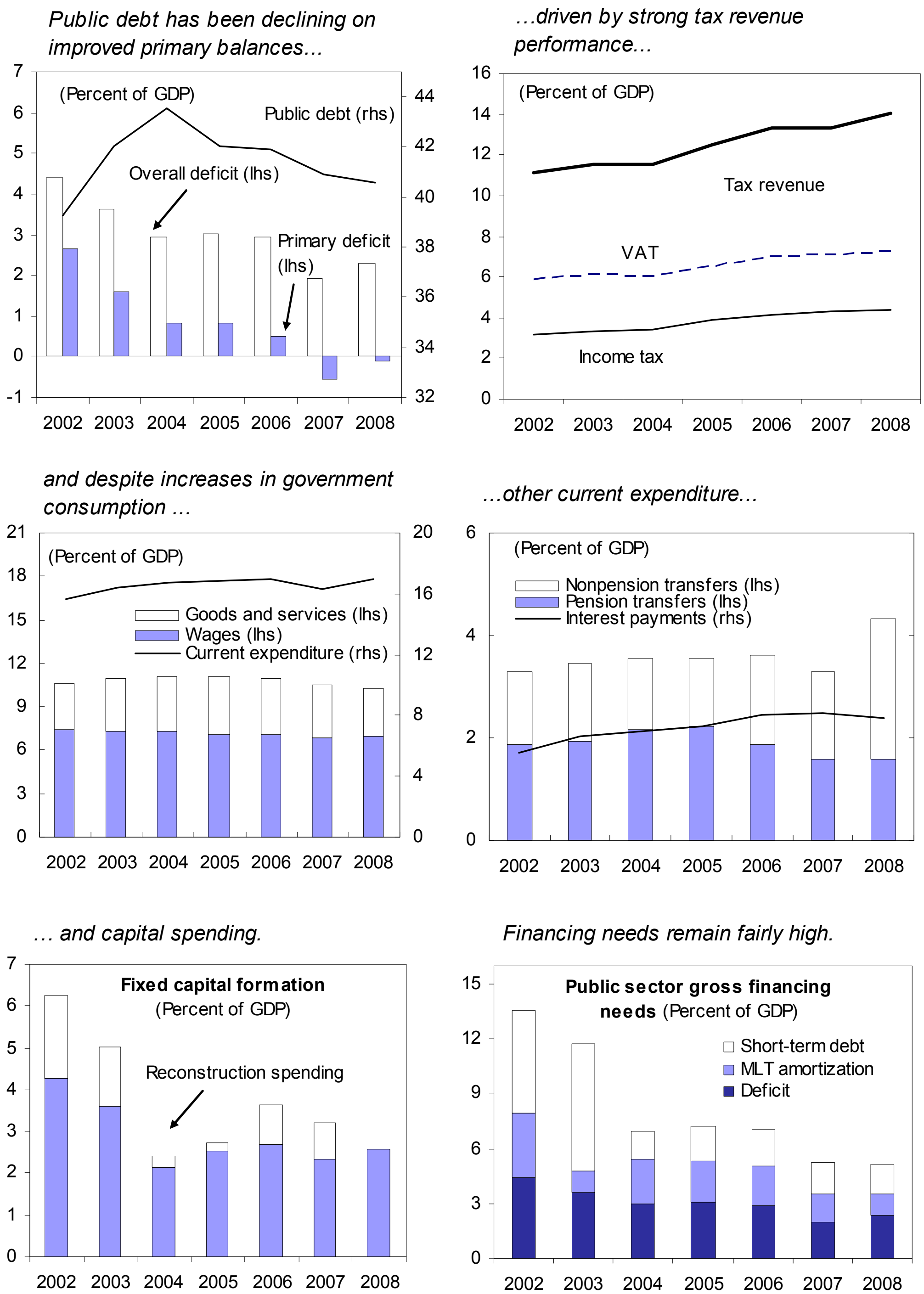
Sources: Central Bank of El Salvador; International Financial Statistics; and Fund staff estimates.

Figure 2. El Salvador: External Sector



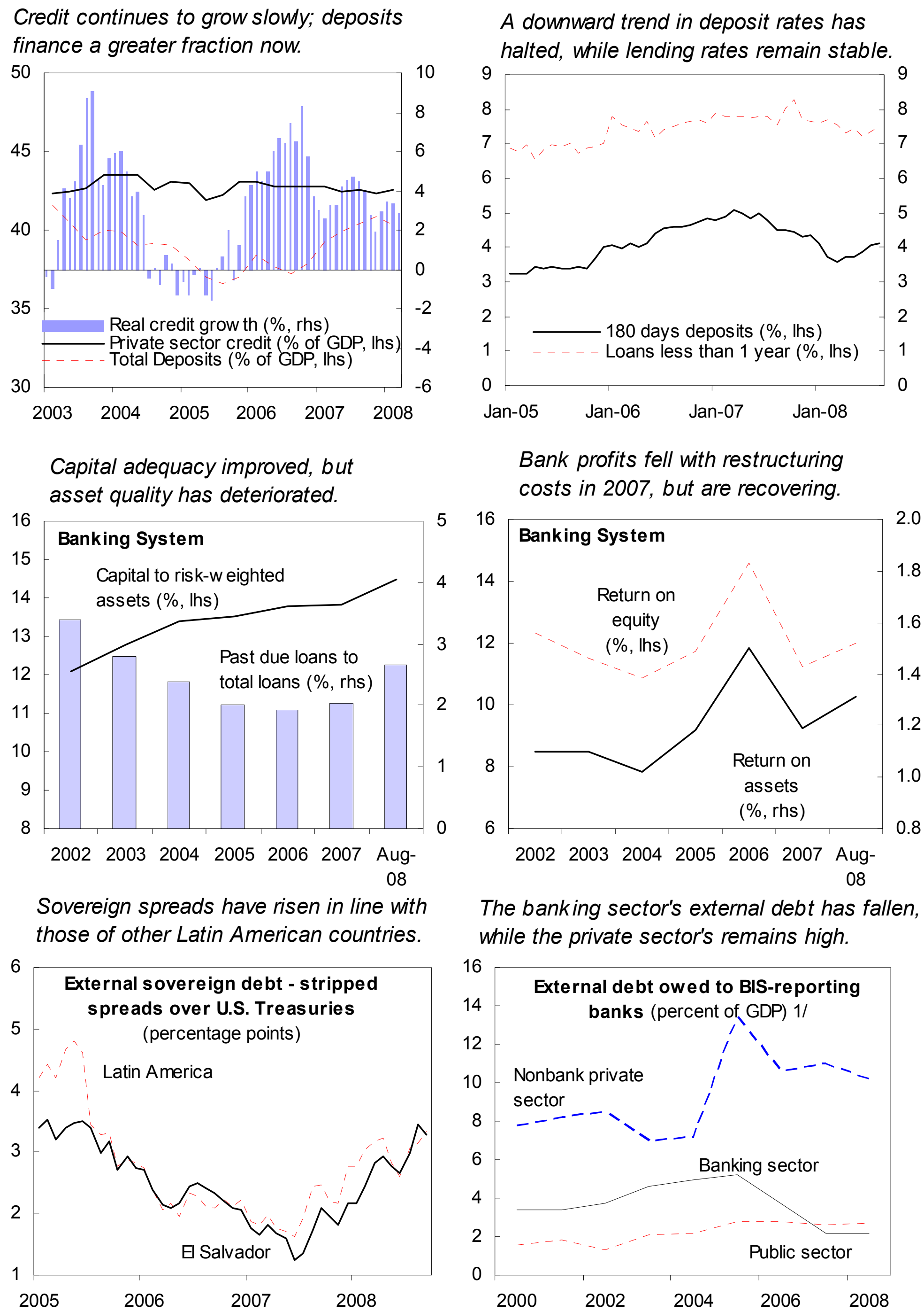
Sources: Central Bank of El Salvador; International Financial Statistics; J.P. Morgan; Bank for International Settlements; and Fund staff estimates.

Figure 3. El Salvador: Fiscal Sector



Sources: Salvadoran authorities; and Fund staff calculations.

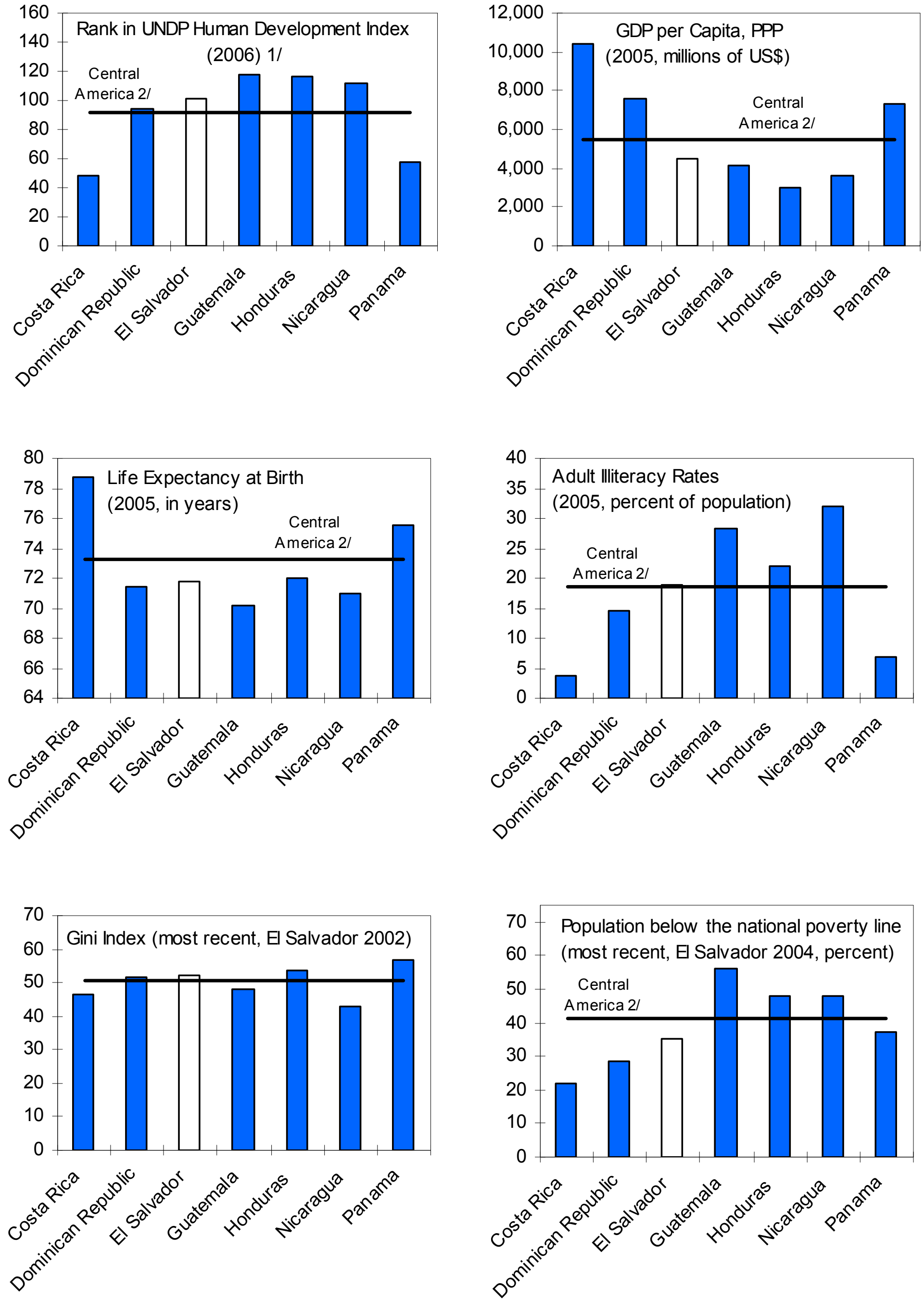
Figure 4. El Salvador: Financial Sector Developments



Sources: Salvadoran authorities; and Fund staff calculations.
1/ Final datapoint is for March 2008.

Figure 5. El Salvador: Social Indicators

Social indicators for El Salvador hover broadly around Central American averages...



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	2006	2007	Proj. 2008
	(Annual percent change, unless otherwise stated)						
Income and prices							
Real GDP	2.3	2.3	1.9	3.1	4.2	4.7	3.0
Unemployment rate	6.2	6.9	6.8	7.8	5.7	5.2	…
Consumer prices (end of period, e.o.p.)	2.8	2.5	5.4	4.3	4.9	4.9	9.0
External sector							
Export f.o.b. volume (including maquila sector)	3.3	-1.4	1.0	-2.0	6.0	3.0	8.4
Import f.o.b. volume (including maquila sector)	-0.6	4.3	2.6	-0.8	8.6	5.7	0.2
Terms of trade	-0.7	-0.8	-2.4	-1.9	-2.3	-0.9	-6.5
Real effective exchange rate (e.o.p., + appreciation)	-1.4	-3.0	-0.7	2.4	-0.2	-0.8	…
External sovereign bond (average spread, basis points) 1	325	386	348	298	209	169	412
	(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	42.3	40.8
Broad money	44.5	43.1	42.2	41.0	42.2	45.6	40.6
Interest rate (annual, time deposits, e.o.p.) 2/	3.4	3.4	3.3	3.4	4.9	4.4	4.1
External sector							
Current account balance	-2.8	-4.7	-4.0	-3.3	-3.6	-5.5	-6.1
Trade balance	-13.0	-15.2	-16.8	-17.2	-19.0	-20.0	-20.3
Exports (f.o.b. including *maquila*)	21.1	21.0	21.1	20.2	20.2	19.8	20.5
Imports (f.o.b. including *maquila*)	34.1	36.1	38.0	37.4	39.1	39.8	40.8
Services and income (net)	-3.9	-3.5	-3.3	-3.9	-3.3	-4.0	-3.5
Transfers (net)	14.0	14.0	16.1	17.7	18.5	18.4	17.4
Public finances							
Combined public sector balance	-4.4	-3.6	-3.0	-3.0	-2.9	-1.9	-2.3
Combined primary balance	-2.7	-1.6	-0.8	-0.8	-0.5	0.5	0.0
Of which: tax revenue	11.2	11.5	11.5	12.5	13.3	13.4	14.1
National Savings and Investment							
Gross domestic investment	16.4	17.0	16.2	15.7	16.1	16.3	16.2
Public sector 3/	3.6	3.3	1.9	2.3	2.2	2.0	2.6
Private sector	12.8	13.7	14.3	13.4	14.0	14.3	13.6
Of which: foreign direct investment	3.3	0.9	2.3	2.3	1.3	7.0	3.0
Gross domestic saving	13.6	12.3	12.2	12.4	12.6	10.8	10.1
Public sector	0.8	-0.4	-1.0	-0.6	0.0	0.5	0.1
Private sector	12.7	12.8	13.2	13.1	12.6	10.3	10.1
Total public debt	39.3	42.1	43.5	42.0	41.9	40.8	40.5
Of which: external public debt	27.9	31.4	30.2	29.2	30.6	26.4	25.2
External public debt service							
(percent of exports of goods and services)	16.8	11.3	20.7	15.9	14.7	14.2	9.5
Net foreign assets of the banking system							
Millions of U.S. dollars	1,294	1,044	1,050	1,104	1,459	2,286	1604.2
Percent of deposits	21.6	14.8	14.0	14.7	17.8	24.5	17.9
Memorandum items:							
Net *maquila* exports (percent of GDP)	3.3	3.3	2.9	3.6	3.3	2.8	2.8
Nominal GDP (billions of U.S. dollars)	14.3	15.0	15.8	17.1	18.7	20.4	22.4

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

1/ The figure for 2008 shows the average spread through October 5.

2/ For 2008, the interest rate shows the average through June.

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)

			Prel.	Proj.					
	2005	2006	2007	2008	2009	2010	2011	2012	2013
Current account	**-569**	**-675**	**-1,119**	**-1,353**	**-1,280**	**-1,354**	**-1,310**	**-1,259**	**-1,286**
Trade balance	-2,938	-3,540	-4,073	-4,516	-4,417	-4,525	-4,659	-4,864	-5,145
Export of goods (f.o.b.)	3,447	3,760	4,035	4,577	4,763	5,088	5,469	5,842	6,211
General merchandise	1,625	1,982	2,234	2,615	2,735	2,956	3,202	3,448	3,696
Goods for processing	1,821	1,777	1,801	1,963	2,029	2,133	2,267	2,395	2,515
Import of goods (f.o.b.)	-6,385	-7,299	-8,108	-9,093	-9,180	-9,613	-10,128	-10,706	-11,356
General merchandise	-5,180	-6,143	-6,871	-7,755	-7,801	-8,170	-8,602	-9,102	-9,679
Goods for processing	-1,205	-1,157	-1,237	-1,338	-1,379	-1,443	-1,526	-1,604	-1,677
Services	-87	-79	-242	-257	-322	-298	-245	-203	-178
Income	-579	-528	-579	-527	-584	-735	-817	-863	-900
Current transfers	3,035	3,472	3,776	3,948	4,042	4,203	4,411	4,670	4,936
Financial and capital account	**875**	**1,129**	**775**	**1,569**	**1,464**	**1,552**	**1,519**	**1,496**	**1,559**
Capital account	94	97	150	161	187	262	160	154	154
Public sector	329	497	-115	-95	-120	44	-6	16	46
Private sector	453	535	740	1,502	1,397	1,246	1,365	1,327	1,359
Foreign direct investment	398	245	1,426	644	685	752	811	880	952
Commercial banks	-51	-209	-498	600	75	224	150	150	150
Currency substitution	**-5**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Errors and omissions	**-360**	**-382**	**624**	**0**	**0**	**0**	**0**	**0**	**0**
Change in net reserves (- = increase)	**59**	**-72**	**-280**	**-216**	**-184**	**-197**	**-209**	**-237**	**-272**
			(Annual percentage change)						
Exports (f.o.b., volume)	-2.0	6.0	3.0	8.4	3.4	4.5	5.5	4.9	4.4
Imports (f.o.b., volume)	-0.8	8.6	5.7	0.2	1.5	2.5	3.5	3.9	4.3
Terms of Trade	-1.9	-2.3	-0.9	-6.5	1.2	0.1	0.1	0.1	0.1
			(In percent of GDP)						
Current account	**-3.3**	**-3.6**	**-5.5**	**-6.1**	**-5.4**	**-5.3**	**-4.8**	**-4.3**	**-4.0**
Export of goods (f.o.b.)	20.2	20.2	19.8	20.5	19.9	19.8	19.9	19.7	19.4
Import of goods (f.o.b.)	-37.4	-39.1	-39.8	-40.8	-38.4	-37.5	-36.8	-36.1	-35.4
Net maquila exports	3.6	3.3	2.8	2.8	2.7	2.7	2.7	2.7	2.6
Remittances	17.7	18.6	18.1	17.2	16.5	16.0	15.6	15.4	15.1
Financial and Capital account	**5.1**	**6.0**	**3.8**	**7.0**	**6.1**	**6.0**	**5.5**	**5.1**	**4.9**
Public sector capital	1.9	2.7	-0.6	-0.4	-0.5	0.2	0.0	0.1	0.1
Private sector capital	2.7	2.9	3.6	6.7	5.8	4.9	5.0	4.5	4.2
Foreign direct investment	2.3	1.3	7.0	2.9	2.9	2.9	2.9	3.0	3.0
Commercial banks	-0.3	-1.1	-2.4	2.7	0.3	0.9	0.5	0.5	0.5
Memorandum items									
Gross international reserves (US$ mln)	1,930	2,005	2,295	2,511	2,695	2,892	3,101	3,338	3,610
in months of imports (excluding maquila) 1/	4.5	3.9	4.0	3.9	4.1	4.2	4.3	4.4	4.5
in percent of total short-term external debt	122	161	184	165	155	154	151	153	132
External debt (in percent of GDP)	53.4	51.5	45.3	46.6	45.9	44.9	43.9	42.3	40.6
Of which : public sector debt	29.2	29.1	25.4	24.1	22.0	20.7	19.2	17.9	16.7
External public debt servicing (US$ mln)	727	760	783	593	619	681	1,358	845	846
percent of exports of goods and services	15.9	14.7	14.2	9.5	9.6	9.8	18.0	10.4	9.7
Gross external financing requirement (US$mln)	2,889	2,713	3,058	3,597	3,822	4,077	4,898	4,508	5,075
percent of GDP	16.9	14.5	15.0	16.1	16.0	15.9	17.8	15.2	15.8

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

1/ Expressed in terms of following year's imports

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

(In percent of GDP)

				Proj. 1/					
	2005	2006	2007	2008	2009	2010	2011	2012	2013
Revenues and grants	**16.5**	**17.2**	**17.1**	**17.5**	**17.7**	**18.6**	**18.6**	**18.7**	**18.7**
Current revenue	16.2	16.9	16.8	17.0	17.2	17.9	18.2	18.4	18.4
Tax revenue	12.5	13.3	13.4	14.1	14.1	14.5	14.9	15.1	15.1
Nontax revenue	3.2	3.0	2.9	2.8	2.8	2.7	2.7	2.7	2.7
Of which: pension revenue	0.2	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Operating surplus of the public enterprises	0.5	0.6	0.5	0.2	0.3	0.6	0.6	0.7	0.6
Operating surplus of the central bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Official grants	0.3	0.2	0.3	0.5	0.5	0.8	0.3	0.3	0.3
Expenditure	**19.5**	**20.1**	**19.0**	**19.8**	**19.9**	**20.0**	**19.6**	**19.3**	**19.2**
Current expenditure	16.8	17.0	16.3	17.0	17.1	16.7	16.5	16.2	16.1
Wages and salaries	7.1	7.1	6.9	6.9	6.8	6.8	6.8	6.7	6.7
Goods and services	4.0	3.9	3.6	3.4	3.6	3.4	3.3	3.2	3.2
Interest	2.2	2.4	2.5	2.4	2.4	2.5	2.4	2.4	2.4
Current transfers	3.6	3.6	3.3	4.3	4.2	4.0	4.0	3.9	3.9
Nonpension payments	1.3	1.8	1.7	2.7	2.7	2.5	2.5	2.5	2.5
Pension payments	2.2	1.9	1.6	1.6	1.6	1.6	1.5	1.5	1.5
Capital expenditure	2.7	3.1	2.8	2.8	2.8	3.3	3.1	3.1	3.0
Primary balance	**-0.8**	**-0.5**	**0.5**	**0.0**	**0.2**	**1.1**	**1.4**	**1.9**	**1.9**
Overall balance	**-3.0**	**-2.9**	**-1.9**	**-2.3**	**-2.2**	**-1.3**	**-1.1**	**-0.5**	**-0.5**
Financing	**3.0**	**2.9**	**1.9**	**2.3**	**2.2**	**1.3**	**1.1**	**0.5**	**0.5**
External	**2.0**	**2.7**	**-0.6**	**-0.4**	**-0.5**	**0.2**	**0.0**	**0.1**	**0.1**
Disbursements	4.3	4.8	1.0	0.7	0.7	1.2	3.3	1.4	1.4
Amortization	-2.3	-2.2	-1.6	-1.2	-1.2	-1.0	-3.3	-1.4	-1.3
Domestic	**1.0**	**0.3**	**2.5**	**2.8**	**2.7**	**1.2**	**1.1**	**0.5**	**0.3**
Central bank	0.5	-0.3	0.7	0.0	0.1	0.2	0.2	0.1	0.0
Banking system	-0.1	0.4	0.2	0.1	0.2	0.2	0.2	0.2	0.2
Private sector	0.7	0.4	1.6	2.7	2.5	0.8	0.7	0.2	0.2
Other	-0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Current account balance	-0.6	0.0	0.5	0.1	0.1	1.2	1.7	2.3	2.3
Pension balance	-2.0	-1.8	-1.5	-1.5	-1.5	-1.5	-1.5	-1.4	-1.4
Gross financing needs	7.2	7.0	5.3	5.1	4.9	3.8	5.7	3.1	2.8
Implicit interest rate (in percent)	5.5	6.3	6.5	6.4	6.5	6.5	6.7	7.0	7.3
Total public sector debt	42.0	41.9	40.8	40.5	40.4	38.8	37.1	34.9	32.7

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

1/ Projections prepared by the staff

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

	2003	2004	2005	2006	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**	**2,206**	**2,051**
Net international reserves	2,003	1,985	1,926	2,004	2,295	2,511
Of which: disposable NIR	153	303	187	191	84	480
Net domestic assets	**653**	**485**	**523**	**412**	**560**	**489**
Nonfinancial public sector	345	287	367	315	462	700
Commercial banks	85	0	0	0	0	0
Nonbank financial institutions	427	434	388	363	378	378
Nonfinancial private sector	0	0	0	0	0	0
Other items (net)	-205	-236	-232	-265	-280	-589
Central bank backed liabilities	**2,361**	**2,248**	**2,232**	**2,293**	**2,766**	**2,540**
Currency issue	42	36	34	34	33	33
Liabilities to other depositary corporations	1,688	1,596	1,644	1,694	2,044	1,998
Other liabilities	630	615	553	565	689	509
	II. Commercial Banks					
Net foreign assets	**-598**	**-682**	**-526**	**-392**	**153**	**-447**
Net domestic assets	**7,287**	**7,417**	**7,623**	**8,392**	**9,272**	**9,778**
Net claims on nonfinancial public sector	-141	-250	-238	-285	-242	-216
Net claims on the financial system	1,817	1,851	1,692	1,791	2,125	2,324
Claims on the private sector	6,541	6,809	7,353	7,986	8,616	9,090
Other items (net)	-929	-993	-1,184	-1,100	-1,227	-1,421
Liabilities to the private sector	**6,689**	**6,735**	**7,097**	**8,001**	**9,425**	**9,331**
Deposits	6,020	6,166	6,328	7,069	8,321	8,238
Other	669	569	769	931	1,104	1,093
	III. Financial System					
Net foreign assets	**1,044**	**1,050**	**1,104**	**1,459**	**2,286**	**1,604**
Net domestic assets	**5,475**	**5,475**	**5,927**	**6,477**	**7,108**	**7,565**
Nonfinancial public sector	209	43	135	30	220	484
Credit to private sector	6,548	6,817	7,361	7,993	8,616	9,090
Other	-1,282	-1,385	-1,569	-1,547	-1,728	-2,009
Liabilities to the private sector	**6,519**	**6,525**	**7,031**	**7,936**	**9,394**	**9,169**
Of which: Broad money	6,479	6,665	6,991	7,881	9,281	9,058
Money	1,073	1,203	1,292	1,488	1,733	1,691
Quasi-money	5,406	5,462	5,699	6,393	7,548	7,367
	(Percent changes relative to previous year's broad money)					
Net domestic assets	8.0	0.0	6.5	7.0	6.8	5.0
Nonfinancial public sector	4.1	-2.5	1.3	-1.3	2.0	2.9
Credit to the private sector	7.7	4.0	7.8	8.0	6.7	5.2
Broad money	1.7	2.9	4.9	12.7	17.8	-2.4
	(Percent of GDP)					
Credit to the private sector	43.5	43.1	43.1	42.9	42.3	40.8
Liabilities to the private sector	43.3	41.3	41.2	42.5	46.2	41.1
	(Annual percent change, unless otherwise stated)					
Memorandum items:						
Credit to the private sector	8.2	4.1	8.0	8.6	7.8	5.5
Total deposits (public and private sectors)	-1.6	6.1	0.3	9.3	13.9	-3.7
Commercial bank liquidity deposits at central bank (percent of total deposits)	28.2	25.9	26.0	23.8	24.4	24.1

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

Table 5. El Salvador: Selected Vulnerability Indicators

(In percent of GDP, unless otherwise indicated)

	2003	2004	2005	2006	2007	Proj. 2008
Fiscal indicators						
Overall balance of the public sector	-3.6	-3.0	-3.0	-2.9	-1.9	-2.3
Public sector primary balance	-1.6	-0.8	-0.8	-0.5	0.5	0.0
Gross public sector financing requirement	11.7	6.9	7.2	7.0	5.3	5.1
Public sector debt	42.1	43.5	42.0	41.9	40.8	40.5
Public sector external debt	31.4	30.2	29.2	29.5	26.4	25.2
External interest payments to total fiscal revenue (percent)	11.2	12.2	11.6	10.7	12.9	8.2
External amortization payments to total fiscal revenue (percent)	7.2	15.2	13.7	12.6	9.2	6.7
Financial indicators 1/						
Broad money (percent change, 12-month basis)	1.7	2.9	4.9	12.7	17.8	-2.4
Private sector credit (percent change, 12-month basis)	8.2	4.1	8.0	8.6	7.8	5.5
Ratio of capital to risk-weighted assets	12.8	13.4	13.5	13.8	13.8	14.5
Ratio of loans more than 90 days past due						
to total loans 2/	2.8	2.4	2.0	1.9	2.1	2.7
Provision coverage						
Ratio of provisions to total loans	3.6	3.2	2.5	2.3	2.5	2.8
Ratio of provisions to loans more than 90 days past due 2/	130	132	127	116.4	120.0	104.3
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	11.3	12
Return to average total assets	1.1	1.0	1.2	1.5	1.2	1.3
Ratio of liquid assets to total deposits	35.7	36.1	33.5	32.3	34.0	34.4
External indicators						
Exports of goods and services (percent change, 12-month basis)	7.8	8.0	3.3	13.4	6.6	12.5
Imports of goods and services (percent change, 12-month basis)	9.9	10.1	6.2	15.9	11.8	11.7
Current account balance	-4.7	-4.0	-3.3	-3.6	-5.5	-6.1
Capital and financial account balance	7.9	1.5	5.1	6.0	3.8	7.0
Gross official reserves (millions of U.S. dollars)	2,007	1,990	1,930	2,005	2,295	2,511
Months of imports of goods and services, excluding maquila	5.9	5.3	4.5	3.9	4.0	3.9
Percent of short-term debt 3/	122	114	122	161	184	165
Percent of gross external financing requirements	71	65	67	74	75	70
Percent of broad money	30.8	30.5	27.4	25.3	24.4	27.4
Total public external debt service	3.1	5.8	4.3	4.1	3.8	2.7
Total external debt to exports of goods and services (percent)	209	200	199	186	167	167
External interest payments to exports of goods and services (percent)	12.4	12.7	13.3	13.2	14.3	9.2
External amortization payments to exports of goods and services (percent)	11.5	15.8	16.1	15.3	12.5	11.6
REER 12-month basis (depreciation -)	-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 August 2008.

2/ Based on past-due loans.

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

Annex Table 1. El Salvador: External Debt Sustainability Framework, 2003-2013

(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
1	**Baseline: External debt**	57.0	56.0	53.4	51.5	45.4	**46.6**	**46.0**	**44.9**	**43.9**	**42.4**	**40.6**	**-3.0**
2	Change in external debt	6.1	-1.0	-2.6	-1.9	-6.1	1.2	-0.7	-1.0	-1.0	-1.5	-1.8	
3	Identified external debt-creating flows (4+8+9)	3.1	-0.3	-3.3	-2.6	-5.4	0.8	1.4	1.1	0.5	-0.4	-0.7	
4	Current account deficit, excluding interest payments	1.3	0.4	-0.2	0.0	1.6	3.5	2.7	2.0	1.4	0.9	0.8	
5	Deficit in balance of goods and services	15.9	17.2	17.7	19.4	21.2	21.4	19.8	18.8	17.8	17.1	16.6	
6	Exports	27.3	28.0	26.8	27.8	27.2	27.9	27.1	27.1	27.4	27.5	27.2	
7	Imports	43.2	45.3	44.5	47.2	48.4	49.4	46.9	46.0	45.3	44.6	43.8	
8	Net non-debt creating capital inflows (negative)	0.9	-1.5	-2.4	-1.6	-6.6	-4.1	-2.8	-2.9	-2.8	-3.0	-3.0	
9	Automatic debt dynamics 1/	0.9	0.8	-0.6	-0.9	-0.5	1.3	1.5	2.0	1.9	1.7	1.4	
10	Contribution from nominal interest rate	3.4	3.5	3.6	3.7	3.9	2.6	2.6	3.3	3.4	3.3	3.2	
11	Contribution from real GDP growth	-1.1	-1.0	-1.6	-2.0	-2.2	-1.2	-1.1	-1.3	-1.5	-1.6	-1.8	
12	Contribution from price and exchange rate changes 2/	-1.4	-1.7	-2.6	-2.5	-2.2	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	3.0	-0.8	0.7	0.7	-0.7	0.5	-2.1	-2.1	-1.5	-1.2	-1.0	
	External debt-to-exports ratio (in percent)	209.1	199.6	199.1	185.1	167.0	166.9	169.6	165.6	160.1	154.4	149.4	
	Gross external financing need (in billions of US dollars) 4/	2.5	3.2	3.1	3.1	3.2	3.5	3.8	4.1	4.2	4.4	4.5	
	in percent of GDP	16.5	20.3	18.0	16.5	15.6	15.6	15.7	15.9	15.4	14.8	14.2	
	Scenario with key variables at their historical averages 5/						**46.6**	**44.3**	**41.8**	**39.6**	**37.7**	**35.8**	**-2.5**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	2.3	1.9	3.1	4.2	4.7	3.0	2.6	3.0	3.5	4.0	4.5	
	GDP deflator in US dollars (change in percent)	2.8	3.1	4.8	4.9	4.4	6.2	4.6	4.2	3.6	3.5	3.5	
	Nominal external interest rate (in percent)	7.0	6.5	6.9	7.5	8.3	6.2	6.1	7.6	8.1	8.1	8.1	
	Growth of exports (US dollar terms, in percent)	7.8	8.0	3.3	13.4	6.6	12.5	4.1	7.5	8.4	7.7	7.2	
	Growth of imports (US dollar terms, in percent)	9.9	10.1	6.2	15.9	11.8	11.7	2.0	5.1	5.6	6.0	6.4	
	Current account balance, excluding interest payments	-1.3	-0.4	0.2	0.0	-1.6	-3.5	-2.7	-2.0	-1.4	-0.9	-0.8	
	Net non-debt creating capital inflows	-0.9	1.5	2.4	1.6	6.6	4.1	2.8	2.9	2.8	3.0	3.0	

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 US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock.

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

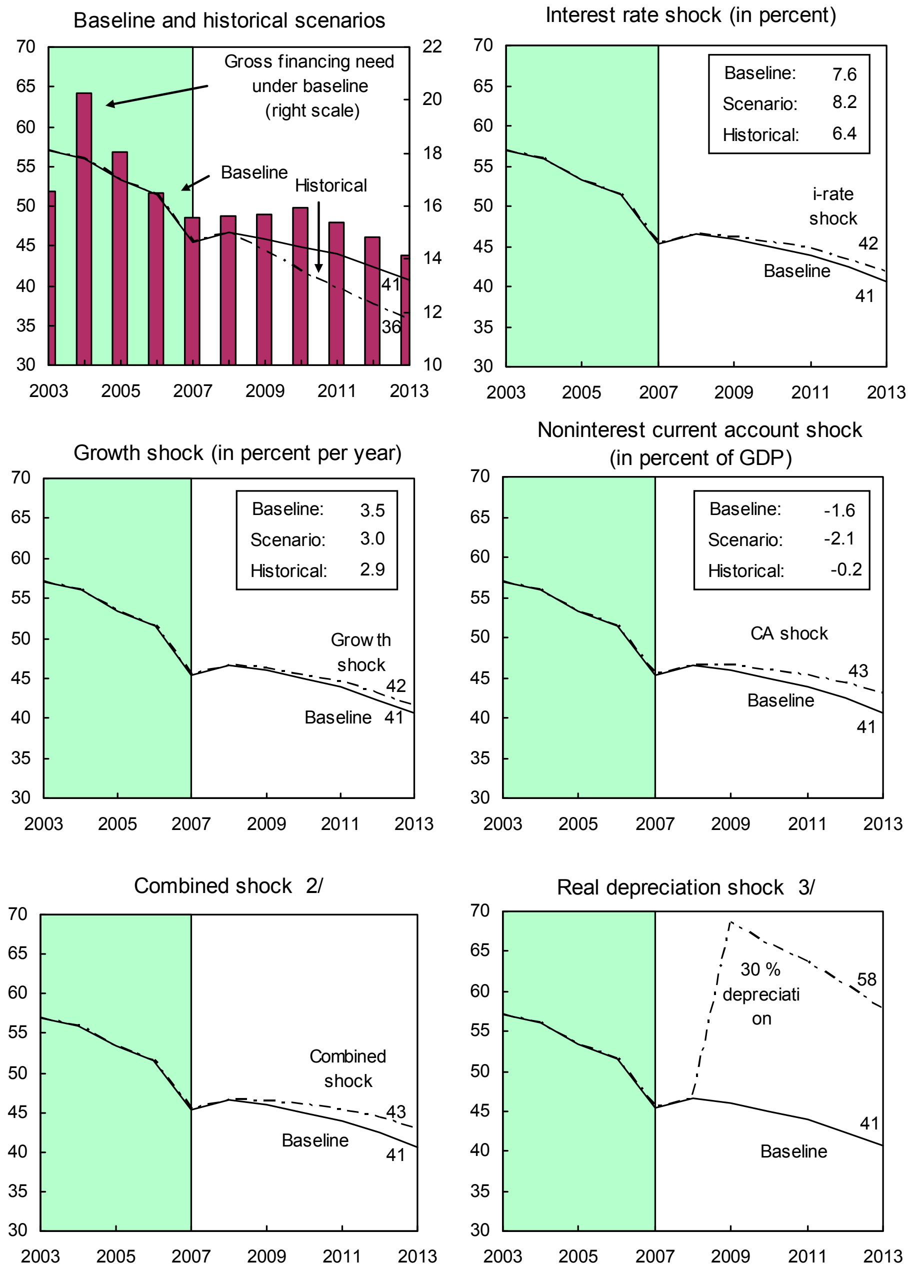
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

Annex Figure 1. El Salvador: External Debt Sustainability: Bound Tests 1/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data; and Fund staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2009.

Annex Table 2. El Salvador: Public Sector Debt Sustainability Framework, 2003-2013

(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing primary balance 9/**
1	**Baseline: Public sector debt 1/**	42.1	43.5	42.0	41.9	40.9	**40.5**	**40.4**	**38.8**	**37.1**	**34.9**	**32.7**	**-0.3**
	o/w foreign-currency denominated	42.1	43.5	42.0	41.9	39.7	40.5	40.4	38.8	37.1	34.9	32.7	
2	Change in public sector debt	2.8	1.5	-1.5	-0.1	-1.0	-0.3	-0.1	-1.6	-1.7	-2.2	-2.2	
3	Identified debt-creating flows (4+7+12)	1.7	2.3	-0.2	-0.6	-1.6	-1.2	-0.6	-1.4	-1.5	-2.1	-2.2	
4	Primary deficit	1.6	0.8	0.8	0.5	-0.5	0.0	-0.2	-1.1	-1.4	-1.9	-1.9	
5	Revenue and grants	16.5	16.0	16.5	17.2	17.1	17.5	17.7	18.6	18.6	18.7	18.7	
6	Primary (noninterest) expenditure	18.1	16.8	17.3	17.6	16.6	17.4	17.5	17.5	17.2	16.9	16.8	
7	Automatic debt dynamics 2/	0.1	0.1	-1.0	-1.1	-1.0	-1.1	-0.3	-0.3	-0.2	-0.2	-0.3	
8	Contribution from interest rate/growth differential 3/	0.1	0.1	-1.0	-1.1	-1.0	-1.1	-0.3	-0.3	-0.2	-0.2	-0.3	
9	Of which contribution from real interest rate	1.0	0.9	0.2	0.5	0.7	0.0	0.7	0.8	1.1	1.1	1.2	
10	Of which contribution from real GDP growth	-0.9	-0.7	-1.2	-1.6	-1.8	-1.1	-1.0	-1.1	-1.3	-1.4	-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	0.0	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13	Privatization receipts (negative)	0.0	1.3	0.0	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/	1.1	-0.8	-1.3	0.5	0.6	0.8	0.4	-0.2	-0.2	-0.1	0.0	
	Public sector debt-to-revenue ratio 1/	255.2	272.1	254.8	244.2	238.8	231.9	228.4	208.4	199.8	186.2	175.2	
	Gross financing need 6/	9.4	2.0	2.7	2.7	2.1	2.8	2.6	1.7	-0.9	0.4	0.3	
	in billions of U.S. dollars	1411.7	323.6	457.6	502.1	436.6	620.3	611.4	435.9	-261.2	117.5	106.8	
	Scenario with key variables at their historical averages 7/						**40.6**	**41.9**	**42.6**	**43.3**	**44.1**	**45.0**	**-0.3**
	Scenario with no policy change (constant primary balance) in 2008-2013						**40.5**	**40.6**	**40.1**	**39.7**	**39.3**	**38.9**	**-0.3**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	2.3	1.9	3.1	4.2	4.7	3.0	2.6	3.0	3.5	4.0	4.5	
	Average nominal interest rate on public debt (in percent) 8/	5.5	5.3	5.5	6.3	6.5	6.4	6.5	6.5	6.7	7.0	7.3	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.7	2.2	0.7	1.5	2.1	0.2	1.9	2.3	3.1	3.5	3.8	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	2.8	3.1	4.8	4.9	4.4	6.2	4.6	4.2	3.6	3.5	3.5	
	Growth of real primary spending (deflated by GDP deflator, in percent)	1.5	-5.1	6.0	6.2	-1.8	8.5	2.8	3.2	1.7	2.2	3.9	
	Primary deficit	1.6	0.8	0.8	0.5	-0.5	0.0	-0.2	-1.1	-1.4	-1.9	-1.9	

1/ Refers to nonfinancial public sector on a gross basis.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (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.

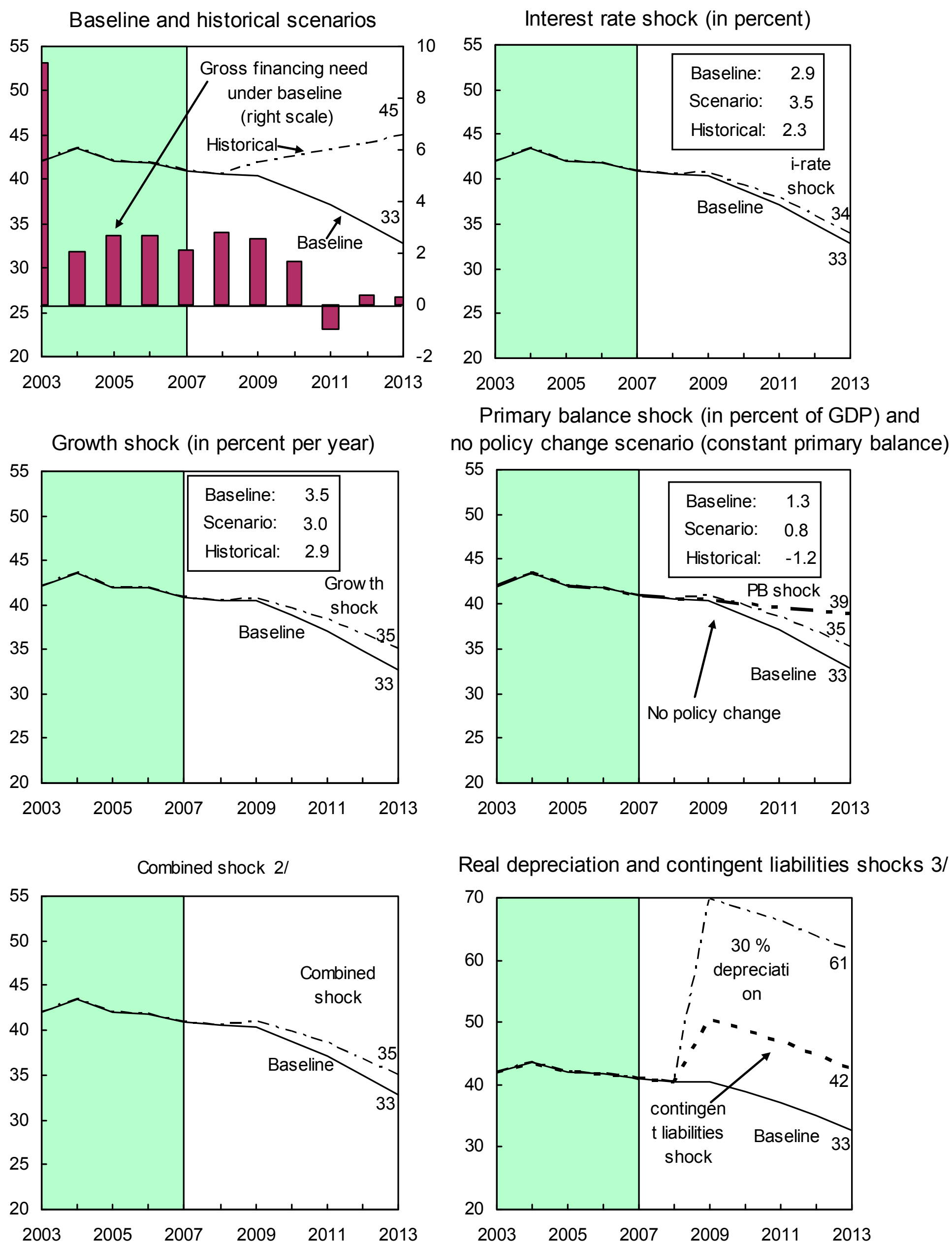
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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.

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



Sources: International Monetary Fund, country desk data, and Fund staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also show n.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, grow th rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, w ith real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix I: El Salvador—Statistical Issues

Data provision has some shortcomings, but is broadly adequate for surveillance. The Central Bank (CB) makes data available to the public through regular official publications and its website (http://www.bcr.gob.sv/). El Salvador subscribed to Special Data Dissemination Standards in June 1998. The data module of the Report on the Observance of Standards and Codes (data ROSC) was published in December 2004.

Monetary and Financial Statistics

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

Government Finance Statistics

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

Real Sector and Prices Statistics

The CB produces both current and constant price (base 1990) annual national accounts following the *1968 SNA*, with a lag of around nine months. Also, it produces quarterly GDP, using the production approach and disseminates these data three months after the end of the reference period. Recognizing the efforts to improve source data, the 2003 data ROSC mission stressed the need for modernizing the statistical system. The Central Bureau of Statistics and Census conducted during August–November 2005 various surveys to improve data sources on industry, trade and services. The CB is in the process of changing the base year of the national accounts and implementing the *1993 SNA*.

The consumer price index has a sound methodological basis and its coverage is confined to the San Salvador metropolitan area and the three largest departmental capitals representing 85 percent of the urban population. New weights derived from the National Urban Household Income and Expenditure Survey of 2007 will be adopted in early 2009. The authorities also compile a producer price index, which is confined to the San Salvador metropolitan area and the departments of La Libertad and Santa Ana.

External Sector Statistics

The compilation of balance of payments statistics follows the fifth edition of the *Balance of Payments Manual (BPM5).* There has been a significant improvement in the coverage and timeliness of balance of payments statistics in recent years. In particular, the CB has made significant progress in obtaining information on services, foreign direct investment, private external debt, and goods for processing, as well as for the international investment position. There is scope for improving the quality and consistency of the customs declaration, processed electronically. Also, a few weaknesses remain in the measurement of cross-border capital flows.

External Vulnerability Indicators

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

El Salvador: Table of Common Indicators Required for Surveillance

(As of October 15, 2008)

	Date of latest observation	Date received	Frequency of Data	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	Sep 08	Sep 08	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Aug 08	Oct 08	M	M	M		
Reserve/Base Money	Jul 08	Sep 08	W	W	W	O, LO, LO, LO	LO, O, O, O, LO
Broad Money	Jul 08	Sep 08	W	W	W		
Central Bank Balance Sheet	Jul 08	Sep 08	W	W	M		
Consolidated Balance Sheet of the Banking System	Jul 08	Sep 08					
Interest Rates[2]	Aug 08	Sep 08	W	W	W		
Consumer Price Index	Aug 08	Sep 08	M	M	M	O, O,LNO, O	LNO, LO, O, O, LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Jun 08	Aug 08	Q	Q	Q	LO, LO, LNO, LO	LO, O, LO, LO, NO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Jul 08	Sep 08	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar 08	May 08	Q	Q	Q		
External Current Account Balance	Mar 08	May 08	M	M	M	O, LO, LNO, LO	LO, LO, O, O, LO
Exports and Imports of Goods and Services	2007	May 08	A	A	A		
GDP/GNP	Dec 07	Feb 08	A,Q	A, Q	A	LO, LNO, LNO, LO	LNO, LNO, LO, O, LO
Gross External Debt	Mar 08	May 08	Q	Q	Q		
International Investment Position[6]	Dec 07	Jul 08	Q	Q	Q		

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

Statement by the IMF Staff Representative
November 12, 2008

1. This statement reports on developments since the issuance of the staff report for the 2008 Article IV Consultation. It does not change the thrust of the staff appraisal.

2. Recent data releases and financial market developments point to a continued economic slowdown and moderation in inflation, but there has been a slight uptick in export and remittance growth.

- The monthly index of economic activity grew 3.5 percent in the year to August, decelerating from a 3.8 percent pace in July, with manufacturing, financial, and tourism-related industries all softening.
- Inflation moderated to 7.4 percent y/y in October, from 8.7 percent in September, owing to the global downturn in commodity prices.
- Remittances rose 4.7 percent in the year to September after increasing 4.4 percent in the year to August, but remain below the 5–6 percent rate of growth seen earlier this year.
- Export and import growth ticked up slightly in the year to September, to 16.3 percent and 16.8 percent (from 15.8 percent and 16.1 percent in August, respectively).
- Sovereign spreads remain at almost 700 basis points, up by 300 basis points since early October and 80 more basis points than the average increase in Latin American spreads.

3. The latest downward revision to the global outlook is expected to weigh on growth in 2009, projected now at 2.0 percent, down from 2.6 percent in the staff report.

4. Lower commodity prices and slower growth in domestic demand than previously forecast are expected to reduce inflation and cut the current account deficit. End-period inflation is now estimated at 7.5 percent in 2008 and 5 percent in 2009—previously at 9 and 6 percent, respectively. The current account deficit is now projected at 5.5 percent of GDP in 2008 and 3.4 percent of GDP in 2009, from 6.1 and 5.4 percent of GDP in the staff report.

5. The government has moved to buttress its short-term liquidity position. An agreement was reached with the opposition party, leading the Salvadoran congress to authorize the government to negotiate $950 million in World Bank and IDB loans; $650 million would be used to repay the sovereign bond maturing in 2011, with the other $300 million to fund various social expenditures. A second congressional vote would be required to approve the borrowing once the loan agreements have been finalized.

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IMF Executive Board Concludes 2008 Article IV Consultation with El Salvador

On November 12, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with El Salvador.[1]

Background

Like in other Central American countries, economic growth is expected to decelerate, on the back of the U.S. slowdown. While real GDP growth rose to 4.7 percent in 2007, a record high in the last decade, it is expected to decelerate to 3.2 percent in 2008. However, the monthly economic activity indicator has signaled a mild but steady slowdown thereafter, reaching an average growth rate of 3.2 percent in the year to August. Headline inflation increased from 4.9 percent (year-on-year) in December 2007 to 9.9 percent this August, mainly due to soaring global commodity (food and fuel) prices. With the sharp decline in commodity prices more recently, inflation fell to 5.3 percent in November. The current account deficit widened in the first part of the year, with strong exports and resilient remittances only partly offsetting higher fuel prices, but is expected to moderate reflecting lower commodity prices and a slower domestic demand. Foreign Direct Investment flows have subsided after their unusually high level in 2007 related to the foreign purchase of banks, but remain relatively strong so far.

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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.

The banking system—now mainly foreign-owned—remains highly liquid, and has shown resilience to the global financial turbulence so far. Over the last two years, the three largest banks were acquired by foreign banks; about 90 percent of the banking system assets in El Salvador are now foreign owned. The banking system shows liquidity ratios above 34 percent. Average profitability levels fell in 2007, mainly on account of acquisition-related restructuring costs, but have recovered this year. With a rising share of consumer and housing loans in total credit, non-performing loans have been on an upward trend since 2006.

The fiscal position improved substantially in 2007, but was undermined in 2008 by the impact of high fuel prices on energy subsidies. The public sector fiscal deficit for the first half of this year increased relative to the same period a year earlier, driven by higher spending on energy subsidies and government actions to mitigate the impact of food prices. Strong revenue performance, particularly regarding income tax and VAT receipts, cuts in nonpriority spending, and some government measures to rationalize energy subsidies, have partly offset the deterioration in the operating surplus of public enterprises and the rapid increase in subsidies. The government has actively responded to high commodity prices with key measures that include expanding well-targeted social programs such as *Red Solidaria* (a conditional cash transfer program), increasing allowances for a tax credit program for middle-income families, eliminating import tariffs on wheat and agricultural inputs, delivering seeds and fertilizers for agricultural production, and granting a selective increase in wages of low-income public servants of between 2.5–5 percent.

Executive Board Assessment

Executive Directors welcomed the strength of El Salvador's macroeconomic fundamentals, which is the result of several years of sound policies, well-oriented structural reforms, and a favorable external environment. However, economic growth has decelerated recently, as in other Central American countries, on the back of the U.S. slowdown and the food and fuel price shock. The global financial crisis and electoral uncertainty have led to some tightening in domestic financial conditions, although the banking system remains resilient.

Directors considered that El Salvador's main challenge in the short run is to maintain macroeconomic stability and mitigate the impact of the shock on the poor. The policy priorities are to improve crisis preparedness in the financial sector, maintain fiscal restraint, and secure government financing in the coming year. Over the medium term, fiscal and financial sector reforms should continue to aim at enhancing the economy's resilience and growth potential. Directors agreed that El Salvador's real effective exchange rate is broadly in line with economic fundamentals, and that the export sector remains competitive.

Directors stressed that, in the face of global shocks and political uncertainty, it will be critically important to prepare the financial sector for potential liquidity or solvency problems and move forward with contingency planning. The introduction of a temporary 3 percent liquid asset requirement and the negotiation of a credit line for the central bank with a regional development bank are welcome steps in this direction. Directors encouraged the authorities to closely monitor banks' short-term borrowing and liquidity positions, enhance cooperation with home supervisors, draw up concrete action plans to deal with possible stress in the banking system in the future, and negotiate additional contingent credit lines to bolster the central bank's ability to provide liquidity for emergency assistance to banks. Careful monitoring of asset quality and credit risk will also be important.

Executive Directors noted that the fiscal deficit targets—2.3 percent of GDP in 2008 and 2.2 percent of GDP in 2009—are consistent with the objective of maintaining fiscal restraint. In this context, they supported the planned expansion of well-targeted social programs and reduction in nonpriority expenditure, while encouraging efforts to enhance controls of energy subsidies and to limit public wage increases.

Directors welcomed recent actions to secure additional financing and to improve the maturity structure of public debt. In particular, they commended the government for reaching a political agreement with the opposition to ensure congressional approval to negotiate loans amounting to US$950 million from the World Bank and the Inter-American Development Bank.

Directors supported the authorities' strategy of anchoring medium-term fiscal policy on the goal of reducing public debt to about 30 percent of GDP by 2013 while increasing well-targeted social and infrastructure spending. This would increase the ability of fiscal policy to react to external or domestic shocks and adopt a counter-cyclical stance, and at the same time enhance the economy's growth potential. Achieving this goal will require measures in several areas, including tax revenue enhancements, further cuts in nonpriority spending, improvements in the efficiency and targeting of subsidies, and a parametric reform of the pension system.

Directors also stressed the importance of further reforms of the financial sector to strengthen El Salvador's resilience to shocks. Key measures include passing the bill to strengthen financial supervision; enhancing the central bank's legal power to provide liquidity to banks in distress; and bolstering the deposit insurance fund. A few Directors expressed reservations against a recommendation, made in the case of El Salvador, for strict regulations to prevent asset originators from fully passing on credit risks to third parties.

El Salvador: Selected Economic and Financial Indicators

	2004	2005	2006	2007	Proj. 2008
Real economy (change in percent)					
Real GDP	1.9	3.1	4.2	4.7	3.2
Consumer prices (end of period)	5.4	4.3	4.9	4.9	5.9
National savings (percent of GDP)	12.2	12.4	12.4	10.6	9.4
Gross domestic investment (percent of GDP)	16.2	15.7	16.1	16.1	15.4
Public finances (percent of GDP)					
Consolidated public sector deficit	-3.0	-3.0	-2.9	-1.9	-2.9
Consolidated primary deficit	-0.8	-0.8	-0.5	0.5	-0.5
Public sector debt (percent of GDP, end of period)	43.5	42.0	41.9	40.8	41.7
Money and credit (end-year, percent change)					
Net domestic assets 1/	0.0	6.5	7.0	6.8	5.0
Of which					
Nonfinancial public sector 1/	-2.5	1.3	-1.3	2.0	2.9
Private sector 1/	4.0	7.8	8.0	6.7	5.2
Liabilities to private sector	0.1	7.8	12.9	18.4	-2.4
Interest rates (average)					
Deposit rate (six months)	3.3	3.4	4.9	4.4	4.1
Lending rate (more than one year)	7.7	8.2	9.0	9.4	9.6
External sector					
Trade balance (percent of GDP)	-16.8	-17.2	-19.0	-20.0	-19.9
Current account balance (percent of GDP)	-4.0	-3.3	-3.6	-5.5	-6.0
Change in net international reserves (millions of U.S. dollars, increase -)	52.5	58.9	-71.6	-280.2	-397.8
Terms of trade	-6.1	-2.9	-0.9	-5.7	-6.6
Real effective exchange rate (end of period)	-0.7	2.4	-0.2	-0.8	…
Net foreign assets of the banking system					
Millions of U.S. dollars	1,063	1,115	1,441	2,177	2,390
Percent of deposits	14.2	14.6	17.3	22.9	25.2

Sources: Central Reserve Bank of El Salvador; Ministry of Finance; and Fund staff estimates.
1/ Relative to previous year's broad money.

Statement by Ramon Guzman, Executive Director for El Salvador and Alvaro Umaña, Senior Advisor to Executive Director November 12, 2008

We would like to thank staff for their efforts in the consultation process and for a concise and well-written report. Sustained economic reforms and sound macro-economic policies implemented by El Salvador over the last four years have paid off in terms of economic growth, which reached its highest level in a decade in 2007. At the same time, poverty has been reduced significantly, the fiscal situation has improved and public debt has declined as a percentage of GDP over the same period. In spite of these important achievements, given the present global crisis, the external environment is challenging for all countries, and there are also some uncertainties associated with the upcoming elections.

The Central American region has started to feel the effects of the slowdown in the US economy, its main economic partner. In the case of El Salvador, the links to the US economy are particularly important both as a destination for exports as well as the source of remittances. Although the growth of remittances has slowed down to 5.3 percent (through September 2008), total remittances have continued to grow in absolute terms. Export growth, close to 16 percent, has been strong, particularly from coffee, maquila and non-traditional sectors. Given these positive results and a strong public investment program, the growth rate is only expected to slow down to 3.5 percent in 2008 and to stay at that level in 2009.

World price increases in food and oil have impacted inflationary levels in the Central American region considerably and El Salvador has not been the exemption; however, the latest figures available (October 2008) show inflation slowing slightly to 7.4 percent, one of the lowest levels in the region. Import growth has been driven primarily by oil and food price increases and this has put pressure on the balance of payments this year. However, recent price decreases in oil and commodities are likely to contribute to easing this pressure as we move into 2009.

The international financial crisis and internal conditions have contributed to some tightening in domestic financial conditions and credit growth has slowed down. The central government has rolled over most of the US$250 million of debt due during the rest of 2008, including a CABEI purchase of US$100 million in one-year LETES, which was completed this past week.

It is important to clarify that El Salvador's sovereign debt rating has not been downgraded by Standard & Poor's. Its rating remains BB+, one notch below investment grade. The outlook, however, has been changed from stable to negative. Sovereign debt spreads have fluctuated in line with other Latin American countries.

The banking system, which is now almost entirely foreign owned, is well capitalized, liquid and profitable. Capital adequacy is well above the regulatory minima, liquidity ratios are above 30 percent and, thus far, the system has shown resilience to the present global turmoil.

The fiscal position, which had improved in 2007, with a deficit 0.3 percent better than the budget, has suffered from high oil and commodity prices in 2008. The government has attempted to offset high oil prices with energy subsidies for electricity, gas and public transportation, as well as with an austerity program for the public sector. Household electricity consumption is subsidized below 99 KWH per month with a cost of US$60 million, or 0.3 percent of GDP. LPG and public transportation are also subsidized and, to partially offset these costs, the government has passed a new tax on incoming international telephone calls that is expected to yield 0.3 percent of GDP. Also, a US$0.10/gal tax on fuels has been adopted to finance the public transportation subsidy. Decreases in world oil prices will have a positive impact on the cost of these subsidies and there are some opportunities for improving the targeting of LPG subsidy.

The government has also put in place or expanded programs to respond to high commodity prices. The *Red Solidaria*, a well-targeted cash transfer program has been expanded. The *Alianza para la Familia* initiative, a broad effort to support working and non-working families includes increases in education and health tax deductions, higher spending for school food programs, free secondary education, and improved seed programs for rural communities. These programs can be accommodated within the 2009 budget leading to a targeted public deficit of 2.2 percent of GDP in that year.

The short-term outlook is challenging due to the difficulties in the external environment and internal factors mentioned earlier. Real growth is expected to remain near 3.5 percent in 2009 and to recover to levels near 4 percent later on, while inflation would gradually fall to about 3 percent in 2010. Public investment will increase by more than 25 percent, including construction of a new hydroelectric project, the start of operations of the new port at La Unión, and a new road in the northern part of the country financed by the Millennium Challenge Account. At the same time the current account deficit would narrow allowing for a reduction in external debt. The real effective exchange rate (REER) is broadly in line with fundamentals. Standard competitive indicators show that the export sector remains competitive.

Key policy decisions in the short term are focused on maintaining macroeconomic stability and enhancing financial sector crisis preparedness, including increasing liquid asset requirements on banks, as well as close monitoring and drawing action plans on how to deal with stress situations in the banking system. It is important to stress that the financial system remains strong and resilient.

Restoring access to longer-term financing is also and important priority and there has been considerable progress on this front since the Article IV consultation. A total of US$950 million has been initially approved by Congress on November 5 from multilateral development institutions, including a US$ 500 million from the IADB and a US$450 million loan from the World Bank. Out of these resources, US$650 million will be used to finance the government's 2011 Eurobond and the remaining resources will go to health, education and priority social spending projects. These loans still require a final approval by Congress, but the use of these funds have been agreed to by the government and the opposition parties.

Over the medium term, the fiscal strategy is geared to reducing public debt to about 30 percent of GDP by improving the public sector primary surplus between 2009 and 2013 through tax revenue measures of around 1 percent of GDP and improving the efficiency and targeting of public spending. However, the authorities have not agreed to potential increase in the VAT rate or pension reform. Other measures such as eliminating the electricity subsidy for the nonresidential sector or better targeting of the gas and transportation subsidies are under consideration but are dependent on the future path of international oil and gas prices.

Structural reforms are needed to increase the resilience of the financial system and these include the passage of a bill to strengthen financial sector supervision, increasing the deposit insurance fund to 5 percent of total deposits and passage of a bill to enhance the legal basis for mutual funds.

In spite of the global economic slowdown, El Salvador is taking concrete and effective contingency measures to face a potential liquidity crisis, it is maintaining a responsible fiscal policy, it is undertaking a solid public investment program, it has a dynamic export sector that has continued to grow, and its economy remains competitive. All these factors will undoubtedly contribute to a prompt recovery in growth rates once the global situation has improved.