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EL SALVADOR

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE AUTHORITIES OF EL SALVADOR

January 2015

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 2014 Article IV consultation with El Salvador, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on October 28, 2014, with the officials of El Salvador on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 26, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** on the conclusion of the 2014 Article IV consultation with El Salvador.
- A **Statement by the National Authorities** for El Salvador.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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Washington, D.C.

EL SALVADOR

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

November 24, 2014

KEY ISSUES

Focus: The main themes centered on tackling macroeconomic vulnerabilities and improving the medium-term outlook by achieving an ambitious fiscal adjustment while protecting social spending, creating an environment for higher private sector-led growth, and building a robust financial sector.

Main policy issues

- A reduction in the fiscal deficit of 3½ percent of GDP is needed over the next three years to place public debt on a sustainable path to maintain access to market financing on favorable terms. This adjustment should be accompanied by well-targeted social spending to protect the most vulnerable and continued progress in lessening inequality.

- A broad strategy is also needed to reduce the growing imbalances in the pension system and restore its sustainability for future generations. In this regard, a broad-based dialog across all segments of Salvadoran society is needed to build support for a reform that should include an increase in the retirement age and introduce a progressive taxation of benefits. Steps are also needed to further strengthen public financial management to mitigate key fiscal risks, including by enhancing expenditure monitoring and control (to avoid future spending arrears) and recording contingent fiscal liabilities transparently in the fiscal accounts.

- The authorities' goal of raising potential growth to 3 percent while reducing inequality will require substantial supply-side measures to enhance productivity and competitiveness. These should aim to reduce red-tape, increase access to credit, upgrade infrastructure, provide access to and lower the cost of energy, and diversifying the economy. The FOMILENIO II grant from the U.S. provides a valuable opportunity to catalyze such growth-enhancing reforms.

- Banking indicators appear sound, a product of prudent supervision and regulation. Nonetheless, there is scope to further strengthen the institutional underpinnings for financial stability by upgrading the legal framework for bank resolution and by creating an appropriate liquidity safety net for banks.

Approved By
Nigel Chalk (WHD) and Athanasios Arvanitis (SPR)

Discussions took place in San Salvador during October 14–28. The staff team comprised U. Ramakrishnan (head), B. Lissovolik, I. Teodoru, J. Wong (all WHD), M. Arena (SPR), and M. Garza (Regional Resident Representative). Mr. Acevedo (OED) also participated in the meetings. The team met with Vice President Ortiz, Technical Secretary Mr. Lorenzana, Minister of Finance Mr. Cáceres, Minister of Economy Mr. Solomon López, Central Bank President Mr. Cabrera, Minister of Public Works Mr. Martínez, Minister of Justice and Security Mr. Lara, Minister of Agriculture Mr. Ortez, members of congress, other senior officials, and representatives of the private sector and civil society.

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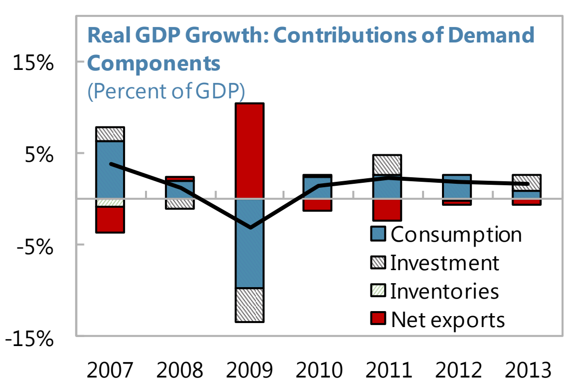
BACKDROP

1. **Economic Context.** Over the last five years, progress has been made in lowering poverty, undertaking tax reforms, and implementing some structural reforms, including recent legislation on Private-Public Partnerships (PPPs) and Anti Money Laundering. These have occurred within the context of low and stable inflation in the fully dollarized economy. Policy initiatives were taken to lower the fiscal deficit—including during two Fund-supported Stand-By Arrangements in 2009 and 2010—but have proved insufficient. Fiscal imbalances, which widened during the 2009 global crisis, have persisted. As a result, public debt is now on an upward trend and projected fiscal and external gross financing needs are high, putting at risk the macroeconomic and social gains made so far. Progress in broader reforms to attract private investment and for financial sector development has been limited causing growth in El Salvador to underperform that of its peers (Annex I).

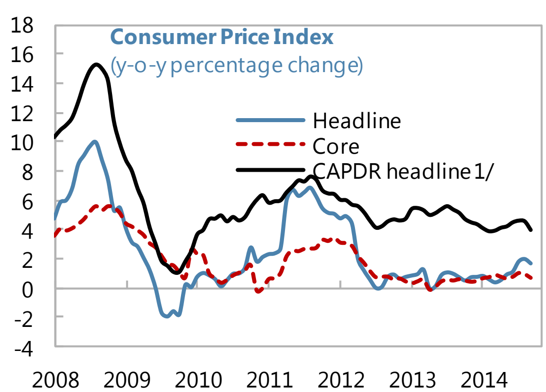
2. **Political context:** President Sanchez Cerén of the left-wing FMLN party took office in June 2014. He has vowed to raise growth to at least 3 percent on a sustained basis and undertake "austerity" in non-essential spending to create room for more social outlays. However, the Congressional elections planned for March 2015 are hindering effective policymaking.

A CHALLENGING ECONOMIC ENVIRONMENT

3. **Low growth, but with low and stable inflation**. For over a decade, El Salvador's growth has lagged the Central American region (Figure 1). Private consumption, partly financed by remittances, has been the main driver while investment has been the lowest in the region. In 2013, against slowing remittances, growth decelerated to 1.7 percent, with some one-off capital projects boosting investment. Growth has picked up to 2 percent in H1 of 2014—reaching El Salvador's estimated potential growth (Box 1)—on the back of higher remittances, but high-frequency indicators have been weaker in Q3. Inflation has hovered at around one percent for the past two years, but peaked at 2 percent in August 2014 due to a drought-related increase in food prices which has now subsided.



Sources: National authorities and Fund staff estimates.

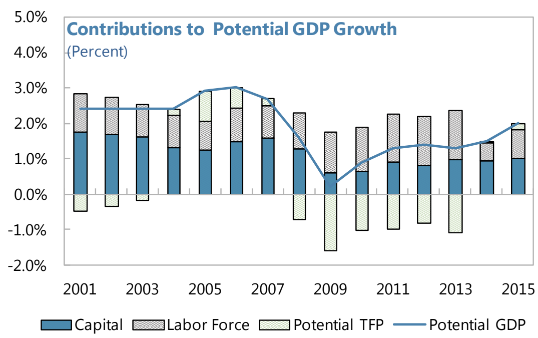


Source: Fund staff estimates and projections.

Box 1. El Salvador: Potential Growth, Investment, and Institutions[1]

Potential growth is estimated to be around 2 percent, with weak capital formation and productivity. Competitiveness gaps, uncertainty from frequent elections, and high debt are a drag on investment.

Potential growth: Based on various filters and total factor productivity (TFP) analysis, potential growth is estimated at about 2 percent for the period of 1999–2015, with factor accumulation being the main contributor. TFP has been negative in recent years, lowering potential growth, unlike in the rest of the region which had a positive contribution to potential growth from TFP.

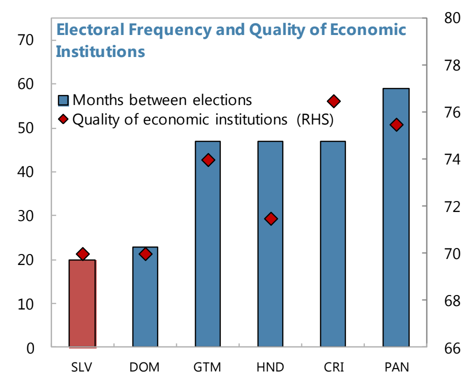


Source: WEO, ILO, UN, and Fund staff estimates.

	Potential GDP Growth Rate				Output gap	
Production Function Approach	1991-2015	1999-2015	2014	2015	2014	2015
	--	1.95	1.53	1.99	0.00	0.40
	Potential GDP Growth Rate					
Cycle Extraction Filters	1991–2015	1999–2015	2014	2015	2014	2015
Hodrick-Prescott	2.91	1.93	1.82	1.86	0.08	0.41
Butterworth	2.95	1.93	2.01	2.06	0.02	0.16
Christiano-Fitzgerald	2.84	1.86	1.46	1.93	0.43	0.69
Univariate and Multivariate	**Potential GDP Growth Rate**				***Output gap***	
Kalman Filters (UVF and MVF)	1991–2015	1999–2015	2014	2015	2014	2015
UVF	--	1.96	1.98	2.17	-0.38	-0.17
MVF: Phillips Curve and Okun's Law	--	1.95	1.53	1.99	0.00	0.40
Average of All Models	**2.90**	**1.93**	**1.72**	**2.00**	**0.03**	**0.32**

Source: Fund staff estimates.

Investment analysis: Average private investment in El Salvador during 2008–13 was below 12 percent of GDP, the lowest in the region. Based on regression analysis, increasing El Salvador's competitiveness, the quality of economic institutions to regional levels, and reducing political uncertainty from frequent electoral cycles would raise private investment between 1 to 6 percent of GDP. If competitiveness scores and institutional quality levels reach the highest scores in the region (Costa Rica and Panama, respectively), the investment ratio increases by about 1¼ and 6 percent of GDP, respectively. Furthermore, investment increases by 1–2 percent of GDP if debt levels drop to 40 percent of GDP.



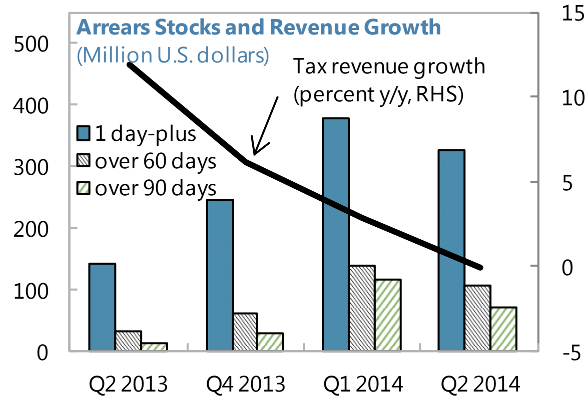
Source: ICRG and Fund staff estimates.

[1] See the 2014 *Selected Issue Papers*.

4. **Low unemployment, but a large informal economy.** The unemployment rate is relatively low (5.9 percent in 2013). This, however, masks the less favorable underlying employment situation given extensive underemployment (28 percent of urban employees either work part-time or receive below-minimum wage) and the large informal economy (about 60 percent of labor force). Private sector minimum wages are not high compared to the region, despite the 4 percent increases in June 2013 and January 2014. However, they are set to rise by another 4 percent in January 2015, which, along with high growth in public wages, may impact competitiveness.

5. **High fiscal imbalances.** The fiscal deficit has been about 4 percent of GDP since 2010, generating annual gross financing needs of around 8–9 percent of GDP, which is significant for a country with the domestic market size of El Salvador, creating periodic financing pressures and

the need to tap external markets (Figure 2). Despite the strong revenue performance through 2013, the fiscal deficit has remained high due to an expanding wage bill and current transfers, as well as pre-electoral spending. In 2013–14, however, revenue growth was weakened by the Constitutional Court reversal of some earlier tax measures. The worsening financing situation resulted in public investment cuts, and an accumulation of payment arrears. The US$800 million Eurobond—issued in September at 6.4 percent yield—has eased immediate financing pressures and allowed a sizable reduction in arrears. However, the public debt stock is likely to rise above 60 percent of GDP by end-2014.



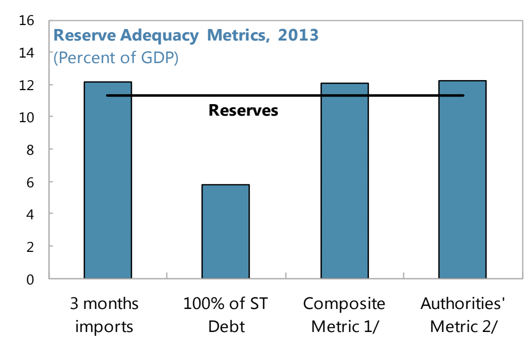
Source: Ministry of Finance of El Salvador.

6. **Weakening competitiveness.** The current account deficit deteriorated in recent years due to a decline in private saving/investment balance and the absence of fiscal consolidation (Figure 3). In 2013, it reached 6½ percent of GDP as exports faced broad-based weaknesses, including from the coffee leaf-rust disease. With very low FDI, the 2013 current account deficit was mostly financed by commercial bank and corporate borrowing, and a drawdown of international reserves.[1] The external position improved in H1 2014 due to lower imports, services exports, and recovering remittances. For the whole year, it is expected to be about 5½ percent, also reflecting the recent drop in oil prices. El Salvador's real effective exchange rate is slightly overvalued (by 2 to 9 percent), and non-price indicators point to a growing competitiveness gap (see Annex II). Reserve coverage is slightly below the IMF's composite metric and the authorities' own goal (of about 12 percent of GDP). However, staff's preferred metric (which is more tailored to a fully-dollarized country requiring fiscal and financial sector buffers) implies a greater shortfall relative to an assessed adequate level of reserves of around 17 percent of GDP.[2]

El Salvador: Exchange Rate Assessment Results

EBA-lite methodology	Cyclically-adjusted CA norm1/	Cyclically-adjusted CA deficit1/	Total gap	REER3/
	-5.5	-6.5	-0.9	2.3
CGER-like methodologies	Current account balance2/			REER3/
	Norm	Underlying		
Macroeconomic balance	-4.8	-6.2		2.3
External sustainability	-2.3	-6.2		6.5
Equilibrium Real Exchange Rate4/				8.6

Source: Fund staff estimates and projections
1/ Percent of GDP. Information for 2013.
2/ Percent of GDP.
3/ (+): overvaluation. Country elasticities based on Tokarick (2010).
4/ Misalignment for 2013



Sources: National authorities and Fund staff estimates.
1/ Consistent with 100 percent of the IMF composite metric.
2/ Includes the authorities' plans for coverage of 8 percent of deposits.

[1] Corporate borrowing may include borrowing by ALBA Petroleos—a joint venture between Venezuela's PDVSA and some municipalities—allowing for deferred payments over 25 years for 40 percent of Venezuelan oil imports.

[2] See Annex II of IMF Country Report No. 13/132 for additional details of staff's preferred metric.

PROSPECTS AND RISKS

7. **Outlook:** Under current policies, growth is expected to be around 2 to 2¼ percent in 2014 and 2015, and reach about 2½ percent in 2016–18 reflecting private and public investment projects expected to come on stream, including those financed under the U.S. Millennium Challenge Corporation (Fomilenio II). Growth would revert to potential as these projects wind down. Dollarization would anchor inflation at 2 percent over the projection period. The reduction in current account deficit in 2014–15 is expected to unwind from 2016 due to receding terms of trade gains and a fiscal deficit widening to 5½ percent of GDP by 2019. Public debt is expected to rise to over 70 percent of GDP by 2019 (Annex III).

El Salvador: Medium-Term Scenario
(In percent of GDP, unless otherwise noted)

		Projections					
	2013	2014	2015	2016	2017	2018	2019
Real GDP growth (percent)	1.7	2.0	2.2	2.4	2.6	2.3	2.0
Inflation (percent, end of period)	0.8	2.0	2.0	2.0	2.0	2.0	2.0
Nonfinancial public sector balance	-4.1	-4.0	-4.4	-4.6	-4.8	-5.1	-5.5
Primary balance	-1.6	-1.5	-1.7	-1.6	-1.6	-1.6	-1.6
Public sector gross debt	57.8	60.0	61.9	63.9	65.9	68.5	71.4
External current account balance	-6.5	-5.5	-4.9	-5.6	-6.5	-6.3	-6.2

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

8. **Risks**: Global uncertainties linked to the normalization of U.S. monetary policy or a deteriorating economic outlook for advanced and emerging markets have the potential to interact with domestic vulnerabilities and create significant downside risks (Table 1).

- **Risks from abroad:** Higher-than-expected global interest rates may increase borrowing costs and worsen the public debt dynamics (since some 43 percent of public debt is at floating rates linked to the U.S. LIBOR). An unexpected increase in global risk aversion could limit access to international capital markets, which may trigger a costly and disorderly adjustment. On the upside, a sustained further fall in oil prices could lessen external imbalances and have some positive growth effects, although these would be partly offset by consumption imports and a limited supply-side response of the economy to the better terms of trade. Similarly, better-than-expected growth in the U.S. would have positive spillovers to El Salvador through remittances and trade.

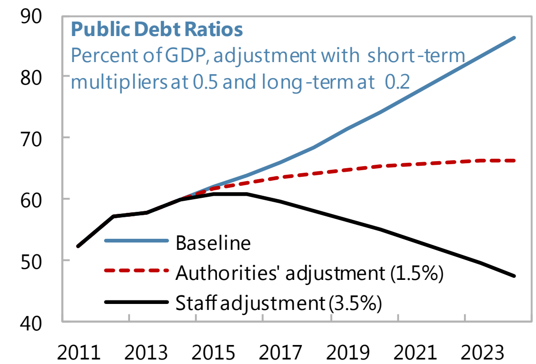
- **Domestic risks***:* A worsening of domestic policies—including through a rise in public spending in the run-up to the March 2015 election—could further weaken fiscal and external balances. Poor security, political fragmentation, and vulnerability to natural disasters pose further downside risks. Growth could also be lower if the expected investment projects face execution or financing delays. A prospective downward statistical revision to GDP could worsen investors' perceived country risk.

9. **Authorities' views.** The authorities argued that staff's baseline was too pessimistic and some risks were exaggerated. They forecast growth of 2.2 percent in 2014 and 3.1 percent in 2015. They cited stronger spillovers from the U.S. recovery, higher investment levels and more favorable investment multipliers than those envisaged by staff. The authorities acknowledged

that higher global interest rates were a possibility, but did not consider this a significant risk for 2015. They were confident that the need for further Eurobond issuance in 2015 and even 2016 was low, and regarded any constraints on market access as unlikely given their successful track record of domestic and international bond issuances.

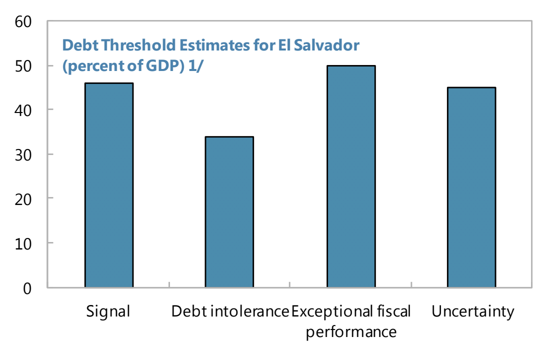
A PHASED FISCAL CONSOLIDATION

10. **Common ground on the need for fiscal adjustment.** There is agreement among the government, political parties, and the private sector about the need to lower fiscal imbalances and reverse the upward trend in debt dynamics. The draft fiscal responsibility law (FRL), submitted to parliament in May 2014, commits to an adjustment of 1½ percent of GDP over a 3-year period, split evenly between current spending restraint and revenue increases. Tax measures were adopted in July 2014—a financial transactions tax (FTT), a 1 percent tax on net assets, the elimination of an income tax exemption on publishing companies, and naming-and-shaming of tax delinquents—but staff estimates that these will only deliver a fraction of the promised adjustment (0.1–0.2 percent of GDP in the long-term, although short-term savings from the FTT could be higher). The remaining measures have yet to be identified or legislated, and may include a luxury property tax and spending cuts. Even if the planned adjustment was fully implemented, it would still be insufficient to prevent a steady increase in public debt over the next decade.



Source: Fund staff estimates and projections.

11. **A more ambitious effort—of 3½ percent of GDP during 2015–17—is needed to achieve debt sustainability**. This adjustment could be spread over 3 years to minimize potentially adverse growth effects, but some frontloading would also help lessen near-term financing risks. Such an adjustment would offset spending slippages and fiscal costs from past reversals of the pension reform (see ¶15) which necessitated substantial transfers from the budget for pension payments. The adjustment will help reduce debt to below 50 percent of GDP by 2024), a level that is consistent with broader debt sustainability (Box 2; see also text table below on a potential fiscal adjustment scenario). The authorities' intentions, as expressed in the FRL, are a good first step and the latest Eurobond issuance helps buy some time to undertake the adjustment. The recent decline in oil prices may also help improve fiscal accounts through lower subsidy spending (particularly on liquefied petroleum gas (LPG)), but staff estimates that such savings would be small (0.1 percent of GDP).



Source: Fund staff estimates and projections.
1/ Methods are described in Annex VI of the staff guidance note to the DSA. (https://www.imf.org/external/pubs/ft/dsa/mac.htm).

Regardless, these favorable developments should not lead to complacency or underestimation of the urgent need for fiscal adjustment. Rather, the uncertainty and risks linked to global interest rates and the market's willingness to continue financing El Salvador should lead to a reinvigorated effort to lower the public sector deficit and build fiscal buffers. Caution should be exercised in spending to limit the 2014 deficit to 4 percent of GDP but without accumulating arrears or creating a large drop in public investment. For 2015, lowering the deficit by around 1½ percent of GDP would represent an important down-payment on the path of fiscal adjustment. Over the next two years, the deficit could then be lowered by around 1 percent of GDP each year.

El Salvador: Comparison of Medium-Term Scenarios 1/

(In percent of GDP, unless otherwise noted)

	Projections					
	2014	2015	2016	2017	2018	2019
Real GDP growth (percent)						
Baseline	2.0	2.2	2.4	2.6	2.3	2.0
Adjustment	2.0	1.5	2.0	2.3	3.0	2.9
Nonfinancial public sector balance						
Baseline	-4.0	-4.4	-4.6	-4.8	-5.1	-5.5
Adjustment	-4.0	-3.0	-2.2	-1.3	-1.2	-1.2
Primary balance						
Baseline	-1.5	-1.7	-1.6	-1.6	-1.6	-1.6
Adjustment	-1.5	-0.4	0.7	1.6	1.7	1.9
Public sector gross debt						
Baseline	60.0	61.9	63.9	65.9	68.5	71.4
Adjustment	60.0	60.9	60.7	59.5	58.0	56.5
Gross fiscal financing requirement						
Baseline	9.1	7.3	8.6	8.1	8.4	11.3
Adjustment	9.1	5.9	6.2	4.6	4.5	7.0
Unidentified fiscal financing						
Baseline	0.0	1.4	3.2	2.7	3.0	3.2
Adjustment	0.0	0.0	0.8	0.0	0.0	0.0
External current account balance						
Baseline	-5.5	-4.9	-5.6	-6.5	-6.3	-6.2
Adjustment	-5.5	-4.3	-4.0	-3.7	-3.9	-4.1

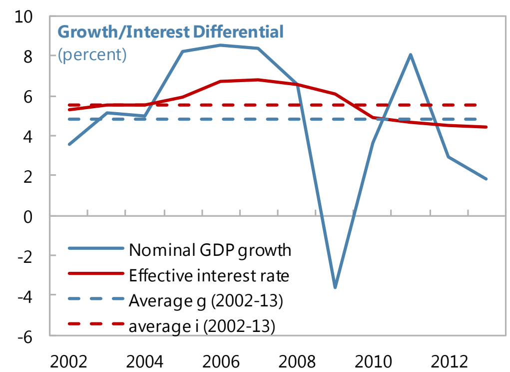
Sources: Central Reserve Bank of El Salvador, Ministry of Finance, and Fund staff estimates.
1/ The adjustment scenario is predicated on (i) a cumulative effort of 3.5 percentage points of GDP in 2015–17, including 1.5 percentage point effort in 2015 (anchored by a VAT increase of 2 percentage points as of January 1, 2015); (ii) impact fiscal multiplier of 0.5 and cumulative multiplier of 0.2; and (iii) positive growth effects of structural reforms (0.3 pp in 2018, 0.7 pp in 2019).

Box 2. Sizing Up a Sustainable Level of Public Debt for El Salvador

The highest debt/GDP ratio consistent with El Salvador's debt sustainability is assessed to be 40–50 percent. To identify a prudent range for El Salvador's public debt, several methodologies were tested:

The Signal Approach minimizes the noise-to-signal ratio during debt distress episodes. For El Salvador, this yields a public debt limit of 46 percent of GDP. The calculation is, however, sensitive to the definition of a debt distress event.

Debt Intolerance Approach infers country-specific debt targets based on determinants of investor ratings. The analysis (Bannister and Barrot, 2012) estimates a debt tolerance of up to 34 percent of GDP, below which the country would be considered sub-investment grade. Such an "investment grade threshold", however, may be a tougher standard than the level consistent with debt sustainability.

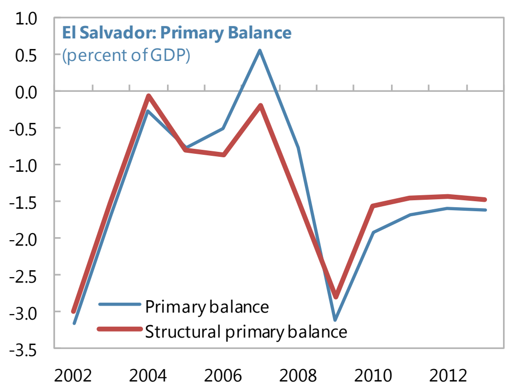


Source: Fund staff estimates.

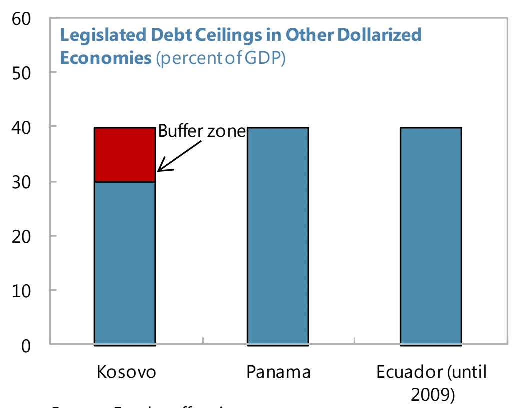
Exceptional Fiscal Performance Approach assesses the maximum debt consistent with a highest primary balance, contingent on a realistic outlook for the interest-growth differential. For El Salvador, the historically negative average growth-interest rate differential is expected to continue. Given that the maximum primary surplus achieved was 0.6 percent of GDP (in 2007), it suggests that public debt should not exceed 50 percent of GDP.

An Uncertainty Approach takes the level of debt consistent with an exceptional fiscal performance and builds in a buffer to handle the likelihood of reasonable shocks to the fiscal position and the interest-growth differential. On this basis, the debt threshold is estimated at about 45 percent of GDP.

Comparing with other fully-dollarized economies with an explicit debt limit in their fiscal framework, a "safe" level of debt is estimated at around 40 percent of GDP.



Source: Fund staff estimates.



Source: Fund staff estimates.

12. **A menu of revenue and expenditure measures to achieve the needed adjustment could include:**

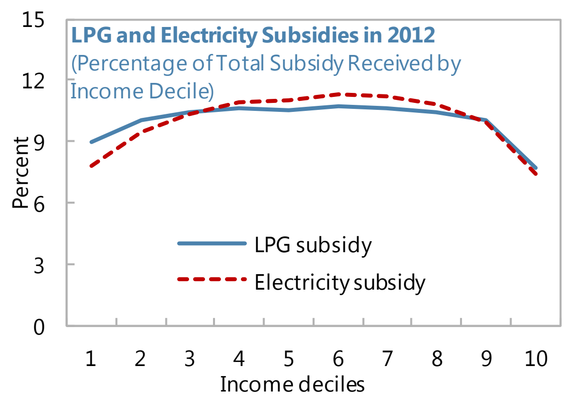
- A VAT increase of 2 percentage points to 15 percent (a level that is broadly aligned with the region), alongside an expansion of well-targeted social assistance programs to mitigate the impact on the poor;

- A hiring freeze and limits on wage increases, including the elimination of the indexation implicit in the *escalafon* (a scheme that provides certain public sector workers with large automatic wage increases, not linked to performance);
- Rationalization of poorly targeted subsidies especially for electricity and LPG (subsidies that accrue to those above the 60th income percentile cost around 1 percent of GDP each year);
- Improving the efficiency of spending on goods and services (particularly in public health administration);
- Phasing in a full-fledged property tax (El Salvador is a rare case in the region without this progressive tax).

Potential Menu of Measures in 2015–17 1/
(Cumulative, percent of GDP)

Measures:	**4.0**
VAT increase to 15%	1.2
Targeting subsidy (excluding pensions)	1.0
Wage bill	0.8
Adoption of full-fledged property tax	0.6
Saving in good and services	0.6
Removal of tax exemptions	0.1
Social support to offset regressive effects	-0.3

Source: Fund staff estimates.
1/ The amount of measures exceeds the staff-recommended adjustment of 3.5 percent of GDP in order to provide more options to the authorities.



Source: Inter-American Development Bank.

13. **The growth implications of the adjustment.** There would likely be a negative growth effect from the proposed fiscal adjustment. Based on conservative multipliers,[3] growth would decline to 1½ percent in the near-term but, with the benefit of supply-side reforms and lower fiscal and external vulnerabilities, growth could accelerate to 3 percent by 2018–19. The adverse short-term growth effects could be more muted if the fiscal effort succeeds in generating positive confidence effects. However, the near-term growth effects should not justify inaction as the benefits would outweigh the costs. Public debt would be lower by 15 percent of GDP in 2019 relative to the baseline, the current account deficit would fall to around 4 percent of GDP, and there would be no fiscal financing gap after 2016. Thus, undertaking the adjustment preemptively in the next few years would lower the probability of a disorderly market-led adjustment, which would be very costly in terms of likely output losses.

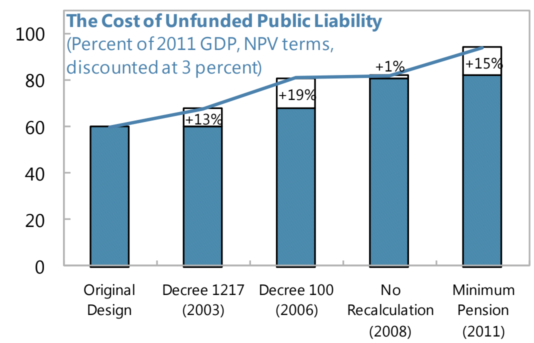
14. **Authorities' views.** The authorities agreed with the need to reduce fiscal imbalances, but disagreed with the recommended size and pace of the proposed adjustment. They were

[3] Estevao and Samake (2013) estimate short-term multipliers in the range of 0–0.2 for El Salvador, with the highest estimated impact multiplier for Central America being 0.5.

concerned that the adverse consequences for growth could be larger than the projected 0.5–0.7 percentage points, and could impact social stability. They expected fiscal financing costs to remain relatively low and stressed that the bulk of the fiscal deficit (about 2 percent of GDP) and debt (11 percent of GDP at end-2013) was linked to imbalances in the pension system. Thus, they considered a smaller and more gradual non-pension fiscal adjustment as striking a reasonable balance between fiscal sustainability and inclusive growth. At the same time, they proposed addressing pension-related imbalances on a separate track over a longer horizon (¶15 and 18). The authorities argued that their preferred adjustment could be achieved by revenue-based measures including a wealth tax and crackdowns on tax exemptions in particular sectors. They did, however, indicate that the potential for subsidy rationalization would be examined after the March elections.

STRENGTHENING THE FISCAL FRAMEWORK

15. **Pension reforms**. The unfunded pension liability has been estimated at 94 percent of GDP, reflecting an overly generous defined benefit (DB) system (which is being phased out) and "top-ups" in the benefits for the defined contribution (DC) system (that are not linked to the rates of return on the system's invested assets). Reforms are necessary to deal with risks to fiscal and social sustainability from the imbalances in the system (Box 3), such as: (i) an increase in the retirement age, (from 55 years for women and 60 for men, among the lowest in the region); (ii) longer contribution periods; (iii) adjusting pension benefits in the DB system; and (iv) a progressive taxation of pension income within the existing personal income tax. The fiscal impact of these reforms would likely be small over the next few years, but would grow over the medium term. Avoiding future top-ups to the defined contribution system is also essential. Any pension system solution should also avoid "accounting" fixes that do little to change the underlying imbalances but cosmetically help improve the near-term fiscal position.



Source: Superintendency of Financial System of El Salvador.

El Salvador: Effects of Selected Pension Measures on Reducing Unfunded Pension Liability 1/ 2/
(In percent of 2011 GDP, NPV terms)

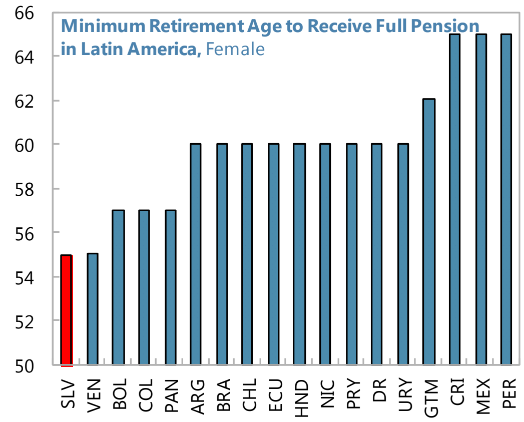
Changing the method of calculating benefits in the new system	19
Increasing minimum contributions period to 30 years	11
Raising retirement age by 5 years	9
Raising contribution rates from 13 to 15 percent	4

Source: Superintendency of Financial System of El Salvador.
1/ The effect of each measure is partial and could be diferengt in a package.
2/ The calculation does not take into effect the beneficial effects of these reforms on raising replacement rates in the new system, which are very important for improving social sustainability.

Box 3. An Unsustainable Pension System

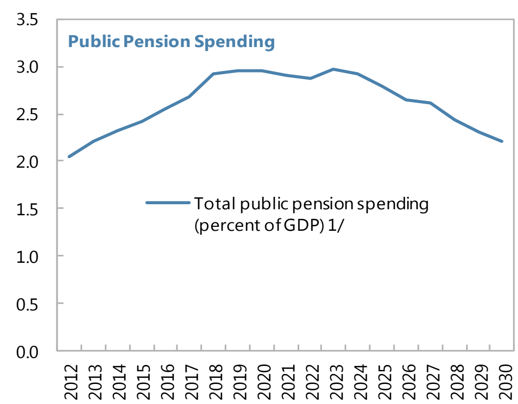
Ambitious pension reform is essential to contain fiscal risks and make the system sustainable. Progress requires a broad dialogue and a public campaign highlighting its unsustainability and the need for a fundamental solution.

Background. Since 1998, El Salvador has been moving toward a fully-funded, defined-contributions (DC) pension system. The reform entailed substantial fiscal "transition costs" as most of the contributions accrued to the private pension funds for future pension payments, but current pension obligations had to be budget financed. Also, over the past decade, there were periodic decisions to "top-up" benefits under the DC system—mostly aiming to match it with the defined benefits (DB) of the old segment—making the transition protracted and more costly. Dependence on budget support remains heavy, including for the still-large "grandfathered" DB segment that offers generous benefits The transition has also distracted attention from parametric reforms like raising retirement age, which is among the lowest in the region.



Source: Superintendency of the Financial System of El Salvador.

Current shortcomings. (i) Pressures for discretionary increases in benefits are a key source of instability and vulnerability; (ii) unfunded liabilities are estimated at 94 percent of GDP in NPV terms; (iii) future replacement rates are projected to almost halve; (iv) coverage, participation, and contribution payments are low (partly due to the expected fall in future replacement rates); (v) benefits are highly unequal across pensioners, and (vi) there is poor diversification and low financial returns in the assets of the private pension funds, partly because they are mandated to buy government pension bonds at very low rates.



Source: Superintendency of the Financial System of El Salvador.
1/ Includes issuance of recognition bonds (CIP-B), which are not included in fiscal accounts.

Projections and risks. Pension payments will significantly burden the fiscal accounts at least for the next 15 years, adding to an already-high public debt. Significant risks also arise from potential new policy initiatives including extending a "top-up" to the cohort who are currently expected to receive fully-private pensions. This would put the unfunded liability near 200 percent of GDP.

Elements of a solution. In 2013, the government evaluated some parametric reforms (e.g., raising retirement ages, adjusting benefits, and contribution rates), and concluded that aligning parameters to international levels eliminates only about one-third of the estimated unfunded liability. Beyond its fiscal impact, a parametric reform would also raise replacement rates, thereby limiting the risk of further top-ups. In staff's view, an effective reform strategy should be comprehensive and include: (i) full costing of key policy options and risks that are integrated and regularly updated within a DSA; (ii) an ambitious package of parametric reforms; (iii) progressive taxation of pension benefits, to mitigate highly unequal benefits; and (iv) clearly identifying the residual budget support needs to maintain the viability of the system for current contributors.

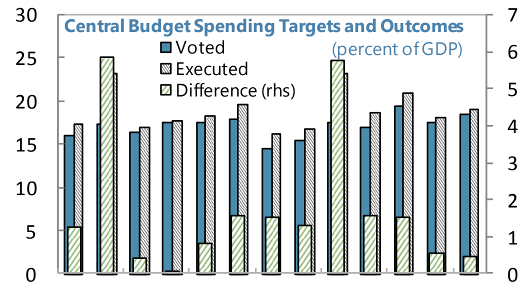
16. **Improvements to the Fiscal Responsibility Law:** The societal dialog triggered by the draft FRL highlights the need for institutional mechanisms to guarantee fiscal discipline. The draft law makes progress in several procedural aspects—e.g., fiscal transparency, cash management, medium-term orientation, and budget process—but needs improvement in other dimensions (Box 4). In particular, the numerical fiscal rules need to (i) prioritize among the multiple (and sometimes inconsistent) fiscal "anchors"; (ii) adopt mechanisms to automatically correct slippages from the targeted medium-term path, and (iii) introduce well-defined escape clauses to allow for policy flexibility during severe economic downturns.

17. **Enhancing public financial management (PFM).** Enhancing the monitoring of spending arrears and creating a more robust system for measurement and control of spending commitments is needed. Fiscal transparency would also benefit from a systematic recording of contingent fiscal liabilities into the budget and the government's accounts (including those linked to pensions and PPPs). This could be complemented by a detailed fiscal risk statement in the annual budget proposal. Finally, transactions with PetroCaribe (if undertaken by the nonfinancial public sector) should be reported in the budget documents and to the public.

18. **Authorities' views**. The authorities agreed that pension reforms are important for fiscal and social sustainability. They committed to action in this area after the March elections, although they do not yet have a clear plan. Counterparts were open to incorporating additional technical recommendations on the FRL, but noted that making changes now would depend on the ability to secure political compromises, noting that several draft versions of the FRL were currently circulating in the Legislative Assembly. Improvements in PFM and fiscal transparency are being considered as part of the FRL, building on recent progress in publishing more comprehensive fiscal information through the Ministry of Finance's transparency portal.

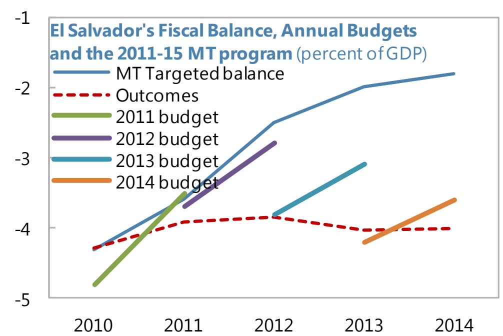
Box 4. Designing an Effective Fiscal Framework for El Salvador

The draft fiscal responsibility law (FRL) is a step forward, offering an opportunity to enhance budget procedures and anchor fiscal policy. However, some modifications are needed to better achieve its goals.



Sources: Ministry of Finance of El Salvador and Fund staff estimates.

Background. El Salvador's fiscal framework: (i) has incomplete coverage of different government levels; (ii) allows higher spending with routine legislative approval if new financing becomes available; (iii) has highly rigid spending (80 percent of spending is deemed "mandatory"); (iv) incompletely identifies general government financing needs and sources in the annual budget (excludes short-term debt, tax refunds, and some future debt issuances and repayments); (v) lacks a medium-term (MT) orientation, and (vi) is typically based on optimistic macroeconomic projections. These problems have contributed to chronic slippages in fiscal outturns relative to targets and an upward drift in spending. Thus, high deficits have become entrenched, raising the risks of periodic financing strains.



Source: Ministry of Finance of El Salvador.

FRL. The draft law aims to address these problems via: (i) a 10-year planning horizon, with a commitment to 1½ percent of GDP adjustment in the first 3 years; (ii) a set of numerical fiscal rules (limiting non-pension public debt at 42 percent of GDP by 2023, non-pension primary deficit targets for 2014–2023, a floor on the tax-GDP ratio (17 percent), a ceiling on current spending (19 percent of GDP) with sub-limits on the wage bill (9 percent of GDP) and goods and services (3½ percent of GDP); and (iii) an array of supporting procedures that include incorporating annual budgets in a MT fiscal framework, limiting public spending in the initial months of electoral years, enhanced reporting by subnational governments, explicit budgeting for tax refunds, reducing scope for short-term debt financing, provisioning to save part of revenue over-performance during the budget year, and escape clauses from numerical targets due to natural or security emergencies.

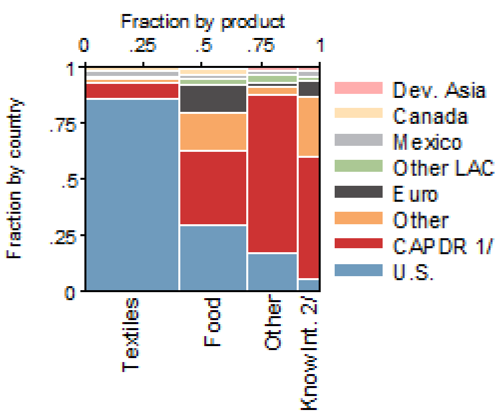
Assessment. The proposed FRL represents important progress. However, several revisions could significantly improve the FRL.

- **Procedural improvements:** (i) a "pay-as-you" go rule could be included for tax reductions or spending initiatives that requires offsetting measures to preserve the primary deficit target and contain any within-year spending drift (e.g., Colombia); (ii) an independent professional body to provide macroeconomic and fiscal projections and limit the optimistic bias in budgetary projections (e.g., Chile); and (iii) a substantial reduction in the constraints on spending to improve reallocational efficiency.
- **Numerical rules improvements**. A more effective rules-based framework would include: (i) an adjustment effort that would credibly deliver sustainable public debt; (ii) streamlining and prioritizing the multiple numerical fiscal objectives—limited to either the overall debt or deficit—focusing on achieving debt sustainability; (iii) an automatic corrective mechanism in this debt/deficit anchor to restore the fiscal position on track following slippages; and (iv) broader escape clauses to cover economic emergencies.

BOOSTING GROWTH AND COMPETITIVENESS

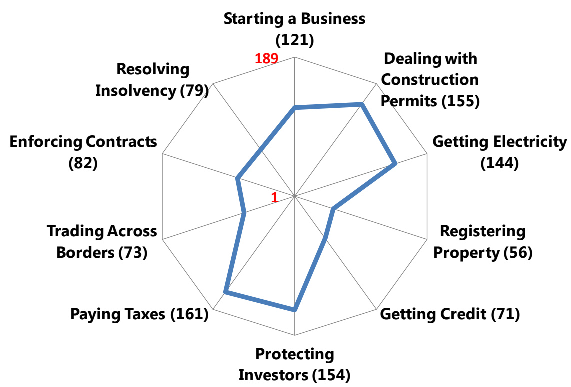
19. **Headwinds to potential growth.** A weak business environment (as typified by El Salvador ranking 84 out of 144 in the Global Competitiveness Survey), combined with low productivity and high crime, has depressed potential growth to about 2 percent.' These factors have discouraged domestic and foreign investment, undercut competitiveness, weakened activity in the tradables sector, and fueled a large informal economy. Exports are relatively low and undiversified both geographically (with the bulk going to the U.S. and Central America) and in composition (concentrated in low value-added sectors and textiles). These growth headwinds are exacerbated by the policy uncertainty associated with frequent election cycles.

El Salvador: Exports by Country and Sector, 2012



Sources: WITS and COMTRADE.
1/Other CAPDR includes Costa Rica, Honduras, Nicaragua, El Salvador, Panama, and the Dominican Republic.
2/ Knowledge intensive products include transport, electrical equipment, machinery, and chemicals.

Doing Business Environment



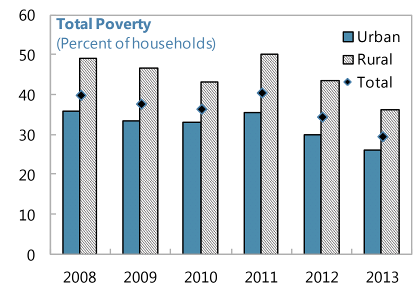
Source: Doing Business database, 2015.

20. **Steps to boost potential growth.** The authorities' goal of reaching 3 percent growth on a sustained basis is achievable if supported by far-reaching structural reforms that enhance productivity and attract investment. There is a common diagnostic across the government and the private sector on the important elements of such a growth-promoting strategy. These include promoting economic diversification, reducing red-tape, increasing access to finance (particularly for SMEs), improving access and lowering the costs of energy, enhancing legal and physical security, and upgrading physical infrastructure. The 2014–19 *Plan Quinquenal* appropriately seeks to promote job creation, education, and security. Staff discussed the authorities' productive transformation policy and welcomed their focus on promoting private sector investment and tradable sector development. In addition, the FOMILENIO II grant offers an opportunity to accelerate structural reforms to help raise productivity and competitiveness. Steps to address organized crime, including by effectively implementing the AML/CFT and anti-corruption frameworks, are also critical. Tangible progress to address these issues has, however, been limited. Staff recommended moving quickly to resolve the remaining bottlenecks to efficient implementation of investment projects, including PPPs, implementing the proposed "regulatory guillotine" project to simplify business regulations, and channeling more resources to SMEs via the development bank (BANDESAL).

Box 5. Tackling Inequality and Fostering Inclusive Growth

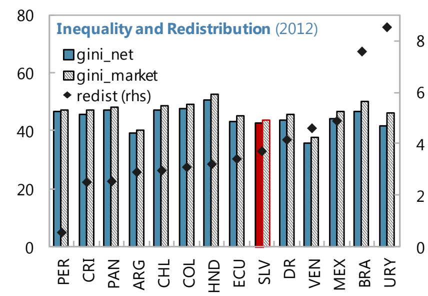
Poverty and inequality in El Salvador have improved but there is still a long way to go.

Inequality has fallen. El Salvador's Gini declined from 54 in 2000 to 41 in 2012, helped by redistributive policies. Still, inequality remains high by global standards (the global Gini is 37). Poverty has been declining from 35 percent in 2005 to about 30 percent of the population in 2013. Rural poverty has declined but remains about 10 percent higher than urban poverty. Inequalities also prevail in education outcomes—average years of schooling are 9.2 years in urban areas but only 5.6 years in rural areas. Illiteracy is also significantly higher in rural areas.



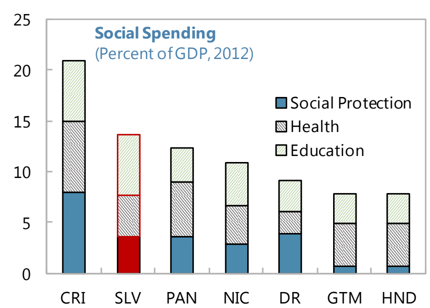
Sources: National household surverys and Fund staff estimates.

Social spending is high and poorly targeted. Spending on education, health, and social protection grew rapidly after 2008, and is among the highest in Central America. However, untargeted school uniform and food programs have accounted for much of the increase in education spending, and about half of it accrues to middle- and high-income households. Despite increased spending, school enrollment rates and test scores have lagged. Likewise, spending on health has increased but access to basic health services for the poor remains limited. Improving efficiency of health and education spending could bring sizeable gains in life expectancy (by 3 years) and school enrollment (25 additional students for every 100 students) at a relatively small fiscal cost (Grigoli (2014) and Grigoli and Kapsoli (2013)).



Sources: Penn World Tables 7.1, SWIID 3.1, and Fund staff estimates.

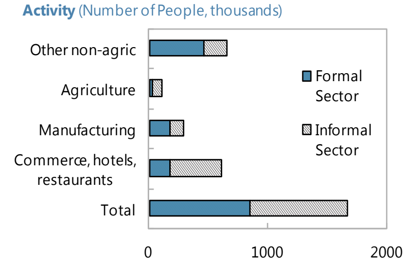
Subsidies are mostly untargeted. Fuel subsidies are the highest in the region, and electricity subsidies are third highest. Higher income deciles benefit from about 40 percent of the LPG subsidies, 50 percent of electricity subsidies, and 70 percent of transportation subsidies. In addition, 60 percent of cross subsidies on water mostly accrue to (wealthier) urban consumers. Eliminating such subsidies while providing a more generous safety net for poorer households could generate fiscal savings of up to about 1 percent of GDP.



Sources: CEPALSTAT, World Health Organization, and Fund staff estimates.

High informality impedes more inclusive growth. Informal employment is about 60 percent of total employment (largely in commerce, hotels, and restaurants). The informal economy is characterized by low productivity, low labor quality, little worker protection, and low and depreciating human capital. There are few opportunities or incentives to move from the informal to the formal sector even though such a move would allow firms to grow, be more productive, and generate employment. Incentives for higher formal labor market participation and lowering migration are key to improving inequality and creating more inclusive growth.

Formal vs Informal Employment in 2013, by Economic Activity (Number of People, thousands)



Sources: National household surveys and Fund staff estimates.

21. **Tackling inequality.** Important progress has been achieved in lowering poverty and income inequality, but these indicators are far from where they need to be to establish a reasonable standard of living (Box 5). Faster and sustained growth will help alleviate poverty and inequality. However, given budget financing constraints, priority should be on (i) better targeting and expanding coverage of the existing conditional cash transfer programs (which cover only a third of those living in poverty); (ii) directing public resources toward raising the effectiveness of health and post-primary education spending; and (iii) rationalizing subsidies to electricity and LPG, since such subsidies largely accrue to higher income groups.

22. **Authorities' views.** The authorities noted that their productive transformation policy—which identifies 6 priority sectors for development—will address the key bottlenecks to the development of the tradable sector. They also pointed to specific plans in multiple areas including electricity generation, light manufacturing, and tourism. PPP projects for airport expansion and renewable energy were expected and a framework for such projects has been legislated. Draft laws are also being prepared to reduce red-tape and provide legal stability by guaranteeing unchanged regulations and taxes for a period of time for investors. The authorities also expressed a strong commitment to maintaining and expanding their existing social programs and prioritizing the financing of such programs.

BUILDING A ROBUST FINANCIAL SECTOR

23. **A broadly sound banking system.** The mostly foreign-owned banking sector is highly liquid and reports strong capital positions, with low non-performing loans (NPL) and high provisioning (Figure 4). The shift to risk-based supervision is ongoing. Credit growth has been moderate (7 percent in 2013–14), but partially funded by external borrowing in the absence of corresponding deposit growth, creating an inherent vulnerability.

24. **Bolstering the institutional framework in the financial system:** Implementation of outstanding financial reforms recommended in the 2010 FSAP and the more recent Financial Stability Strategy (Table 2) would strengthen the institutional underpinnings for financial sector stability. Specifically:

- The legal framework for bank resolution needs amending, including eliminating the requirement to notify an affected bank 3 days before potential resolution measures are implemented, and accelerating the provision of bank recovery and resolution plans for each bank.

- Additional funding needs to be secured to back the public LOLR facility, building on an initial US$100 million credit line from the IDB. Also, a complementary Financial Stability Liquidity Fund should be created by pooling a small part of banks' required reserves. Use of the latter mechanism should be conditioned on strict requirements on the solvency of those banks that draw resources from the fund and a clear decision-making framework to provide such support.

- Crisis management procedures need improvement through an updated memorandum of understanding between the central bank, the superintendency, and the deposit guarantee institute to strengthen interagency cooperation and coordination. Establishing a permanent financial sector stability committee with clear legal powers to decide on systemic cases and help design prudential norms for systemic institutions would be a critical step forward.

- Developing a well-functioning secondary market for LETES, including building a yield curve that could be monitored by market participants, would make public debt instruments more liquid (particularly given LETES currently qualifies as a liquid asset for the purposes of fulfilling the 3 percent Liquid Assets Requirement).

25. **Authorities' views.** The authorities highlighted their progress in improving the institutional framework for financial stability. The central bank is exploring options to create a pooled reserve fund that would be fuelled by an IFI credit line and a portion of the banks' reserve requirements. There is a need, however, to build broader political and societal support for such measures in order to secure legislative approval.

STAFF APPRAISAL

26. **El Salvador's growth has been modest and macroeconomic vulnerabilities are rising.** The persistently low growth reflects both domestic policy weaknesses and a fragile external environment. Public debt dynamics are becoming unsustainable, the fiscal and current account deficits have grown, and gross financing needs are sizable.

27. **The new government has an opportunity to build on the emerging broad social and political consensus to address the economic imbalances and social challenges.** There is agreement on the need to strengthen the foundations for growth, address the country's fiscal imbalances, and deepen efforts to support the poor. Progress has been achieved in recent years to raise tax revenues, lower inequality, and maintain financial stability, but significant challenges remain. The ongoing parliamentary discussion of the draft FRL has brought fiscal issues to the forefront. However, the support for the necessary fiscal adjustment is lacking, and social and political pressures ahead of the 2015 congressional elections are delaying effective policymaking.

28. **An ambitious fiscal adjustment that protects social spending should be a top priority.** With medium-term gross financing needs projected to remain high, policies must focus on mitigating potential risks posed by a future increase in global risk aversion or higher global interest rates. A fiscal adjustment of around 3½ percent of GDP over the next three years will help maintain access to market financing on favorable terms and place debt on a sustainable path, while reducing the risks of a disorderly macroeconomic adjustment. The adjustment would likely have an adverse growth impact, but it could accelerate to 3 percent in the medium term with the benefit of supply-side reforms. The fiscal adjustment should occur alongside an increase in targeted social spending to protect the most vulnerable and lessen income inequality. A

broader strategy will also be needed to attain a sustainable pension system and strengthen budget procedures.

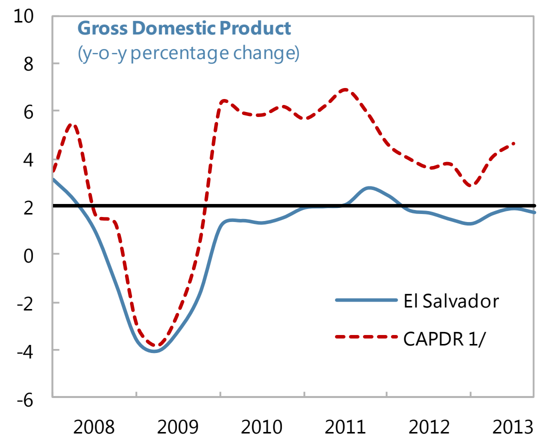
29. **A better business environment is imperative to enable private-sector led growth.** Raising potential growth to 3 percent is an achievable goal but will require determined and ambitious supply-side reforms that substantially raise productivity and competitiveness and improve security. The envisaged steps to bolster public investment and promote economic transformation by diversifying the energy matrix, prioritizing key manufacturing and tradable service sectors, and upgrading infrastructure. Reforms to reduce red-tape and bureaucracy, increase financing for SMEs, improve access to energy and lower its costs, and better security should be quickly legislated to attract high-quality private investment. FOMILENIO II offers an opportunity to accelerate such reforms.

30. **Improving the institutional framework for the banking sector is important.** Financial indicators generally appear sound, a product of ongoing prudent supervision and regulation. Nonetheless, there is still scope to upgrade the legal framework for bank resolution and install an appropriately funded safety net for the banks.

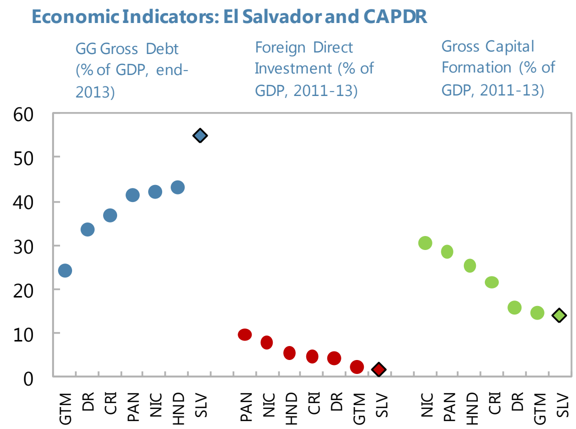
31. **Staff recommends that the next Article IV Consultation be held on the standard 12-month cycle.**

Figure 1. El Salvador: Long-Term Growth and Poverty

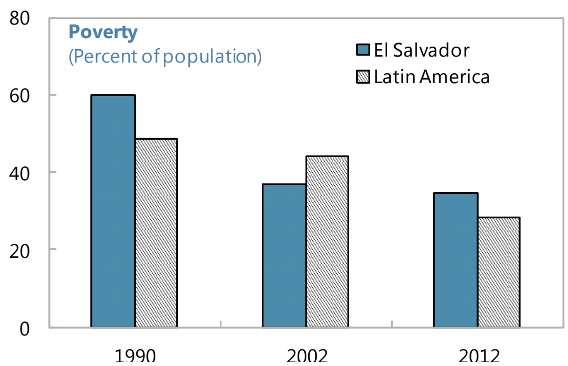
Growth has been among the lowest in the Americas.



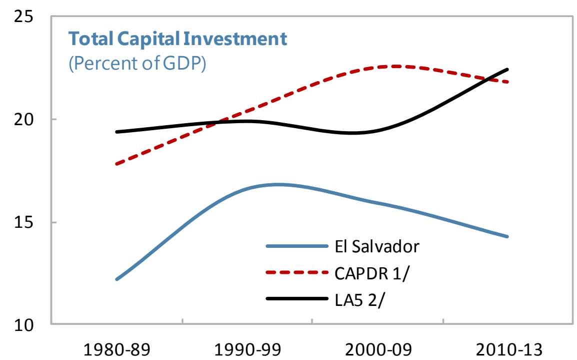
Key investment and fiscal indicators lag behind peers...



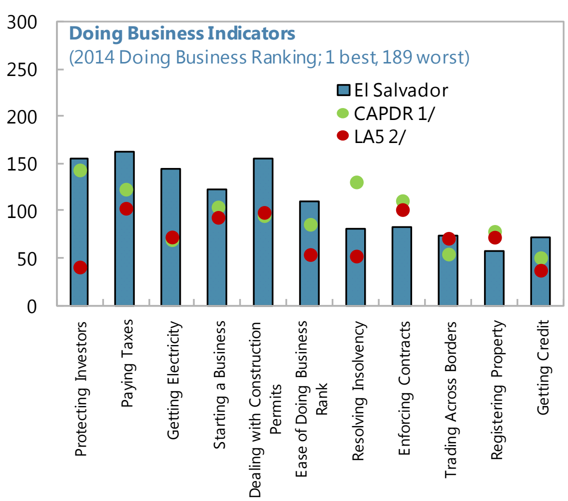
...and poverty remains high.



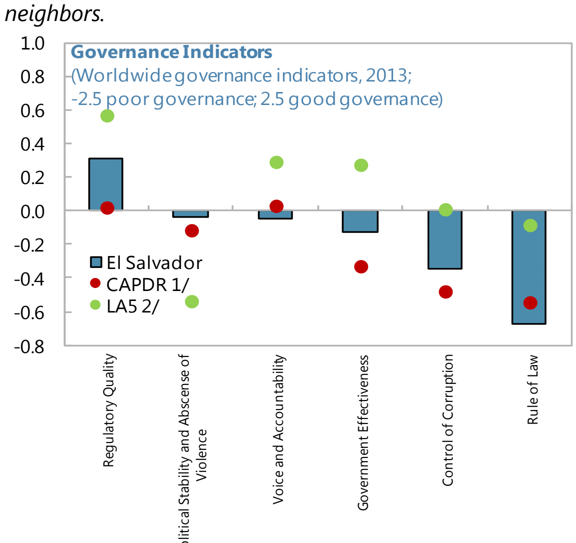
Capital investment is among the lowest in the region...



...and doing business indicators rank generally low....



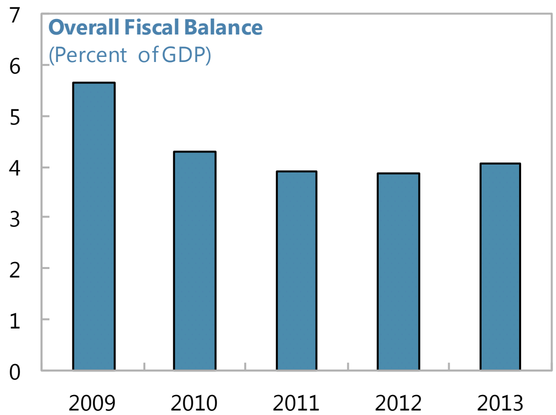
...though governance indicators are better than in neighbors.



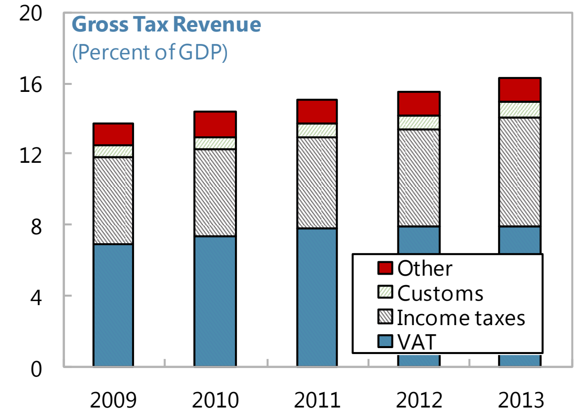
Sources: ECLAC; Barro and Lee educational attainment dataset; and World Bank, World Development Indicators, Doing Business Indicators, and Governance Indicators.
1/ Simple average of Costa Rica, Guatemala, Honduras, Nicaragua, Panama, and the Dominican Republic.
2/ Simple average of Brazil, Chile, Colombia, Mexico, and Peru.

Figure 2. El Salvador: Fiscal Developments

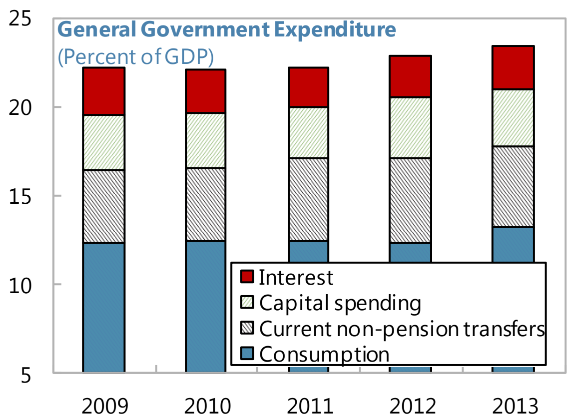
The fiscal deficit has stabilized at a high level of 4 percent of GDP ...



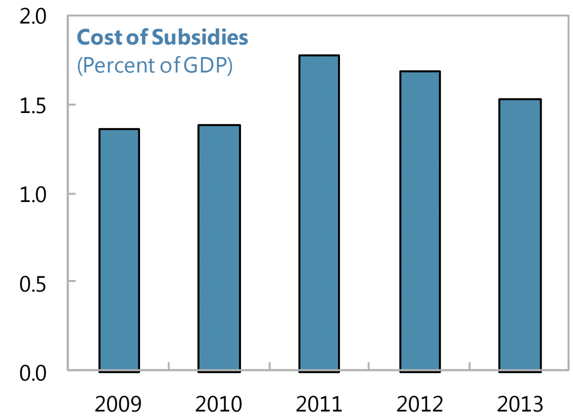
...as revenue increases in recent years...



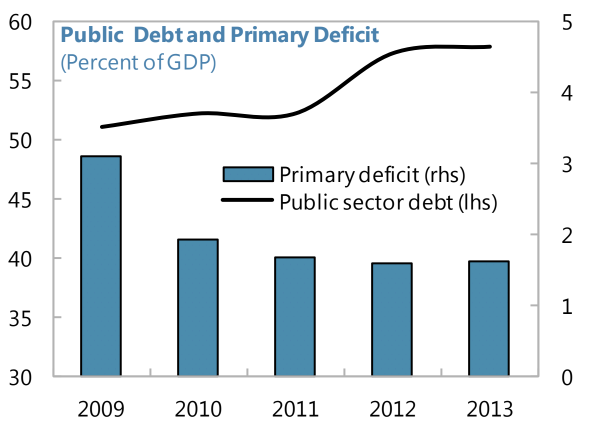
...have been offset by expenditure increases



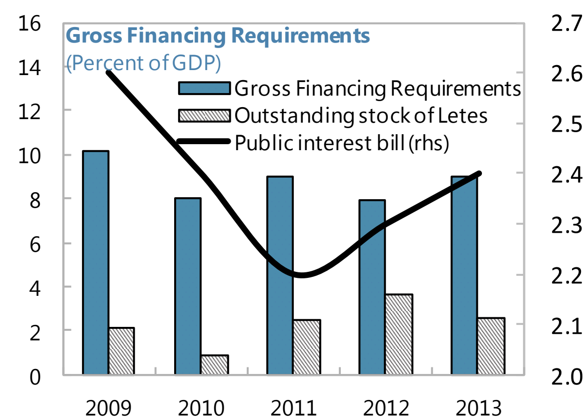
Untargeted subsidies on gas, electricity, and transportation remain large.



Public debt has been trending up...



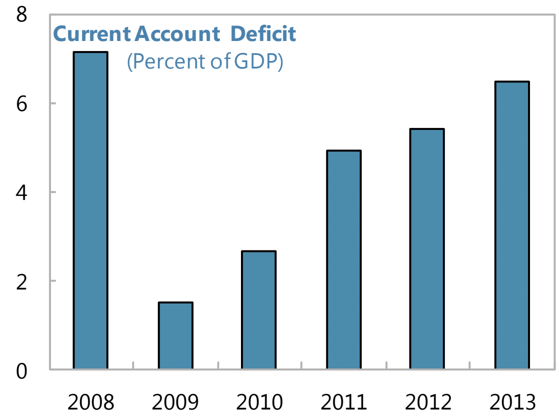
...and borrowing costs are on the rise.



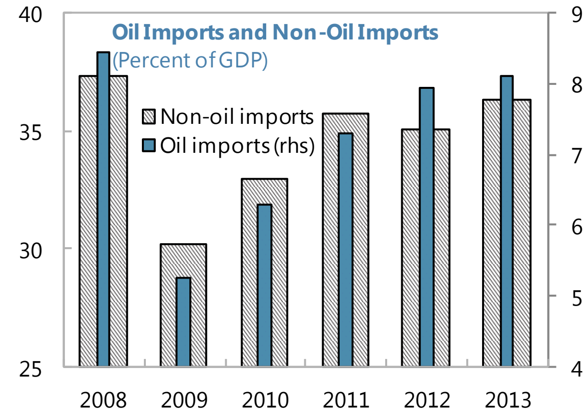
Sources: National authorities and Fund staff estimates and projections.

Figure 3. El Salvador: Balance of Payments Developments

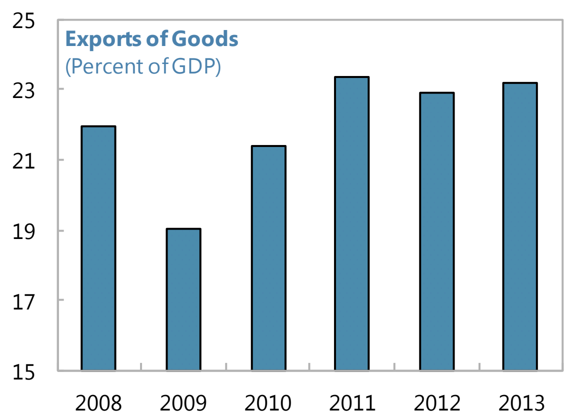
The external current account deficit has dramatically increased since 2009…



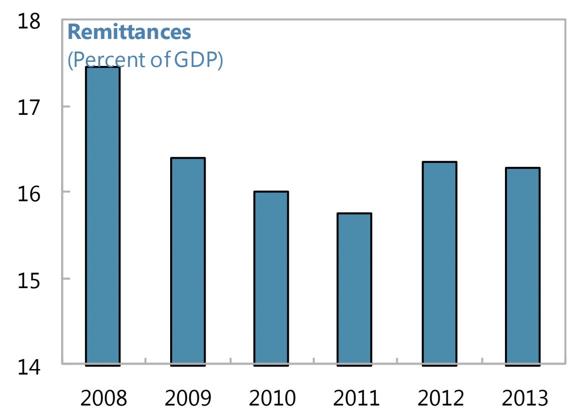
…due to higher oil and non-oil imports…



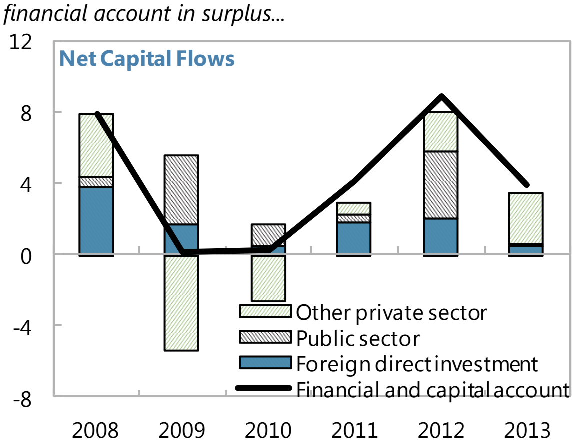
…and sluggish exports.



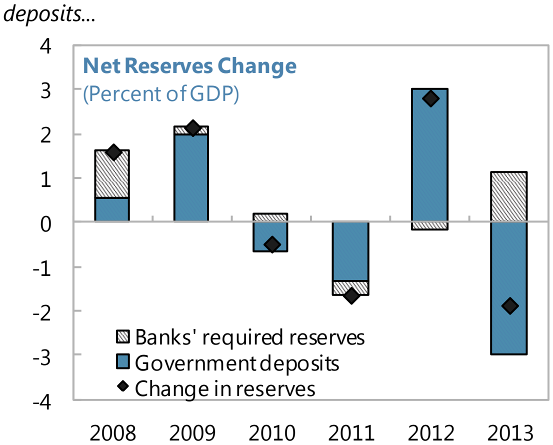
Remittances decelerated and remain below their pre-crisis levels…



Official borrowing and private sector flows have kept the financial account in surplus…



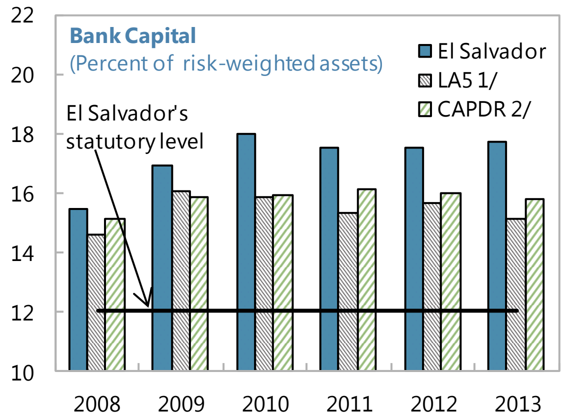
…while changes in net reserves were driven by government deposits…



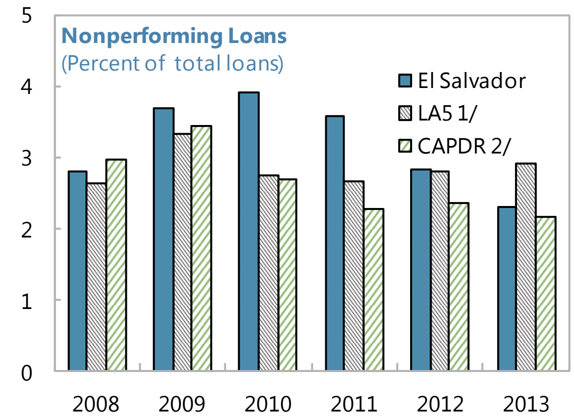
Sources: Central Reserve Bank of El Salvador, Haver Analytics, and Fund staff estimates and projections.

Figure 4. El Salvador: Financial Sector Developments

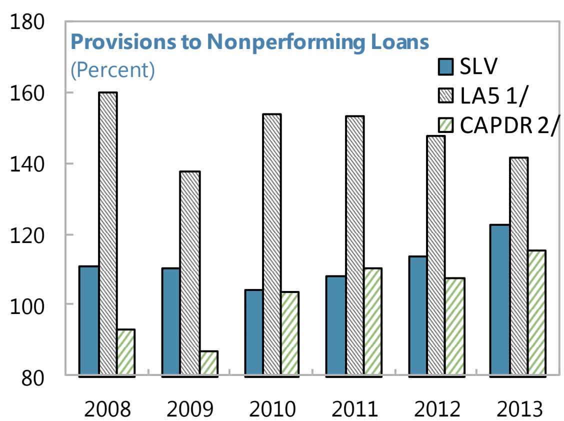
Banks' capital buffers exceed those of regional peers...



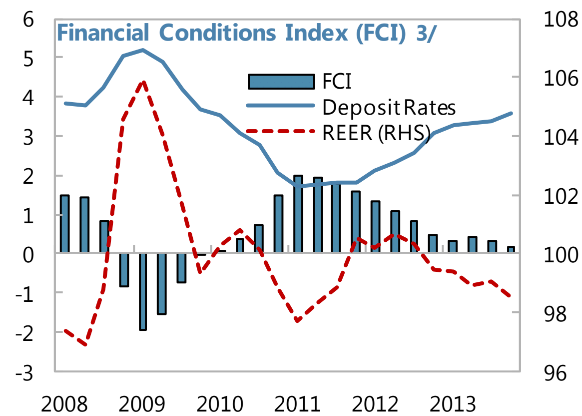
...while banks asset quality has improved...



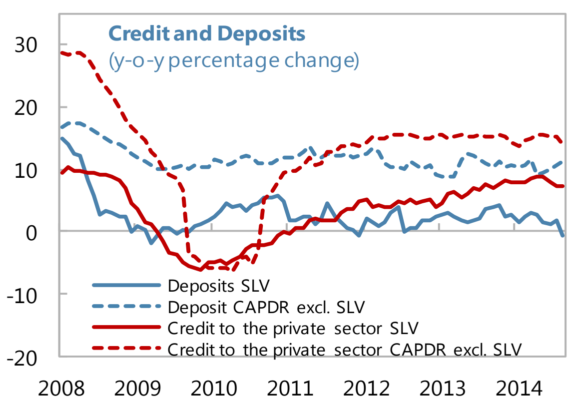
...and provisioning has remained adequate.



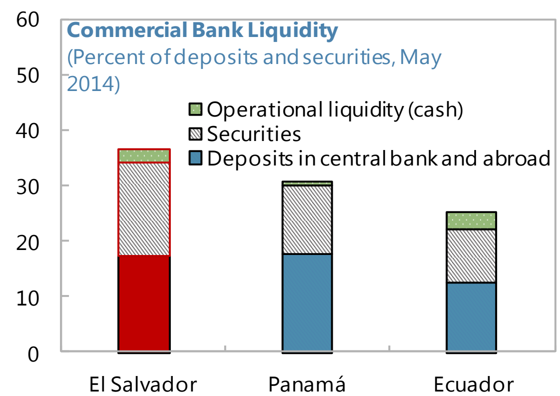
Financial conditions have been tightening since 2011...



...and deposit and credit growth have been below regional levels...



...though banks have higher liquidity than in other dollarized economies.



Sources: National authorities, IMF Financial Soundness Indicators, and Fund staff estimates and projections.
1/ Simple average of Brazil, Chile, Colombia, Mexico, and Peru.
2/ Simple average of Costa Rica, Guatemala, Honduras, Panama, and the Dominican Republic.
3/ Constructed as the sum of the 2-period cumulative impulse response of real GDP to financial variables such as bank deposit rates, REER, EMBI spread, and LIBOR and t-bill rates.

Table 1. Risk Assessment Matrix[1]

Source of risk	Up/Downside	Likelihood	Impact	Policy response
Geopolitical fragmentation that erodes the globalization process and fosters inefficiency: Heightened risk of fragmentation/state failure in the Middle East, leading to a sharp rise in oil prices, with negative spillovers to the global economy.	↓	**Medium.** Geopolitical risks in the Middle East could lead to a sharp rise in oil prices, with negative spillovers to the global economy. In the case of El Salvador, its energy matrix heavily relies on oil imports.	**High.** A sharp increase in oil prices would worsen the trade balance due to the high dependence on oil imports.	Allow full pass-through and strengthen targeted social safety net, including targeted assistance, to protect the vulnerable. Over the medium-term increase reliance on renewable sources of energy.
Side-effects from global financial conditions: an abrupt surge in global financial market volatility.	↓	**High.** Revised market expectations on UMP exit in the US could trigger higher global interest rates and/or a sustained reversal of capital flows with high risk premiums across vulnerable markets.	**High.** A global interest rate shock would both constrain access to international capital markets in the context of elevated financing needs and worsen public debt dynamics (almost half of public debt is linked to the US LIBOR).	Implement fiscal consolidation to both reduce external financing needs and improve debt dynamics. Improve fiscal and external buffers.
Protracted period of slower growth in advanced and emerging economies.	↓	**High.** Slower growth in the US (main trading partner of El Salvador) and regional trading partners.	**Medium/High**. A slowdown in the US would reduce El Salvador's exports, remittances inflows, and GDP growth.	Given limited fiscal space, implement refroms to attract private investment, including better business climate, export diversification, and competitiveness. Strengthen tax administration and expenditure management to protect the fiscal position.
Further weakening of the fiscal position	↓	**Medium** Given upcoming elections in March 2015.	**High.** Fiscal slippages will worsen macroeconomic imbalances and affect confident economic growth.	Implement fiscal consolidation to both reduce external financing needs and improve debt dynamics.
Political fragmentation and worsening security	↓	**Medium.** El Salvador is exposed to frequent electoral cycles. Also, security, which is one of the worst across the region, is among the critical factors affecting the business climate.	**Medium.** Political paralysis will exacerbate macroeconomic imbalances because of ineffective policy making. Lack of security would adversely affect investment.	Broad based policy dialogue to support macroeconomic stability. Develop and implement coherent and comprehensive policies to improve domestic security, including by effectively implementing the AML and anti-corruption frameworks.
Natural disasters	↓	**Medium.** El Salvador is exposed to earthquakes, floods, droughts, and hurricanes.	**Medium/High**. The economic impact could be significant through its effects on economic growth and fiscal pressures.	Ensure that fiscal buffers (including official loans) are adequate to support vulnerable segments of the population. Prepare and assess enrollment in insurance schemes against natural disasters.

1 The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Table 2. El Salvador: High Priority Recommendations of Financial Stability Strategy (2014)	
Recommendation	**Timeframe**
Bank Regulation and Supervision	
Continue transitioning towards risk-based supervision, building on the regulation framework issued in 2011 and making the most of the current platform, procedures and methodologies	ST
Streamline the Process of Regulation, improve the interaction of SSF and BCR, consider a temporary exchange of officials	ST
Systemic Liquidity Issues	
Improve communications and coordination between the BCR and SSF on stress testing and liquidity monitoring	ST
Approve new liquidity requirements retaining key provisions	ST
Exclude government debt as a liquid asset for the purposes of the 3 percent Liquid Assets Requirement and the 2 percent contingency reserve	ST
Ministerio de Hacienda should open and fund a current account at the BCR	ST
Identify alternative external funding sources for a LOLR facility	ST
Reform law to allow cooperative banks to be eligible for Repo and Liquidity credits.	LT
Implement Financial System Liquidity Fund; prepare policies, manuals and procedures; maintain effective communications with the banking industry	ST
Resolution and Crisis Management	
Prepare a comprehensive Crisis Prevention and Management Strategy, including key policies, legal reforms needed, operational aspects, contingency planning and inter-agency coordination as well as cross-border coordination and planning.	ST
Create Financial Stability Committee with clear legal basis, and appropriate decision and coordination powers	ST
Provide legal powers to impose different prudential requirements, special supervision regimes and special resolution measures to systemic institutions and conglomerates	ST
Amend the Bank Law to have a more efficient resolution framework; amend the deposit insurance regime including additional funding options.	ST
Securities Markets	
Join public and private efforts to define a clear strategy to develop the securities market	ST
Within the defined strategy, undertake a complete overhaul of the Securities Market Law	MT
Implement a risk-based supervision system for the securities sector that is consistent with the global methodology approved by the SSF	MT
Approve the Law of Investment Funds	ST
Provide sufficient training to staff in the SSF for efficient supervision of the securities markets	ST
Complete the project to develop a yield curve for the valuation of portfolios	ST

Table 3. El Salvador: Selected Economic Indicators

I. Social Indicators

Rank in UNDP Development Index 2013 (of 187)	115	Population (million)	6.3
Per capita income (U.S. dollars)	3,780	Life expectancy at birth in years (2011)	72
Percent of pop. below poverty line (2012)	35	Infant mortality (per 1,000 live births, 2011)	13
Gini index (2009)	48	Primary education completion rate (percent, 2011)	101

II. Economic Indicators (percent of GDP, unless otherwise indicated)

							Proj.	
	2008	2009	2010	2011	2012	2013	2014	2015
Income and Prices								
Real GDP growth (percent)	1.3	-3.1	1.4	2.2	1.9	1.7	2.0	2.2
Consumer price inflation (average, percent)	7.3	0.5	1.2	5.1	1.7	0.8	1.2	2.0
GDP deflator (percent)	5.3	-0.5	2.3	5.7	1.0	0.2	1.2	2.2
External Sector								
Exports of goods, volume	7.4	-15.3	14.4	7.8	-0.2	4.7	-5.1	4.9
Imports of goods, volume	-6.5	-14.4	6.9	6.0	2.1	4.7	-0.9	5.0
Terms of trade, percent change	-9.5	12.6	-5.6	-2.5	0.5	-1.6	2.1	1.9
Real effective exchange rate (+ = appreciation)	7.1	-4.6	-0.7	1.7	-1.6	-0.8	…	…
External sovereign bond spread (basis points)	396	502	316	374	448	378	…	…
Money and Credit								
Credit to the private sector	43.0	42.4	40.9	39.8	40.2	42.7	44.2	44.1
Broad money	45.0	47.3	47.2	43.6	43.2	43.4	42.9	42.8
Interest rate (time deposits, percent)	4.2	4.5	2.9	1.8	2.5	3.4	…	…
External Sector								
Current account balance	-7.1	-1.5	-2.7	-4.9	-5.4	-6.5	-5.5	-4.9
Oil prices (U.S. dollars per barrel)	97.0	61.8	79.0	104.0	105.0	104.1	98.9	84.6
Trade balance	-21.8	-15.0	-16.5	-18.4	-18.7	-19.7	-19.3	-18.8
Exports (f.o.b. including *maquila*)	21.9	19.0	21.4	23.3	22.9	23.1	21.7	21.9
Imports (f.o.b. including *maquila*)	-43.8	-34.1	-37.8	-41.7	-41.6	-42.8	-41.0	-40.7
Services and income (net)	-2.8	-3.1	-3.0	-3.2	-3.5	-3.7	-3.6	-3.7
Transfers (net)	17.5	16.7	16.8	16.6	16.9	16.9	17.5	17.5
Foreign direct investment	3.8	1.8	0.5	1.8	2.0	0.6	0.5	1.7
Gross international reserves (millions of U.S. dollars)	2,545	2,987	2,882	2,503	3,175	2,745	2,638	2,742
Nonfinancial Public Sector								
Overall balance	-3.2	-5.7	-4.3	-3.9	-3.9	-4.1	-4.0	-4.4
Primary balance	-0.8	-3.1	-1.9	-1.7	-1.6	-1.6	-1.5	-1.7
Of which: tax revenue	13.5	12.6	13.5	13.8	14.4	15.4	15.2	15.2
Public sector debt 1/	42.4	51.0	52.2	52.2	57.3	57.8	60.0	61.9
National Savings and Investment								
Gross domestic investment	15.2	13.4	13.3	14.4	14.1	15.1	14.8	14.9
Public sector	2.4	2.2	2.4	2.4	2.5	2.6	2.4	2.6
Private sector	12.8	11.2	10.9	11.9	11.6	12.5	12.4	12.3
National savings	8.1	11.9	10.7	9.4	8.7	8.6	9.3	10.0
Public sector	-0.4	-3.1	-1.9	-2.0	-1.2	-1.2	-1.1	-1.4
Private sector	8.4	15.0	12.5	11.4	9.9	9.8	10.5	11.4
Net Foreign Assets of the Financial System								
Millions of U.S. dollars	2,208	3,028	3,378	2,811	3,229	2,473	1,843	1,846
Percent of deposits	24.4	32.4	34.5	28.8	32.6	24.0	17.8	17.1
Memorandum Items:								
Nominal GDP (billions of U.S. dollars)	21.4	20.7	21.4	23.1	23.8	24.3	25.0	26.2

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.

Table 4. Medium-Term Baseline Scenario

	2011	2012	2013	2014	2015	2016	2017	2018	2019
				Projections					
				(Annual percentage change)					
Real GDP growth	2.2	1.9	1.7	2.0	2.2	2.4	2.6	2.3	2.0
Domestic demand	4.0	2.0	2.1	1.5	2.5	3.4	3.6	2.0	2.0
Inflation (end of period)	5.1	0.8	0.8	2.0	2.0	2.0	2.0	2.0	2.0
				(Contributions to growth, percentage points)					
Private consumption	2.2	2.4	0.3	1.5	1.9	2.8	3.1	2.3	2.3
Private investment	2.1	-0.2	1.5	0.3	0.6	0.8	1.0	-0.1	0.0
Government	0.4	0.2	0.6	0.0	0.5	0.4	0.3	0.2	0.1
Net exports	-2.5	-0.5	-0.8	0.1	-0.8	-1.6	-1.8	-0.2	-0.4
				(Percent of GDP)					
Nonfinancial public sector balance	-3.9	-3.9	-4.1	-4.0	-4.4	-4.6	-4.8	-5.1	-5.5
Primary balance	-1.7	-1.6	-1.6	-1.5	-1.7	-1.6	-1.6	-1.6	-1.6
Public sector gross debt 1/	52.2	57.3	57.8	60.0	61.9	63.9	65.9	68.5	71.4
External current account balance	-4.9	-5.4	-6.5	-5.5	-4.9	-5.6	-6.5	-6.3	-6.2
Exports of goods	23.3	22.9	23.1	21.7	21.9	22.0	22.0	22.2	22.3
Imports of goods	-41.7	-41.6	-42.8	-41.0	-40.7	-41.3	-42.1	-42.0	-41.8
Current transfers	16.6	16.9	16.9	17.5	17.5	17.4	17.3	17.3	17.2
Gross domestic investment	14.4	14.1	15.1	14.8	14.9	15.2	15.5	15.1	14.6
Private	11.9	11.6	12.5	12.4	12.3	12.5	12.8	12.3	11.9
Public	2.4	2.5	2.6	2.4	2.6	2.8	2.7	2.7	2.6
Gross national saving	9.4	8.7	8.6	9.3	10.0	9.6	9.0	8.8	8.4
Private	11.4	9.9	9.8	10.5	11.4	11.2	10.7	10.8	10.8
Public	-2.0	-1.2	-1.2	-1.1	-1.4	-1.6	-1.8	-2.1	-2.5
External saving	4.9	5.4	6.5	5.5	4.9	5.6	6.5	6.3	6.2

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.

Table 5. El Salvador: Balance of Payments 1/

							Projections					
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
						(In millions of U.S. dollars)						
Current Account	**-1,532**	**-312**	**-569**	**-1,137**	**-1,290**	**-1,574**	**-1,380**	**-1,289**	**-1,535**	**-1,866**	**-1,869**	**-1,899**
Merchandise trade balance	-4,677	-3,108	-3,530	-4,246	-4,465	-4,773	-4,842	-4,912	-5,291	-5,739	-5,879	-6,017
Export of goods (f.o.b.)	4,703	3,930	4,577	5,401	5,447	5,616	5,427	5,724	5,995	6,289	6,591	6,891
General merchandise	3,334	2,984	3,548	4,332	4,341	4,458	4,339	4,599	4,832	5,083	5,341	5,600
Goods for processing	1,368	945	1,029	1,069	1,106	1,158	1,088	1,125	1,163	1,206	1,250	1,291
Import of goods (f.o.b.)	-9,380	-7,038	-8,107	-9,647	-9,912	-10,388	-10,269	-10,636	-11,286	-12,028	-12,470	-12,909
General merchandise	-8,374	-6,433	-7,493	-9,010	-9,195	-9,636	-9,562	-9,916	-10,554	-11,269	-11,670	-12,070
Goods for processing	-1,005	-605	-614	-637	-717	-752	-707	-720	-732	-760	-800	-839
Services	-213	-90	-94	-77	45	65	197	207	213	216	235	252
Income	-389	-556	-544	-655	-890	-966	-1,110	-1,163	-1,211	-1,273	-1,347	-1,454
Current transfers	3,747	3,442	3,599	3,841	4,020	4,100	4,375	4,579	4,754	4,930	5,123	5,321
Financial and Capital Account	**1,702**	**42**	**52**	**961**	**2,117**	**950**	**1,108**	**1,394**	**1,564**	**1,901**	**1,906**	**1,920**
Capital account	80	131	232	266	201	101	75	93	144	172	176	136
Public sector financial flows	127	785	274	121	912	13	772	67	59	57	65	128
Disbursements	427	1,076	584	1,067	1,202	269	1,028	334	358	362	377	1,227
Amortization	-300	-291	-310	-946	-290	-256	-256	-267	-299	-305	-312	-1,099
Private sector financial flows	954	1,113	-22	521	552	170	134	390	428	551	509	539
Foreign direct investment	824	366	99	420	484	137	124	440	487	610	567	597
Portfolio investment	131	747	-121	100	68	33	10	-50	-59	-59	-58	-58
Other 2/	541	-1,988	-431	53	451	666	127	844	934	1,120	1,156	1,117
Errors and Omissions	**164**	**693**	**222**	**-238**	**-177**	**298**	**164**	**0**	**0**	**0**	**0**	**0**
Change in Reserves (- = increase)	**-333**	**-423**	**296**	**416**	**-650**	**327**	**107**	**-104**	**-29**	**-35**	**-37**	**-21**
						(Percent of GDP)						
Current Account	**-7.1**	**-1.5**	**-2.7**	**-4.9**	**-5.4**	**-6.5**	**-5.5**	**-4.9**	**-5.6**	**-6.5**	**-6.3**	**-6.2**
Merchandise trade balance	-21.8	-15.0	-16.5	-18.4	-18.7	-19.7	-19.3	-18.8	-19.4	-20.1	-19.8	-19.5
Export of goods (f.o.b.)	21.9	19.0	21.4	23.3	22.9	23.1	21.7	21.9	22.0	22.0	22.2	22.3
Net maquila exports	1.7	1.6	1.9	1.9	1.6	1.7	1.5	1.6	1.6	1.6	1.5	1.5
Import of goods (f.o.b.)	-43.8	-34.1	-37.8	-41.7	-41.6	-42.8	-41.0	-40.7	-41.3	-42.1	-42.0	-41.8
Petroleum and products	-8.4	-5.3	-6.3	-7.3	-8.0	-8.1	-7.0	-6.0	-6.0	-6.1	-6.1	-6.0
Services	-1.0	-0.4	-0.4	-0.3	0.2	0.3	0.8	0.8	0.8	0.8	0.8	0.8
Income	-1.8	-2.7	-2.5	-2.8	-3.7	-4.0	-4.4	-4.4	-4.4	-4.5	-4.5	-4.7
Current transfers	17.5	16.7	16.8	16.6	16.9	16.9	17.5	17.5	17.4	17.3	17.3	17.2
Financial and Capital Account	**7.9**	**0.2**	**0.2**	**4.2**	**8.9**	**3.9**	**4.4**	**5.3**	**5.7**	**6.7**	**6.4**	**6.2**
Capital account	0.4	0.6	1.1	1.2	0.8	0.4	0.3	0.4	0.5	0.6	0.6	0.4
Public sector financial flows	0.6	3.8	1.3	0.5	3.8	0.1	3.1	0.3	0.2	0.2	0.2	0.4
Private sector financial flows	4.5	5.4	-0.1	2.2	2.3	0.7	0.5	1.5	1.6	1.9	1.7	1.7
Foreign direct investment	3.8	1.8	0.5	1.8	2.0	0.6	0.5	1.7	1.8	2.1	1.9	1.9
Portfolio investment	0.6	3.6	-0.6	0.4	0.3	0.1	0.0	-0.2	-0.2	-0.2	-0.2	-0.2
Other 2/	2.5	-9.6	-2.0	0.2	1.9	2.7	0.5	3.2	3.4	3.9	3.9	3.6
						(Annual percentage change)						
Merchandise Trade (f.o.b.)												
Exports (nominal)	15.6	-16.4	16.5	18.0	0.8	3.1	-3.4	5.5	4.7	4.9	4.8	4.6
Volume	7.4	-15.3	14.4	7.8	-0.2	4.7	-5.1	4.9	4.5	4.4	4.3	4.0
Price	7.6	-1.3	1.8	9.5	1.1	-1.6	1.8	0.6	0.3	0.5	0.5	0.5
Imports (nominal)	11.2	-25.0	15.2	19.0	2.7	4.8	-1.1	3.6	6.1	6.6	3.7	3.5
Volume	-6.5	-14.4	6.9	6.0	2.1	4.7	-0.9	5.0	6.0	6.2	3.2	3.5
Price	18.9	-12.3	7.8	12.3	0.6	0.1	-0.3	-1.3	0.1	0.4	0.5	0.1
Terms of trade	-9.5	12.6	-5.6	-2.5	0.5	-1.6	2.1	1.9	0.2	0.1	0.0	0.5
Memorandum Items												
Gross international reserves (US$ million) 3/	2,545	2,987	2,882	2,503	3,175	2,745	2,638	2,742	2,771	2,806	2,843	2,864
In months of imports (excluding maquila) 4/	4.1	4.2	3.4	2.9	3.4	3.0	2.8	2.7	2.6	2.5	2.5	2.4
In percent of total short-term external debt	158	329	345	205	208	148	133	130	123	116	110	104
External debt (in percent of GDP)	49.2	53.0	54.2	52.5	58.0	58.1	59.4	60.4	61.5	62.9	64.6	66.2
Of which: public sector debt	24.5	30.0	30.3	28.8	32.1	32.0	34.1	33.8	34.9	35.6	36.7	38.1
Of which: private sector debt	24.7	23.0	23.9	23.7	25.9	26.1	25.3	26.5	26.6	27.3	27.9	28.1
External public debt servicing (US$ million)	584	562	561	1,230	580	582	627	705	783	840	900	1,765
Percent of exports of goods and services	10.1	11.7	10.1	19.0	8.6	8.2	8.9	9.5	10.1	10.3	10.6	19.8
Gross external financing requirement (US$ million)	3,662	2,670	2,264	3,453	3,332	3,934	4,025	4,054	4,518	5,013	5,235	6,262
Percent of GDP	17.1	12.9	10.6	14.9	14.0	16.2	16.1	15.5	16.5	17.6	17.6	20.3

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

1/ Presented in BPM5 format.

2/ Assumed to include both private and potential public sector flows, including 70 percent of the fiscal financing gap.

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).

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

Table 6. El Salvador: Operations of the Nonfinancial Public Sector

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
							Projections					
						(In millions of U.S. dollars)						
Revenue and Grants	**3,732**	**3,399**	**3,804**	**4,219**	**4,507**	**4,678**	**4,753**	**4,966**	**5,289**	**5,560**	**5,785**	**5,978**
Current revenue	3,679	3,290	3,639	4,005	4,329	4,607	4,714	4,911	5,183	5,461	5,688	5,926
Tax revenue	2,886	2,609	2,883	3,192	3,434	3,745	3,814	3,980	4,211	4,444	4,631	4,827
Nontax revenue	619	573	651	644	734	756	780	820	856	895	931	967
Operating surplus of the public enterprises	174	108	105	169	162	106	120	111	116	121	126	131
Capital revenue	0	0	0	0	0	0	0	0	0	0	0	0
Official grants	53	109	164	214	178	71	39	54	106	100	97	52
Expenditure	**4,415**	**4,569**	**4,721**	**5,125**	**5,427**	**5,665**	**5,750**	**6,124**	**6,541**	**6,934**	**7,301**	**7,677**
Current expenditure	3,754	3,927	4,044	4,457	4,609	4,889	5,000	5,284	5,613	5,969	6,301	6,682
Wages and salaries 1/	1,528	1,659	1,710	1,928	2,005	2,115	2,225	2,378	2,483	2,596	2,700	2,806
Goods and services 1/	823	874	944	932	935	1,075	1,053	1,075	1,122	1,173	1,221	1,268
Interest	520	531	508	518	540	594	615	715	825	923	1,035	1,192
Current transfers	884	863	882	1,079	1,128	1,105	1,107	1,116	1,183	1,277	1,345	1,416
Nonpension payments	425	493	525	673	709	663	621	601	627	656	682	709
Of which: subsidies 2/	393	336	371	467	481	442	420	387	404	422	439	457
Pension payments	458	370	357	406	419	442	487	516	555	621	663	707
Capital expenditure	661	642	677	668	818	776	750	840	928	965	1,001	995
Primary Balance	**-164**	**-640**	**-410**	**-388**	**-379**	**-393**	**-382**	**-444**	**-427**	**-451**	**-481**	**-507**
Overall Balance	**-683**	**-1,171**	**-917**	**-906**	**-919**	**-987**	**-997**	**-1,159**	**-1,252**	**-1,373**	**-1,516**	**-1,699**
Financing	**683**	**1,171**	**917**	**906**	**919**	**987**	**997**	**1,159**	**1,252**	**1,373**	**1,516**	**1,699**
External	**127**	**785**	**274**	**121**	**912**	**13**	**772**	**67**	**59**	**57**	**65**	**128**
Disbursements	427	1,076	584	1,067	1,202	269	1,028	334	358	362	377	1,227
Amortization	-300	-291	-310	-946	-290	-256	-256	-267	-299	-305	-312	-1,099
Domestic	**557**	**385**	**643**	**785**	**7**	**975**	**225**	**729**	**312**	**536**	**550**	**577**
Change in deposits at central bank (- = increase)	26	-296	271	197	-737	758	0	0	0	0	0	0
Banking system	93	239	-67	164	162	-171	-215	158	0	0	0	0
Private sector 3/	438	440	436	421	582	388	440	571	312	536	550	577
Unidentified financing	**...**	**...**	**...**	**...**	**...**	**...**	**0**	**364**	**882**	**780**	**901**	**994**
Memorandum Items:												
Current revenue minus current expenditure	-75	-637	-405	-452	-279	-282	-286	-373	-430	-508	-612	-756
Gross financing needs	1,281	2,097	1,718	2,087	1,877	2,180	2,279	1,907	2,345	2,313	2,491	3,478
Implicit nominal interest rate (in percent)	6.5	5.8	4.8	4.6	4.5	4.4	4.4	4.8	5.1	5.3	5.5	5.9
Public sector debt (gross) 4/	9,094	10,544	11,175	12,076	13,641	14,031	15,028	16,187	17,439	18,813	20,329	22,028
						(In percent of GDP)						
Revenue and Grants	**17.4**	**16.4**	**17.8**	**18.2**	**18.9**	**19.3**	**19.0**	**19.0**	**19.4**	**19.5**	**19.5**	**19.4**
Current revenue	17.2	15.9	17.0	17.3	18.2	19.0	18.8	18.8	19.0	19.1	19.2	19.2
Tax revenue	13.5	12.6	13.5	13.8	14.4	15.4	15.2	15.2	15.4	15.6	15.6	15.6
Nontax revenue	2.9	2.8	3.0	2.8	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Operating surplus of the public enterprises	0.8	0.5	0.5	0.7	0.7	0.4	0.5	0.4	0.4	0.4	0.4	0.4
Official grants	0.2	0.5	0.8	0.9	0.7	0.3	0.2	0.2	0.4	0.3	0.3	0.2
Expenditure	**20.6**	**22.1**	**22.0**	**22.2**	**22.8**	**23.4**	**23.0**	**23.4**	**24.0**	**24.3**	**24.6**	**24.9**
Current expenditure	17.5	19.0	18.9	19.3	19.4	20.2	20.0	20.2	20.6	20.9	21.2	21.7
Wages and salaries	7.1	8.0	8.0	8.3	8.4	8.7	8.9	9.1	9.1	9.1	9.1	9.1
Goods and services	3.8	4.2	4.4	4.0	3.9	4.4	4.2	4.1	4.1	4.1	4.1	4.1
Interest	2.4	2.6	2.4	2.2	2.3	2.4	2.5	2.7	3.0	3.2	3.5	3.9
Current transfers	4.1	4.2	4.1	4.7	4.7	4.6	4.4	4.3	4.3	4.5	4.5	4.6
Nonpension payments	2.0	2.4	2.5	2.9	3.0	2.7	2.5	2.3	2.3	2.3	2.3	2.3
Pension payments	2.1	1.8	1.7	1.8	1.8	1.8	1.9	2.0	2.0	2.2	2.2	2.3
Capital expenditure	3.1	3.1	3.2	2.9	3.4	3.2	3.0	3.2	3.4	3.4	3.4	3.2
Primary Balance	**-0.8**	**-3.1**	**-1.9**	**-1.7**	**-1.6**	**-1.6**	**-1.5**	**-1.7**	**-1.6**	**-1.6**	**-1.6**	**-1.6**
Overall Balance	**-3.2**	**-5.7**	**-4.3**	**-3.9**	**-3.9**	**-4.1**	**-4.0**	**-4.4**	**-4.6**	**-4.8**	**-5.1**	**-5.5**
Memorandum Items:												
Current revenue minus current expenditure	-0.4	-3.1	-1.9	-2.0	-1.2	-1.2	-1.1	-1.4	-1.6	-1.8	-2.1	-2.5
Gross financing needs	6.0	10.2	8.0	9.0	7.9	9.0	9.1	7.3	8.6	8.1	8.4	11.3
Implicit nominal interest rate (in percent)	6.5	5.8	4.8	4.6	4.5	4.4	4.4	4.8	5.1	5.3	5.5	5.9
Public sector debt (gross) 4/	42.4	51.0	52.2	52.2	57.3	57.8	60.0	61.9	63.9	65.9	68.5	71.4
Nominal GDP	21,431	20,661	21,418	23,139	23,814	24,259	25,030	26,151	27,303	28,545	29,692	30,853

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/ Excludes subsidized social programs, such as a "school package."

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

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

Table 7. El Salvador: Summary Accounts of the Financial System

	2008	2009	2010	2011	2012	2013	Projections 2014	2015
	(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**	**2,290**	**2,183**	**2,287**
Of which: Net international reserves 1/	2,540	2,983	2,881	2,502	3,173	2,721	2,613	2,718
Net Domestic Assets	**442**	**35**	**36**	**300**	**-450**	**278**	**278**	**278**
Nonfinancial public sector (net)	515	219	490	688	-49	710	710	710
Claims	839	836	833	833	832	832	832	832
Liabilities	323	617	343	145	881	122	122	122
Rest of the financial system (net)	158	98	109	175	186	119	119	119
Nonfinancial private sector (claims)	32	15	1	0	0	0	0	0
Other items (net)	-264	-298	-564	-563	-587	-551	-551	-551
Liabilities	**2,690**	**2,629**	**2,586**	**2,476**	**2,381**	**2,566**	**2,461**	**2,565**
Base Money	2,291	2,282	2,354	2,275	2,229	2,481	2,376	2,480
Currency in circulation	33	33	5	5	4	4	4	5
Liabilities to depositary corporations	2,258	2,250	2,349	2,271	2,224	2,476	2,372	2,476
Other liabilities to the public	399	347	232	201	152	85	85	85
	II. Depository corporations							
Net Foreign Assets	**-98**	**376**	**697**	**295**	**-62**	**-417**	**-926**	**-949**
Net Domestic Assets	**9,152**	**8,832**	**8,987**	**9,383**	**9,985**	**10,614**	**11,313**	**11,791**
Nonfinancial public sector (net)	351	499	445	465	578	373	539	539
Claims	469	680	627	681	762	672	818	818
Liabilities	118	181	182	215	184	299	278	278
Rest of the financial system (net)	1,491	1,571	1,928	1,888	1,981	2,150	2,028	2,123
Credit to the private sector	9,017	8,572	8,559	8,984	9,332	10,078	10,770	11,242
Other items (net)	-1,707	-1,809	-1,946	-1,955	-1,907	-1,988	-2,025	-2,113
Liabilities to the Private Sector	**9,053**	**9,209**	**9,683**	**9,678**	**9,923**	**10,196**	**10,387**	**10,842**
Deposits	8,884	9,043	9,474	9,413	9,638	9,907	10,092	10,534
Securities	169	166	209	264	285	289	295	308
	III. Other financial corporations 2/							
Net Foreign Assets	**58**	**58**	**132**	**339**	**460**	**600**	**586**	**508**
Net Domestic Assets	**4,657**	**5,260**	**5,789**	**6,108**	**6,687**	**7,121**	**7,587**	**8,119**
Nonfinancial public sector (net)	3,030	3,607	4,281	4,960	5,660	6,036	6,482	6,976
Rest of the financial system (net)	1,544	1,620	1,490	1,121	987	1,007	918	948
Credit to the private sector	166	166	195	215	242	279	284	297
Other items (net)	-84	-133	-177	-188	-201	-201	-205	-211
Liabilities to the Private Sector	**4,715**	**5,318**	**5,921**	**6,447**	**7,147**	**7,721**	**8,173**	**8,627**
Pension fund contributions	4,547	5,139	5,734	6,247	6,931	7,470	7,920	8,370
	IV. Financial System							
Net Foreign Assets	**2,208**	**3,028**	**3,378**	**2,811**	**3,229**	**2,473**	**1,843**	**1,846**
Net Domestic Assets	**11,993**	**11,878**	**12,463**	**13,519**	**13,997**	**15,533**	**16,806**	**17,712**
Net claims on nonfinancial public sector	3,897	4,325	5,216	6,113	6,189	7,118	7,731	8,224
Credit to private sector	9,215	8,753	8,755	9,199	9,574	10,357	11,055	11,538
Other	-1,118	-1,200	-1,508	-1,793	-1,766	-1,942	-1,979	-2,051
Liabilities to the Private Sector	**14,201**	**14,906**	**15,841**	**16,331**	**17,226**	**18,006**	**18,649**	**19,559**
Money	1,875	2,183	2,542	2,669	2,681	2,759	2,810	2,934
Quasi-money	7,780	7,584	7,565	7,415	7,614	7,777	7,919	8,254
Pension fund contributions	4,547	5,139	5,734	6,247	6,931	7,470	7,920	8,370
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	8.9	12.1	8.4
Nonfinancial public sector	3.6	3.0	6.0	5.7	0.5	5.4	5.8	4.6
Credit to the private sector	3.3	-3.3	0.0	2.8	2.3	4.5	6.6	4.5
Liabilities to the private sector	3.6	5.0	6.3	3.1	5.5	4.5	6.1	8.5
	(Percent of GDP)							
Credit to the private sector	43.0	42.4	40.9	39.8	40.2	42.7	44.2	44.1
Liabilities to the private sector	66.3	72.1	74.0	70.6	72.3	74.2	74.5	74.8
Excluding pension contributions	45.0	47.3	47.2	43.6	43.2	43.4	42.9	42.8
	(Annual percentage change, unless otherwise noted)							
Credit to the private sector	5.1	-5.0	0.0	5.1	4.1	8.2	6.7	4.4
Private sector deposits in depository corporations	-0.1	1.8	4.8	-0.6	2.4	2.8	1.9	4.4
Depository corporations liquid deposits at central bank								
(In percent of total deposits)	25.4	24.9	24.8	24.1	23.1	25.0	23.5	23.5
(In percent of NIR)	88.9	75.4	81.5	90.7	70.1	91.0	90.8	91.1

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

Table 8. El Salvador: Selected Vulnerability Indicators

(In percent of GDP; unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	Projections 2014	2015
Fiscal Indicators								
Overall balance of the nonfinancial public sector	-3.2	-5.7	-4.3	-3.9	-3.9	-4.1	-4.0	-4.4
Primary balance of the nonfinancial public sector	-0.8	-3.1	-1.9	-1.7	-1.6	-1.6	-1.5	-1.7
Gross public sector financing requirement	6.0	10.2	8.0	9.0	7.9	9.0	9.1	7.3
Public sector debt (gross) 1/	42.4	51.0	52.2	52.2	57.3	57.8	60.0	61.9
Public sector external debt	24.5	30.0	30.3	28.8	32.1	32.0	34.1	33.8
External interest payments to total fiscal revenue (percent)	9.3	10.1	8.5	7.8	7.2	7.7	7.6	8.7
External amortization payments to total fiscal revenue (percent) 2/	8.0	8.6	8.1	22.4	6.4	5.5	5.4	5.4
Financial Indicators 3/ 4/								
Broad money (percent change, end-of-period)	0.0	1.2	3.5	-0.2	2.1	2.3	1.8	4.3
Private sector credit (percent change, end-of-period)	5.1	-5.0	0.0	5.1	4.1	8.2	6.7	4.4
Ratio of capital to risk-weighted assets	15.1	16.5	17.6	17.1	17.3	17.0	17.3	...
Ratio of loans more than 90 days past due to total loans	2.8	3.7	3.9	3.6	2.9	2.4	2.3	...
Ratio of provisions to total loans	3.1	4.0	4.3	3.8	3.3	2.9	2.9	...
Ratio of provisions to loans more than 90 days past due	110.4	109.9	107.9	107.8	113.3	120.7	121.6	...
Return on average equity	8.7	2.8	7.3	12.2	12.4	12.0	12.4	...
Return on average total assets	1.0	0.3	0.9	1.5	1.6	1.6	1.6	...
Loans as percent of deposits	101.4	91.3	82.8	88.9	93.7	97.4	97.2	...
Ratio of liquid assets to total deposits	35.7	41.3	42.0	37.0	31.9	29.9	30.7	...
External Indicators								
Exports of goods and services (percent change, 12-month basis)	10.7	-16.8	15.9	16.6	4.7	5.1	-0.7	4.9
Imports of goods and services (percent change, 12-month basis)	9.7	-25.0	14.8	17.7	3.7	5.7	-0.9	3.4
Current account balance	-7.1	-1.5	-2.7	-4.9	-5.4	-6.5	-5.5	-4.9
Capital and financial account balance	7.9	0.2	0.2	4.2	8.9	3.9	4.4	5.3
Gross international reserves (millions of U.S. dollars) 3/	2,545	2,987	2,882	2,503	3,175	2,745	2,638	2,742
Months of imports of goods and services, excluding maquila	4.1	4.2	3.4	2.9	3.4	3.0	2.8	2.7
Percent of short-term debt	158	329	345	205	208	148	133	130
Percent of gross external financing requirements	69	112	127	72	95	70	66	68
Percent of broad money	26.4	30.6	28.5	24.8	30.8	26.1	24.6	24.5
Public external debt service 2/	2.7	2.7	2.6	5.3	2.4	2.4	2.5	2.7
External debt to exports of goods and services (percent)	183	229	209	187	192	198	210	213
External interest payments to exports of goods and services (percent)	9.5	12.8	10.6	10.7	13.8	14.1	16.3	16.4
External amortization to exports of goods and services (percent) 2/	37.0	49.2	30.5	35.8	30.2	33.1	37.4	37.3
REER, depreciation is negative (percent change, end-of-period)	7.1	-4.6	-0.7	1.7	-1.6	-0.8	...	...

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.
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).
4/ Data for 2014 are as of end-September.

Table 9. El Salvador: Public Sector Financing Requirements and Sources

	2012	2013	2014	2015	2016	2017	2018	2019
			Projections					
			(Millions of U.S. dollars)					
Gross financing requirements	**1,877**	**2,180**	**2,279**	**1,907**	**2,345**	**2,313**	**2,491**	**3,478**
Overall deficit	919	987	997	1,159	1,252	1,373	1,516	1,699
Public debt amortizations	958	1,193	1,282	748	1,093	940	975	1,779
External	290	256	256	267	299	305	312	1099
Multilaterals and bilaterals	290	256	256	267	299	305	312	299
Bonds	0	0	0	0	0	0	0	800
Domestic	668	937	1026	481	794	635	663	680
o.w. short-term debt (letes)	559	829	607	392	550	550	550	550
Sources of financing	**1,877**	**2,180**	**2,279**	**1,907**	**2,345**	**2,313**	**2,491**	**3,478**
External	1,202	269	1,028	334	358	362	377	1,227
Multilaterals and bilaterals	402	269	228	334	358	362	377	427
Bonds	800	0	800	0	0	0	0	800
Domestic	676	1,911	1,251	1,210	1,105	1,171	1,213	1,257
Pension funds	419	442	487	516	555	621	663	707
Use of banking system deposits	-577	587	0	0	0	0	0	0
Short-term debt (letes)	829	607	392	550	550	550	550	550
Others, including floating debt	4	275	372	144	0	0	0	0
Unidentified financing	0	0	0	364	882	780	901	994
Memorandum items:								
Nominal GDP	23,814	24,259	25,030	26,151	27,303	28,545	29,692	30,853
			(Percent of GDP)					
Gross financing requirements	**7.9**	**9.0**	**9.1**	**7.3**	**8.6**	**8.1**	**8.4**	**11.3**
Overall deficit	3.9	4.1	4.0	4.4	4.6	4.8	5.1	5.5
Public debt amortizations	4.0	4.9	5.1	2.9	4.0	3.3	3.3	5.8
External	1.2	1.1	1.0	1.0	1.1	1.1	1.1	3.6
Multilaterals and bilaterals	1.2	1.1	1.0	1.0	1.1	1.1	1.1	1.0
Bonds	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.6
Domestic	2.8	3.9	4.1	1.8	2.9	2.2	2.2	2.2
o.w. short-term debt (letes)	2.3	3.4	2.4	1.5	2.0	1.9	1.9	1.8
Sources of financing	**7.9**	**9.0**	**9.1**	**7.3**	**8.6**	**8.1**	**8.4**	**11.3**
External	5.0	1.1	4.1	1.3	1.3	1.3	1.3	4.0
Multilaterals and bilaterals	1.7	1.1	0.9	1.3	1.3	1.3	1.3	1.4
Bonds	3.4	0.0	3.2	0.0	0.0	0.0	0.0	2.6
Domestic	2.8	7.9	5.0	4.6	4.0	4.1	4.1	4.1
Pension funds	1.8	1.8	1.9	2.0	2.0	2.2	2.2	2.3
Use of banking system deposits	-2.4	2.4	0.0	0.0	0.0	0.0	0.0	0.0
Short-term debt (letes)	3.5	2.5	1.6	2.1	2.0	1.9	1.9	1.8
Others, including floating debt	0.0	1.1	1.5	0.6	0.0	0.0	0.0	0.0
Unidentified financing	0.0	0.0	0.0	1.4	3.2	2.7	3.0	3.2

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

Table 10. El Salvador: External Financing Requirements and Sources

	2011	2012	2013	2014	2015	2016	2017	2018	2019
				Projections					
				(Millions of U.S. dollars)					
Gross Financing Requirements	**3,453**	**3,332**	**3,934**	**4,025**	**4,054**	**4,518**	**5,013**	**5,235**	**6,262**
Current account deficit	1,137	1,290	1,574	1,380	1,289	1,535	1,866	1,869	1,899
Debt amortization	2,732	1,393	2,687	2,753	2,660	2,953	3,112	3,330	4,341
Public sector	946	290	256	256	267	299	305	312	1,099
Private sector	1,786	1,104	2,431	2,497	2,393	2,654	2,807	3,018	3,242
GIR accumulation	-416	650	-327	-107	104	29	35	37	21
Gross Financing Sources	**3,453**	**3,332**	**3,934**	**4,025**	**4,054**	**4,518**	**5,013**	**5,235**	**6,262**
Public sector disbursements	1,067	1,202	269	1,028	334	358	362	377	1,227
Private sector net inflows	2,386	2,131	3,666	2,997	3,720	4,160	4,651	4,858	5,035
Foreign direct investment	420	484	137	124	440	487	610	567	597
Other	1,966	1,647	3,528	2,873	3,280	3,673	4,041	4,291	4,438
				(Percent of GDP)					
Gross Financing Requirements	**14.9**	**14.0**	**16.2**	**16.1**	**15.5**	**16.5**	**17.6**	**17.6**	**20.3**
Current account deficit	4.9	5.4	6.5	5.5	4.9	5.6	6.5	6.3	6.2
Debt amortization	11.8	5.9	11.1	11.0	10.2	10.8	10.9	11.2	14.1
Public sector	4.1	1.2	1.1	1.0	1.0	1.1	1.1	1.1	3.6
Private sector	7.7	4.6	10.0	10.0	9.2	9.7	9.8	10.2	10.5
Gross Financing Sources	**14.9**	**14.0**	**16.2**	**16.1**	**15.5**	**16.5**	**17.6**	**17.6**	**20.3**
Public sector disbursements	4.6	5.0	1.1	4.1	1.3	1.3	1.3	1.3	4.0
Private sector net inflows	10.3	8.9	15.1	12.0	14.2	15.2	16.3	16.4	16.3
Foreign direct investment	1.8	2.0	0.6	0.5	1.7	1.8	2.1	1.9	1.9
Other	8.5	6.9	14.5	11.5	12.5	13.5	14.2	14.5	14.4

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

Annex I. Implementation of Fund Policy Advice

The 2013 Article IV Consultation focused on the need to ensure economic stability during the government transition in mid-2014 and tackle longer-term challenges. Directors recommended:

- **Facilitating a nation-wide dialogue on short- and medium-term growth priorities**, including developing a medium-term growth agenda. *The process is still at an early stage since the government took office in June.*

- **Implementing fiscal consolidation** to lower the deficits by 1 percentage point of GDP annually in 2013–14 to stabilize the public debt ratio. *Consolidation efforts have not borne fruit and the 2013–14 deficits have stayed at around 4 percent of GDP with debt-GDP continuing to rise. The draft Fiscal Responsibility Law commits to a cumulative adjustment of 1½ percent of GDP over 3 years, which is insufficient to prevent a steadily increasing debt-GDP ratio.*

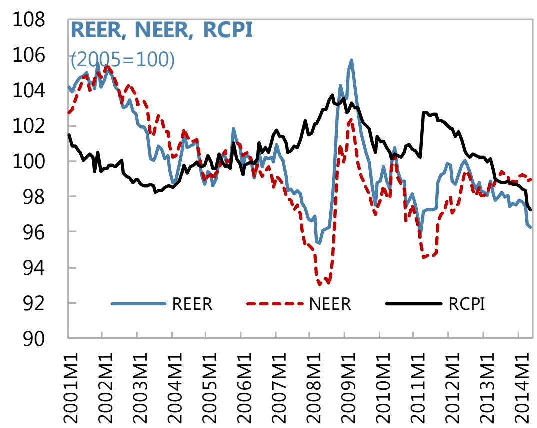
- **Pursuing comprehensive pension reform** to ensure sustainability and reduce inequalities in the system. *There have been no policy steps to address imbalances in the pension system.*

- **Completing financial sector reform agenda,** by fully funding the central bank's new liquidity framework, including the LOLR facility, and raising reserves of the deposit insurance fund to strengthen the financial safety net. *Partial progress has been made on funding the LOLR facility with a US$100 credit line from IDB but there has been no progress on deposit insurance.*

Annex II. External Assessment[1]

Based on quantitative indicators, El Salvador's real effective exchange rate (REER) is assessed to be modestly overvalued by 2–9 percent. Non-price indicators also point to diminished competitiveness.

El Salvador's CPI-based REER has depreciated by 7.6 percent since end-2001. However, this decline masks a real depreciation with respect to most regional trade partners that was offset by a 9 percent real appreciation vis-à-vis the U.S. (El Salvador's largest trading partner buying 47 percent of exports). Since end-2012, the small appreciation of the nominal effective exchange rate has been more than offset by the decline in relative inflation.



Source: Fund staff estimates.

The External Balance Assessment (EBA-lite)—based on existing fundamentals and desirable policies—suggests an overvaluation of about 2½ percent. The methodology points to a cyclically-adjusted current account norm of 5½ percent of GDP, which is about 1 percentage point smaller than the actual deficit of 6½ percent in 2013. This gap mainly reflects fiscal and reserve adequacy policy gaps. The identified fiscal gap is a significant contributor to El Salvador's current account gap. However, these estimates should be treated cautiously since the methodology does not account for dollarization and its implication for reserve adequacy.

CGER-like methods indicate an REER overvaluation in the range of 2 to 9 percent.

- The macro balance approach (based on medium-term fundamentals) points to an overvaluation of about 2½ percent.

- The external sustainability approach estimates the overvaluation to be above 6 percent, based on stabilizing the NFL position at 60 percent of GDP observed at end-2013. However, it is unclear whether the NFL position for El Salvador should be kept at 60 percent of GDP or reduced below that level in order to lessen external vulnerabilities (which would suggest a larger overvaluation).

- The equilibrium real exchange rate methodology, modeled as a function of terms of trade, relative productivity, relative government consumption, initial net foreign assets, and remittance flows, suggests an overvaluation of about 9 percent.

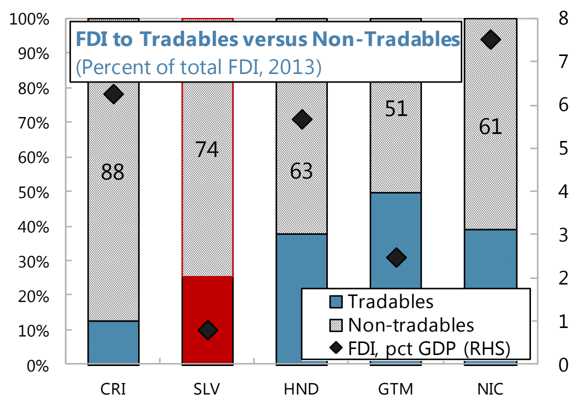
El Salvador: Exchange Rate Assessment Results

EBA-lite methodology	Cyclically-adjusted CA norm 1/	Cyclically-adjusted CA deficit 1/	Total gap	REER 3/
	-5.5	-6.5	-0.9	2.3
CGER-like methodologies	Current account balance 2/			REER 3/
	Norm	Underlying		
Macroeconomic balance	-4.8	-6.2		2.3
External sustainability	-2.3	-6.2		6.5
Equilibrium Real Exchange Rate 4/				8.6

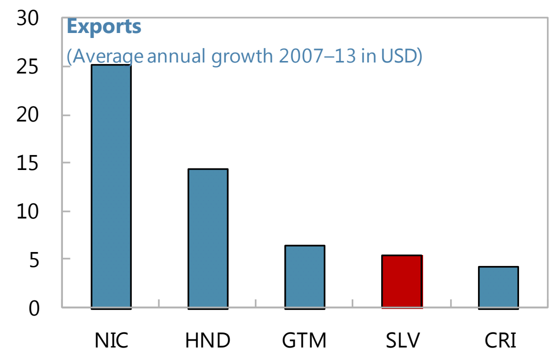
Source: Fund staff estimates and projections.
1/ Percent of GDP. Information for 2013.
2/ Percent of GDP.
3/ (+): overvaluation. Country elasticities based on Tokarick (2010).
4/ Misalignment for 2013

[1] Prepared by Marco Arena and Joyce Wong.

Other indicators suggest a clear problem with competitiveness, some part of which may be linked to an overvalued exchange rate. FDI and exports are the lowest in the region. FDI has averaged 2.3 percent of GDP since 2005, peaking in 2007 from banking sector investments. In 2013, nearly three-quarters of total FDI was in non-tradables, one of the highest shares in the region. Exports of goods and services are only 24 percent of GDP compared to 33 and 43 percent in Honduras and Nicaragua, respectively. Also, while total exports have risen in recent years, the growth rate is among the lowest in the region.

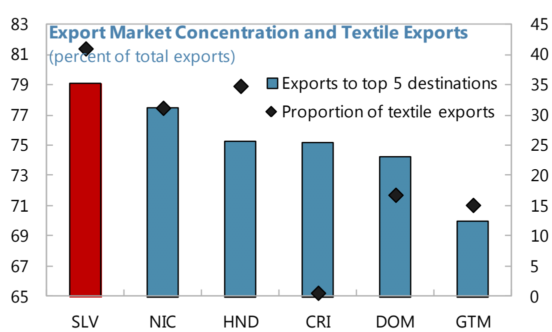


Source: National Authorities.

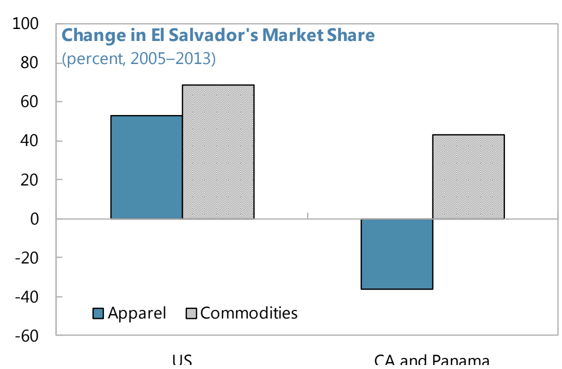


Source: WEO.

El Salvador's exports are highly concentrated in both destination and composition. The top 5 export destinations (U.S., Guatemala, Honduras, Nicaragua and Costa Rica) account for almost 80 percent of all exports. No other country in the region trades as much with CAPDR— El Salvador exports 40 percent to the regional block followed by Guatemala with 26 percent. El Salvador's exports are also concentrated in relatively low value-added and labor intensive goods, which are likely to be sensitive to the relative valuation of the exchange rate (40 percent of exports are clustered in low-end textiles). While El Salvador's market share of textiles (apparel) in the U.S. has increased by over 50 percent since 2005, it has declined by over a third in Central America and Panama. El Salvador's market share in commodities (mostly coffee and sugar) has in general increased but accounts for a much smaller portion of its total export basket (8 percent).

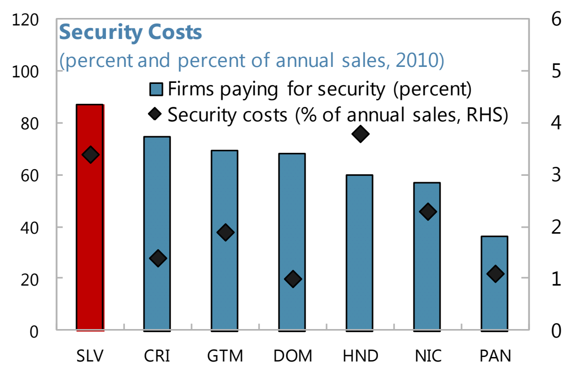


Source: Central Bank of El Salvador

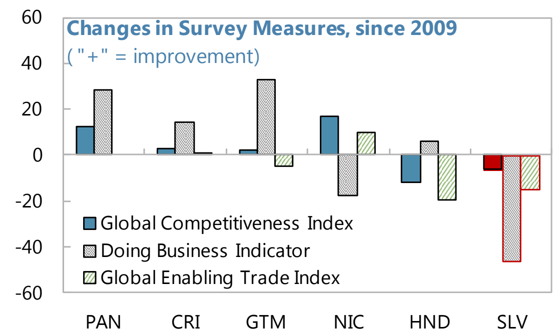


Source: Central Bank of El Salvador.

El Salvador's business environment has deteriorated. According to the World Bank's Doing Business indicators, El Salvador shows a low ranking in investor protection, starting a business, tax payment, dealing with construction payments and contract enforcement.[2] The World Economic Forum's competitiveness index has shown some improvement particularly in 2013 (e.g. intellectual property protection, transparency of government policymaking, efficiency of legal framework, infrastructure, goods market efficiency, business sophistication and innovation). Nevertheless, it also points to an erosion in labor market efficiency (i.e., in the flexibility of wage determination and pay and productivity) and the institutional environment (notably weaker investor protections and the rise of organized crime and general business costs). According to the World Bank's enterprise survey, El Salvador has the highest proportion of firms paying for security with average security costs equal to about 3.4 percent of annual sales, the highest in the region after Honduras.



Source: World Bank.



Source: Global Competitiveness Index, Doing Business Indicator, and Global Enabling Trade Index.

The investment climate faces multiple bottlenecks. These include security, legal stability, red tape (government bureaucracy), infrastructure services (transport, logistics and customs), access to financing (especially for SMEs), and low access and high cost of energy. The authorities are addressing some of these bottlenecks in the context of its Productive Transformation Policy (PTP).[3] They have drafting new legislation to address some of these issues (e.g., red tape to facilitate private sector investment, electronic signature and legal stability). The development bank (BANDESAL) also plans to channel more resources to SMEs. Finally, the implementation of energy projects would increase the reliability and lower the cost of energy over the medium-term.

[2] These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.

[3] The PTP has identified productive sectors with higher value added and comparative advantages in international markets (vertical policies), and also bottlenecks that are common across sectors (transversal policies).

Annex III. El Salvador: Public Debt Sustainability Analysis (Higher Scrutiny Case)[1]

The DSA highlights El Salvador's unsustainable debt dynamics under current policies. The drivers include high primary deficits, low growth, and rising interest rates. The relatively high financing needs and large contingent pension liabilities are key vulnerabilities in the fully dollarized economy. Downside risks from growth and global interest rate shocks are partly mitigated by the relatively long maturity of existing debt and a stable investor base.

A. Key Assumptions

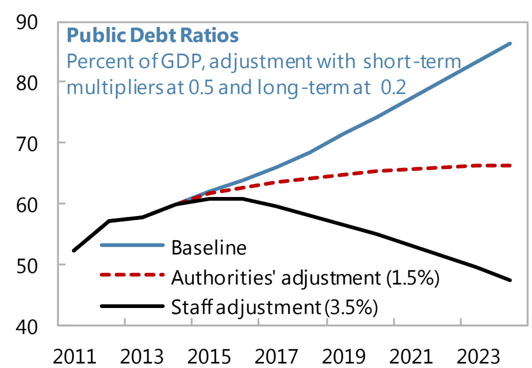
Debt definition. El Salvador's public debt is defined as the sum of gross debt of nonfinancial public sector (including pension-related debt) and external debt of the central bank (1 percent of GDP). This definition better captures quasi-fiscal liabilities (relating to public enterprises and the public financial sector) due to the large role of a fiscal backstop under a dollarized economy's funding constraints.

Growth. The baseline reflects the estimated growth potential of 2 percent. Susceptibility to shocks (including natural disasters and external spillovers especially from the U.S.) is a downside risk.

Fiscal policy and financing. Under current policies, the primary deficit remains broadly constant. The headline deficit would increase above 5 percent of GDP in the medium term, due to the higher interest bill from the rising debt and (US LIBOR-dependent) servicing costs. The baseline assumes that unidentified financing gaps are filled with long-term loans from official and private creditors. Alternatively, the debt profile could become riskier, reflecting a growing share of short-term debt.

B. Results and Assessment

Results. Under current policies, public debt would be over 70 percent of GDP by 2019, staying on an upward trajectory thereafter.[2] The gross financing needs would average above 8 percent of GDP, increasing to 11 percent by 2019 due to a Eurobond repayment. The authorities' draft fiscal responsibility law would imply a cumulative adjustment of 1½ percent of GDP. Debt dynamics under this scenario would be more benign than under the baseline, but would still imply a debt of 66 percent of GDP in 2024 and rising thereafter. This would be well above the assessed sustainable level of public debt.



Source: Fund staff estimates and projections.

Drivers. The upward debt dynamic is driven by high real interest rates and primary deficits (contributing about 2 and 1½ percent of GDP respectively on an annual basis). Real GDP growth would reduce the ratio by a little more than 1¼ percent of GDP annually.

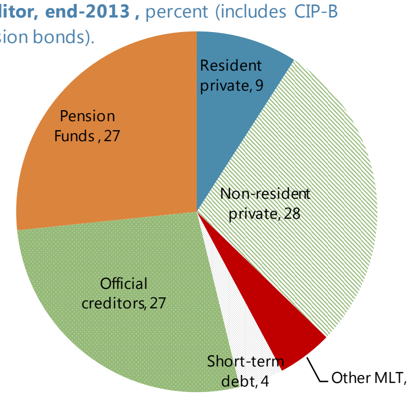
[1] Prepared by Bogdan Lissovolik.
[2] Staff estimates public debt threshold for El Salvador within the 40–50 percent range (see Box 2).

Assessment. Most standard debt profile characteristics are at or close to "danger" levels (see heat-map). The heat-map may also be understating some risks: (i) the threshold for gross financing (15 percent of GDP) does not take into account funding constraints of dollarization, whereby there is no backstop for LOLR or other shocks; (ii) the indicator of change in short-term external debt in 2013 is favorably impacted by the one-off repayment of LETES from the stock of reserves (since the repayment did not improve the underlying debt sustainability position); and (iii) the measured share of "foreign currency" debt (close to zero) reflects the legal adoption of the US dollar, not the implied benefits of issuing own-currency liabilities.

Mitigating factors. Existing debt has a relatively long average debt maturity (12 years) and a stable investor base (over a half of the debt is held by domestic pension funds and official creditors). In the latter aspect, the heat-map may overstate risks from "nonresident holdings."

Stress tests. Real GDP, interest rate, and contingent liability shocks have a significant impact. The real GDP shock causes the 2019 debt ratio to increase 5 percentage points over the baseline. A "combined macro-fiscal shock" would be particularly challenging (with the debt/GDP ratio reaching 79 percent). For a financial contingent liability shock, the 2015 gross financing requirement would rise to 12 percent of GDP, almost 5 percentage points above the baseline. Higher global interest rates would have a large impact as some 43 percent of existing debt is mostly linked to U.S. LIBOR floating rates. If there is greater recourse to short-term borrowing (e.g. half of the projected financing gaps is met with short-term borrowing), public gross financing needs would rise to 15 percent of GDP in 2019.

El Salvador: Composition of Public Debt by Creditor, end-2013 , percent (includes CIP-B pension bonds).



Source: Ministry of Finance of El Salvador.

Idiosyncratic risks and issues: These include: (i) A potential one-off downward revision of nominal GDP; (ii) unfunded pension-related liabilities, estimated at 94 percent of GDP in NPV terms; (iii) the potential assumption of enterprise debt; and (iv) contingent liabilities from PPP projects (the legal cumulative ceiling for PPPs has been set at 3 percent of GDP, but it could be increased up to 5 percent in some circumstances). In addition, some of the pension bonds already issued (the so-called CIP-B series), equivalent to 6 percent of GDP, should also be recognized as public debt.

Long-term debt and pensions. Projections were extended to 2030. Assuming a constant primary deficit at the 2019 level, debt would continue growing rapidly, exceeding 100 percent of GDP by 2030, with the overall deficit exceeding 7 percent of GDP. El Salvador's pension system would be a key additional driver of debt dynamics and would increase the deficit by an annual average of ½ percent of GDP during 2015–30 relative to the baseline, and steadily increase fiscal spending.

Authorities' views. In addition to considering staff's growth and interest rate assumptions to be pessimistic, the authorities also regarded gross national disposable income (which would include the high remittance flows), rather than GDP, to be a better measure to gauge the country's capacity to repay.

Table A2.1. El Salvador: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

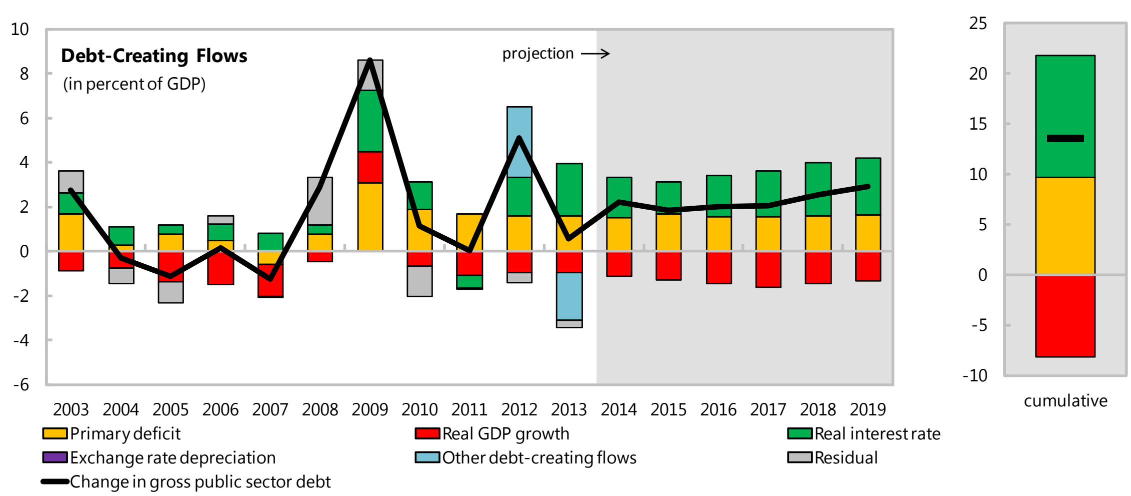
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	44.8	57.3	57.8	60.0	61.9	63.9	65.9	68.5	71.4
Public gross financing needs	9.0	7.9	9.0	9.1	7.3	8.6	8.1	8.4	11.3
Real GDP growth (in percent)	1.9	1.9	1.7	2.0	2.2	2.4	2.6	2.3	2.0
Inflation (GDP deflator, in percent)	3.5	1.0	0.2	1.2	2.2	2.0	1.9	1.7	1.9
Nominal GDP growth (in percent)	5.6	2.9	1.9	3.2	4.5	4.4	4.5	4.0	3.9
Effective interest rate (in percent) [4/]	5.7	4.5	4.4	4.4	4.8	5.1	5.3	5.5	5.9

As of November 07, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		375
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	Ba3	Ba3
S&Ps	BB-	BB-
Fitch	BB-	BB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.4	5.1	0.6	2.2	1.9	2.0	2.0	2.6	2.9	13.6	
Identified debt-creating flows	1.2	5.5	0.9	2.2	1.9	2.0	2.0	2.6	2.9	13.6	
Primary deficit	1.1	1.6	1.6	1.5	1.7	1.6	1.6	1.6	1.6	9.6	1.3
Primary (noninterest) revenue and grants	17.0	18.9	19.3	19.0	19.0	19.4	19.5	19.5	19.4	115.7	
Primary (noninterest) expenditure	18.2	20.5	20.9	20.5	20.7	20.9	21.1	21.1	21.0	125.3	
Automatic debt dynamics [5/]	0.1	0.8	1.4	0.7	0.2	0.4	0.5	0.9	1.3	3.9	
Interest rate/growth differential [6/]	0.1	0.8	1.4	0.7	0.2	0.4	0.5	0.9	1.3	3.9	
Of which: real interest rate	0.9	1.7	2.3	1.8	1.4	1.9	2.1	2.4	2.6	12.1	
Of which: real GDP growth	-0.7	-1.0	-0.9	-1.1	-1.3	-1.4	-1.6	-1.5	-1.3	-8.2	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	3.2	-2.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization/Drawdown of Deposits	0.0	3.1	-2.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase BCR's external debt	0.0	0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.2	-0.4	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: Fund staff estimates and projections.

1/ Public sector is defined as non-financial public sector.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = 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).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

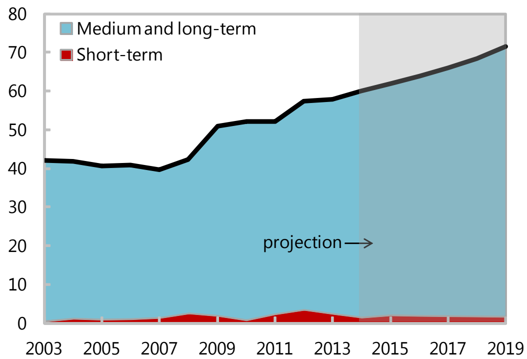
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

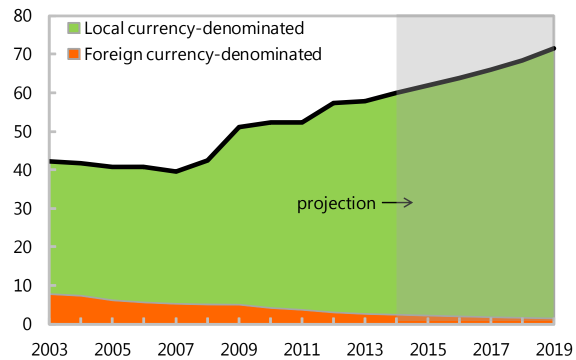
Table A2.2. El Salvador: Public Sector DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)

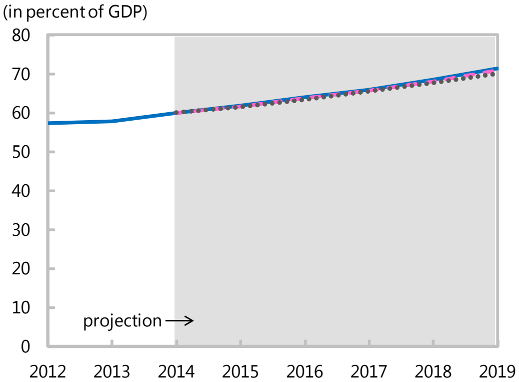


By Currency
(in percent of GDP)

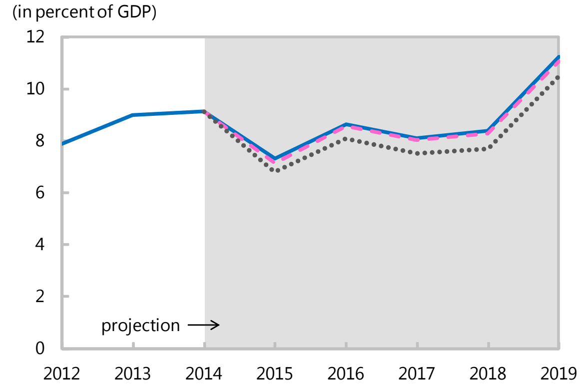


Alternative Scenarios

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	2.2	2.4	2.6	2.3	2.0
Inflation	1.2	2.2	2.0	1.9	1.7	1.9
Primary Balance	-1.5	-1.7	-1.6	-1.6	-1.6	-1.6
Effective interest rate	4.4	4.8	5.1	5.3	5.5	5.8
Constant Primary Balance Scenario						
Real GDP growth	2.0	2.2	2.4	2.6	2.3	2.0
Inflation	1.2	2.2	2.0	1.9	1.7	1.9
Primary Balance	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5
Effective interest rate	4.4	4.8	5.1	5.3	5.5	5.8

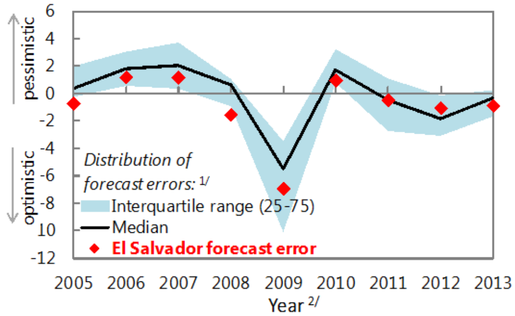
Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	1.8	1.8	1.8	1.8	1.8
Inflation	1.2	2.2	2.0	1.9	1.7	1.9
Primary Balance	-1.5	-1.2	-1.2	-1.2	-1.2	-1.2
Effective interest rate	4.4	4.8	5.0	5.2	5.3	5.6

Source: Fund staff estimates and projections.

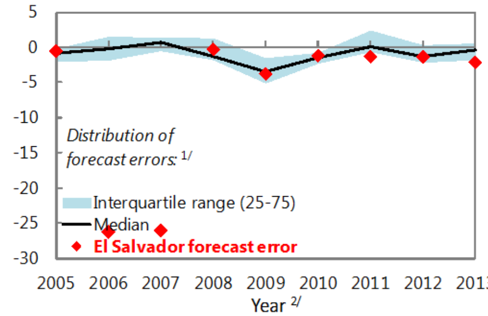
Table A2.3. El Salvador: Public Sector DSA – Realism of Baseline Assumptions

Forecast Track Record, versus program countries

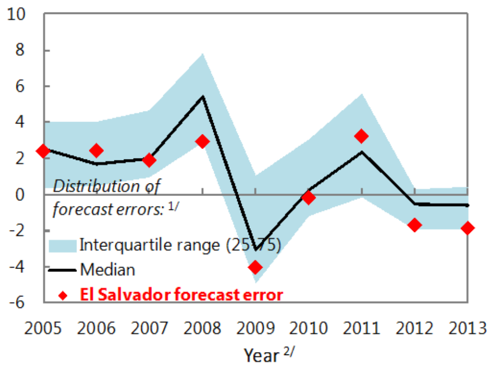
Real GDP Growth
(in percent, actual-projection)
El Salvador median forecast error, 2005-2013: -0.75
Has a percentile rank of: 25%



Primary Balance
(in percent of GDP, actual-projection)
El Salvador median forecast error, 2005-2013: -1.38
Has a percentile rank of: 24%

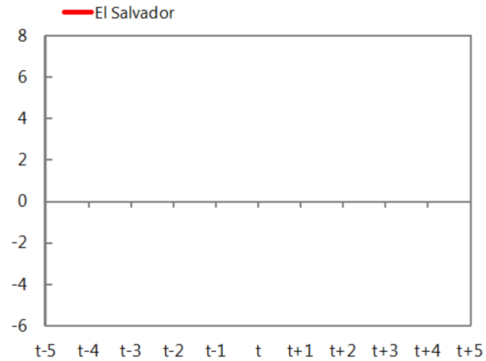


Inflation (Deflator)
(in percent, actual-projection)
El Salvador median forecast error, 2005-2013: 1.86
Has a percentile rank of: 63%



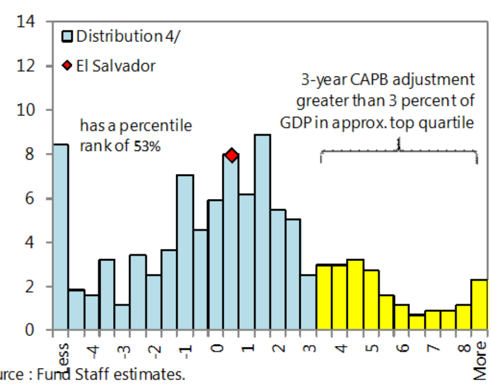
Boom-Bust Analysis 3/

Real GDP growth
(in percent)

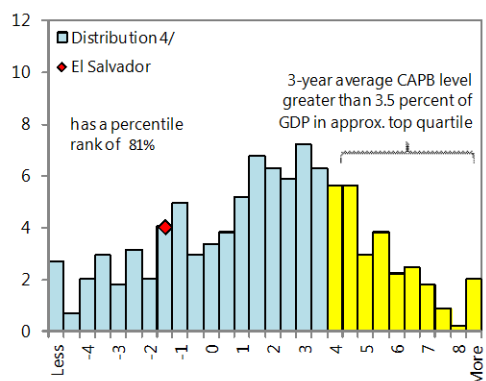


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



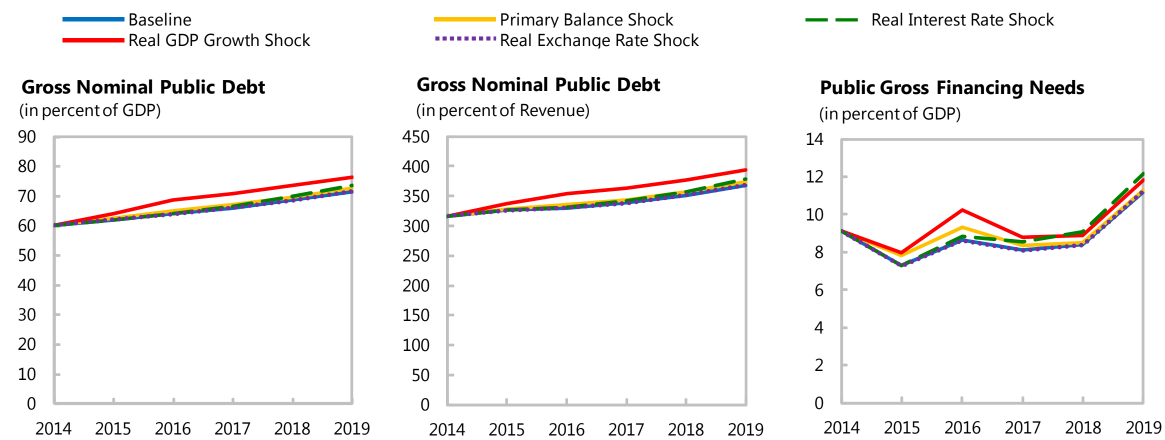
3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



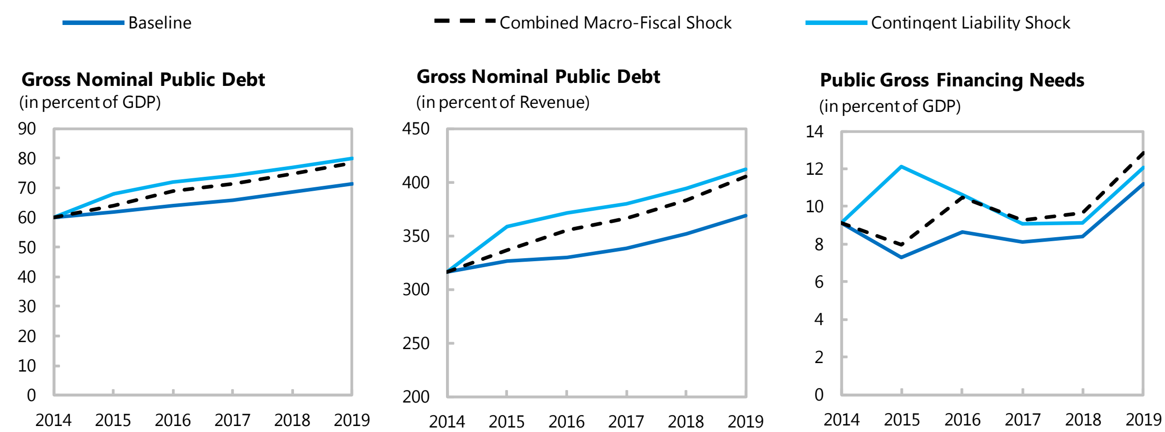
Source : Fund Staff estimates.
1/ Plotted distribution includes program countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for El Salvador.
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Table A2.4. El Salvador: Public Sector DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	2.2	2.4	2.6	2.3	2.0
Inflation	1.2	2.2	2.0	1.9	1.7	1.9
Primary balance	-1.5	-2.2	-2.1	-1.6	-1.6	-1.6
Effective interest rate	4.4	4.8	5.2	5.4	5.5	5.9
Real Interest Rate Shock						
Real GDP growth	2.0	2.2	2.4	2.6	2.3	2.0
Inflation	1.2	2.2	2.0	1.9	1.7	1.9
Primary balance	-1.5	-1.7	-1.6	-1.6	-1.6	-1.6
Effective interest rate	4.4	4.8	5.5	6.0	6.4	7.0
Combined Shock						
Real GDP growth	2.0	0.2	0.4	2.6	2.3	2.0
Inflation	1.2	1.7	1.5	1.9	1.7	1.9
Primary balance	-1.5	-2.2	-2.6	-1.6	-1.6	-1.6
Effective interest rate	4.4	4.8	5.5	6.0	6.4	7.0

Real GDP Growth Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	0.2	0.4	2.6	2.3	2.0
Inflation	1.2	1.7	1.5	1.9	1.7	1.9
Primary balance	-1.5	-2.2	-2.6	-1.6	-1.6	-1.6
Effective interest rate	4.4	4.8	5.1	5.3	5.5	5.8
Real Exchange Rate Shock						
Real GDP growth	2.0	2.2	2.4	2.6	2.3	2.0
Inflation	1.2	2.2	2.0	1.9	1.7	1.9
Primary balance	-1.5	-1.7	-1.6	-1.6	-1.6	-1.6
Effective interest rate	4.4	4.8	5.1	5.3	5.5	5.8
Contingent Liability Shock						
Real GDP growth	2.0	0.2	0.4	2.6	2.3	2.0
Inflation	1.2	1.7	1.5	1.9	1.7	1.9
Primary balance	-1.5	-6.1	-1.6	-1.6	-1.6	-1.6
Effective interest rate	4.4	5.2	5.2	5.4	5.5	5.8

Source: Fund staff estimates and projections.

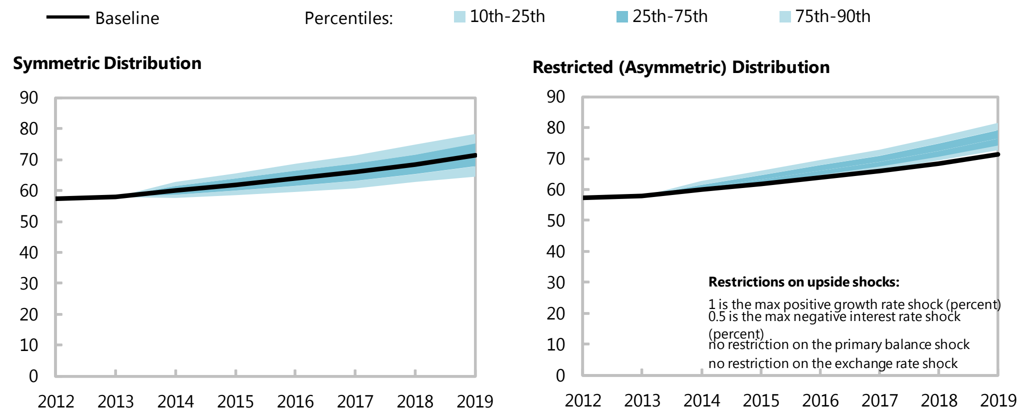
Table A2.5. El Salvador: Public Sector DSA – Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

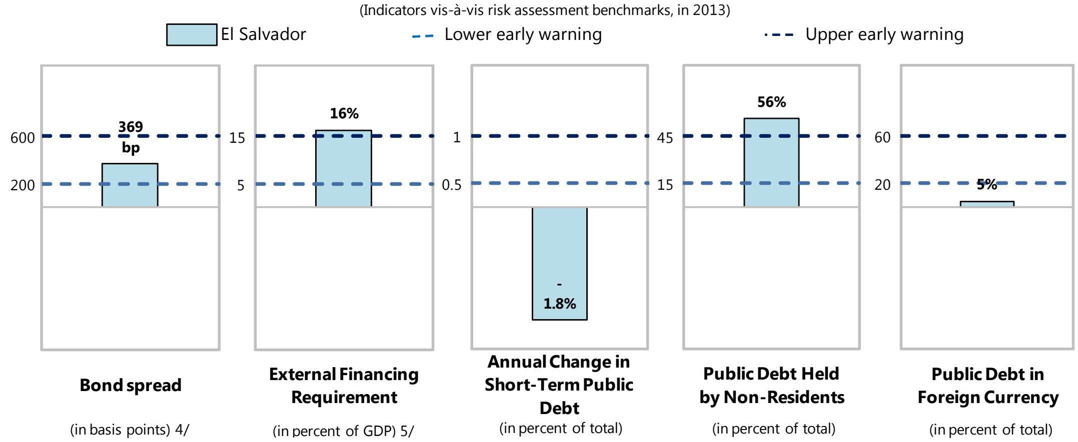
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



Source: Fund staff estimates and projections.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

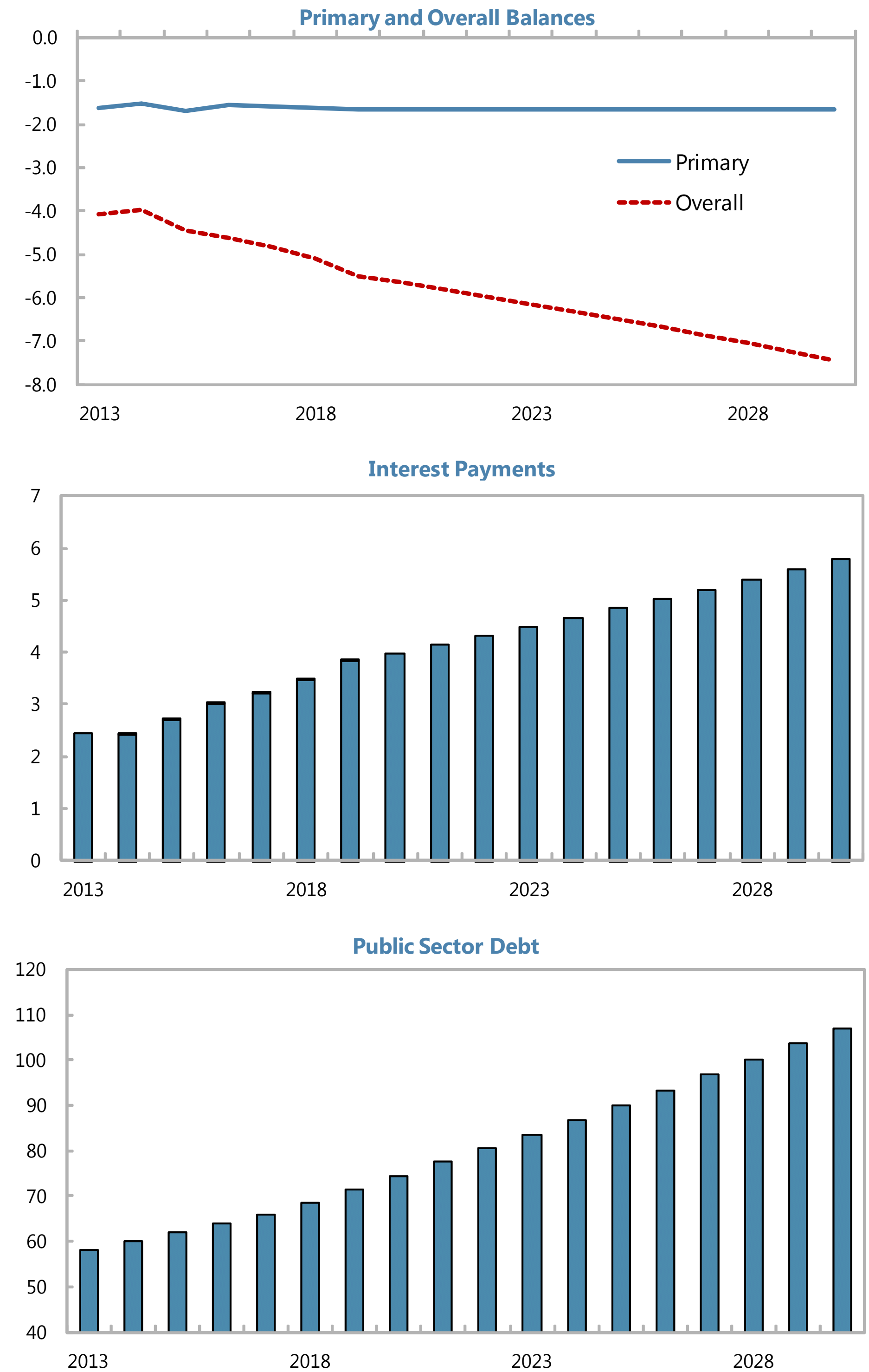
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 09-Aug-14 through 07-Nov-14.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure A2. El Salvador: Long-Term Fiscal Sustainability (2013–30), Baseline 1/

(Percent of GDP)



Source: Fund staff estimates and projections.

1/ This path is the baseline through 2019, with a constant primary balance thereafter.

INTERNATIONAL MONETARY FUND

EL SALVADOR

November 24, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The Western Hemisphere Department

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FUND RELATIONS

(As of October 31, 2014)

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	165.56	101.07

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				
	2014	2015	2016	2017	2018
Principal		0.00	0.00	0.00	0.00
Charges/Interest		0.00	0.00	0.00	0.00
Total		**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 May 20, 2013 (Country Report No. 13/132).

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 2011. A data module ROSC was conducted in 2004.

Technical Assistance.

Department	Purpose	Time of Delivery
FAD	Customs Administration	May 2011
FAD	Medium-Term Expenditure Framework	Dec 2011
FAD	Single Treasury Account	Jan 2012
FAD	Medium-Term Expenditure Framework	Apr 2012
FAD	Customs Administration	Jun 2012
FAD	Single Treasury Account	Nov 2012
FAD	Medium-Term Expenditure Framework	Feb 2013
FAD	Tax Administration, Auditing, Strategic Plan, IVA Tax Credit Control, Control Model Based on Information.	Jun 2013 Jul 2013 Sept 2013 Oct 2013
FAD	Customs Post Clearance Audit	Mar 2014
FAD	Tax Administration, Auditing, Strategic Plan, IVA Tax Credit Control, Control Model Based on Information.	Mar 2014 Jun 2014 Aug 2014
FAD	Coordinated Border Management	Aug 2014 Sept 2014
FAD	Tax Administration, Auditing, Strategic Plan, IVA Tax Credit Control, Control Model Based on Information	Sept 2014
MCM	Liquidity Management	Sept 2011
MCM	Macroeconomic Modeling of Aggregate Demand, Potential Output, and Inflation Forecasting	Oct 2011 Feb 2012
MCM	Cross-Border Consolidated Banking Supervision	Mar 2012
MCM	Liquidity Management	Apr 2012
MCM	Border Consolidated Banking Supervision	Jun 2012
MCM	Econometric Estimation of the Real Effective Exchange Rate	Jul 2012
MCM	Liquidity Risk Management	Jul 2012
MCM	Integration of the Labor and Interest Rate Sectors to Aggregate Demand Models	Aug 2012
MCM	Risk-based Insurance Supervision	Sep 2012
MCM	Risk-based Pension Supervision	Oct 2012
MCM	Operational Risk Regulation	Oct 2012
MCM	Inflation Rate Modeling	Oct 2012

MCM	Risk-based Insurance Supervision	Jan 2013
MCM	Completion of the Macro Econometric Integrated Model for the Salvadorian Economy	Jan 2013
MCM	Cross-Border Consolidated Banking Supervision	Feb 2013
MCM	Risk-based Pension Supervision	Feb 2013
MCM	Quarterly Econometric Models for GDP (including by sectors) and Inflation Rate Projections	Aug 2013 Nov 2013
MCM	Stress Testing for Banking Supervision	Nov 2013
MCM	Financial Stability Strategy/Interbank Market	Jan 2014
MCM	Risk-based Securities Supervision	Feb 2014
MCM	Stress Testing for Banking Supervision	Feb 2014
MCM	Technological Information Risk Regulation	Mar 2014
MCM	Bank Resolution Framework	Apr 2014
MCM	Risk-based Securities Supervision	Apr 2014
MCM	Bank Resolution Framework	May 2014
MCM	Consumer Protection Regulation	Jun 2014
MCM	Technological Information Risk Regulation	Jun 2014
MCM	Stress Testing for Banking Supervision	Jun 2014
MCM	Credit Classification	Jul 2014
MCM	Asset Classification	Oct 2014
MCM	Bank Resolution Framework	Nov 2014
STA	Source Data	2011
STA	Annual National Accounts (ANA) – Multiple missions	2011
STA	Regional Harmonization of Monetary and Financial Statistics (second phase)	Jun 2011
STA	Producer Price Index (PPI) – multiple missions	2012
STA	Exports/Imports Price Indices (XMPIs) – multiple missions	2012
STA	Annual National Accounts (ANA) – multiple missions	2012
STA	Financial Services Indirectly Measured (FISIM)	2012
STA	Quarterly National Accounts (QNA) – multiple missions	2012
STA	Regional Harmonization of Monetary and Financial Statistics (second phase)	Feb 2012
STA	External Statistics, Service Account, Financial Account (Sixth Manual of Balance of Payments)	Mar 2012
STA	Financial Account of the BOP	Mar 2012
STA	Balance of Payments (BOP) and International Investment Position (IIP), BPM6	Sep 2012
STA	Services Account of the BOP	Oct 2012
STA	External Statistics, Service Account, Financial Account, BPM6	Oct 2012 Nov 2012
STA	Producer Price Index (PPI) – multiple missions	2013
STA	Exports/Imports Price Indices (XMPIs) – multiple missions	2013
STA	Annual National Accounts (ANA) – multiple missions	2013

STA	Non-observed Economy/Employment Matrix – multiple missions	2013
STA	Financial Account of the BOP	Apr 2013
STA	Balance of Payments (BOP) and International Investment Position (IIP), BPM6	Jun 2013
STA	Topics of the Current Account of the BOP	Sep 2013
STA	Producer Price Index (PPI) – multiple missions	2014
STA	Exports/Imports Price Indices (XMPIs) – multiple missions	2014
STA	Annual National Accounts (ANA) – multiple missions	2014
STA	Non-observed Economy/Employment Matrix – multiple missions	2014
STA	Quarterly National Accounts (QNA) – multiple missions	2014
STA	Balance of Payments (BOP) and International Investment Position (IIP), BPM6	Apr 2014
STA	Coordinated Direct Investment Survey (CDIS) and Coordinated Portfolio Investment Survey (CPIS)	Apr 2014
STA	Balance of Payments (BOP) and International Investment Position (IIP), BPM6	Jun 2014
STA	Topics of the Secondary Income Account of the BOP.	Jun 2014

Resident Representative: Mario Garza (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 met on several occasions with the World Bank team 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, boost growth and shared prosperity. The priority is to place the public debt-to-GDP ratio on a sustainable 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 since 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. Resolving these weaknesses will improve the ability to control public expenditure and execute the investment budget.

- **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 tax policy TA, 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 to implement 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	2014–2015	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)
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 2015 December 2013, June 2014 2014–2015 Ongoing Ongoing Ongoing Ongoing Ongoing	July 2015 December 2013, June 2014 2014–2015

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK (IADB)

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

As of October 2014, the IADB has pending disbursements for US$ 523 million, which correspond to public-sector guaranteed loans and which are mostly concentrated in seventeen programs in thirteen sectors. For 2014, the IADB approved two loans for US$ 140 million in the area of enhance productivity (US$ 40 million) and access to finance (US$ 100 million).

El Salvador: Relations with the Inter-American Development Bank
(As of October 1, 2014, in millions of U.S. dollars)

Operations			
Sector	**Commitments**	**Amount Disbursed**	**Amount Undisbursed**
Competitiveness and Innovation	225	2.1	222.9
Gender and Diversity	20	19	1
Health	60	50.8	9.2
Labor Markets	20	0	20
Modernization of the State	5	2.9	2.1
Roads and Transportation	210	66.1	143.9
Urban Dev. And Housing	120	35.3	84.7
Violence Prevention	45	0	45
Water and Sanitation	20	16.5	3.5

Loan Disbursements and Amortizations									
	2006	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014p**
Disbursements	100.2	96.1	288.1	487.4	115.5	202.8	266.1	97.3	67.7
Repayments	88.9	90.5	104.8	278.3	125.5	116.3	114.7	104.2	128.5
Net lending	**11.29**	**5.6**	**183.3**	**209.1**	**-10.0**	**86.5**	**151.4**	**-6.9**	**-60.8**
Interest and charges		62.3	67.3	67.8	56.5	55.0	51.8	51	49.4
Subscriptions and contributions		-	2.9	2.9	1.2	1.5	2.7	1.7	2
Net transfer	**11.29**	**-56.6**	**113.1**	**138.4**	**-67.7**	**30.0**	**96.9**	**-59.6**	**-112.2**

STATISTICAL ISSUES

(As of October 2014)

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 the most important recommendations of 2008 SNA for the country, with 2005 as new reference year. 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 November 24, 2014)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Oct-2014	Nov-2014	M	M	M		
Reserve/Base Money	Sep-2014	Oct-2014	M	M	M	O, LO, LO, LO	O, O, O, LO, O
Broad Money	Sep-2014	Oct-2014	M	M	M		
Central Bank Balance Sheet	Sep-2014	Oct-2014	W	W	M		
Consolidated Balance Sheet of the Banking System	Sep-2014	Oct-2014	W	W	M		
Interest Rates[2]	Nov-2014	Nov-2014	W	W	W		
Consumer Price Index	Oct-2014	Nov-2014	M	M	M	O,O,LNO,O	LNO,LO,O,O,LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Sep-2014	Oct-2014	M	M	M	LO, LO,LNO,LO	LO,O,LO,LO,NO
Revenue, Expenditure, Balance, and Composition of Financing[3]– Central Government	Sep-2014	Oct-2014	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[4]	Sep-2014	Oct-2014	M	M	M		
External Current Account Balance	Jun-2014	Sep-2014	Q	Q	Q	O, LO, LNO,LO	LO, LO,O,O,LO
Exports and Imports of Goods and Services	Sep-2014	Oct-2014	M	M	M		
GDP/GNP	Jun-2014	Sep-2014	Q	Q	Q	LO,LNO,LNO,LO	LNO,LNO,LO,O,LO
Gross External Debt	Jun-2014	Sep-2014	Q	Q	Q		
International Investment Position[6]	Jun-2014	Sep-2014	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
COMMUNICATIONS DEPARTMENT

Press Release No. 14/567
FOR IMMEDIATE RELEASE
December 11, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with El Salvador

On December 11, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with El Salvador[1] and considered and endorsed the staff appraisal without a meeting.[2]

Background

El Salvador's growth—driven by private consumption—has continued to lag the Central American region. In 2013, growth decelerated to 1.7 percent, as private consumption slowed against weaker remittances. Growth accelerated slightly to 2 percent in the first half of 2014 as remittances recovered. Inflation—anchored by full dollarization—has remained low at 1-2 percent.

The fiscal deficit has remained high and external imbalance has risen since 2010. Despite strong revenue performance through 2013, the fiscal deficit has remained at 4 percent of GDP due to higher wage bill and current transfers. The resulting tight financing situation has lowered public investment and caused an accumulation of payment arrears; the latter reduced sizably following the issuance of a US$800 million Eurobond in September. However, public debt is set to reach 60 percent of GDP by end-2014. The rising current account deficit reflects a decline in private saving/investment balance and sustained fiscal deficits. In 2013, it reached 6½ percent of GDP as exports faced broad-based weaknesses. The external position is, however, improving in 2014 due to lower imports, services exports, recovering remittances, and the recent drop in oil prices.

The banking system is broadly sound. The mostly foreign-owned banking sector is highly liquid and reports strong capital positions, with low non-performing loans and high

[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.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

provisioning. Credit growth has been moderate (7 percent in 2013–14), but partially funded by external borrowing in the absence of corresponding deposit growth.

Under current policies, growth is expected to be around 2 to 2¼ percent in 2014-15, and reach about 2½ percent in 2016–18 reflecting private and public investment projects expected to come on stream. The ongoing reduction in external current account deficit would unwind in the medium term partly as the fiscal deficit is projected to widen to 5½ percent of GDP and public debt would rise above 70 percent of GDP by 2019.

Key risks include global uncertainties linked to the normalization of U.S. monetary policy or a deteriorating economic outlook for advanced and emerging markets, which could interact with domestic fiscal and external vulnerabilities. On the upside, a more sustained fall in oil prices could lessen external imbalances and have some positive growth effects, while better-than-expected growth in the U.S. would have positive spillovers to El Salvador. In addition, promoting regional cooperation, including under the Alliance for Prosperity in the Northern Triangle, could also attract further private investment and provide sustained job creation.

Executive Board Assessment

In concluding the 2014 Article IV consultation with El Salvador, Executive Directors endorsed staff's appraisal as follows:

El Salvador's growth has been modest and macroeconomic vulnerabilities are rising. The persistently low growth reflects both domestic policy weaknesses and a fragile external environment. Public debt dynamics are becoming unsustainable, the fiscal and current account deficits have grown, and gross financing needs are sizable.

The new government has an opportunity to build on the emerging broad social and political consensus to address the economic imbalances and social challenges. There is agreement on the need to strengthen the foundations for growth, address the country's fiscal imbalances, and deepen efforts to support the poor. Progress has been achieved in recent years to raise tax revenues, lower inequality, and maintain financial stability, but significant challenges remain. The ongoing parliamentary discussion of the draft Fiscal Responsibility Law has brought fiscal issues to the forefront. However, the support for the necessary fiscal adjustment is lacking, and social and political pressures ahead of the 2015 congressional elections are delaying effective policymaking.

An ambitious fiscal adjustment that protects social spending should be a top priority. With medium-term gross financing needs projected to remain high, policies must focus on mitigating potential risks posed by a future increase in global risk aversion or higher global interest rates. A fiscal adjustment of around 3½ percent of GDP over the next three years will help maintain access to market financing on favorable terms and place debt on a sustainable path, while reducing the risks of a disorderly macroeconomic adjustment. The adjustment would likely have an adverse growth impact, but it could accelerate to 3 percent in the medium term with the benefit of supply-side reforms. The fiscal adjustment should occur alongside an increase in targeted social spending to protect the most vulnerable and lessen income inequality. A broader strategy will also be needed to attain a sustainable pension system and strengthen budget procedures.

A better business environment is imperative to enable private-sector led growth. Raising potential growth to 3 percent is an achievable goal but will require determined and ambitious supply-side reforms that substantially raise productivity and competitiveness and improve security. The envisaged steps aim to bolster public investment and promote economic transformation by diversifying the energy matrix, prioritizing key manufacturing and tradable service sectors, and upgrading infrastructure. Reforms to reduce red-tape and bureaucracy, increase financing for SMEs, improve access to energy and lower its costs, and better security should be quickly legislated to attract high-quality private investment. FOMILENIO II offers an opportunity to accelerate such reforms.

Improving the institutional framework for the banking sector is important. Financial indicators generally appear sound, a product of ongoing prudent supervision and regulation. Nonetheless, there is still scope to upgrade the legal framework for bank resolution and install an appropriately funded safety net for the banks.

Table. El Salvador: Selected Economic Indicators

	2008	2009	2010	2011	2012	2013	Proj. 2014	Proj. 2015
Income and Prices		**In percent of GDP (unless otherwise indicated)**						
Real GDP growth (percent)	1.3	-3.1	1.4	2.2	1.9	1.7	2.0	2.2
Consumer price inflation (average, percent)	7.3	0.5	1.2	5.1	1.7	0.8	1.2	2.0
GDP deflator (percent)	5.3	-0.5	2.3	5.7	1.0	0.2	1.2	2.2
External Sector								
Exports of goods, volume	7.4	-15.3	14.4	7.8	-0.2	4.7	-5.1	4.9
Imports of goods, volume	-6.5	-14.4	6.9	6.0	2.1	4.7	-0.9	5.0
Terms of trade, percent change	-9.5	12.6	-5.6	-2.5	0.5	-1.6	2.1	1.9
Real effective exchange rate (+ = appreciation)	7.1	-4.6	-0.7	1.7	-1.6	-0.8	...	...
External sovereign bond spread (basis points)	396	502	316	374	448	378	...	...
Money and Credit								
Credit to the private sector	43.0	42.4	40.9	39.8	40.2	42.7	44.2	44.1
Broad money	45.0	47.3	47.2	43.6	43.2	43.4	42.9	42.8
Interest rate (time deposits, percent)	4.2	4.5	2.9	1.8	2.5	3.4	...	...
External Sector								
Current account balance	-7.1	-1.5	-2.7	-4.9	-5.4	-6.5	-5.5	-4.9
Oil prices (U.S. dollars per barrel)	97.0	61.8	79.0	104.0	105.0	104.1	98.9	84.6
Trade balance	-21.8	-15.0	-16.5	-18.4	-18.7	-19.7	-19.3	-18.8
Exports (f.o.b. including *maquila*)	21.9	19.0	21.4	23.3	22.9	23.1	21.7	21.9
Imports (f.o.b. including *maquila*)	-43.8	-34.1	-37.8	-41.7	-41.6	-42.8	-41.0	-40.7
Services and income (net)	-2.8	-3.1	-3.0	-3.2	-3.5	-3.7	-3.6	-3.7
Transfers (net)	17.5	16.7	16.8	16.6	16.9	16.9	17.5	17.5
Foreign direct investment	3.8	1.8	0.5	1.8	2.0	0.6	0.5	1.7
Gross international reserves (millions of U.S. dollars)	2,545	2,987	2,882	2,503	3,175	2,745	2,638	2,742
Nonfinancial Public Sector								
Overall balance	-3.2	-5.7	-4.3	-3.9	-3.9	-4.1	-4.0	-4.4
Primary balance	-0.8	-3.1	-1.9	-1.7	-1.6	-1.6	-1.5	-1.7
Of which: tax revenue	13.5	12.6	13.5	13.8	14.4	15.4	15.2	15.2
Public sector debt 1/	42.4	51.0	52.2	52.2	57.3	57.8	60.0	61.9
National Savings and Investment								
Gross domestic investment	15.2	13.4	13.3	14.4	14.1	15.1	14.8	14.9
Public sector	2.4	2.2	2.4	2.4	2.5	2.6	2.4	2.6
Private sector	12.8	11.2	10.9	11.9	11.6	12.5	12.4	12.3
National savings	8.1	11.9	10.7	9.4	8.7	8.6	9.3	10.0
Public sector	-0.4	-3.1	-1.9	-2.0	-1.2	-1.2	-1.1	-1.4
Private sector	8.4	15.0	12.5	11.4	9.9	9.8	10.5	11.4
Net Foreign Assets of the Financial System								
Millions of U.S. dollars	2,208	3,028	3,378	2,811	3,229	2,473	1,843	1,846
Percent of deposits	24.4	32.4	34.5	28.8	32.6	24.0	17.8	17.1
Memorandum Items:								
Nominal GDP (billions of U.S. dollars)	21.4	20.7	21.4	23.1	23.8	24.3	25.0	26.2

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.

SECRETARÍA TÉCNICA
Y DE PLANIFICACIÓN
DE LA PRESIDENCIA
GOBIERNO DE
EL SALVADOR
UNÁMONOS PARA CRECER

San Salvador, January 8, 2015

STATEMENT OF THE ECONOMIC AUTHORITIES OF EL SALVADOR REGARDING THE 2014 IMF ARTICLE IV CONSULTATION

First, we would like to thank the staff of the International Monetary Fund for the visit to El Salvador in October of last year, which had the primary purpose of conducting a short- and medium-term assessment of economic growth, the fiscal situation and the pension system, the external sector, and the financial system. We are also grateful for the technical and professional rigor of the staff of the mission headed by Uma Ramakrishnan.

In general, we are in agreement with many of the assessments in the IMF report that recognize the country's advances in the areas of poverty reduction, enacted tax reforms, reforms that have enhanced the investment incentives, and anti-money laundering measures. We also share the assessment of the major challenges facing the country such as boosting economic growth, private investment, public investment, and social expenditure, as well as the opportunities that the current government must continue to use in order to make gradual progress on the structural correction of macroeconomic imbalances and achieve sustained growth that yields decent jobs, better education with social inclusion, and strengthened security. Such are the priorities of the 2014-2019 Five-Year Development Plan, which aims to achieve a more productive, educated, and secure country.

However, as regards the Fund's macroeconomic and fiscal projections made at the time of the mission, it is important to note that recently there have been significant changes in international commodity prices and stronger growth in the U.S. economy, which confirm the government's more optimistic assessment as reflected in its projections. These factors are positively impacting the country's domestic and external economic position, as reflected in increased demand for goods, lower inflation and energy prices – and the resulting effect on purchasing power and competitiveness, lower costs of inputs and raw materials for industries and activities that use petroleum products, lower expenditures on subsidies on public transportation and liquid petroleum gas, which could conceivably continue to shrink without any impact on the number of beneficiaries, and a reduction in the external sector deficit. Similarly, our authorities believe that an increase in international interest rates is unlikely to materialize in the short term.

Based on the projections of public and private investment and of the implementation of strategic projects considered in the Five-Year Development Plan – diversification of the production and energy matrices, reduction of energy costs, simplification of bureaucratic procedures, and expansion of the logistical and road infrastructure, among others – we are convinced that it will be possible to achieve a sustained rate of economic growth of 3 percent in the next five years.

The economic authorities also do not agree with the fiscal adjustment target of 3.5 percent of GDP proposed by the Fund nor with its speed (3 years), as this would have a negative impact on growth and on the socioeconomic conditions of the poorest and most vulnerable segments of the population, which could in turn affect the governability of the country.

Regarding the pension system, a concerted process of comprehensive reform will be implemented, which would guarantee the right to a decent pension and the system's financial sustainability; gradually provide universal coverage, especially in excluded sectors; and function within a framework of equity and solidarity-based collective and individual protection. These reforms will reduce the pressure on public finances currently exerted by the pension system.

Finally, we agree with the Fund on the importance of moving forward with a comprehensive process of dialogue with the main sectors of society, which would permit to conclude basic agreements around a national agenda on key development issues such as growth, fiscal sustainability, and pension system reform.