INTERNATIONAL MONETARY FUND

IMF Country Report No. 13/132

EL SALVADOR

2013 ARTICLE IV CONSULTATION

May 2013

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2013 Article IV consultation with El Salvador, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 19, 2013, 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 April 29, 2013. 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.
- **Informational Annex** to the Staff Report of April 29, 2013.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its May 20, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Directors** for El Salvador.

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

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International Monetary Fund
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STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

April 29, 2013

KEY ISSUES

Context. Economic growth has been sluggish since 2010, while a gradual fiscal consolidation under a Fund arrangement stalled in late 2011, leaving the public debt on an upward trend and raising external vulnerabilities. El Salvador faces a prolonged electoral period, with presidential elections in February 2014 and congressional elections one year later; this may constrain the scope for policy action.

Outlook. Economic growth is expected to remain sluggish and the fiscal deficit is unlikely to decline exacerbating financing pressures. Main risks to the outlook stem from lower-than-envisaged growth in the U.S. economy and loss of confidence during the electoral period. Key challenges facing the economy are to increase potential growth (which for many years has lagged behind regional averages), reduce the fiscal deficit and the level of public debt, and rebuild the buffers of the dollarized economy to deal with shocks.

Focus of the consultation. Discussions centered on the appropriate policies to ensure economic stability during the transition to a new government in mid-2014 and tackle longer-term challenges. Staff urged the authorities and presidential candidates to start a national dialogue on the key economic challenges, especially on fiscal sustainability, during the prolonged election.

- **Near-term policies.** Policies should give priority to stabilizing the public debt-to-GDP ratio and closing identified financing gaps, through a fiscal effort of some 2 percent of GDP in 2013-14, while reinforcing liquidity buffers in the banking system.
- **Medium-term strategy.** The goal to increase El Salvador's potential output growth to regional levels should be facilitated by enhancing competitiveness, improving the business climate, and deepening banking reforms. Several years of strong fiscal performance, anchored on strict control of current expenditure and higher tax revenues, would be necessary to underpin the strategy.

Approved By:
Miguel Savastano (WHD) and Martin Mühleisen (SPR)

Discussions took place in San Salvador during March 5-19, 2013. The team comprised M. Garza (Head), P. Druck, B. Sbrancia, and Y. Ustyugova (all WHD), F. Roch (SPR), and F. Delgado (Regional Resident Representative). Luis Cosenza (OED) participated in the policy meetings.

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OVERVIEW

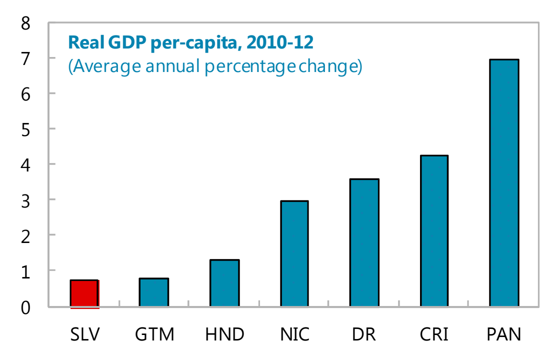
1. **El Salvador's economy recovered slowly from the global financial crisis of 2008-09.** Output growth was sluggish in 2010-11, as low rates of domestic investment, low competitiveness, and a weather related-shock held back the recovery. The large fiscal stimulus allowed in 2009-10 to mitigate the negative impact of the global crisis elevated the fiscal deficit and public debt. At the same time, the fully-dollarized regime firmly anchored a low rate of inflation.

2. **Performance under a Stand-By Arrangement (SBA) with the Fund was mixed.** Under the 3-year precautionary SBA, the authorities preserved financial stability and adopted successive tax reforms. However, fiscal consolidation stalled in late 2011, as strong political opposition discontinued the revenue and expenditure policies envisaged under the arrangement. The third review of the SBA was completed in September 2011, and since the authorities and staff did not reach agreement on policies in the ensuing period, the SBA expired in March 2013 (Box 1).

3. **The government has indicated that it is committed to prudent policies through the end of its five-year term in June 2014.** The authorities began a dialogue on fiscal policy options with all political parties in October 2012. Presidential candidates are aware of the risks associated with the weakened fiscal position and agree that a high-level dialogue would be useful to enable corrective actions. However, a divided political landscape may hinder the dialogue.

RECENT ECONOMIC DEVELOPMENTS

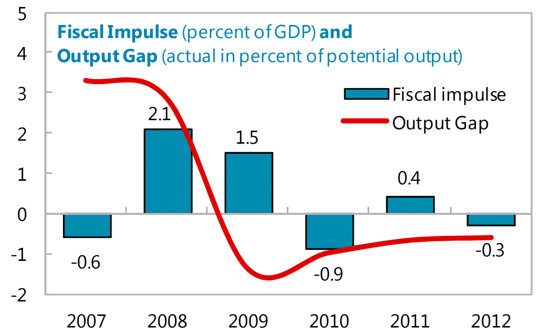
4. **Economic growth in 2012 remained low.** Real GDP grew by 1½ percent, a pace that continued in early 2013 (Figures 1 and 2). Persistently low rates of domestic investment, rooted in long-standing structural weaknesses, have kept income per-capita growth below regional peers for many years and appear to have slowed potential growth to about 1½ percent recently (Annex I). Anchored by the fully-dollarized regime, headline inflation was the lowest in the region, less than 1 percent (y/y) by end-2012, and has remained low through March 2013.



Sources: National authorities and Fund staff calculations.

5. **The external current account deficit widened to 5¼ percent of GDP in 2012.** A decline in export prices (mainly coffee) and higher profit repatriation pushed the deficit up, despite some pickup in workers' remittances. Borrowing by the public sector and commercial banks, and foreign investment covered most of the current account deficit; excluding an Eurobond placed in late 2012 (see below), the underlying balance of payments in 2012 recorded a small deficit (Figure 3). At end-2012, the gross international reserve position was US$3.2 billion, about three-fourths of the level that may be considered "adequate" for El Salvador (Annex II).

6. **The overall fiscal deficit stayed at about 4 percent of GDP for the third year in a row.** Income tax measures taken in early 2012 and strict control over current outlays were offset by higher public investment and some increases in the wage bill and transfers (related to security, health, and other social projects). Generalized subsidies (mainly on gas, electricity, and transportation) and pension payments continued to overburden the public finances (Box 2), while tax buoyancy was limited owing to slow economic activity. In all, there was a small fiscal withdrawal in 2012.



Sources: National authorities and Fund staff calculations.

7. **The government's financing needs were large.** Government financing requirements reached $1.9 billion (7.9 percent of GDP) in 2012 and were covered by increased reliance on short-term debt (Letes) and borrowing from commercial banks, driving up the cost of borrowing (Figure 4). In November 2012, the government tapped the Eurobond market, for the third time in four years, and placed a 12-year bond for US$800 million (3¼ percent of GDP).[1] Resources from the placement are being used to prepay short-term debt. Excluding this operation, the public debt rose to 54¼ percent of GDP at end-2012, from 52¼ percent a year earlier.

8. **The financial system remains sound.** Banks appear to be well capitalized and liquid, with low overdue loans and adequate provisioning. While the exposure of the banking system to public debt was substantial at end-2012 (45 percent of capital), it has declined by more than one-half following the debt pre-payment noted above. With bank deposits growing modestly, banks borrowed abroad to accommodate a moderate increase in credit demand from the private sector, and a declining trend in lending rates recorded since 2009 was slightly reversed (Figure 5).

MACROECONOMIC OUTLOOK AND RISKS

9. **Staff presented a baseline scenario to anchor the discussions.** The scenario assumed a continuation of current policies and real GDP growth of 1½ percent in 2013-14 and 2 percent over the medium term. Domestic investment was assumed to remain subdued, constrained by structural weaknesses and a wait-and-see attitude during the electoral period. Inflation was projected to hover around the level of key trading partners. Despite the projected decline in oil prices, the external current account deficit was projected to remain at about 4½ percent of GDP per year, largely reflecting the sizable fiscal deficit.

10. **The scenario highlighted the looming difficulties in financing the fiscal deficit.** Under current policies, the fiscal deficit is projected to stabilize at about 4 percent of GDP which would

[1] The Eurobond carries a yield of 5⅞ percent, some 400 basis points above comparable U.S. Treasury bills. The previous two placements made in 2009 and 2011 had maturities of 10 and 30 years and carried an average yield of 7⅜ and 7⅝ percent, respectively.

make the public debt dynamics unsustainable over the long term. While the successful Eurobond issuance has reduced immediate financing risks, identified financing gaps over the medium term would leave El Salvador vulnerable to shifts in market sentiment. Persistently large government financing requirements, if covered with short-term financing, would increase borrowing costs and rollover risks, further weakening the debt dynamics (Annex IV).

11. **External competitiveness would remain low.** While the real effective exchange rate appears to be broadly consistent with fundamentals (see Annex II), other indicators suggest a steady loss of competitiveness and deterioration in investment climate in recent years. This could be intensified if the government's plan to increase the minimum wage by 10 percent this year materializes. Over time, low competitiveness would pose risks to the stability of the balance of payments.

El Salvador – Illustrative Macroeconomic Scenario

(In percent of GDP, unless otherwise noted)

		Prel.	Projections					
	2011	2012	2013	2014	2015	2016	2017	2018
Real GDP growth (percent)	2.0	1.6	1.6	1.6	1.7	1.8	2.0	2.0
Inflation (percent, end of period)	5.1	0.8	2.3	2.6	2.6	2.6	2.6	2.6
Nonfinancial public sector balance	-3.9	-3.9	-3.9	-3.8	-3.8	-3.8	-3.8	-3.8
Primary balance	-1.7	-1.6	-1.4	-1.3	-1.3	-1.2	-1.1	-1.1
Public sector gross debt	52.3	54.3	56.4	58.0	59.5	60.8	62.0	63.1
External current account balance	-4.6	-5.3	-5.0	-4.8	-4.6	-4.5	-4.4	-4.4
Gross domestic investment	14.4	14.6	14.6	14.6	14.6	14.7	14.7	14.7
National savings	9.8	9.3	9.5	9.8	10.1	10.2	10.3	10.3

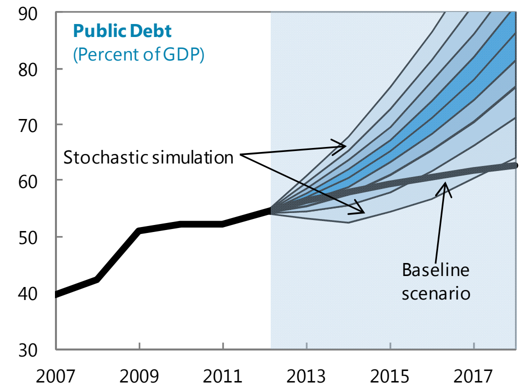
Sources: Central Reserve Bank of El Salvador; Ministry of Finance; and Fund staff estimates.

12. **Risks to the scenario are tilted to the downside** (Box 3).

- *External conditions*. Weaker-than-expected U.S. growth, e.g., due to fiscal shocks, would have adverse spillovers, through exports and remittances, on El Salvador's economic activity and tax revenue. The scope for inward real spillovers from neighboring countries, however, appears to be modest (Annex III). Higher-than-projected world oil prices would widen the external current account deficit, weaken growth, and possibly, deteriorate the fiscal accounts through higher energy subsidies. An increase in investor risk aversion, whether caused by a global or regional shock (e.g., reflecting developments in neighboring countries), could raise borrowing costs and limit access to international capital markets by banks and the government.

- *Policy implementation*. Spending pressures in the run-up to the upcoming two rounds of elections may increase the fiscal deficit above 4 percent of GDP in 2013-14. This would accelerate the deterioration of the public debt dynamics (which is highly sensitive to shocks to the primary balance, growth, and interest rates, as indicated by staff simulations) relative to the baseline, exacerbate sustainability concerns, and diminish the odds of an orderly adjustment.

- *Confidence shocks.* Electoral uncertainty and concerns about fiscal solvency may trigger deposit outflows. In the absence of a lender-of-last resort, this may deteriorate borrowing conditions and weaken economic activity, in turn affecting tax revenue. In response, a strong front-loaded fiscal adjustment may be necessary.



Sources: National authorities and Fund staff calculations.

13. **The authorities considered that the baseline scenario was too pessimistic.** They were of the view that ongoing improvements in the investment climate would support a pick-up in growth in 2013-14, and that the ongoing fiscal dialogue would enable revenue measures that would help lower the fiscal deficit in 2013 and reach broad agreements on a fiscal consolidation strategy (¶15). The authorities reiterated their view that staff's public debt dynamics were unduly influenced by pension payments, and that sustainability risks were lower than suggested by staff because those payments are covered with resources from private pension funds (see Box 2).

POLICY DISCUSSIONS

14. **Discussions focused on the contours of a strategy to safeguard macroeconomic stability in the near term and enhance the resilience of the economy over the medium term.** Staff and the authorities agreed that the near-term priority should be to reduce vulnerabilities during the electoral period and the transition to the new government by strengthening the fiscal position and increasing banks' liquidity buffers. There was also agreement that the medium-term strategy should focus on improving conditions for private-sector led growth, maintaining sustainable public finances, and completing ongoing financial reforms to strengthen buffers. Staff encouraged the authorities and presidential candidates to transform the ongoing fiscal dialogue into a national dialogue to build support for this strategy.

A. Near-term Policies

Safeguarding macro stability

15. **The authorities aim at lowering the fiscal deficit to 3.3 percent of GDP in 2013 and 3 percent in 2014.** They expect to propose new tax revenue measures to congress by mid-year and have taken steps to control spending, including by reducing the transportation subsidy. The authorities estimated that these actions would yield fiscal savings of about 1 percent of GDP on an

annual basis.[2] [3] The 2014 budget would incorporate the full-year impact of these actions, resulting in a further decline in the deficit. Staff welcomed the fiscal efforts but cautioned that, under more conservative revenue projections and including election-related spending, the fiscal deficit may remain at about 4 percent of GDP during 2013-14 and give rise to financing pressures.

16. **Staff recommended more ambitious fiscal targets for 2013 and 2014.** To stabilize the debt ratio, staff advised the authorities to set a fiscal deficit target of 3 percent of GDP in 2013 and 2 percent in 2014. Staff acknowledged that these more ambitious targets may have an adverse impact on economic activity, but argued that these costs would be smaller than those implied by the adjustment that would be necessary if downside risks materialize. Staff proposed the following measures to attain the proposed reduction in the deficit:

- ***On the revenue side,*** in line with FAD TA recommendations, staff advised the removal of income tax exemptions (including on high-income pensioners) and broadening the scope of the new property tax. It also recommended considering a financial activity tax instead of a financial transaction tax, which tends to have larger distortionary effects.[4]

- ***On the expenditure side,*** staff noted that the budgeted increase in expenditure in 2013 was too large and encouraged the authorities to aim at keeping the nominal wage bill at the 2012 level, exercise firm control over expenditures on goods and services, and reduce subsidies that do not benefit low-income families.

Additional Fiscal Measures Proposed by Staff
(Cumulative; percent of GDP)

	2013	2014
Overall balance (passive policies)	**-3.9**	**-3.8**
Measures:	**1.0**	**1.8**
Removal of tax exemptions	0.3	0.4
Adoption of property tax	0.1	0.2
Freezing of wage bill	0.3	0.6
Saving on goods and services	0.1	0.2
Targeting of subsidies	0.2	0.4
Overall balance (after measures)	**-3.0**	**-2.0**

Sources: Fund staff estimates.

- ***On the financing side,*** staff supported plans to amortize the short-term debt to reduce costs and rollover risks, and encouraged the authorities to secure as early as possible the long-term financing to cover the projected deficits for 2013-14.

[2] Planned revenue measures include: (i) a financial transaction tax of 0.25 percent on bank operations by economic agents above US$500; (ii) a property tax of 1 percent on urban real estate with value above US$350,000, and (iii) removal of income tax exemptions to newspaper and book-publishing companies; with an expected combined yield of 0.3 percent of GDP.

[3] Other expenditure measures include: (i) extending a freeze on selected current outlays; (ii) reducing the cost of the subsidy on propane gas; and (iii) limiting the carryover of unspent appropriations from previous budgets.

[4] The financial activity tax is levied on a measure of the value added of the financial system (profits and wages paid by institutions). This tax does not appear to discourage financial intermediation, while the financial transaction tax tends to reduce bank services, as agents try to avoid paying the tax.

The authorities were in broad agreement with staff recommendations, but noted that the feasibility of additional measures during 2013-14 depended critically on reaching consensus with other political parties. If that consensus proved elusive, the authorities would give priority to securing new external financing at reasonable terms to cover the fiscal deficit.

17. **There was agreement that banks would benefit from maintaining relatively large liquidity buffers during the electoral period.** The capital buffers currently held by banks seem sufficient to manage high credit risk, including from exposure to the public sector.[5] Banks may also be able to accommodate moderate deposits losses (of up to 10 percent of total deposits), but higher buffers are desirable given the large share of short-term deposits. The authorities also noted that resource constraints are making it difficult to activate the newly-created lender-of-last-resort facility, and said that they are considering a transitory increase in liquidity requirements to underpin financial stability.

B. Medium-term Challenges

Improving growth prospects

18. **The authorities agreed that it is necessary to develop broad-based consensus on a medium-term growth strategy for El Salvador.** For many years, growth and domestic investment in El Salvador have been much lower than in neighboring countries. Main stakeholders are aware that the key to unleash growth resides in policies that enhance human capital, upgrade infrastructure, lower the cost of doing business, and develop local capital markets. Nonetheless, support for undertaking those policies has been half-hearted. Staff's estimates show that closing the investment gap (of up to 10 percent of GDP) with the region or with Chile, Mexico, and Peru could raise El Salvador's potential growth to 4-4½ percent per year (see Annex I).

19. **Staff supported the government's initiatives to promote investment, which could help improve conditions for growth.** Staff cautioned the authorities to not make the initiatives dependent on costly tax exemptions or new fiscal contingencies, and advised to continue reducing crime and perceived corruption by mobilizing the anti-money laundering (AML) framework.[6] The authorities' initiatives cover two broad areas:

- ***Private sector participation on infrastructure projects.*** The authorities are encouraging private sector participation in the management of the major port, the expansion of the main airport, and new projects for electricity generation and public transportation. In addition, the authorities expect that ongoing initiatives to develop the coastal area, provide support to low-income farmers, and set up a public-private partnership framework (PPPs) would boost

[5] Based on previous technical assistance, the authorities prepared stress tests that revealed low vulnerability to credit risk arising from a prolonged period of lower output growth than that assumed in the baseline projection.

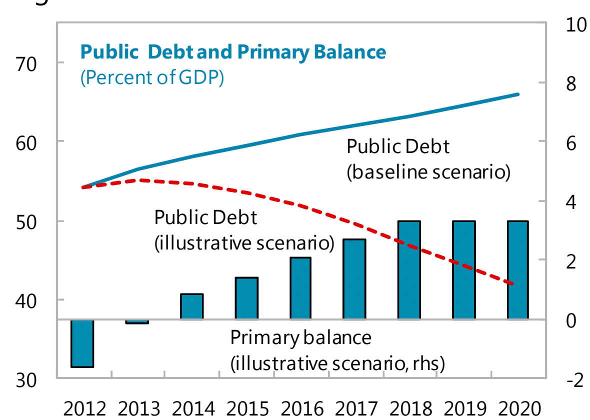
[6] This should include measures to mitigate the risk posed by cash operations and ensure that politically exposed persons are subject to enhanced customer due diligence (CDD) measures, in accordance with the Financial Action Task Force (FATF) standard.

growth in several sectors (e.g. agriculture, tourism, and high value-added manufacture). With weak prospects for external demand, the authorities noted that renewed focus on regional integration could raise export growth. Staff advised the authorities to strengthen capacity to manage PPPs. In particular, they need to set up a sound legal framework (comprising principles of value for money, transparency, and containing fiscal risks) that integrates all costs (including contingent liabilities) in the budget and in their fiscal sustainability analysis. The authorities agreed with this advice and expect congressional approval of this framework by year-end.

- ***Business climate.*** Steps towards improving the business climate include: (i) legislation to reduce red tape, clarify investment rules (on contract enforcement, dispute/resolution, electronic signature, and insolvency), and strengthen the AML framework; (ii) efforts to continue lowering crime; and (iii) upgrading key business indicators (with assistance from the World Bank).

Strengthening the fiscal position

20. **Staff recommended framing the national dialogue on fiscal policy in terms of medium-term targets for public debt.** There was agreement that the current level of debt was high and a major source of risks. The authorities and staff jointly assessed alternative debt targets and sustainability gaps (see Annex IV), and concluded that a return to the public debt ratio attained in 2008 (42 percent of GDP) by the year 2020 would allow to gradually rebuild fiscal buffers, and keep financing requirements manageable without unduly stifling growth. It was recognized that a sustained increase in the primary balance (by 5 percentage point of GDP relative to 2012 levels) would be necessary to attain those targets in the seven-year horizon.

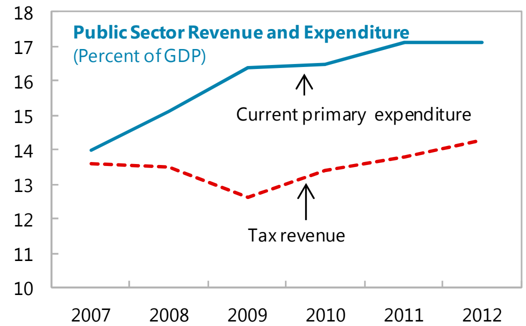


Sources: National authorities and Fund staff calculations.

21. **Staff welcomed recent improvements in tax administration and public financial management**. These include the creation of a special unit to monitor large taxpayers, improved coordination between the tax and customs agencies, and further strengthening tax auditing capacity. On the expenditure side, the authorities highlighted their plans to adopt a treasury single account by mid-2014 and the shift to a programmatic coverage of the budget, which would facilitate the adoption of a medium-term expenditure framework by 2015. Staff welcomed these plans and encouraged the authorities to also develop a plan to gradually unify the budgets of the various government entities.

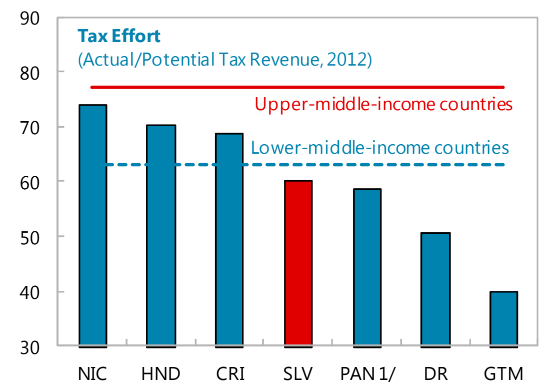
22. **It was agreed, however, that the initiatives underway were not a substitute for a strong fiscal consolidation strategy comprising both expenditure and revenue measures.**

- ***Expenditure.*** Staff argued that current primary spending had to be lowered gradually to the levels prevailing prior to the 2009 crisis. The authorities considered that it would be difficult to compress expenditure that much given the large demand for security, education, health, and social infrastructure, which are key to improving social conditions and reducing inequality. However, they agreed that expenditure control had to focus on improving the targeting of subsidies, reforming the civil service, reducing the earmarking of revenue, and increasing the effectiveness of social spending.



Sources: National authorities and Fund staff calculations.

- ***Revenues.*** There was agreement on the necessity to increase the tax revenue intake, given the relatively low tax effort of El Salvador. Staff noted that it was important to draw lessons from this government's initial strategy to raise tax revenues in the context of a "fiscal pact". It suggested that it may be preferable to focus on specific areas such as reducing tax expenditure and raising the rate of the value-added tax (VAT) rate closer to levels prevailing in peer countries.



Sources: National authorities and Fund staff calculations.
1/ Includes dividends from the Panama Canal.

23. **Pension reform should be part of the medium-term fiscal strategy.** The authorities' preliminary assessment suggests that unfunded fiscal liabilities of the pension system (comprising a public and a private component) range from 65 to 75 percent of GDP, and raises important equity issues, as half of those liabilities represent benefits accruing to only 10 percent of affiliates (see Box 2). Staff agreed that the assessment underscored the urgent need for parametric changes to lower benefits, increase contributions, and extend retirement ages. The authorities noted that they plan to work on developing a proposal to reform the pension system that could be taken by the new government, but indicated that there was little public support for this reform.

24. **Staff advised against changes in the accounting treatment of pension liabilities.** The authorities explained their plans to absorb in the government accounts those private pension accounts that receive defined benefits, as well as their counterpart assets (mainly, government securities). They argued that this operation would reduce El Salvador's public debt and make it more comparable to neighboring countries (which have pay-as-you-go pension schemes). Staff strongly advised against this operation, stressing that it would not remedy the underlying imbalances of the pension system, because the gap between benefits and contributions would not be reduced, making unfunded liabilities less transparent than at present.

Underpinning financial stability

25. **The authorities are keen to complete pending financial reforms.** Although financial supervision has improved, the pace of adoption of the recommendations of the 2010 FSAP Update has recently slowed (Box 4). The authorities intend to make further progress towards risk-based supervision and improve cross-border consolidated supervision. In addition, they are seeking congress' support for frameworks to facilitate bank resolution, broaden the perimeter of supervision, and create investment funds, though it is unclear whether sufficient support will exist before the new government takes office. Staff encouraged the authorities to strengthen the reserves of the deposit insurance fund and set up a liquidity fund in line with the new central bank's liquidity framework.

26. **Staff advocated a gradual adoption of Basel III standards.** Staff argued that El Salvador is well placed to make the transition to Basel III standards, since banks already maintain levels of capital and liquidity that comply with those standards (Annex V). In particular, staff recommended the adoption of stricter definitions of capital and the introduction of new capital requirements, but advised against reducing liquidity requirements to Basel III standards until the lender-of-last-resort facility and the liquidity fund were activated. The authorities said that they would consider these suggestions.

STAFF APPRAISAL

27. **Since 2010 economic growth in El Salvador has been sluggish and vulnerabilities have risen.** Although the financial system has remained sound and inflation low, anchored by full dollarization, the recovery never gained strength. Output growth has been the lowest in Central America, owing largely to weak private investment and severe supply constraints. The fiscal consolidation strategy of the government, which was supported by a Fund arrangement, stalled in late 2011 due to lack of broad political support. As a result, the fiscal deficit has hovered around 4 percent of GDP since 2010 and the public debt-to-GDP ratio has kept rising.

28. **Policy inaction in the long electoral period that lies ahead may heighten risks.** Staff advised the authorities and all political groups to initiate a national dialogue on short- and medium-term priorities for El Salvador. The latter should comprise measures aiming at improving growth prospects, restoring fiscal sustainability, and making the dollarized economy more resilient to shocks.

29. **Fiscal consolidation should not be further delayed.** Staff projections suggest that under current policies the fiscal deficit would stabilize at about 4 percent of GDP during 2013-14; this level of deficit would keep the public debt ratio on an upward path and increase financing pressures. Staff urges the authorities to lower their fiscal deficit targets for 2013-14 to reduce these risks. Broadening the scope of the revenue measures currently contemplated and keeping current expenditure in check would be necessary to attain these fiscal targets. A transitory increase in liquidity requirements, to strengthen buffers in the banking system during the electoral period, would also be advisable.

30. **The government should promote a national dialogue to develop a medium-term growth agenda.** El Salvador's weak growth performance is well documented and all key stakeholders are aware of the reforms that are needed to reduce the long-standing investment gap and unleash growth potential. The authorities should take advantage of this common understanding of key obstacles to build broad consensus on a medium-term growth strategy. At the same time, they should move forward with their initiatives to create a framework for PPPs, foster private participation in infrastructure, and reduce red tape, while taking steps to prevent that these initiatives lead to new tax exemptions or create fiscal contingencies.

31. **A strategy to strengthen the fiscal position should be the second pillar of the national dialogue.** Staff recommends framing that discussion in terms of medium-term targets for the public debt-to-GDP ratio and aiming at reducing the public debt ratio to about 40 percent of GDP by 2020. The fiscal consolidation strategy should comprise revenue and expenditure measures including improving the targeting of subsidies, lowering the earmarking of revenue, further reducing tax expenditure and evasion, and raising the VAT rate to levels observed in other Latin America countries. A comprehensive reform of the pension system to put it on a strong financial footing and reduce inequalities should also be a part of the strategy.

32. **Staff encourages the authorities to complete the reform agenda for the financial system.** Staff welcomes the progress in adopting risk-based supervision and improving cross-border consolidated supervision, but progress in other areas has slowed. Staff encourages the authorities to focus their efforts on securing resources to activate the new liquidity framework of the central bank, especially the lender-of-last-resort facility, and raising the reserves of the deposit insurance fund to strengthen the financial safety net. It is also important to move forward with the financial reforms aimed at facilitating bank resolution and broadening the perimeter of supervision.

33. **Staff recommends that the next Article IV Consultation takes place on the standard 12-month cycle.**

Box 1. Implementation of Fund Policy Advice

The previous Article IV consultation combined with the first review under the SBA with El Salvador focused on the need to regain the fiscal space used during the 2008-09 crisis and enhance the resilience of the financial system (IMF Country Reports 10/307). Directors recommended:

- **Strengthening fiscal policy gradually** to strike a balance between supporting an economic recovery and placing the debt-to-GDP ratio on a modest declining path. *The authorities reduced the fiscal deficit in 2010, but fiscal policy slippages emerged in late 2011 and the public debt ratio rose through 2012.*

- **Implementing a broad tax reform** to support the planned fiscal consolidation. *The authorities raised the marginal income tax and some excise tax rates, and eliminated exemptions in two steps in 2010 and 2012 (with a combined yield of 1.2 percent of GDP). However, other tax reforms were not pursued.*

- **Improving the targeting of energy subsidies to the poor** to make room for higher social investment. *The authorities made good progress in 2010, but it was largely reversed in April 2011 following a temporary surge in oil prices. Presently, subsidies on the consumption of electricity and liquid propane gas benefit disproportionally the wealthy.*

- **Advancing banking reforms** to shift to risk-based supervision, strengthen the financial safety net, and develop the local capital market. *The authorities have issued most regulations on financial risk management, set up a lender-of-last-resort facility, and made progress in improving the bank resolution process.*

- **Improving the business climate** to foster investment and lift growth prospects. *The authorities have been able to reduce crime and improve the road network. However, insecurity and perceived corruption continue to affect the investment climate.*

Box 2. El Salvador—Subsidies and Pension Payments

For several years, payments on subsidies and pensions have been a burden to the public finances and have raised equity questions. To deal with these issues, reforms are required to target subsidies only to the most vulnerable, and reduce the actuarial deficit of the pension system and increase its fairness.

SUBSIDIES

Subsidies on the consumption of electricity, liquid propane gas (LPG), and public transportation averaged 1½ percent of GDP yearly during 2008-12, but low-income households received only one-third of the amount spent, highlighting the need to improve the targeting of subsidies.

- **Targeting.** The coverage and magnitude of subsidies are relatively large. Presently, over 80 percent of households receive a subsidy on electricity and LPG, both granted to those consuming up to 200 kWh of electricity. The subsidies represent up to 70-75 percent of recovery cost. Meanwhile, subsidized tariffs on public transportation benefit mainly low- and middle-income agents. Reducing eligibility of subsidies to low-income families and lowering their size could produce fiscal savings of up to 1 percent of GDP per year.

- **Crossed subsidies**. Scaled consumption-based tariffs on water allow a subsidy to low- and middle-income families, without an impact on the budget. Urban families benefit the most from these tariffs since only some 5 percent of rural families have access to drinkable water.

Subsidies in 2012

	% GDP	Level 1/	Coverage 2/
Total	**1.5**	...	...
Eletricity 3/	0.7	57	81
Under 99 kWh	0.5	70	58
100-200 kWh	0.2	25	23
LPG	0.6	75	83
Transportation	0.3	...	...

Sources: National authorities.
1/ Percent of recovery cost.
2/ Percent of total households.
3/ Monthly consumption.

PENSION SYSTEM

Pensions paid by the government reached almost 2 percent of GDP per year during the last five years. As these outlays were financed with debt placements with private pension funds, government debt held by these funds has accumulated rapidly, reaching 10 percent of GDP at end-2012 (one-fifth of total public debt).

- **Financial position.** Individual pension accounts have been replacing a pay-as-you-go scheme since 1998, but unfunded fiscal liabilities continued to accumulate, as successive legal changes in the 2000's provided defined benefits to some accounts (which are unlinked to contributions as in the old scheme) and guaranteed a minimum pension. On a preliminary basis, the authorities estimate that unfunded liabilities presently amount to 65-75 percent of GDP and that pension payments would rise gradually to 2-3 percent of GDP yearly by the end of this decade.

- **Equity.** The authorities estimate that defined benefits in both pension schemes have large distributional implications. Over half of the unfunded liabilities are due to only 10 percent of affiliates. On a flow basis, 20 percent of current pensioners (mostly, high-income) presently receive about 50 percent of the overall pensions paid by the government. Effectively, present defined benefits provide large subsidies to a small group of the population at the expense of current and future generations of taxpayers.

Box 3. El Salvador—Risk Assessment Matrix[1]

	Up/down side	*Risk*	*Impact*	*Policy Response*
A fiscal policy shock in the United States leading to lower U.S. growth.	↓	M	M	Given limited fiscal space, move forward investment reforms, including on business climate and competitiveness, and strengthen tax policy to offset revenue losses.
Emerging markets capital flow reversal (lower access to external financing).	↓	M	M	Move forward the proposed fiscal effort to reduce external financing needs. Lower liquidity mismatches in the banking system.
Global oil shock triggered by geopolitical events (driving oil prices to US$140 per barrel).	↓	L	H	Allow full pass-through, maintain strict wage policy, and strengthen the social safety net aided by tax policy.
Weakened fiscal policy stance (driven by electoral pressures).	↓	H	H	Reach immediate consensus with stakeholders on a fiscal and growth agenda to protect stability.
Confidence shock to depositors (triggered by electoral uncertainty and large fiscal deficits).	↓	M	L	Use existing liquidity buffers. Strengthen the insurance deposit scheme and the supervision of small cooperatives, as advised by the FSAP.
Natural disasters	↓	M	M	Deepen use of official loans to accommodate fiscal costs from targeted assistance.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of the staff). The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities. The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding this baseline.

Box 4. Main Recommendations from the 2010 FSAP Update

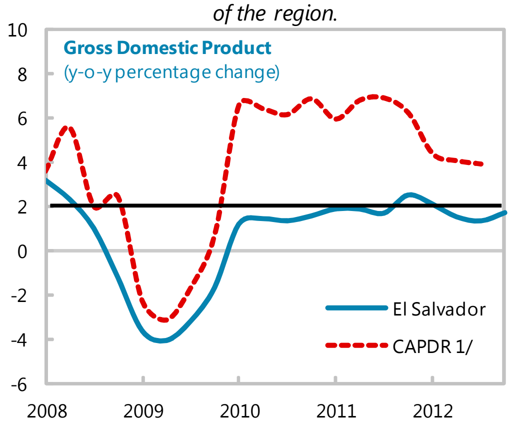
Financial Supervision	Status [1]
• Approve modifications to the law on financial system supervision and regulation to broaden the autonomy and remedial action powers of the supervisory authority, and strengthen legal protection for supervisors.	PI
• Gradually shift to risk-based supervision by: (i) issuing and adopting norms for key risks and corporate governance; and (ii) bringing qualitative assessments in line with international best practices and appoint dedicated manager responsible for the overall supervision of each bank.	PI
• Intensify supervision of credit concentration and debtor repayment capacity.	PI
Liquidity Management	
• Amend the central bank law granting it powers of lender of last resort.	FI
• Implement a comprehensive liquidity policy, which includes objectives, creation of a liquidity fund, and contingency plans.	PI
Bank Resolution	
• Undertake a comprehensive bank resolution simulation exercise.	FI
• Elaborate manuals to formalize procedures for banks resolution and crisis management.	PI
• Update the legal framework for bank resolution by: (i) eliminating the 3-day notification period for resolution measures; (ii) requiring removal of a bank's board at judicial intervention; (iii) ensuring least-cost solution; and (iv) increasing the funding of the deposit insurance scheme.	PL
• Update the legal framework for the cooperative banks and their resolution process.	PL
Capital Markets	
• Approve an investment funds law to potentially broaden the investor base and develop domestic capital markets.	PL
• Approve an overhaul of the regulatory framework of the securities market.	NI
• Amend the pension funds law to broaden investment opportunities for private pension funds.	NI

[1] FI: fully implemented; PI: partially implemented; PL: pending legislation; NI: Not implemented.

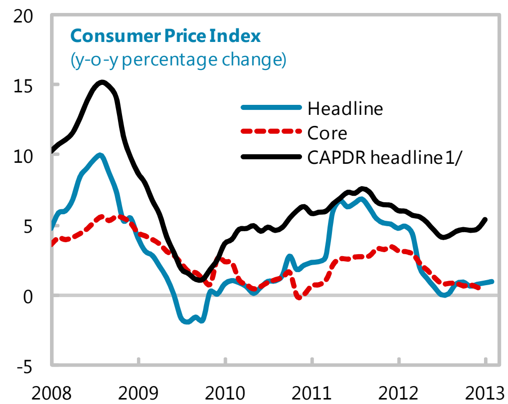
Figure 1. El Salvador: Recent Economic Developments

Growth remained sluggish following the global financial crisis.

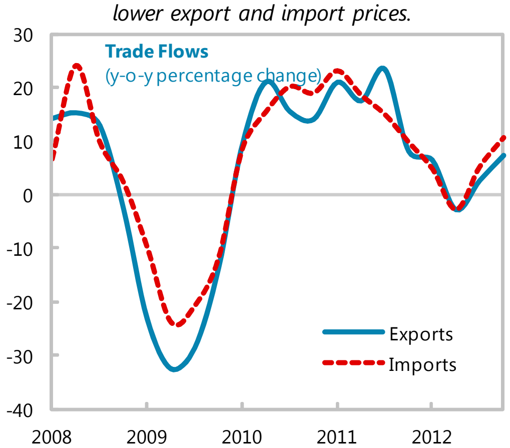
Growth has been lower than in the rest of the region.



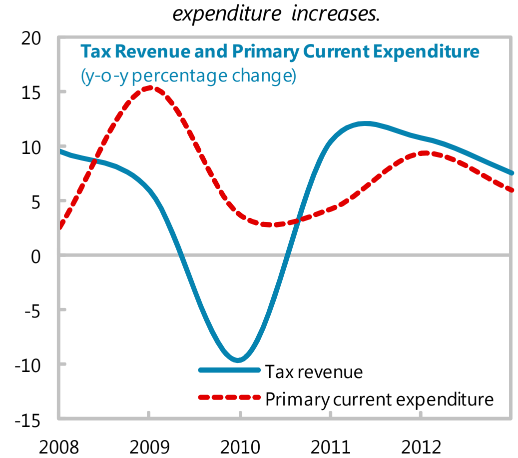
Inflation fell below 1 percent in 2012.



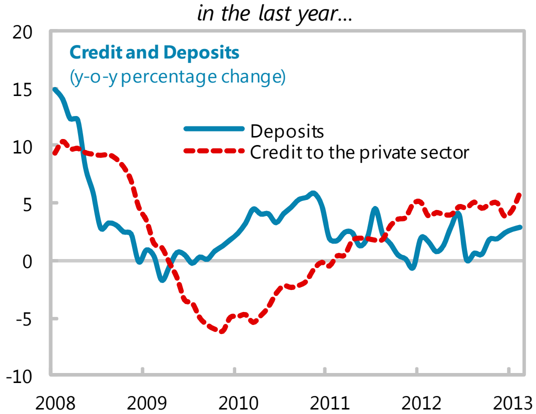
Trade flows growth slowed in 2012 owing to lower export and import prices.



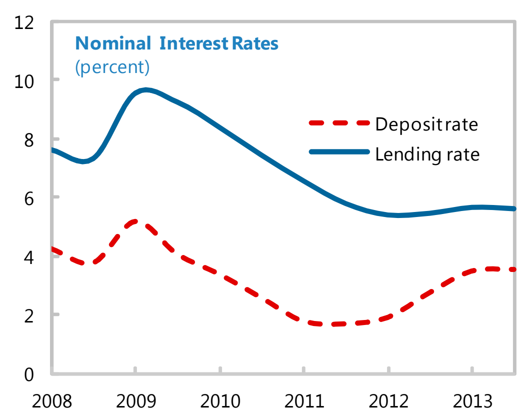
Tax revenue growth has not offset past expenditure increases.



Deposits and bank credit picked up moderately in the last year...



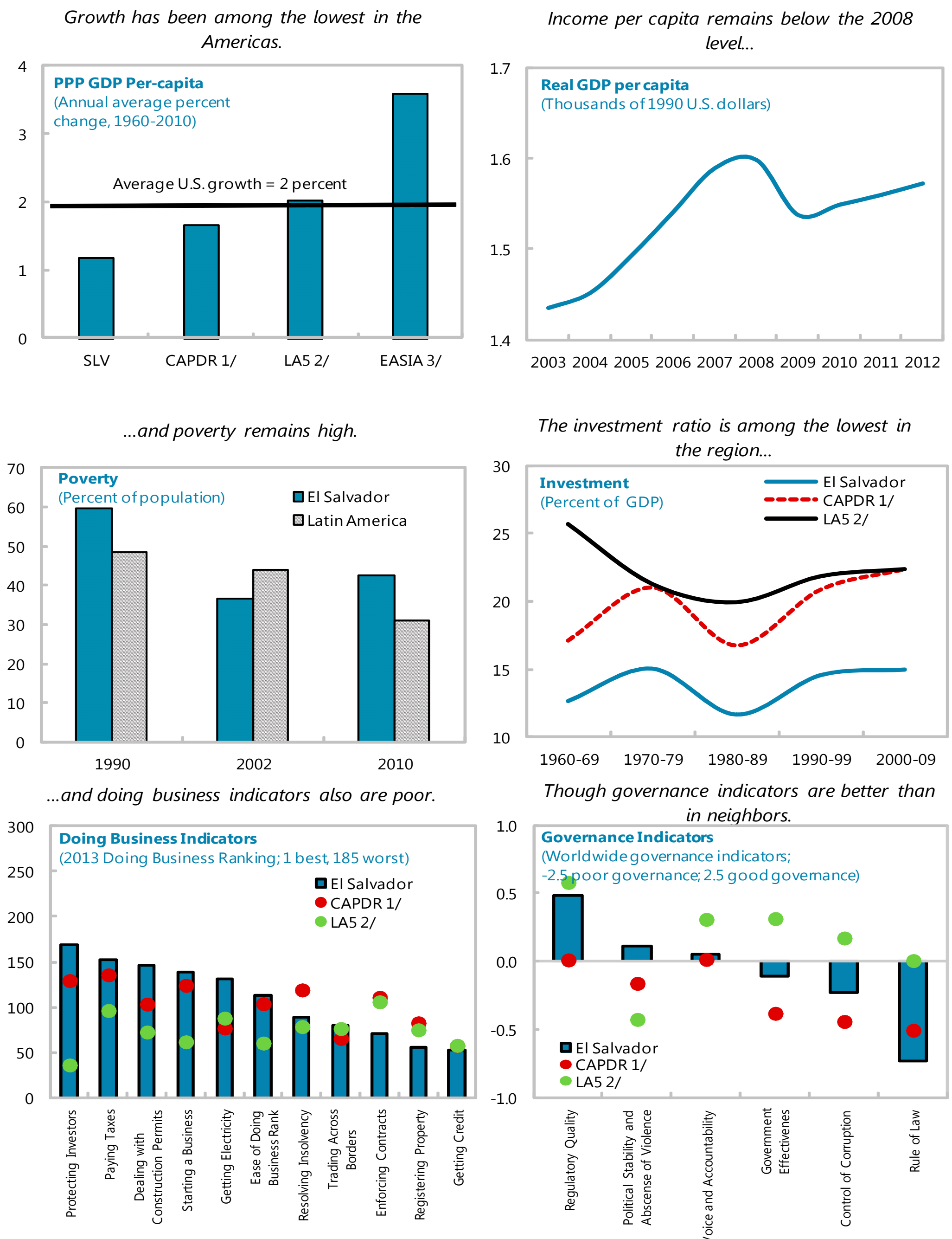
...while interest rates increased.



Sources: National authorities and Fund staff calculations.
1/ Simple average of Costa Rica, Guatemala, Honduras, Nicaragua, Panama, and the Dominican Republic.

Figure 2. El Salvador: Long-term Growth and Poverty

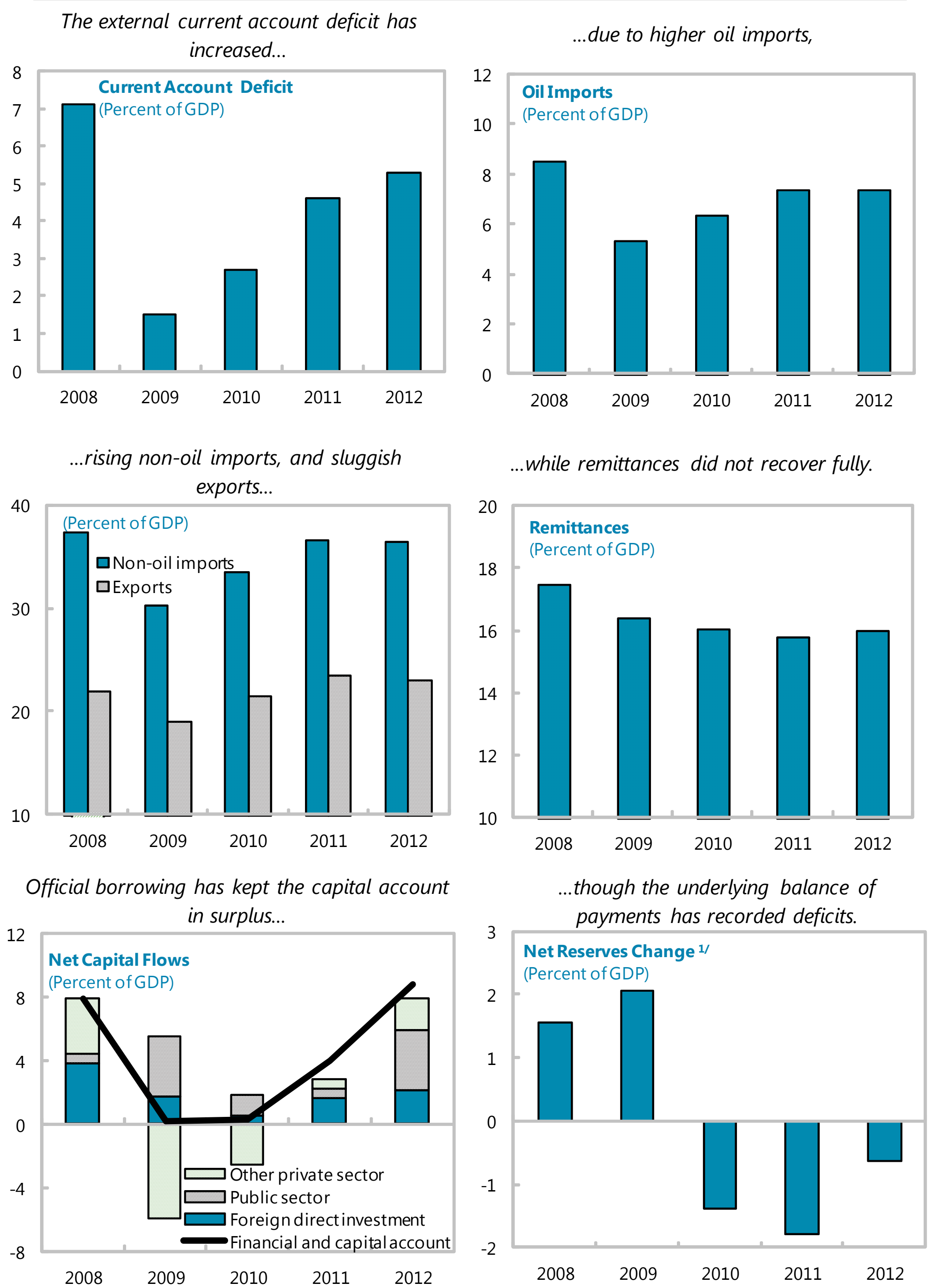
Structural bottlenecks have inhibited long-term growth.



Sources: Penn World Tables; ECLAC; Barro and Lee educational attainment dataset; and World Bank, World Development Indicators Doing Business Indicators, and Governance Indicators.
1/ Simple average of Costa Rica, Guatemala, Honduras, Nicaragua, Panama, and the Dominican Republic.
2/ Simple average of Brazil, Chile, Colombia, Mexico, and Peru.
3/ Simple average of Bangladesh, Bhutan, Cambodia, China, Hong Kong SAR, India, Indonesia, Korea, Lao P.D.R., Macau, Malaysia, Philippines, Singapore, Sri Lanka, Taiwan Province of China, Thailand, and Vietnam.

Figure 3. El Salvador: Balance of Payments Developments

The external accounts have weakened since the global crisis.



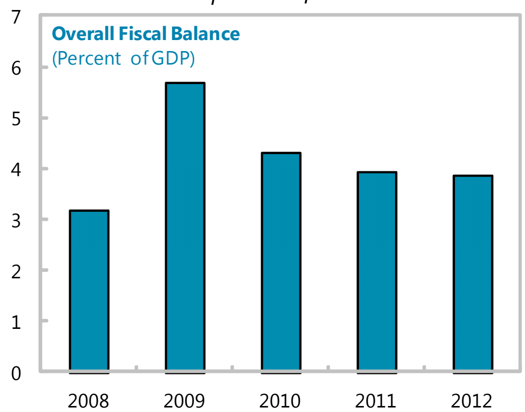
Sources: Central Reserve Bank of El Salvador, Haver Analytics, and Fund staff calculations.

1/ Excludes the Eurobonds proceeds in November 2012.

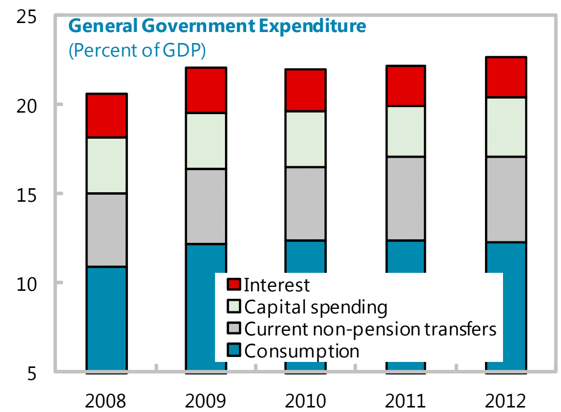
Figure 4. El Salvador: Fiscal Developments

Vulnerabilities in the public sector have increased, as fiscal consolidation has been slow.

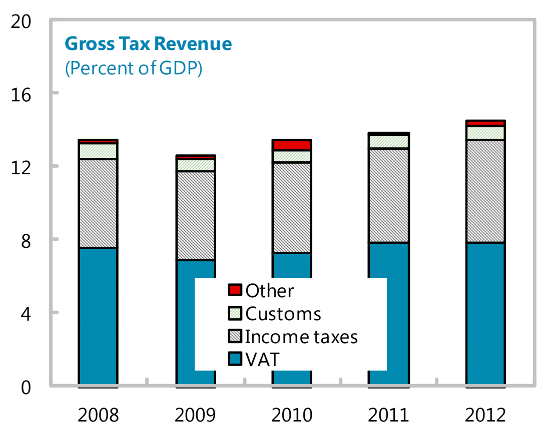
The fiscal deficit has stabilized at about 4 percent of GDP…



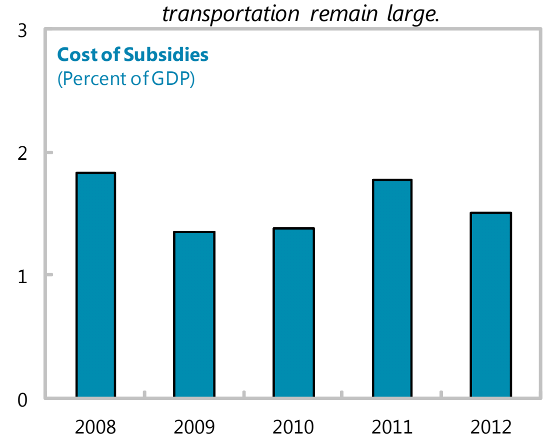
…as expenditures stayed above pre-crisis level…



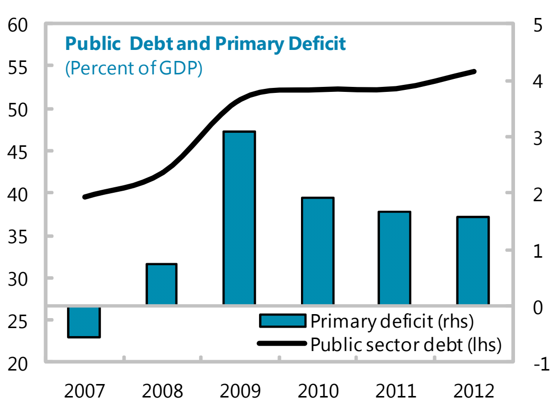
…and the increase in revenue was modest.



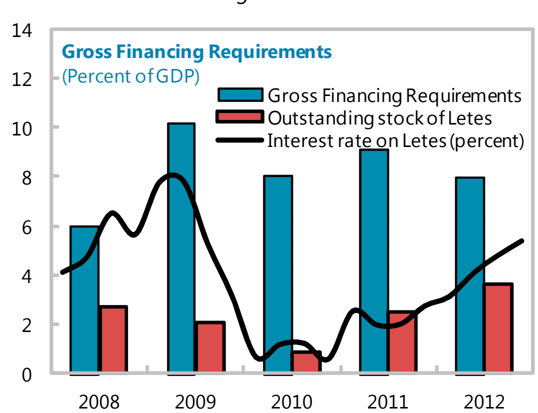
Untargeted subsidies on gas, electricity, and transportation remain large.



Public debt is high and continues to rise…



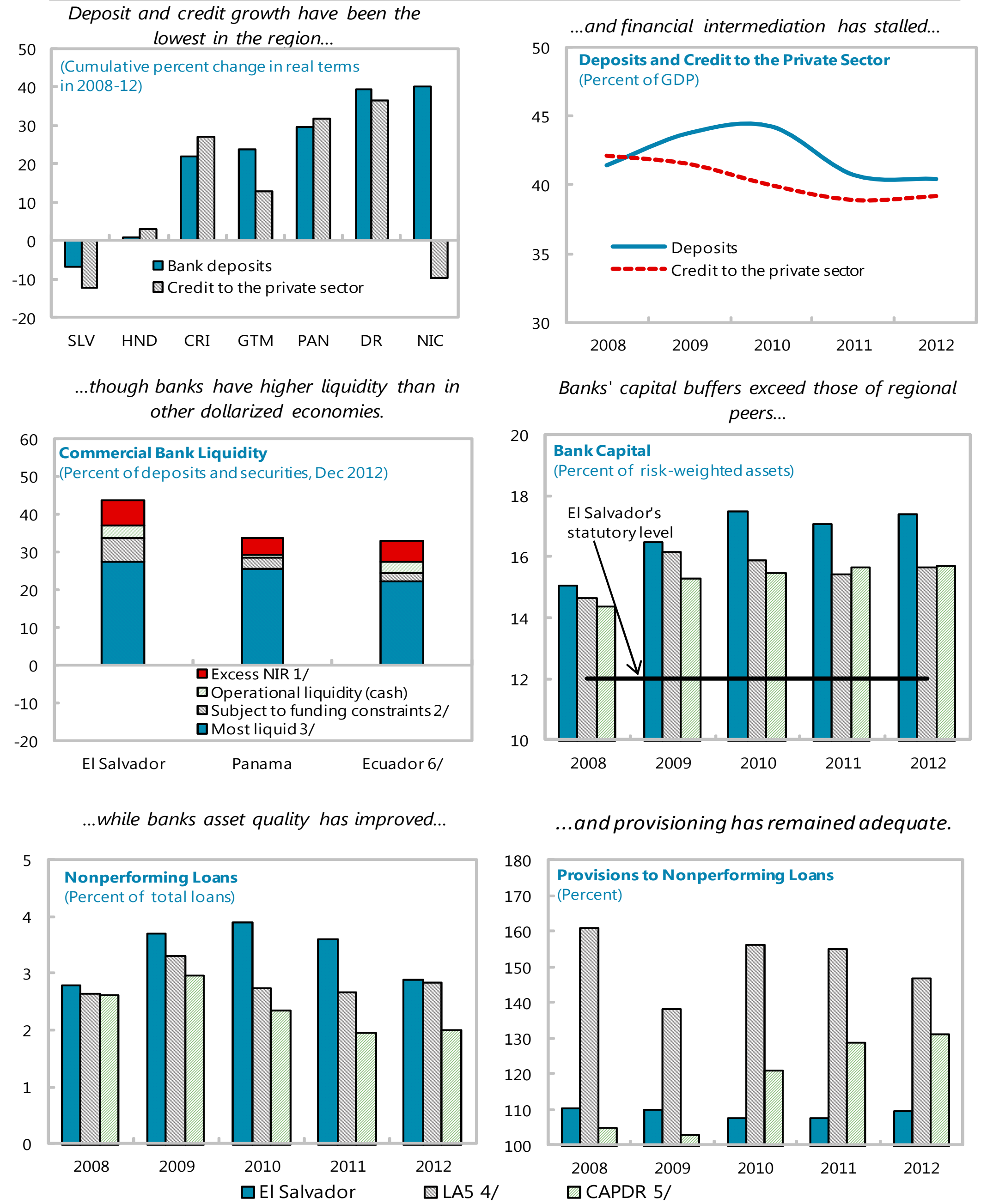
…and borrowing costs are on the rise.



Sources: National authorities and Fund staff calculations.

Figure 5. El Salvador: Financial Sector Developments

Intermediation has slowed, but the banking system appears sound.



Sources: National authorities, IMF Financial Soundness Indicators, and Fund staff calculations.

1/ Net international reserves in excess of commercial bank claims on the central bank
2/ Commercial bank holdings of central bank and central government securities.
3/ Deposits at the central bank, deposits abroad, and securities abroad.
4/ Simple average of Brazil, Chile, Colombia, Mexico, and Peru.
5/ Simple average of Costa Rica, Guatemala, Honduras, Panama, and the Dominican Republic.
6/ Data as of June 2012.
Note: CRI denotes Costa Rica, DR Dominican Republic, SLV El Salvador, GTM Guatemala, HND Honduras, NIC Nicaragua, PAN Panama.

Table 1. El Salvador: Selected Economic Indicators

I. Social Indicators

Rank in UNDP Development Index 2012 (of 186)	107	Population (million)	6.2
Per capita income (U.S. dollars)	3,823	Life expectancy at birth in years	71
Percent of pop. below poverty line (2010)	43	Infant mortality (per 1,000 live births)	15
Gini index	47	Primary education completion rate (percent)	89

II. Economic Indicators

					Prel.	Projections	
	2008	2009	2010	2011	2012	2013	2014
	(Annual percent change, unless otherwise stated)						
Income and Prices							
Real GDP	1.3	-3.1	1.4	2.0	1.6	1.6	1.6
Consumer prices (end of period)	5.5	0.1	2.1	5.1	0.8	2.3	2.6
GDP deflator	5.3	-0.5	2.3	5.7	1.5	1.7	2.4
External Sector							
Exports of goods and services, volume	6.9	-16.0	11.6	9.3	4.8	4.0	4.5
Imports of goods and services, volume	3.3	-24.8	10.4	10.3	2.3	3.9	4.0
Terms of trade	-9.5	12.6	-5.8	-2.6	-3.6	-2.7	1.6
Real effective exchange rate (+ = appreciation)	7.0	-4.3	-0.6	1.7	-1.7	…	…
External sovereign bond spread (basis points)	388	486	315	374	448	…	…
	(Percent of GDP, unless otherwise stated)						
Money and Credit							
Credit to the private sector	43.0	42.4	40.9	39.8	40.1	39.6	38.9
Broad money	45.0	47.3	47.2	43.7	43.2	42.8	42.1
Interest rate (time deposits, percent)	4.2	4.5	2.9	1.8	2.5	…	…
External Sector							
Current account balance	-7.1	-1.5	-2.7	-4.6	-5.3	-5.0	-4.8
Trade balance	-21.8	-15.0	-16.5	-18.4	-18.7	-19.1	-19.1
Exports (f.o.b. including *maquila*)	21.9	19.0	21.4	23.4	23.0	23.0	23.1
Imports (f.o.b. including *maquila*)	-43.8	-34.1	-37.8	-41.8	-41.7	-42.1	-42.3
Services and income (net)	-2.8	-3.1	-3.0	-2.9	-3.3	-2.9	-2.8
Transfers (net)	17.5	16.7	16.8	16.6	16.8	17.0	17.1
Foreign direct investment	3.8	1.8	0.5	1.7	2.2	1.0	1.1
Nonfinancial Public Sector							
Overall balance	-3.2	-5.7	-4.3	-3.9	-3.9	-3.9	-3.8
Primary balance	-0.8	-3.1	-1.9	-1.7	-1.6	-1.4	-1.3
Of which: tax revenue	13.5	12.6	13.5	13.8	14.4	15.3	15.5
Public sector debt 1/ 2/	42.4	51.0	52.2	52.3	54.3	56.4	58.0
External public debt service							
(Percent of exports of goods and services)	8.2	10.2	9.4	18.4	9.4	8.1	7.9
National Savings and Investment							
Gross domestic investment	15.2	13.4	13.3	14.4	14.6	14.6	14.6
Public sector	2.4	2.2	2.4	2.5	2.9	2.9	2.9
Private sector	12.8	11.2	10.9	11.9	11.7	11.7	11.8
National savings	8.1	11.9	10.6	9.8	9.3	9.5	9.8
Public sector	-0.4	-3.1	-1.9	-2.0	-1.2	-0.8	-0.5
Private sector	8.4	15.0	12.5	11.7	10.5	10.4	10.3
Net Foreign Assets of the Financial System 3/							
Millions of U.S. dollars	2,208	3,028	3,378	2,811	3,229	3,266	3,136
Percent of deposits	24.4	32.4	34.5	28.8	32.6	32.4	30.2
Memorandum Items:							
Nominal GDP (billions of U.S. dollars)	21.4	20.7	21.4	23.1	23.8	24.6	25.6

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

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

2/ Excludes sovereign debt placed in November 2012 (3¼ percent of GDP) to pre-finance amortizations of short-term debt in 2013.

3/ Beginning in 2010, gold in international reserves is valued at the price determined by the London Bullion Market (resulting in a valuation gain of US$170 million).

Table 2. El Salvador: Balance of Payments

					Prel.	Projections					
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					(In millions of U.S. dollars)						
Current Account	**-1,532**	**-312**	**-576**	**-1,070**	**-1,258**	**-1,238**	**-1,224**	**-1,222**	**-1,253**	**-1,290**	**-1,326**
Merchandise trade balance	-4,677	-3,108	-3,530	-4,246	-4,465	-4,708	-4,900	-5,076	-5,307	-5,539	-5,792
Export of goods (f.o.b.)	4,703	3,930	4,577	5,401	5,467	5,655	5,928	6,213	6,485	6,806	7,144
General merchandise	3,334	2,984	3,442	4,200	4,284	4,461	4,685	4,917	5,139	5,391	5,675
Goods for processing	1,368	945	1,134	1,201	1,183	1,194	1,243	1,296	1,347	1,416	1,469
Import of goods (f.o.b.)	-9,380	-7,038	-8,107	-9,647	-9,932	-10,363	-10,828	-11,289	-11,793	-12,345	-12,936
General merchandise	-8,374	-6,433	-7,354	-8,794	-9,092	-9,527	-9,970	-10,395	-10,863	-11,368	-11,922
Goods for processing	-1,005	-605	-753	-854	-840	-836	-858	-894	-929	-977	-1,014
Services	-213	-90	-94	-33	136	100	88	91	97	101	106
Income	-389	-556	-551	-632	-933	-820	-793	-809	-834	-868	-900
Current transfers	3,747	3,442	3,599	3,841	4,004	4,189	4,382	4,572	4,791	5,015	5,259
Financial and Capital Account	**1,702**	**42**	**70**	**926**	**2,093**	**444**	**1,281**	**1,278**	**1,310**	**1,363**	**1,400**
Capital account	80	131	232	266	201	168	181	191	201	216	226
Public sector financial flows	127	785	274	121	903	149	175	78	44	68	102
Disbursements	427	1,076	584	1,067	1,190	401	447	391	398	442	457
Amortization	-300	-291	-310	-946	-287	-252	-272	-313	-353	-374	-355
Private sector financial flows	1,495	-875	-436	539	989	127	925	1,009	1,065	1,080	1,072
Foreign direct investment	824	366	117	385	515	250	271	290	307	325	327
Portfolio investment	131	747	-121	100	11	-59	-44	-21	-29	-27	-25
Other	541	-1,988	-431	53	463	-64	698	740	787	782	770
Errors and Omissions	**164**	**693**	**211**	**-271**	**-186**	**0**	**0**	**0**	**0**	**0**	**0**
Change in Reserves (- = increase)	**-333**	**-423**	**295**	**414**	**-650**	**795**	**-57**	**-56**	**-58**	**-73**	**-74**
					(Percent of GDP)						
Current Account	**-7.1**	**-1.5**	**-2.7**	**-4.6**	**-5.3**	**-5.0**	**-4.8**	**-4.6**	**-4.5**	**-4.4**	**-4.4**
Merchandise trade balance	-21.8	-15.0	-16.5	-18.4	-18.7	-19.1	-19.1	-19.0	-19.0	-19.0	-19.0
Export of goods (f.o.b.)	21.9	19.0	21.4	23.4	23.0	23.0	23.1	23.3	23.3	23.4	23.5
Net maquila exports	1.7	1.6	1.8	1.5	1.4	1.5	1.5	1.5	1.5	1.5	1.5
Import of goods (f.o.b.)	-43.8	-34.1	-37.8	-41.8	-41.7	-42.1	-42.3	-42.3	-42.3	-42.4	-42.5
Petroleum and products	-8.4	-5.3	-6.3	-7.3	-7.3	-7.2	-6.9	-6.6	-6.3	-6.2	-6.1
Services	-1.0	-0.4	-0.4	-0.1	0.6	0.4	0.3	0.3	0.3	0.3	0.3
Income	-1.8	-2.7	-2.6	-2.7	-3.9	-3.3	-3.1	-3.0	-3.0	-3.0	-3.0
Current transfers	17.5	16.7	16.8	16.6	16.8	17.0	17.1	17.1	17.2	17.2	17.3
Financial and Capital Account	**7.9**	**0.2**	**0.3**	**4.0**	**8.8**	**1.8**	**5.0**	**4.8**	**4.7**	**4.7**	**4.6**
Capital account	0.4	0.6	1.1	1.2	0.8	0.7	0.7	0.7	0.7	0.7	0.7
Public sector financial flows	0.6	3.8	1.3	0.5	3.8	0.6	0.7	0.3	0.2	0.2	0.3
Private sector financial flows	7.0	-4.2	-2.0	2.3	4.2	0.5	3.6	3.8	3.8	3.7	3.5
Foreign direct investment	3.8	1.8	0.5	1.7	2.2	1.0	1.1	1.1	1.1	1.1	1.1
Portfolio investment	0.6	3.6	-0.6	0.4	0.0	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1
Other	2.5	-9.6	-2.0	0.2	1.9	-0.3	2.7	2.8	2.8	2.7	2.5
					(Annual percentage change)						
Merchandise Trade (f.o.b.)											
Exports (nominal)	15.6	-16.4	16.5	18.0	1.2	3.4	4.8	4.8	4.4	4.9	5.0
Volume	7.4	-15.3	13.8	8.3	5.1	6.0	3.3	4.0	4.3	3.6	4.0
Price	7.6	-1.3	2.4	9.0	-3.7	-2.4	1.5	0.8	0.0	1.3	0.9
Imports (nominal)	11.2	-25.0	15.2	19.0	3.0	4.3	4.5	4.3	4.5	4.7	4.8
Volume	-6.5	-14.4	6.0	6.4	3.1	4.0	4.6	4.4	4.2	4.0	4.0
Price	18.9	-12.3	8.7	11.8	-0.1	0.3	-0.1	-0.2	0.3	0.7	0.7
Terms of trade	-9.5	12.6	-5.8	-2.6	-3.6	-2.7	1.6	1.0	-0.2	0.6	0.2
Memorandum Items											
Underlying change in reserves (- = increase) 1/	-333	-423	295	414	150	-5	-57	-56	-58	-73	-74
Gross international reserves (US$ million) 2/	2,545	2,987	2,883	2,504	3,154	2,359	2,416	2,473	2,531	2,604	2,677
In months of imports (excluding maquila) 3/	4.1	4.3	3.5	3.0	3.6	2.5	2.5	2.4	2.4	2.4	2.4
In percent of total short-term external debt	158	329	343	205	229	169	162	156	151	147	143
External debt (in percent of GDP) 1/	43.8	46.1	46.3	46.9	47.8	50.1	51.6	52.5	53.3	53.9	54.5
Of which: public sector debt	24.5	30.0	30.3	28.8	31.7	31.3	30.8	29.8	28.7	27.7	26.8
Of which: private sector debt	19.3	16.1	16.0	18.1	19.5	18.8	20.8	22.7	24.6	26.2	27.6
External public debt servicing (US$ million)	475	489	523	1,193	628	561	571	610	653	682	671
Percent of exports of goods and services	8.2	10.2	9.4	18.4	9.4	8.1	7.9	8.1	8.3	8.3	7.8
Gross external financing requirement (US$ million)	3,895	2,945	1,791	2,756	3,777	2,470	3,341	3,553	3,801	4,057	4,258
Percent of GDP	18.2	14.3	8.4	11.9	15.9	10.0	13.0	13.3	13.6	13.9	14.0

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

1/ Excludes sovereign debt placed in November 2012 (3¼ percent of GDP) to pre-finance amortizations of short-term debt in 2013.

2/ Beginning in 2010, gold in international reserves is valued at the price determined by the London Bullion Market (resulting in a valuation gain of US$170 million).

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

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

(In millions of U.S. dollars)

	2008	2009	2010	2011	Prel. 2012	Projections 2013	2014
Revenue and Grants	**3,732**	**3,399**	**3,802**	**4,219**	**4,507**	**4,792**	**5,025**
Current revenue	3,679	3,290	3,638	4,005	4,329	4,724	4,975
Tax revenue	2,886	2,609	2,882	3,192	3,434	3,773	3,974
Nontax revenue	619	573	651	644	734	783	828
Operating surplus of the public enterprises	174	108	105	169	162	167	174
Official grants	53	109	164	214	178	68	49
Expenditure	**4,415**	**4,571**	**4,721**	**5,127**	**5,427**	**5,754**	**5,996**
Current expenditure	3,754	3,929	4,044	4,459	4,609	4,925	5,133
Wages and salaries 1/	1,528	1,659	1,710	1,928	2,000	2,161	2,248
Goods and services 1/	823	874	944	932	940	980	1,020
Interest	520	531	508	518	540	608	642
Current transfers	884	865	883	1,081	1,128	1,176	1,223
Nonpension payments	425	495	525	675	709	742	772
Pension payments	458	370	357	406	419	433	451
Capital expenditure	661	642	677	668	818	829	862
Primary Balance	**-164**	**-642**	**-411**	**-390**	**-379**	**-353**	**-329**
Overall Balance	**-683**	**-1,173**	**-919**	**-908**	**-919**	**-962**	**-971**
Financing	**683**	**1,173**	**919**	**908**	**919**	**962**	**971**
External	**127**	**785**	**274**	**121**	**903**	**149**	**175**
Disbursements	427	1,076	584	1,067	1,190	401	447
Amortization	-300	-291	-310	-946	-287	-252	-272
Domestic	**557**	**387**	**645**	**787**	**16**	**526**	**362**
Change in deposits at central bank (- = increase)	26	-296	271	197	-737	800	0
Banking system	93	239	-67	164	328	-617	300
Private sector 2/	438	442	438	423	425	343	62
Unidentified financing	**...**	**...**	**...**	**...**	**...**	**287**	**433**
Memorandum Items:							
Current revenue minus current expenditure	-75	-639	-407	-453	-280	-201	-158
Gross financing needs	1,281	2,099	1,720	2,089	1,885	2,171	1,881
Implicit nominal interest rate (in percent)	6.5	5.8	4.8	4.3	4.5	4.4	4.6
Public sector debt (gross) 3/ 4/	9,094	10,544	11,175	12,076	12,934	13,896	14,867
Public sector debt (net) 5/	8,665	9,757	10,661	11,728	12,680	13,601	14,529
Nominal GDP	21,431	20,661	21,418	23,095	23,816	24,618	25,614

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

1/ In 2011, the cost of formerly contractual staff in education (US$73 million) was reclassified from services into wages.

2/ Includes financing for education, health, pension trust funds, and other non-depositary corporations.

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

4/Excludes sovereign debt placed in November 2012 (US$800 million) to pre-finance amortizations of short-term debt in 2013.

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

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

(In percent of GDP)

	2008	2009	2010	2011	Prel. 2012	Projections 2013	2014	2015	2016	2017	2018
Revenue and Grants	**17.4**	**16.4**	**17.8**	**18.3**	**18.9**	**19.5**	**19.6**	**19.6**	**19.7**	**19.8**	**19.8**
Current revenue	17.2	15.9	17.0	17.3	18.2	19.2	19.4	19.5	19.6	19.6	19.7
Tax revenue	13.5	12.6	13.5	13.8	14.4	15.3	15.5	15.6	15.6	15.7	15.8
Nontax revenue	2.9	2.8	3.0	2.8	3.1	3.2	3.2	3.2	3.2	3.2	3.2
Operating surplus of the public enterprises	0.8	0.5	0.5	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Official grants	0.2	0.5	0.8	0.9	0.7	0.3	0.2	0.2	0.1	0.1	0.2
Expenditure	**20.6**	**22.1**	**22.0**	**22.2**	**22.8**	**23.4**	**23.4**	**23.5**	**23.5**	**23.6**	**23.6**
Current expenditure	17.5	19.0	18.9	19.3	19.4	20.0	20.0	20.1	20.1	20.2	20.3
Wages and salaries 1/	7.1	8.0	8.0	8.3	8.4	8.8	8.8	8.8	8.8	8.8	8.8
Goods and services 1/	3.8	4.2	4.4	4.0	3.9	4.0	4.0	4.0	4.0	4.0	4.0
Interest	2.4	2.6	2.4	2.2	2.3	2.5	2.5	2.6	2.6	2.7	2.7
Current transfers	4.1	4.2	4.1	4.7	4.7	4.8	4.8	4.8	4.8	4.8	4.8
Nonpension payments	2.0	2.4	2.5	2.9	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Pension payments	2.1	1.8	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Capital expenditure	3.1	3.1	3.2	2.9	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Primary Balance	**-0.8**	**-3.1**	**-1.9**	**-1.7**	**-1.6**	**-1.4**	**-1.3**	**-1.3**	**-1.2**	**-1.1**	**-1.1**
Overall Balance	**-3.2**	**-5.7**	**-4.3**	**-3.9**	**-3.9**	**-3.9**	**-3.8**	**-3.8**	**-3.8**	**-3.8**	**-3.8**
Financing	**3.2**	**5.7**	**4.3**	**3.9**	**3.9**	**3.9**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**
External	**0.6**	**3.8**	**1.3**	**0.5**	**3.8**	**0.6**	**0.7**	**0.3**	**0.2**	**0.2**	**0.3**
Disbursements	2.0	5.2	2.7	4.6	5.0	1.6	1.7	1.5	1.4	1.5	1.5
Amortization	-1.4	-1.4	-1.4	-4.1	-1.2	-1.0	-1.1	-1.2	-1.3	-1.3	-1.2
Domestic	**2.6**	**1.9**	**3.0**	**3.4**	**0.1**	**2.1**	**1.4**	**1.5**	**0.9**	**1.5**	**1.4**
Change in deposits at central bank (- = increase)	0.1	-1.4	1.3	0.9	-3.1	3.2	0.0	0.0	0.0	0.0	0.0
Banking system	0.4	1.2	-0.3	0.7	1.4	-2.5	1.2	0.0	0.0	0.0	0.0
Private sector 2/	2.0	2.1	2.0	1.8	1.8	1.4	0.2	1.5	0.9	1.5	1.4
Unidentified financing	**...**	**...**	**...**	**...**	**...**	**1.2**	**1.7**	**2.0**	**2.7**	**2.1**	**2.1**
Memorandum Items:											
Current revenue minus current expenditure	-0.4	-3.1	-1.9	-2.0	-1.2	-0.8	-0.6	-0.6	-0.6	-0.6	-0.6
Gross financing needs	6.0	10.2	8.0	9.0	7.9	8.8	7.3	7.3	7.9	7.3	7.1
Implicit nominal interest rate (in percent)	6.5	5.8	4.8	4.6	4.5	4.4	4.6	4.6	4.6	4.6	4.6
Public sector debt (gross) 3/ 4/	42.4	51.0	52.2	52.3	54.3	56.4	58.0	59.5	60.8	62.0	63.1
Public sector debt (net) 5/	40.4	47.2	49.8	50.8	53.2	55.2	56.7	58.0	59.1	60.0	61.3
Nominal GDP	21,431	20,661	21,418	23,095	23,816	24,618	25,614	26,702	27,871	29,141	30,457

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

1/ In 2011, the cost of formerly contractual staff in education (US$73 million) was reclassified from services into wages.

2/ Includes financing for education, health, pension trust funds, and other non-depositary corporations.

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

4/Excludes sovereign debt placed in November 2012 (3¼ percent of GDP) to pre-finance amortizations of short-term debt in 2013.

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

Table 5. El Salvador: Summary Accounts of the Financial System

	2008	2009	2010	2011	Prel. 2012	Projections 2013	Projections 2014
	(End of period stocks; in millions of U.S. dollars)						
	I. Central Bank						
Net Foreign Assets	**2,248**	**2,594**	**2,550**	**2,177**	**2,831**	**2,036**	**2,093**
Of which: Net international reserves 1/ 2/	2,514	2,956	2,852	2,472	3,141	2,346	2,404
Net Domestic Assets	**442**	**35**	**36**	**300**	**-450**	**345**	**340**
Nonfinancial public sector (net)	515	219	490	688	-49	751	751
Claims	839	836	833	833	832	832	832
Liabilities 2/	323	617	343	145	881	81	81
Rest of the financial system (net)	158	98	109	175	186	186	186
Nonfinancial private sector (claims)	32	15	1	0	0	0	0
Other items (net)	-264	-298	-564	-563	-587	-592	-597
Liabilities	**2,690**	**2,629**	**2,586**	**2,476**	**2,381**	**2,381**	**2,433**
Base Money	2,291	2,282	2,354	2,275	2,229	2,229	2,281
Currency in circulation	33	33	5	5	4	4	5
Liabilities to depositary corporations	2,258	2,250	2,349	2,271	2,224	2,224	2,276
Other liabilities to the public	399	347	232	201	152	152	152
	II. Depository corporations						
Net Foreign Assets	**-98**	**376**	**697**	**295**	**-62**	**684**	**433**
Net Domestic Assets	**9,152**	**8,832**	**8,987**	**9,383**	**9,985**	**9,484**	**9,974**
Nonfinancial public sector (net)	351	499	445	465	578	-39	261
Claims	469	680	627	681	762	145	445
Liabilities	118	181	182	215	184	184	184
Rest of the financial system (net)	1,491	1,571	1,928	1,888	1,981	1,961	1,997
Credit to the private sector	9,017	8,572	8,559	8,984	9,332	9,516	9,715
Other items (net)	-1,707	-1,809	-1,946	-1,955	-1,907	-1,954	-2,000
Liabilities to the Private Sector	**9,053**	**9,209**	**9,683**	**9,678**	**9,923**	**10,168**	**10,407**
Deposits	8,884	9,043	9,474	9,413	9,638	9,876	10,107
Securities	169	166	209	264	285	292	299
	III. Other financial corporations 3/						
Net Foreign Assets	**58**	**58**	**132**	**339**	**460**	**546**	**610**
Net Domestic Assets	**4,657**	**5,260**	**5,786**	**6,108**	**6,687**	**7,154**	**7,645**
Nonfinancial public sector (net)	3,030	3,607	4,262	4,960	5,682	6,118	6,571
Rest of the financial system (net)	1,544	1,620	1,508	1,121	978	1,011	1,052
Credit to the private sector	166	166	195	215	227	232	238
Other items (net)	-84	-133	-179	-188	-201	-208	-216
Liabilities to the Private Sector	**4,715**	**5,318**	**5,918**	**6,447**	**7,147**	**7,700**	**8,255**
Pension fund contributions	4,547	5,139	5,734	6,247	6,931	7,481	8,031
	IV. Financial System						
Net Foreign Assets	**2,208**	**3,028**	**3,378**	**2,811**	**3,229**	**3,266**	**3,136**
Net Domestic Assets	**11,993**	**11,878**	**12,460**	**13,519**	**13,997**	**14,759**	**15,682**
Net claims on nonfinancial public sector	3,897	4,325	5,198	6,113	6,212	6,830	7,583
Credit to private sector	9,215	8,753	8,755	9,199	9,559	9,748	9,953
Other	-1,118	-1,200	-1,493	-1,793	-1,774	-1,819	-1,854
Liabilities to the Private Sector	**14,201**	**14,906**	**15,838**	**16,331**	**17,226**	**18,025**	**18,818**
Money	1,875	2,183	2,542	2,669	2,681	2,748	2,812
Quasi-money	7,780	7,584	7,562	7,415	7,614	7,797	7,975
Pension fund contributions	4,547	5,139	5,734	6,247	6,931	7,481	8,031
Memorandum Items:	(Percent changes relative to previous year's liabilities to the private sector)						
Net domestic assets	4.4	-0.8	3.9	6.7	2.9	4.4	5.1
Nonfinancial public sector	3.6	3.0	5.9	5.8	0.6	3.6	4.2
Credit to the private sector	3.3	-3.3	0.0	2.8	2.2	1.1	1.1
Liabilities to the private sector	3.6	5.0	6.3	3.1	5.5	4.6	4.4
	(Percent of GDP)						
Credit to the private sector	43.0	42.4	40.9	39.8	40.1	39.6	38.9
Liabilities to the private sector	66.3	72.1	73.9	70.7	72.3	73.2	73.5
Excluding pension contributions	45.0	47.3	47.2	43.7	43.2	42.8	42.1
	(Annual percentage change, unless otherwise noted)						
Credit to the private sector	5.1	-5.0	0.0	5.1	3.9	2.0	2.1
Private sector deposits in depository corporations	-0.1	1.8	4.8	-0.6	2.4	2.5	2.3
Depository corporations liquid deposits at central bank							
(In percent of total deposits)	24.1	24.1	22.4	23.0	23.1	22.5	22.5
(In percent of NIR)	89.8	76.1	82.4	91.9	70.8	94.8	94.7

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

1/ Beginning in 2010, gold in international reserves is valued at the price determined by the London Bullion Market (resulting in a valuation gain of US$170 million).

2/ Reflects proceeds from sovereign debt placed in November 2012 (US$800 million) to pre-financed amortizations of short-term government debt in 2013.

3/ Includes private pension funds, insurance corporations, and the state Development Bank.

Table 6. El Salvador: Selected Vulnerability Indicators

(In percent of GDP; unless otherwise indicated)

	2008	2009	2010	2011	Prel. 2012	Projections 2013	Projections 2014
Fiscal Indicators							
Overall balance of the nonfinancial public sector	-3.2	-5.7	-4.3	-3.9	-3.9	-3.9	-3.8
Primary balance of the nonfinancial public sector	-0.8	-3.1	-1.9	-1.7	-1.6	-1.4	-1.3
Gross public sector financing requirement	6.0	10.2	8.0	9.0	7.9	8.8	7.3
Public sector debt (gross) 1/	42.4	51.0	52.2	52.3	54.3	56.4	58.0
Public sector external debt	24.5	30.0	30.3	28.8	31.7	31.3	30.8
External interest payments to total fiscal revenue (percent)	9.3	9.6	8.0	7.3	6.7	7.1	7.2
External amortization payments to total fiscal revenue (percent) 2/	8.0	8.6	8.2	22.4	6.4	5.3	5.4
Financial Indicators 3/							
Broad money (percent change, end-of-period)	0.0	1.2	3.5	-0.2	2.1	2.4	2.3
Private sector credit (percent change, end-of-period)	5.1	-5.0	0.0	5.1	3.9	2.0	2.1
Ratio of capital to risk-weighted assets	15.1	16.5	17.6	17.1	17.3	...	...
Ratio of loans more than 90 days past due to total loans	2.8	3.7	3.9	3.6	2.9	...	...
Ratio of provisions to total loans	3.1	4.0	4.3	3.8	3.3	...	...
Ratio of provisions to loans more than 90 days past due	110.4	109.9	107.9	107.8	113.3	...	...
Return on average equity	8.7	2.8	7.3	12.2	12.4	...	...
Return on average total assets	1.0	0.3	0.9	1.5	1.6	...	...
Loans as percent of deposits	101.4	91.3	84.7	88.9	93.7	...	...
Ratio of liquid assets to total deposits	35.7	41.3	42.0	37.0	31.9	...	...
External Indicators							
Exports of goods and services (percent change, 12-month basis)	10.7	-16.8	15.9	16.6	3.0	4.4	4.6
Imports of goods and services (percent change, 12-month basis)	9.7	-25.0	14.8	17.2	4.3	4.4	4.2
Current account balance	-7.1	-1.5	-2.7	-4.6	-5.3	-5.0	-4.8
Capital and financial account balance	7.9	0.2	0.3	4.0	8.8	1.8	5.0
Gross international reserves (millions of U.S. dollars) 3/	2,545	2,987	2,883	2,504	3,154	2,359	2,416
Months of imports of goods and services, excluding maquila	4.1	4.3	3.5	3.0	3.6	2.5	2.5
Percent of short-term debt	158	329	343	205	229	169	162
Percent of gross external financing requirements	65	101	161	91	83	95	72
Percent of broad money	26.4	30.6	28.5	24.8	30.6	22.4	22.4
Public external debt service 2/	2.2	2.4	2.4	5.2	2.6	2.3	2.2
External debt to exports of goods and services (percent)	163	199	179	167	171	179	184
External interest payments to exports of goods and services (percent)	9.5	12.8	10.7	10.4	14.6	12.4	11.6
External amortization to exports of goods and services (percent) 2/	35.2	46.1	27.2	32.4	28.0	29.4	28.7
REER, depreciation is negative (percent change, end-of-period)	7.0	-4.3	-0.6	1.7	-1.7	...	...

Sources: Central Reserve 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. Excludes sovereign debt placed in November 2012 (3¼ percent of GDP) to pre-finance amortizations of short-term debt in 2013.
2/ In 2011, includes rollover of a maturing external bond.
3/ Beginning in 2010, gold in international reserves is valued at the price determined by the London Bullion Market (resulting in a valuation gain of US$170 million).

Table 7. El Salvador: Public Sector Financing Requirements and Sources

		Prel.	Projections					
	2011	2012	2013	2014	2015	2016	2017	2018
	(Millions of U.S. dollars)							
Gross Financing Requirements	**2,089**	**1,885**	**2,171**	**1,881**	**1,945**	**2,202**	**2,120**	**2,173**
Overall deficit	908	919	962	971	1,018	1,061	1,110	1,162
Public debt amortizations	1,181	965	1,209	910	926	1,141	1,009	1,011
External	946	287	252	272	313	353	374	355
Of which: multilaterals and bilatera	946	287	252	272	313	353	374	355
Domestic	235	679	957	639	614	788	635	656
Of which: short-term debt (letes)	191	570	867	250	550	550	550	550
Gross Financing Sources	**2,089**	**1,885**	**2,171**	**1,881**	**1,945**	**2,202**	**2,120**	**2,173**
External	1,067	1,190	401	447	391	398	442	457
Multilaterals and bilaterals	413	390	401	447	391	398	442	457
Bonds	654	800	0	0	0	0	0	0
Domestic	1,022	695	1,483	1,001	1,020	1,041	1,063	1,086
Private pension funds	406	419	433	451	470	491	513	536
Use of banking system deposits	361	-708	800	0	0	0	0	0
Short-term debt (letes)	570	867	250	550	550	550	550	550
Others, including floating debt	-314	117	0	0	0	0	0	0
Unidentified financing	0	0	287	433	534	764	614	630
	(Percent of GDP)							
Gross Financing Requirements	**9.0**	**7.9**	**8.8**	**7.3**	**7.3**	**7.9**	**7.3**	**7.1**
Overall deficit	3.9	3.9	3.9	3.8	3.8	3.8	3.8	3.8
Public debt amortizations	5.1	4.1	4.9	3.6	3.5	4.1	3.5	3.3
External	4.1	1.2	1.0	1.1	1.2	1.3	1.3	1.2
Of which: multilaterals and bilatera	4.1	1.2	1.0	1.1	1.2	1.3	1.3	1.2
Domestic	1.0	2.9	3.9	2.5	2.3	2.8	2.2	2.2
Of which: short-term debt (letes)	0.8	2.4	3.5	1.0	2.1	2.0	1.9	1.8
Gross Financing Sources	**9.0**	**7.9**	**8.8**	**7.3**	**7.3**	**7.9**	**7.3**	**7.1**
External	4.6	5.0	1.6	1.7	1.5	1.4	1.5	1.5
Multilaterals and bilaterals	1.8	1.6	1.6	1.7	1.5	1.4	1.5	1.5
Bonds	2.8	3.4	0.0	0.0	0.0	0.0	0.0	0.0
Domestic	4.4	2.9	6.0	3.9	3.8	3.7	3.6	3.6
Private pension funds	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Use of banking system deposits	1.6	-3.0	3.2	0.0	0.0	0.0	0.0	0.0
Short-term debt (letes)	2.5	3.6	1.0	2.1	2.1	2.0	1.9	1.8
Others, including floating debt	-1.4	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Unidentified financing	0.0	0.0	1.2	1.7	2.0	2.7	2.1	2.1

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

Table 8. El Salvador: External Financing Requirements and Sources

	2011	Prel. 2012	Projections 2013	2014	2015	2016	2017	2018
	(Millions of U.S. dollars)							
Gross Financing Requirements	**2,756**	**3,777**	**2,470**	**3,341**	**3,553**	**3,801**	**4,057**	**4,258**
Current account deficit	1,070	1,258	1,238	1,224	1,222	1,253	1,290	1,326
Debt amortization	2,100	1,870	2,027	2,060	2,276	2,491	2,694	2,858
Public sector	946	287	252	272	313	353	374	355
Private sector	1,154	1,583	1,775	1,788	1,963	2,138	2,320	2,503
GIR accumulation	-414	650	-795	57	56	58	73	74
Gross Financing Sources	**2,756**	**3,777**	**2,470**	**3,341**	**3,553**	**3,801**	**4,057**	**4,258**
Public sector disbursements	1,067	1,190	401	447	391	398	442	457
Private sector net inflows	1,690	2,588	2,070	2,894	3,163	3,404	3,615	3,801
Foreign direct investment	385	515	250	271	290	307	325	327
Other	1,304	2,073	1,820	2,623	2,873	3,097	3,290	3,474
	(Percent of GDP)							
Gross Financing Requirements	**11.9**	**15.9**	**10.0**	**13.0**	**13.3**	**13.6**	**13.9**	**14.0**
Current account deficit	4.6	5.3	5.0	4.8	4.6	4.5	4.4	4.4
Debt amortization	9.1	7.9	8.2	8.0	8.5	8.9	9.2	9.4
Public sector	4.1	1.2	1.0	1.1	1.2	1.3	1.3	1.2
Private sector	5.0	6.6	7.2	7.0	7.4	7.7	8.0	8.2
GIR accumulation	-1.8	2.7	-3.2	0.2	0.2	0.2	0.3	0.2
Gross Financing Sources	**11.9**	**15.9**	**10.0**	**13.0**	**13.3**	**13.6**	**13.9**	**14.0**
Public sector disbursements	4.6	5.0	1.6	1.7	1.5	1.4	1.5	1.5
Private sector net inflows	7.3	10.9	8.4	11.3	11.8	12.2	12.4	12.5
Foreign direct investment	1.7	2.2	1.0	1.1	1.1	1.1	1.1	1.1
Other	5.6	8.7	7.4	10.2	10.8	11.1	11.3	11.4

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

Table 9. Public Sector Debt Sustainability Framework, 2008-18

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	**Debt-stabilizing primary balance 7/**
Public sector debt 1/	42.4	51.0	52.2	52.3	54.3	**56.4**	**58.0**	**59.5**	**60.8**	**62.0**	**63.1**	**0.1**
o/w foreign-currency denominated	42.4	51.0	52.2	52.3	54.3	56.4	58.0	59.5	60.8	62.0	63.1	
Change in public sector debt	2.9	8.6	1.1	0.1	2.0	2.1	1.6	1.4	1.3	1.2	1.1	
Identified debt-creating flows	0.7	7.3	2.5	0.1	2.3	2.1	1.6	1.4	1.3	1.2	1.1	
Primary deficit	0.8	3.1	1.9	1.7	1.6	1.4	1.3	1.3	1.2	1.1	1.1	
Revenue and grants	17.4	16.4	17.8	18.3	18.9	19.5	19.6	19.6	19.7	19.8	19.8	
Primary (noninterest) expenditure	18.2	19.6	19.7	20.0	20.5	20.9	20.9	20.9	20.9	20.9	20.9	
Automatic debt dynamics 2/	0.0	4.2	0.6	-1.5	0.7	0.7	0.3	0.2	0.1	0.0	0.1	
Contribution from interest rate/growth differential 3/	0.0	4.2	0.6	-1.5	0.7	0.7	0.3	0.2	0.1	0.0	0.1	
Of which contribution from real interest rate	0.4	2.8	1.2	-0.6	1.5	1.5	1.2	1.1	1.1	1.2	1.3	
Of which contribution from real GDP growth	-0.5	1.4	-0.7	-1.0	-0.8	-0.8	-0.9	-0.9	-1.0	-1.2	-1.2	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
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	
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	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes	2.1	1.3	-1.3	0.0	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	244	310	294	286	287	290	296	303	309	314	318	
Gross financing need 5/	6.3	10.2	8.0	9.0	7.9	8.8	7.3	7.3	7.9	7.3	7.1	
in millions of U.S. dollars	1,351	2,099	1,720	2,089	1,874	2,171	1,881	1,945	2,202	2,120	2,173	
Key Macroeconomic and Fiscal Assumptions												Projected Average
Real GDP growth (in percent)	1.3	-3.1	1.4	2.0	1.6	1.6	1.6	1.7	1.8	2.0	2.0	1.8
Average nominal interest rate on public debt (in percent) 6/	6.5	5.8	4.8	4.6	4.5	4.7	4.6	4.6	4.6	4.6	4.6	4.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.3	6.3	2.5	-1.1	3.0	3.0	2.2	2.1	2.0	2.1	2.2	2.1
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	5.3	-0.5	2.3	5.7	1.5	1.7	2.4	2.5	2.5	2.5	2.5	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	9.6	4.2	2.0	3.4	4.5	3.5	1.6	1.7	1.8	2.0	2.0	1.8
Primary deficit	0.8	3.1	1.9	1.7	1.6	1.4	1.3	1.3	1.2	1.1	1.1	1.2

1/ Includes gross debt of the nonfinancial public sector and 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).

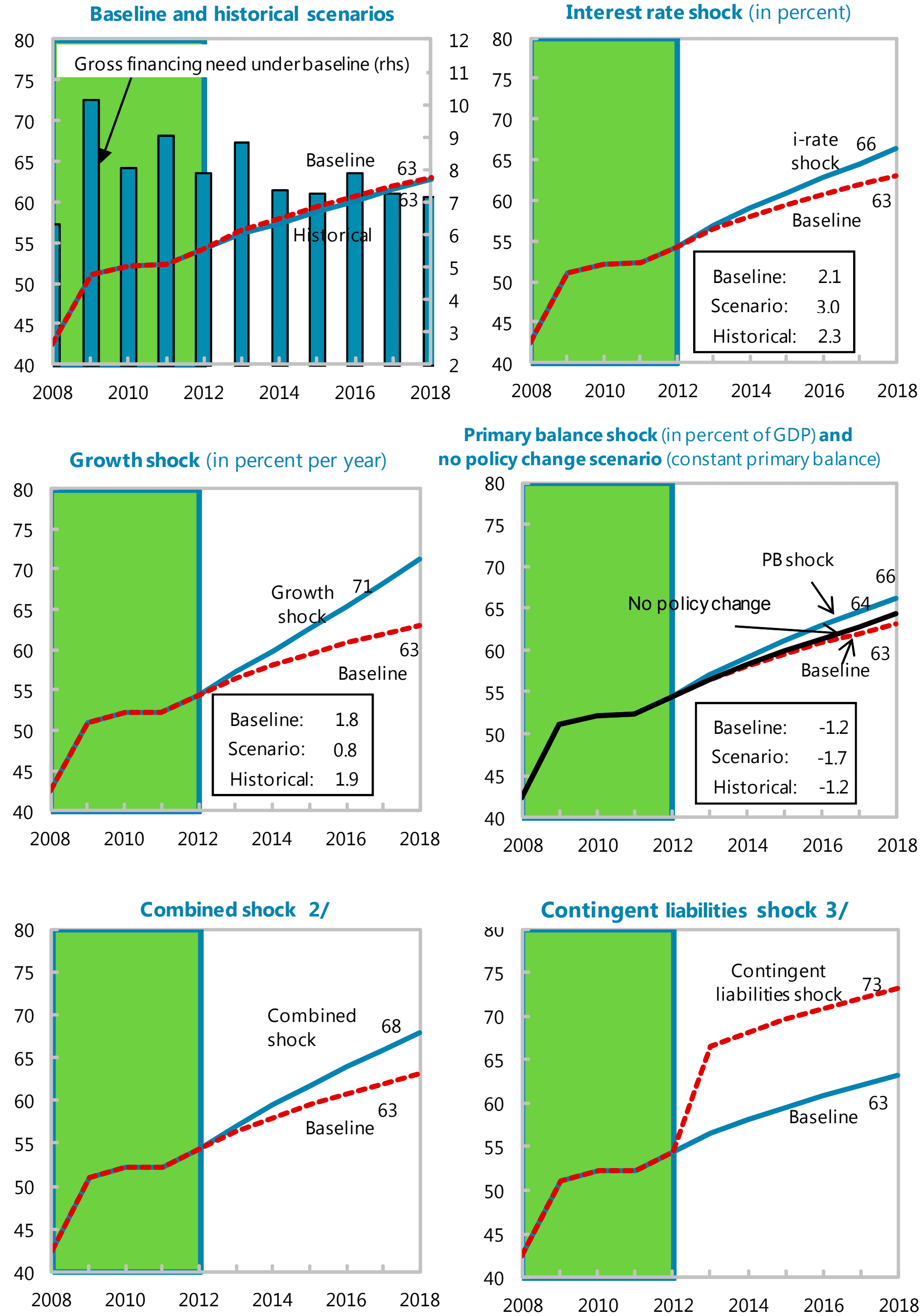
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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

7/ 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 6. El Salvador: Public Debt Sustainability: Bound Tests 1/

(Public debt in percent of GDP)



Sources: National Authorities and Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks.
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.

Table 10. Country: External Debt Sustainability Framework, 2008-18

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	**Debt-stabilizing non-interest current account 6/**
External debt	**43.8**	**46.1**	**46.3**	**46.9**	**47.8**	**50.1**	**51.6**	**52.5**	**53.3**	**53.9**	**54.5**	**-0.4**
Change in external debt	-4.5	2.3	0.2	0.6	1.0	2.3	1.5	1.0	0.8	0.6	0.5	
Identified external debt-creating flows	0.3	1.4	0.5	-0.4	1.7	2.5	1.8	1.4	1.2	1.0	1.0	
Current account deficit, excluding interest payments	4.9	-1.0	0.3	2.2	2.1	2.1	2.0	1.8	1.6	1.5	1.3	
Deficit in balance of goods and services	22.8	15.5	16.9	18.5	18.2	18.7	18.8	18.7	18.7	18.7	18.7	
Exports	26.9	23.2	25.9	28.0	28.1	28.0	28.1	28.1	28.1	28.2	28.3	
Imports	49.7	38.7	42.8	46.6	46.2	46.7	46.8	46.8	46.8	46.9	47.0	
Net non-debt creating capital inflows (negative)	-3.8	-1.8	-0.5	-1.7	-2.2	-1.0	-1.1	-1.1	-1.1	-1.1	-1.1	
Automatic debt dynamics 1/	-0.7	4.2	0.8	-0.9	1.8	1.3	0.8	0.7	0.6	0.6	0.7	
Contribution from nominal interest rate	2.3	2.5	2.4	2.5	3.2	2.9	2.8	2.8	2.8	2.9	3.0	
Contribution from real GDP growth	-0.6	1.4	-0.6	-0.8	-0.7	-0.7	-0.8	-0.8	-0.9	-1.0	-1.0	
Contribution from price and exchange rate changes 2/	-2.4	0.2	-1.0	-2.5	-0.7	-0.8	-1.2	-1.3	-1.3	-1.3	-1.3	
Residual, incl. change in gross foreign assets 3/	-4.8	0.9	-0.3	1.0	-0.7	-0.2	-0.3	-0.4	-0.4	-0.4	-0.4	
External debt-to-exports ratio (in percent)	163.1	198.9	178.6	167.3	170.5	179.3	183.9	186.7	189.6	191.2	192.4	
Gross external financing need 4/	18.2	14.3	8.4	11.9	15.9	10.0	13.0	13.3	13.6	13.9	14.0	
in billions of U.S. dollars	3.9	2.9	1.8	2.8	3.8	2.5	3.3	3.6	3.8	4.1	4.3	
Scenario with key variables at their historical averages 5/	...	...	...	...	...	**50.1**	**49.3**	**48.5**	**47.6**	**46.7**	**45.8**	**-2.1**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	1.3	-3.1	1.4	2.0	1.6	1.6	1.6	1.7	1.8	2.0	2.0	
GDP deflator in US dollars (change in percent)	5.3	-0.5	2.3	5.7	1.5	1.7	2.4	2.5	2.5	2.5	2.5	
Nominal external interest rate (in percent)	5.0	5.6	5.5	5.8	7.0	6.3	5.7	5.6	5.6	5.7	5.8	
Growth of exports (US dollar terms, in percent)	10.7	-16.8	15.9	16.6	3.2	3.0	4.4	4.6	4.3	4.8	4.9	
Growth of imports (US dollar terms, in percent)	9.7	-25.0	14.8	17.2	2.4	4.3	4.4	4.2	4.4	4.6	4.8	
Current account balance, excluding interest payments	-4.9	1.0	-0.3	-2.2	-2.1	-2.1	-2.0	-1.8	-1.6	-1.5	-1.3	
Net non-debt creating capital inflows	3.8	1.8	0.5	1.7	2.2	1.0	1.1	1.1	1.1	1.1	1.1	

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

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

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

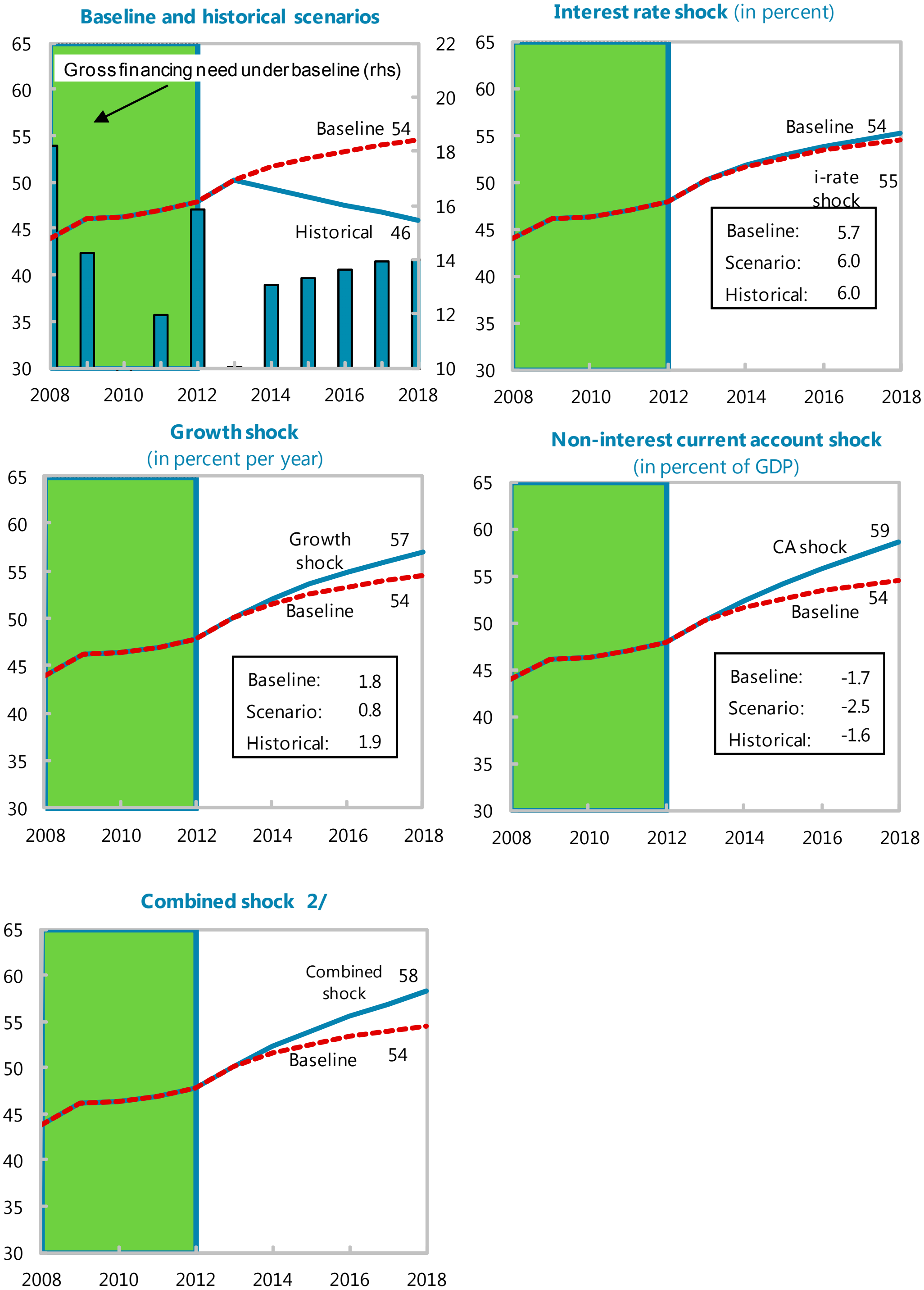
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

Figure 7. El Salvador: External Debt Sustainability: Bound Tests 1/

(External debt in percent of GDP)



Sources: National Authorities and Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Annex I. El Salvador: Assessing Potential Output[1]

El Salvador's growth performance has been lagging the strength of the region for many years. This is largely the result of low rates of domestic investment mostly associated with a weakening of the business climate, loss of competitiveness, and vulnerability to external shocks. Raising potential growth would require reforms to substantially increase investment and productivity.

Background

1. **Historically, economic growth of El Salvador has been below the level observed in the CAPDR region.**[2] Real GDP growth decelerated from nearly 4 percent during 1993-2002, which included the period of reconstruction after the end of the civil war in 1992, to under 2 percent during 2003-12. Conversely, growth in the region accelerated somewhat from 4 percent to 5 percent over the same period. Such a growth differential is largely the result of a large investment gap with the rest of the region. Over the two decades, the rate of domestic investment amounted to 16 percent of GDP in El Salvador compared to 23 percent in regional peers (Figure AI.1). Moreover, during the most recent decade, foreign direct investment attracted by El Salvador was only half of the level received by other CAPDR countries (5 percent of GDP). From a longer perspective, investment gaps with the region also persisted during 1960-90.

2. **Key underlying factors behind this performance in growth include weaknesses in competitiveness and vulnerability to shocks.**

- The authorities have identified weak productivity and high cost of doing business, including those arising from violent crime, as key constraints for growth in recent years.[3,4] Deficiencies in physical infrastructure, human capital, and financing to small- and middle-sized businesses are also impediments for growth. In particular, according to UNESCO indicators for 2010, over 40 percent of population had either no schooling or incomplete primary education compared to 23 percent in Latin America, with emigration constituting a major drain on skilled workers in El Salvador. Moreover, competitive indicators also deteriorated in recent years relative to the region (Annex II).

- In addition to spillovers from abroad (Annex III), El Salvador is highly susceptible to natural disasters. The direct and indirect costs associated with losses to existing infrastructure, crops, housing, and other losses of revenue have been estimated at 20 percent of GDP over the

[1] Prepared by B. Sbrancia and Y. Ustyugova.

[2] CAPDR comprises Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama, and the Dominican Republic.

[3] See the 2001 Partnership for Growth Report at: http://photos.state.gov/libraries/elsavador/92891/PFG/ES%20Constraints_Analysis.pdf

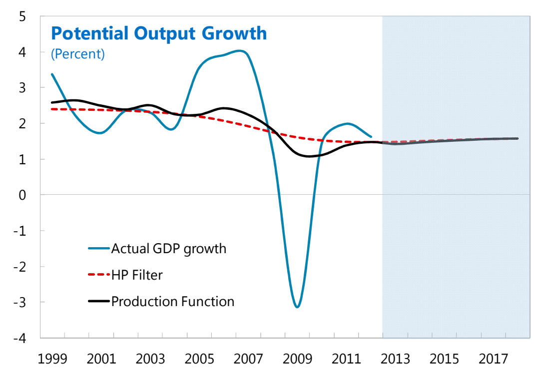
[4] According to the United Nations, El Salvador ranked 87 out of 88 countries in homicide rates in 2010.

period 2000-12, compared to an average of only 1½ percent in other countries in the region.[5]

Potential Output Estimates

3. **The average potential output growth of El Salvador in 1998-2012 was the lowest in the region.** Two standard methodologies were used to estimate potential output (the Hodrick-Prescott (HP) filter and the production function (PF) approach).[6] The period 1998-2012 was selected to exclude the growth rebound experienced in the immediate years after the end of the civil war, and thus analyze a period that could capture underlying growth. The results show that potential growth averaged 2 percent in this period, compared to 4½ percent in the region.[7]

4. **Moreover, potential output growth appears to have been declining over time.** Both methodologies suggest that potential growth declined from about 2½ percent in 1998 to 1½ percent by 2012.[8] The estimates also suggest that the negative output gap that reached about 1½ percent during the 2008-09 global crisis narrowed to ¾ percent in 2012.



Source: Fund staff estimates.

5. **Under current investment trends, potential growth would remain unchanged at the 1998-2002 level over the long term.** Keeping the rate of domestic investment at the level observed over the last three years (14 percent of GDP), the PF approach projects an average growth of 2 percent over the period 2013-23. The macroeconomic projections prepared for the staff report imply that El Salvador would broadly grow at its potential over the medium-term. Two additional illustrative scenarios were prepared:

- **Pessimistic scenario.** The persistence of low growth could create an uncertain environment that may reduce domestic investment with a negative feedback on growth. To illustrate this low-growth trap, a decline in investment (by one-standard deviation) would lower potential growth to 1.2 percent over the long term.

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[5] OFDA/CRED International Disaster Database (EM-DAT), Université Catholique de Louvain, Belgium (www.emdat.net).

[6] The PF approach uses a Cobb-Douglas production function, assuming an elasticity of labor of 0.5 and a depreciation rate on the stock of capital of 5 percent per year.

[7] The estimates are sensitive to the selected sample period: potential growth for El Salvador was 2.6 percent for the period 1964-2012; 3 percent for the period 1990-2012; and between 2.5-2.8 percent for 1994-2011.

[8] Based on Bai-Perron methodology, structural declines in potential output growth were identified in 1994, 1997, and 2007, while a structural increase in growth was captured in 2003.

- **Optimistic scenario.** Restoring the rate of growth of 4 percent observed in 1993-2003 would require a substantial increase in both the contribution of capital, consistent with a rate of domestic investment of 20 percent of GDP, and the contribution of productivity, which will require efficiency-enhancing reforms.

Alternative Scenarios Under Growth Accounting

(Contribution in percentage points)

	Real GDP	Capital	Labor	Total Factor Productivity
1998-2012	2.0	1.1	0.6	0.3
2010-2012	1.7	0.9	0.9	-0.1
2019-2023 (pessimistic)	1.2	0.4	0.6	0.2
2019-2023 (baseline)	2.0	0.9	0.6	0.5
2019-2023 (optimistic)	4.0	2.2	0.6	1.2

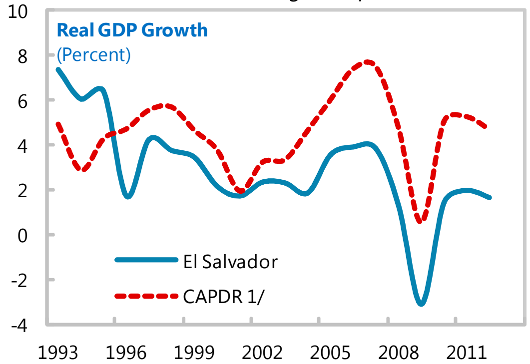
Sources: Fund staff estimates and projections.

6. **An alternative approach also suggests that raising potential output would require substantial increases in investment and productivity.** Based on a GMM (dynamic panel) system, Swiston and Barrot (2012)[9] estimate that El Salvador would boost potential growth to about 4-4½ percent by bringing physical and human capital to levels comparable to those in Chile, Mexico, and Peru—that is, by bringing the rate of domestic investment to 25 percent of GDP and extending the average level of education by two years. El Salvador could further increase potential growth by an additional 1-1½ percentage points by undertaking reforms in other areas (mainly, deepening of the financial system and broadening the export base, including through greater regional integration).

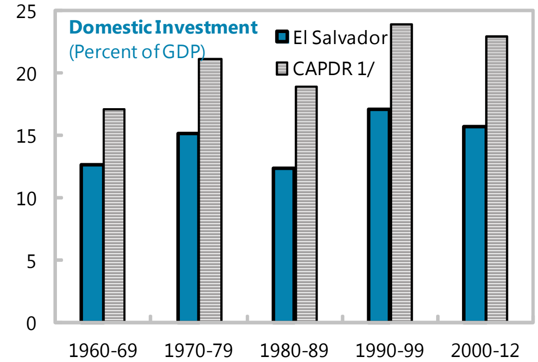
[9] Swiston, A. and L.D. Barrot, 2012, "The Role of Structural Reforms in Raising Growth in Central America," Central America, Panama, and the Dominican Republic: Challenges Following the 2008-09 Global Crisis, pp. 65-86 Washington: International Monetary Fund.

Figure AI.1. El Salvador: Indicators of Actual and Potential Growth

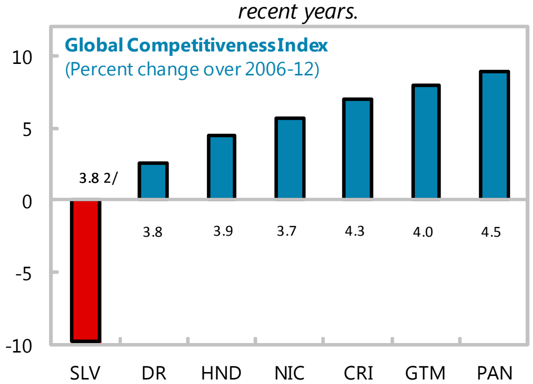
Economic growth in El Salvador has lagged behind the regional pace.



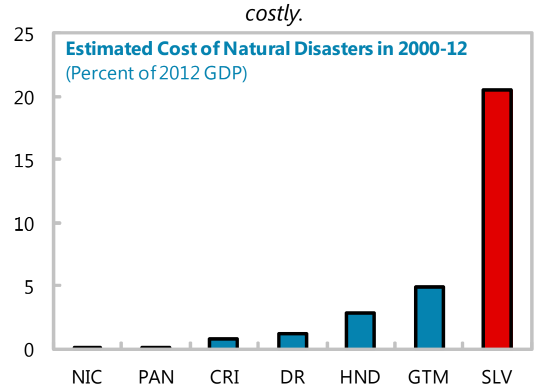
Investment rates have been persistently lower than those of regional peers.



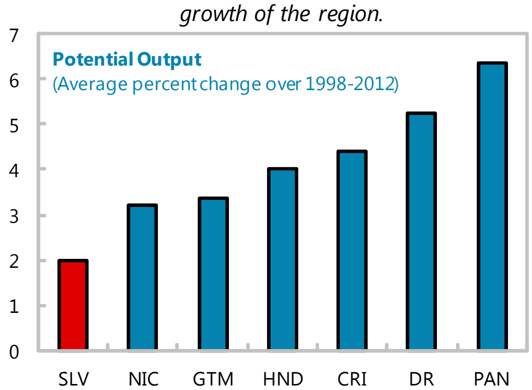
Competitiveness has deteriorated markedly in recent years.



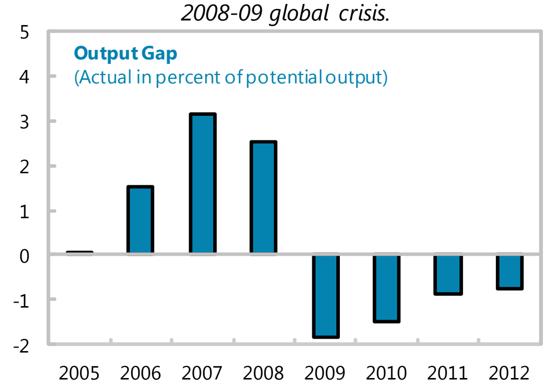
Natural disasters in El Salvador are very costly.



El Salvador has the lowest potential output growth of the region.



The output gap has narrowed since the 2008-09 global crisis.



Sources: National authorities, Fund staff estimates; and World Economic Forum.
1/ Simple average of Costa Rica, Guatemala, Honduras, Nicaragua, Panama, and the Dominican Republic.
2/ Current ranking; higher number indicates higher competitiveness.

Annex II. El Salvador: Balance of Payments Stability Assessment[1]

El Salvador's real effective exchange rate (REER) appears to be broadly in line with fundamentals. However, competitiveness challenges and financing vulnerabilities could threaten balance of payments stability over the long term, while the foreign reserve position could be strengthened to provide better protection against adverse shocks.

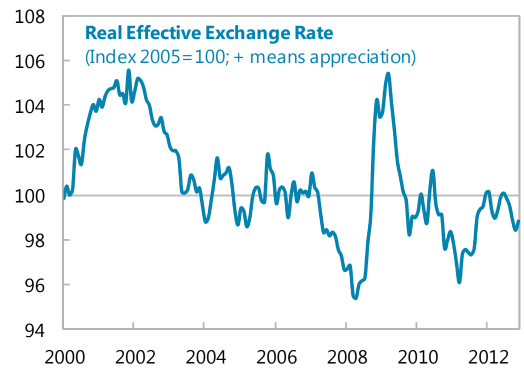
Current Account Balance, Exchange Rate, and Competitiveness

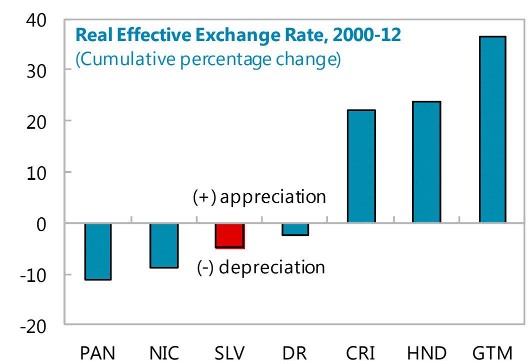
CGER Assessment

1. **Developments.** El Salvador's REER has remained relatively stable during the last decade, as domestic inflation has been broadly similar to that in trading partners. Since 2000 the REER depreciated only by about 5 percent, while the regional peers demonstrated a much larger change in the REER (from 37 percent of appreciation in Guatemala to 10 percent of depreciation in Panama).

2. **Assessment results.** Methodologies developed by the IMF's Consultative Group on Exchange Rate Issues (CGER) suggest that El Salvador's REER is broadly in line with fundamentals, with estimations ranging from an overvaluation of 8 percent to an undervaluation of 2 percent.

- Under the **macroeconomic balance approach**, the current account deficit norm of El Salvador is estimated at 3.3 percent of GDP taking into consideration medium-term fundamentals, including a sustainable fiscal deficit path. Meanwhile, the underlying current account deficit is projected at 4.4 percent of GDP, taking into account the baseline fiscal deficit path. A comparison of this norm and the underlying current account





Sources: National authorities and Fund staff calculations.

Exchange Rate Assessment Results 1/

Approach	Current Account Balance 2/		REER Gap 3/
	Norm	Underlying	
Macroeconomic Balance	-3.3	-4.4	7.8
External Sustainability	-3.4	-4.4	7.0
Equilibrium Real Exchange Rate	...	...	-1.9

1/ Based on IMF CGER methodology.
2/ Percent of GDP.
3/ Percent.

[1] Prepared by F. Roch and Y. Ustyugova.

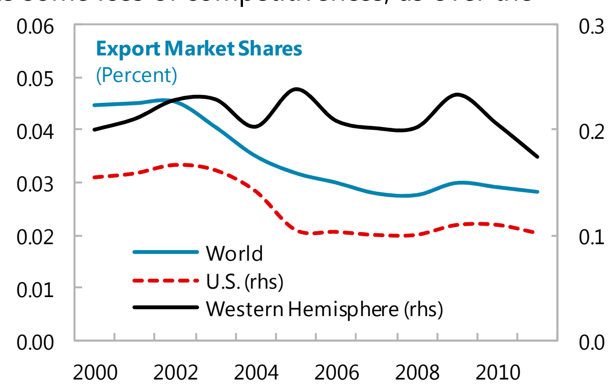
balance, using standard trade elasticities, yields an overvaluation of 8 percent, which largely reflects the impact of a large fiscal deficit.

- Under the **external sustainability approach**, the net foreign asset (NFA) position, as measured by the net international investment position (see below), would stabilize at the benchmark level of 2011 (-54 percent of GDP) with a current account deficit norm of 3.4 percent. This suggests that the REER is overvalued by 7 percent. However, if the pre-crises level of the NFA was a benchmark (-44 percent of GDP), the estimated REER overvaluation would be larger, at about 11½ percent.

- The **equilibrium real exchange rate methodology** suggests a small undervaluation of about 2 percent.

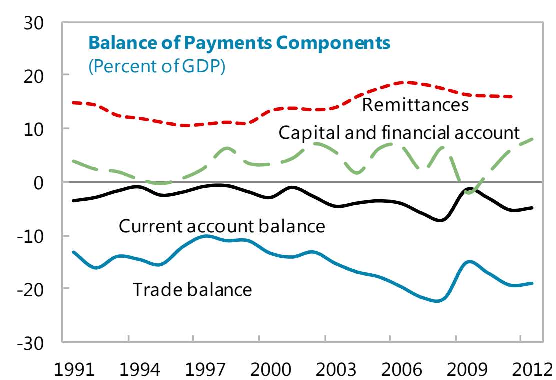
Other Assessments

3. **Export performance.** Export performance signals some loss of competitiveness, as over the last decade El Salvador's global export market share declined. The exports-to-GDP ratio also hovered at about 21 percent. On the structure of exports, the share of traditional exports (coffee, shrimp, and sugar) has remained broadly stable (at some 9 percent of total exports), while a decline in the share of net maquila exports (to 10 percent in total exports from 28 percent a decade earlier) has been offset by a steady increase in non-traditional exports, mainly ethyl alcohol, iron, steel, and related products, cotton yarn, fruit juice, and other (to 81 percent of total exports).



Sources: International Financial Statistics and Fund staff calculations.

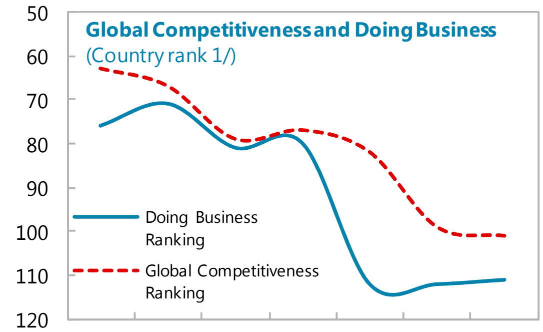
4. **Remittances.** El Salvador's external sector is highly dependent on workers' remittances. Large remittance inflows (in the range of 16-19 percent of GDP) have proved to be stable and somewhat increased during the last decade, leading to higher consumption imports and, in turn, to a moderate deterioration in trade balance. While the risk of a gradual phasing out of remittances over the long term should not be discarded, the external stability of El Salvador in such a scenario would not seem to be threatened, since the household's spending on imports is highly and positively correlated with remittance inflows. This suggests that the adjustment in the current account balance would not be abrupt.



Sources: National authorities and Fund staff calculations.

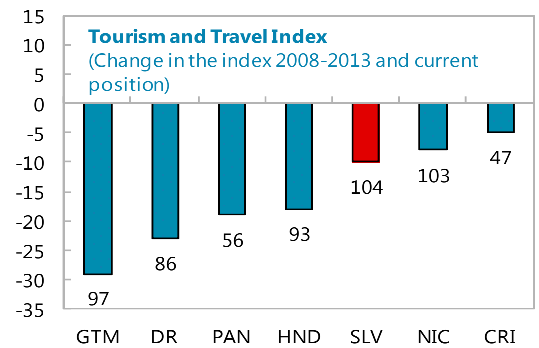
5. **Business environment.** Survey-based indicators also highlight a steady decline in competitiveness in recent years. In particular, El Salvador's ranking in the 2012-13 World Economic

Forum's Global Competitiveness Index fell to the 101st position (out of 144 countries), from 63rd in the 2006 survey. Weak institutions, low labor market efficiency and innovation, together with poor quality of higher education weigh on the country's competitiveness. El Salvador also stands low in the World Bank's Doing Business Index, ranking 113rd out of 185 countries, compared to 77th in 2006. As for the governance indicators, El Salvador ranks particularly low on "rule of law" that reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.



Sources: Doing Business and World Economic Forum.
1/ Lower number indicates higher competitiveness.

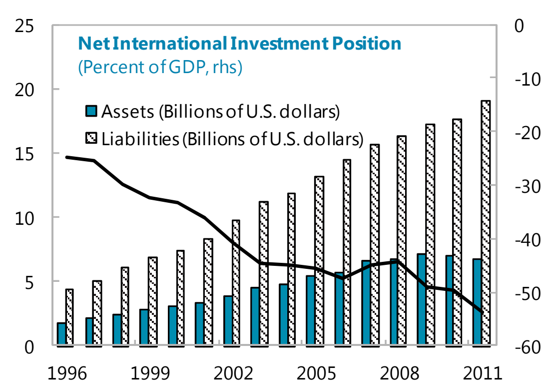
6. **Tourism.** El Salvador's ranking in the 2013 World Economic Forum's Travel and Tourism Competitiveness Index fell to the 104th position (out of 140 countries), from the 94th in 2008, the first year the index was compiled. El Salvador ranks relatively low due to high business costs (including, from crime), and low quality of the natural environment. The decline in El Salvador's ranking was one of the smallest in the region during this period.



Sources: World Economic Forum.

Capital and Financial Account, and International Investment Position

7. **Capital and financial account.** The financing structure of the current account deficit points to external vulnerabilities. The FDI inflows during the last decade hovered around 2 percent, excluding the one-off sales of domestic banks, and only financed about 40 percent of the current account deficit. The remaining gap was covered by other private capital and external public sector borrowing. Should the foreign credit lines be disrupted by higher global risk aversion or other adverse external or domestic developments, El Salvador could have to face serious external adjustment.



Source: National authorities.

8. **International investment position.** The net international investment position (IIP) of El Salvador has been steadily declining, especially in recent years as assets have fallen and liabilities continued to rise. As noted above, the negative net IIP decreased from 44 percent of GDP in the pre-crisis years to 54 percent in 2011. The liabilities reached 83 percent of GDP (US$19 billion), with

FDI stock and public sector liabilities amounting to about 44 percent and 35 percent of total liabilities, respectively.

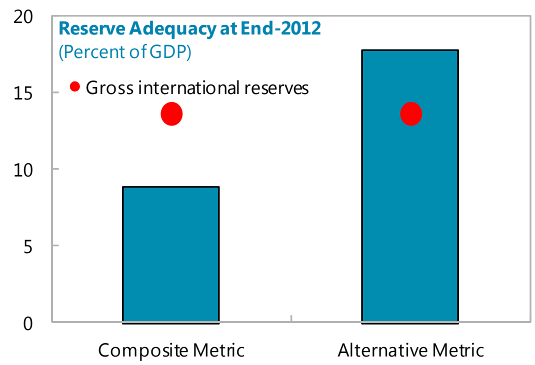
International Reserve adequacy

9. **Composite reserve adequacy metric.** An adequate level of gross international reserves would cover potential balance of payments needs. For emerging economies, reserve adequacy could then be assessed in terms of a risk-weighted metric of export earnings and the liability structure:[2]

$$\text{Reserve adequacy metric } = 10\% \text{ exports} + 30\% \binom{\text{short}-\text{term}}{\text{debt}} + 10\%\text{M2} + 15\% \binom{\text{other portf.}}{\text{liabilities}}$$

Accordingly, El Salvador's reserve position would be within the suggested adequacy range (100-150 percent), as it covered about 150 percent of the metric at end-2012.

10. **Alternative metric for El Salvador.** The above metric, however, needs to be revised to capture the specific features of El Salvador's dollarized regime. In particular, the export and portfolio components should be excluded from the calculation of the metric, as the central bank does not have to intervene to manage an exchange rate. Instead, balance of payments needs could stem from pressure in the financial system and the public finances. In this context, an alternative metric may encompass two foreign reserve buffers. One associated with the authorities' objective of safeguarding financial stability;[3] and the other designed to cover the short-term public debt and one-month of public spending. The latter would provide protection under an adverse shock on tax revenue. Based on the alternative metric, El Salvador's foreign reserve position would be somewhat weak, as it would cover some 76 percent of the metric. It should be noted, however, that the alternative metric is very demanding, since the policy for financial stability is aimed to deal with the unlikely event of a very large deposit outflow from the banking system.



Sources: National authorities and Fund staff calculations

[2] See IMF Board Paper SM/11/31, 2011, "Assessing Reserve Adequacy", Washington: International Monetary Fund.

[3] This buffer may comprise the resources derived from the present policy for the financial system, including: (i) the liquidity requirements (22 percent of deposits), (ii) the lender-of-last-resort facility (up to 8 percent of deposits over the medium term), and (iii) the deposit insurance fund (5 percent of deposits).

Annex III. El Salvador: Assessing Spillovers[1]

External disturbances spill over to the Salvadorian economy mainly through its trade and financial linkages. Growth shocks in the United States, the main trading partner, appear to have a large impact on the country's economic activity, while planned fiscal consolidation abroad and financial stress in the Euro area were estimated to have small to modest effects on El Salvador. Outward spillovers from El Salvador to the region appear to be negligible.

Key Linkages

1. **El Salvador is a small open economy with important linkages abroad:**

- **Trade.** While the trade flows are relatively large (over 60 percent of GDP), diversification of trading partners of El Salvador is fairly limited. The main trading partner is the United States (about 40 percent of Salvadorian trade), followed by CAPDR countries (25 percent of trade), and other Latin American countries (15 percent of trade). Trade with the Europe and Asia is modest, although China is becoming an important source of imports (7 percent of total).

El Salvador. Trade Flows, 2011

Origin / Destination	Exports		Imports		Balance
	Value 1/	Share (Percent)	Value 1/	Share (Percent)	Value 1/
Total	5,161	100	9,518	100	-4,357
United States	2,325	45	3,709	39	-1,383
Canada	131	3	40	0	91
Euro Area	348	7	451	5	-103
Germany	212	4	98	1	114
Spain	66	1	65	1	1
China 2/	149	3	694	7	-546
Latin America and the Caribbean	1,970	38	3,968	42	-1,998
Guatemala	687	13	930	10	-243
Honduras	442	9	313	3	129
Nicaragua	266	5	207	2	59
Costa Rica	179	3	317	3	-138
Mexico	110	2	734	8	-624
Panama	93	2	8	0	84
Dominican Republic	93	2	14	0	78

Sources: IMF Direction of Trade Statistics and Fund staff calculations.
1/ Millions of U.S dollars.
2/ Includes flows with China's Mainland, Hong Kong, Macao, and the province of Taiwan.

- **Remittances.** El Salvador is highly dependent on worker's remittances. In 2012, remittances were close to 17 percent of GDP, originating mostly in the construction and service sectors of the United States (nearly 90 percent of total remittances).

[1] Prepared by Y. Ustyugova.

- **Investment.** The stock of foreign direct investment amounted to 35 percent of GDP at end-2011. The United States and Panama constitute the main source of investment for El Salvador (a combined 60 percent of the total stock), followed by Mexico. El Salvador's stock of direct investment abroad is small and concentrated in Nicaragua.

Direction of Direct Investment, 2011

	Inward			Outward	
	Value 1/	Share (Percent)		Value 1/	Share (Percent)
Total	8,172	100	Total	6	100
United States	2,695	33	Nicaragua	5	83
Panama	2,290	28	Others	1	17
Mexico	823	10			
Virgin Islands, British	509	6			
Guatemala	249	3			
Others	1,607	20			

Source: IMF Coordinated Direct Investment Survey.
1/ Millions of U.S dollars.

- **Financial.** According to BIS data, international banks have large claims on Salvadorian borrowers. As of 2012, these claims reached 30 percent of GDP, and mostly originate from the United States (one-third of total claims) and also from Europe (one-third of total), with the United Kingdom being the main player. Foreign banks operating in El Salvador (mainly from the United States, Canada, Colombia, and Panama) account for 95 percent of the banking system's total assets.

Consolidated Foreign Banks' Claims on El Salvador 1/
(Millions of U.S. dollars)

	2011-Q1	2011-Q4	2012-Q3
All reporting banks	7,081	6,622	6,847
United States	2,634	2,204	2,303
European Banks	2,127	2,061	2,138
United Kingdom	1,842	1,800	1,747
Germany	144	176	265
Switzerland	65	27	61
Spain	35	20	21
Belgium	2	3	3
Sweden	2	2	2
Portugal	1	2	1
Others	2,320	2,357	2,406

Source: BIS, Table 9D.
1/ BIS-reporting banks only.

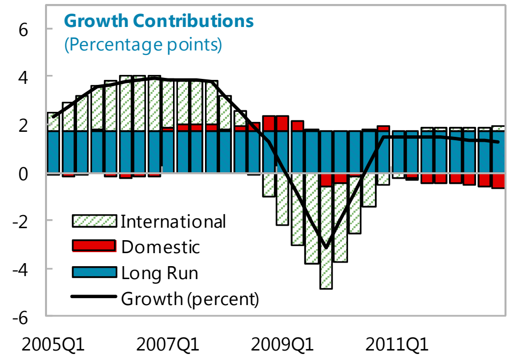
Spillovers from Abroad

Impact on Growth

2. **A multi-country VAR analysis was used to assess the impact on El Salvador of a decline in domestic demand in main trading partners.** Following the approach described in Poirson and Weber (2011), real GDP was decomposed into long-run growth, domestic factors, and foreign factors.[2] Accordingly, foreign factors drove deviations from long-run growth in El Salvador, boosting the economy prior to 2008 and depressing growth during the global crisis, while domestic factors played a marginal role.

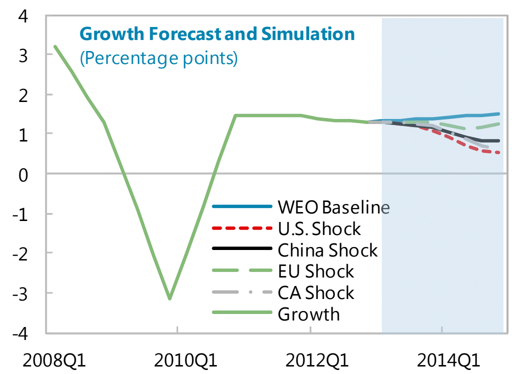
[2] Poirson, H. and Weber, Sebastian, 2011, "Growth Spillover Dynamics from Crisis to Recovery?" IMF Working Paper 11/218, Washington: International Monetary Fund.

3. **Four separate shock scenarios were assumed to assess the impact on growth in El Salvador.** Each scenario entailed a reduction of one-half standard deviation in the domestic growth component for 2013 (relative to WEO projections) of the United States, China, CAPDR, and European main trading partners. In each scenario, the impact on growth for all the 18 countries in the sample was estimated, keeping their domestic component unchanged.[3] Spillover results from the VAR analysis are as follows:



Sources: World Economic Outlook, OECD and Fund staff calculations.

- **United States.** The adverse shock in U.S. growth would have a large impact, as growth in El Salvador would decline by 0.2 percentage points in 2013 and 1 percentage point in 2014. The large sensitivity is explained by the close trade linkage of El Salvador with the U.S. Also, given El Salvador's linkage with CAPDR, growth would also be adversely affected by lower regional growth, since the U.S. is the main trading partner of the other CAPDR countries.[4]



Sources: World Economic Outlook, OECD and Fund staff calculations.

- **CAPDR.** The adverse growth shock in CAPDR would have a large negative impact on growth, due to close trade linkages with the region (0.2 and 0.9 percentage points in 2013 and 2014, respectively). Based on past experience the likelihood of a broad region-specific shock is low.

- **China.** The growth shock in China would have a similar intensity as the shock in CAPDR. The shock would propagate to El Salvador mainly through its impact on U.S. growth.

- **Europe.** A growth shock in Europe would have a negligible effect on El Salvador, since the U.S. growth would not be significantly affected by the shock.

[3] The VAR results underestimate the spillover on growth as there is no second-round effect on other countries' domestic component, but take into account third country effects through the foreign component—e.g., the impact on El Salvador of the fall in China's domestic demand channeled through the United States. The VAR included the following countries for the period 1975-2012: Belgium, Canada, China, Germany, Hong Kong, Italy, Mexico, Peru, Spain, Sweden and the United States, as well as CAPDR countries.

[4] The spillover of the growth shock through remittances appears to be low in El Salvador, see Swiston, A., 2012, "External Linkages and Economic Integration as of 2009," Central America, Panama, and the Dominican Republic: Challenges Following the 2008-09 Global Crisis, pp. 5-32, Washington: International Monetary Fund.

4. **As for fiscal spillovers, the impact of automatic spending cuts in the United States would be moderate.** Fiscal sequestration in the United States would slow growth in El Salvador by 0.2 percent in the near term, and by up to 0.6 percent cumulatively over a two-year period. This effect has been incorporated into the baseline projection of the staff report. Conversely, the anticipated fiscal consolidation in Europe would have a negligible effect on El Salvador.

Banking and Sovereign Stress Spillovers

5. **The direct spillovers to El Salvador from stress in international banks were assessed based on the RES/MFU Bank Contagion Module.**[5] The module estimates potential vulnerability of the Salvadorian economy stemming from international banks that operate in El Salvador or are involved into direct cross-border lending, based on the BIS banking statistics.[6]

6. **Foreign credit availability to Salvadorian borrowers would be moderately affected by large losses in claims of international banks on selected economies.** Based on the default rates on the private and public sector assets assumed in the table below, the module estimates the losses on the international banking systems. If the banks do not hold excess capital to cover such losses, they would have to deleverage (reduce their foreign and domestic assets) to restore their required capital adequacy ratios, thus squeezing credit lines to El Salvador and other countries.[7] The largest direct impact of this shock in terms of reduction in foreign banks credit to Salvadorian borrowers would stem from combined losses in U.S. and Canadian assets (nearly 5 percent of GDP), followed by a default shock in European assets (3½ percent of GDP). These shocks would imply a reduction in credit to El Salvador by about 8 and 6 percent, respectively.

[5] For methodological details see Cerutti, Eugenio, Stijn Claessens, and Patrick McGuire, 2012, "Systemic Risks in Global Banking: What can Available Data Tell Us and What More Dare are Needed?" BIS Working Paper 376, Bank for International Settlements.

[6] The analysis may understate potential spillovers, since exposure of resident banks not-reporting to BIS is not captured. This omission could be important, since Colombian banks (not included in BIS data) own about two-fifths of the Salvadorian banking system. The analysis also ignores the negative indirect effects of deleveraging in international banks on global market confidence, balance sheets of corporates, and economic activity, which could affect Salvadorian and foreign banks, including through an increase in nonperforming loans.

[7] Bank recapitalization and other supportive policy actions at the host and/or home country are not assumed.

Spillovers to El Salvador from International Banks' Exposures

Shock originating from:	Magnitude 1/	Impact (Percent of GDP) 2/
Greece	30	0.0
Greece, Ireland, and Portugal	30	0.0
Italy	10	-0.1
Spain	10	-0.1
France	10	0.0
Germany	10	-1.1
Belgium	10	0.0
Switzerland	10	0.0
UK	10	-2.0
Selected European Countries 3/	10	-3.4
US and Canada	10	-4.8

Sources: RES/MFU Bank Contagion Module based on BIS, ECB, and IFS data.
1/ Denotes the percent of banks' claims on all sectors that lose value.
2/ Reduction in foreign banks credit to El Salvador, assuming a uniform deleveraging across domestic and external claims.
3/ Greece, Ireland, Portugal, Italy, Spain, France, Germany, Belgium, Switzerland, and UK.

7. **A default shock on the sovereign debt of selected European countries would not directly affect foreign credit availability to El Salvador.** The impact of the simulated losses in the balance sheets of international banks actively lending to El Salvador's borrowers would be virtually zero, as those banks have a limited sovereign exposure to these European countries.

Spillovers to El Salvador from International Banks' Sovereign Exposures

Shock originating from:	Magnitude 1/	Impact (Percent of GDP) 2/
Greece	50	0.0
Greece, Ireland, and Portugal	50	0.0
Spain	25	0.0
Italy	25	0.0

Sources: RES/MFU Bank Contagion Module based on BIS, ECB, and IFS data.
1/ Denotes the percent of sovereign-related claims that lose value.
2/ Reduction in foreign banks credit to El Salvador, assuming a uniform deleveraging across domestic and external claims.

Outward Spillovers

8. **The importance of spillovers from El Salvador to neighboring countries appears to be limited.** The main channel of transmission of shocks from El Salvador to the region is through the trade linkage, but the share of Salvadorian trade in total trade of individual neighbors is modest, suggesting that the potential for real spillovers from the Salvadorian economy is small. The other channel for propagation is financial sector (e.g., cross-border bank lending and portfolio and foreign

direct investment links), but these linkages between El Salvador and its neighbors are also small. There could be potential for pure market contagion through investor perception of regional risk, e.g., in response to adverse economic or political developments in either El Salvador or its neighboring countries, but this is by nature difficult to gauge, and there are no signs of such contagion at present.

Annex IV. El Salvador: Public Debt Sustainability Analysis[1]

The public debt of El Salvador is large and continues to grow, posing risk to fiscal sustainability over the long term. Returning to pre-crisis debt levels would restore fiscal space to manage shocks and reduce financing needs to more manageable levels, but a fairly gradual adjustment could still lead to moderate output gaps.

Overview

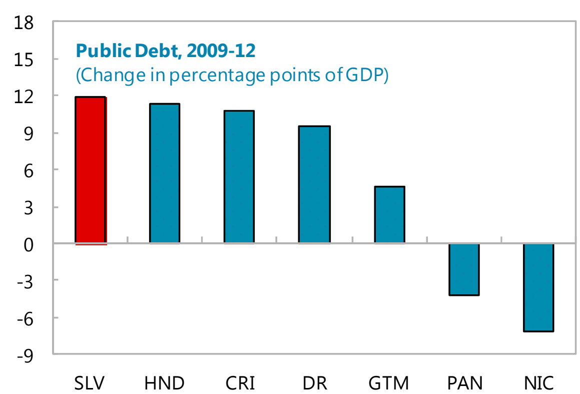
1. **Developments.** The public debt-to-GDP ratio rose substantially from about 42½ percent at end-2008 to 54¼ percent at end-2012. Key drivers were as follows:

- Over the period 2003-08, the debt ratio increased slightly as the size of the primary deficit was moderate and largely offset by the effect of a positive growth-interest rate differential.
- In contrast, the large buildup of public debt recorded in the following four-year period resulted from a widening of the primary deficit during the 2008-09 global crisis, which was only partly reversed, and the effect of a negative growth-interest rate differential, as growth weakened (Annex I).
- From a regional perspective, El Salvador experienced one of the largest increases in public debt over the latter period, as the primary deficit was relatively large. This trajectory was compounded by the effect of a weak growth performance relative to regional peers (Figure AIV.I). By the end of 2012, El Salvador had the highest debt ratio in the region, even if public debt arising from the transition to individual pension accounts is excluded.[2]

Decomposition in Debt Dynamics
(Percent of GDP)

	2003-08	2009-12
Change in public debt	**3.1**	**11.9**
Primary deficit	3.4	8.3
Growth	-6.4	-1.1
Real interest rate	4.2	4.9
Other	1.8	-0.3
Memo item:		
Public debt (end period)	42.4	54.3
Implicit nominal interest rate	6.0	4.9

Sources: National authorities and Fund staff calculations.



Sources: National authorities and Fund staff calculations.

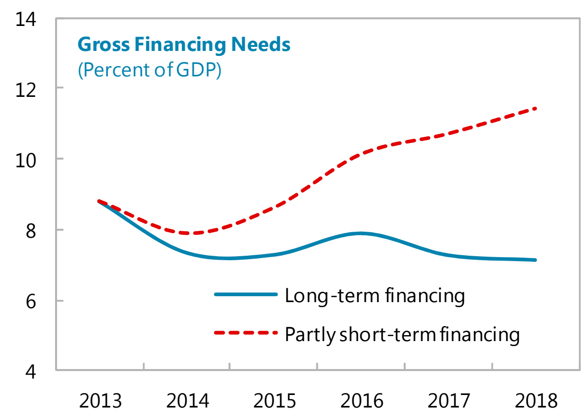
2. **Baseline scenario.** The public debt ratio is projected to rise to 63 percent by 2018, and further to 66 percent by 2020, mainly because the primary deficit would remain at over 1 percent of GDP in the medium and long terms. Such a trajectory faces substantial risk:

[1] Prepared by P. Druck and M. Garza.

[2] The exclusion of pension-related debt makes the El Salvador's stock of public debt more comparable to those in neighboring countries, which have pay-as-you-go pension schemes.

- Bound tests indicate that the public debt path is sensitive to shocks, as slippages in the primary deficit, lower growth, or higher interest rates would further accelerate the debt dynamics. Based on past experience, the likelihood of these shocks is high (Table 9 and Figure 6).
- Stochastic simulations show that the median public debt forecast would exceed 80 percent of GDP by 2018.[3] These forecasts consistently exceed baseline projections for the public debt and are subject to considerable medium-term risks, as evidenced by the width of the fan chart presented in the main text of the staff report (¶12).

3. **Borrowing needs.** The baseline projected gross financing needs would exceed the available financing, exposing the public finances to changes in market sentiment. Financing needs are projected at 7-9 percent of GDP per year, provided that the stock of short-term public debt remains at 2 percent of GDP and financing gaps are covered with long-term loans from official and private creditors. Conversely, gross financing needs would reach 11 percent of GDP by 2018, if one-half of the projected financing gaps were covered with short-term debt financing.



Sources: National authorities and Fund staff calculations.

4. **Debt structure**.[4] A fairly strong public debt structure mitigates risks. At end-2012, the average maturity of public debt stood at 8 years, with only 15 percent of the stock maturing over the next 5 years (or an average amortization of 1½ percent per year). A large share of this stock (70 percent of total) was subject to fixed interest rates, which limited exposure to interest rate volatility. The existence of a stable investor base was also a source of strength, with domestic private pension funds and official creditors holding a large portion of public debt (70 percent).

5. **Risk perception.** The perception of sovereign debt risk is moderate, with spreads averaging 450 basis points in 2012, compared to 180 basis points in the highest-rated countries in Latin America. El Salvador maintained investment grade level during 2002-09, but ever since two of the rating agencies have been gradually downgrading its sovereign debt-risk rating, and presently, the country stands three notches below investment grade level.

[3] The stochastic simulations were made by (i) estimating the implicit fiscal reaction function to public debt developments and the output gap in past fiscal behavior, and (ii) producing frequency distributions of the debt paths under growth, interest rates, and fiscal shocks of similar magnitude observed in the past.

[4] Based on IMF Board Paper SM/11/211, 2011, "Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis". Washington: International Monetary Fund.

Restoring Debt Sustainability

6. **Alternative long-term debt targets were used to assess the required effort to achieve debt sustainability.** The estimated size of the sustainability gap depends on the speed of the fiscal adjustment and the scope of the public debt target.[5]

- **Debt stability.** Maintaining the public debt ratio at 55 percent in 2013 and beyond would require a sustained fiscal effort of 2 percent of GDP, which would shift the primary balance into a small surplus (0.2 percent of GDP). This type of fiscal consolidation, however, would still result in relatively high gross financing needs and limited fiscal space to react against adverse shocks.
- **Pre-crisis debt level.** Reducing the public debt ratio to pre-crisis levels (42 percent) by 2020 would result in a sustainability gap of 5 percent of GDP relative to 2012-levels. Closing this gap would raise the primary surplus to 3¼ percent of GDP and move the overall fiscal balance into a small surplus, while financing needs would decline to manageable levels (3-4 percent of GDP). A gradual adjustment, with some moderate front-loading, spread out over a 6-year period through 2018 is projected to result in moderate output gaps (see below).
- **Debt level to improve risk perceptions.** Lowering the public debt ratio to levels that could support investment grade (35 percent of GDP by 2020) would require a sustained effort of 7 percent of GDP, assuming that the adjustment is spread out over the same six-year period.[6]

It is worthwhile noting that the adjustment predicated under these scenarios could subsequently be relaxed as a small primary surplus would stabilize debt once the target was met. Moreover, if the fiscal consolidation would also target a strengthening of the foreign reserve position to the adequacy level discussed in Annex II, the gradual adjustment envisaged under these scenarios would need to be supplemented by an additional effort of 0.8 percent of GDP per year.

7. **The debt-reduction scenarios consider a moderate up-front fiscal effort to mitigate output losses.** El Salvador faces the challenge of undertaking fiscal consolidation, while minimizing its impact on growth. To reconcile both objectives, simulations were prepared based on a model of optimal fiscal consolidation.[7] In light of the small output gap in 2012, the simulation pertaining to

[5] For more details on this methodology see: Garza, M., P. Morra, and D. Simard, 2012, "The Fiscal Position: Prospects and Options for Adjustment," Central America, Panama, and the Dominican Republic: Challenges Following the 2008-09 Global Crisis, pp.105-135, Washington: International Monetary Fund.

[6] For an estimation of sovereign debt-risk ratings based on models of the public debt intolerance see: Bannister, G. and L.D. Barrot, 2012, "A Framework for Assessing the Level of Public Debt," Central America, Panama, and the Dominican Republic: Challenges Following the 2008-09 Global Crisis, pp. 87-104, Washington: International Monetary Fund.

[7] See Kanda, Daniel, 2011, "Modeling Optimal Fiscal Consolidation Paths in a Selection of European Countries," IMF Working Paper 11/164, Washington: International Monetary Fund.

the pre-crisis debt scenario predicts a fiscal tightening of some 2 percent of GDP in 2013-14 and smaller additional adjustment in the following 4 years. Under this scenario, the output gap would stay at 0.6 percent of potential output in the first year, and close slowly thereafter**.**

Illustrative Fiscal Consolidation Path Under Model of Quadratic Preferences 1/

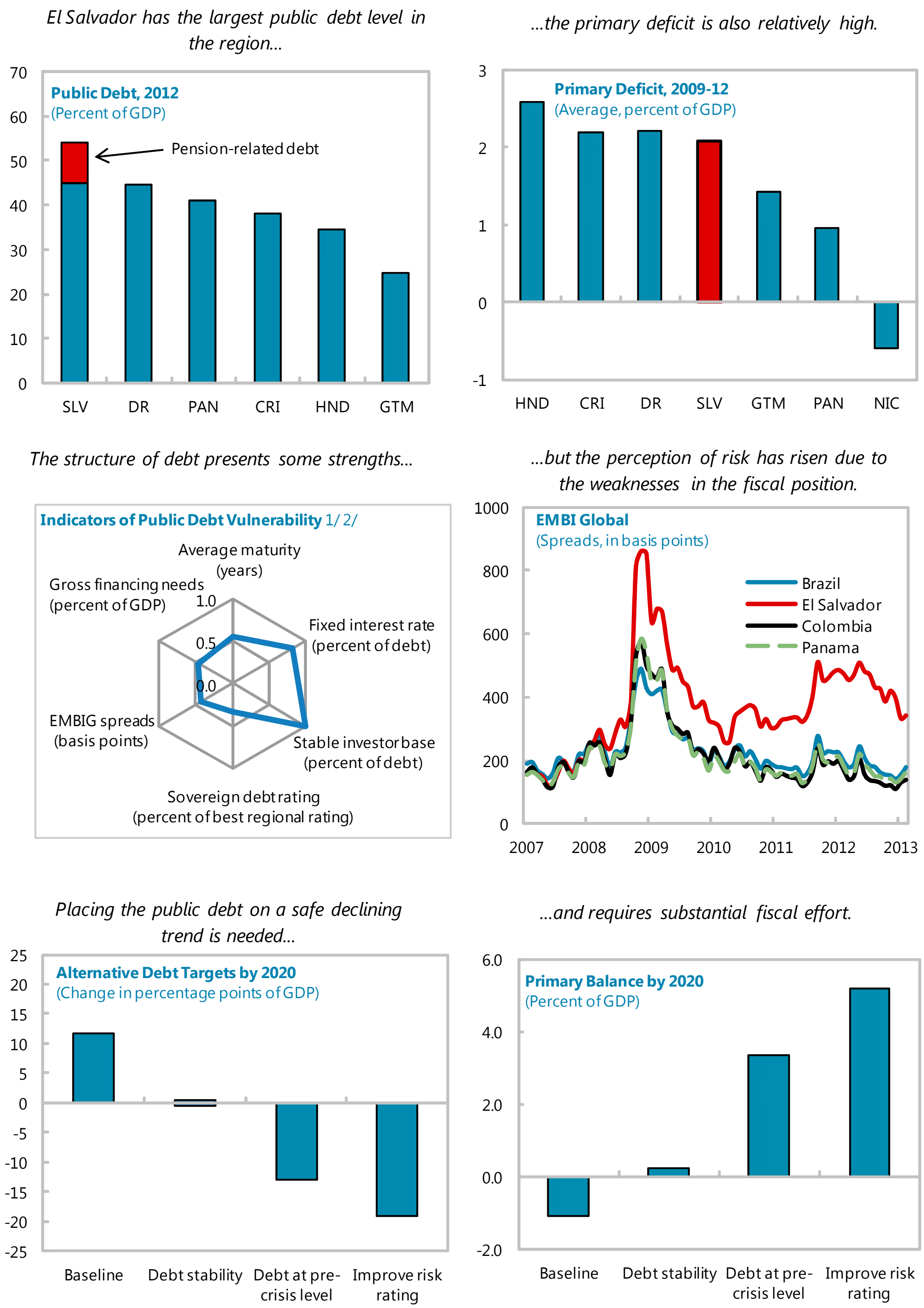
(Percent of GDP, unless otherwise stated)

	Projection									
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Discretionary fiscal adjustment	1.3	0.9	0.7	0.7	0.7	0.7	0.0	0.0	0.0	0.0
Fiscal sustainability gap	3.4	2.6	1.9	1.3	0.6	0.0	0.0	0.0	0.0	0.0
Output gap (percent of potential GDP)	-0.6	-0.5	-0.4	-0.4	-0.4	-0.4	-0.2	-0.1	0.0	0.0

Source: Fund staff estimates and projections.

1/ Pre-crisis debt level scenario.

Figure AIV.1. El Salvador: Public Debt Dynamics



Sources: Bloomberg and Fund staff estimates.
1/ A value of one means that an indicator is at the threshold level. The closer the indicator is to the center, the higher the vulnerability along this dimension.
2/ For each indicator, the threshold is the best regional performer among countries with market access in the region (Costa Rica, El Salvador, Guatemala, Honduras, Panama, and the Dominican Republic).

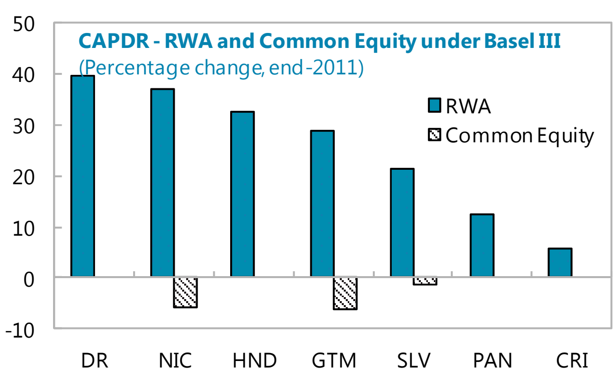
Annex V. El Salvador: Implementing Basel III Standards[1]

Due to comfortable capital and liquidity levels in the banking system, El Salvador is well placed to perform a gradual transition to the stricter Basel III standards, without dampening credit supply and economic activity in the near term.

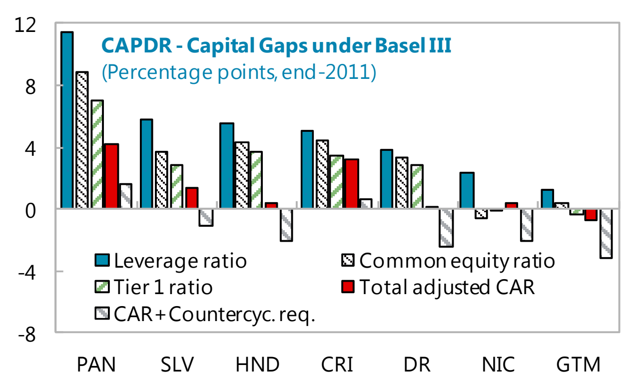
1. **While Basel III standards seek to enhance the soudness of the banking system, there is risk that more demanding rules could dampen growth.** Basel standards have been upgraded through stricter capital and new liquidity guidelines to address weaknesses uncovered during the 2008-09 global crisis. Meeting the enhanced requirements, however, may lead banks to transitorily curtail the credit supply and thus affect economic activity.

2. **El Salvador is well placed to gradually implement key Basel III standards.** The banking system is already in compliance with most of Basel I standards and has made good progress in applying Basel core principles. At end-2012, banks had capital adequacy ratios of 17 percent, well above the required level of 8 percent under Basel I standards (and 12 percent under Salvadorian rules). Also, the shift to risk-based supervision is advancing, while the integration of the superintendencies of banks, pension funds, and securities in 2011 has facilitated the application of consolidated supervision.

3. **Banks will likely face small capital gaps under the stricter standards.** Adjusting for Basel III definitions, risk-weighted assets (RWA) in the Salvadorian banking system would increase by some 20 percent, while common equity would decline by only 1½ percent—this impact compares favorably to some countries in the region. Thanks to the present capital position, banks would be able to meet all of the new capital requirements, although the application of a recommended countercyclical buffer (2½ percent of RWA) would result in a capital gap of 1½ percent of RWA—this gap is still smaller than those that could arise in some countries in the region.



Sources: Supervisory authorities and Fund staff estimates.

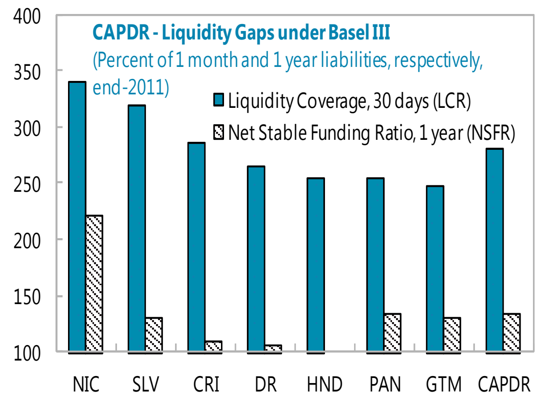


Sources: Supervisory authorities and Fund staff estimates.

4. **Liquidity levels in El Salvador's banking system also exceed minimum standards.** Adjusting for Basel III methodologies, the system's liquidity would be more than three times the

[1] Prepared by F. Delgado. Based on Basso, O., Delgado, F. and M. Meza, 2012, "Strengthening Bank Capital and Liquidity in Central America: the Road to Basel III," IMF, Working Paper (unpublished).

minimum implied by the 30-day liquidity requirement and some 30 percent above the level suggested by the one-year funding requirement.[2]



Sources: Supervisory Authorities and Fund staff estimates.

5. **The macroeconomic impact of the transition to Basel III capital standards would be negligible for El Salvador.** Broadly speaking, aligning to the stricter rules should have no transitory impact on credit nor economic activity, since the system already exceeds most of those standards, unless a countercyclical capital buffer is also introduced. To measure the real effect of adopting Basel III standards, a vector auto regression (VAR) was used. It suggests that raising the capital adequacy ratio by one percentage point would lower economic activity in El Salvador by only 0.05 percent, with the effect dissipating in two years. The estimated impact is low compared to the estimations made for other countries by the BIS Macroeconmic Analysis Group.

6. **The transition to Basel III standards should be tailored to the features of the banking system.** These standards would be appropriate for El Salvador, given the size and complexity of the banking system, and would also guide improvements in supervisory practices and skills, as well as in the regulatory and risk management frameworks.

- Short-term priorities should focus on upgrading capital definitions and introducing the new capital requirements, although the recommended countercyclical buffers may take longer to implement. However, required liquidity levels should not be reduced until the liquidity facilities envisaged by the central bank become fully activated, particularly the lender-of-last resort window.

- Over the medium term, it is important to strengthen the supervisory processes (the so called "Pillar II" under the Basel accord) and upgrade practices for market discipline and transparency (Pillar III).

- In the long term, additional elements should be considered, such as macroprudential instruments and capital charges for systemically important financial institutions.

7. **Challenges to the transition to Basel III strandards seem manageable.** Most of the regulatory changes associated with implementation of those standards fall under the powers of the central bank. At the industry level, the presence of large international financial groups in El Salvador should facilitate the transition, since these banks are subject to stricter prudential practices dictated by home countries

[2] Both liquidity requirements provide for full coverage of liabilities maturing within a 30-day and one-year period.

INTERNATIONAL MONETARY FUND

EL SALVADOR

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 29, 2013

Prepared By: The Western Hemisphere Department

CONTENTS

FUND RELATIONS

(As of March 31, 2013)

Membership Status: Joined: March 14, 1946;

General Resources Account:	**SDR Million**	**% Quota**
Quota	171.30	100.00
Fund holdings of currency (Exchange Rate)	171.30	100.00
Reserve Tranche Position	0.00	0.00

SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	163.81	100.00
Holdings	164.30	100.30

Outstanding Purchases and Loans:

None

Latest Financial Arrangements:

Type	**Date of Arrangement**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	03/17/2010	03/16/2013	513.90	0.00
Stand-By	01/16/2009	03/16/2010	513.90	0.00
Stand-By	09/23/1998	02/22/2000	37.68	0.00

Projected Payments to Fund
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2013	2014	2015	2016	2017
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**

Exchange Rate Arrangement. The U.S. dollar is legal tender and circulates freely. The dollar is used as a unit of account and a medium of exchange, with no limitations. All payments may be made in either dollars or colones. The BCR has the obligation to exchange colones for dollars upon request from banks, at a fixed and unalterable exchange rate of C8.75 per U.S. dollar. As a result, El Salvador has an exchange rate arrangement with no separate legal tender category. El Salvador has accepted the obligations of Article VIII, Sections 2(a), 3, and 4, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

Article IV Consultation. The last Article IV consultation was concluded on September 15, 2010 (Country Report No. 10/307).

FSAP participation and ROSCs. An FSAP Update was conducted in 2010 and the report was considered by the Executive Board on September 15, 2010. A fiscal ROSC was conducted in 2010. A data module ROSC was conducted in 2003.

Technical Assistance.

Department	Time of Delivery	Purpose
Statistics, CAPTAC-DR	February 2013, October 2012, April 2012, September 2011	New base year for national accounts, quarterly national accounts by expenditure
	February 2012, June 2011	Regional harmonization of monetary and financial statistics (second phase)
	August 2011	Consumer price index
	November 2012, October 2012, March 2012	External statistics, service account, financial account (sixth manual of balance of payments)
	February 2013, August 2012, May 2012, February 2012	Producer price index
	November 2012, May 2012, February 2012	Export and import price indexes
Monetary and capital markets, CAPTAC-DR	September 2011-April 2012	Liquidity management
	October 2011	Macroeconomic modeling and inflation forecasting
	February 2012, October 2011	Macroeconomic modeling of aggregate demand, potential output, and inflation forecasting
	February 2013, June 2012, March 2012	Risk-based and cross-border consolidated banking supervision
	July 2012	Liquidity risk management
	October 2012	Operational risk regulation
Fiscal Affairs, CAPTAC-DR	June 2012,May 2011	Customs administration
	February 2013, July 2012, March 2012, August 2011	Tax Administration, auditing, and large taxpayers
	November 2012, January 2012	Single treasury account
	February 2013, April 2012, December 2011	Medium-term expenditure framework

Resident Representative: Fernando Delgado (based in Guatemala) is the regional resident representative for Central America, Panama and the Dominican Republic.

RELATIONS WITH THE WORLD BANK

1. **Collaboration.** In the context of the joint management action plan (JMAP) for Bank-Fund collaboration, the IMF team led by Mr. Garza (Mission Chief) met on several occasions with the World Bank team led by Mr. Razafimandimby (Senior Country Economist) to discuss El Salvador's main macroeconomic challenges, identify macro-critical structural reforms, and coordinate the work of both teams.

2. **Macroeconomic challenges.** The teams have agreed that the challenges facing El Salvador are to safeguard fiscal sustainability, deepen financial reforms, and boost growth. The priority is to place the public debt-to-GDP ratio on a declining path and reduce the government's financing needs. Improvements in competitiveness and the business climate are needed to unleash the growth potential of the dollarized economy and elevate standards of living.

3. **Structural reforms.** Based on this shared assessment, the teams have identified four macro-critical structural reform areas:

- **Fiscal sustainability.** The fiscal consolidation strategy should comprise expenditure and revenue reforms to lower the fiscal deficit, while raising infrastructure, security, and other social spending. In particular, the increase in current primary spending recorded during the global crisis of 2008-09 should be reversed, including subsidies and wages, and the tax effort should be aligned with country peers. The pension system should also be put on a sound financial footing.

- **Public financial management.** The focus should be on addressing shortcomings in the budget process, including by: (i) adopting a medium-term expenditure framework; (ii) introducing a unified budget for the nonfinancial public sector; and (iii) broadening coverage of autonomous and decentralized institutions. By resolving these weaknesses, the authorities' ability to control public expenditure and execute the investment budget will improve.

- **Financial system.** The priority should be to strengthen its crisis preparedness and increase financial intermediation by: (i) making operational the central bank's lender-of-last-resort facility and setting up an additional liquidity fund; (ii) shifting to risk-based supervision and improving cross-border consolidated supervision; (iii) addressing deficiencies in bank resolution procedures and strengthening the deposit insurance scheme; and (iv) improving the legal framework for El Salvador's capital markets.

- **Competitiveness.** There is a need to boost domestic investment in El Salvador, which for many years has remained low in terms of GDP and compared to regional peers. Weaknesses in areas such as security, education, and innovation, and lack of private participation in large infrastructure projects weigh on investment and growth.

4. **Division of labor.** The teams agreed on the following division of labor:

- **Fiscal sustainability**. The IMF (the Fund) will continue to provide advice on macro-fiscal issues, including fiscal consolidation, and technical assistance (TA) to strengthen tax collection and reduce evasion. Building upon previous TA on tax policy, the Fund support will focus on improving control of large taxpayers and enhancing auditing capacity, as well as strengthening customs control while facilitating trade through risk-management schemes.

- **Public financial management.** The Fund will further assist the authorities in implementing medium-term expenditure framework, setting up a treasury single account, and enhancing capabilities in debt sustainability analysis. The World Bank is undertaking a regional study on public expenditure review in the social sector in Central America.

- **Financial system.** The Bank and the Fund will continue to cooperate as needed in assisting the authorities in implementing the 2010 FSAP Update advice. The Fund will provide assistance with norms and procedures to shift to risk-based supervision, cross-border consolidation supervision, and the liquidity policy of the central bank. The Bank will provide new assistance on the regulatory framework for the provision of mobile financial services and insurance.

- **Competitiveness.** The Fund will also assist in strengthening the framework for public-private partnerships and managing potential fiscal risks through regional seminars. The World Bank has also been working to strengthen the legal framework for public-private partnerships and to improve the investment climate. The World Bank is also providing TA to build the institutional capacity for technology and innovation.

5. **Information sharing.** The teams have agreed to share information on progress in the above macro-critical structural reform areas.

6. **Work programs.** The following table lists the teams' work programs through April 2014.

World Bank and Fund Planned Activities in Macro-Critical Structural Reform Areas

Title	Products	Provisional Timing of Missions	Expected Delivery Date
World Bank Work Program	Income Support and Employability Project Fiscal Management and Public Sector Performance T.A. loan Local Government Strengthening Project Health Sector and Governance Project Education Quality Improvement Second Programmatic Public Finance and Social Progress DPL Public Finance DPL	2013	Ongoing, Nov. 2009 (Board approval) Ongoing, Nov. 2009 (Board approval) Ongoing, Jun. 2010 (Board approval) Ongoing, July 2011 (Board approval) Ongoing, December 2011 (Board approval) May 2013 (Expected Board approval)
Fund Work Program	Regional Conference Staff Visit Technical Assistance: Enhancing tax auditing and strengthening of custom controls Adopting a medium-term expenditure framework; improving multi-year budgeting; and setting up a treasury single account Following up on risk-based supervision for banks; initiating the shift to risk-based supervision for insurance and pension system; improving cross-border consolidated financial supervision Building models for debt sustainability analysis and macroeconomic forecasting Developing an interbank market	July 2013 November 2013 2013-2014 To be scheduled To be scheduled To be scheduled To be scheduled To be scheduled	July 2013 November 2013 2013-2014

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK (IADB)

1. The IADB completed the last country strategy for El Salvador in 2010 for the 2011–14 period. The next country strategy for El Salvador is scheduled for completion in 2015.

2. As of February 2013, the IADB has pending disbursements for US$376 million, which correspond to public-sector guaranteed loans and which are mostly concentrated in thirteen programs in eight sectors. For 2013, the IADB will work on the preparation of four loans (US$250 million), in the areas of health (US$180 million), competitiveness and innovation (US$50 million) and rural development (US$20 million).

El Salvador: Relations with the Inter-American Development Bank
(As of February 28, 2013, in millions of U.S. dollars)

A. Operations

Sector	Commitments	Amount Disbursed	Amount Undisbursed
Competitiveness and Innovation	60.0	0.0	60.0
Gender and Diversity	20.0	13.6	7.2
Health	60.0	18.8	41.2
Labor Markets	65.0	0.0	65.0
Modernization of the State	5.0	1.1	3.9
Roads and Transportation	95.0	17.6	77.4
Urban Dev. And Housing	120.0	10.3	109.7
Water and Sanitation	20.0	8.5	11.5
Total	**445.0**	**69.9**	**375.9**

B. Loan disbursements and amortizations
(In millions of U.S. dollars)

	2006	2007	2008	2009	2010	2011	2012	2013P
Disbursements	100.2	96.1	288.1	487.4	115.5	202.8	266.1	169.8
Repayments	88.9	90.5	104.8	278.3	125.5	116.3	114.7	108.3
Net lending	**11.29**	**5.6**	**183.3**	**209.1**	**-10.0**	**86.5**	**151.4**	**61.5**
Interest and charges		62.3	67.3	67.8	56.5	55.0	51.8	49.1
Subscriptions and contributions		-	2.9	2.9	1.2	1.5	2.7	2.7
Net transfer	**11.29**	**-56.6**	**113.1**	**138.4**	**-67.7**	**30.0**	**96.9**	**9.7**

STATISTICAL ISSUES

(As of April 2013)

A. Assessment of Data Adequacy for Surveillance

General: Data provision is adequate for surveillance.

National Accounts: National accounts data are based on 1990 weights and compiled under the 1968 SNA, although a project is underway to transition to the 1993 SNA and update the series to 2005 weights. The project also envisages the publication of quarterly national accounts by expenditure, which are currently available only on an annual basis.

B. Data Standards and Quality

El Salvador is a subscriber to the Fund's Special Data Dissemination Standard (SDDS) since 1998. El Salvador is taking a flexibility option for the periodicity of the labor market and wages/earnings data category and will continue at this time to publish annual data with a timeliness of one quarter after the end of the reference year. A data ROSC was published in December 2004

El Salvador: Table of Common Indicators Required for Surveillance

(As of April 30, 2013)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality – Accuracy and reliability[9]
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar-2013	Mar-2013	M	M	M		
Reserve/Base Money	Feb-2013	Apr-2013	M	M	M	O, LO, LO, LO	O, O, O, LO, O
Broad Money	Feb-2013	Apr-2013	M	M	M		
Central Bank Balance Sheet	Feb-2013	Apr-2013	W	W	M		
Consolidated Balance Sheet of the Banking System	Feb-2013	Apr-2013	W	W	M		
Interest Rates[2]	Apr-2013	Apr-2013	W	W	W		
Consumer Price Index	Mar-2013	Mar-2013	M	M	M	O,O,LNO,O	LNO,LO,O,O,LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Feb-2013	Apr-2013	M	M	M	LO, LO,LNO,LO	LO,O,LO,LO,NO
Revenue, Expenditure, Balance, and Composition of Financing[3]– Central Government	Feb-2013	Apr-2013	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[4]	Feb-2013	Feb-2013	M	M	M		
External Current Account Balance	Dec-2012	Mar-2013	Q	Q	Q	O, LO, LNO,LO	LO, LO,O,O,LO
Exports and Imports of Goods and Services	Dec-2012	Mar-2013	M	M	M		
GDP/GNP	Dec-2012	Mar-2013	Q	Q	Q	LO,LNO,LNO,LO	LNO,LNO,LO,O,LO
Gross External Debt	Dec-2012	Mar-2013	Q	Q	Q		
International Investment Position[6]	Dec-2012	Mar-2013	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discounts rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds).
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] Reflects the assessment provided in the data ROSC, published in February, 2010 and based on the findings of the mission that took place in April, 2009, for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[9] Same as footnote 8, except referring to international standards concerning source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 13/59
FOR IMMEDIATE RELEASE
May 22, 2013

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

IMF Executive Board Concludes 2013 Article IV Consultation with El Salvador

On May 20, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with El Salvador.[1]

Background

The economy recovered slowly from the 2008-09 global financial crisis. Output growth was sluggish in 2010-12, owing to low rates of private investment, declining competitiveness, and weather-related shocks. Inflation remained low, firmly anchored by the fully-dollarized regime. Despite weak economic activity, the external current account deficit widened to 5.25 percent of Gross Domestic Product (GDP) in 2012, partly due to lower export prices. This deficit exceeded the underlying capital account surplus. The foreign reserve position as of end-2012 may not be sufficient to absorb large adverse shocks.

The overall fiscal deficit in 2012 remained close to 4 percent of GDP, broadly the same level as in 2010-11. The revenue gain from income tax measures taken early in 2012 and strict control over current expenditures were offset by higher public investment and spending on security, health, and other social projects. Generalized subsidies and pension payments continued to place a burden on the public finances. The government's financing needs were large, amounting to nearly 8 percent of GDP in 2012. The stock of public sector debt continued to grow, reaching 54.25 percent of GDP at end-2012.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

The banking system appears well capitalized and liquid. At end-2012, the average capital adequacy ratio was 17 percent, while overdue loans declined to under 3 percent of total loans, with provisioning fully covering these loans. During 2012, total bank deposits increased by just 2.5 percent, while credit to the private sector grew by 4 percent.

El Salvador faces presidential elections in early 2014 and congressional elections one year later. The long electoral period may reduce the scope for corrective fiscal policies. Output growth would remain subdued as investment would remain low due to long-standing structural weaknesses. The overall fiscal deficit will likely stay at 4 percent of GDP in 2013 and beyond, increasing the public debt further, keeping government's financing needs high, and elevating external vulnerabilities.

Executive Board Assessment

Directors noted that, while El Salvador enjoys low inflation and a resilient financial system, output growth is weak, and vulnerabilities from the fiscal deficit and debt are high. They urged the authorities to build a broad consensus on a short- and medium-term strategy to ensure fiscal and debt sustainability and bolster the economy's resilience and growth potential.

Directors concurred that the short-term priority should be to maintain macroeconomic stability and investor confidence during the electoral period. They encouraged the authorities to exercise restraint on public sector wages and poorly-targeted subsidies, and broaden the scope of envisaged revenue measures. Over the medium term, a gradual reduction in the public debt ratio to pre-2009 levels by the end of the decade should anchor El Salvador's macroeconomic strategy. This would strike an adequate balance between restoring fiscal buffers and supporting priority infrastructure and social spending. Directors emphasized that fiscal consolidation should encompass revenue and expenditure, including improving the targeting of subsidies, lowering the earmarking of revenues, reducing tax expenditure and evasion, and increasing the rate of the value-added tax. Directors also stressed the need for pension reforms to ensure sustainability and reduce inequalities in the system.

Directors noted that a temporary increase in banks' liquidity buffers would help safeguard financial stability during the election cycle. They welcomed the authorities' plans to make progress in implementing risk-based and cross-border consolidated bank supervision. They stressed the importance of adopting the outstanding recommendations of the 2010 Financial Sector Assessment Program (FSAP) Update, including activating the newly-created lender-of-last-resort facility, facilitating bank resolution, and raising the reserves of the deposit insurance fund. A gradual implementation of key Basel III standards would also be important.

Directors emphasized that a sustained increase in investment is necessary to raise El Salvador's potential growth. They saw broad consensus on a medium-term strategy aimed at bolstering competitiveness and improving the business climate as critical. In this regard, they supported the authorities' initiatives to promote private investment in key infrastructure areas, set up an effective framework for public-private partnerships, and reduce red tape.

El Salvador: Selected Economic Indicators

I. Social Indicators

Rank in UNDP Development Index 2012 (of 186)	107	Population (million)	6.2
Per capita income (U.S. dollars)	3,864	Life expectancy at birth in years	71
Percent of pop. below poverty line (2010)	43	Infant mortality (per 1,000 live births)	15
Gini index	47	Primary education completion rate (percent)	89

II. Economic Indicators

					Prel.	Projections	
	2008	2009	2010	2011	2012	2013	2014
	(Annual percent change, unless otherwise stated)						
Income and Prices							
Real GDP	1.3	-3.1	1.4	2.0	1.6	1.6	1.6
Consumer prices (end of period)	5.5	0.1	2.1	5.1	0.8	2.3	2.6
GDP deflator	5.3	-0.5	2.3	5.7	1.5	1.7	2.4
	(Percent of GDP, unless otherwise stated)						
Money and Credit							
Credit to the private sector	43.0	42.4	40.9	39.8	40.1	39.6	38.9
Broad money	45.0	47.3	47.2	43.7	43.2	42.8	42.1
Interest rate (time deposits, percent)	4.2	4.5	2.9	1.8	2.5	…	…
External Sector							
Current account balance	-7.1	-1.5	-2.7	-4.6	-5.3	-5.0	-4.8
Trade balance	-21.8	-15.0	-16.5	-18.4	-18.7	-19.1	-19.1
Exports (f.o.b. including *maquila*)	21.9	19.0	21.4	23.4	23.0	23.0	23.1
Imports (f.o.b. including *maquila*)	-43.8	-34.1	-37.8	-41.8	-41.7	-42.1	-42.3
Services and income (net)	-2.8	-3.1	-3.0	-2.9	-3.3	-2.9	-2.8
Transfers (net)	17.5	16.7	16.8	16.6	16.8	17.0	17.1
Foreign direct investment	3.8	1.8	0.5	1.7	2.2	1.0	1.1
Nonfinancial Public Sector							
Overall balance	-3.2	-5.7	-4.3	-3.9	-3.9	-3.9	-3.8
Primary balance	-0.8	-3.1	-1.9	-1.7	-1.6	-1.4	-1.3
Public sector debt 1/ 2/	42.4	51.0	52.2	52.3	54.3	56.4	58.0
Of which: external public debt 1/	24.5	30.0	30.3	28.8	31.7	31.3	30.8
External public debt service							
(Percent of exports of goods and services)	8.2	10.2	9.4	18.4	9.4	8.1	7.9
National Savings and Investment							
Gross domestic investment	15.2	13.4	13.3	14.4	14.6	14.6	14.6
National savings	8.1	11.9	10.6	9.8	9.3	9.5	9.8
Net Foreign Assets of the Financial System 3/							
Millions of U.S. dollars	2,208	3,028	3,378	2,811	3,370	2,708	2,797
Percent of deposits	24.4	32.4	34.5	28.8	34.0	26.1	26.2

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

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

2/ Excludes sovereign debt placed in November 2012 (3¼ percent of GDP) to pre-finance amortizations of short-term debt in 2013.

3/ Beginning in 2010, gold in international reserves is valued at the price determined by the London Bullion Market (resulting in a valuation gain of US$170 million).

Statement by Mr. Rojas and Mr. Acevedo Flores on El Salvador
May 20, 2013

We would like to thank staff for their thorough analysis and balanced report on the country's economic situation, and the main challenges that El Salvador faces ahead in order to attain higher growth rates and achieve fiscal sustainability. The authorities appreciate the frank and constructive dialogue during the consultation process and the frequent policy discussions held with the Fund. They broadly agree with the identified medium term challenges facing the economy, but they would like to emphasize the following points:

Economic Growth

Boosting growth definitely remains the main challenge for the country. Growth has been modest for many years, undermining fiscal sustainability and eroding social conditions. El Salvador's growth has been below that of Central America, Latin America, and world averages for almost two decades (since the Tequila Crisis)—in particular the decade that followed the adoption of full dollarization in 2001, with the lowest growth in the Salvadoran economic history excluding the period of civil war during the 1980s. This trend worsened amid the recent global recession, and the recovery has been quite slow. After dropping 3.1 percent in 2009, real GDP growth has averaged 1.5 percent during 2010-2012.

The key underlying factors behind this growth performance have been well documented and include low productivity levels due to low human capital, physical infrastructure deterioration, low private sector investment (including low flows of FDI), poor security conditions owing to gang-related activity, and political uncertainty. With the exception of political uncertainty, most of these factors have been present at least since the mid 1990s. So far, political institutions have failed to generate the necessary conditions to improve the country's business climate and boost growth, while productivity growth has been virtually nonexistent. It is particularly worrisome that, according to the macroeconomic projections prepared for the Staff Report, under current investment trends potential growth would remain around 2 percent over the long term.

Fiscal stance

When the current administration took office in June 1st 2009, it encountered a fiscal deficit close to 6.3 percent of GDP. As a result of efforts to advance a program of fiscal consolidation, the fiscal deficit has steadily declined from 5.7 percent of GDP in 2009 to 3.4 percent in 2012, and the objective is to further reduce it to 3.3 percent of GDP in 2013. Roughly half of last year's fiscal deficit is explained by pension liabilities, which averaged 1.7 percent of GDP per year between 2009 and 2012. At the same time, the public debt-to-GDP ratio rose from about 42½ percent at end-2008 to 54¼ percent at end-2012. Almost 10 percentage points of the outstanding public debt are due to pension liabilities.

Although El Salvador public debt is not that high if we measure it, for instance, by European standards, the authorities are well aware that reducing the debt burden is imperative to guarantee fiscal sustainability in the long term. Returning to pre-crisis debt levels would restore fiscal space to manage shocks and reduce financing needs to more manageable levels. However, the government's options to ease the burden appear to be quite limited, given El Salvador's poor track record of fostering growth and the polarized political environment ahead of next February's presidential election. Moreover, authorities are concerned that a too drastic fiscal adjustment might self-defeat the goal of improving growth prospects. Also, despite the government's commitment to stabilize public finances, there exists high risk that the election year will complicate fiscal consolidation efforts by raising pressure to increase spending beyond current targets. Politicians do not always appreciate the virtues of being fiscally responsible.

Monetary regime

The authorities' space of maneuver to foster growth and in turn stabilize public finances has been further complicated by the monetary regime. Since the adoption of full dollarization in 2001, El Salvador has been trapped into a risky combination of low growth, fiscal imbalances and hard currency that has proven to be a lethal trap in other countries. Dollarization has helped to consolidate monetary stability and to maintain inflation low, but inflation rates were actually lower when El Salvador had a de facto pegged exchange rate before dollarization was adopted (the Latin American economies that have consistently maintained the lowest inflation rates in the last decade have not been the dollarized ones). On the other hand, dollarization seems to have affected the competitiveness of Salvadoran exporters and has failed to sufficiently lower local interest rates. In the end, it has not led to more investment and growth over the long term, as its advocates promised when it was adopted. Macroeconomic performance under dollarization has been in general quite poor.

Nevertheless, despite the economic costs associated with this monetary regime, the government is committed to maintain this arrangement. The authorities are convinced that the costs of abandoning dollarization exceed potential benefits in the medium term. Hence, much of the focus of the government policy is on boosting productivity and lowering crime to promote investment.

Economic policies

The authorities are committed to a growth-friendly fiscal consolidation process as described above, recognizing that in the last year of the Funes Administration there will be severe limitations to pursue the fiscal consolidation effort.

Assuming that the main challenge to resume growth is to create a better environment for attracting new private investment, the government has introduced new pro-investment laws and decrees in early 2013. The measures include cutting red tape for construction projects, a new public-private partnership law (now in Congress), and reforms to free-trade zones. El Salvador is also working with the U.S. in its Partnership for Growth initiative to create programs that remove obstacles to growth. The initiative is focused on crime and security as well as on raising productivity in the tradable sector of the economy. El Salvador is also in a good position to get potential new funding from a second program from the Millenium

Challenge Corporation, which should sustain U.S. aid to the country in the coming years and provide a modest impetus for GDP growth, although its impact would be felt during the next presidential term.

On the fiscal side, the government is working to further advance fiscal consolidation gradually. In addition to implementing a hiring freeze in much of the public sector, it has worked on reducing subsidies for transportation (which however would be politically difficult if oil prices rise). Also, the Administration plans to introduce new tax measures in Congress, after getting approval of its legislative agenda of laws designed to promote investment and growth.

Conclusion

We would like to close this statement by reiterating our appreciation for the thorough analysis that underlies the report prepared by the IMF mission team. The authorities fully agree that the key challenges facing the economy are to increase growth, reduce the fiscal deficit and the level of public debt, and rebuild the buffers of the dollarized economy to deal with shocks. They welcome the goal to increase El Salvador's potential output to regional levels, which should be facilitated by enhancing competitiveness and improving the business climate. They also agree that policies should give priority to stabilizing the public debt- to-GDP ratio and closing financing gaps, although they are afraid that the fiscal effort suggested by the Staff Report for 2013-14 might not be achievable due to political factors.

The authorities are committed to guarantee an orderly political transition to the next Administration in early 2014 and are looking forward to find the appropriate policies to ensure economic stability during this transition. They would greatly appreciate the support from the IMF to start a national dialogue on the key economic challenges, especially on fiscal sustainability, during this difficult period.