IMF Country Report No. 16/208

EL SALVADOR

July 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR EL SALVADOR

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with El Salvador, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 20, 2016 consideration of the staff report that concluded the Article IV consultation with El Salvador
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 20, 2016, following discussions that ended on May 6, 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 June 1, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for El Salvador.

The documents listed below have been or will be separately released.

Selected Issues Paper

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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June 22, 2016

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IMF Executive Board Concludes 2016 Article IV Consultation with El Salvador

On June, 20, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with El Salvador.

El Salvador continues to suffer from significantly lower growth than neighboring countries amid low investment, high outward migration, weak competitiveness, and political gridlock. GDP growth has averaged 2 percent over 2000-2014, well below the Central American regional average of 4½ percent.

Low oil prices helped growth and the current account improve in 2015 alongside low headline inflation. GDP grew 2½ percent in 2015, up from 1½ percent in 2014, supported by steady growth in the US, robust exports to the rest of Central America, and a stimulus from lower oil prices. Investment also increased significantly. Headline inflation was slightly negative (-0.7 percent). The current account deficit fell 1½ percentage points to 3½ percent of GDP.

The fiscal deficit fell by 0.1 percentage point to 3.4 percent of GDP in 2015. Fiscal expenditure remained broadly constant as a percent of GDP, with conservative increases in wages and lower energy subsidies. Capital expenditure remained subdued. Revenues were helped by the banking transactions tax (BTT) but were lower than expected. New taxes on telecommunications services and large enterprise profits were introduced in late-2015 to finance a needed increase in law enforcement and security spending. However, fiscal risks are rising. Reflecting a parliamentary impasse over approval to access external financing, domestic financing has risen sharply in 2015 and early 2016, pushing up yields on government short term domestic securities and raising the prospect of disorderly adjustment if the impasse continues.

The financial sector is stable but is exposed to the rising sovereign risks. Banking sector capital adequacy ratio remains substantially above the minimum statutory level of 12 percent. Provisioning is adequate, and asset quality continues to improve while liquidity appears ample. However, bank profitability is relatively low. Deposits and credit to the private sector grew by around 6 and 5 percent, respectively, in 2015 as corporate credit picked up and household credit

[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.

slowed. Financial sector credit to the public sector, on the other hand, increased by nearly 15 percent and now accounts for about 35 percent of private financial system assets.

GDP growth is expected to be 2.3 percent in 2016 and 2.4 in 2017, falling over the medium-term toward a potential growth rate of 2 percent. There is some near-term upside risk if several significant investment projects get underway (notably a large gas project). However, US growth is projected to decline over the medium term. Moreover, oil prices are expected to trend upwards over the medium term, tempering the recent boost to demand and causing the current account deficit to rise to 5½ percent of GDP by 2021. The fiscal deficit is expected to widen to 5½ percent of GDP over the medium term absent measures, reflecting pressures from wages, interest payments, security-related expenses, and public investment. Alongside, public debt is expected to exceed 70 percent of GDP by 2021.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They noted that while favorable external conditions and low oil prices have contributed to some improvement in the economic situation, El Salvador continues to suffer from low growth due to a host of complex issues, including low investment, high crime and emigration, and weak competitiveness. Directors underscored that ensuring fiscal and debt sustainability and raising potential growth will require strong policies and far-reaching structural reforms supported by broad political consensus.

Directors generally emphasized that frontloaded fiscal consolidation is needed to reverse the upward trajectory of public debt, entrench fiscal sustainability, and create space to fund the lender of last resort (LOLR) facility and fully implement the authorities' crime prevention strategy. They highlighted that both revenue and expenditure measures will be important to deliver the required adjustment while safeguarding social spending safety nets. Introducing less-distortionary taxes will be helpful in this regard. Directors took note of the authorities' initiatives to reform the pension system and called for further steps to adjust the system to include changes essential to ensure its long-run fiscal and social sustainability. A sound medium-term fiscal framework will be essential going forward.

Directors noted that the authorities have made good progress in financial sector reforms and encouraged them to implement the remaining reforms, including those aimed at addressing liquidity risks. They also highlighted the importance of increasing annual budget allocations for the LOLR facility and making further progress in risk-based supervision along with comprehensive legislative reform to strengthen the bank resolution and crisis management framework.

Directors emphasized that structural reforms will be key to increasing investment and fostering inclusive growth. They encouraged the authorities to enhance the flexibility of wages and prices, including by containing minimum wage increases, ease barriers to entry and competition, and curb anti-competitive practices in key sectors and improving the effectiveness of the Competition

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Agency. Efforts should also continue towards improving the business climate, developing human and physical capital, and reducing crime and corruption.

It is expected that the next Article IV consultation with El Salvador will be held on the standard 12-month cycle.

El Salvador: Selected Economic Indicators

Rank in UNDP Development Index 2013 (of 187)	115	Population (million)	6.3
Per capita income (U.S. dollars)	4,129	Life expectancy at birth in years (2014)	72
Percent of pop. below poverty line (2013)	30	Infant mortality (per 1,000 live births, 2014)	19
Gini index (2014)	38	Primary education completion rate (percent, 2013)	100

					Est.	Proj.	
	2011	2012	2013	2014	2015	2016	2017
	(Percent of GDP unless otherwise noted)						
Income and Prices							
Real GDP growth (percent)	2.2	1.9	1.8	1.4	2.5	2.3	2.4
Consumer price inflation (average, percent)	5.1	1.7	0.8	1.1	-0.7	2.1	1.9
GDP deflator (percent)	5.7	1.0	0.4	1.4	0.7	1.8	1.7
Terms of trade, percent change	-2.5	0.5	-1.6	3.3	12.4	-1.6	-1.6
Real effective exchange rate (+ =appreciation)	2.6	-1.5	-0.8	0.5	0.0	…	…
External sovereign bond spread (basis points)	374	448	378	400	497	…	…
Money and Credit							
Credit to the private sector	39.8	40.2	42.5	44.1	44.9	45.1	45.3
Broad money	43.6	43.2	43.3	42.2	43.4	43.4	43.4
Interest rate (time deposits, percent)	1.8	2.5	3.4	3.8	4.2	…	…
External Sector							
Current account balance	-4.8	-5.4	-6.5	-5.2	-3.6	-3.7	-4.9
Trade balance	-20.6	-20.7	-21.7	-20.8	-19.1	-19.2	-20.2
Exports (f.o.b. excluding *maquila*)	18.3	17.8	17.8	17.0	16.9	16.5	16.7
Imports (f.o.b. excluding *maquila*)	-39.0	-38.5	-39.5	-37.8	-36.1	-35.7	-36.9
Services and income (net)	-0.7	-1.6	-1.6	-1.3	-1.4	-1.5	-1.7
Transfers (net)	16.6	16.9	16.8	16.9	16.9	17.0	16.9
Foreign direct investment	0.9	2.0	0.7	1.2	1.7	1.5	1.8
Gross international reserves (millions of U.S. dollars)	2,503	3,175	2,745	2,693	2,787	2,908	2929
Nonfinancial Public Sector							
Overall balance	-3.9	-3.9	-4.1	-3.5	-3.4	-4.0	-4.0
Primary balance	-1.7	-1.6	-1.6	-1.1	-0.9	-1.2	-1.0
Of which: tax revenue	13.8	14.4	15.4	15.1	15.2	15.4	15.7
Public sector debt 1/	52.2	57.3	57.6	59.2	60.6	62.2	63.7
National Savings and Investment							
Gross domestic investment	14.4	14.1	15.0	13.6	14.0	14.2	14.7
Public sector	2.4	2.5	2.5	2.1	2.1	2.5	2.5
Private sector	11.9	11.6	12.5	11.5	11.9	11.7	12.2
National savings	9.6	8.7	8.5	8.4	10.4	10.4	9.8
Public sector	-2.0	-1.2	-1.2	-0.9	-0.9	-1.0	-1.1
Private sector	11.5	9.9	9.7	9.3	11.3	11.5	10.9
Net Foreign Assets of the Financial System							
Millions of U.S. dollars	2,811	3,229	2,473	2,211	1,931	2,177	1,882
Percent of deposits	28.8	32.6	24.0	21.6	17.8	19.5	16.2
Memorandum Items:							
Nominal GDP (billions of U.S. dollars)	23.1	23.8	24.4	25.1	25.9	26.9	28.0

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.

EL SALVADOR

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

June 1, 2016

KEY ISSUES

Context: El Salvador continues to suffer from significantly lower growth than neighboring countries amid low investment, high outward migration, weak competitiveness, and political gridlock. Fiscal pressures remain substantial.

Focus: The consultation focused on policies to raise growth, underpin fiscal sustainability while enhancing social safety nets, and strengthen financial sector stability, deepening, and inclusiveness.

Main policy issues

- Raising potential growth will require far-reaching structural reforms to foster competitiveness and investment, supported by measures to reduce crime and regulatory uncertainty.
- The authorities should assertively target a front-loaded reduction in the fiscal deficit of 3 percent of GDP over the next 3 years to ensure a sustainable budgetary position. Successful fiscal consolidation will require both revenue and expenditure measures, investing in a robust social safety net and reductions in distortionary taxation. A sound medium term framework will be essential.
- Meaningful pension reform proposal will require parametric changes—including raising the retirement age, higher contributions, and more tightly linking benefits to contributions— and the identification of non-contributory revenue sources to match any residual actuarial imbalance in the pension system.
- The banking system appears sound and well capitalized. However, there is a need to upgrade the framework for crisis resolution and management, establish a liquidity backstop, and enhance risk-based and cross border supervision. Financial deepening and inclusion would help boost growth and mitigate poverty. The loss of correspondent banking relationships has been manageable thus far, but there is a need to undertake contingency planning to delineate the authorities' response in the event of a broader loss of correspondent banking relationships.

Approved By
Nigel Chalk (WHD) and Steven Alan Barnett (SPR)

Discussions took place in San Salvador during April 25–May 6. The staff team comprised D. Kanda (head), B. Lissovolik, I. Teodoru (all WHD), and L. Kohler (FIN), and was supported by M. Garza (Regional Resident Representative). The team met with Technical Secretary Mr. Lorenzana, Minister of Finance Mr. Cáceres, Minister of Economy Mr. Solomon López, Central Bank President Mr. Cabrera, Minister of Justice and Security Mr. Landaverde, Minister of Labor Ms. Guevara, members of congress, other senior officials, and representatives of the private sector, trade unions, and civil society.

CONTENTS

INADEQUATE GROWTH AND TOUGH CHALLENGES — **4**

DEVELOPMENTS, OUTLOOK, AND RISKS — **7**

FISCAL STRAINS — **9**

FINANCIAL SECTOR STABILITY, DEEPENING, AND INCLUSION — **13**

SUPPLY SIDE REFORMS — **15**

STATISTICS — **16**

STAFF APPRAISAL — **16**

FIGURES
1. Long-term Growth and Poverty — 19
2. Fiscal Developments — 20
3. Balance of Payments Developments — 21
4. Financial Sector Developments — 22
5. Financial Sector Inclusion — 23

TABLES
1. Selected Economic Indicators — 24
2. Medium-Term Baseline Scenario — 25
3. Balance of Payments — 26
4. Operations of the Nonfinancial Public Sector — 27
5. Summary Accounts of the Financial System — 28
6. Selected Vulnerability Indicators — 29
7. Authorities' Recent Key Growth-Promoting Steps — 30

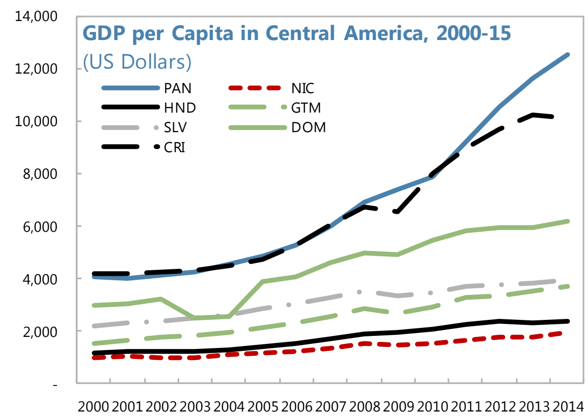
ANNEXES

I. Implementation of Fund Policy Advice ____ 31
II. El Salvador: Debt Sustainability Analysis (Higher Scrutiny Case) ____ 32
III. External Assessment ____ 40

INADEQUATE GROWTH AND TOUGH CHALLENGES

1. **GDP growth has averaged 2 percent over 2000-2014, well below the Central American regional average of 4½ percent (Figure 1)**. Alongside, GDP per capita has risen slowly and well behind the frontrunners in the region.

2. **While the underlying causes of the low growth are complex, a key channel through which they are expressed appears to be low investment.**[1] El Salvador's investment rate has averaged only 15½ percent of GDP since 2000. Data gaps preclude strong conclusions, but the available evidence suggests that the likely culprits include:



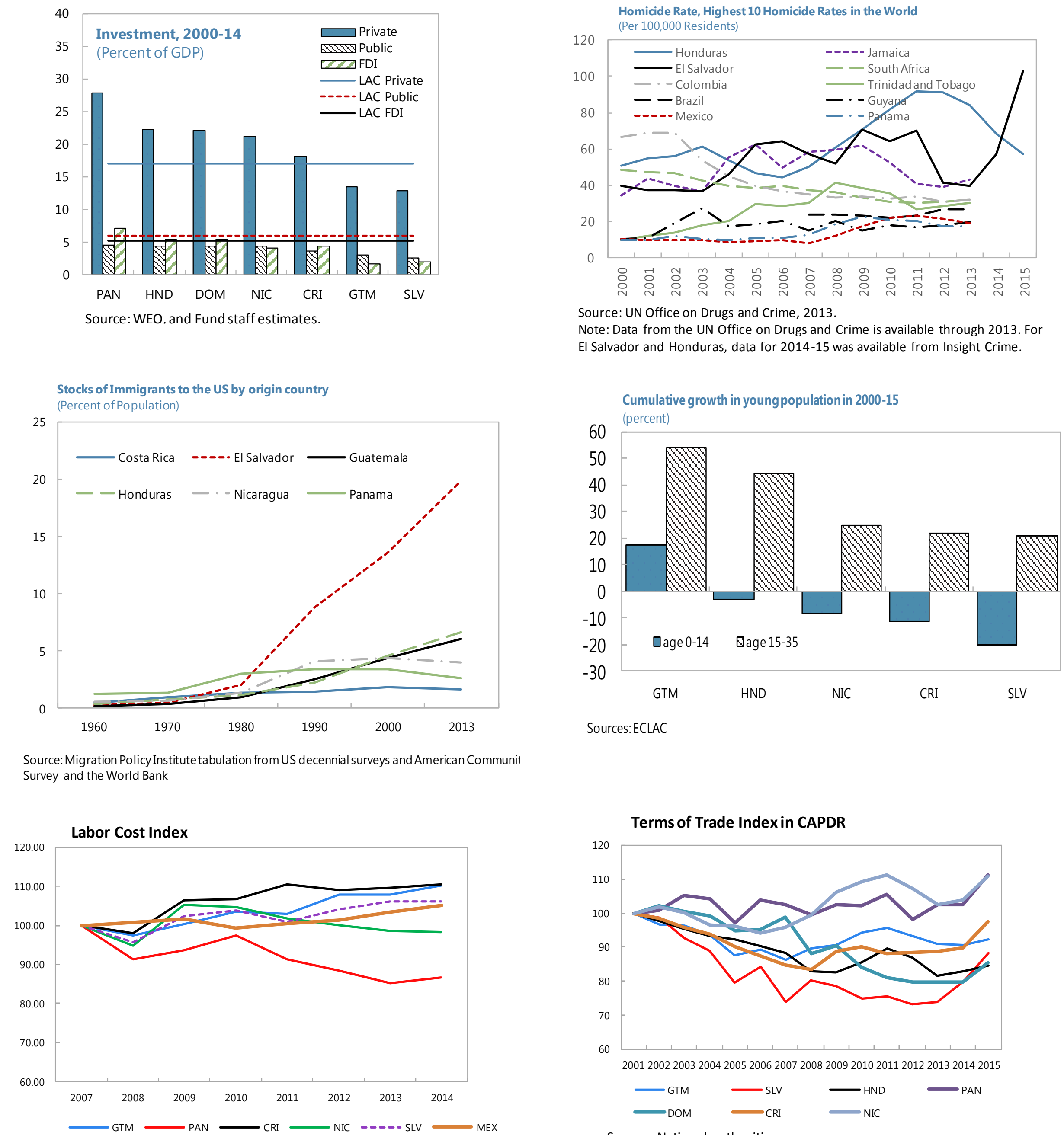
Sources: WEO and Fund Staff estimates.

- political polarization;
- high crime;
- rising unit labor costs;
- worsening terms of trade (until recently);
- high energy and logistics costs;
- barriers to entry and expansion of business;
- high exposure to natural disasters;
- fiscal and regulatory uncertainty; and
- limited human capital.

However, along many of these dimensions El Salvador does not appear materially worse than its faster-growing neighbors aside from the inter-related forces of high levels of outward migration and violent crime. Most likely, it is the complex interaction of all of these factors that is at the core and, as such, resolving low growth will require action along multiple fronts.

[1] Chapter I of the accompanying Selected Issues Paper examines the causes of low growth in El Salvador, and the macroeconomic effects of remittances.

Factors Underlying Low Growth in El Salvador



Source: WEO. and Fund staff estimates.

Source: UN Office on Drugs and Crime, 2013.
Note: Data from the UN Office on Drugs and Crime is available through 2013. For El Salvador and Honduras, data for 2014-15 was available from Insight Crime.

Source: Migration Policy Institute tabulation from US decennial surveys and American Communit Survey and the World Bank

Sources: ECLAC

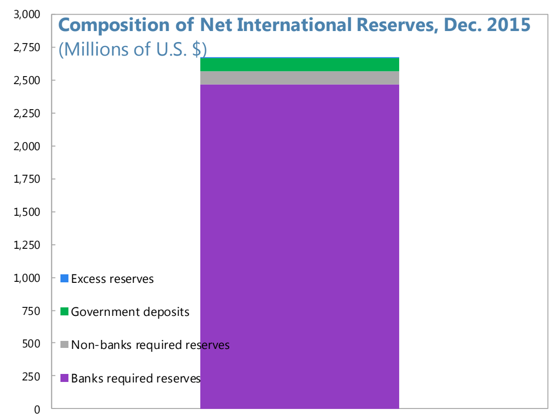
Sources: ECLAC, national authorities, and Fund staff estimates.

Source: National authorities.
Note: A lower TOT index means a worse TOT.

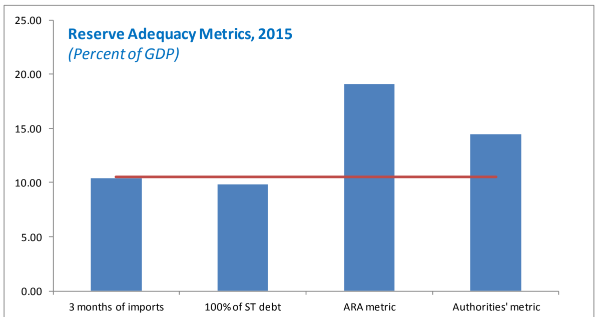
3. **The adverse effect of high emigration on growth goes beyond its impact on investment**. Emigration since the civil war, triggered in part by insecurity, reduced labor supply, particularly among the more flexible and potentially productive young workers, restraining growth. And while there was a concurrent surge in remittances that supported consumption, this also likely raised reservation wages and limited competitiveness. Moreover, in recent years the growth of remittances has been lower than in neighboring countries, reflecting the earlier start of migration and more mature family unification process.

4. **The low-growth feeds a number of vicious cycles**. First, it hinders efforts to reduce the high crime rate and improve educational attainment, which in turn deters investment and growth. It also encourages emigration, which limits labor supply and in turn dampens growth. Low growth also creates fiscal pressures, as social demands continue to increase while fiscal revenues remain subdued. The resulting adverse trends in public debt increase macroeconomic instability and undermine investor confidence. Breaking these vicious cycles will require strong concerted efforts.

5. **El Salvador's competitiveness problem has been exacerbated by the run-up in the U.S. dollar (Annex III)**. Staff's estimates using the three EBA-lite methodologies suggest REER overvaluation close to 10 percent. International reserves are broadly adequate by traditional metrics but fall short against more suitable risk-weighted benchmarks that are tailored to a fully dollarized economy. And after an initial post civil war spurt El Salvador's export performance has been stagnant since 1998, with its share of world goods and services exports flat at 0.03 percent.



Source: Central Bank of El Salvador, and IMF staff calculations.



Source: National authorities and Fund staff estimates.
Notes: The ARA metric for fixed exchange rate regimes is calculated as follows: 10% × Exports + 10% × Broad Money + 30% × Short-term Debt + 20% × Other Liabilities.
The Authorities' metric includes coverage of: (i) liquidity requirements and a liquidity fund, amounting to 22 percent of deposits, (ii) a newly created lender of last resort, with resources amounting to 8 percent of deposits over the medium term, and (iii) deposit insurance with 5 percent of deposits.

El Salvador: Exchange Rate Assessment Results

EBA-lite CA methodology	CA norm (% of GDP)	Underlying CA (% of GDP)[1/]	REER gap[2/]
	-3.7	-5.8	13.9
EBA-lite IREER methodology	ln(REER) norm	ln(REER) actual	REER gap[2/]
	4.0	4.6	0.7
	CA norm (% of GDP)	Underlying CA (% of GDP)	REER gap[2/]
EBA-lite ES methodology[2/]	-2.8	-5.0	14.1

Source: Fund staff estimates and projections.

1/ Oil prices are assumed to affect the CA norm and underlying CA symmetrically.
2/ (+): overvaluation. In the CA and ES methodologies, export elasticity: -0.71, import elasticity: 0.92.
3/ The CA norm stabilizes the net IIP position at the target level of -50% of GDP.

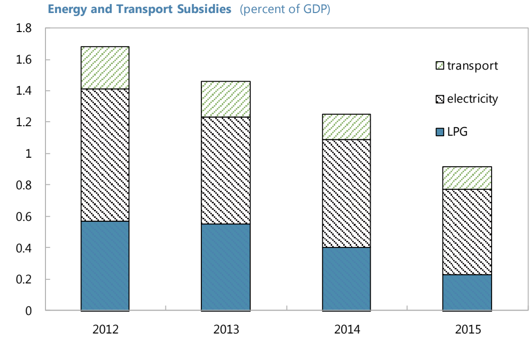
6. **Political gridlock is an obstacle even to incremental reform**. The authorities' 5-year plan puts growth as the overriding priority, and many growth-promoting measures have been pursued. However, while there is broad agreement on the need to increase inclusive growth and public sector efficiency, and to reduce crime and corruption, the main political parties are far apart on how to achieve these objectives, resulting in legislative stalemate on many important initiatives.

DEVELOPMENTS, OUTLOOK, AND RISKS

7. **Low oil prices helped growth and the current account improve in 2015 alongside low headline inflation (Table 1)**. GDP grew 2½ percent in 2015, up from 1½ percent in 2014, supported by steady growth in the US which increased remittances, robust export growth to the rest of Central America, and a stimulus from lower oil prices. Investment also increased significantly, helped by better corporate balance sheets (also in part a consequence of low oil prices). Headline inflation was slightly negative (-0.7 percent), anchored by the fully dollarized regime and lower energy prices. The current account deficit fell 1½ percentage points to 3½ percent of GDP (Figure 3).

8. **The fiscal deficit fell by 0.1 percentage point to 3.4 percent of GDP in 2015 (Figure 2)**. Fiscal expenditure remained broadly constant as a percent of GDP. The wage bill increased slightly by 0.1 percent of GDP, largely reflecting ingrained indexation in selected sectors, and the interest bill also rose marginally. However, the authorities took advantage of low oil prices to reduce energy subsidies. Capital expenditure remained subdued at 2¾ percent of GDP. Revenues were helped by the banking transactions tax (BTT) adopted in the second half of 2014 but were lower than expected. New taxes on telecommunications services and large enterprise profits were introduced in late-2015 to finance a needed increase in law enforcement and security spending.

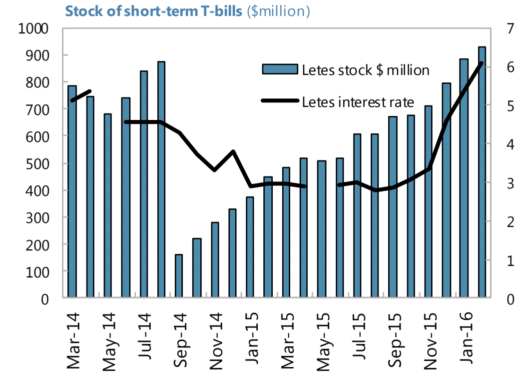
Energy and Transport Subsidies (percent of GDP)



Source: El Salvador Ministry of Finance

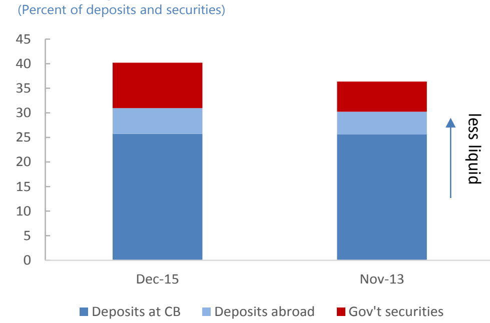
9. **However, fiscal risks are rising.** Reflecting a parliamentary impasse over approval to access external financing, domestic financing rose sharply in 2015 and early 2016, pushing up yields on government short term domestic securities (LETES). Without a resolution of the impasse, the authorities are likely to reach the limits of the domestic system to finance the budget toward the end of this year, raising the prospect of disorderly adjustment. Moreover, despite recent declines EMBI spreads relative to other emerging markets remain elevated, raising risks that external financing could be more expensive than earlier envisaged. The tightening liquidity position of the budget has increased difficulties in making timely payments to suppliers and exporters (for VAT refunds).

Stock of short-term T-bills ($million)



Source: El Salvador Ministry of Finance

Banks' Liqudity Position
(Percent of deposits and securities)



Source: BCR, IMF

10. **The financial sector is stable but is exposed to the rising sovereign risks** (Figure 4)**.** Banking sector capital remains high (17.2 percent of risk-weighted assets), substantially above the minimum statutory level of 12 percent. Provisioning is adequate (nearly 115 percent of NPLs) and asset quality continues to improve. Banking system liquidity appears ample. However, bank profitability is relatively low due to a narrowing loan to deposit rate spread and high liquidity. Deposits and credit to the private sector grew by around 6 and 5 percent, respectively, in 2015 as corporate credit picked up and household credit slowed. Credit to the private sector nudged up to nearly 45 percent of GDP. Financial sector credit to the public sector, on the other hand, increased by nearly 15 percent and now accounts for about 35 percent of private financial system assets, increasing the exposure of the financial sector to fiscal shocks such as a repricing of sovereign risk.

11. **GDP growth is expected to be 2.3 percent in 2016 and 2.4 percent in 2017, falling over the medium-term toward a potential growth rate of 2 percent (Tables 2-7)**.[2] There is some near-term upside risk if several significant investment projects get underway (notably a large gas project). However, US growth (with which Salvadoran growth is highly correlated) is projected to decline over the medium term. Moreover, oil prices are expected to trend upwards over the medium term, tempering the recent boost to demand. Inflation is expected to remain anchored by the fully dollarized regime. Given the rise in oil import prices and difficult prospects to strengthen and diversify exports the current account deficit is expected to rise to 5½ percent of GDP by 2021.

12. **The fiscal deficit is expected to widen to 4 percent of GDP in 2016, with further increases over the medium term absent measures**. While revenues are expected to increase, reflecting full-year impacts of recent measures and rising import taxes as oil prices rise, expenditures are projected to rise faster. In addition to wage pressures and higher interest payments, the authorities plan additional security-related expenses of 0.6 percent of GDP over 2016–17 to counter the recent uptick in crime. Public investment is also assumed to recover from recent lows. Alongside, public debt is expected to exceed 70 percent of GDP by 2021 (see the DSA).

13. **Risks to the outlook are significant and tilted to the downside**.

- Increased global financial market turmoil could limit access or raise the cost of external fiscal financing, adding to fiscal strains.

- A surge in the US dollar could further undermine El Salvador's competitiveness relative to non-dollarized neighboring countries and weaken growth prospects. Also, the forthcoming implementation of the Trans Pacific Partnership agreement may intensify competition from Asia.

- Weaker than expected global growth would depress Salvadoran growth, particularly without the exchange rate as a shock absorber (although lower oil prices that accompany weaker growth would be a mitigant).

[2] Chapter II of the accompanying Selected Issues Paper discusses the potential growth rate of El Salvador.

- Increased de-risking by major international banks could increase intermediation costs and hamper the flow of remittances to El Salvador, dampening consumption and growth.

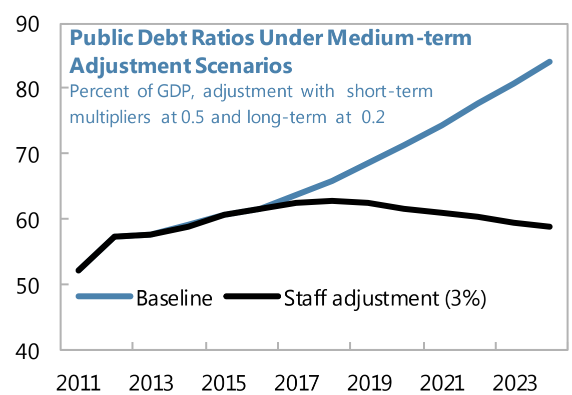
- Rising fiscal risks could undermine confidence and depress medium term growth below staff estimates.

- On the upside, lower energy prices would support the economy, suppress inflation and support the balance of payments. Sustained strong implementation of public and private investment projects would also create an upside to growth.

14. **The authorities were more optimistic about the outlook and balance of risks**. In particular, they believed that the pickup in domestic investment observed in 2015 would endure and that the large investment projects in the pipeline, together with efforts to promote growth more generally, would support an increase in potential growth above 2½ percent.

FISCAL STRAINS

15. **There was agreement that without assertive fiscal consolidation public debt will continue to rise**. A frontloaded primary balance adjustment of at least 3 percent of GDP over 2017-19 is the minimum needed to reverse the upward debt dynamics over the medium term, with more needed over a longer horizon to entrench sustainability. Under plausible multipliers the adjustment could reduce growth below 2 percent in the short run. However, a more solid and credible fiscal position, combined with vigorous structural reforms, would create the conditions for a rebound in growth toward 3 percent over the medium term. Incorporating longer-term factors, staff estimates indicate a fiscal sustainability gap of about 4–5 percent of GDP, the result of the significant structural primary deficit and rising demographic pressures in pension and health spending.[3] Still more adjustment would be needed to create fiscal space to fully implement the authorities' crime prevention strategy and credibly fund the authorities' LOLR facility. Successful consolidation will require both revenue and expenditure measures, and a stronger fiscal framework. The authorities agreed in principle, and noted that their Medium-term Fiscal Framework targets adjustment of 2½ percent of GDP, although no specific set of measures have been agreed upon. However, they considered that this adjustment, at least in non-pension fiscal accounts, was close to the maximum feasible given low growth and pressing social needs.



Source: Fund staff estimates and projections.

[3] The fiscal sustainability gap is the total amount of fiscal measures that (if immediately implemented) would assure a non-explosive path for government debt over the long run. Kanda (IMF WP/11/164) describes the methodology underpinning the estimates.

16. **Given the need to increase growth, revenue-raising measures should be accompanied by cuts in distortionary taxation**. Raising the VAT rate to 15 percent, broadly around the regional average, would increase revenues by 1¼ percent of GDP. Efforts to establish a property tax should be strengthened. A corporate tax rate of 35 percent appears too high given low investment and high informality, and should be reduced significantly, while limiting incentives and loopholes to broaden the tax base. There may also be scope for less-distortionary progressive taxation by introducing a wealth tax, taxing (highly inequitable) pensions, or increasing personal income tax rates for the highest earners. The bank transactions tax and telecommunications tax have relatively low yield but significantly hamper financial intermediation and inclusion, and should be reduced or phased out. Also, all other taxes should be reviewed, phasing out those with low yield but high distortionary effects. Finally, plans to boost tax collection should be carefully calibrated to avoid dampening the investment climate.

El Salvador: Comparison of Medium-Term Scenarios 1/
(In percent of GDP, unless otherwise noted)

		Projections				
	2016	2017	2018	2019	2020	2021
Real GDP growth (percent)						
Baseline	2.3	2.4	2.3	2.1	2.0	2.0
Adjustment	2.3	1.7	2.1	2.2	2.8	2.7
Nonfinancial public sector balance						
Baseline	-4.0	-4.0	-4.5	-5.0	-5.3	-5.6
Adjustment	-4.0	-2.6	-2.3	-1.9	-1.8	-1.8
Primary balance						
Baseline	-1.2	-1.0	-1.1	-1.3	-1.4	-1.6
Adjustment	-1.2	0.4	0.9	1.6	1.6	1.6
Public sector gross debt						
Baseline	62.2	63.7	65.5	67.9	70.5	73.2
Adjustment	62.2	62.8	62.5	61.9	60.8	59.7
Gross fiscal financing requirement						
Baseline	9.0	7.5	8.0	11.0	8.5	9.3
Adjustment	9.0	6.1	5.8	7.9	5.1	5.5
Unidentified fiscal financing 2/						
Baseline	3.6	2.1	2.7	3.0	3.4	4.2
Adjustment	3.6	0.7	0.5	-0.1	0.0	0.5

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 percentage points of GDP in 2017–19, including 1.5 percentage point effort in 2017; (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 2019, 0.5 pp starting from 2020).
2/ Residual financing need after accounting for normal domestic and official external financing sources.

El Salvador: Tax Rates in Latest Available Year

	Top personal income tax rate	Corporate income tax rate	VAT rate
Costa Rica	25	30	13
Dominican Republic	25	27	18
El Salvador 1/	30	35(30)	13
Guatemala	7	25	12
Honduras	25	30	15
Panama	25	25	15
Nicaragua	30	30	15
CAPDR average	23.9	27.8	14.4
LAC average	33.1	24.1	17.2

Source: National authorities.
1/ For El Salvador, reflects an additional recent 5 pp surcharge on corporate profits exceeding $0.5 million.

Potential Menu of Measures in 2017–19
(Cumulative, percent of GDP)

Wage bill	1.4
VAT increase to 15%	1.2
Adoption of full-fledged property tax	0.6
Savings in good and services	0.4
Targeting subsidy	0.4
Progressive taxation	0.4
Removal of tax exemptions	0.1
Streamlining of "nuisance taxes"	-0.7
Social support to offset VAT regressive effects	-0.3
Total:	**3.5**

Source: Fund staff estimates.

17. **The authorities were supportive of property, wealth and progressive individual income taxation.** However, they believed that the distortionary effects of the BTT and telecom tax were modest and indicated that raising VAT would be politically difficult because of its effects on the poor. They were however optimistic about the yield from several administrative initiatives that were underway to strengthen tax collections.

18. **The authorities agreed that durable consolidation will require addressing the sources of expenditure pressures**. Recent revenue-based consolidation has largely been offset by increased spending, notably on the wage bill which has risen by 1 percent of GDP in the past 5 years, and is projected to rise by a further one percent of GDP by 2021 without measures. Addressing wage pressures will require eliminating the generous wage indexation mechanism (escalafon) in the health sector, limiting general wage indexation to increases below the rate of inflation, and curbing nontransparent bonuses. Also, hiring in all sectors—except security—should be significantly reduced. There is need to strengthen the efficiency of expenditure across a range of functions (notably reducing the fragmentation of the health system and improving the targeting of school assistance programs to protect the needy). There is scope for further rationalizing LPG and electricity subsidies. However, public investment should be increased to alleviate infrastructure bottlenecks, and the social safety net should be enhanced. The authorities were open to considering measures in all these areas, but were not yet prepared to commit to specific steps along those lines.

19. **The authorities are continuing efforts to upgrade the fiscal framework to support consolidation efforts, including developing a fiscal responsibility law (FRL)**.[4] 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 rigid); (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 an upward drift in spending, high deficits, and periodic financing strains.

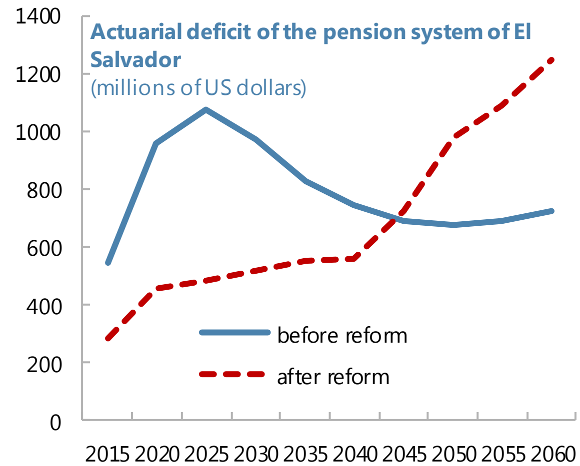
20. **A draft FRL is currently under discussion and should**:

- Adopt strong procedures to increase transparency and comprehensiveness of budget presentation, improve forecasting and spending control, and reduce the upper limit on LETES issuance. Ideally, the regular budgetary process should also include the pre-approval of all the necessary financing for the budget year, thereby reducing the probability of financing crunches.
- Include a formal numerical target. One option could be a budget balance rule with countercyclical properties, incorporating a clear link to a prudent debt objective and corrective mechanisms to achieve it, which appears appropriate for El Salvador's political and economic circumstances. An expenditure-based rule, or a combination of expenditure and deficit-based rules, could also be options should they command bipartisan support.

The authorities' current draft FRL contains many of the above elements, including a combination of deficit-based and expenditure-based rules. However, it still lacks clarity on the hierarchy of procedural and numerical rules and, as currently framed, the draft does not garner broad political and societal support.

[4] Chapter III of the accompanying Selected Issues Paper discusses the fiscal framework and rules for El Salvador.

21. **Pension reforms are essential to ensure fiscal and social sustainability.**[5] The transition to a fully funded defined contribution (DC) system has sputtered due to inadequate asset returns that have led the government to periodically top up and guarantee pension benefits. The pension deficit is currently about 2 percent of GDP and will rise substantially in the next decade without policy change. Unfunded liabilities are estimated at almost 100 percent of GDP in NPV terms; future replacement rates under the DC system are projected to almost halve; coverage, participation, and contribution payments are low; benefits are highly unequal across pensioners; and there is poor diversification and low financial returns, partly because the private pension funds are mandated to buy government pension bonds at very low rates, although a recent Constitutional Court decision to raise those rates would change this going forward.



Source: Salvadoran Authorities

22. **Faced with a difficult political environment, the authorities' pension reform proposed in February seeks to buy time but does not secure the long run sustainability of the system**. The proposal would (i) reverse some of the recent benefit top-ups, (ii) transfer to the public sector over half of contributions and private pension system assets (reducing measured deficits and debt), and (iii) offer lower-income contributors a flat pension. However, preliminary calculations suggest that it would not materially reduce the NPV of future unfunded pension liabilities, while introducing legal risks given public opposition to nationalization of private assets.

23. **There is an urgent need for the following additional steps to secure the sustainability of the pension system in the face of looming population aging pressures**:

- Parametric reforms to increase the retirement age and contribution rates (key to supporting long-term fiscal sustainability in the PAYG component and social sustainability in the DC component). Steps to better-align the number of years of contributions with benefits would also be important, especially if they are accompanied by measures to encourage formal employment.

- Greater coverage through an expansion of the means-tested basic universal pension and incentive schemes and other steps to encourage labor force formalization.

- A credible commitment to fund projected pension deficits from general revenue sources. The evolution of pension deficits over the long run would depend on the strength of the parametric reform package and coverage objectives.

[5] Chapter IV of the accompanying Selected Issues Paper examines the pension system of El Salvador and explores options for reform.

FINANCIAL SECTOR STABILITY, DEEPENING, AND INCLUSION

24. **Stress tests suggest that financial buffers are adequate to contain most risks**. The largest banks are international banking groups, which currently enjoy access to foreign financing, and the system is characterized by very limited interbank exposures, which reduces the risk of internal contagion. At the same time, this structure exposes the sector to external risks. The central bank (BCR) and the Financial Superintendent (SSF) have run credit and liquidity risk sensitivity tests which suggest adequate resilience of the system to stress scenarios.

25. **The authorities have made good progress on implementing the financial reforms recommended in the 2010 FSAP, the 2014 Financial Stability Strategy, and other TA reports but a substantial agenda remains**.

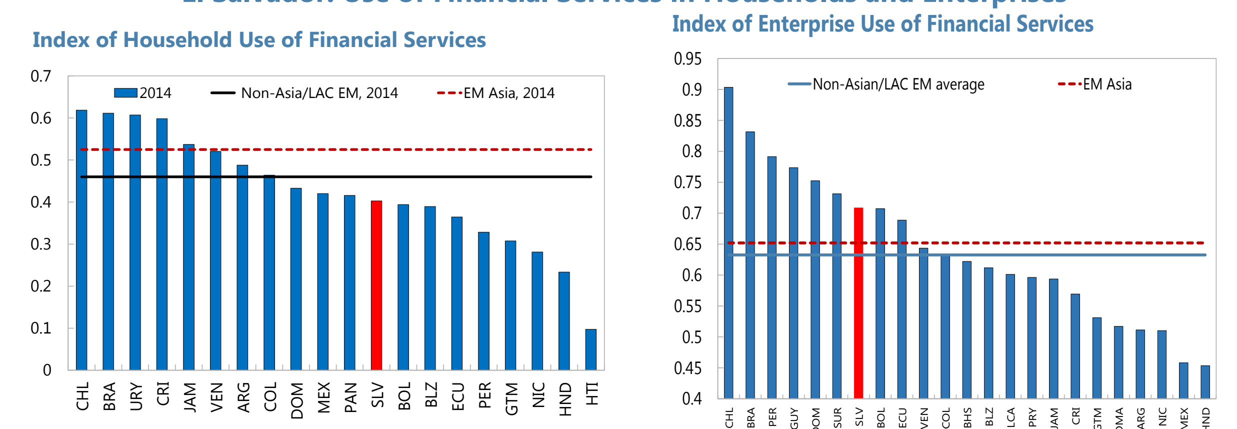
- *Emergency liquidity backstops*. While dollarization helps contain currency and interest rate risks, it can amplify liquidity risks. Importantly, in the absence of sufficient lender of last resort (LOLR) capacity and robust bank resolution structures, institution-specific liquidity shocks could have systemic repercussions. And relying on high institution-specific buffers reduces the capacity of banks to lend to the economy. A plan for a liquidity fund based on a partial pooling of the banks' liquid assets is nearing completion, which could be helpful in addressing non-systemic liquidity needs, but coordination and governance issues need to be fully resolved. Staff encouraged the authorities to credibly increase annual budget allocations to the LOLR, revive and expand an IDB credit line for the LOLR that has expired, and resolve the remaining hurdles to establishing the liquidity fund in consultation with stake-holders. Also, given the key role of the central bank in the operation of the LOLR its financial position should also be protected.

- *Regulation and supervision*. Coordination between the financial supervisor and the central bank has improved. Risk-based supervision is being implemented, and the implementation of Basel III has been initiated. The process of extending the supervisory perimeter to smaller and cooperative banks and savings and loans associations (to encompass 90 percent of deposits in that sector) is ongoing and will need to be completed.

- *Bank resolution and crisis management.* In line with staff advice the authorities are finalizing a strategy to mitigate weaknesses while comprehensive legislation that thoroughly addresses the key challenges is developed. Staff encouraged the authorities to expedite progress in both areas, noting that the legal reforms should make the Systemic Risk Committee permanent, strengthen crisis prevention and bank resolution authority and procedures, clarify procedures for the cooperative financial institutions, abolish the three-day notification to a bank before taking resolution measures, and strengthen legal protection for supervisors. Also, domestic interagency coordination as well as cross-border cooperation should be strengthened with clear and comprehensive MoUs between relevant agencies. The preparation of contingent bank-by-bank recovery and resolution plans should be accelerated. Finally, the deposit insurance agency should be strengthened by increasing bank contributions and clarifying protocols for its role in a crisis.

26. **There was agreement that financial deepening and advancing financial inclusion could have a meaningful impact on both growth and poverty** (Figure 5).[6] Household access to financial services is relatively low with only 34 percent of individuals holding bank accounts. Steps to increase mobile banking and improve dispute resolutions mechanisms could boost the penetration of banking services, and in this regard staff welcomed the recent passage of the Financial Inclusion Law. However, staff also stressed that recent legal changes limiting the acquisition, transfer, and storage of debtor information in credit bureaus increase credit risks and intermediation costs in the financial system, and should be reconsidered. A modern law and improved corporate financial reporting standards are needed to support the expansion of the securities market, which could help pension funds increase returns and improve pricing and liquidity of government debt.

El Salvador. Use of Financial Services in Households and Enterprises



Sources: FINDEX, World Bank and IMF staff calculations.

Sources: World Bank Enterprise Survey and IMF staff calculations.

27. **To date the loss of correspondent banking relationships has been manageable**. Some larger international banks have left, but have been replaced by other, regional, banks, with the overall nominal value of the correspondent lines broadly unchanged thus far. The authorities continue to work to maintain sound AML/CFT standards, and maintain active engagement with the US Treasury in this area. A recent bank collapse in Honduras amid money laundering charges by the US government appears to have had no impact on El Salvador, but has heightened concerns and increased regulators' supervisory vigilance. Staff argued for quickly undertaking contingency planning to delineate the authorities' response in the event of a broader loss of correspondent banking relationships.

[6] Chapter V of the accompanying Selected Issues Paper examines financial inclusion in El Salvador.

SUPPLY SIDE REFORMS

28. **The authorities broadly concurred that investment and inclusive growth can be improved by forging social consensus around sound policies that**:

- Enhance the flexibility of wages and prices, given the fully dollarized economy. In this context, staff recommended that it would be advisable to contain minimum wage increases until there is clear evidence of rising productivity. The authorities responded, however, that a balance would have to be struck given the need to increase incomes of the poor and rural populations.

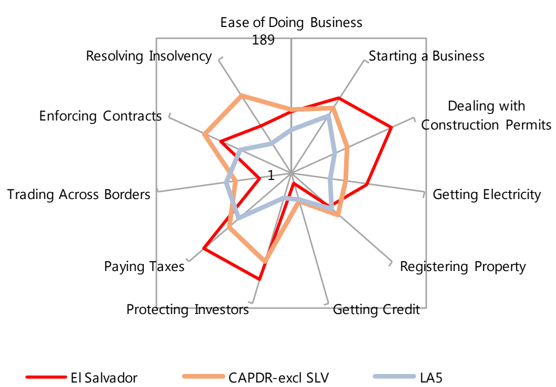
- Ease barriers to entry and competition, curb anti-competitive practices such as price fixing in key sectors, including air transport, pharmaceuticals, iron, and agricultural markets such as sugar, rice and fertilizers, and improve the staffing and sanctions effectiveness of the Competition Superintendent. Lowering entry barriers in transport and electricity sectors would help reduce utility and logistics costs.

- Boost educational attainment (particularly for secondary and vocational education) by creating the necessary fiscal space and improving accountability for results.

- Reduce crime and corruption (including by effectively implementing the AML/CFT and anti-corruption frameworks)—the authorities' plan "For a Safe El Salvador" unveiled in early 2015, and recent follow-up plans, lay out a comprehensive strategy, but financing (estimated at 1.7 percent of GDP annually) is a key bottleneck.

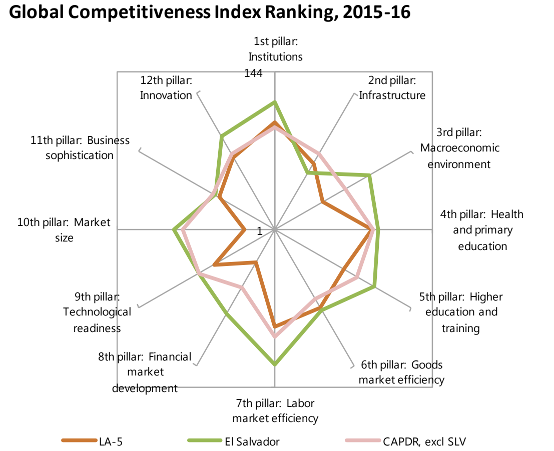
Staff encouraged the authorities to press on with their 2014–19 plan which targets potential growth of 3 percent, taking advantage also of the FOMILENIO II grant from the U.S. and the funding for the "Northern triangle" countries to raise productivity and competitiveness.

Doing Business Ranking, 2016



Source: World Bank Doing Business Indicators.

Global Competitiveness Index Ranking, 2015-16



Source: World Economic Forum Global Competitiveness Indicators.

STATISTICS

29. **Data provision is adequate for surveillance.** Staff encouraged the authorities to publish revised national accounts in line with their public commitment and best practices. The technical work is nearing completion and the authorities have requested Fund assistance in crafting an appropriate communication strategy ahead of publishing the improved data.

STAFF APPRAISAL

30. **El Salvador continues to suffer from significantly lower growth than neighboring countries amid low investment, high crime and emigration, and weak competitiveness**. Several factors appear to be contributing to the low growth rate, but along many dimensions El Salvador is not materially different from neighboring countries except for the interrelated forces of high crime and emigration. Most likely, the low growth is the result of the complex interaction of several factors that reduce the expected return to investment, reduce labor supply, and increase uncertainty, and as such resolving low growth will require action along multiple fronts. The low-growth in turn feeds a number of vicious cycles: it hinders efforts to reduce the high crime rate and improve educational attainment; encourages outward migration and weakens labor force participation; and creates fiscal pressures (as social demands continue to increase while fiscal revenues remain subdued). Moreover, political gridlock is an obstacle to even incremental reform.

31. **Strong efforts are needed to address rising fiscal risks**. Without a resolution of the parliamentary impasse blocking external financing, the authorities are likely to reach the limits of the domestic system to finance the budget toward the end of this year, raising the prospect of disorderly adjustment. Moreover, substantial frontloaded fiscal adjustment is needed to reverse the upward trajectory of public debt, entrench fiscal sustainability, and create space to credibly fund the public LOLR and the authorities' crime prevention strategy over the medium term. In addition, the authorities' current pension reform proposals should be adjusted to include parametric changes essential to ensure the long run fiscal and social sustainability of the system as the population ages.

32. **The authorities have made good progress in financial sector reforms, but there remains an important unfinished agenda**. While dollarization helps contain currency and interest rate risks, it can amplify liquidity risks. Thus, annual budget allocations for the LOLR should be credibly increased, and the IDB credit line for the LOLR facility revived and expanded. Also, the hurdles to establishing the bank liquidity fund should be resolved in consultation with stake-holders. Progress in risk-based supervision should continue, and the supervisory perimeter extended to smaller financial institutions. The bank resolution and crisis management framework should be strengthened as soon as possible by a comprehensive legislative reform to address various weaknesses, clarifying the authority, protocols, and legal protections of regulators.

33. **Investment and inclusive growth can be improved by forging social consensus around sound policies that**: enhance the flexibility of wages and prices (including by limiting increases in

minimum wages); ease barriers to entry and competition, curb anti-competitive practices in key sectors, including air transport, pharmaceuticals, iron, and agricultural markets, and improve the effectiveness of the Competition Agency; create fiscal space and improve accountability to boost secondary and vocational educational attainment; reduce crime and corruption; and reduce utility and logistics costs by allowing greater competition in those sectors.

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

Risk Assessment Matrix[1]

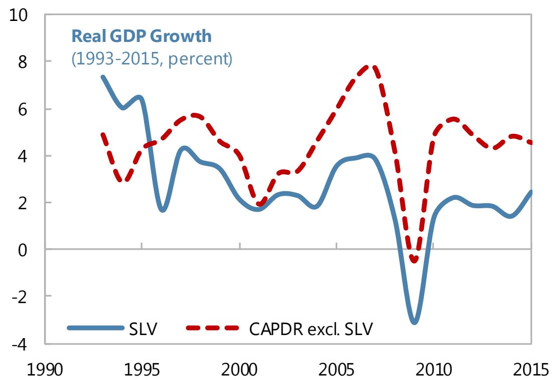
Main Threats	Likelihood of Realization of the Threat	Expected Impact if Threat is Realized	Policy Response
Tighter or more volatile global financial conditions	**Medium/High** Investors could reassess underlying risk in the global economy. Improving US economic prospects could lead to a further dollar surge.	**High** Constrained access to international capital markets and higher cost of external financing, worsening public debt dynamics. Dollar appreciation could further undermine El Salvador's competitiveness.	Implement fiscal consolidation to both reduce external financing needs and improve debt dynamics. Improve fiscal and external buffers. Implement structural reforms to improve competitiveness.
Sharper-than-expected global growth slowdown	**Medium** A sharper-than expected downturn in China or other large EMs, or structurally weak growth in key AEs and EMs could take place.	**High** Negative spillovers to growth are likely to be larger in the absence of the exchange rate as a shock absorber.	Structural reforms to boost private investment and growth. Strengthen tax administration and expenditure management to protect the fiscal position.
Dislocation in capital flows	**Medium** Broader loss in correspondent banking services.	**Medium/High** Increased costs for transfer of funds, which could reduce remittances, dampening consumption and growth.	Further strengthen the AML/CFT framework to minimize the withdrawal of correspondent banking services, and strengthen the bank resolution framework.
Persistently lower energy prices	**High** Energy supply factors could reverse only gradually.	**Medium/High** Higher consumption and growth, with lower inflation and current account deficit.	Save a part of the windfall from lower energy prices.
Fiscal pressures	**Medium** Delays in Congress in approval of external financing.	**High** Higher financing costs and the prospect of disorderly adjustment, worsening macroeconomic imbalances and growth outlook.	Forge consensus in Congress on the fiscal agenda. Fiscal consolidation to both reduce external financing needs and improve debt dynamics.

[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 of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities.

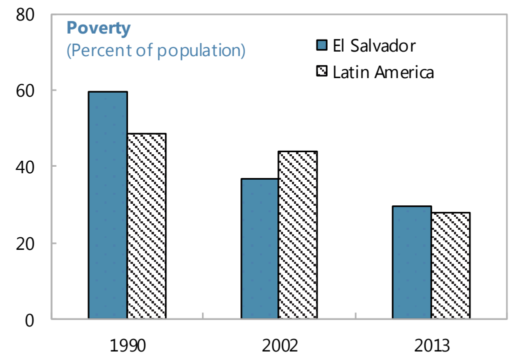
Figure 1. El Salvador: Long-term Growth and Poverty

Structural bottlenecks have inhibited long-term growth.

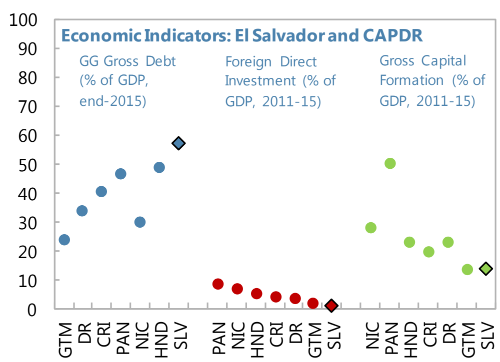
Growth has been among the lowest in the Americas.



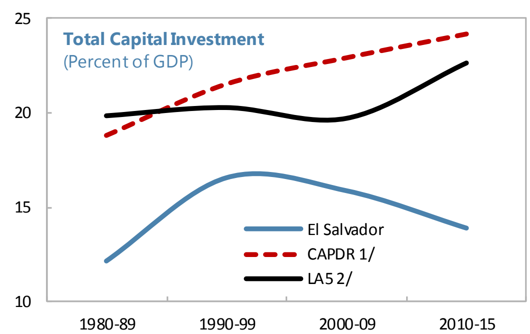
...and poverty remains high.



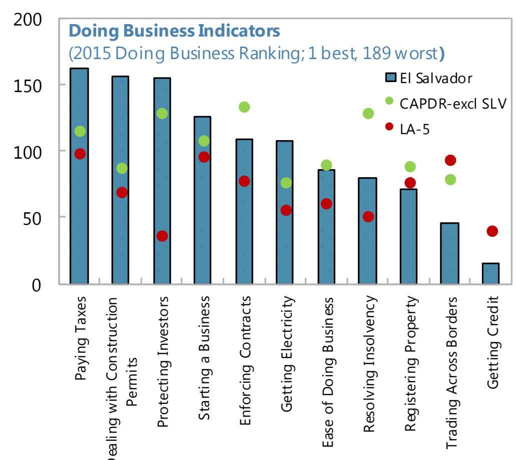
Key investment and fiscal indicators lag behind peers...



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

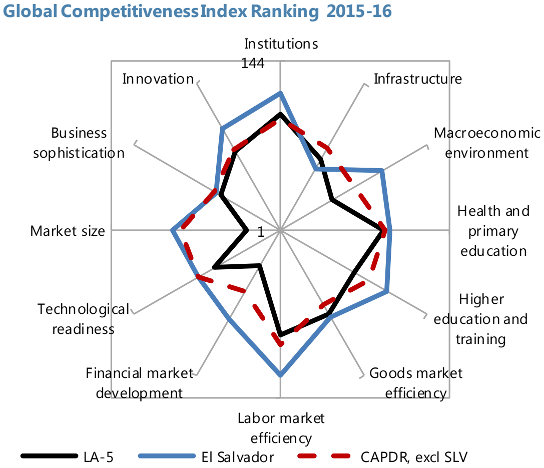


...and doing business indicators rank generally low...



...while competitiveness indicators point to institutional, human capital, and labor market weaknesses.

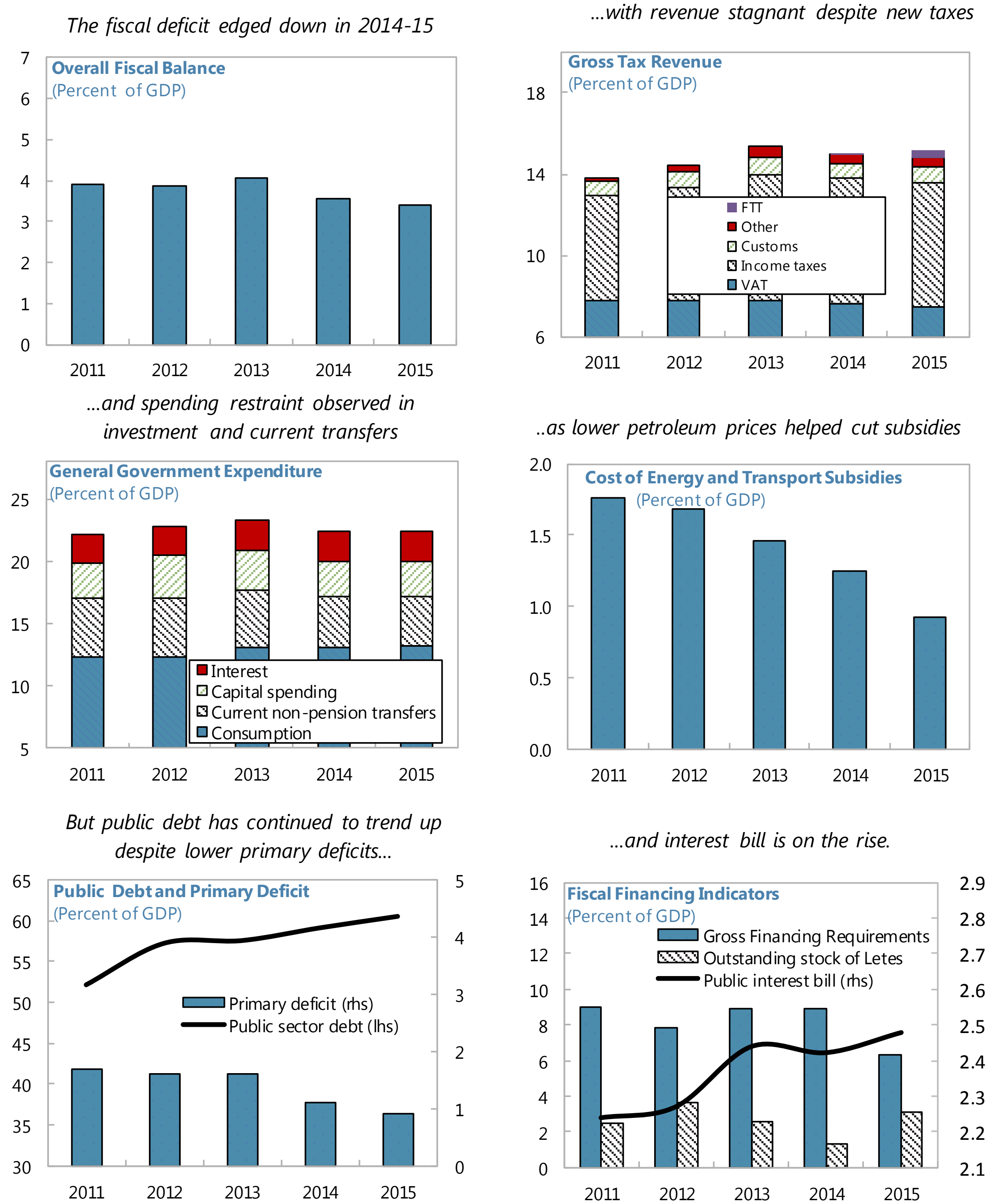
Global Competitiveness Index Ranking 2015-16



Sources: ECLAC; and World Bank, World Development Indicators, Doing Business Indicators, and Global Competitiveness 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.

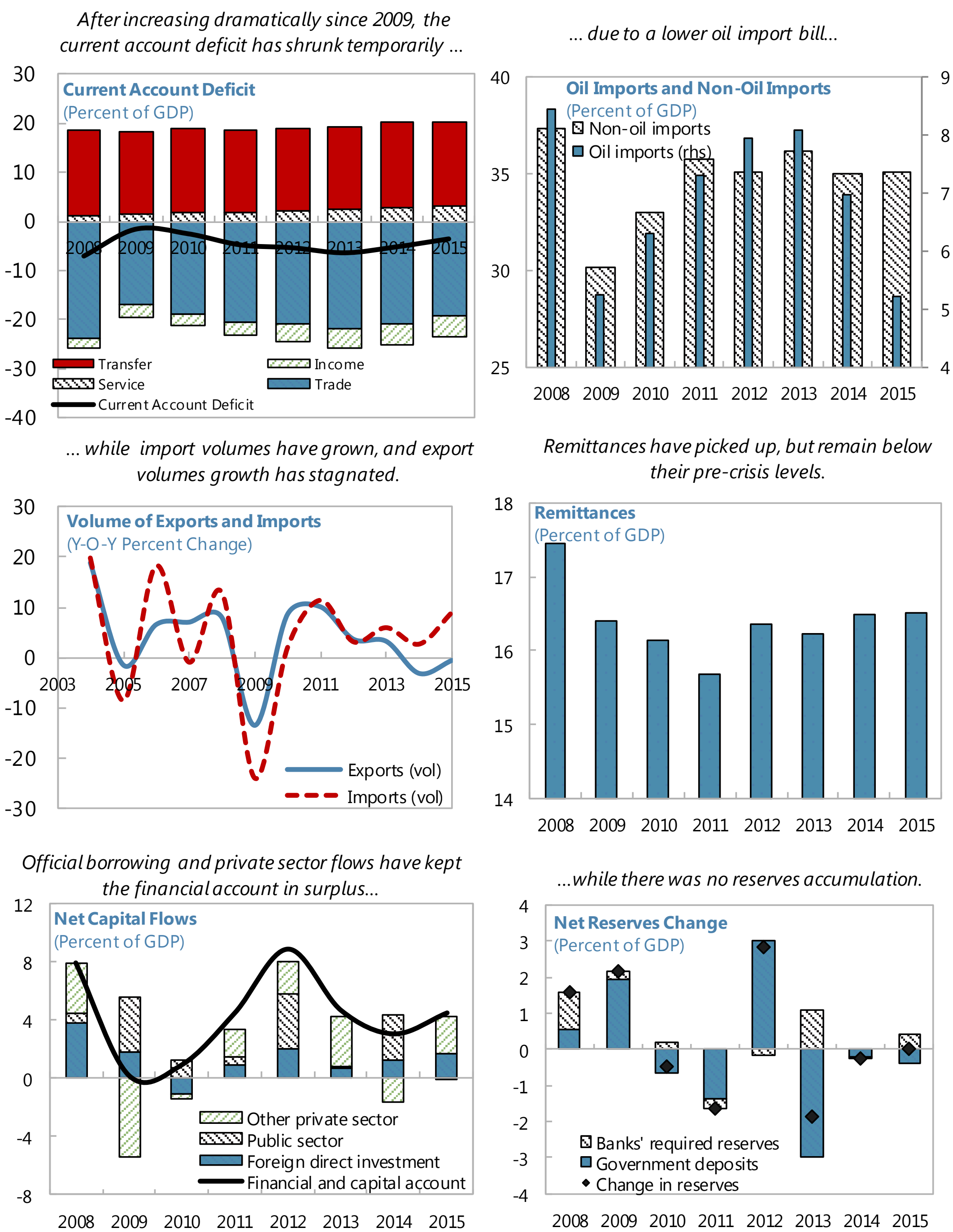
Figure 2. El Salvador: Fiscal Developments

Spending restraint helped cut the deficit somewhat, but financing remains a concern



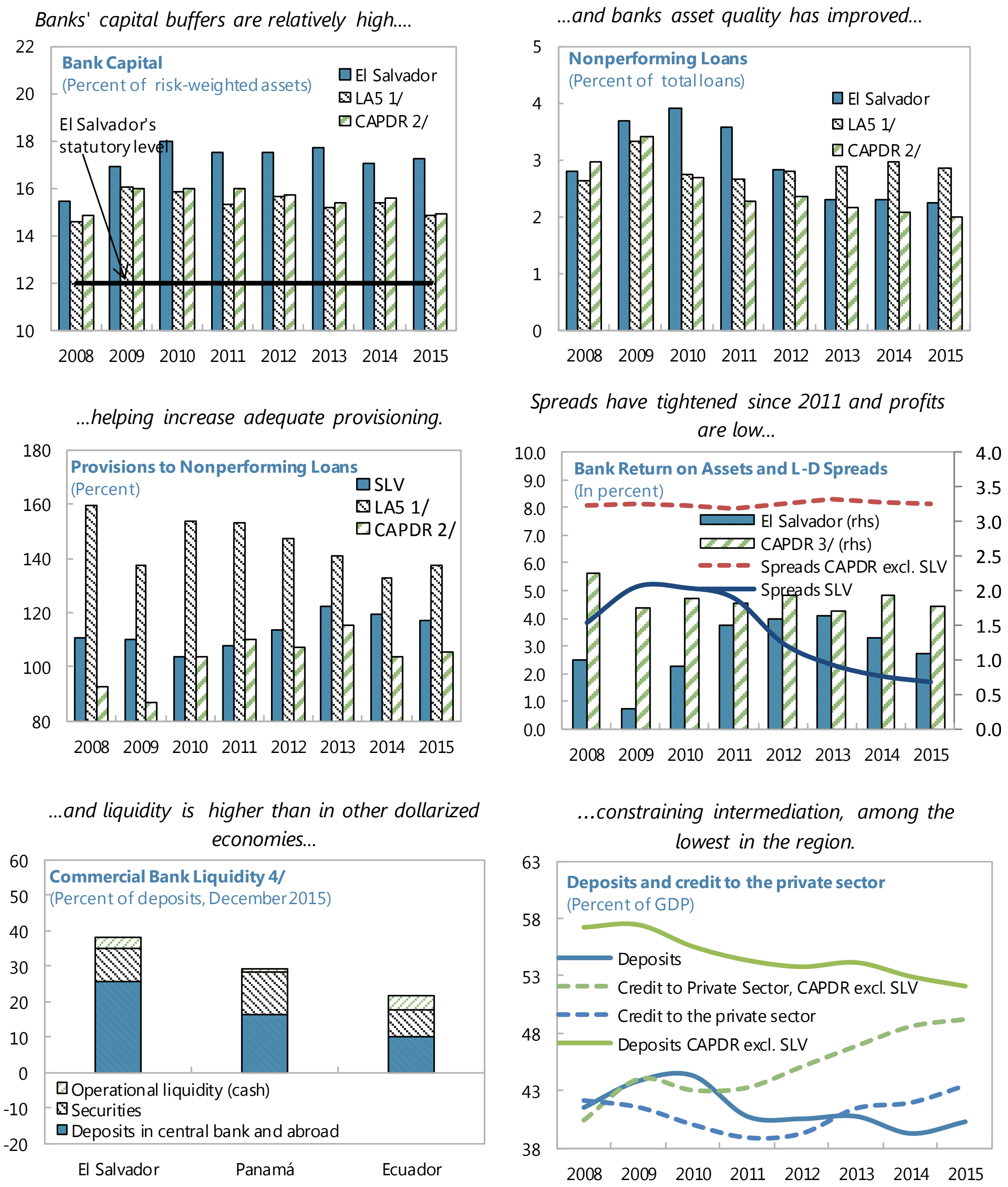
Sources: National authorities and Fund staff calculations.

Figure 3. El Salvador: Balance of Payments Developments



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

Figure 4. El Salvador: Financial Sector Developments

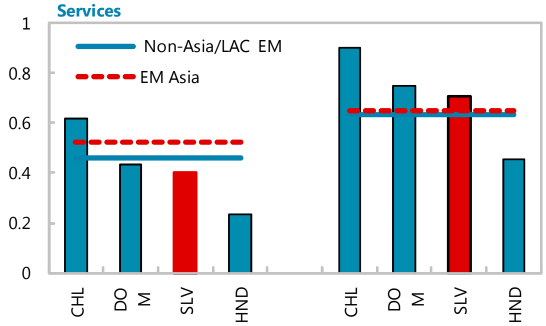


Sources: National authorities, IMF Financial Soundness Indicators, and Fund staff calculations.
1/ Simple average of Brazil, Chile, Colombia, Mexico, and Peru.
2/ Simple average of Costa Rica, Guatemala, Honduras, Panama, and the Dominican Republic.
3/ CAPDR for year 2015 includes Costa Rica, Honduras and Guatemala.
4/ The latest data available for ECU are till July 2015

Figure 5. El Salvador: Financial Sector Inclusion

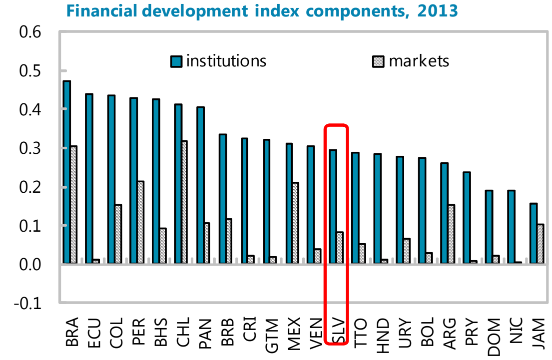
Households have limited access, while enterprises have ready access.

Index of Household and Enterprise Use of Financial Services



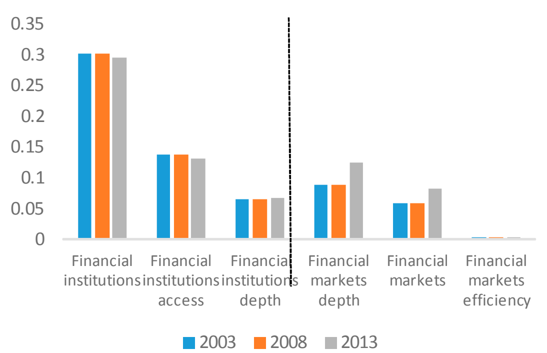
SLV trails its peer group, particularly on financial development for HHs.

Financial development index components, 2013



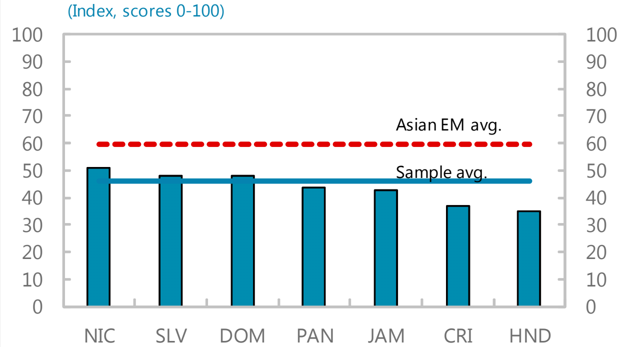
At the same time, little progress has been made since 2003...

Financial Development Index



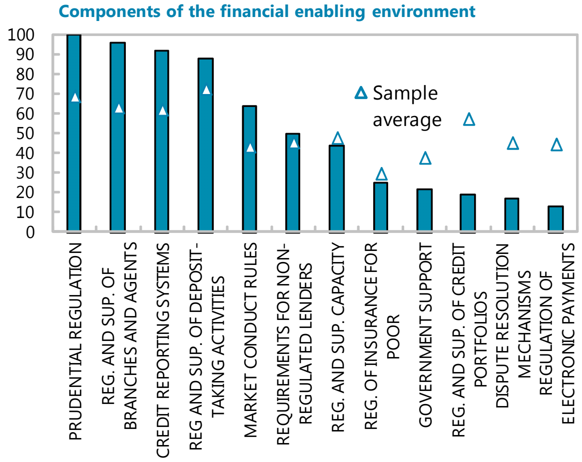
...however, the potential for improvement is there.

Financial Inclusion Enabling Environment
(Index, scores 0-100)

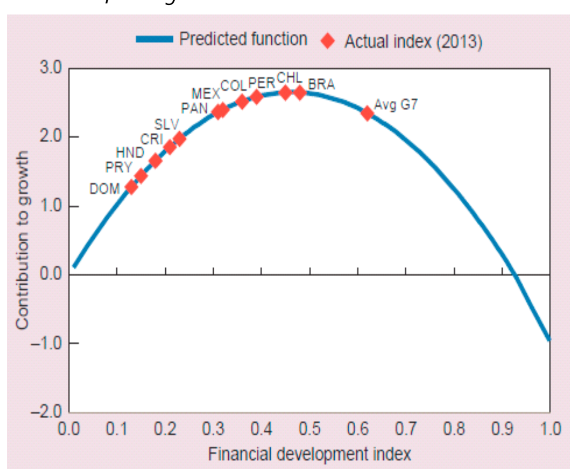


Reforms that focus on main contraints...

Components of the financial enabling environment



...should yield relatively high marginal benefits in terms of GDP growth.



Sources: World Bank Global Findex; World Bank Enterprise Survey; Economic Intelligence Unit Global Microscope and Fund staff calculations.

Table 1. El Salvador: Selected Economic Indicators

Rank in UNDP Development Index 2013 (of 187)	115	Population (million)	6.3
Per capita income (U.S. dollars)	4,129	Life expectancy at birth in years (2014)	72
Percent of pop. below poverty line (2013)	30	Infant mortality (per 1,000 live births, 2014)	19
Gini index (2014)	38	Primary education completion rate (percent, 2013)	100

					Est.	Proj.	
	2011	2012	2013	2014	2015	2016	2017
Income and Prices							
Real GDP growth (percent)	2.2	1.9	1.8	1.4	2.5	2.3	2.4
Consumer price inflation (average, percent)	5.1	1.7	0.8	1.1	-0.7	2.1	1.9
GDP deflator (percent)	5.7	1.0	0.4	1.4	0.7	1.8	1.7
Terms of trade, percent change	-2.5	0.5	-1.6	3.3	12.4	-1.6	-1.6
Real effective exchange rate (+ = appreciation)	2.6	-1.5	-0.8	0.5	0.0	...	...
External sovereign bond spread (basis points)	374	448	378	400	497	...	...
Money and Credit							
Credit to the private sector	39.8	40.2	42.5	44.1	44.9	45.1	45.3
Broad money	43.6	43.2	43.3	42.2	43.4	43.4	43.4
Interest rate (time deposits, percent)	1.8	2.5	3.4	3.8	4.2	...	...
External Sector							
Current account balance	-4.8	-5.4	-6.5	-5.2	-3.6	-3.7	-4.9
Trade balance	-20.6	-20.7	-21.7	-20.8	-19.1	-19.2	-20.2
Exports (f.o.b. excluding *maquila*)	18.3	17.8	17.8	17.0	16.9	16.5	16.7
Imports (f.o.b. excluding *maquila*)	-39.0	-38.5	-39.5	-37.8	-36.1	-35.7	-36.9
Services and income (net)	-0.7	-1.6	-1.6	-1.3	-1.4	-1.5	-1.7
Transfers (net)	16.6	16.9	16.8	16.9	16.9	17.0	16.9
Foreign direct investment	0.9	2.0	0.7	1.2	1.7	1.5	1.8
Gross international reserves (millions of U.S. dollars)	2,503	3,175	2,745	2,693	2,787	2,908	2929
Nonfinancial Public Sector							
Overall balance	-3.9	-3.9	-4.1	-3.5	-3.4	-4.0	-4.0
Primary balance	-1.7	-1.6	-1.6	-1.1	-0.9	-1.2	-1.0
Of which: tax revenue	13.8	14.4	15.4	15.1	15.2	15.4	15.7
Public sector debt 1/	52.2	57.3	57.6	59.2	60.6	62.2	63.7
National Savings and Investment							
Gross domestic investment	14.4	14.1	15.0	13.6	14.0	14.2	14.7
Public sector	2.4	2.5	2.5	2.1	2.1	2.5	2.5
Private sector	11.9	11.6	12.5	11.5	11.9	11.7	12.2
National savings	9.6	8.7	8.5	8.4	10.4	10.4	9.8
Public sector	-2.0	-1.2	-1.2	-0.9	-0.9	-1.0	-1.1
Private sector	11.5	9.9	9.7	9.3	11.3	11.5	10.9
Net Foreign Assets of the Financial System							
Millions of U.S. dollars	2,811	3,229	2,473	2,211	1,931	2,177	1,882
Percent of deposits	28.8	32.6	24.0	21.6	17.8	19.5	16.2
Memorandum Items:							
Nominal GDP (billions of U.S. dollars)	23.1	23.8	24.4	25.1	25.9	26.9	28.0

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 2. El Salvador: Medium-Term Baseline Scenario

	2012	2013	2014	2015	Projections 2016	2017	2018	2019	2020	2021
	(Annual percentage change)									
Real GDP growth	1.9	1.8	1.4	2.5	2.3	2.4	2.3	2.1	2.0	2.0
Domestic demand	1.8	2.2	0.4	2.8	3.2	3.4	2.8	2.2	2.0	2.4
Inflation (end of period)	0.8	0.8	0.5	1.0	1.9	2.0	2.0	2.0	2.0	2.0
	(Contributions to growth, percentage points)									
Private consumption	2.2	0.7	1.7	1.6	2.2	2.5	2.2	1.7	1.8	2.1
Private investment	-0.2	1.5	-0.9	1.2	0.7	1.1	0.8	0.6	0.5	0.5
Government	0.2	0.4	-0.3	0.5	0.9	0.4	0.4	0.3	0.2	0.4
Net exports	-0.3	-0.7	1.0	-0.9	-1.5	-1.6	-1.1	-0.5	-0.5	-1.0
	(Percent of GDP)									
Nonfinancial public sector balance	-3.9	-4.1	-3.5	-3.4	-4.0	-4.0	-4.5	-5.0	-5.3	-5.6
Primary balance	-1.6	-1.6	-1.1	-0.9	-1.2	-1.0	-1.1	-1.3	-1.4	-1.6
Public sector gross debt 1/	57.3	57.6	59.2	60.6	62.2	63.7	65.5	67.9	70.5	73.2
External current account balance	-5.4	-6.5	-5.2	-3.6	-3.7	-4.9	-5.3	-5.4	-5.5	-5.5
Exports of goods	17.8	17.8	17.0	16.9	16.5	16.7	16.8	16.9	17.1	17.1
Imports of goods	-38.5	-39.5	-37.8	-36.1	-35.7	-36.9	-37.3	-37.5	-37.6	-37.8
Current transfers	16.9	16.8	16.9	16.9	17.0	16.9	16.8	16.8	16.8	16.8
Gross domestic investment	14.1	15.0	13.6	14.0	14.2	14.7	15.0	15.1	15.0	15.1
Private	11.6	12.5	11.5	11.9	11.7	12.2	12.5	12.6	12.7	12.8
Public	2.5	2.5	2.1	2.1	2.5	2.5	2.5	2.5	2.3	2.3
Gross national saving	8.7	8.5	8.4	10.4	10.4	9.8	9.6	9.7	9.6	9.6
Private	9.9	9.7	9.3	11.3	11.5	10.9	11.3	11.8	12.0	12.3
Public	-1.2	-1.2	-0.9	-0.9	-1.0	-1.1	-1.6	-2.1	-2.4	-2.7
External saving	5.4	6.5	5.2	3.6	3.7	4.9	5.3	5.4	5.5	5.5

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 3. El Salvador: Balance of Payments

					Projections					
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
					(In millions of U.S. dollars)					
Current Account	**-1,288**	**-1,574**	**-1,306**	**-920**	**-1,006**	**-1,386**	**-1,567**	**-1,659**	**-1,737**	**-1,821**
Merchandise trade balance	-4,927	-5,295	-5,208	-4,940	-5,163	-5,667	-6,016	-6,275	-6,530	-6,863
Export of goods (f.o.b.)	4,235	4,334	4,256	4,381	4,443	4,692	4,924	5,172	5,419	5,668
Import of goods (f.o.b.)	-9,162	-9,629	-9,463	-9,321	-9,606	-10,358	-10,940	-11,447	-11,949	-12,531
Services	508	618	741	786	790	790	825	879	931	971
Exports of processing services	424	440	375	464	468	482	483	485	485	484
Income	-890	-997	-1,074	-1,137	-1,200	-1,254	-1,312	-1,399	-1,480	-1,489
Current transfers	4,021	4,100	4,234	4,372	4,567	4,745	4,936	5,135	5,343	5,559
Workers' remittances (credits)	3,894	3,954	4,133	4,270	4,484	4,672	4,868	5,073	5,286	5,508
Financial and Capital Account	**2,116**	**1,138**	**766**	**1,163**	**1,127**	**1,406**	**1,571**	**1,774**	**1,854**	**1,950**
Capital account	201	101	64	66	144	172	176	136	136	136
Public sector financial flows	912	13	788	-13	30	16	21	80	30	51
Disbursements	1,202	269	1,059	332	338	363	377	1,227	386	402
Amortization	-290	-256	-271	-345	-308	-347	-356	-1,147	-355	-351
Private sector financial flows	1,352	190	1,100	448	341	441	463	493	514	514
Foreign direct investment	484	176	311	429	400	500	521	551	571	571
Portfolio investment	868	14	789	19	-59	-59	-58	-58	-57	-57
Other 1/	-349	835	-1,186	663	612	776	910	1,063	1,173	1,249
Errors and Omissions	**-177**	**109**	**508**	**-130**	**0**	**0**	**0**	**0**	**0**	**0**
Change in Reserves (- = increase)	**-651**	**327**	**33**	**-113**	**-121**	**-21**	**-4**	**-115**	**-117**	**-128**
					(Percent of GDP)					
Current Account	**-5.4**	**-6.5**	**-5.2**	**-3.6**	**-3.7**	**-4.9**	**-5.3**	**-5.4**	**-5.5**	**-5.5**
Merchandise trade balance	-20.7	-21.7	-20.8	-19.1	-19.2	-20.2	-20.5	-20.6	-20.6	-20.7
Export of goods (f.o.b.)	17.8	17.8	17.0	16.9	16.5	16.7	16.8	16.9	17.1	17.1
Import of goods (f.o.b.)	-38.5	-39.5	-37.8	-36.1	-35.7	-36.9	-37.3	-37.5	-37.6	-37.8
Petroleum and products	-8.0	-8.1	-7.0	-5.2	-4.2	-4.9	-5.0	-5.0	-5.1	-5.1
Services	2.1	2.5	3.0	3.0	2.9	2.8	2.8	2.9	2.9	2.9
Exports of processing services	1.8	1.8	1.5	1.8	1.7	1.7	1.6	1.6	1.5	1.5
Income	-3.7	-4.1	-4.3	-4.4	-4.5	-4.5	-4.5	-4.6	-4.7	-4.5
Current transfers	16.9	16.8	16.9	16.9	17.0	16.9	16.8	16.8	16.8	16.8
Workers' remittances (credits)	16.4	16.2	16.5	16.5	16.7	16.7	16.6	16.6	16.6	16.6
Financial and Capital Account	**8.9**	**4.7**	**3.1**	**4.5**	**4.2**	**5.0**	**5.4**	**5.8**	**5.8**	**5.9**
Capital account	0.8	0.4	0.3	0.3	0.5	0.6	0.6	0.4	0.4	0.4
Public sector financial flows	3.8	0.1	3.1	-0.1	0.1	0.1	0.1	0.3	0.1	0.2
Private sector financial flows	5.7	0.8	4.4	1.7	1.3	1.6	1.6	1.6	1.6	1.6
Foreign direct investment	2.0	0.7	1.2	1.7	1.5	1.8	1.8	1.8	1.8	1.7
Portfolio investment	3.6	0.1	3.1	0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Other 1/	-1.5	3.4	-4.7	2.6	2.3	2.8	3.1	3.5	3.7	3.8
					(Annual percentage change)					
Merchandise Trade (f.o.b.)										
Exports (nominal)	-0.2	2.3	-1.8	2.9	1.4	5.6	5.0	5.0	4.8	4.6
Volume	-1.3	4.0	-3.3	1.0	7.0	5.5	4.8	4.6	4.6	4.6
Price	1.1	-1.6	1.5	1.9	-5.3	0.1	0.2	0.4	0.2	0.0
Imports (nominal)	1.6	5.1	-1.7	-1.5	3.1	7.8	5.6	4.6	4.4	4.9
Volume	1.0	5.0	0.0	8.6	7.1	6.0	4.7	3.7	3.6	4.3
Price	0.6	0.1	-1.7	-9.3	-3.8	1.7	0.9	0.9	0.8	0.5
Terms of trade	0.5	-1.6	3.3	12.4	-1.6	-1.6	-0.7	-0.5	-0.6	-0.5
Memorandum Items										
Gross international reserves (US$ million) 2/	3,175	2,745	2,693	2,787	2,908	2,929	2,932	3,047	3,164	3,292
In months of imports (excluding maquila) 3/	3.4	3.0	3.0	2.9	2.8	2.6	2.5	2.5	2.5	2.5
In percent of total short-term external debt	208	148	133	138	138	132	124	120	117	114
External debt (in percent of GDP)	56.1	57.9	60.9	56.6	56.8	57.3	58.0	59.4	60.9	62.3
Of which: public sector debt	32.1	31.9	34.6	33.1	34.1	34.8	35.8	37.2	38.7	40.1
Of which: private sector debt	24.0	26.0	26.3	23.5	22.6	22.5	22.2	22.2	22.2	22.1
External public debt servicing (US$ million)	580	582	598	779	743	812	878	1,753	974	1,043
Percent of exports of goods and services	9.5	9.1	9.2	11.6	10.3	10.5	10.8	20.6	10.9	11.2
Gross external financing requirement (US$ million)	3,311	3,877	3,969	3,749	3,660	4,152	4,459	5,473	4,924	5,178
Percent of GDP	13.9	15.9	15.8	14.5	13.6	14.8	15.2	17.9	15.5	15.6

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

1/ Assumed to include both private and potential public sector flows, including 75 percent of the fiscal financing gap.

2/ Gold in international reserves is valued at the price determined by the London Bullion Market.

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

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

	2012	2013	2014	2015	Projections. 2016	2017	2018	2019	2020	2021
					(In millions of U.S. dollars)					
Revenue and Grants	**4,507**	**4,678**	**4,739**	**4,923**	**5,236**	**5,587**	**5,841**	**6,090**	**6,285**	**6,557**
Current revenue	4,329	4,607	4,692	4,870	5,196	5,499	5,751	6,003	6,260	6,532
Tax revenue	3,434	3,745	3,772	3,918	4,155	4,410	4,613	4,817	5,026	5,245
Nontax revenue	734	756	797	836	942	982	1,026	1,069	1,113	1,161
Operating surplus of the public enterprises	162	106	124	115	98	107	112	117	122	127
Capital revenue	0	0	0	0	0	0	0	0	0	0
Official grants	178	71	46	53	41	88	91	87	25	24
Expenditure	**5,427**	**5,665**	**5,626**	**5,799**	**6,323**	**6,707**	**7,159**	**7,623**	**7,962**	**8,412**
Current expenditure	4,609	4,889	4,926	5,098	5,477	5,810	6,227	6,656	7,017	7,427
Wages and salaries	2,005	2,115	2,228	2,326	2,500	2,648	2,809	2,971	3,139	3,324
Goods and services	935	1,075	1,049	1,083	1,141	1,195	1,249	1,301	1,354	1,413
Interest	540	594	609	644	763	842	988	1,148	1,230	1,334
Current transfers	1,128	1,105	1,040	1,045	1,074	1,125	1,181	1,237	1,294	1,356
Nonpension payments	709	663	573	560	508	529	553	576	600	626
Pension payments	419	442	467	485	566	595	628	661	694	731
Capital expenditure	818	776	700	701	846	897	932	967	945	985
Primary Balance	**-379**	**-393**	**-278**	**-233**	**-324**	**-278**	**-329**	**-386**	**-447**	**-521**
Overall Balance	**-919**	**-987**	**-887**	**-876**	**-1,087**	**-1,120**	**-1,317**	**-1,533**	**-1,677**	**-1,855**
Financing	**919**	**987**	**887**	**876**	**1,087**	**1,120**	**1,317**	**1,533**	**1,677**	**1,855**
External	**912**	**13**	**788**	**-13**	**30**	**16**	**21**	**80**	**30**	**51**
Disbursements	1,202	269	1,059	332	338	363	377	1,227	386	402
Amortization	-290	-256	-271	-345	-308	-347	-356	-1,147	-355	-351
Domestic	**7**	**975**	**100**	**889**	**100**	**511**	**515**	**531**	**564**	**401**
Change in deposits at central bank (- = increase)	-737	758	-5	24	0	0	0	0	0	0
Banking system	162	-171	-557	732	-222	0	0	0	0	0
Private sector 1/	582	388	662	133	322	511	515	531	564	401
Unidentified financing	**…**	**…**	**…**	**…**	**957**	**593**	**781**	**922**	**1,083**	**1,404**
Memorandum Items:										
Current revenue minus current expenditure	-279	-282	-234	-228	-281	-311	-476	-653	-757	-894
Gross financing needs	1,877	2,180	2,244	1,628	2,412	2,102	2,336	3,360	2,712	3,087
Public sector debt (gross) 2/	13,641	14,031	14,827	15,663	16,750	17,869	19,187	20,720	22,397	24,252
					(In percent of GDP)					
Revenue and Grants	**18.9**	**19.2**	**18.9**	**19.0**	**19.5**	**19.9**	**19.9**	**20.0**	**19.8**	**19.8**
Current revenue	18.2	18.9	18.7	18.8	19.3	19.6	19.6	19.7	19.7	19.7
Tax revenue	14.4	15.4	15.1	15.2	15.4	15.7	15.7	15.8	15.8	15.8
Nontax revenue	3.1	3.1	3.2	3.2	3.5	3.5	3.5	3.5	3.5	3.5
Operating surplus of the public enterprises	0.7	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Official grants	0.7	0.3	0.2	0.2	0.2	0.3	0.3	0.3	0.1	0.1
Expenditure	**22.8**	**23.3**	**22.5**	**22.4**	**23.5**	**23.9**	**24.4**	**25.0**	**25.1**	**25.4**
Current expenditure	19.4	20.1	19.7	19.7	20.4	20.7	21.3	21.8	22.1	22.4
Wages and salaries	8.4	8.7	8.9	9.0	9.3	9.4	9.6	9.7	9.9	10.0
Goods and services	3.9	4.4	4.2	4.2	4.2	4.3	4.3	4.3	4.3	4.3
Interest	2.3	2.4	2.4	2.5	2.8	3.0	3.4	3.8	3.9	4.0
Current transfers	4.7	4.5	4.2	4.0	4.0	4.0	4.0	4.1	4.1	4.1
Nonpension payments	3.0	2.7	2.3	2.2	1.9	1.9	1.9	1.9	1.9	1.9
Pension payments	1.8	1.8	1.9	1.9	2.1	2.1	2.1	2.2	2.2	2.2
Capital expenditure	3.4	3.2	2.8	2.7	3.1	3.2	3.2	3.2	3.0	3.0
Primary Balance	**-1.6**	**-1.6**	**-1.1**	**-0.9**	**-1.2**	**-1.0**	**-1.1**	**-1.3**	**-1.4**	**-1.6**
Overall Balance	**-3.9**	**-4.1**	**-3.5**	**-3.4**	**-4.0**	**-4.0**	**-4.5**	**-5.0**	**-5.3**	**-5.6**
Memorandum Items:										
Current revenue minus current expenditure	-1.2	-1.2	-0.9	-0.9	-1.0	-1.1	-1.6	-2.1	-2.4	-2.7
Gross financing needs	7.9	9.0	9.0	6.3	9.0	7.5	8.0	11.0	8.5	9.3
Public sector debt (gross) 2/	57.3	57.6	59.2	60.6	62.2	63.7	65.5	67.9	70.5	73.2
Nominal GDP	23,814	24,351	25,054	25,850	26,908	28,034	29,293	30,521	31,774	33,148

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

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

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

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

	2009	2010	2011	2012	2013	2014	2015	Proj. 2016
	(End of period stocks; in millions of U.S. dollars)							
	I. Central Bank							
Net Foreign Assets	**2,594**	**2,550**	**2,177**	**2,831**	**2,290**	**2,275**	**2,393**	**2,514**
Of which: Net international reserves 1/	2,983	2,881	2,502	3,173	2,721	2,661	2,670	2,792
Net Domestic Assets	**35**	**36**	**300**	**-450**	**278**	**309**	**285**	**309**
Nonfinancial public sector (net)	219	490	688	-49	710	704	726	750
Claims	836	833	833	832	832	831	830	830
Liabilities	617	343	145	881	122	127	103	79
Rest of the financial system (net)	98	109	175	186	119	139	93	93
Nonfinancial private sector (claims)	15	1	0	0	0	0	0	0
Other items (net)	-298	-564	-563	-587	-551	-533	-534	-534
Liabilities	**2,629**	**2,586**	**2,476**	**2,381**	**2,566**	**2,582**	**2,675**	**2,823**
Base Money	2,282	2,354	2,275	2,229	2,481	2,474	2,569	2,716
Currency in circulation	33	5	5	4	4	4	4	5
Liabilities to depositary corporations	2,250	2,349	2,271	2,224	2,476	2,470	2,565	2,712
Other liabilities to the public	347	232	201	152	85	109	107	107
	II. Depository corporations							
Net Foreign Assets	**376**	**697**	**295**	**-62**	**-417**	**-672**	**-963**	**-804**
Net Domestic Assets	**8,832**	**8,987**	**9,383**	**9,985**	**10,614**	**10,853**	**11,809**	**12,094**
Nonfinancial public sector (net)	499	445	465	578	373	258	762	494
Claims	680	627	681	762	672	546	1,015	1,015
Liabilities	181	182	215	184	299	287	254	521
Rest of the financial system (net)	1,571	1,928	1,888	1,981	2,150	2,158	2,214	2,350
Credit to the private sector	8,572	8,559	8,984	9,332	10,078	10,539	11,028	11,535
Other items (net)	-1,809	-1,946	-1,955	-1,907	-1,988	-2,102	-2,195	-2,285
Liabilities to the Private Sector	**9,209**	**9,683**	**9,678**	**9,923**	**10,196**	**10,181**	**10,846**	**11,290**
Deposits	9,043	9,474	9,413	9,638	9,907	9,863	10,498	10,927
Securities	166	209	264	285	289	318	348	362
	III. Other financial corporations 2/							
Net Foreign Assets	**58**	**132**	**339**	**460**	**600**	**608**	**501**	**467**
Net Domestic Assets	**5,260**	**5,789**	**6,108**	**6,687**	**7,121**	**7,794**	**8,500**	**9,140**
Nonfinancial public sector (net)	3,607	4,281	4,960	5,660	6,036	6,448	7,019	7,598
Rest of the financial system (net)	1,620	1,490	1,121	987	1,007	943	1,105	1,150
Credit to the private sector	166	195	215	242	279	508	569	592
Other items (net)	-133	-177	-188	-201	-201	-198	-277	-289
Liabilities to the Private Sector	**5,318**	**5,921**	**6,447**	**7,147**	**7,721**	**8,402**	**9,001**	**9,607**
Pension fund contributions	5,139	5,734	6,247	6,931	7,470	8,133	8,729	9,329
	IV. Financial System							
Net Foreign Assets	**3,028**	**3,378**	**2,811**	**3,229**	**2,473**	**2,211**	**1,931**	**2,177**
Net Domestic Assets	**11,878**	**12,463**	**13,519**	**13,997**	**15,533**	**16,484**	**18,027**	**18,831**
Net claims on nonfinancial public sector	4,325	5,216	6,113	6,189	7,118	7,410	8,507	8,843
Credit to private sector	8,753	8,755	9,199	9,574	10,357	11,047	11,597	12,127
Other	-1,200	-1,508	-1,793	-1,766	-1,942	-1,973	-2,077	-2,138
Liabilities to the Private Sector	**14,906**	**15,841**	**16,331**	**17,226**	**18,006**	**18,695**	**19,957**	**21,008**
Money	2,183	2,542	2,669	2,681	2,759	2,788	3,108	3,237
Quasi-money	7,584	7,565	7,415	7,614	7,777	7,775	8,120	8,442
Pension fund contributions	5,139	5,734	6,247	6,931	7,470	8,133	8,729	9,329
Memorandum Items:	(Percent changes relative to previous year's liabilities to the private sector)							
Net domestic assets	-0.8	3.9	6.7	2.9	8.9	9.0	14.6	7.2
Nonfinancial public sector	3.0	6.0	5.7	0.5	5.4	2.8	10.4	3.0
Credit to the private sector	-3.3	0.0	2.8	2.3	4.5	6.6	5.2	4.7
Liabilities to the private sector	5.0	6.3	3.1	5.5	4.5	6.5	11.9	9.4
	(Percent of GDP)							
Credit to the private sector	42.4	40.9	39.8	40.2	42.5	44.1	44.9	45.1
Liabilities to the private sector	72.1	74.0	70.6	72.3	73.9	74.6	77.2	78.1
Excluding pension contributions	47.3	47.2	43.6	43.2	43.3	42.2	43.4	43.4
	(Annual percentage change, unless otherwise noted)							
Credit to the private sector	-5.0	0.0	5.1	4.1	8.2	6.7	5.0	4.6
Private sector deposits in depository corporations	1.8	4.8	-0.6	2.4	2.8	-0.4	6.4	4.1
Depository corporations liquid deposits at central bank								
(In percent of total deposits)	24.9	24.8	24.1	23.1	25.0	25.0	24.4	24.8
(In percent of NIR)	75.4	81.5	90.7	70.1	91.0	92.8	96.1	97.1

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 6. El Salvador: Selected Vulnerability Indicators

(In percent of GDP; unless otherwise indicated)

						Projections	
	2011	2012	2013	2014	2015	2016	2017
Fiscal Indicators							
Overall balance of the nonfinancial public sector	-3.9	-3.9	-4.1	-3.5	-3.4	-4.0	-4.0
Primary balance of the nonfinancial public sector	-1.7	-1.6	-1.6	-1.1	-0.9	-1.2	-1.0
Gross public sector financing requirement	9.0	7.9	9.0	9.0	6.3	9.0	7.5
Public sector debt (gross) 1/	52.2	57.3	57.6	59.2	60.6	62.2	63.7
Public sector external debt	28.8	32.1	31.9	34.6	33.1	34.1	34.8
External interest payments to total fiscal revenue (percent)	7.8	7.2	7.7	7.6	8.1	8.3	8.0
External amortization payments to total fiscal revenue (percent) 2/	22.4	6.4	5.5	5.7	7.0	5.9	6.2
Financial Indicators							
Broad money (percent change, end-of-period)	-0.2	2.1	2.3	0.3	6.3	4.0	4.1
Private sector credit (percent change, end-of-period)	5.1	4.1	8.2	6.7	5.0	4.6	4.7
Ratio of capital to risk-weighted assets	17.1	17.3	17.3	16.6	16.8	…	…
Ratio of loans more than 90 days past due to total loans	3.6	2.9	2.3	2.4	2.3	…	…
Ratio of provisions to total loans	3.8	3.3	2.9	2.8	2.7	…	…
Ratio of provisions to loans more than 90 days past due	107.8	113.3	121.6	119.0	115.9	…	…
Return on average equity	12.2	12.4	12.4	10.0	7.9	…	…
Return on average total assets	1.5	1.6	1.6	1.3	1.0	…	…
Loans as percent of deposits	88.9	93.7	97.2	103.2	102.1	…	…
Ratio of liquid assets to total deposits	37.0	31.9	30.7	28.1	32.3	…	…
External Indicators							
Exports of goods and services (percent change, 12-month basis)	18.3	3.7	5.4	0.9	3.5	7.7	6.9
Imports of goods and services (percent change, 12-month basis)	18.7	3.1	5.6	-1.4	-0.8	6.8	8.6
Current account balance	-4.8	-5.4	-6.5	-5.2	-3.6	-3.7	-4.9
Capital and financial account balance	4.5	8.9	4.7	3.1	4.5	4.2	5.0
Gross international reserves (millions of U.S. dollars)	2,503	3,175	2,745	2,693	2,787	2,908	2,929
Months of imports of goods and services, excluding maquila	3.1	3.7	3.2	3.2	3.1	2.9	2.8
Percent of short-term debt	204	208	148	133	138	138	132
Percent of gross external financing requirements	74	96	71	68	74	79	71
Percent of broad money	24.8	30.8	26.1	25.5	24.8	24.9	24.1
Public external debt service 2/	5.3	2.4	2.4	2.4	3.0	2.8	2.9
External debt to exports of goods and services (percent)	204	206	219	236	218	211	208
External interest payments to exports of goods and services (percent)	11.1	15.3	16.2	17.3	17.7	17.1	16.7
External amortization to exports of goods and services (percent) 2/	38.9	33.2	35.9	41.1	42.2	36.7	35.8
REER, depreciation is negative (percent change, end-of-period)	2.6	-1.5	-0.8	0.5	0.0	0.0	0.0

Sources: Central Reserve Bank of El Salvador, Ministry of Finance, Financial System Superintendency, and Fund staff est

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.

Table 7. El Salvador: Authorities' Recent Key Growth-Promoting Steps

Key growth-promoting steps	Status	Assessment/effects
Public Private Partnerships (2013)	Law adopted but creation of any PPPs has yet to happen	Legal interpretation and project selection issues caused delays
Large project implementation (2014-)	Progress is being made, particularly on two large projects (Fomilenio-2 and gas plant)	Implementation processes improved relative to the past, but projects are still at early stage
Central bank credit facilitation (2015)	Central bank introduced incentives reducing liquidity requirements on loans to certain "productive sectors"	Design interferes with prudential policies, while credit growth has remained relatively low
Ministry of Economy's measures (2015)	Nine laws on aspects of business facilitation supplemented by other steps supporting sectors	Cross-cutting simplification measures are sometimes accompanied by ad-hoc exemptions and incentives
Crime prevention (2015-16)	Many measures have been announced, with key financing to come from two new taxes	Receipts from the new taxes so far have proved insufficient and there have been delays in approving financing for the security measures
Public investment (2016, planned)	The authorities have committed to achieve a 70% average execution rate	The execution rate is so far around 60-65% due to budget constraints and political impasse for project loan approval

Annex I. Implementation of Fund Policy Advice

The 2014 Article IV Consultation focused on reaching social and political consensus to enhance growth and social objectives, while pursuing a much needed fiscal adjustment and reforms to improve the investment climate. Directors recommended:

- **Reaching broad political and social consensus to address economic inequalities and low economic growth.** *While there is broad consensus on the objectives of reducing inequality and increasing underlying growth, there is little political agreement on the means to achieve these aims. Political intransigence is obstructing short- and medium-term reforms to support stability and growth.*

- **Implementing fiscal consolidation while protecting social spending** to lower the deficits by 3.5 percentage points of GDP in 2015–17 to stabilize the public debt ratio. *Consolidation efforts have not been sufficient with the 2014–15 deficits falling cumulatively by around 0.7 percent of GDP reflecting lower current transfers and capital expenditures.*

- **Promoting a better investment climate to achieve higher, private-sector lead growth.** *While progress on diversifying the energy mix and improving security (in recent months) has been made, the political gridlock is preventing meaningful progress on expanding investment and creating sustainable fiscal space to achieve security and social objectives, as well as making meaningful progress on reducing red tape.*

- **Improving the financial institutional framework for the banking sector,** including the legal framework and appropriate safety net for banks. *Risk-based supervision is being implemented and short-term legal fixes have been identified while a new banking sector law is being prepared. A bank liquidity pool decree is nearly complete but progress on financing LOLR capacity has not been made.*

Annex II. El Salvador: Debt Sustainability Analysis (Higher Scrutiny Case)

The debt stock is estimated at around 61 percent of GDP at end-2015 and is set to rise to 73 percent of GDP in 2021 under current policies.[7] The drivers for the increase include relatively high fiscal deficits, low growth, and rising interest rates. While the gross financing requirement is not high compared to other emerging markets, it is elevated for a fully dollarized economy. Susceptibility to growth shocks is an additional risk. Shortcomings in pension system design and uncertainty over the proposed pension reform are sources of significant long-term risks that are exacerbated by population aging over the next few decades. Vulnerabilities are moderated by a relatively high maturity of existing debt, a stable investor base, and the fact that some of the public debt (14 percent of GDP) was issued to pre-finance future pensions obligations.

A. Key Assumptions

Debt definition. El Salvador's public debt is defined as the sum of gross debt of nonfinancial public sector (including explicit pension-related debt) and the external debt of the central bank (currently about ½ percent of GDP). This definition aims to better capture 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. The definition of the nonfinancial public sector debt as reported by the Ministry of Finance excludes liabilities of municipalities and some public enterprises.

Growth. The baseline reflects the estimated growth potential of around 2 percent. Susceptibility to shocks (including natural disasters and external economic shocks) is a downside risk.

Fiscal policy and financing. The baseline scenario assumes no fiscal adjustment and no pension reform, with the primary deficit rising gradually largely reflecting generous public wage indexation for certain key sectors. The headline deficit would increase above 5 percent of GDP in the medium term, also due to the higher interest bill from rising debt and (US LIBOR-dependent) servicing costs. The scenario assumes that unidentified financing gaps are filled with long-term loans from official and private creditors. Alternatively, the debt profile could become riskier from the financing perspective, reflecting a growing share of short-term debt. The proposed pension reform has significant implications for short-term headline debt and deficit dynamics, but a relatively minor impact on long-term debt sustainability.

B. Results and Assessment

Baseline results. The public debt ratio would reach 73 percent of GDP in 2021, staying on an upward trajectory thereafter. The gross financing needs would average 8–9 percent of GDP, increasing to 11 percent of GDP in 2019 due to a Eurobond repayment that year.

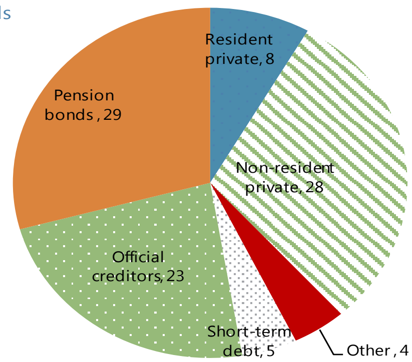
[7] Staff estimates public debt threshold for El Salvador within the 40–50 percent range (see IMF Country report 15/13).

Drivers. The upward debt dynamics are driven by real interest rates and primary deficits (contributing about 2¼ and 1¼ percent of GDP on an annual basis respectively). Real GDP growth would reduce the ratio by less than 1½ percent of GDP annually.

Assessment. Most standard debt profile characteristics are of concern (see heat-map). Moreover, the heat-map on balance may understate risks: (i) the threshold for gross financing (15 percent of GDP) does not take into account funding constraints of full dollarization; and (ii) the measured share of "foreign currency" debt (close to zero) reflects the legal adoption of the US dollar, not the implied benefits of issuing an own-currency.

Mitigating factors. Unlike many countries, El Salvador has pre-funded some of its future pension liabilities (but the overall assessment of the pension system is less reassuring (see below)). Existing debt has a relatively long average debt maturity (12 years) and a stable investor base (over one-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." Remittances are over 16 percent of GDP. The authorities believe that GNDI would be a better denominator than GDP, and have provided alternative calculations.

El Salvador: Composition of Public Debt by Creditor, end-2015, percent, includes CIP-B bonds



Source: Ministry of Finance of El Salvador.

Stress tests. Real GDP, interest rate, and contingent liability shocks have a relatively significant impact. Hence a "combined macro-fiscal shock" would be particularly challenging. The vulnerability to a rise in global interest rates has been recently reduced with the interest rate on pension bonds being de-linked from LIBOR in February 2016, though this has increased interest payments in the baseline scenario. If there is greater recourse to short-term borrowing (assuming that one-half of the projected financing gaps is filled with short-term borrowing), public gross financing needs would rise to 15 percent of GDP in 2021.

Idiosyncratic risks and issues. These include: (i) a potentially substantial one-off downward revision of nominal GDP; (ii) pension-related liabilities, estimated at around 100 percent of GDP in NPV terms (there is also the need to recognize as public debt recognition bonds already issued equivalent to 6 percent of GDP); (iii) potential assumption of enterprise debt; (iv) municipal debt that is not officially recorded as public debt (around 2 percent of GDP); and (v) contingent liabilities from future PPP projects (the PPP law is relatively new, adopted in 2013).

El Salvador's **pension system** would be a key additional driver of the long-term debt dynamics. Under current rules, the system would increase spending over the next 15 years by about ½ percent of GDP relative to the assumption of constant primary balance, as the actuarial deficit is projected to increase over the next few years. After 2030, fiscal pension spending burden is expected to ease, but this assumption would depend on the pension system surviving in the current form, and the proposed pension reform would change this conclusion. Significant long-term population aging[8] is expected to put an additional burden on pension and health expenditure, not least due to pressures of significantly increasing the low coverage in both systems.

[8] El Salvador is so far in a demographic "sweet spot," but the share of population over 64 is projected to increase from 7 percent now to 16 percent in 2050 and 29 percent in 2100. Emigration of the young population can exacerbate those trends.

El Salvador: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

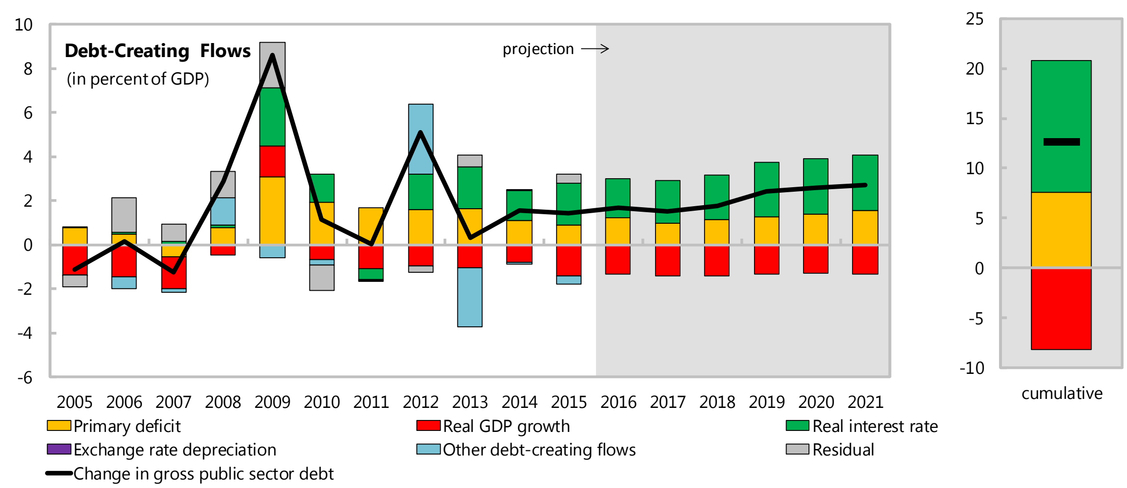
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2005-2013 [2/]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	48.2	59.2	60.6	62.2	63.7	65.5	67.9	70.5	73.2
Public gross financing needs	7.9	9.0	6.3	9.0	7.6	8.0	11.0	8.5	9.3
Real GDP growth (in percent)	1.9	1.4	2.5	2.3	2.4	2.3	2.1	2.0	2.0
Inflation (GDP deflator, in percent)	3.0	1.4	0.7	1.8	1.7	2.1	2.1	2.1	2.3
Nominal GDP growth (in percent)	5.0	2.9	3.2	4.1	4.2	4.5	4.2	4.1	4.3
Effective interest rate (in percent) [4/]	5.5	4.3	4.3	4.9	5.0	5.5	6.0	5.9	6.0

As of May 11, 2016		
Sovereign Spreads		
EMBIG (bp) 3/		654
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							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.8	1.6	1.4	1.7	1.5	1.8	2.4	2.6	2.7	12.6	
Identified debt-creating flows	1.3	1.6	1.0	1.7	1.5	1.8	2.4	2.6	2.7	12.6	
Primary deficit	1.3	1.1	0.9	1.2	1.0	1.1	1.3	1.4	1.6	7.6	1.1
Primary (noninterest) revenue and grants	17.7	18.9	19.0	19.5	19.9	19.9	20.0	19.8	19.8	118.8	
Primary (noninterest) expenditure	18.9	20.0	19.9	20.7	20.9	21.1	21.2	21.2	21.4	126.4	
Automatic debt dynamics [5/]	0.0	0.5	0.5	0.5	0.5	0.6	1.1	1.2	1.1	5.0	
Interest rate/growth differential [6/]	0.0	0.5	0.5	0.5	0.5	0.6	1.1	1.2	1.1	5.0	
Of which: real interest rate	0.8	1.3	1.9	1.8	1.9	2.0	2.5	2.5	2.5	13.2	
Of which: real GDP growth	-0.8	-0.8	-1.4	-1.3	-1.4	-1.4	-1.3	-1.3	-1.4	-8.2	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	-0.1	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization/Drawdown of Deposits	0.0	0.0	-0.1	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	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.5	0.0	0.4	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, including external central bank debt.

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 $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; 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 $r - \pi(1+g)$ 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.

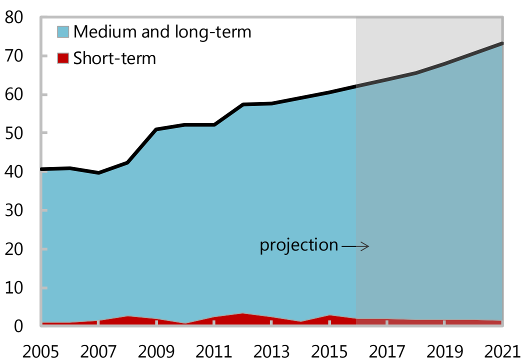
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

El Salvador: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

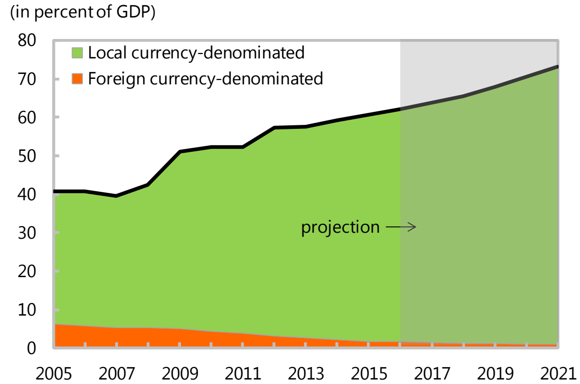
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

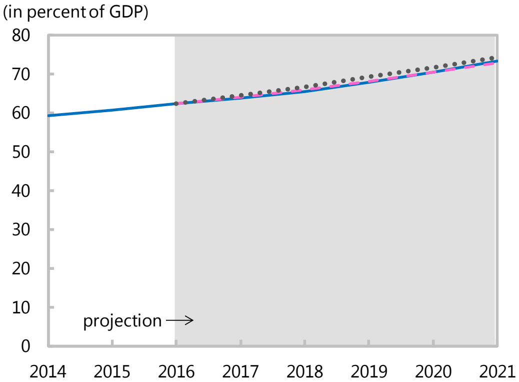


Alternative Scenarios

Historical Constant Primary Balance

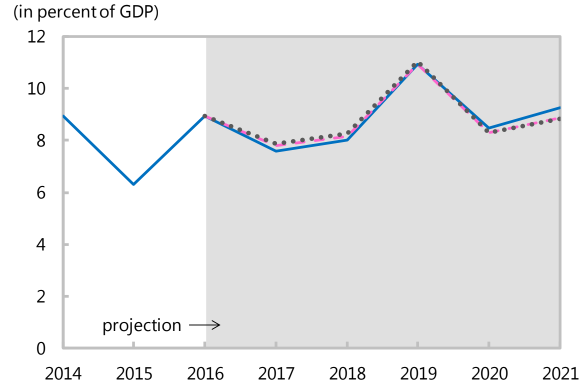
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	2.3	2.4	2.3	2.1	2.0	2.0
Inflation	1.8	1.7	2.1	2.1	2.1	2.3
Primary Balance	-1.2	-1.0	-1.1	-1.3	-1.4	-1.6
Effective interest rate	4.9	5.0	5.5	6.0	5.9	6.0
Constant Primary Balance Scenario						
Real GDP growth	2.3	2.4	2.3	2.1	2.0	2.0
Inflation	1.8	1.7	2.1	2.1	2.1	2.3
Primary Balance	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2
Effective interest rate	4.9	5.0	5.5	6.0	5.9	6.0

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	2.3	1.7	1.7	1.7	1.7	1.7
Inflation	1.8	1.7	2.1	2.1	2.1	2.3
Primary Balance	-1.2	-1.3	-1.3	-1.3	-1.3	-1.3
Effective interest rate	4.9	5.0	5.4	5.8	5.6	5.7

Source: Fund staff estimates and projections.

El Salvador: Public DSA – Realism of Baseline Assumptions

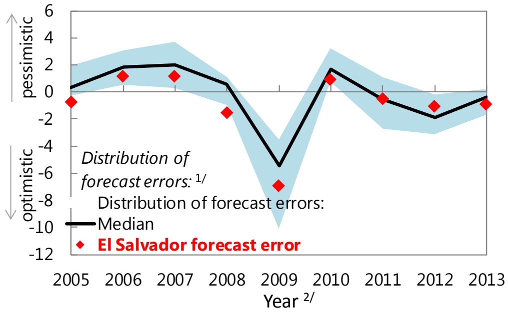
Forecast Track Record, versus program countries

Real GDP Growth

(in percent, actual-projection)

El Salvador median forecast error, 2005-2013: **-0.75**

Has a percentile rank of: **25%**

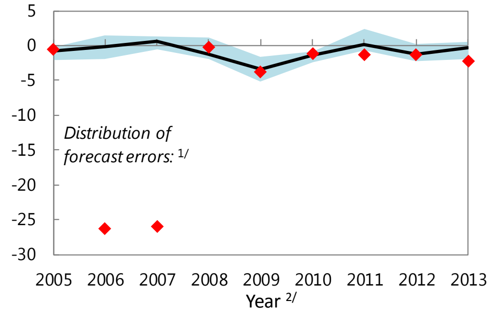


Primary Balance

(in percent of GDP, actual-projection)

El Salvador median forecast error, 2005-2013: **-1.38**

Has a percentile rank of: **24%**

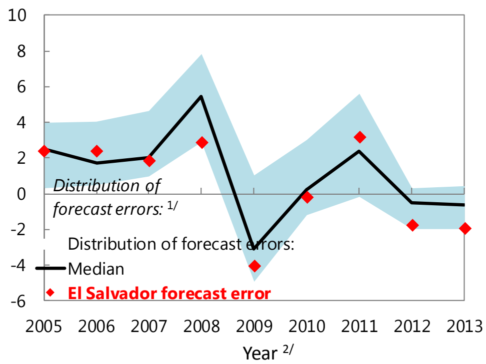


Inflation (Deflator)

(in percent, actual-projection)

El Salvador median forecast error, 2005-2013: **1.86**

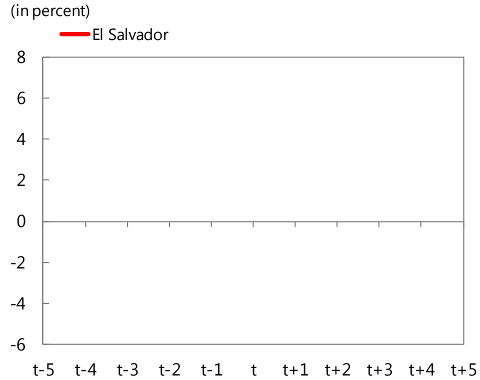
Has a percentile rank of: **63%**



Boom-Bust Analysis 3/

Real GDP growth

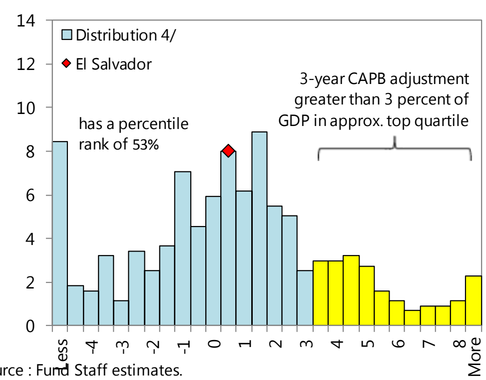
(in percent)



Assessing the Realism of Projected Fiscal Adjustment

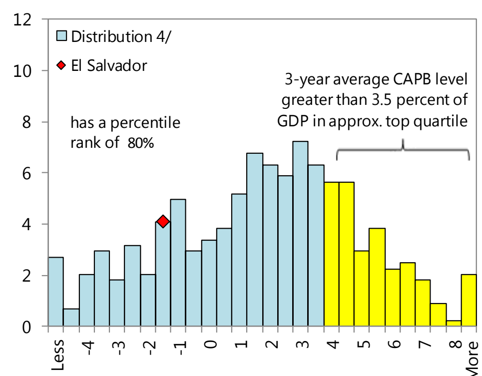
3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)

(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.

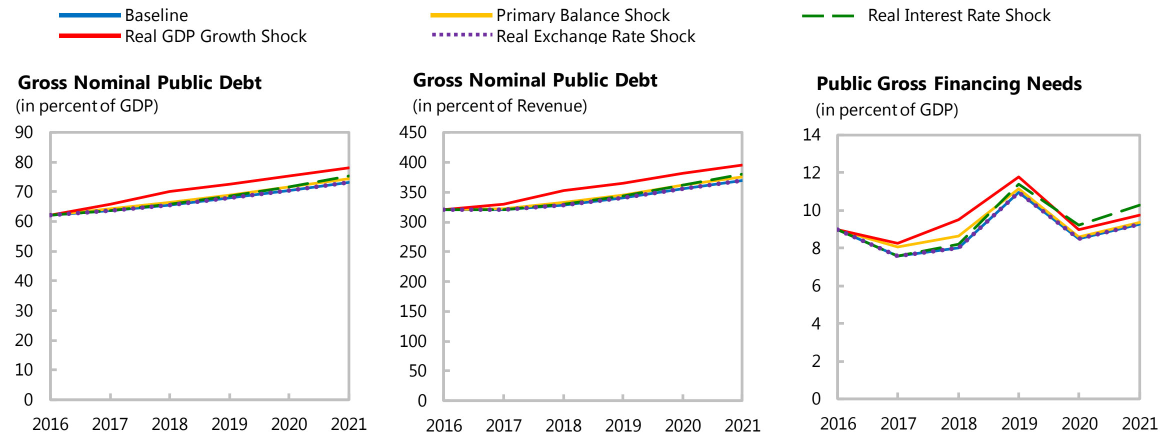
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for El Salvador.

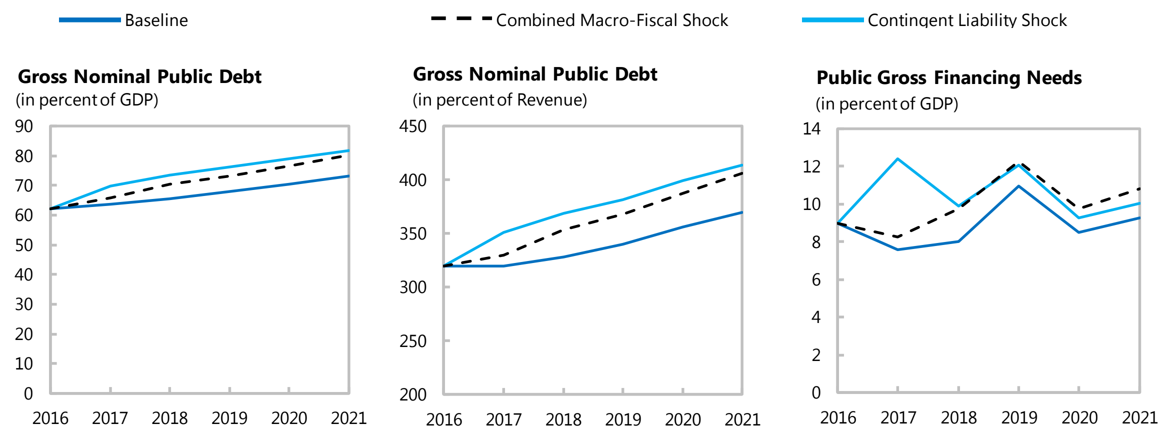
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

El Salvador: Public DSA – Stress Test

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	2.3	2.4	2.3	2.1	2.0	2.0
Inflation	1.8	1.7	2.1	2.1	2.1	2.3
Primary balance	-1.2	-1.5	-1.6	-1.3	-1.4	-1.6
Effective interest rate	4.9	5.0	5.6	6.0	5.9	6.0
Real Interest Rate Shock						
Real GDP growth	2.3	2.4	2.3	2.1	2.0	2.0
Inflation	1.8	1.7	2.1	2.1	2.1	2.3
Primary balance	-1.2	-1.0	-1.1	-1.3	-1.4	-1.6
Effective interest rate	4.9	5.0	5.9	6.6	6.8	7.2
Combined Shock						
Real GDP growth	2.3	0.5	0.4	2.1	2.0	2.0
Inflation	1.8	1.3	1.7	2.1	2.1	2.3
Primary balance	-1.2	-1.5	-2.2	-1.3	-1.4	-1.6
Effective interest rate	4.9	5.0	5.9	6.6	6.9	7.2

Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	2.3	0.5	0.4	2.1	2.0	2.0
Inflation	1.8	1.3	1.7	2.1	2.1	2.3
Primary balance	-1.2	-1.5	-2.2	-1.3	-1.4	-1.6
Effective interest rate	4.9	5.0	5.5	6.0	5.9	6.0
Real Exchange Rate Shock						
Real GDP growth	2.3	2.4	2.3	2.1	2.0	2.0
Inflation	1.8	1.7	2.1	2.1	2.1	2.3
Primary balance	-1.2	-1.0	-1.1	-1.3	-1.4	-1.6
Effective interest rate	4.9	5.0	5.5	6.0	5.9	6.0
Contingent Liability Shock						
Real GDP growth	2.3	0.5	0.4	2.1	2.0	2.0
Inflation	1.8	1.3	1.7	2.1	2.1	2.3
Primary balance	-1.2	-5.4	-1.1	-1.3	-1.4	-1.6
Effective interest rate	4.9	5.4	5.7	6.0	6.0	6.0

Source: Fund staff estimates and projections.

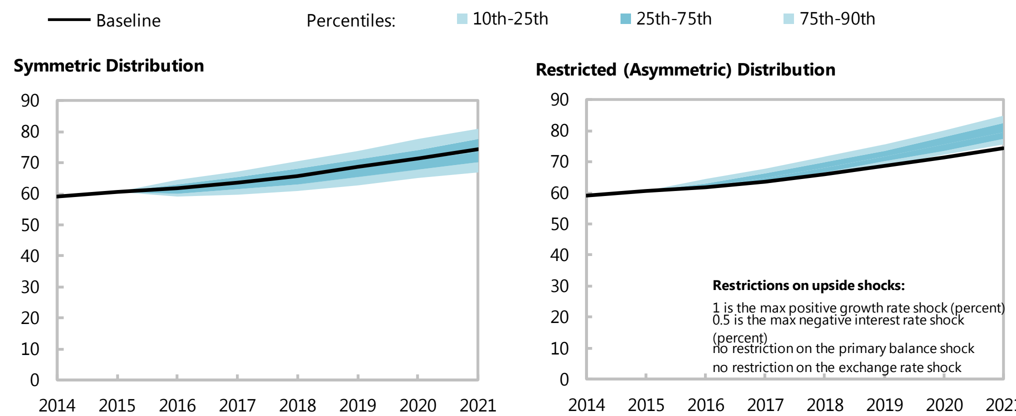
El Salvador: Public DSA Risk Assessment

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

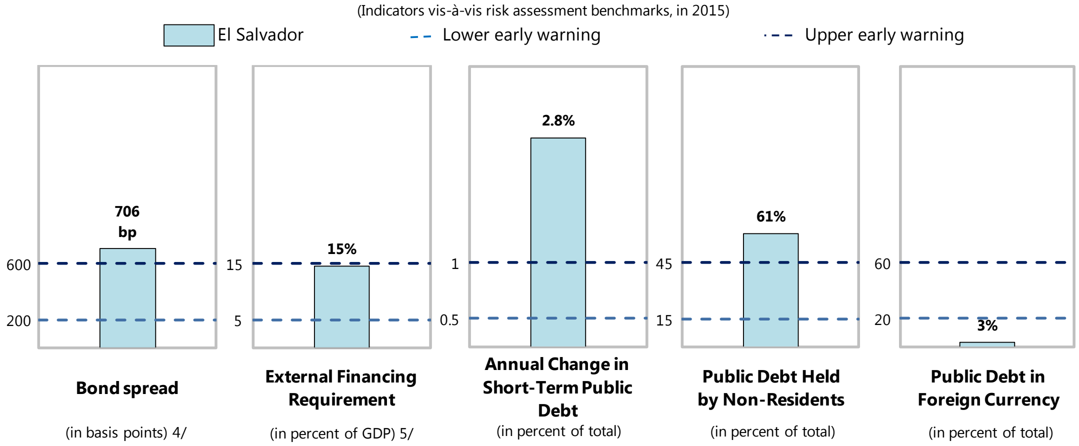
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2015)



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.

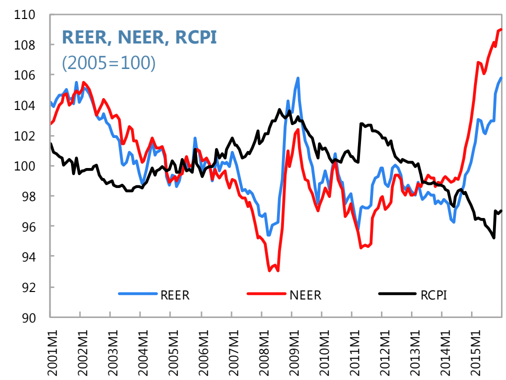
4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 08-Jan-16 through 07-Apr-16.

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.

Annex III. External Assessment

El Salvador's real effective exchange rate (REER) is assessed to be moderately overvalued. Non-price indicators also point to diminished competitiveness.

Since 2001, the CPI-based REER has appreciated by 6 percent. This appreciation is due to a 10 percent real appreciation vis-à-vis the U.S. (El Salvador's largest trading partner buying 47 percent of exports), while a real depreciation with respect to Guatemala and Honduras (the second and third largest trading partners accounting each for 14 percent of exports) offset somewhat this appreciation.



Source: Fund staff estimates.

IMF's multilaterally consistent estimates suggest that El Salvador's REER is moderately weaker than the level consistent with medium term fundamentals and desirable policies:

- **The EBA-lite CA** estimate based on existing fundamentals (including remittances which are significant for El Salvador) and desirable policies points to a sustainable cyclically-adjusted CA deficit norm of 3.7 percent of GDP, which is 2 percentage points below a cyclically-adjusted deficit of 5.8 percent. This gap mainly reflects fiscal and reserve adequacy policy gaps. The identified fiscal gap of 1.2 percent and reserve adequacy gap of 1.4 percent are significant contributors to El Salvador's current account gap. At the same time, oil prices are assumed to affect the CA norm and underlying CA symmetrically (i.e. the 5.8 percent of GDP current account deficit incorporates an adjustment for savings from the lower oil prices which amounted to 2.5 percent of GDP in 2015).

El Salvador: Exchange Rate Assessment Results

EBA-lite CA methodology	CA norm (% of GDP)	Underlying CA (% of GDP)[1/]	REER gap[2/]
	-3.7	-5.8	13.9
EBA-lite REER methodology	ln(REER) norm	ln(REER) actual	REER gap[2/]
	4.0	4.6	0.7
	CA norm (% of GDP)	Underlying CA (% of GDP)	REER gap[2/]
EBA-lite ES methodology[3/]	-2.8	-5.0	14.1

Source: Fund staff estimates and projections.
1/ Oil prices are assumed to affect the CA norm and underlying CA symmetrically.
2/ (+): overvaluation. In the CA and ES methodologies, export elasticity: -0.71, import elasticity: 0.92.
3/ The CA norm stabilizes the net IIP position at the target level of -50% of GDP.

- **The EBA-lite External Sustainability (ES)** estimate compares projected medium-term CA with the level that stabilizes the external position (i.e., IIP) at its current level (-60 percent of GDP) or at somewhat improved level (-50 percent of GDP). This approach suggests an overvaluation of 11 percent of GDP, if the IIP position is to be stabilized at -50 percent of GDP.

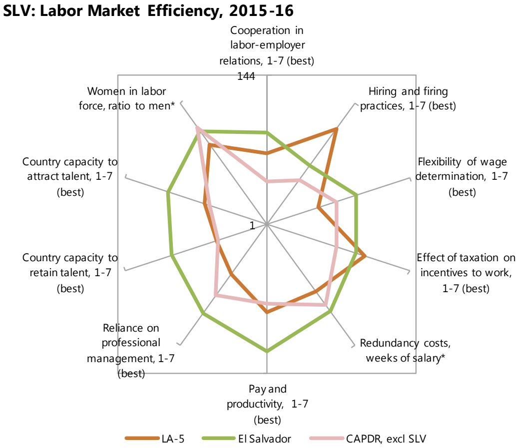
- **The EBA-lite REER** estimate based on existing fundamentals and desirable policies that would affect the REER directly or indirectly through changes to the CA balance points to a REER which is broadly in line with fundamentals and desirable policies.

El Salvador's labor costs are on the rise. Labor costs have been rising since 2008, and, if the recent government-proposed increase of 118 percent in minimum wage in agriculture (and around 20 percent in other areas) passes and is binding, that would entail significant increases in labor costs that would erode the competitiveness of businesses.

Other indicators suggest no improvement in competitiveness. Notably, El Salvador's world export market share has been flat over the past 15 years.

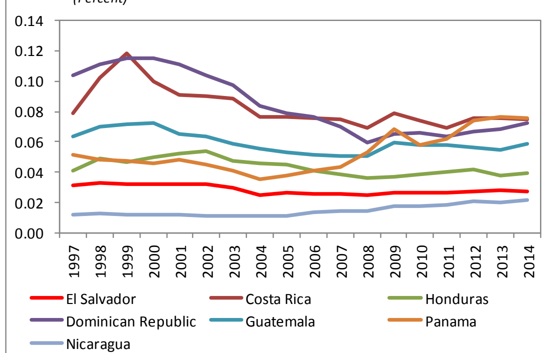
El Salvador's investment climate faces multiple challenges. According to the World Bank's Doing Business indicators, El Salvador ranks poorly relative to other countries in Central and Latin America in starting a business, dealing with construction permits, access to and cost of electricity, protection of investors, and paying taxes. El Salvador ranks 125 (out of 189 countries) in terms of regulations on starting a business. It has a very low new business entry density compared to the LA-5 and other CAPDR economies. According to the Global Competitiveness indicators, El Salvador lags behind other CAPDR and LA-5 countries in terms of the institutional and macro environment, labor market efficiency, financial market development, higher education, and innovation. The WB-OECD Product Market Regulation indicators also suggest that there are certain barriers to entrepreneurship (e.g. license and permits system), and to trade and investment. In addition, state control in certain sectors may hinder market entry and a level playing field for all enterprises. According to Salvadoran think tank Fusades business surveys, uncertainty and crime/extortion are the most important factors explaining the weak business confidence in El Salvador.

SLV: Labor Market Efficiency, 2015-16

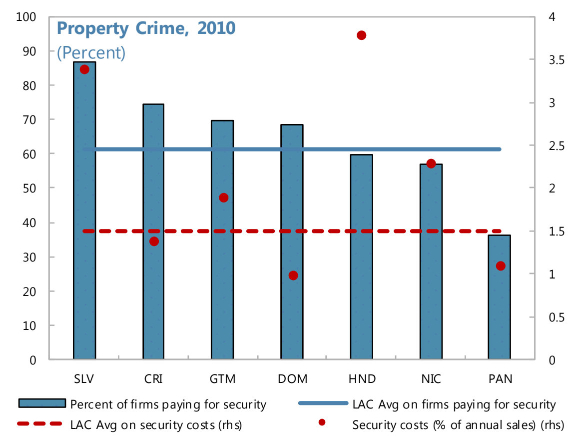


Source: World Economic Forum Global Competitiveness Indicators.

World Export Market Share, Goods and Services
(Percent)



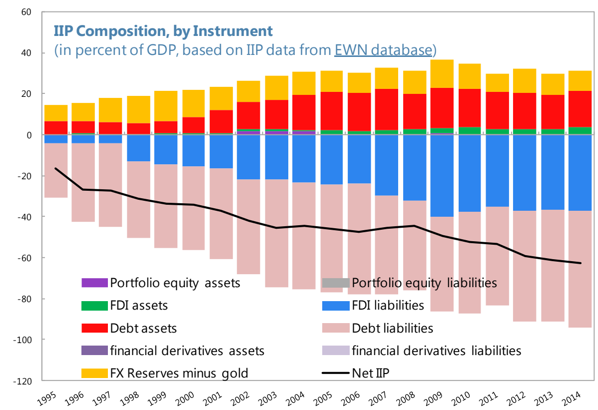
Source: WEO, and IMF staff calculations.



Source: WB Enterprise Surveys.

Gross financing needs are large. While the oil price fall contributed to reduce the current account deficit, the external gross financing requirements were still high at 14 percent of GDP in 2015. In the medium term, gross financing requirements are projected to peak at 17.5 percent of GDP in 2019 and stabilize at 15.5 percent of GDP, reflecting high current account deficits and an increase in the amortization on private sector external debt (and amortization of public long-term bonds in 2019).

The net international investment position (IIP) remains significantly negative. In 2015, the net IIP was -64 percent of GDP and is projected to worsen further to -80 percent of GDP in the medium term. Large current account deficits are backed by a rapid accumulation of private and public sector liabilities, mostly concentrated in FDI and other investment (external bonds needed to fill the fiscal gap). The stock of international reserves has fallen over the past few years and, at 10 percent of GDP, is well below the Fund's composite ARA metric which suggests a level of reserves of 19 percent of GDP to be adequate for a fully-dollarized country.



Source: Lane and Milesi-Ferretti's External Wealth of Nations Dataset, IMF WEO

INTERNATIONAL MONETARY FUND

EL SALVADOR

May 31, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | The Western Hemisphere Department

CONTENTS

FUND RELATIONS 2

RELATIONS WITH THE WORLD BANK 6

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK (IADB) 9

STATISTICAL ISSUES 10

FUND RELATIONS

(As of March 31, 2016)

Membership Status: Joined: March 14, 1946

General Resources Account:	**SDR Million**	**% Quota**
Quota	287.20	100.00
Fund holdings of currency (Exchange Rate)	287.20	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				
	2016	2017	2018	2019	2020
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**

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

Article IV Consultation. The last Article IV consultation was concluded on December 11, 2014 (Country Report No. 15/13).

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
FAD	Strengthening tax and customs administration	Dec 2014
FAD	Strengthening the medium term fiscal framework and fiscal risks	Mar 2015
FAD	Challenges in managing government wage bill	Feb 2016
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	Monetary Operations	Nov 2014
MCM	Bank Supervision & Regulation	Nov 2014
MCM	Financial Stability Strategy	Nov 2014
MCM	CAPTAC-Market Risk Management	Nov 2014
MCM	DR Strengthen Management of Systemic Liquidity	Nov 2014
MCM	Bank Supervision & Regulation	Jan 2015
MCM	Asset Classification	Jan 2015
MCM	CAPTAC-Strengthen Management and Systemic Liquidity	Feb 2015
MCM	CAPTAC-Development of regulations to support the financial supervision	Feb 2015
MCM	Crisis Management and Prevention Strategy	March 2015
MCM	Asset Classification	April 2015
MCM	Bank Supervision & Regulations	April 2015
MCM	CAPTAC-Seminar on Financial Consumer Protection	May 2015
MCM	CAPTAC-DR Strengthen Management of Systemic Liquidity	June 2015
MCM	CAPTAC-Regulation of Base II/III	Sep 2015
MCM	CAPTAC-Operational Risk Supervision	Oct 2015
MCM	CAPTAC: High Level Seminar on Bank Resolution	Oct 2015
MCM	CAPTAC-Regulation of Base II/III	Nov 2015
MCM	CAPTAC: E-banking regulation	Dec 2015
MCM	CAPTAC: Operational Risk Supervision	Jan 2016
MCM	CAPTAC-Strengthening Central Reserve Bank of El Salvador capacities for macroeconomic analysis	Jan 2016
MCM	CAPTAC: Regional Macroprudential Policies Central America Countries	Feb 2016
MCM	Crisis Management Strategy Follow up	Feb 2016
MCM	CAPTAC: fortalecimiento del Manejo de la liquidez del Banco Central y Sistemica	Feb 2016
MCM	Crisis Management Strategy Follow up	Feb 2016
MCM	Countercyclical Financial Policy and Road to Basel III	Apr 2016
MCM	Basel III implementation	Apr 2016
MCM	Central Bank Capital	Apr 2016
STA	Source Data	2011
STA	Annual National Accounts (ANA) – Multiple missions	2011
STA	Regional Harmonization of Monetary and Financial Statistics	Jun 2011

	(second phase)	
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
STA	Annual National Accounts – multiple missions	2015
STA	Quarterly National Accounts (QNA) – multiple missions	2015
STA	Exports/Imports Price Indices (XMPIs) – multiple missions	2015
STA	Annual National Accounts – Source Data	May 2015

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 led by Daniel Kanda met on several occasions with the World Bank team comprising Mrs. Manuela Francisco (Program Leader) and Mr. Fernando Im (Senior Country Economist) to discuss El Salvador's main macroeconomic challenges, identify macro-critical structural reforms, and coordinate the work of both teams.

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

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

- **Fiscal sustainability.** The fiscal consolidation strategy should comprise expenditure and revenue reforms to lower the fiscal deficit, while raising infrastructure, security, and other social spending. In particular, the increase in current primary spending ratio 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. A fiscal responsibility law, a modernized medium-term fiscal framework, and improved tax and customs administration could usefully underpin the fiscal adjustment strategy.

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

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

- **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.** Based on this assessment, the IMF and the World Bank agreed to support the authorities' efforts in the following areas:

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

- **Public financial management.** The Fund will further assist the authorities in implementing medium-term expenditure framework, setting up a treasury single account, and enhancing capabilities in debt sustainability analysis, and the analysis of fiscal implications of pension reforms. The World Bank is planning to undertake a public expenditure review. The two institutions will collaborate on improving budget procedures, including in the context of the fiscal responsibility law.

- **Financial system.** The Bank and the Fund will continue to cooperate as needed in assisting the authorities in implementing the 2010 FSAP Update and 2014 Financial Stability strategy 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 completed a mission on the Developmental FSAP module in March 2016 and will continue to provide assistance in these areas, including financial sector infrastructure, public and development banks, capital markets, and insurance. The two institutions will collaborate on the financial sector aspects of the pension system and financial inclusion.

- **Competitiveness.** The Fund will also assist the authorities 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 in addition 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.

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	2016	Ongoing, August 2016 (expected)
	Strengthening public health care system	2016	Ongoing, Dec. 2017 (expected)
	Local Government Strengthening Project	2016	Ongoing, Dec. 2016 (expected)
	Education Quality Improvement Project	2016	Ongoing, December 2017 (expected)
	El Salvador FSAP Development Module	2016	Ongoing, Nov. 2016 (expected)
	El Salvador Public Expenditure Review	2016-2017	June 2017 (expected)
	Fiscal Management and Public Sector Performance TA Loan	2016	Ongoing, September 2016 (expected)
	Youth Employment and Employability Project	2016	Ongoing, November 2016 (expected)
	Central America Migration and Shared Prosperity	2016	Ongoing, May 2016 (expected)
	Local Governance and Economic Development	2016-2017	Ongoing, Nov. 2016 (Board approval)
Fund Work Program	Regional Conference	November 2016	November 2016
	Staff Visit	November 2016	November 2016
	Technical Assistance:	2016-2017	2016-2017
	Enhancing tax auditing and strengthening of custom controls	Ongoing	
	Adopting a medium-term expenditure framework; improving multi-year budgeting; and setting up a treasury single account	Ongoing	
	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	Ongoing	
	Building models for debt sustainability analysis and macroeconomic forecasting	Ongoing	
	Assistance on improved national income accounts	Ongoing	

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK (IADB)

1. The IADB completed the last country strategy for El Salvador in 2015, for the 2015–19 period.

2. As of April 2016, the IADB has pending disbursements for US$ 547 million, which correspond to public-sector guaranteed loans and which are mostly concentrated in seventeen programs in thirteen sectors. For 2015, the IADB approved two loans for US$ 200 million in the areas of health (US$ 170 million) and gender (US$ 30 million).

El Salvador: Relations with the Inter-American Development Bank
(As of May 11th 2016, in millions of U.S. dollars)

A. Operations

Sector	Commitments	Amount Disbursed	Amount Undisbursed
Human capital	330.0	96.3	233.7
Logistics infrastructure	210.0	94.0	116.0
Public security	45.0	1.9	43.1
Productive development	195.0	45.2	149.8
Urban development	90.0	88.3	1.7
Other areas	5.0	4.7	0.3

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

	2008	2009	2010	2011	2012	2013	2014	2015	2016p
Disbursements	294.6	488.3	115.5	202.8	266.1	97.3	71.8	72.4	19.1
Repayments	105.3	278.8	126.0	116.8	115.2	106.6	136.8	138.4	45.3
Net lending	-189.3	-209.5	10.5	-86.0	-150.9	9.3	65.0	66.0	26.2
Interest and charges	67.6	68.3	57.1	55.6	52.3	51.8	49.5	46.5	15.9
Subscriptions and contributions	2.9	2.9	1.2	1.5	2.7	1.7	1.7	1.5	0.0
Net cash flow	-118.8	-138.3	68.8	-28.9	-95.8	62.8	116.2	114.0	42.1

STATISTICAL ISSUES

(As of May 2016)

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 2014 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 May 11, 2016)

	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]	Apr-2016	May-2016	M	M	M		
Reserve/Base Money	Mar-2016	Apr-2016	M	M	M	O, LO, LO, LO	O, O, O, LO, O
Broad Money	Mar-2016	Apr-2016	M	M	M		
Central Bank Balance Sheet	Mar-2016	Apr-2016	M	M	M		
Consolidated Balance Sheet of the Banking System	Mar-2016	Apr-2016	M	M	M		
Interest Rates[2]	Apr-2016	May-2016	W	W	W		
Consumer Price Index	Apr-2016	May-2016	M	M	M	O,O,LNO,O	LNO,LO,O,O,LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar-2016	Apr-2016	M	M	M	LO, LO,LNO,LO	LO,O,LO,LO,NO
Revenue, Expenditure, Balance, and Composition of Financing[3]– Central Government	Mar-2016	Apr-2016	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[4]	Mar-2016	Apr-2016	M	M	M		
External Current Account Balance	Dec-2015	Mar-2016	Q	Q	Q	O, LO, LNO,LO	LO, LO,O,O,LO
Exports and Imports of Goods and Services	Mar-2016	Apr-2016	M	M	M		
GDP/GNP	Dec-2015	Mar-2016	Q	Q	Q	LO,LNO,LNO,LO	LNO,LNO,LO,O,LO
Gross External Debt	Dec-2015	Mar-2016	Q	Q	Q		
International Investment Position[6]	Dec-2015	Mar-2016	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.

Statement by Mr. Jimenez Latorre, Executive Director for El Salvador and Mr. Pacheco, Senior Advisor to the Executive Director June 20, 2016

The Salvadoran authorities thank staff for the constructive and frank engagement on the occasion of the Article IV consultation. They consider the report objective and clear in depicting the main economic and social issues the country faces. In fact, they coincide with most of the assessment of the different sectors and policies with some nuances on the approach and timeliness of the report.

The authorities concur that insecurity and low investment are relevant factors to explain El Salvador's low potential growth. They believe any fiscal consolidation plan should take into account at least three key particularities of the Salvadoran economy. First, dollarization has helped maintain inflation under control but has eliminated the scope to undertake monetary and exchange rate policies and has also reduced flexibility to face external shocks as well as natural disasters. Second, the scarcity of development funds constrains a smoother consolidation path. Finally, a series of negative cycles between low growth, fiscal imbalances -including pension system- and low development, poverty, inequality and social inclusion.

Recent Developments

The country is enjoying the windfall from low oil prices and the U.S. economic recovery which was reflected in the decrease of the current account deficit from 5.2 percent of GDP in 2014 to 3.6 percent in 2015. Electricity price has gone down markedly which is helping business competitiveness and families' income. Inflation continues under control at 0.86 percent (Apr. 2016). Driven by investment (private and public) and consumption, growth is on track to end 2016 within a range of 2.3-2.6 percent. This projection is reinforced by the behavior of other variables: (1) Credit to private sector has grown at 5.3 percent, similar to 2015, with corporate credit growing at 6.9 percent (Apr. 2016), faster than consumption credit. (2) Public investment at USD230.5 million (Jan.-Apr. 2016) has grown at 33.9 percent compared with the same period last year. (3) Remittances are growing at 6.8 percent (Jan.-Apr. 2016) compared with the same period last year.

While political gridlock has been a constant barrier for needed reforms, the recent approval of USD152 million earmarked to strengthen domestic security proves that political agreement can be achieved and sends a positive signal for the oncoming reform agenda.

Fiscal Policy

The authorities concur on the need to pursue fiscal consolidation and agree that without measures debt could rise to unsustainable levels. They are planning a fiscal adjustment of 2.5 percent of GDP -close to staff's recommendation- balanced between revenues and expenditures measures. A large adjustment might jeopardize country stability since cuts on key social expenditure and investment would be needed. The authorities find the adjustment period (2017-2019) proposed by staff tight, given El Salvador's known low-growth problem and that fiscal uncertainty is not the main factor in explaining it –as rightly asserted in the report. Absent of financing to smooth the adjustment period, growth would be markedly hurt.

The authorities concur that, given the need to increase growth, efficiency on taxation is a relevant issue. They will continue looking for options to introduce less-distortionary progressive taxation. Unlike staff, the authorities consider that the yield of taxes on bank transactions and telecommunications is not negligible and their distortionary effects are not currently extreme. In the case of the telecommunication tax, it is levied on consumers who currently own 11 million mobiles. (Salvadorans own almost two mobiles each on average.) Proceeds from this tax are earmarked to increase law enforcement and security spending which is key to counter recent uptick in crime. The bank transactions tax is relevant to the treasury (USD80 million) while credit to business grew at 6.9 percent during the first four months of the year.

The government and staff share most of the measures on tax policy. They agree on the importance to introduce less-distortionary progressive taxation to wealth, property, and high inequitable pensions. They also concur on increasing personal income tax rates for the highest earners and reduce the corporate tax rate while broadening the base. In the case of increasing the VAT rate they would use it as a last-resort measure given its well-known regressive effects and above-mentioned recession risk.

With regard to the expenditure control measures, the authorities in principle agree with the idea laid out in the report to limit wage indexation to increases below the rate of inflation. However, they are examining options for the lower-income tiers since minimum wages are about USD250 per month and the low-income consumer basket grows at a higher rate than the CPI. They need to protect this segment of the population in order to avoid impact on poverty and exacerbate income inequality. The authorities have taken advantage of low oil prices to reduce subsidies in transport, electricity and LPG. They agree there is space to continue strengthening the energy subsidies targeting. The government is analyzing other ways to create fiscal space in order to strengthen security and social spending.

In addition, the authorities are negotiating a pension reform initiative in order to reduce the short-term financial gap. They recognize that further reforms would be needed to restore long-run sustainability of the system, including parametric changes, but further political support is still needed.

Financial Sector

Current levels of financial buffers are sufficient to contain mayor risk, as demonstrated by the different sets of stress tests run by the central bank and the financial superintendent.

Despite growing credit to the public sector, credit to the private sector has been showing healthy rates of growth. The withdrawal of correspondent banking relations has been manageable; while some international banks have left, they have been replaced by large regional banks. Most of the risks are self-contained by the sector's structure or alleviated by the authorities' actions. International and large regional banks maintain a strong presence, in fact, currently about 90 percent of the remittances flows pass across these banks. Supervisory vigilance has been tightened and the authorities keep close collaboration with international and bilateral initiatives on tax compliance. The AML/CFT framework keeps improving and fulfilling international standards and the authorities are ready to act should any regulatory gap persist or new international standards are brought up.

The authorities continue working on the establishment of the lender-of-last-resort facility (LOLR) with the support of MCM Department's technical assistance. There is agreement that the central bank should coordinate and manage the facility so final details are being worked out.

Finally, the report characterizes the current political scenario generally as one of gridlock and polarization, mentioning this as a constrain even to incremental reform. The authorities would have preferred a more cautious approach to the domestic political environment to better serve the dialogue to advance needed structural reforms. The government is working on building political consensus, they are negotiating a financial plan with the main opposition party in order to swap short-term domestic bonds (LETES) for Eurobonds and to attain Congress' endorsement of external loans. Agreements were also reached on security funds, as described above.