March 2010
IMF Country Report No. 10/82

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

In the context of the Request for a Stand-By Arrangement and Cancellation of the Current Arrangement, the following documents have been released and are included in this package:

- The staff report for the Request for a Stand-By Arrangement and Cancellation of Current Arrangement prepared by a staff team of the IMF, following discussions that ended on January 31, 2010 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 March 17, 2010. 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 press release summarizing the views of the Executive Board as expressed during its March 17, 2010 discussion of the staff report that approved the Request for a Stand-By Arrangement and Cancellation of Current Arrangement.

- A statement by the Executive Director for El Salvador.

The documents listed below have been separately released.

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

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

DMSDR1S-#4147009-v1-SLV - 2010 - Request for a Stand-By Arrangement and Cancellation of Current Arrangement - Cover Sheet for Bundle for PUBLICATION March 19, 2010 (4:12 PM)

INTERNATIONAL MONETARY FUND

EL SALVADOR

Request for a Stand-By Arrangement and Cancellation of Current Arrangement

Prepared by the Western Hemisphere Department
(in Consultation with Other Departments)

Approved by Miguel Savastano and Michele Shannon

March 2, 2010

Discussions. A staff team comprised of A. Wolfe (Head), J. Prat, A. Swiston (all WHD), and R. Llaudes (SPR) visited San Salvador on August 24–27, September 17–23, and December 14–17, 2009 to hold discussions on a Fund-supported program. Mr. Gramajo-Marroquin (OED) joined some meetings. The team met with Central Bank Governor Acevedo, Finance Minister Cáceres, and Technical Secretary to the President Segovia, other government officials, and representatives of the financial sector and business community.

Stand-By Arrangement. The Salvadoran authorities are requesting a 36-month Stand-By Arrangement (SBA) from the Fund with total access of SDR 513.9 million (300 percent of quota, about US$800 million) and the cancellation of the current SBA. An initial purchase of SDR 171.30 million (100 percent of quota, about US$261 million) would become available upon Board approval; the remainder would be available in twelve purchases subject to six reviews, with total availability frontloaded (200 percent of quota) to the first twelve months of the arrangement. The authorities plan to treat the arrangement as precautionary.

The Economic Program. The program seeks to preserve financial stability, safeguard the economic recovery, and strengthen the medium-term fiscal position. Fiscal policy will aim at offsetting the impact of the adverse external environment on domestic activity and the most vulnerable, while ensuring debt sustainability over the medium term. Fund financial support would have a catalytic role for official creditors (including international financial institutions (IFIs)) and private investors. It would also provide a liquidity buffer to help absorb any potential shocks to the financial system in the context of El Salvador's officially dollarized economy.

Contents Page

Contents Page

I. Background

1. **Mauricio Funes of the left-of-center FMLN party assumed the Presidency on June 1, 2009 for a five-year term**. He is committed to pursuing sound macroeconomic policies and maintaining official dollarization as the monetary regime. A key priority for President Funes is to expand social programs to alleviate poverty, and improve the provision of public goods. Shortly after taking office, President Funes launched his anti-crisis plan (PGA) to mitigate the effects of the global crisis on the most vulnerable.

2. **The FMLN does not have a majority in congress, but President Funes has been able to forge support for his agenda**. The largest blocs of the 84-seat unicameral congress are the FMLN (35 deputies) and ARENA, the main opposition party (19 deputies). To date, two smaller blocs (PCN and GANA) have been providing support to the President's agenda, and, together with the FMLN, hold enough seats to pass legislation that requires a two-thirds majority.[1]

3. **The precautionary SBA approved in January 2009 served an important role in reducing election-related uncertainty**. The program aimed at reducing uncertainty about the continuity of macroeconomic policies during the election cycle and the political transition in the wake of the global financial crisis. The endorsement of the arrangement by the presidential candidates provided a strong signal of the national commitment to policy continuity and helped mitigate election-related uncertainty. Banking system liquidity remained high through the elections and the transition, and there was no need to draw on Fund resources. Although the March performance criterion on the fiscal deficit was breached, and Fund resources were not available since April, the SBA facilitated the policy dialogue with the former and incoming governments.[2]

4. **The new government would like to build on the success of the 2009 arrangement with a new Fund-supported program**. They are requesting a three-year arrangement to help bolster confidence in their commitment to preserving macroeconomic stability and to take fuller account of the impact of the global crisis and their policy priorities. The three-year arrangement would provide the time necessary to achieve the program's objectives in the context of the authorities' medium-term strategy.

---

[1] This includes the approval of long-term budget financing; passage of the annual budget requires a simple majority.

[2] Staff will prepare an Ex-Post Evaluation (EPE) of the 2009 SBA in the context of the joint 2010 Article IV Consultation and First Program Review.

II. Economic Developments in 2009

5. **The global slowdown hit economic activity very hard, but the balance of payments and the financial system remained resilient**.

- **Output growth**. The global slowdown hit all sectors, with manufacturing, construction, and retail being the most impacted. In addition, agricultural output was adversely affected by Hurricane Ida in November. Output fell in the first three quarters of 2009, and economic activity indicators for the fourth quarter suggest a bottoming out, but no clear sign of a robust recovery (Figure 1). Real GDP in 2009 is estimated to have declined by 3.3 percent, almost 6 percentage points lower than envisaged under the January 2009 SBA.

- **Prices**. Inflation was flat in 2009, down from nearly 10 percent in mid-2008, owing to the reversal of the food and fuel price spike and weak domestic demand. Core inflation, which excludes food and energy prices, was 2.6 percent at end-2009, down from 5.1 percent in 2008.

- **Balance of payments**. The external current account deficit narrowed to an estimated 1.6 percent of GDP in 2009 from over 7½ percent of GDP in 2008 (Figure 2). Imports (c.i.f.) fell by 26 percent (y/y), outstripping the decline in exports (17 percent), with maquila trade experiencing some of the steepest declines. Remittances were down 8.5 percent in the year, though the pace of decline eased late in the year. Net capital flows fell, but remained positive overall, as higher government borrowing more than offset private capital outflows and low FDI flows. As a result, net international reserves (NIR) rose by about US$440 million.[3]

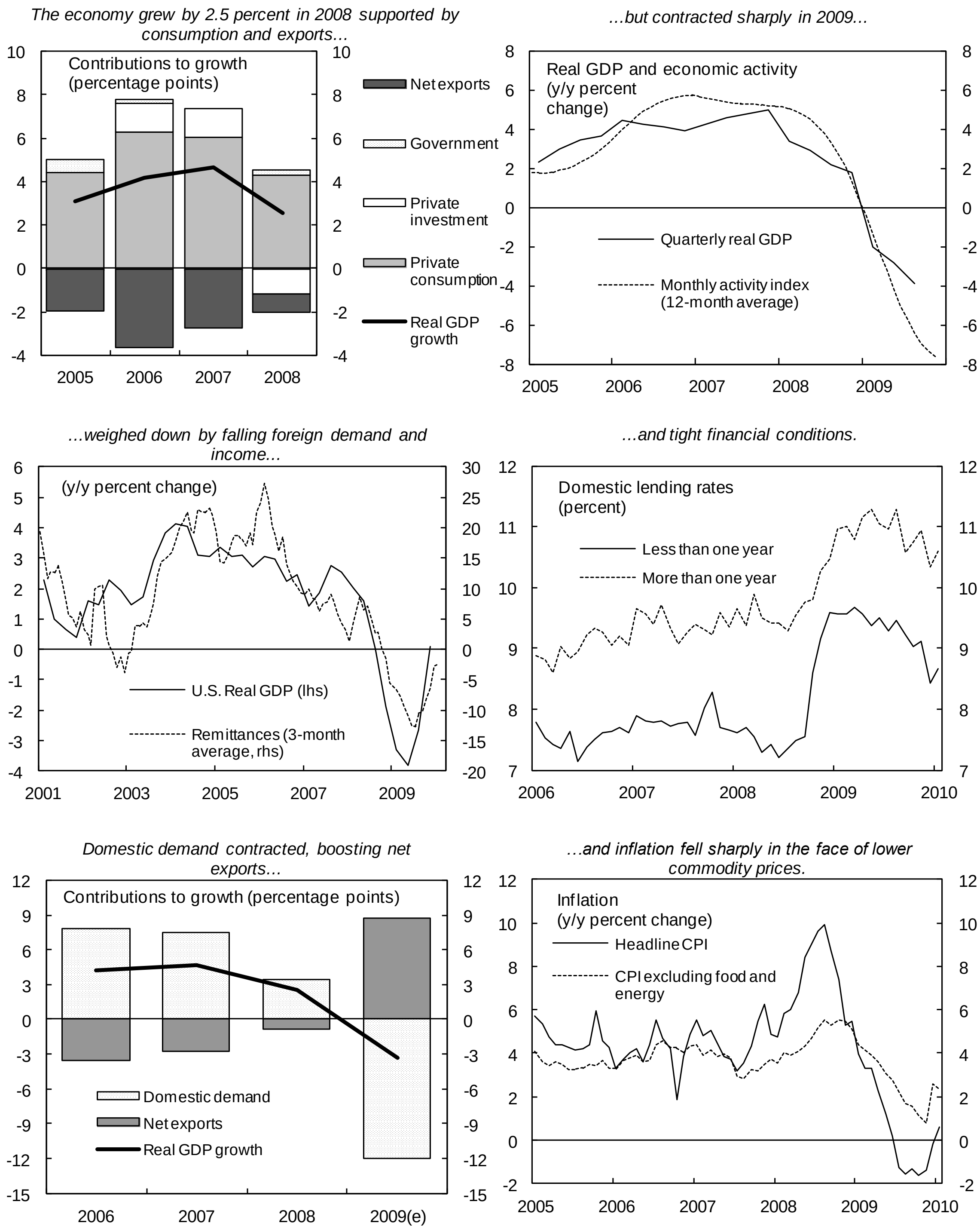
6. **The economic slowdown weighed heavily on tax revenues**. Total net tax revenues are estimated to have reached US$2.6 billion (12.1 percent of GDP) at end-2009, about US$600 million below those projected in the SBA. Revenue from customs and import-related domestic taxes collapsed in line with imports, though VAT and income tax revenues were also weak (Figure 3).

7. **Although the new government launched an ambitious anti-crisis plan (PGA), it exercised firm control over other government spending** (see Memorandum of Economic and Financial Policies, MEFP, ¶2). Shortly after taking office, the new government enhanced the austerity policy that had been adopted by the previous administration by enacting: (i) a 15 percent cut in the executive budget, covering all line ministries (except education and health); (ii) a general hiring freeze; (iii) strict guidelines on goods and services expenditures

---

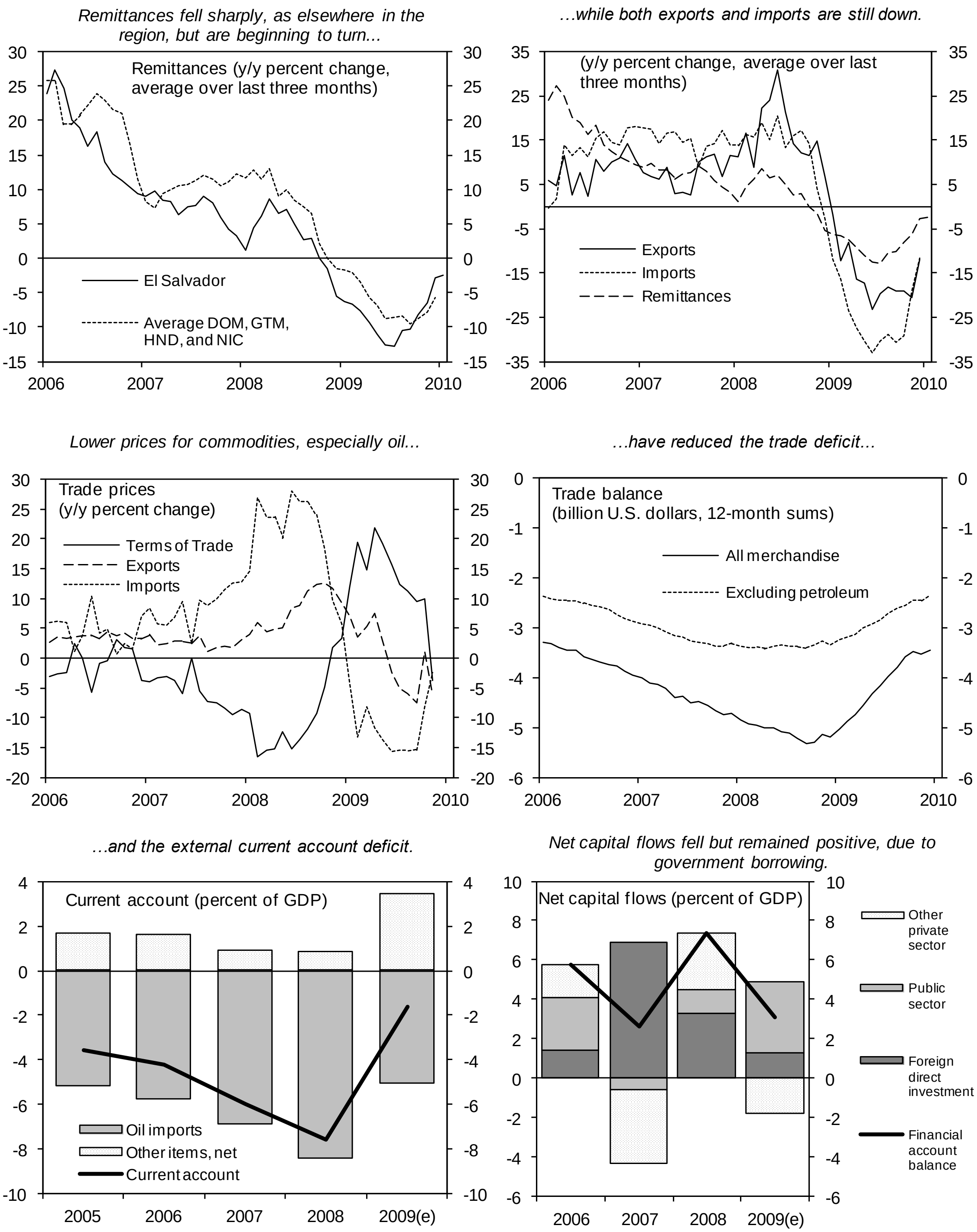
[3] This includes the SDR allocations in August and September 2009, equivalent to around US$220 million.

Figure 1. El Salvador: Economic Activity and Inflation



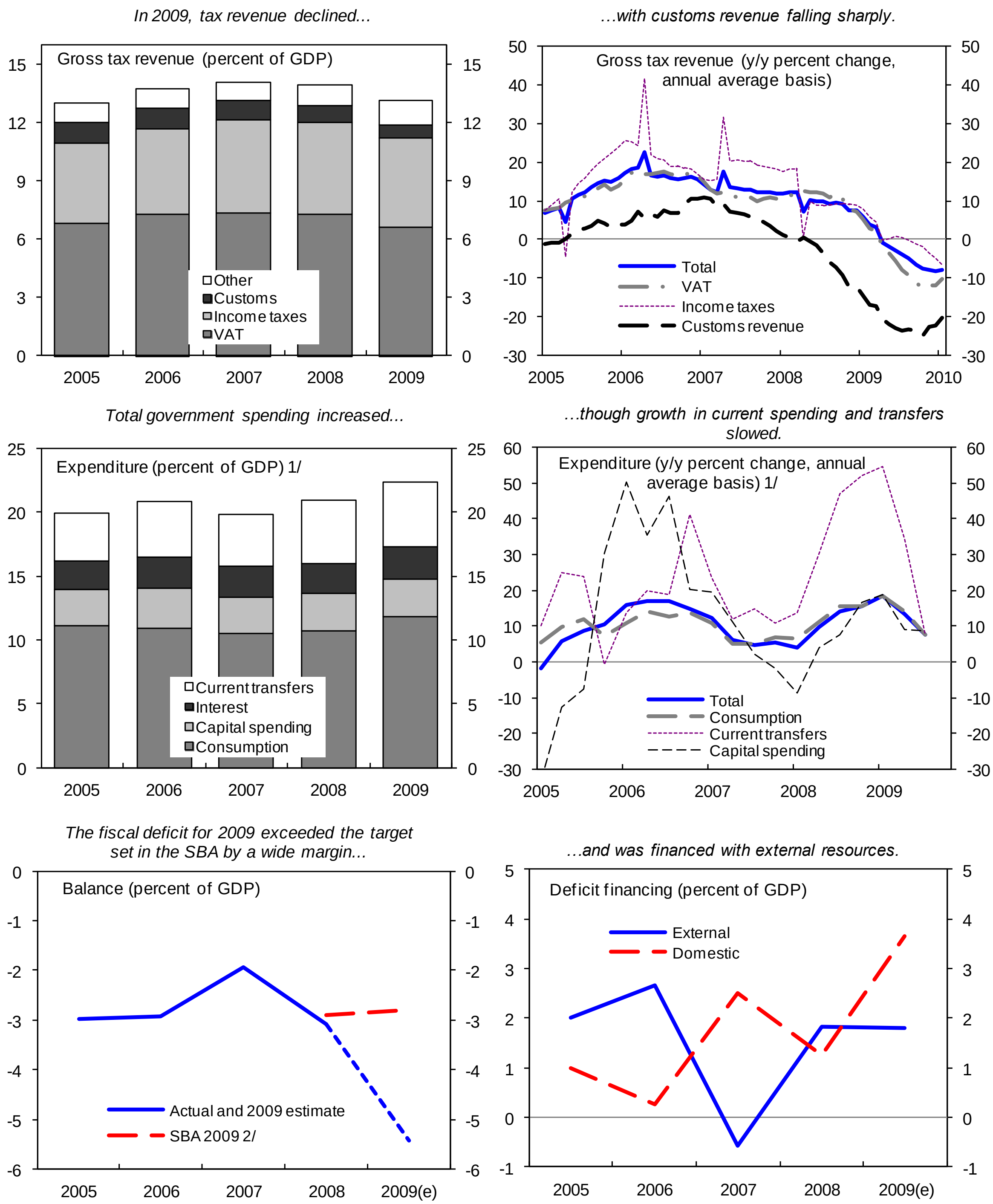
Sources: Central Reserve Bank of El Salvador; Haver Analytics; and Fund staff calculations.

Figure 2. El Salvador: Balance of Payments Developments



Sources: Central Reserve Bank of El Salvador; Haver Analytics; National sources; and Fund staff calculations.

Figure 3. El Salvador: Fiscal Developments



Sources: Ministry of Finance; and Fund staff calculations.
1/ Includes VAT refunds and income tax refunds in current transfers.
2/ IMF Country Report No. 09/71.

and transfers; and (iv) limits on hiring of external consultants. These measures are estimated to have yielded savings of about US$45 million (about 0.2 percent of GDP). The authorities also slowed the execution of the public investment program and re-prioritized projects, with an estimated savings of US$100 million (0.4 percent of GDP). In addition, the fall in oil prices allowed the authorities to cut the transportation subsidy by 40 percent in July (while maintaining the excise on gasoline and international telephone calls earmarked for the subsidy) saving an additional US$90 million (0.4 percent of GDP). These savings allowed the authorities to launch the PGA, which includes a temporary work program, the provision of free medicines to hospitals and uniforms for school children, and social investment projects. Spending under the PGA reached US$60 million (0.3 percent of GDP) in 2009.[4]

8. **The nonfinancial public sector (NFPS) deficit widened, despite expenditure restraint**. The 2009 fiscal deficit is estimated to have reached US$1.2 billion (5.4 percent of GDP), almost twice the numerical target set in the January 2009 SBA (US$670 million) and also higher than the NFPS deficit in 2008 of 3.1 percent of GDP. The revenue shortfall of more than US$650 million was only partly offset by expenditure savings of over US$150 million (See MEFP ¶3).

9. **The additional borrowing needed to finance the larger fiscal deficit received timely congressional approval**. On May 22, 2009, before the new government took office, congress approved unanimously a revised financing strategy for 2009. The strategy authorized the government to redirect US$650 million of loans from the World Bank and Inter-American Development Bank (IADB) (originally earmarked to refinance a Eurobond maturing in 2011) to cover the 2009 deficit, and allowed new government borrowing of up to US$1.1 billion.[5] With this, the government was able to place US$300 million of short-term debt with domestic banks (which allowed the clearing of domestic payments arrears of US$127 million that had been incurred since the start of the year), and, in November, issued an US$800 million, fixed-rate, 10-year Eurobond. Even though credit rating agencies had downgraded El Salvador's sovereign rating with some giving it a negative outlook, the Eurobond was oversubscribed and carried an effective yield of 7.375 percent.

[4] The PGA is projected to cost US$575 million over a three-year period (about 1 percent of GDP per year). PGA outlays are embedded in the fiscal program, mostly in wages and salaries, goods and services, and capital spending.

[5] The package also extended an explicit sovereign guarantee to US$350 million in domestically-held bonds associated with the education and health trust fund. At the same time, the superintendency of the financial system allowed banks to use government bonds to fulfill a 3-percent liquid asset requirement (established in 2004) that previously could only be met with overseas investment-grade securities.

10. **Bank deposits remained stable throughout the year, despite the political uncertainty, but lending declined and asset quality deteriorated**.[6] Lending and deposit rates rose substantially prior to the elections, but there were no deposit outflows. Many foreign-owned banks made contingent credit lines available to their local affiliates. Deposit rates fell following the elections, but lending rates remain high, and banks are applying strict standards to new loans and are holding larger liquidity buffers (Figure 4).[7] Bank profitability has fallen as provisioning has risen in line with non-performing loans.

Financial Soundness Indicators

	2007	2008	2009
Capital adequacy ratio	13.8	15.1	16.5
Non-performing loans (percent of total)	2.1	2.8	3.7
Return to average equity (percent)	11.3	8.7	2.8
Liquid assets to total deposits (percent)	34.0	35.7	41.3

Source: Financial System Superintendency.

III. THE NEW GOVERNMENT'S ECONOMIC PROGRAM

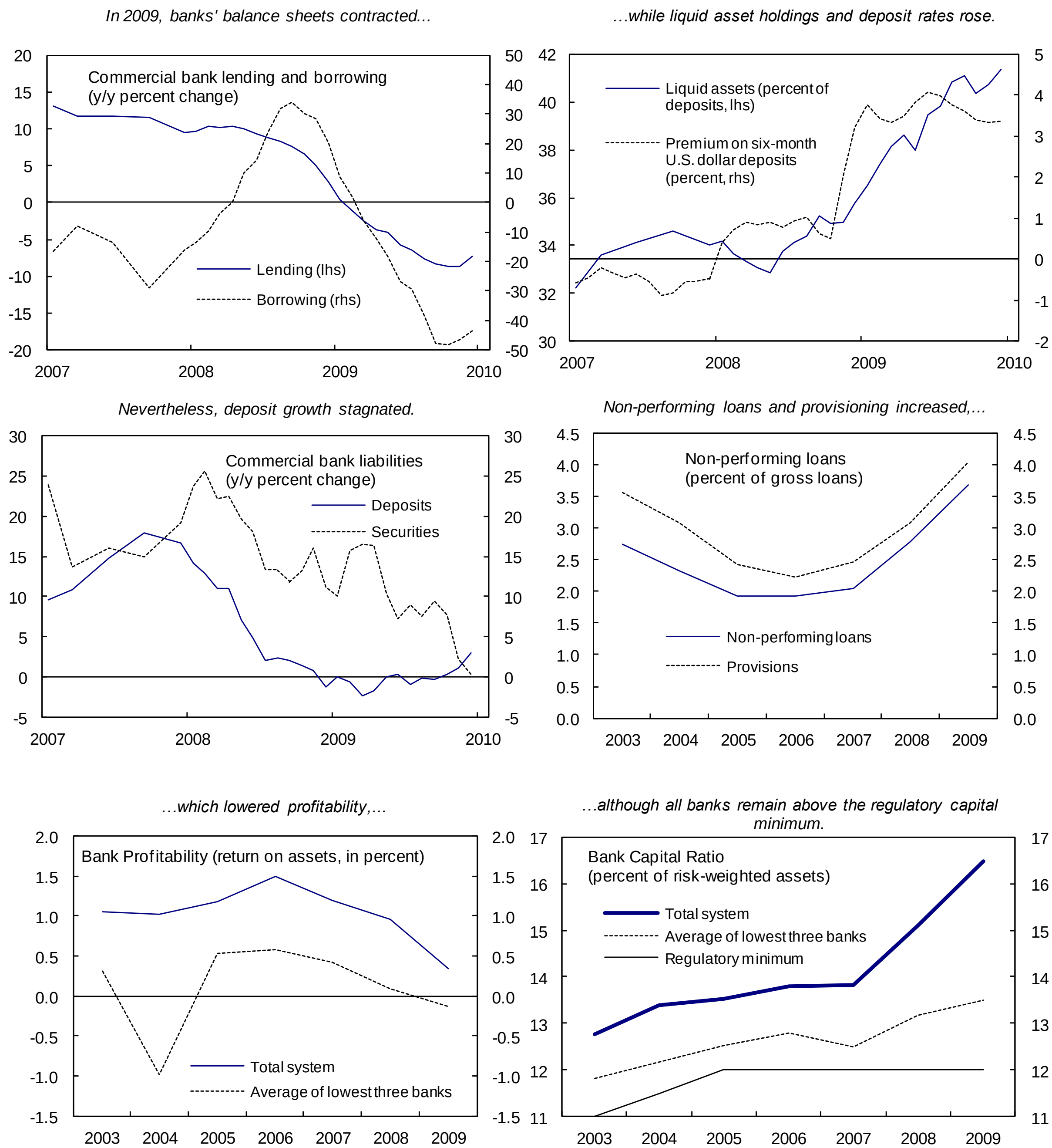
11. **The new government's economic policy priority is to increase the efficiency of government spending, while strengthening the fiscal position and preserving macroeconomic stability** (see MEFP ¶3). In 2010 it aims to continue mitigating the effects of the economic slowdown on the most vulnerable through countercyclical fiscal policy, while introducing a comprehensive reform of subsidy programs. Thereafter, during 2011–12, the government plans to rein in government spending and aims to secure support for a tax reform that would raise tax revenue by at least 1½ percent of GDP.

12. **The authorities are requesting Fund support for their economic strategy**. They view a Fund-supported program as critical for catalyzing financial support from official creditors (including other IFIs) and for bolstering confidence from foreign and domestic investors. In addition, the Fund-supported program would provide an important liquidity buffer to help overcome possible negative shocks to the dollarized financial system.

[6] Deposits were stable accounting for a seasonal uptick in December.

[7] To ensure an adequate level of bank liquidity, in late 2008, the authorities secured a credit line for US$400 million from the IADB to provide trade credit and working capital to banks (through the central bank); in addition, following the elections, they eliminated (in phases) the 3-percent liquid asset requirement instituted before the elections. The IADB credit line was not fully drawn, however, as banks found it too costly and restrictive.

Figure 4. El Salvador: Financial Sector Developments



Sources: Financial System Superintendency; Central Reserve Bank of El Salvador; Haver Analytics; and Fund staff calculations.

A. Macroeconomic Framework

13. **The economic recovery is projected to be slow**. El Salvador's strong linkages to activity and employment in the United States, combined with transmission lags to domestic activity, are expected to dampen growth prospects through 2011. Real GDP growth in 2010 is projected to be 1 percent, and output growth is expected to remain below potential (estimated at 4 percent) through 2012. Inflation is expected to remain subdued, in line with price developments in the United States.

Macroeconomic Framework
(In percent of GDP, unless otherwise noted)

			Estimate	Projections		
	2007	2008	2009	2010	2011	2012
Real GDP growth (percent)	4.7	2.5	-3.3	1.0	2.5	3.0
Inflation (percent, end of period)	4.9	5.5	-0.2	1.5	2.8	2.8
Nonfinancial public sector balance	-1.9	-3.1	-5.4	-4.7	-3.5	-2.5
Primary balance	0.5	-0.7	-3.0	-1.7	-0.5	0.5
Public sector gross debt	39.1	41.2	49.4	52.2	51.9	51.5
Public sector net debt 1/	34.9	37.8	44.7	47.8	49.3	48.7
External current account balance	-6.0	-7.6	-1.6	-2.7	-2.8	-2.7
Exports of goods	19.8	20.8	17.9	18.2	18.6	18.8
Imports of goods	-40.0	-40.7	-31.1	-32.9	-33.6	-34.0
Of which: oil	-6.9	-8.4	-5.0	-6.1	-6.2	-6.2
Current transfers	18.4	17.3	16.5	17.1	17.3	17.6

Sources: Central Reserve Bank of El Salvador; Ministry of Finance; and Fund staff estimates.
1/ Defined as public sector gross debt less government deposits held at the central bank or commercial banks.

14. **The external current account deficit is expected to stabilize at around 2¾ percent of GDP, and net capital flows to become predominantly private over the medium term**. Following a sharp compression in 2009, imports are projected to grow by almost 10 percent in 2010 and by almost 8 percent per year thereafter, while exports and remittances are also expected to rebound from their depressed 2009 levels. Private capital flows are expected to remain subdued in 2010 and to start recovering from 2011 onwards, when government net external borrowing is expected to subside.

B. Fiscal Policy

15. **The government's economic program aims at reducing gradually the overall fiscal deficit to support the economic recovery in the near term, while placing the public finances on a sustainable path** (see MEFP ¶7). The authorities and staff agreed on the need for continued, albeit reduced, fiscal stimulus in 2010. Thus, the fiscal program targets a deficit of the nonfinancial public sector of 4.7 percent of GDP for 2010 (including Ida-related expenditures of 0.4 percent of GDP). After 2010, expenditure restraint and comprehensive tax

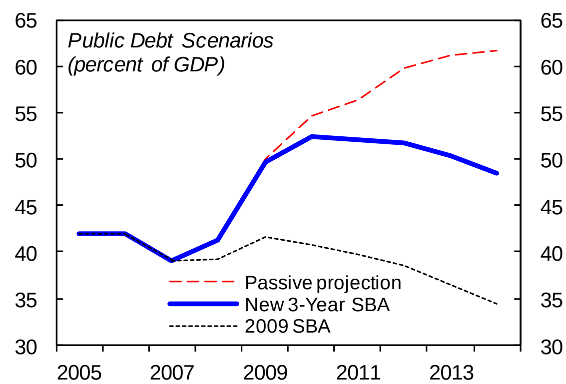
and subsidy reforms are expected to continue to lower gradually the NFPS deficit until it stabilizes at around 1.5 percent of GDP by 2015.

Medium-Term Fiscal Stance Excluding Ida-Related Spending
(in percent of GDP)

			Estimate	Projections		
	2007	2008	2009	2010	2011	2012
Nonfinancial public sector overall balance	-1.9	-3.1	-5.3	-4.3	-3.3	-2.5
Primary balance	0.5	-0.7	-2.9	-1.3	-0.3	0.5
Cyclically-adjusted overall balance	-1.9	-1.9	-3.0	-3.1	-3.1	-2.9
Cyclically-adjusted primary balance	0.5	0.6	-0.3	-0.5	-0.4	-0.3
Fiscal stance 1/	0.0	1.2	2.4	1.2	0.2	-0.5

Sources: Ministry of Finance; and Fund staff estimates.
1/ Defined as overall balance minus the cyclically adjusted overall balance.

16. **The authorities' strategy is consistent with debt sustainability**. Gross public debt as a share of GDP (which rose by 8.2 percentage points of GDP as a result of the recession) is projected to increase by an additional 2.8 percentage points in 2010, but will be placed on a downward path thereafter and is expected to fall below 50 percent of GDP by 2014. Staff agreed with the authorities that the projected debt path is sustainable, as confirmed by the results of staff's dynamic debt sustainability analysis (Box 1). Nonetheless, there was also agreement that there is little scope for fiscal slippages.



Sources: Ministry of Finance; and Fund staff calculations.

17. **During 2010 the NFPS fiscal balance is projected to improve by 0.7 percent of GDP**. The implementation of the fiscal package approved by congress in late 2009, in combination with tax administration measures, would yield revenues between 0.7 to 0.9 percent of GDP annually (see ¶18). Moreover, the authorities will have greater access to grants from the Millennium Challenge Corporation (of about ½ percent of GDP) which would be used to build new roads through the public investment program. In

Operations of the Nonfinancial Public Sector
(In percent of GDP)

	2009	2010	Change
Revenue and grants	15.8	17.4	1.7
Current revenue	15.3	16.6	1.3
Tax revenue	12.1	13.2	1.1
Nontax revenue	2.7	2.8	0.2
Operating surplus of pub. enterprises	0.5	0.6	0.1
Official grants	0.5	0.8	0.3
Expenditure	21.2	22.2	0.9
Current expenditure	18.2	18.5	0.3
Wages and salaries	7.7	7.9	0.2
Goods and services	4.1	4.3	0.2
Interest	2.5	3.0	0.5
Current transfers	4.0	3.3	-0.7
Capital expenditure	3.0	3.6	0.6
Overall balance	-5.4	-4.7	0.7
Primary balance	-3.0	-1.7	1.2

Sources: Ministry of Finance; and Fund staff estimates.

addition, savings on energy subsidies will allow the expansion of their flagship PGA (see ¶20 and ¶22).

18. **The revenue package approved by congress in December 2009 and tax administration measures adopted in the fourth quarter of last year were important first steps of the fiscal strategy** (see MEFP ¶5). The tax package included:

- **Excise taxes**. Excise taxes on alcoholic and carbonated beverages and tobacco were increased, and the taxes were also made applicable to non-carbonated products. The combined estimated yield of these measures is 0.3 percent of GDP on an annual basis. In addition, unitary taxes on alcoholic products were increased and a new 5 percent ad valorem tax on these products was introduced.

- **Tax on registration of new vehicles**. A tax on new vehicles (to compensate for lowering import duties on vehicle imports under the CAFTA-DR agreement) was introduced. The tax has 5 brackets and a maximum rate of 10 percent. Its estimated yield is 0.1 percent of GDP on an annual basis. Staff argued for a simpler structure of this tax with fewer brackets and a higher rate to fully offset the lost tariff revenue. However, the authorities were of the view that adopting a higher rate was not feasible politically, and that the multiple rates introduced some degree of progressivity to the measure.

- **Tax on interest income of banks licensed abroad**. These banks are currently subject to the same tax on interest income applicable to domestic banks. The measure is expected to generate revenue on the order of 0.1 percent of GDP on an annual basis. Moreover, the tax should improve bank efficiency and competition.

- **Tax on interest income of individuals**. Individuals' interest income higher than US$25,000 will no longer be exempted. The measure is expected to yield about 0.2 percent of GDP on an annual basis, and could improve tax efficiency.

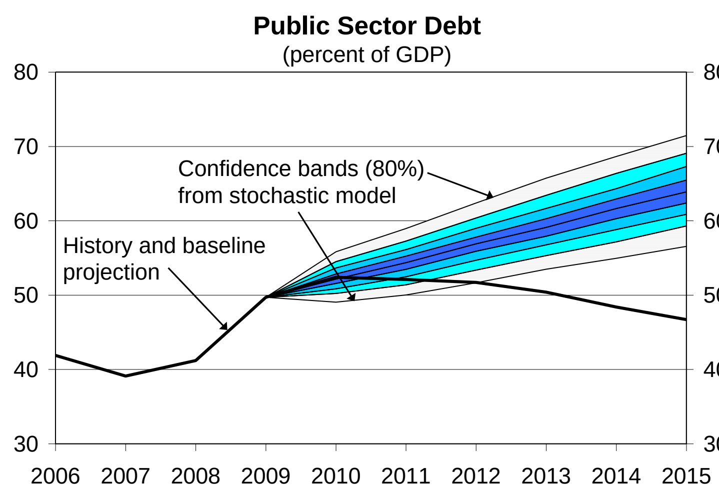
19. **Aside from these new taxes, the government made improvements in tax administration (see MEFP ¶7).** Measures were taken in 2009 to improve the revenue department's audit capabilities and bolster the Treasury's tax collection powers (including by extending the collection period on tax arrears), which should aid the authorities in the process of curbing tax evasion. The authorities plan to step up these efforts in 2010 by: (i) unifying the tax collection process under the Ministry of Finance; (ii) moving away from tax audits based on the auditors' current portfolio to risk-based auditing; (iii) using a newly created taskforce to identify non-filers and stop-filers; and (iv) updating and modernizing the large taxpayers unit.

Box 1. El Salvador's Public Debt Path

A key element of El Salvador's economic program is to preserve debt sustainability. A stochastic debt sustainability analysis (DSA) suggests that plausible shocks could endanger this objective. This highlights the importance for the authorities of adhering to the short-term fiscal objectives of their economic program.

The authorities' medium-term fiscal strategy aims at preserving public debt sustainability. Under the baseline scenario, gross public sector debt is expected to peak at 52.2 percent of GDP in 2010, up from 41.2 percent in 2008. Thereafter, public debt is expected to decline steadily (see Table 8).

A stochastic debt sustainability analysis is useful to assess the risks of the government's fiscal strategy. Drawing on Celasun, Debrun, and Ostry (2006),[1] alternative debt paths were obtained based on stochastic projections for key variables—GDP growth, interest rates, and the real effective exchange rate.[2] The results showed that deviations from baseline GDP growth posed the largest risk to the debt projections.



The stochastic DSA suggests that lower-than-projected growth outturns could result in public debt levels considerably higher than those envisaged by the authorities. This reflects the dependence on historical data in the stochastic analysis, including conservative fiscal reaction to debt increases. Nonetheless, the results point to the sensitivity of El Salvador's debt to lower than projected output in the coming period. For example, if real GDP growth were to remain around 2 percent a year, the debt-to-GDP ratio would rise to about 62 percent by 2015. Moreover, debt levels of as much as 72 percent of GDP lie within an 80-percent confidence interval. These results highlight the importance of adhering to the key fiscal commitments under the authorities' program, namely firm expenditure restraint starting in 2011 and a tax and subsidy reform to strengthen the underlying fiscal position. They also point to the need for having contingency measures ready to contain the deterioration of the NFPS fiscal balance should any of these risks materialize (see ¶28).

[1] "*Primary Surplus Behavior and Risks to Fiscal Sustainability in Emerging Market Countries: A 'Fan Chart' Approach*," IMF WP/06/67, O. Celasun, X. Debrun, and J.D. Ostry.

[2] These stochastic projections were derived from an unrestricted VAR model, with shocks around the deterministic projection calibrated to match the historical properties of the data. The stochastic projections were then combined with an estimated fiscal policy reaction function to produce public debt paths. The algorithm is iterated a large number of times (1,000) to obtain a "fan chart" for the debt projection.

20. **The authorities' fiscal strategy also focuses on redirecting inefficient expenditures toward social programs and infrastructure**. Key in this regard are their on-going efforts to further reform subsidy programs, modernize the road network, and bolster electricity generation (see MEFP ¶7). With assistance from the IADB, the authorities are improving the subsidy programs for liquid petroleum gas (LPG), water, and electricity. In 2010, liquid propane gas prices will be set closer to market rates, while a consumption subsidy will be introduced to protect the most vulnerable. On electricity, the authorities plan to adjust tariffs to improve the targeting of the subsidy. The tariff structures for water usage and public transportation operators were revamped in 2009 and are expected to result in better targeting of these subsidies. Altogether, these reforms are expected to result in savings of up to 0.4 percent of GDP on an annual basis. Additionally, the Millennium Challenge Corporation is assisting in the expansion of rural infrastructure, and CEL (the public electricity company) intends to start construction on two hydroelectric plants this year.

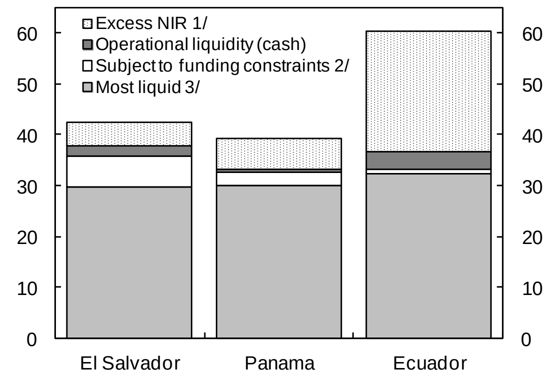
21. **A comprehensive tax reform that yields additional revenues of at least 1½ percent of GDP is the centerpiece of the medium-term fiscal strategy** (see MEFP ¶7). Staff supported the authorities' plan to start a dialogue with key stakeholders on a fiscal reform pact this year and will discuss with the authorities at the time of the first review the steps that will be needed to move this process forward effectively. The authorities anticipate that the consultation process will be difficult and time consuming, as the reform will have to cover politically sensitive issues (such as possible increases in VAT rates and a reallocation of government expenditures). The authorities are confident that they will garner support for a fiscal structure with higher and more stable tax revenues that provides adequate resources for key social programs and infrastructure spending and is consistent with debt sustainability.

22. **The government's ambitious social agenda should make inroads on poverty reduction** (see MEFP ¶3). The authorities attach the highest priority to reducing poverty rates, which have increased significantly in recent years. The latest World Bank survey (for 2008) showed 40 percent of Salvadoran households in poverty (a 10-percentage point increase with respect to 2006), and the situation is likely to have worsened during 2009. In response to this, the government has expanded its conditional cash transfer program (*comunidades solidarias*), is designing a temporary employment program (as part of the PGA and supported by the World Bank), and has started (with IADB resources) a special public investment program concentrated on health, education, and infrastructure. The improved targeting of energy and water subsidies is also part of the anti-poverty effort.

C. Financial System Issues

23. **The authorities recognize that official dollarization is a key anchor of macroeconomic stability**. Even though the regime withstood the global financial crisis without major strains, the authorities attach high priority to increasing further the resilience of the dollarized financial system. They view the resources under a Fund SBA as providing an additional liquidity buffer to help absorb negative confidence shocks, while they put in place more permanent measures to overcome the central bank's limited capacity to undertake lender-of-last-resort operations. A key difference in this regard is that while liquid assets held by Salvadoran commercial banks are roughly comparable to those in the other fully-dollarized economies of Latin America, Salvadoran banks hold a higher proportion of their liquid assets in central government securities.

Commercial Bank Liquidity
(percent of deposits and securities, November 2009)



Sources: IMF, *International Financial Statistics*; and Fund staff calculations.
1/ Net international reserves in excess of commercial bank claims on the monetary authority.
2/ Commercial bank holdings of central government securities.
3/ Deposits at the monetary authority, central bank securities, deposits abroad, and securities abroad.

24. **The authorities plan to step up their vigilance of the financial system**. While all commercial banks comfortably meet regulatory thresholds, the economic slowdown is expected to have lasting effects on the quality of banks' assets. The authorities are closely monitoring the situation, working with banks to ensure the appropriate risk classification of assets, and conducting stress tests to evaluate whether banks necessitate further capital injections. They plan to accelerate the buildup of the deposit insurance fund by postponing repayment to the central bank for its initial capital contribution. Increasing the differentiation of fund premia according to a bank's risk rating is also being evaluated.

25. **The authorities have requested a follow-up FSAP to assist them in designing the reform agenda for the financial sector** (see MEFP ¶13).[8] They are especially interested in recommendations to strengthen the bank resolution framework and mechanisms to pool reserves for liquidity support. The authorities noted that bank resolution procedures could be strengthened by reducing the time required for each stage of the resolution process; clarifying the roles of the superintendency, central bank, and deposit insurance fund; and exploring options for allowing a bank to continue operating while intervention procedures are ongoing. The authorities will likely use FSAP recommendations to design their financial sector reform agenda in the coming years (some of which could be incorporated as structural benchmarks

[8] The previous FSAP update was completed in 2004, before the largest commercial banks were purchased by international conglomerates. The second FSAP update is expected to be concluded at the time of the first review.

under the program during future reviews). In addition, the authorities are confident that a law currently before congress and aimed at providing a clear legal basis for investment funds and setting accounting and asset valuation standards for investors would help enhance financial intermediation.

26. **Financial regulation and supervision will be strengthened by the passage of the financial sector law currently before the financial commission of congress** (a structural benchmark under the program, see MEFP ¶11).[9] Financial supervision will be unified under the superintendency and financial regulation under the central bank. The law will: (i) strengthen consolidated supervision of the financial sector by merging the supervisory entities for banks, pensions, and the stock market and enhancing the autonomy of the merged institution; and (ii) grant supervisors legal protection from criminal prosecution.

D. Downside Risks

27. **A slower recovery and lack of political support for fiscal consolidation are the two main downside risks of the authorities' economic strategy**. If either of these risks were to materialize, tighter expenditure restraint would be the only available tool to preserve macroeconomic stability.

- A prolonged period of low growth or a double-dip recession would result in lower than envisaged tax collections, and could impact the yield of the proposed revenue measures. As noted in Box 1, El Salvador's public debt path is highly sensitive to a growth shock.

- The fiscal strategy for the short and medium term hinges on timely disbursements of IFI loans and on broad-based political support for further reforms and for authorizations of borrowing from IFIs. To date, President Funes has been able to forge such a consensus and financing commitments are quite firm for 2010 and 2011 (see Table 2). However, the challenge remains to garner and maintain a broad-based consensus to support continued fiscal consolidation and the prospective tax reform under the fiscal pact. Furthermore, as most of the external financing for the fiscal program comes from IFIs, timely compliance with program conditions agreed with those entities is essential for avoiding delays in projected disbursements.

28. **The government would need to take additional measures if these risks were to materialize**. Even though the authorities' strategy provides a solid basis to move forward in a baseline scenario, they are designing a strategy to respond to a more adverse scenario. If external financing were not to materialize or if the government were not able to garner the necessary congressional support for further reforms, spending would need to be reduced to avoid recourse to riskier forms of financing (such as the issuance of short-term debt in the

[9] Approval of this law was a structural benchmark under the January 2009 SBA.

domestic market). An important safeguard in this regard is the authorities' plan to reprioritize the public investment program to identify projects that could be delayed with the least social impact.

IV. Program Modalities

A. Program Duration

29. **The authorities have requested a three-year arrangement**. A Fund-supported program covering the period of the slow recovery would allow them to establish a track record of sound macroeconomic policies. A three-year arrangement will give the authorities time to garner support for the fiscal pact and its tax reform, which is essential to meet their ambitious social goals while ensuring debt sustainability. In addition, the arrangement, which they plan to treat as precautionary, would help serve as a catalyst for financing by official creditors (including IFIs) and private investors.

B. Conditionality, Access, and Monitoring

30. **Staff is proposing a total level of access of 300 percent of quota (SDR 513.9 million), with semi-annual reviews**. In view of the reduced political risks, the solid level of bank liquidity that provides comfortable coverage of deposits in the dollarized regime, and the absence of financing gaps for the budget or the balance of payments, access under normal limits seems adequate. The proposed phasing would make available 100 percent of quota at program approval, 12.5 percent of quota following compliance with the March 2010 performance criteria, 62.5 percent of quota more at the time of the first review, and the rest distributed uniformly over the arrangement. The proposed total access and front-loaded phasing would be similar to that in the January 2009 SBA and would allow the government to establish a buffer against financial sector distress, as well as provide a clear signal of Fund support for the new government's program. Program reviews would be semi-annual, beginning with the first one to be completed on or after September 15, 2010.

31. **The program includes policy measures to help mitigate the negative impact of the economic slowdown on the fiscal accounts, bolster the financial system, and support the authorities' medium-term priorities**.

- **Prior actions**. Include: congressional approval of a set of tax measures that would yield an estimated US$140 million (met); and congressional approval of the 2010 budget consistent with a NFPS deficit of no more than US$1,047 million (met).

- **Quantitative performance criteria**. Quarterly ceilings on the NFPS deficit consistent with a deficit for 2010 of US$1,047 million (4.7 percent of GDP).[10] Quarterly ceilings on the contracting of public sector debt, consistent with an end-2010 stock of public sector debt of no more than US$11,800 million. In addition, the authorities have committed to maintaining zero external debt arrears and zero domestic payments arrears (see Table 13).

- **Structural benchmarks**. Structural conditionality under the program would cover actions to support a durable improvement in the public finances and to bolster financial sector oversight, including: modernization of tax administration, reform of subsidies, and congressional approval of the financial supervision law and the investment funds law (see MEFP Table 3).

- **Consultation clauses**. The program will contain two clauses under which the authorities commit to consult with Fund staff and reach understandings on corrective measures (see Table 13). The first would be triggered if the sum of private sector deposits and short-term external obligations were to fall by 10 percent or more with respect to their end-November 2009 levels (US$8,258 million). The other one would be triggered in the event that the authorities considered that financial conditions warranted a change in commercial bank reserve requirements or system-wide liquid asset requirements (approximately 22 percent and 3 percent, respectively, as of December 2009).

32. **Staff will evaluate, before completion of the first review, progress on the recommendations made in the recent safeguards assessment**. The safeguards assessment report completed in May 2009 found a relatively strong safeguards framework at the central bank, particularly in the audit and internal control areas. However, staff recommended enhancements in the legal and financial reporting frameworks and the review of program monetary data.

V. Capacity to Repay the Fund

33. **If the authorities were to make all the purchases under the SBA, El Salvador's capacity to repay the Fund would be strong**. When the global crisis subsides and world growth settles on its long-term growth path, El Salvador will be well poised to exploit the benefits of solid economic fundamentals, its geographical position, and its reform agenda. Even if all purchases under the program were made, the maximum repayment in any one year (2014) would represent only 4.2 percent of exports of goods and services (Table 11).

[10] The target for the fiscal deficit will contain an adjuster based on the performance of tax revenue. If tax revenue were to exceed the quarterly targets established under the program, the authorities would be allowed to spend up to 50 percent of the excess revenue on social programs, while using the remainder to reduce net public sector debt (defined as gross public debt less government deposits at the central bank and commercial banks).

Medium-Term Framework
(In percent of GDP, unless otherwise noted)

	Estimate	Projections					
	2009	2010	2011	2012	2013	2014	2015
				(Percent change)			
Real GDP	-3.3	1.0	2.5	3.0	4.0	4.0	4.0
Domestic demand	-9.5	2.8	3.0	3.6	4.6	4.4	4.2
Consumer prices (end of period)	-0.2	1.5	2.8	2.8	2.8	2.8	2.8
Contributions to growth				(Percentage points)			
Private consumption	-9.3	2.4	3.1	3.4	4.6	4.4	4.2
Private investment	-3.3	0.3	0.5	0.6	0.6	0.6	0.7
Government	0.5	0.7	0.0	0.3	0.4	0.4	0.4
Net exports	8.7	-2.3	-1.2	-1.3	-1.6	-1.5	-1.2
				(Percent of GDP)			
Gross domestic investment	13.2	13.6	13.6	13.6	13.6	13.7	13.8
Private	10.8	10.8	11.0	11.0	11.0	11.0	11.1
Public	2.4	2.7	2.7	2.6	2.6	2.7	2.7
Gross national saving	11.6	10.9	10.8	11.0	10.9	10.9	11.0
Private	14.5	12.8	11.8	10.7	9.5	9.4	9.2
Public	-3.0	-1.9	-1.0	0.3	1.4	1.5	1.8
External saving	1.6	2.7	2.8	2.7	2.7	2.8	2.8

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

VI. Staff Appraisal

34. **Economic performance in El Salvador has been much weaker than expected at the time of approval of the January 2009 SBA**. The global recession impacted El Salvador significantly more than envisaged at that moment and resulted in a sizeable contraction in output and a large shortfall in tax collections. Nevertheless, political risks associated with the election cycle and transition period did not materialize, bank deposits remained stable, and financial stability was maintained.

35. **As risks have shifted from political uncertainty to mitigating the effects of the recession, the new authorities have refocused their economic policy priorities**. Key in this regard is their intention to pursue a countercyclical fiscal policy while activity remains depressed, yet safeguarding macroeconomic stability through medium-term fiscal consolidation plans to ensure public debt sustainability. Staff welcomes the authorities' short-term plans for assisting those adversely affected by the slowdown and, more generally, their intention to increase social spending and infrastructure investment.

36. **The authorities' fiscal strategy aims at lowering the fiscal deficit over time through revenue-enhancing measures and more efficient spending**. The large fiscal deficit of 2009 contributed to support domestic demand, but at the cost of a sharp rise in the public debt. The revenue package approved by congress in mid-December 2009 carefully avoided recourse to general rate hikes, focusing instead on widening the tax base. The planned reform of energy and water subsidies should help improve the efficiency of public sector spending.

Staff sees merit in the authorities' strategy to seek a national consensus on a fiscal pact that could be implemented within the program period. Such a pact would establish a sustainable resource base for the financing of needed social and infrastructure spending over the medium term, while ensuring that fiscal deficits decline and the public debt-to-GDP ratio is placed on a firm downward path.

37. **The government needs to maintain the momentum of structural reforms to lay the foundations for stronger economic performance in the medium term**. El Salvador has achieved hard-won gains that put it in a good position to overcome a period of low global growth. Staff agrees with the strategy of improving and modernizing tax administration, as well as curbing tax evasion, before implementing a comprehensive fiscal pact. A broader tax base, improved targeting of subsidies, and a stepped-up public investment program should help improve resource mobilization and anti-poverty spending, and achieve higher growth over the medium term.

38. **Continued adherence to the full dollarization regime is the cornerstone of maintaining financial stability**. Given El Salvador's close economic ties to the United States, the current regime has served the country well. Inflation is expected to remain low, and the external current account deficit will remain sustainable. Liquid assets held by commercial banks are roughly comparable to those of other fully-dollarized economies in Latin America, and maintenance of adequate reserve requirements is a crucial liquidity buffer.

39. **Continued close monitoring of the financial system is crucial**. All institutions are currently well-capitalized, but the need to provision for rising non-performing loans will weigh on credit growth and profitability going forward. Staff supports the authorities' efforts to step up their monitoring of financial institutions. Staff also encourages the timely passage of the financial supervision and regulation bill, which had been before the financial commission of the previous congress since early 2009 and now is being discussed by the new members of this commission. Progress in strengthening financial sector oversight will be a key issue in the context of the first program review. Further reforms, such as a revision of the bank resolution framework and approval of the investment funds law, will increase the system's resilience and help enhance financial intermediation capacity. Staff welcomes the authorities' request for an FSAP update, which should help clarify the financial sector reform agenda.

40. **A protracted recovery and an unforeseen decline in political support for the fiscal strategy are important risks to the program**. The cautious assumption on the pace of economic recovery underlying the Fund-supported program provides an important safeguard. Broad-based political support will be crucial for the successful implementation of the fiscal strategy, and the authorities will need to overcome traditional polarization and congressional gridlock through a dialogue with all stakeholders as they do not hold a majority in congress. Approvals of the 2010 budget and the tax package in December 2009 were important steps, but efforts to maintain the political consensus and move the authorities' agenda forward will have to be sustained.

41. **In light of these considerations, staff supports the authorities' request for a new SBA of SDR 513.9 million**.

Table 1. El Salvador: Selected Economic Indicators

	2006	2007	2008	2009		2010	
				SBA 09 1/	Estimate	SBA 09 1/	Projection
	(Annual percent change, unless otherwise stated)						
Income and Prices							
Real GDP	4.2	4.7	2.5	2.5	-3.3	2.5	1.0
Consumer prices (end of period) 2/	4.9	4.9	5.5	3.8	-0.2	2.9	1.5
GDP deflator (period average)	4.9	4.4	5.9	3.6	0.7	3.2	2.3
External Sector							
Exports of goods and services, volume	5.6	6.2	5.5	3.1	-15.6	3.0	2.5
Imports of goods and services, volume	9.5	8.0	4.7	-3.5	-22.3	2.6	5.8
Terms of trade	-0.9	-5.7	-10.2	6.0	12.5	-1.2	-3.5
Real effective exchange rate (+ is appreciation) 2/	0.4	-0.5	0.5	…	2.2	…	…
External sovereign bond (spread, basis points) 2/	200	163	388	…	486	…	…
	(Percent of GDP, unless otherwise stated)						
Money and Credit							
Credit to the private sector	43.0	42.8	41.3	41.2	40.4	41.1	41.5
Broad money	43.8	47.1	43.9	42.6	46.7	42.4	46.9
Interest rate (time deposits, percent) 2/	4.4	4.7	4.2	…	4.5	…	…
External Sector							
Current account balance	-4.2	-6.0	-7.6	-2.7	-1.6	-3.4	-2.7
Trade balance	-18.9	-20.1	-19.9	-16.5	-13.2	-16.8	-14.7
Exports (f.o.b. including *maquila*)	20.1	19.8	20.8	21.1	17.9	20.8	18.2
Imports (f.o.b. including *maquila*)	-39.1	-40.0	-40.7	-37.6	-31.1	-37.6	-32.9
Services and income (net)	-3.9	-4.3	-5.1	-3.1	-4.9	-3.1	-5.1
Transfers (net)	18.6	18.4	17.3	16.9	16.5	16.5	17.1
Nonfinancial Public Sector							
Overall balance	-2.9	-1.9	-3.1	-2.8	-5.4	-1.7	-4.7
Primary balance	-0.5	0.5	-0.7	-0.5	-3.0	0.7	-1.7
Of which: tax revenue	13.3	13.4	13.0	13.6	12.1	14.3	13.2
Gross Public Debt 3/	41.9	39.1	41.2	41.5	49.4	40.7	52.2
Of which: external public debt 3/	27.5	24.3	23.7	24.0	28.0	22.8	30.5
Net debt 4/	36.7	34.9	37.8	38.7	44.7	38.2	47.8
External public debt service 3/ (percent of exports of goods and services)	15.6	12.3	9.6	12.5	11.4	10.2	12.0
National Savings and Investment							
Gross domestic investment	16.1	16.1	15.0	15.3	13.2	15.4	13.6
Public sector	2.2	2.0	2.1	2.2	2.4	2.5	2.7
Private sector	13.9	14.1	12.8	13.0	10.8	12.9	10.8
Of which: foreign direct investment	1.4	6.9	3.3	1.4	1.3	1.9	0.9
Gross domestic saving	11.9	10.1	7.4	12.5	11.6	12.1	10.9
Public sector	0.0	0.5	-0.3	0.0	-3.0	1.3	-1.9
Private sector	11.9	9.6	7.7	12.5	14.5	10.8	12.8
Net Foreign Assets of the Financial System							
Millions of U.S. dollars	1,398	2,134	2,035	1,871	2,922	1,766	3,044
Percent of deposits	16.8	22.5	21.7	19.8	29.4	19.2	29.6
Memorandum Items:							
Net *maquila* exports	3.4	2.8	2.9	3.2	3.0	3.1	3.0
Nominal GDP (billions of U.S. dollars)	18.7	20.4	22.1	23.6	21.5	24.8	22.3

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

1/ IMF Country Report No. 09/71.

2/ Actual data through end-2009.

3/ Includes gross debt of the nonfinancial public sector and external debt of the central bank.

4/ Public sector gross debt less government deposits held at the central bank or commercial banks.

Table 2. El Salvador: Balance of Payments
(In US$ millions)

				Estimate	Projections					
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Current Account	**-783**	**-1,221**	**-1,682**	**-347**	**-606**	**-661**	**-664**	**-729**	**-787**	**-847**
Merchandise trade balance	-3,533	-4,105	-4,394	-2,840	-3,271	-3,508	-3,791	-4,138	-4,488	-4,890
Export of goods (f.o.b.)	3,759	4,039	4,611	3,857	4,045	4,343	4,688	5,050	5,463	5,826
General merchandise	1,983	2,235	2,683	2,369	2,426	2,597	2,809	3,035	3,319	3,544
Goods for processing	1,775	1,804	1,928	1,488	1,620	1,745	1,879	2,015	2,145	2,282
Import of goods (f.o.b.)	-7,291	-8,144	-9,004	-6,697	-7,317	-7,851	-8,479	-9,188	-9,952	-10,716
General merchandise	-6,148	-6,907	-7,723	-5,858	-6,361	-6,813	-7,370	-7,999	-8,686	-9,370
Goods for processing	-1,143	-1,237	-1,282	-839	-956	-1,038	-1,109	-1,189	-1,265	-1,346
Services	-192	-291	-584	-444	-464	-480	-521	-566	-611	-648
Income	-531	-576	-536	-620	-671	-723	-727	-784	-830	-876
Of which: interest on public debt	-342	-315	-245	-251	-320	-378	-406	-422	-448	-463
Current transfers	3,472	3,750	3,832	3,558	3,800	4,051	4,375	4,759	5,143	5,567
Financial and Capital Account	**1,166**	**680**	**1,714**	**777**	**698**	**429**	**832**	**998**	**834**	**929**
Capital account	97	151	80	114	169	155	101	96	95	95
Public sector financial flows	497	-115	277	785	760	159	221	174	238	-31
Of which : disbursements	901	205	577	1,076	1,036	1,086	493	415	494	220
Of which : amortization	-404	-320	-300	-291	-276	-927	-273	-241	-256	-251
Private sector financial flows	572	645	1,357	-121	-231	115	510	727	501	865
Foreign direct investment	267	1,408	719	271	203	248	323	416	506	611
Commercial banks	-209	-467	143	-412	-21	140	140	180	140	140
Other	513	-296	495	20	-414	-272	47	132	-146	114
Errors and Omissions	**-311**	**821**	**302**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Change in Reserves (- = increase)	**-72**	**-280**	**-334**	**-430**	**-92**	**232**	**-168**	**-269**	**-48**	**-82**
					(In percent of GDP)					
Current Account	**-4.2**	**-6.0**	**-7.6**	**-1.6**	**-2.7**	**-2.8**	**-2.7**	**-2.7**	**-2.8**	**-2.8**
Merchandise trade balance	-18.9	-20.1	-19.9	-13.2	-14.7	-15.0	-15.2	-15.5	-15.7	-16.1
Export of goods (f.o.b.)	20.1	19.8	20.8	17.9	18.2	18.6	18.8	18.9	19.1	19.2
Net maquila exports	3.4	2.8	2.9	3.0	3.0	3.0	3.1	3.1	3.1	3.1
Import of goods (f.o.b.)	-39.1	-40.0	-40.7	-31.1	-32.9	-33.6	-34.0	-34.3	-34.8	-35.3
Petroleum and products	-5.8	-6.9	-8.4	-5.0	-6.1	-6.2	-6.2	-6.2	-6.2	-6.2
Services	-1.0	-1.4	-2.6	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1
Income	-2.8	-2.8	-2.4	-2.9	-3.0	-3.1	-2.9	-2.9	-2.9	-2.9
Current transfers	18.6	18.4	17.3	16.5	17.1	17.3	17.6	17.8	18.0	18.4
Financial and Capital account	**6.2**	**3.3**	**7.7**	**3.6**	**3.1**	**1.8**	**3.3**	**3.7**	**2.9**	**3.1**
Capital account	0.5	0.7	0.4	0.5	0.8	0.7	0.4	0.4	0.3	0.3
Public sector financial flows	2.7	-0.6	1.3	3.6	3.4	0.7	0.9	0.7	0.8	-0.1
Private sector financial flows	3.1	3.2	6.1	-0.6	-1.0	0.5	2.0	2.7	1.8	2.9
Foreign direct investment	1.4	6.9	3.3	1.3	0.9	1.1	1.3	1.6	1.8	2.0
Commercial banks	-1.1	-2.3	0.6	-1.9	-0.1	0.6	0.6	0.7	0.5	0.5
Other	2.8	-1.5	2.2	0.1	-1.9	-1.2	0.2	0.5	-0.5	0.4
Merchandise Trade (f.o.b.)					(annual percent change)					
Exports (nominal)	9.1	7.5	14.1	-16.4	4.9	7.3	8.0	7.7	8.2	6.6
Volume	5.3	4.8	5.5	-15.3	4.0	5.8	6.7	6.5	7.0	5.4
Price	3.5	2.5	8.2	-1.2	0.8	1.5	1.2	1.2	1.1	1.2
Imports (nominal)	14.2	11.7	10.6	-25.6	9.3	7.3	8.0	8.4	8.3	7.7
Volume	9.3	2.8	-8.2	-15.3	4.6	4.5	6.5	6.8	6.9	6.3
Price	4.5	8.6	20.4	-12.2	4.5	2.7	1.4	1.5	1.3	1.3
Terms of trade	-0.9	-5.7	-10.2	12.5	-3.5	-1.2	-0.3	-0.3	-0.3	-0.2
Memorandum Items										
Gross international reserves (US$ million)	1,908	2,198	2,545	2,975	3,067	2,835	3,003	3,272	3,319	3,401
in months of imports (excluding maquila) 1/	2.7	2.8	4.2	4.6	4.4	3.8	3.7	3.8	3.6	3.6
in percent of total short-term external debt	150	171	166	192	191	175	176	183	182	182
External debt (in percent of GDP)	51.4	44.5	43.9	45.5	45.7	44.0	43.2	42.2	40.5	39.0
Of which : public sector debt	27.5	24.3	23.7	28.0	30.5	29.7	28.8	27.5	26.6	24.9
Of which : private sector debt	23.9	20.2	20.2	17.4	15.2	14.2	14.4	14.7	13.9	14.0
External public debt servicing (US$ million)	746	635	545	542	596	1,305	679	663	704	714
percent of exports of goods and services	15.6	12.3	9.6	11.4	12.0	24.5	11.9	10.8	10.7	10.2
Gross external financing requirement (US$ million)	3,376	3,487	3,945	2,960	2,785	3,169	2,925	3,161	3,126	3,260
percent of GDP	18.1	17.1	17.8	13.7	12.5	13.5	11.7	11.8	10.9	10.7

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 Nonfinancial Public Sector

(In US$ millions)

	2006	2007	2008	2009		2010	
				SBA 09 1/	Estimate	SBA 09 1/	Projection
Revenue and Grants	**3,199**	**3,484**	**3,732**	**4,059**	**3,400**	**4,610**	**3,884**
Current revenue	3,158	3,422	3,679	3,941	3,291	4,414	3,702
Tax revenue	2,488	2,720	2,886	3,216	2,609	3,553	2,940
Nontax revenue	552	590	619	610	573	699	634
Of which: pension revenue	16	15	14	15	13	14	12
Operating surplus of the public enterprises	118	111	174	115	109	162	128
Capital revenue	0	0	0	0	0	0	0
Official grants	41	62	53	118	109	197	182
Expenditure	**3,746**	**3,880**	**4,415**	**4,728**	**4,571**	**5,030**	**4,931**
Current expenditure	3,167	3,312	3,754	3,938	3,929	4,088	4,123
Wages and salaries	1,315	1,409	1,528	1,705	1,659	1,797	1,769
Goods and services	719	728	823	830	874	826	959
Interest	455	507	520	541	531	582	661
Current transfers	677	667	884	862	865	883	735
Nonpension payments	328	348	563	505	519	483	374
Pension payments	349	319	321	357	346	400	361
Capital expenditure	580	568	661	790	642	943	808
Primary Balance	**-92**	**111**	**-164**	**-128**	**-640**	**162**	**-387**
Overall Balance	**-547**	**-396**	**-683**	**-669**	**-1,171**	**-420**	**-1,047**
Financing	**547**	**396**	**683**	**669**	**1,171**	**420**	**1,047**
External	**497**	**-115**	**277**	**-24**	**785**	**28**	**760**
Disbursements	901	205	577	555	1,076	465	1,036
Amortization	-404	-320	-300	-578	-291	-437	-276
Domestic	**50**	**511**	**407**	**693**	**386**	**392**	**288**
Central bank	-47	146	26	254	-293	10	44
Banking system	78	43	93	35	239	42	-43
Private sector 2/	-19	335	357	404	401	340	286
Other	38	-13	-69	0	39	0	0
Memorandum Items:							
Current balance	-9	110	-75	3	-638	326	-421
Pension balance	-333	-304	-306	-342	-333	-386	-348
Gross financing needs	1,173	1,027	1,567	1,608	1,962	1,217	1,474
Implicit nominal interest rate (in percent)	6.3	6.5	6.5	6.1	5.8	5.9	6.2
Total public sector debt (gross) 3/	7,813	7,966	9,110	9,790	10,639	10,125	11,611
Nominal GDP	18,654	20,373	22,115	23,565	21,531	24,847	22,260

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

1/ IMF Country Report No. 09/71.

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

3/ Includes gross debt of the nonfinancial public sector and external debt of the central bank.

Table 4. El Salvador: Operations of the Nonfinancial Public Sector

(In percent of GDP)

	2006	2007	2008	2009		2010	
				SBA 09 1/	Estimate	SBA 09 1/	Projection
Revenue and Grants	**17.2**	**17.1**	**16.9**	**17.2**	**15.8**	**18.6**	**17.4**
Current revenue	16.9	16.8	16.6	16.7	15.3	17.8	16.6
Tax revenue	13.3	13.4	13.0	13.6	12.1	14.3	13.2
Nontax revenue	3.0	2.9	2.8	2.6	2.7	2.8	2.8
Of which: pension revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Operating surplus of the public enterprises	0.6	0.5	0.8	0.5	0.5	0.7	0.6
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Official grants	0.2	0.3	0.2	0.5	0.5	0.8	0.8
Expenditure	**20.1**	**19.0**	**20.0**	**20.1**	**21.2**	**20.2**	**22.2**
Current expenditure	17.0	16.3	17.0	16.7	18.2	16.5	18.5
Wages and salaries	7.1	6.9	6.9	7.2	7.7	7.2	7.9
Goods and services	3.9	3.6	3.7	3.5	4.1	3.3	4.3
Interest	2.4	2.5	2.3	2.3	2.5	2.3	3.0
Current transfers	3.6	3.3	4.0	3.7	4.0	3.6	3.3
Nonpension payments	1.8	1.7	2.5	2.1	2.4	1.9	1.7
Pension payments	1.9	1.6	1.5	1.5	1.6	1.6	1.6
Capital expenditure	3.1	2.8	3.0	3.4	3.0	3.8	3.6
Primary Balance	**-0.5**	**0.5**	**-0.7**	**-0.5**	**-3.0**	**0.7**	**-1.7**
Overall Balance	**-2.9**	**-1.9**	**-3.1**	**-2.8**	**-5.4**	**-1.7**	**-4.7**
Financing	**2.9**	**1.9**	**3.1**	**2.8**	**5.4**	**1.7**	**4.7**
External	**2.7**	**-0.6**	**1.3**	**-0.1**	**3.6**	**0.1**	**3.4**
Disbursements	4.8	1.0	2.6	2.4	5.0	1.9	4.7
Amortization	-2.2	-1.6	-1.4	-2.5	-1.4	-1.8	-1.2
Domestic	**0.3**	**2.5**	**1.8**	**2.9**	**1.8**	**1.6**	**1.3**
Central bank	-0.3	0.7	0.1	1.1	-1.4	0.0	0.2
Banking system	0.4	0.2	0.4	0.1	1.1	0.2	-0.2
Private sector 2/	-0.1	1.6	1.6	1.7	1.9	1.4	1.3
Other	0.2	-0.1	-0.3	0.0	0.2	0.0	0.0
Memorandum Items:							
Current balance	0.0	0.5	-0.3	0.0	-3.0	1.3	-1.9
Pension balance	-1.8	-1.5	-1.4	-1.5	-1.5	-1.6	-1.6
Gross financing needs	6.3	5.0	7.1	6.8	9.1	4.9	6.6
Implicit nominal interest rate (in percent)	6.3	6.5	6.5	6.1	5.8	5.9	6.2
Total public sector debt (gross) 3/	41.9	39.1	41.2	41.5	49.4	40.7	52.2
Nominal GDP (million U.S. dollars)	18,654	20,373	22,115	23,565	21,531	24,847	22,260

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

1/ IMF Country Report No. 09/71.

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

3/ Includes gross debt of the nonfinancial public sector and external debt of the central bank.

Table 5. El Salvador: Operations of the Nonfinancial Public Sector

(In percent of GDP)

				Estimate	Projections					
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Revenue and Grants	**17.2**	**17.1**	**16.9**	**15.8**	**17.4**	**18.3**	**19.3**	**19.6**	**19.6**	**19.6**
Current revenue	16.9	16.8	16.6	15.3	16.6	17.4	18.6	19.4	19.4	19.4
Tax revenue	13.3	13.4	13.0	12.1	13.2	13.9	15.1	16.0	16.1	16.1
Nontax revenue	3.0	2.9	2.8	2.7	2.8	2.8	2.7	2.6	2.6	2.5
Of which: pension revenue	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Operating surplus of the public enterprises	0.6	0.5	0.8	0.5	0.6	0.6	0.7	0.8	0.8	0.7
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Official grants	0.2	0.3	0.2	0.5	0.8	0.9	0.7	0.2	0.2	0.2
Expenditure	**20.1**	**19.0**	**20.0**	**21.2**	**22.2**	**21.8**	**21.8**	**21.4**	**21.3**	**21.0**
Current expenditure	17.0	16.3	17.0	18.2	18.5	18.3	18.3	17.9	17.9	17.6
Wages and salaries	7.1	6.9	6.9	7.7	7.9	7.8	7.8	7.7	7.8	7.8
Goods and services	3.9	3.6	3.7	4.1	4.3	4.2	4.3	4.3	4.3	4.2
Interest	2.4	2.5	2.3	2.5	3.0	3.0	3.0	3.0	2.9	2.8
Current transfers	3.6	3.3	4.0	4.0	3.3	3.3	3.2	3.0	2.9	2.8
Nonpension payments	1.8	1.7	2.5	2.4	1.7	1.6	1.6	1.4	1.3	1.3
Pension payments	1.9	1.6	1.5	1.6	1.6	1.6	1.6	1.6	1.6	1.5
Capital expenditure	3.1	2.8	3.0	3.0	3.6	3.5	3.4	3.4	3.4	3.4
Primary Balance	**-0.5**	**0.5**	**-0.7**	**-3.0**	**-1.7**	**-0.5**	**0.5**	**1.2**	**1.3**	**1.4**
Overall Balance	**-2.9**	**-1.9**	**-3.1**	**-5.4**	**-4.7**	**-3.5**	**-2.5**	**-1.8**	**-1.6**	**-1.4**
Financing	**2.9**	**1.9**	**3.1**	**5.4**	**4.7**	**3.5**	**2.5**	**1.8**	**1.6**	**1.4**
External	**2.7**	**-0.6**	**1.3**	**3.6**	**3.4**	**0.7**	**0.9**	**0.7**	**0.8**	**-0.1**
Disbursements	4.8	1.0	2.6	5.0	4.7	4.6	2.0	1.6	1.7	0.7
Amortization	-2.2	-1.6	-1.4	-1.4	-1.2	-4.0	-1.1	-0.9	-0.9	-0.8
Domestic	**0.3**	**2.5**	**1.8**	**1.8**	**1.3**	**2.8**	**1.6**	**1.1**	**0.8**	**1.5**
Central bank	-0.3	0.7	0.1	-1.4	0.2	1.5	-0.3	-0.5	0.4	0.4
Banking system	0.4	0.2	0.4	1.1	-0.2	-0.2	0.5	0.3	0.3	-0.1
Private sector 1/	-0.1	1.6	1.6	1.9	1.3	1.5	1.4	1.3	0.1	1.2
Other	0.2	-0.1	-0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items:										
Current balance	0.0	0.5	-0.3	-3.0	-1.9	-1.0	0.3	1.4	1.5	1.8
Pension balance	-1.8	-1.5	-1.4	-1.5	-1.6	-1.6	-1.6	-1.6	-1.5	-1.5
Gross financing needs	6.3	5.0	7.1	9.1	6.6	8.1	4.2	3.2	3.1	2.7
Implicit nominal interest rate (in percent)	6.3	6.5	6.5	5.8	6.2	6.1	6.2	6.2	6.3	6.1
Total public sector debt (gross) 2/	41.9	39.1	41.2	49.4	52.2	51.9	51.5	50.2	48.3	46.5
Nominal GDP (million U.S. dollars)	18,654	20,373	22,115	21,531	22,260	23,388	24,925	26,756	28,573	30,327

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

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

2/ Includes gross debt of the nonfinancial public sector and external debt of the central bank.

Table 6. El Salvador: Summary Accounts of the Financial System

	2006	2007	2008	2009 1/		2010 1/	
				SBA 09 2/	Estimate	SBA 09 2/	Projection
	(End of period stocks; millions of U.S. dollars)						
	I. Central Bank						
Net Foreign Assets	**1,843**	**2,167**	**2,248**	**1,847**	**2,700**	**1,971**	**2,802**
Net international reserves	1,907	2,198	2,541	2,482	2,985	2,606	3,076
Of which : "Free" NIR 3/	122	50	169	129	622	135	597
Net Domestic Assets	**432**	**580**	**544**	**695**	**237**	**685**	**272**
Nonfinancial public sector	320	465	521	622	224	632	269
Claims	813	812	839	839	836	839	836
Deposits	493	347	318	217	612	207	567
Commercial banks	0	0	0	0	0	0	0
Nonbank financial institutions	340	355	255	231	265	211	265
Nonfinancial private sector	0	0	32	400	10	400	0
Other items (net)	-228	-240	-264	-558	-262	-558	-262
Central Bank Backed Liabilities	**2,273**	**2,745**	**2,791**	**2,542**	**2,938**	**2,656**	**3,074**
Currency issue	34	33	33	33	33	33	33
Liabilities to other depositary corporations	1,694	2,044	2,258	2,091	2,256	2,193	2,316
Other liabilities	545	668	500	418	649	430	725
	II. Commercial Banks						
Net Foreign Assets	**-420**	**39**	**-98**	**24**	**314**	**-81**	**334**
Net Domestic Assets	**8,709**	**9,681**	**9,944**	**9,993**	**9,886**	**10,555**	**10,259**
Net claims on nonfinancial public sector	-85	-36	12	70	251	111	208
Net claims on the financial system	2,124	2,504	2,591	2,440	2,723	2,502	2,797
Claims on the private sector	7,907	8,617	8,985	9,225	8,587	10,212	9,112
Other items (net)	-1,236	-1,404	-1,644	-1,743	-1,674	-2,270	-1,857
Liabilities to the Private Sector	**8,289**	**9,719**	**9,845**	**10,017**	**10,200**	**10,474**	**10,594**
Deposits	7,360	8,641	8,646	8,780	8,911	9,198	9,302
Other	929	1,078	1,199	1,237	1,290	1,276	1,292
	III. Financial System 4/						
Net Foreign Assets	**1,398**	**2,134**	**2,035**	**1,871**	**2,922**	**1,766**	**3,044**
Net Domestic Assets	**6,525**	**7,186**	**7,478**	**7,872**	**6,975**	**8,458**	**7,306**
Nonfinancial public sector	265	464	610	778	551	829	555
Credit to private sector	8,022	8,726	9,134	9,716	8,709	10,212	9,231
Other	-1,762	-2,004	-2,266	-2,622	-2,284	-2,584	-2,479
Liabilities to the Private Sector	**7,924**	**9,320**	**9,513**	**9,743**	**9,898**	**10,224**	**10,351**
Broad money	8,172	9,601	9,709	10,037	10,058	10,532	10,444
Money	1,510	1,765	1,789	1,845	1,845	1,936	1,898
Quasi-money	6,662	7,836	7,921	8,192	8,213	8,596	8,546
	(Percent changes relative to previous year's broad money)						
Net domestic assets	8.3	8.1	3.0	3.5	-5.2	5.8	3.3
Nonfinancial public sector	-1.5	2.4	1.5	2.9	-0.6	0.5	0.0
Credit to the private sector	9.7	8.6	4.2	4.6	-4.4	4.9	5.2
Liabilities to the private sector	12.8	17.1	2.0	-1.2	4.0	4.8	4.5
	(Percent of GDP)						
Credit to the private sector	43.0	42.8	41.3	41.2	40.4	41.1	41.5
Liabilities to the private sector	42.5	45.7	43.0	41.3	46.0	41.1	46.5
Memorandum Items:	(Annual percent change, unless otherwise stated)						
Financial system credit to the private sector	9.6	8.8	4.7	5.0	-4.7	5.1	6.0
Private sector deposits in commercial banks	11.4	17.4	0.1	0.3	3.1	4.8	4.4
Commercial bank liquidity deposits at central bank (percent of total deposits)	22.9	23.5	25.9	24.4	24.8	24.4	24.4

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

1/ Revised projections are consistent with the SDR allocations made in August and September 2009.

2/ IMF Country Report No. 09/71.

3/ Free NIR are defined as the difference between the central bank's net international reserves, which include government deposits, and its liquid liabilities with domestic residents.

4/ Includes nonbank financial institutions not included elsewhere.

Table 7. El Salvador: Selected Vulnerability Indicators

(In percent of GDP, unless otherwise indicated)

	2005	2006	2007	2008	Est. 2009	Proj. 2010
Fiscal Indicators						
Overall balance of the nonfinancial public sector	-3.0	-2.9	-1.9	-3.1	-5.4	-4.7
Primary balance of the nonfinancial public sector	-0.8	-0.5	0.5	-0.7	-3.0	-1.7
Gross public sector financing requirement	6.3	6.3	5.0	7.1	9.1	6.6
Public sector debt (gross) 1/	42.0	41.9	39.1	41.2	49.4	52.2
Public sector external debt	26.2	27.5	24.3	23.7	28.0	30.5
External interest payments to total fiscal revenue (percent)	11.8	10.7	9.0	6.6	7.4	8.2
External amortization payments to total fiscal revenue (percent)	13.8	12.6	9.2	8.0	8.6	7.1
Financial Indicators						
Broad money (percent change, end-of-period)	6.3	12.4	17.5	1.1	3.6	3.8
Private sector credit (percent change, end-of-period)	10.8	9.6	8.8	4.7	-4.7	6.0
Ratio of capital to risk-weighted assets 2/	13.5	13.8	13.8	15.1	16.5	…
Ratio of loans more than 90 days past due to total loans 2/	1.9	1.9	2.1	2.8	3.7	…
Ratio of provisions to total loans 2/	2.4	2.2	2.5	3.1	4.0	…
Ratio of provisions to loans more than 90 days past due 2/	126.6	116.1	120.0	110.4	109.9	…
Return to average equity 2/	11.8	14.6	11.3	8.7	2.8	…
Return to average total assets 2/	1.2	1.5	1.2	1.0	0.3	…
Loans as percent of deposits 2/	100.4	103.8	97.4	101.4	91.3	…
Ratio of liquid assets to total deposits 2/	33.5	32.3	34.0	35.7	41.3	…
External Indicators						
Exports of goods and services (percent change, 12-month basis)	2.4	8.7	8.3	9.3	-16.0	4.8
Imports of goods and services (percent change, 12-month basis)	6.1	13.9	12.5	11.1	-24.4	8.4
Current account balance	-3.6	-4.2	-6.0	-7.6	-1.6	-2.7
Capital and financial account balance	5.1	6.2	3.3	7.7	3.6	3.1
Gross international reserves (millions of U.S. dollars)	1,833	1,908	2,198	2,545	2,975	3,067
Months of imports of goods and services, excluding maquila	3.0	2.7	2.8	4.2	4.6	4.4
Percent of short-term debt	101	150	171	166	192	191
Percent of gross external financing requirements	64	57	63	65	101	110
Percent of broad money	25.2	23.4	22.9	26.2	29.6	29.4
Total public external debt service	4.2	4.0	3.1	2.5	2.5	2.7
Total external debt to exports of goods and services (percent)	199	201	176	172	206	204
External interest payments to goods and services exports (percent)	16.6	15.4	16.2	13.1	17.3	17.5
External amortization to goods and services exports (percent)	52.5	52.8	38.4	34.1	46.0	42.0
REER, depreciation is negative (percent change, end-of-period)	2.4	-0.2	-2.3	6.6	-2.2	…

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

1/ Includes gross debt of the nonfinancial public sector and external debt of the central bank.

2/ Column for 2009 reflects actual data.

Table 8. El Salvador: Public Sector Debt Sustainability Framework, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual				Estimate	Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Debt-stabilizing primary balance 9/
1 **Baseline: Public sector debt 1/**	42.0	41.9	**39.1**	**41.2**	**49.4**	**52.2**	**51.9**	**51.5**	**50.2**	**48.3**	**46.5**	**0.0**
o/w foreign-currency denominated	42.0	41.9	39.1	41.2	49.4	52.2	51.9	51.5	50.2	48.3	46.5	
2 Change in public sector debt	-1.5	-0.1	-2.8	2.1	8.2	2.7	-0.3	-0.4	-1.3	-1.9	-1.7	
3 Identified debt-creating flows (4+7+12)	-0.2	-0.3	-1.6	0.0	6.6	3.1	1.0	-0.7	-1.7	-1.5	-1.4	
4 Primary deficit	0.8	0.8	-0.5	0.7	3.0	1.7	0.5	-0.5	-1.2	-1.3	-1.4	
5 Revenue and grants	16.0	16.5	17.1	16.9	15.8	17.4	18.3	19.3	19.6	19.6	19.6	
6 Primary (noninterest) expenditure	16.8	17.3	16.6	17.6	18.8	19.2	18.7	18.7	18.4	18.3	18.3	
7 Automatic debt dynamics 2/	-1.0	-1.1	-1.0	-0.7	3.6	1.3	0.5	-0.2	-0.6	-0.3	0.0	
8 Contribution from interest rate/growth differential 3/	-1.0	-1.1	-1.0	-0.7	3.6	1.3	0.5	-0.2	-0.6	-0.3	0.0	
9 Of which contribution from real interest rate	0.2	0.5	0.7	0.2	2.2	1.8	1.8	1.3	1.3	1.6	1.8	
10 Of which contribution from real GDP growth	-1.2	-1.6	-1.8	-0.9	1.4	-0.5	-1.2	-1.5	-1.9	-1.9	-1.8	
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	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	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/	-1.3	0.2	-1.2	2.1	1.7	-0.3	-1.3	0.3	0.5	-0.4	-0.4	
Public sector debt-to-revenue ratio 1/	262.7	254.0	228.6	244.1	312.9	299.0	284.1	267.0	256.3	245.8	237.3	
Gross financing need 6/	6.3	6.3	**5.0**	**7.1**	**9.1**	**6.6**	**8.1**	**4.2**	**3.2**	**3.1**	**2.7**	
in millions of U.S. dollars	1076.4	1173.2	1026.9	1567.3	1961.7	1473.6	1896.1	1036.8	866.3	877.3	831.1	
Scenario with key variables at their historical averages 7/						**52.2**	**51.6**	**52.6**	**53.7**	**53.9**	**54.2**	**-0.6**
Scenario with no policy change (constant primary balance) in 2010-2015						**52.2**	**53.2**	**55.1**	**56.6**	**57.7**	**59.0**	**0.0**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.1	4.2	4.7	2.5	-3.3	1.0	2.5	3.0	4.0	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	5.5	6.3	6.5	6.5	5.8	6.2	6.1	6.2	6.2	6.3	6.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.7	1.5	2.1	0.7	5.1	3.9	3.6	2.7	2.9	3.5	4.1	
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	4.8	4.9	4.4	5.9	0.7	2.3	2.5	3.5	3.3	2.7	2.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	7.4	7.5	-1.8	9.1	3.0	3.3	0.0	3.1	2.1	3.6	3.5	
Primary deficit	0.8	0.8	-0.5	0.7	3.0	1.7	0.5	-0.5	-1.2	-1.3	-1.4	

1/ The table covers gross debt of the nonfinancial public sector plus external debt of the central bank.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = 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 ae(1+r).

5/ For projections, this line includes exchange rate changes.

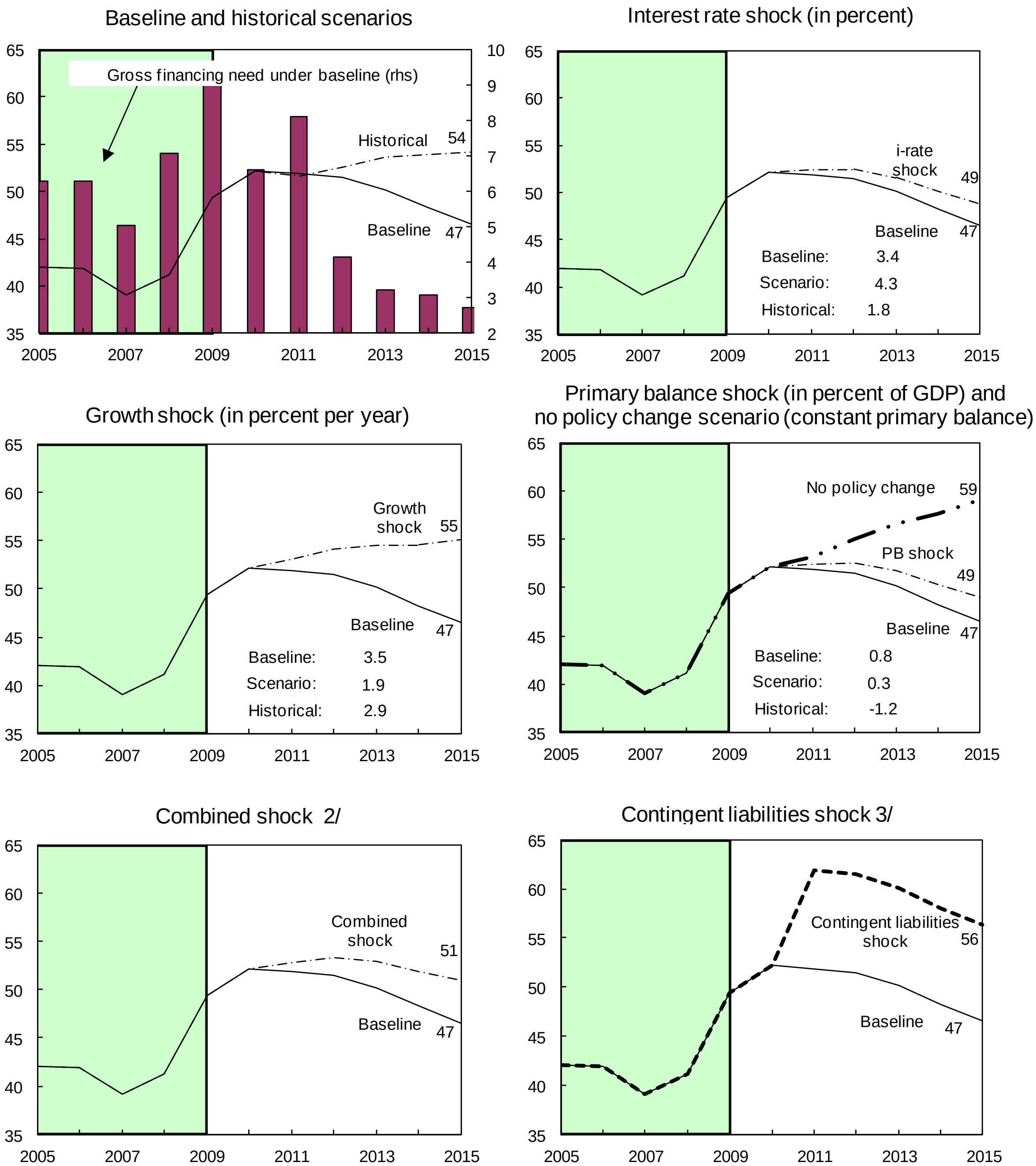
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 5. 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 or estimated data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ Ten percent of GDP shock to contingent liabilities occurs in 2009.

Table 9. El Salvador: External Debt Sustainability Framework, 2005-2015
(In percent of GDP, unless otherwise indicated)

		Actual				Estimate	Projections						
		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Debt-stabilizing non-interest current account 5/
1	**Baseline: External debt**	51.3	51.4	44.5	43.9	**45.5**	**45.7**	**44.0**	**43.2**	**42.2**	**40.5**	**39.0**	**-1.7**
2	Change in external debt	-0.6	0.1	-6.8	-0.6	1.6	0.2	-1.7	-0.7	-1.0	-1.7	-1.5	
3	Identified external debt-creating flows (4+8+9)	-2.6	-1.6	-5.3	0.8	1.5	0.3	-0.4	-1.3	-1.8	-1.7	-1.6	
4	Current account deficit, excluding interest payments	0.1	1.0	2.6	4.9	-1.5	-0.3	-0.3	-0.3	-0.2	-0.1	0.1	
5	Deficit in balance of goods and services	18.0	20.0	21.6	22.5	15.3	16.8	17.1	17.3	17.6	17.8	18.3	
6	Exports	25.7	25.6	25.4	25.6	22.1	22.3	22.8	22.9	22.9	23.0	23.1	
7	Imports	43.7	45.6	46.9	48.1	37.3	39.1	39.8	40.2	40.4	40.9	41.4	
8	Net non-debt creating capital inflows (negative)	-2.3	-1.4	-6.9	-3.3	-1.3	-0.9	-1.1	-1.3	-1.6	-1.8	-2.0	
9	Automatic debt dynamics 1/	-0.4	-1.1	-1.0	-0.8	4.3	1.6	0.9	0.2	0.0	0.1	0.3	
10	Contribution from nominal interest rate	3.5	3.2	3.4	2.7	3.1	3.1	3.1	2.9	2.9	2.8	2.6	
11	Contribution from real GDP growth	-1.5	-2.0	-2.2	-1.0	1.5	-0.5	-1.1	-1.2	-1.6	-1.6	-1.5	
12	Contribution from price and exchange rate changes 2/	-2.4	-2.4	-2.1	-2.5	-0.3	-1.0	-1.1	-1.5	-1.4	-1.1	-0.8	
13	Residual, incl. change in gross foreign assets (2-3)	2.0	1.7	-1.6	-1.5	0.0	-0.1	-1.3	0.6	0.7	0.0	0.0	
	External debt-to-exports ratio (in percent)	199.5	200.8	175.6	171.8	206.3	204.5	193.2	188.7	184.5	175.8	168.7	
	Gross external financing need (in millions of US dollars) 3/	2,858	3,376	3,487	3,945	2,960	2,785	3,169	2,925	3,161	3,126	3,260	
	in percent of GDP	16.7	18.1	17.1	17.8	13.7	12.5	13.5	11.7	11.8	10.9	10.8	
	Scenario with key variables at their historical averages 4/					**45.5**	**44.0**	**41.4**	**40.6**	**39.9**	**38.6**	**37.2**	**-2.4**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	3.1	4.2	4.7	2.5	-3.3	1.0	2.5	3.0	4.0	4.0	4.0	
	GDP deflator in US dollars (change in percent)	4.8	4.9	4.4	5.9	0.7	2.3	2.5	3.5	3.3	2.7	2.0	
	Nominal external interest rate (in percent)	7.3	6.9	7.1	6.6	6.9	7.0	7.2	7.1	7.3	7.1	6.9	
	Growth of exports (US dollar terms, in percent)	2.4	8.7	8.3	9.3	-16.0	4.8	7.0	7.2	7.2	7.6	6.4	
	Growth of imports (US dollar terms, in percent)	6.1	13.9	12.5	11.1	-24.4	8.4	6.9	7.6	8.0	7.9	7.4	
	Current account balance, excluding interest payments	-0.1	-1.0	-2.6	-4.9	1.5	0.3	0.3	0.3	0.2	0.1	-0.1	
	Net non-debt creating capital inflows	2.3	1.4	6.9	3.3	1.3	0.9	1.1	1.3	1.6	1.8	2.0	

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

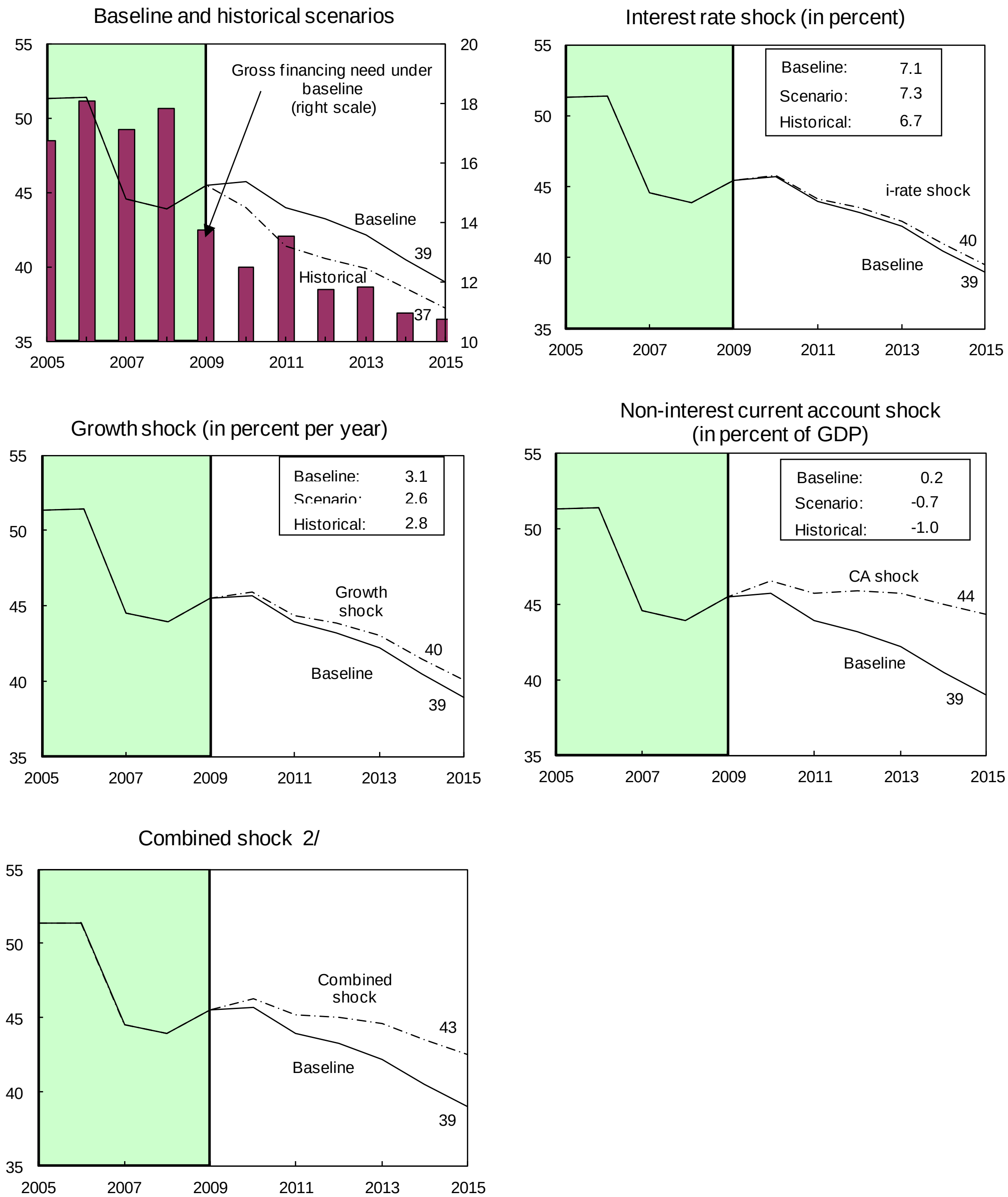
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

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

4/ 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.

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

Figure 6. 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 or estimated 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.

Table 10. El Salvador: External Financing Requirements and Sources

(In US$ millions)

	2006	2007	2008	2009		2010	
				SBA 09 1/	Estimate	SBA 09 1/	Projection
Gross Financing Requirements	**3,376**	**3,487**	**3,945**	**2,982**	**2,960**	**3,046**	**2,785**
Current account deficit	783	1,221	1,682	645	347	836	606
Debt amortization	2,521	1,986	1,929	2,414	2,182	2,085	2,087
Public sector	404	320	300	578	291	437	276
Private sector	2,117	1,665	1,629	1,836	1,891	1,649	1,811
GIR accumulation	72	280	334	-77	430	124	92
Gross Financing Sources	**3,376**	**3,487**	**3,945**	**2,982**	**2,960**	**3,046**	**2,785**
Public sector disbursements	901	205	577	918	1,076	465	1,036
Private sector net inflows	2,474	3,282	3,368	2,065	1,884	2,581	1,749
Foreign direct investment	267	1,408	719	323	271	462	203
Other	2,207	1,874	2,649	1,741	1,613	2,119	1,546

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

1/ IMF Country Report No. 09/71.

Table 11. El Salvador: Indicators of Fund Credit

(In units indicated)

	Projections					
	2010	2011	2012	2013	2014	2015
Existing and prospective Fund credit 1/						
In millions of SDRs	321.2	406.8	492.5	430.9	254.3	117.8
In percent of exports of goods and services	9.9	11.7	13.2	10.8	5.9	2.6
In percent of public sector external debt	7.2	8.9	10.5	9.0	5.1	2.4
In percent of gross reserves	16.0	21.9	25.1	20.1	11.7	5.3
In percent of quota	187.5	237.5	287.5	251.6	148.4	68.8
Repurchases and charges due from existing and prospective drawings						
In millions of SDRs	3.2	4.7	5.8	89.2	181.4	139.1
In percent of exports of goods and services	0.1	0.1	0.2	2.2	4.2	3.0
In percent of public sector external debt service	0.8	0.6	1.3	20.6	39.4	29.8
In percent of gross reserves	0.2	0.3	0.3	4.2	8.4	6.3
In percent of quota	1.9	2.8	3.4	52.1	105.9	81.2

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

1/ End of period.

Table 12. El Salvador: Purchase Schedule and Terms Under the Stand-By Arrangement

		Purchase			
Date	Conditions for purchase	Million SDR	Million US$ 1/	Percent of Quota	Percent of Total Access
March 17, 2010	Board approval of the SBA	171.30	261.17	100.00	33.33
May 17, 2010	Performance criteria based on end-March 2010	21.41	32.65	12.50	4.17
September 15, 2010	First review, based on end-June 2010 performance criteria	107.06	163.23	62.50	20.83
November 15, 2010	Performance criteria based on end-September 2010	21.41	32.65	12.50	4.17
March 15, 2011	Second review, based on end-December 2010 performance criteria	21.41	32.65	12.50	4.17
May 16, 2011	Performance criteria based on end-March 2011	21.41	32.65	12.50	4.17
September 15, 2011	Third review, based on end-June 2011 performance criteria	21.41	32.65	12.50	4.17
November 15, 2011	Performance criteria based on end-September 2011	21.41	32.65	12.50	4.17
March 15, 2012	Fourth review, based on end-December 2011 performance criteria	21.41	32.65	12.50	4.17
May 15, 2012	Performance criteria based on end-March 2012	21.41	32.65	12.50	4.17
September 17, 2012	Fifth review, based on end-June 2012 performance criteria	21.41	32.65	12.50	4.17
November 15, 2012	Performance criteria based on end-September 2012	21.41	32.65	12.50	4.17
March 8, 2013	Sixth review, based on end-December 2012 performance criteria	21.41	32.65	12.50	4.17
Total 2/		513.90	783.51	300.00	100.00

Source: Fund staff estimates.

1/ SDR/US$ exchange rate of 0.655892 as of February 19, 2010.
2/ May not reflect the sum of individual lines because of rounding.

Table 13. El Salvador: Quantitative Performance Measures

(in millions of U.S. dollars)

	2009	2010				2011	2012
	Estimated			Indicative			
	end-Dec.	end-Mar.	end-Jun.	end-Sep.	end-Dec.	end-Dec.	end-Dec.
Performance criteria							
Overall balance of the nonfinancial public sector (cumulative floor) 1/	-1,171	-300	-475	-700	-1,047	-830	-637
Gross debt of the public sector (flows) 2/ 3/	1,235	339	468	729	1,117	895	637

Continuous performance criteria

Standard continuous performance criterion of zero-ceiling on non-accumulation of external debt service arrears by the nonfinancial public sector. 4/

Continuous zero-ceiling on non-accumulation of domestic payment arrears by the nonfinancial public sector. 5/

Consultation clauses

If at any point during the arrangement, the sum of private-sector bank deposits and external short-term bank liabilities, should be less than US$7,432.4 million (i.e., ten percent below the end-November 2009 level), a consultation clause will be triggered and the authorities will contact Fund staff to discuss possible remedial actions. 6/

If at any point during the arrangement the authorities consider it necessary to modify the reserve requirements or liquid asset requirements, a consultation clause will be triggered and the authorities will contact Fund staff to discuss such actions. 7/

1/ Adjusted upward if observed tax revenues are higher than projected, as defined in the accompanying TMU.

2/ Excludes Central Bank obligations to the Fund incurred under the SBA.

3/ Adjusted upward for any debt placed for prefinancing that would result in an increase in BCR deposits.

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

5/ For the purpose of the program ceiling, domestic payment arrears of the nonfinancial public sector are defined as unpaid obligations overdue by more than 60 days.

6/ For definition of private sector deposits and external liabilities, see TMU ¶8.

7/ For reference rates of reserve and liquid asset requirements, see TMU ¶9.

Table 14. El Salvador: Rationale for Proposed Structural Conditionality

The structural benchmarks are designed to support a durable improvement in public finances and to bolster financial sector supervision and intermediation.

Fiscal measures
To facilitate the achievement of the targeted reduction in the fiscal deficit the authorities plan to modernize the structure of the tax administration. Enhanced coordination in the tax collection process across agencies and improvements in their audit and collection capacities will boost revenue yields and reduce tax evasion.

The authorities' plan to improve the targeting of subsidies for electricity, water, and liquid propane gas will remove existing inefficiencies while generating savings that would be redirected toward other social spending.

Financial sector measures
The Financial System Supervision and Regulation Law seeks to bolster the supervision of financial conglomerates by merging three superintendencies, enhancing the autonomy of the new institution, strengthening legal protection for supervisors, and shifting regulatory authority to the central bank.

To improve financial system intermediation the Investment Funds Law seeks to create a clear framework governing the operation of investment funds, including the terms for investor entry and exit and uniform rules for accounting and asset valuation.

ATTACHMENT I. LETTER OF INTENT

San Salvador, March 1, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C., 20431

Dear Mr. Strauss-Kahn:

1. El Salvador's economy performed strongly in the years prior to the world financial and economic crisis of 2008–09. Sound macroeconomic policies and structural reforms delivered buoyant economic growth, a declining public debt-to-GDP ratio, and low and stable inflation. The global slowdown caused by the world financial crisis, however, has severely affected El Salvador's economy. International trade flows and remittances have declined, and foreign financing has become scarce. In addition, in November 2009, the country was hit by Hurricane Ida. These developments took a heavy toll on domestic economic activity and tax collections during 2009. The Government of El Salvador, with the support of the International Monetary Fund (IMF) and other multilaterals, has tried to shield the domestic economy—especially the most vulnerable sectors—from the impact of the crisis and the hurricane, while, at the same time, adhering to macroeconomic policies that safeguard fiscal and financial sustainability in El Salvador's dollarized economy.

2. The recent period of macroeconomic stability, structural reforms and relatively high growth carried many benefits, but did not result in the desired improvement in income distribution and poverty reduction. From 2006 to 2008 the number of households living below the poverty line increased by almost 10 percentage points, reaching a level of 40 percent by end-2008 and reversing progress achieved up to 2006. The Government of El Salvador reiterates its firm commitment to improving social conditions through the expansion of poverty-reducing programs and improved targeting of critical government expenditure, within a policy framework that safeguards macroeconomic stability.

3. The attached Memorandum of Economic and Financial Policies (MEFP) presents the plans and policies of the Government of El Salvador for 2010–12. In support of our economic program, we request the cancellation of the Stand-By Arrangement (SBA) with the IMF approved on January 16, 2009—which achieved its broad objective of helping to maintain macroeconomic and financial sector stability in the run-up to the presidential election and the follow-up transitional period—and the approval of a new SBA totaling SDR 513.9 million (300 percent of quota), covering the period through March 16, 2013. In line with the previous SBA, our intention is to treat the new arrangement as precautionary. We believe that the new SBA will provide critical support for our commitment to continued sound macroeconomic

policies, help anchor the confidence of depositors, investors, and creditors (including multilaterals), and provide potential access to liquidity support for the financial system, if the need were to arise.

4. We believe that the policies described in the attached MEFP are sufficient to meet the objectives of our program and we stand ready to take additional measures that may be needed for this purpose. We will consult with the Fund in advance of any revisions to the policies described in the MEFP, as well as the adoption of additional measures, in accordance with IMF policies on such consultations. Consultations with Fund staff would also occur in the event of a significant decline in the sum of private sector deposits and short-term external liabilities of the banking system, or if the need were to arise to change reserve requirements or liquid asset requirements for the banking system. We will continue our close dialogue with IMF staff on our economic policies after the expiration of the arrangement, for as long as there are any outstanding purchases in the upper credit tranches. During the program, we will continue to comply with all obligations of Article VIII of the IMF's Articles of Agreement.

5. Program implementation will be monitored through semi-annual reviews, with the first review to be completed on or after September 15, 2010. The performance criteria and structural benchmarks under the program are set out in Tables 2 and 3 of the attached MEFP.

6. We authorize the IMF to publish this Letter of Intent and its attachments, and the related staff report.

Sincerely yours,

/s/	/s/
Carlos Cáceres Minister of Finance	Carlos Acevedo President, Central Reserve Bank of El Salvador

Attachments

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

I. BACKGROUND AND PROGRAM OBJECTIVES

1. The global financial crisis severely affected the performance of the Salvadoran economy in 2009 through a sharp fall in proceeds from exports and remittances, and lower private capital inflows. As a result, real GDP is estimated to have fallen by 3.3 percent during the year, annual inflation declined to around zero, and the external current account deficit is estimated to have narrowed to 1.6 percent of GDP (from over 7½ percent in 2008). Measures taken in recent years to strengthen our banking system, together with the credibility-enhancing effects of the IMF's Stand-By Arrangement (SBA) approved in January of last year, helped maintain stability and left our banks liquid and well capitalized. However, our domestic financial system was affected; bank deposits and credit growth stalled, and interest rates remained high.

2. The larger-than-expected fall in economic activity resulted in a sharp decline in government revenue and a higher public sector deficit than was projected under the January 2009 program. Total revenues and grants fell by 9.8 percent compared with 2008, a shortfall of more than US$650 million with respect to the revenue forecast under the program, despite measures taken to minimize the revenue loss. Austerity and expenditure restraining measures taken by the Government were effective in keeping total government spending more than US$150 million below that envisaged in the program. Nonetheless, the effects of the slowdown on revenue and nominal GDP resulted in an increase in the nonfinancial public sector (NFPS) deficit to 5.4 percent of GDP, higher than the deficit target under the program of 2.8 percent of GDP.

3. Our economic priorities going forward will be to preserve financial stability, foster economic recovery, bring down poverty, and gradually reduce the public sector deficit and debt to ensure fiscal sustainability. To this effect, our economic program aims at: (i) bolstering confidence in the government's commitment to macroeconomic stability; (ii) strengthening the fiscal position and placing public sector debt on a firm downward path; (iii) increasing the scope and efficiency of social programs; and (iv) maintaining the liquidity buffers of the financial system.

4. Our program will be anchored on strict adherence to official dollarization and a prudent fiscal policy. For 2010, we envisage a reduction of almost 1 percent of GDP in the NFPS deficit from its level in 2009. This decline will help signal that fiscal consolidation is underway and, at the same time, allow fiscal support for the incipient economic recovery. Furthermore, we are putting in place measures that will help strengthen the fiscal position as the economy approaches its potential, shifting spending toward social programs and other high-priority sectors, and enhancing the financial system's resilience.

5. A significant measure to reduce the NFPS deficit was taken last year when congress approved (in December) a set of revenue measures expected to yield at least 0.5 percent of GDP on an annual basis. The measures include: (i) an increase in excise taxes on alcoholic and non-alcoholic beverages and tobacco; (ii) a widening of the tax base on beverages to include non-carbonated products; (iii) the introduction of a tax on the registration of new vehicles; (iv) taxation of interest income of banks licensed abroad (putting this income source on an equal footing with banks licensed domestically); and (v) the introduction of a tax on the interest income of individuals. Approval by congress of this legislation is a prior action for the program.

6. We are committed to improving our debt management practices. As a first step in this regard, in November 2009 we placed successfully a 10-year Eurobond for US$800 million. The proceeds are being used mainly to redeem short-term domestic debt as it falls due and improve the maturity structure of our public debt.

II. Economic and Financial Policies for 2010–2012

A. Fiscal Policy

7. Fiscal policy is aimed at reducing the NFPS deficit to no more than US$1,047 million (4.7 percent of GDP) in 2010, while protecting spending on social programs and investment in key sectors, as well as accommodating reconstruction costs related to Hurricane Ida (of about 0.4 percent of GDP). The proposed deficit targets from 2010–12 (including Ida-related spending), against the backdrop of a slow recovery of economic activity, will take the overall public debt-to-GDP ratio (after netting out government deposits at the central bank and commercial banks) to just under 50 percent by end-2011 (and the non-financial public sector debt ratio to 47.5 percent of GDP); thereafter, the ratio is expected to decline steadily. Key elements of our fiscal strategy include the following:

- ***Congressional approval of a budget for 2010 consistent with the NFPS deficit under the program***, which is a prior action for the program.

- ***Improvements in tax administration***, which are expected to yield about 0.4 percent of GDP on an annual basis. In addition, we are adopting strategic planning processes at the Domestic Tax Administration Directorate (DGII) and the Customs Administration Directorate (DGA), and are preparing modernization strategies and action plans for both agencies. These plans will define steps to enhance coordination in the tax collection process across agencies; strengthen the large taxpayers unit at the DGII; consolidate the authority of the audit department at the DGII and improve its auditing capacity (including by refining the risk-management approach of taxpayer selection for audits); and include measures to reduce fiscal fraud by reforming the tax and penal codes. We will monitor progress on these fronts through structural benchmarks under the program (see ¶10 of the attached Technical Memorandum of Understanding, TMU).

- ***Better targeting of subsidies***. With subsidies costing over 1 percent of GDP in 2009, we have placed a high priority on implementing a broad-based reform of all such expenditures. In 2010, we intend to bring liquid propane gas prices closer to market rates, while still protecting the most vulnerable through a consumption subsidy (see TMU ¶11). We will also finalize plans to improve the targeting of the remaining electricity subsidy, which, complemented with a campaign to reduce electricity usage, should bring additional savings (see TMU ¶11). We have implemented a new tariff structure for water utilities, which will help target better the current water subsidy. These reforms are expected to generate savings of about 0.4 percent of GDP in 2010 that would be redirected toward other social spending, and will build on progress already achieved last year. For example, the subsidy to public transportation operators was reduced by 40 percent in 2009, bringing its costs fully in line with receipts from dedicated revenue sources; control over outlays for this subsidy has been strengthened through a special unified account at the Treasury.

- ***Strict control of current expenditure***. Our austerity policy (in place since June 2009) will be maintained in 2010. It has been effective in controlling expenditure by reducing non-priority outlays, mainly on purchases of goods and services by public ministries and institutions.

- ***Increased spending on social programs***. The anti-crisis plan that we have adopted since June 2009 is helping to mitigate the effects of the economic slowdown on the most vulnerable sectors and will be maintained. Total spending on the plan is expected to reach US$575 million, about 1 percent of GDP on an annual basis through 2011. Key components of the program include: a system of loan guarantees for construction of low-cost housing; a temporary employment program; elimination of co-payments for services and medicines at public medical facilities; and provision of school uniforms and meals to low-income students.

- ***Saving of revenue over-performance***. Our fiscal program is based on conservative projections for output and revenue growth. If tax revenues were to exceed those projected under the program in 2010, we will use up to 50 percent of the excess revenue to increase spending on the social programs listed above, with the remainder allocated to meet the adjusted performance criterion on the overall balance of the non-financial public sector (as detailed in TMU ¶7).

- ***Medium-term fiscal strategy***. We plan to improve the transparency and planning of government operations by implementing a multi-year fiscal strategy starting with the publication of our 2010–15 government program. This publication will have a five-year macroeconomic framework, including a medium-term fiscal framework consistent with the SBA and our medium-term objectives of reducing the combined public sector deficit and debt to sustainable levels. Key to this effort will be the implementation of a fiscal pact arrived at (by end-June 2012) through consultation with a broad range of stakeholders that will aim to increase government revenues over the medium term, on the order of

1.5 to 3 percent of GDP. Beginning with the 2011 budget, we will introduce a multi-year budget framework that will ensure consistency between short-term and medium-term objectives.

8. Financing. The government expects to cover the bulk of its financing needs during 2010–12 with external resources of relatively long maturity. We have firm commitments from the World Bank and IADB for more than US$1,100 million of gross disbursements, and we are discussing with the Central American Bank for Economic Integration possible loans for about US$240 million. Following the large but transitory increase in net public debt from 37.8 percent to under 50 percent of GDP in 2011, our fiscal consolidation strategy will yield a declining debt path in the medium term, with our public debt falling to less than 45 percent of GDP by 2015.

B. Financial System Policies

9. The government is committed to preserving and protecting the soundness and stability of the Salvadoran banking system and plans to adopt reforms to enhance its resilience and increase the efficiency of financial intermediation.

10. We regard the current level of liquidity coverage at banks as broadly adequate, and therefore plan to maintain reserve requirements and liquid asset requirements at their present level (detailed in TMU ¶9) during the program period. However, if we were to consider it necessary to modify either of those requirements, we would consult with IMF staff on such a change. In addition, if at any point during the program period we were to observe a significant decline in the sum of external short-term liabilities of banks and total private sector deposits held in the banking system (as defined in TMU ¶8), we would evaluate the appropriate policy response in consultation with IMF staff.

11. We will seek congressional approval in the coming months of the Financial Sector Supervision and Regulation Law (a structural benchmark under the program and described in TMU ¶12). The bill strengthens financial sector supervision by merging the supervisory entities for banks, pensions, and the stock market; enhances the autonomy of the merged institution; empowers the Central Reserve Bank of El Salvador (BCR) to be the sole regulator of the financial system; and provides legal protection for supervisors. In addition, the bill bolsters cross-border consolidated supervision by permitting the financial system superintendency to share information on local operations with foreign supervisors.

12. We will also seek congressional approval during 2010 of the Investment Funds Law (a structural benchmark under the program and described in TMU ¶13). The law aims at facilitating financial intermediation by creating a clear framework for investment funds, specifying accounting and asset valuation rules, and setting the terms for investor entry and exit.

13. Given the significant changes that have taken place in the Salvadoran financial system in recent years (including the sale of the majority of domestic banks to foreign-owned

institutions), we have requested a second update of the Financial Sector Assessment Program (FSAP; the first update was completed in 2004). In addition, we are considering requesting technical assistance, including from the IMF, on the following: financial system regulation and supervision, the bank resolution framework, mechanisms of parent-subsidiary support within international financial conglomerates, and steps for bolstering the BCR's lender-of-last-resort capabilities. The FSAP update, together with technical assistance, will help us shape our financial sector reform agenda for the coming years.

III. Safeguards Assessment Update

14. We recognize the importance of evaluating progress made by the BCR on the recommendations contained in the safeguards assessment performed under the January 2009 SBA. We have authorized the central bank's external auditors to provide IMF staff with all necessary information and to discuss directly with them any issues relevant to this process. The safeguards assessment update should be completed by the time of the first review of the SBA (September 15, 2010).

IV. Program Monitoring

15. The program will cover economic policies from March 2010 through end-2012, will be monitored through semi-annual reviews, and will contain quarterly and continuous quantitative performance criteria, structural benchmarks, and consultation clauses. The phasing of access under the arrangement and the schedule of reviews are set out in Table 1 of this memorandum; the quantitative targets and performance criteria through September 30, 2010 and indicative targets through December 31, 2012 are set out in Table 2; while the prior actions and structural benchmarks through June 30, 2012 are set out in Table 3. The definitions of the prior actions, quantitative performance criteria, structural benchmarks, and consultation clauses described in Tables 2 and 3 are further specified in the accompanying TMU.

Table 1. El Salvador: Purchase Schedule and Terms Under the Stand-By Arrangement

Date	Conditions for purchase	Purchase Million SDR	Million US$ 1/	Percent of Quota	Percent of Total Access
March 17, 2010	Board approval of the SBA	171.30	261.17	100.00	33.33
May 17, 2010	Performance criteria based on end-March 2010	21.41	32.65	12.50	4.17
September 15, 2010	First review, based on end-June 2010 performance criteria	107.06	163.23	62.50	20.83
November 15, 2010	Performance criteria based on end-September 2010	21.41	32.65	12.50	4.17
March 15, 2011	Second review, based on end-December 2010 performance criteria	21.41	32.65	12.50	4.17
May 16, 2011	Performance criteria based on end-March 2011	21.41	32.65	12.50	4.17
September 15, 2011	Third review, based on end-June 2011 performance criteria	21.41	32.65	12.50	4.17
November 15, 2011	Performance criteria based on end-September 2011	21.41	32.65	12.50	4.17
March 15, 2012	Fourth review, based on end-December 2011 performance criteria	21.41	32.65	12.50	4.17
May 15, 2012	Performance criteria based on end-March 2012	21.41	32.65	12.50	4.17
September 17, 2012	Fifth review, based on end-June 2012 performance criteria	21.41	32.65	12.50	4.17
November 15, 2012	Performance criteria based on end-September 2012	21.41	32.65	12.50	4.17
March 8, 2013	Sixth review, based on end-December 2012 performance criteria	21.41	32.65	12.50	4.17
Total 2/		513.90	783.51	300.00	100.00

Source: Fund staff estimates.

1/ SDR/US$ exchange rate of 0.655892 as of February 19, 2010.

2/ May not reflect the sum of individual lines because of rounding.

Table 2. El Salvador: Quantitative Performance Measures

(in millions of U.S. dollars)

	2009	2010				2011	2012
	Estimated				Indicative		
	end-Dec.	end-Mar.	end-Jun.	end-Sep.	end-Dec.	end-Dec.	end-Dec.
Performance criteria							
Overall balance of the nonfinancial public sector (cumulative floor) 1/	-1,171	-300	-475	-700	-1,047	-830	-637
Gross debt of the public sector (flows) 2/ 3/	1,235	339	468	729	1,117	895	637

Continuous performance criteria

Standard continuous performance criterion of zero-ceiling on non-accumulation of external debt service arrears by the nonfinancial public sector. 4/

Continuous zero-ceiling on non-accumulation of domestic payment arrears by the nonfinancial public sector. 5/

Consultation clauses

If at any point during the arrangement, the sum of private-sector bank deposits and external short-term bank liabilities, should be less than US$7,432.4 million (i.e., ten percent below the end-November 2009 level), a consultation clause will be triggered and the authorities will contact Fund staff to discuss possible remedial actions. 6/

If at any point during the arrangement the authorities consider it necessary to modify the reserve requirements or liquid asset requirements, a consultation clause will be triggered and the authorities will contact Fund staff to discuss such actions. 7/

1/ Adjusted upward if observed tax revenues are higher than projected, as defined in the accompanying TMU.

2/ Excludes Central Bank obligations to the Fund incurred under the SBA.

3/ Adjusted upward for any debt placed for prefinancing that would result in an increase in BCR deposits.

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

5/ For the purpose of the program ceiling, domestic payment arrears of the nonfinancial public sector are defined as unpaid obligations overdue by more than 60 days.

6/ For definition of private sector deposits and external liabilities, see TMU ¶8.

7/ For reference rates of reserve and liquid asset requirements, see TMU ¶9.

Table 3. El Salvador: Structural Measures

Prior actions	Test date
Congressional approval of legislation projected to raise tax revenue by about US$140 million in 2010.	n/a
Congressional approval of budget for 2010 consistent with a nonfinancial public sector deficit of no more than US$1,047 million.	n/a
Structural benchmarks	
Tax Administration	
Publication of strategic plan for the modernization of both DGII and DGA.	Apr. 30, 2010
Enhance coordination in the tax collection process across agencies. 1/	Apr. 30, 2010
Strengthen the large taxpayers office at the DGII. 1/	June 30, 2010
Consolidate the authority of the audit department at the DGII and improve its auditing capacity. 1/	Dec. 31, 2010
Subsidy Reform	
Finalize plans to improve the targeting of subsidies for electricity, water, and liquid propane gas.	May 30, 2010
Implement plans to improve the targeting of subsidies for electricity, water, and liquid propane gas.	Oct. 31, 2010
Budget and Tax Policy	
Implement revenue measures yielding 1.5 percent of GDP.	June 30, 2012
Financial System	
Pass financial supervision bill containing following elements: i) Merge the supervisory entities for banks, pensions, and the stock exchange. ii) Enhance the autonomy of the merged supervisory institution. iii) Strengthen legal protection for supervisors. iv) Strengthen cross-border consolidated supervision. v) Empower the central bank to be the sole regulator of the financial system.	July 31, 2010
Congressional approval of investment funds law containing following elements: i) Create clear legal framework for investment funds. ii) Specify accounting and asset valuation rules. iii) Set terms for investor entry and exit.	Oct. 31, 2010

1/ A description of the steps needed to meet this benchmark is in ¶10 of the TMU.

ATTACHMENT III. TECHNICAL MEMORANDUM OF UNDERSTANDING

1. **This Technical Memorandum of Understanding (TMU) describes the understandings** reached between the authorities of El Salvador and IMF staff for monitoring performance under the Stand-By Arrangement (SBA). In particular, it defines concepts employed in measuring the quarterly fiscal and debt quantitative performance criteria; the continuous performance criteria on external debt and domestic payments arrears; the adjuster for the overperformance of tax revenues; triggers for consultation clauses; structural benchmarks; and reporting requirements under the SBA.

A. Quantitative Performance Criterion on the Fiscal Balance of the NonFinancial Public Sector

2. **The nonfinancial public sector (NFPS) comprises** the central government, the rest of the general government (Instituto Salvadoreño del Seguro Social (ISSS), municipal governments, public hospitals, the national university, and other decentralized agencies), and the non-financial public-sector enterprises (Comisión Ejecutiva Hidroeléctrica del Río Lempa (CEL), Comisión Ejecutiva Portuaria Autónoma (CEPA), Administración Nacional de Acueductos y Alcantarillados (ANDA), and Lotería Nacional de Beneficiencia (LNB)).

3. **The overall balance of the NFPS is measured on a cash basis from below the line**, defined as: (a) net domestic financing of the NFPS; *plus* (b) net external financing of the NFPS; *plus* (c) proceeds from exceptional sources such as, but not limited to, proceeds from privatization or licenses and concessions, (see Table A1). The components of NFPS financing are defined and measured as follows:

(a) **The net domestic financing of the NFPS is defined** as the sum of: (i) the increase in net claims of the domestic financial system on the NFPS, excluding government bonds initially sold abroad; (ii) the net increase in the amount of public sector short-term paper (LETES) and bonds held outside the domestic financial system and the NFPS, excluding bonds initially sold to nonresidents; and (iii) floating debt of the NFPS due to expenditure operations and tax refund payments.

(b) **The net external financing of the NFPS** comprises: (i) disbursements of external loans; plus (ii) receipts from the issuance of government bonds abroad and LETES held by nonresidents; minus (iii) cash payments of principal (current maturities of loans, bonds, and LETES); minus (iv) cash payments of external arrears (principal and interest); minus (v) debt buy-backs or other prepayments of debt (at market value); minus (vi) debt-equity swaps accounted at the market value of these papers; and minus/plus (vii) the increase/decrease in other net foreign assets of the non-financial public sector.

(c) **Proceeds from exceptional sources** such as, but not limited to, privatization, the sale of licenses, and the granting of concessions are defined as: (i) the cash payments received by the Treasury from the sale of state-owned assets; plus (ii) debt-equity swaps, accounted at market values. Also included are up-front payments received by the Treasury for the granting of concessions for public services and capital leasing agreements.

B. Performance Criterion on Debt Flows Contracted by the Public Sector

4. **The performance criterion measures the sum of debt contracted by the non-financial public sector in the year**, as defined in paragraph 2, which shall apply to all external debt as specified in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-00/85), and all domestic debt flows in the year; plus external debt contracted by the central bank (excluding any obligations to the IMF under the SBA) in the year; plus any new debt with a sovereign guarantee.

C. Non-Accumulation of External Debt or Domestic Payments Arrears

5. **The NFPS will not accumulate any external debt arrears during the program period**. For the purpose of this performance criterion, an external debt payment arrear will be defined as a payment by the NFPS that has not been made within thirty days after falling due under the contractual agreement, unless specified otherwise. The performance criterion will apply on a continuous basis.

6. **The NFPS will not accumulate any domestic payments arrears during the program period**. For the purpose of this performance criterion, a domestic payments arrear will be defined as an obligation by the NFPS that has not been paid within sixty days after falling due under the contractual agreement, unless specified otherwise. The performance criterion will apply on a continuous basis.

D. Adjuster for Overperformance of Tax Revenue in 2010

7. **In the event that net tax collections exceed the program baseline of** US$662 million as of end-March 2010, US$1,531 million as of end-June 2010, US$2,220 million as of end-September 2010, and of US$2,940 million as of end-2010,[11] the performance criterion on the overall balance of the NFPS will be raised by 50 percent of any such excess.

E. Consultation Clauses

8. **Floor on the sum of total bank deposits of the private sector and external short-term liabilities of banks**. These are defined, respectively, as deposits of the private sector in commercial banks, and external liabilities of commercial banks with an original maturity of up

[11] The latter two estimates of tax collections are indicative.

to one year.[12] If at any point during the arrangement, the sum of private-sector bank deposits and external short-term bank liabilities should be less than US$7,432.4 million (i.e., ten percent below the end-November 2009 level), a consultation clause will be triggered and the authorities will contact Fund staff to discuss possible remedial actions.

9. **The reserve requirements and liquid asset requirements of the banking system are defined as in current regulations**[13] (currently at about 22 percent and about 3 percent, in effective terms, respectively). If at any point during the arrangement the authorities consider it necessary to modify the reserve requirements or liquid asset requirements, a consultation clause will be triggered and the authorities will contact Fund staff to discuss such actions.

F. Structural Benchmarks

10. **The authorities will publish their strategic plan for the modernization of the Domestic Tax Administration Directorate (DGII) and the General Custom Administration Directorate (DGA) by end-April 2010 (structural benchmark)**. The plan will include the following steps:

- *Enhance coordination in the tax collection process across agencies*. The DGII and DGA should move to the same IT platform so that there can be communication between the databases of the two units.

- *Strengthen the large taxpayers unit (LTU) at the DGII*. The authorities should create a new centralized LTU office located in San Salvador. The LTU would perform audits of the largest 50 taxpayers, and also perform collection and taxpayer assistance functions for those taxpayers.

- *Consolidate the authority of the audit department at the DGII and improve its auditing capacity, including by refining the risk-management approach to taxpayer selection for audits*. Improving the audit capacities would include the following: (i) implementing a new structure for the audit department that encompasses all activities related to auditing, including planning and taxpayer selection; (ii) adopting international practices by establishing a clear model of taxpayer selection, using cross-checked information; (iii) changing the focus of the "gestion de carteras" from a flexible and negotiable on-going audit into a group performing monitoring, analysis, and internal audits; and (iv) increasing the number of traditional external audits.

[12] The definition consists of the sum of line items 211 (*DEPOSITOS)* and 212108 (*PRESTAMOS PACTADOS HASTA UN AÑO PLAZO—ADEUDADO A ENTIDADES EXTRANJERAS*) of the balance sheets of banks as compiled by the Superintendency of the Financial System on a weekly basis; minus the lines noted in Table A2, which represent public sector deposits and accrued interest. As of November 27, 2009 (the agreed baseline data) the sum of private sector bank deposits and external short term liabilities of banks was US$8,258.3 million.

11. **The reform on the liquid propane gas (LPG) and electricity subsidies will contain the following elements**: (i) for LPG we will introduce a new tariff structure and a new targeted subsidy to assist the most vulnerable; and (ii) for electricity, we will adjust tariffs, so these reflect market prices better, and will improve the targeting of the subsidy for low usage customers.

12. **The Financial System Supervision and Regulation Law should contain the following elements**: (i) merger of the supervisory entities for banks, pensions, and the stock exchange; (ii) enhanced functional autonomy of the new supervisory institution; (iii) stronger legal protection for supervisors; (iv) provisions to strengthen cross-border supervision through improved information sharing; and (v) invest the Central Bank to be the consolidated financial system regulatory authority.

13. **The Investment Funds Law should contain the following elements**: (i) a clear legal framework for investment funds; (ii) accounting and asset valuation rules for investment funds; and (iii) terms for investor entry and exit.

G. Reporting Requirements

14. **To facilitate monitoring of program implementation, the government of El Salvador will prepare and send to the IMF**, by e-mail or by fax, monthly data and reports within six weeks following the end of the preceding month, and quarterly data and reports within six weeks after each test date, unless specified otherwise. Such data will include (but are not limited to) the following:

(a) The Central Bank of El Salvador will provide on a monthly basis the comprehensive monetary survey and the central bank balance sheet (electronic file);

(b) The Central Bank of El Salvador will provide on a daily basis the total bank deposits in commercial banks with a lag of at most three working days;

(c) The Central Bank of El Salvador will provide on a weekly basis the balance sheets of individual banks and the total banking system, as well as detailed information on their liquidity positions, with a lag of at most five working days;

(d) The Central Bank of El Salvador will provide quarterly balance of payments data in electronic format with a lag of a quarter;

(e) The Ministry of Finance will provide monthly data on tax revenue with a lag of at most five working days;

---

[13] Regulations on liquid reserve requirements NPB3-06 and NPB3-11.

(f) The Ministry of Finance will provide monthly data on revenue and the execution of expenditure for the central government and the rest of the general government (ISSS, the municipal governments, public hospitals, the national university, and other decentralized agencies) with a lag of at most four weeks, and quarterly data on revenue and the execution of expenditure for the four non-financial public sector enterprises (CEL, CEPA, ANDA, and LNB);

(g) The Ministry of Finance will provide monthly information on the financing of the nonfinancial public sector and stock of debt of the NFPS (as defined above) as specified in the table attached to this TMU;

(h) Indicators and other statistical data on recent economic developments, such as the household consumer price index, will be provided as they become available. In addition, the central bank will provide its quarterly reports on economic activity with a lag of at most a quarter;

(i) The authorities will provide a status report on the implementation of the structural reforms specified in Table 3 of the Memorandum of Economic and Financial Policies attached to the Letter of Intent of March 1, 2010; and

(j) The authorities will provide to IMF staff any other information that the latter may deem necessary for the effective monitoring of the Stand-By Arrangement.

Table A1. El Salvador Financing of the Non-Financial Public Sector

	2010			
	March	**June**	**September**	**December**
A. Net domestic financing of the non-financial public sector (NFPS)				
i. Net claims of the financial system (1+2+3)				
1. Net credit of commercial banks to the NFPS:				
a. Credits				
b. Liabilities				
2. Net credit of the BCR to the NFPS:				
a. Credits				
b. Deposits				
3. Net credit of the non-bank financial institutions to the NFPS 1/				
a. Credits				
b. Liabilities				
ii. Stock of NFPS liabilities (including Letes) held outside the domestic financial system and the NFPS 2/				
iii. Floating debt				
B. Net external financing				
i. Multilateral development banks (IADB, WB, CABEI)				
a. Disbursements				
b. Amortizations				
ii. Bilateral creditors				
a. Disbursements				
b. Amortizations				
iii. Financial institutions				
of which : bonds				
of which : LETES				
iv. Other				
C. Privatization and concessions				
D. Non-financial public sector overall balance (A+B+C)				
Memorandum:				
Stock of LETES in circulation				
Disbursements				
Amortization				

Sources: Ministry of Finance; Fund staff estimates.

1/ Includes trust funds: (FOSEDU, FOP).
2/ Includes amortization of ISTA bonds.

Table A2. Public-Sector Deposit Account Numbers

Public Sector Accounts

2110010101, 2110010102, 2110010201, 2110010202, 2110020101, 2110020102, 2110020201, 2110020202, 2111010101, 2111010102, 2111010201, 2111010202, 2111020101, 2111020102, 2111020201, 2111020202, 2111030101, 2111030102, 2111030201, 2111030202, 2111040101, 2111040102, 2111040201, 2111040202, 2111050101, 2111050102, 2111050201, 2111050202, 2111060101, 2111060102, 2111060201, 2111060202, 2111070101, 2111070102, 2111070201, 2111070202, 2111080101, 2111080102, 2111080201, 2111080202, 2111130101, 2111130102, 2111130201, 2111130202, 2111140101, 2111140102, 2111140201, 2111140202, 2111990101, 2111990102, 2111990201, 2111990202, 2112010101, 2112010102, 2112010201, 2112010202, 2112020101, 2112020102, 2112020201, 2112020202, 2112030101, 2112030102, 2112030201, 2112030202, 2112040101, 2112040102, 2112040201, 2112040202, 2114010101, 2114010102, 2114010201, 2114010202, 2114020101, 2114020102, 2114020201, 2114020202, 2114030101, 2114030102, 2114030201, 2114030202, 2114040101, 2114040102, 2114040201, 2114040202, 2114050101, 2114050102, 2114050201, 2114050202, 2114060101, 2114060102, 2114060201, 2114060202, 2114070101, 2114070102, 2114070201, 2114070202.

Accrued Interest

2110019901, 2110019902, 2110029901, 2110029902, 2111019901, 2111019902, 2111029901, 2111029902, 2111039901, 2111039902, 2111049901, 2111049902, 2111059901, 2111059902, 2111069901, 2111069902, 2111079901, 2111079902, 2111089901, 2111089902, 2111139901, 2111139902, 2111149901, 2111149902, 2111999901, 2111999902, 2112019901, 2112019902, 2112029901, 2112029902, 2112039901, 2112039902, 2112049901, 2112049902, 2114019901, 2114019902, 2114029901, 2114029902, 2114039901, 2114039902, 2114049901, 2114049902, 2114059901, 2114059902, 2114069901, 2114069902, 2114079901, 2114079902.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 10/95
FOR IMMEDIATE RELEASE
March 17, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US$790 Million Stand-by Arrangement for El Salvador

The Executive Board of the International Monetary Fund (IMF) today approved a 36-month, SDR 513.9 million (about US$790 million) Stand-By Arrangement (SBA) for El Salvador to help the country mitigate the adverse effects of the global crisis. The new arrangement, which the authorities intend to treat as precautionary, will succeed the 15-month SBA approved on January 16, 2009 (see Press Release No. 09/10).

The main objectives of El Salvador's economic program are to speed up the economic recovery, reduce poverty, preserve financial stability, and secure debt sustainability. One of the immediate priorities is to support domestic demand through a countercyclical fiscal policy in 2010, which includes modernizing the country's road network and bolstering electricity generation.

Another key priority is to increase the reach and efficiency of social programs. Following El Salvador's government focus on reducing poverty, the Fund program embeds the government's general anti-crisis program ("Programa General Anti-Crisis – PGA), which will allow for almost 1% of GDP (or around US$200 million annually) in social spending in 2010-11. It includes an expansion in the conditional cash transfer program (*Comunidades Solidarias)*, creation of a temporary employment program, and the launch of a special public investment program concentrated on health, education and infrastructure. Water and electricity subsidies are being redesigned to protect the most vulnerable.

The Fund arrangement is designed to maintain investor and depositor confidence by supporting the authorities' commitment to macroeconomic stability and official dollarization. The arrangement is expected to play a catalytic role for creditors, including private investors and other international financial institutions, by laying out the authorities' strategy to ensure medium-term fiscal and debt sustainability.

Following the Executive Board discussion on the SBA, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, made the following statement:

"The global downturn of 2009 severely affected El Salvador, despite the economy's strong fundamentals achieved through several years of prudent macroeconomic policies and structural reforms. Trade flows and remittances declined, foreign financing contracted, while economic activity and tax collections were hit hard. Against this backdrop, the Stand-By Arrangement approved on January 2009 served an important role in reducing uncertainty by facilitating the dialogue between the outgoing and incoming administrations.

"The authorities' Fund-supported economic program is appropriately underpinned by the strategy of continuing to support domestic demand in 2010, while safeguarding debt sustainability through a medium-term fiscal consolidation plan. In this context, the fiscal deficit target agreed for 2010 should help support the recovery and avoid a decline in key social spending and public investment.

"The revenue package and budget approved by congress in December 2009 and the ongoing efforts on tax administration will help increase the resources to address pressing social and infrastructure needs, while allowing for a reduction in the fiscal deficit over the medium term. Securing a broad-based consensus on a fiscal pact will be critical to solidify the fiscal consolidation.

"The Salvadoran financial system has been resilient to the domestic and global economic downturn. Nonetheless, it will be important to continue with reforms that enhance the system's ability to withstand shocks. Key in this regard would be the approval in the coming months of the Financial Sector Supervision and Regulation Law, presently with congress. Continued commitment to the full dollarization regime will be paramount to maintaining financial stability," Mr. Portugal said.

ANNEX

Recent Economic Developments

El Salvador's economy performed well in the years leading up to the global financial and economic crisis. Sound macroeconomic policies and structural reforms, anchored by full dollarization, delivered buoyant economic growth, a declining public debt-to-GDP ratio, and low and stable inflation.

The global slowdown, however, severely affected economic performance, owing to El Salvador's close linkages with the United States. Economic activity in 2009 is estimated to have declined by 3.3 percent, as exports, imports, and remittances fell sharply. Bank deposits remained stable and the banking system is well-capitalized with significant liquidity buffers. Nevertheless, total lending declined and asset quality deteriorated.

The economic slowdown weighed heavily on tax revenues. Total net tax revenue contracted strongly and was about US$600 million below the levels envisaged in the 2009 SBA. Despite the authorities' efforts to adhere to austerity measures and restrain expenditure, the 2009 fiscal deficit reached an estimated at 5.4 percent of GDP, compared with 3.1 percent of GDP in 2008.

The nascent economic recovery is expected to be gradual, in line with an improving external environment, and supported by the authorities' anti-crisis plan (PGA). Inflation should remain low, and the external current account deficit is expected to widen moderately, in line with the recovery in economic activity.

Program Summary

The authorities' economic program seeks to support domestic demand in the short run, refocus public spending on social programs and other high-priority sectors, strengthen the medium-term fiscal position and place public debt on a firm downward path, and bolster financial stability.

Fiscal policy for 2010: The approved budget is consistent with a fiscal deficit of 4.7 percent of GDP and would provide an adequate fiscal stimulus to support economic recovery. In addition, the revenue package approved in late 2009, improvements in tax administration, strict control of current expenditure, and reforms of energy and water subsidies would open space for increasing key social spending and help mitigate the effects of the economic slowdown on the most vulnerable.

Medium-term fiscal consolidation: The authorities' strategy envisages the adoption of a multi-year budgeting framework and reaching broad-based agreement on a fiscal pact that would increase government revenue over the medium term.

Financial sector policies: The authorities intend to continue with reforms aimed at enhancing the financial system's ability to withstand shocks. To this end, they are seeking congressional approval of two key laws: the Financial Sector Supervision and Regulation Law (to strengthen supervision by merging three supervisory entities) and the Investment Funds Law (to enhance intermediation by providing a legal framework for investment funds).

El Salvador joined the IMF on March 14, 1946, and its quota is SDR 171.3 million (about US$261.3 million). El Salvador has had no outstanding IMF credits since 1991.

Statement by Ramón Guzmán, Executive Director for El Salvador
March 17, 2010

We would like to express our appreciation to staff for their continued dialogue with our Salvadoran authorities and for their well-balanced report. Our authorities broadly agree with Staff's assessment and recommendations.

In support of their economic program, the authorities request the cancellation of the Stand-By Arrangement (SBA) approved on January 16, 2009 *(which achieved its broad purpose of helping preserve macroeconomic and financial sector stability in the run-up to the presidential election and the follow-up transitional period)* and the approval of a new SBA totaling SDR 513.9 million *(300 percent of quota)*, covering the following three years. As with the previous SBA, their intention is to treat the new arrangement as precautionary.

The new SBA will provide crucial support to the authorities' commitment to sound macroeconomic policies and will help anchor the confidence of depositors, investors (domestic and foreign) and creditors. It will also provide an important liquidity buffer to support the dollarized financial system in case negative shocks occur. Finally, it will also open the door to further credit from multilateral institutions.

Recent Developments

El Salvador's economy performed strongly in the years preceding the global crisis. Sound macroeconomic policies and structural reforms delivered sustained economic growth, a declining public debt-to-GDP ratio, and low and stable inflation. The global slowdown, however, has severely affected the Salvadoran economy. International trade flows and remittances have declined, and foreign financing has become scarce. Moreover, in November 2009, the country was hit by hurricane Ida. These developments greatly affected domestic economic activity and tax collection during 2009.

The Government, with the support of the Fund and other multilaterals, has tried to shield the domestic economy *(especially the most vulnerable sectors)* from the effects of the crisis and the hurricane, while adhering to macroeconomic policies that safeguard fiscal and financial sustainability in the context of a dollarized economy.

Economic and Social Program

Our authorities' economic and social program's main priorities are to preserve financial stability, foster economic recovery, reduce poverty and gradually decrease the public sector deficit and debt to ensure fiscal sustainability. In this context, the economic program aims at: i) bolstering confidence in the government's commitment to macroeconomic stability; ii) strengthening the fiscal position and placing public sector debt on a firm downward path; iii) increasing the scope and efficiency of social programs; and iv) maintaining the liquidity buffers of the financial system.

Fiscal Policy

Even in an adverse economic context and short of a majority in congress, the government was able in 2009 to overcome traditional political polarization and get support for the fiscal reform.

For 2010, fiscal policy is aimed at reducing the NFPS deficit to 4.7 percent of GDP (5.3 percent in 2009) while protecting spending on social programs and investment in key sectors, as well as accommodating reconstruction costs related to Hurricane Ida (about 0.4 percent of GDP). The envisaged deficit targets from 2010 to 2012 will take the overall public debt-to-GDP ratio to just fewer than 50 percent by end-2011 *(and the non-financial public sector debt ratio to 47.5 percent of GDP)*; thereafter, the ratio is expected to decline steadily. Staff has indicated that the projected debt path is sustainable, as confirmed by the results of a dynamic debt sustainability analysis. Key elements of the fiscal strategy include the following:

- **Congressional approval of a budget for 2010 consistent with the NFPS deficit under the program,** which is a prior action for the program.

- **Improvements in tax administration**, which are expected to yield about 0.4 percent of GDP on an annual basis. Authorities are adopting strategic planning processes at the Domestic Tax Administration Directorate (DGII) and the Customs Administration Directorate (DGA), and are preparing modernization strategies and action plans for both agencies. These plans will define steps to enhance coordination in the tax collection process across agencies; strengthen the large taxpayers unit at the DGII; consolidate the authority of the audit department at the DGII thus improving its auditing capacity; and include measures to reduce fiscal fraud by reforming the tax and penal codes.

- **Better targeting of subsidies**. With subsidies weighting over 1 percent of GDP in 2009, authorities have placed a high priority on implementing a comprehensive reform of all such expenditures. In 2010, they intend to bring liquid propane gas prices closer to those in the market, while still protecting the most vulnerable through a consumption subsidy. They will also complete plans to improve targeting of the remaining electricity subsidy, which, complemented with a campaign to reduce electricity usage, should bring additional savings. Authorities have implemented a new tariff structure for water utilities, which will help to improve targeting of the current water subsidy. These reforms are expected to generate savings of about 0.4 percent of GDP in 2010 that would be redirected toward other social spending, and will build on progress already achieved last year.

It is worth to mention that the subsidy to public transportation operators was decreased by 40 percent in 2009, bringing its costs fully in line with receipts from dedicated revenue sources; control over outlays for this subsidy has been strengthened through a special unified account at the Treasury.

• **Strict control of current expenditure**. The current austerity policy (in place since June 2009) will be maintained in 2010. It has been effective in controlling expenditure by reducing non-priority outlays, mainly on purchases of goods and services by public ministries and institutions.

• **Increased spending on social programs**. The anti-crisis plan adopted by authorities since June 2009 is helping to mitigate the effects of the economic slowdown on the most vulnerable sectors and they intend to maintain it. Total spending on the plan is expected to reach US$575 million, about 1 percent of GDP on annual basis through 2011. Key components of the program include: a system of loan guarantees for construction of low-cost housing; a temporary employment program; elimination of co-payments for services and medicines at public medical facilities; and provision of school uniforms and meals to low-income students.

• **Saving of revenue overperformance**. The fiscal program is based on conservative projections for revenue growth. If tax revenues were to exceed those projected under the program in 2010, authorities will use up to 50 percent of the excess revenue to increase spending on social programs, with the remainder allocated to meet the adjusted performance criterion on the overall balance of the non-financial public sector.

• **Medium-term fiscal strategy**. Authorities plan to improve the transparency and planning of government operations by implementing a multi-year fiscal strategy starting with the publication of the 2010–14 government program. This publication will have a five-year macroeconomic framework, including a medium-term fiscal framework consistent with the SBA and the medium-term objectives of reducing the combined public sector deficit and debt to sustainable levels. Key to this effort will be the implementation of a fiscal pact *(by end-June 2012)* achieved after intensive consultation with a broad range of stakeholders that will aim to increase government revenues over the medium term on the order of 1.5 to 3 percent of GDP. Beginning with the 2011 budget, authorities will introduce a multi-year budget framework that will ensure consistency between short-term and medium-term goals.

Financial Sector

The authorities are committed to preserving and protecting the soundness and stability of the Salvadoran banking system, and they plan to adopt reforms to enhance its resilience and increase efficiency of financial intermediation.

The current level of banks' liquidity coverage is broadly adequate; therefore authorities plan to maintain reserve requirements and liquid asset requirements at their current level during the program period.

In the coming months, authorities will seek congressional approval of the Financial Sector Supervision and Regulation Law *(a structural benchmark under the program).* The bill strengthens financial sector supervision by merging supervisory entities for banks, pensions, and the stock market; it enhances the autonomy of the merged institution; empowers the Central Reserve Bank of El Salvador (BCR) to be the only regulator of the financial system;

and provides legal protection for supervisors. In addition, the bill bolsters cross-border consolidated supervision by permitting the superintendency of the financial system to share information on local operations with foreign supervisors.

Authorities will also seek congressional approval during 2010 of the Investment Funds Law *(a structural benchmark under the program).* The law aims at facilitating financial intermediation by creating a clear framework for investment funds, specifying accounting and asset valuation rules, and setting the rules for investor entry and exit.

Given the significant changes that have taken place in the Salvadoran financial system in recent years *(including the sale of the majority of domestic banks to foreign-owned institutions)*, authorities have requested a second update of the Financial Sector Assessment Program *(the first update was completed in 2004)*. The FSAP update, together with possible financial sector technical assistance, will help authorities design financial sector reform agenda for the following years.

We believe that the envisaged policies are adequate to meet the objectives of authorities' economic and social program and we are certain that authorities stand ready to take additional measures *(in consultation with the Fund)* that should be necessary for that purpose. We also think that a new SBA will be instrumental to preserve El Salvador's macroeconomic stability and to help support economic recovery during the following years.