EL SALVADOR

1. General trends

In 2001 the Salvadoran economy continued to slow down for the fourth year in a row, with GDP growth reaching only 1.8%; as a result, there was almost no growth in per capita output. The adverse situation of the world economy was reflected in a decline in maquila exports and a drastic fall in international coffee prices, which eroded the terms of trade. The country was hit at the beginning of the year by two earthquakes, and later by a serious drought. A steady stream of family remittances, however, equivalent to 14% of GDP, and an increase in public investment for rebuilding damaged areas staved off a more serious contraction in domestic demand, although public finances became more fragile. Meanwhile, inflation remained under control and exhibited a downward tendency, encouraged by the entry into force of the Monetary Integration Act, which fixed the exchange rate and established the United States dollar as the unit of account.

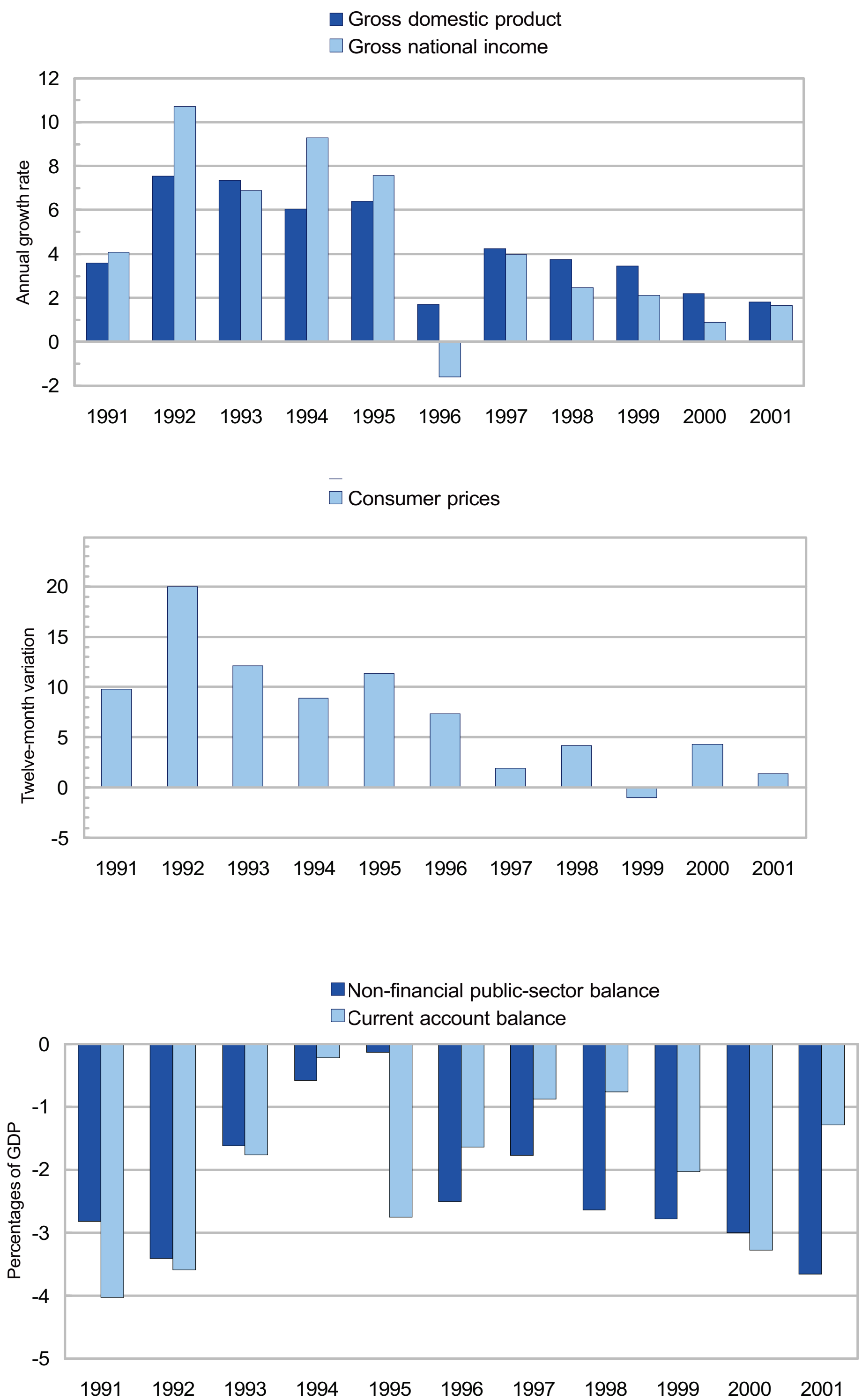
NATURAL DISASTERS again exacerbated the country's vulnerability. In January and February, two earthquakes left hundreds dead and thousands injured or homeless, and caused total damage estimated at over US$ 1.6 billion. Later in the year, a severe drought caused losses of close to 16% of national output and affected coffee cultivation and exports. Both disasters altered the country's poverty map.

Exports turned in a lacklustre performance, largely because of the slowdown in the United States economy, which is the destination for two thirds of El Salvador's merchandise exports. Purchase orders for maquila enterprises were reduced or delayed, dampening activity in that sector after a long period of very robust growth. The slide in international coffee prices and the damage caused by the earthquakes slashed production by almost 37%, while income from coffee exports plummeted. Although its relative importance in terms of GDP has diminished in the past few years, this area continues to be one of the main sources of foreign exchange, employment and income for the population.

In January the Monetary Integration Act entered into force and started the process of dollarizing the economy. The exchange rate was fixed at 8.75 colones to the dollar, the dollar was established as the unit of account and the Central Reserve Bank was stripped of its power to issue local currency. This was the most significant economic policy measure of the year.

The substantial rise in public expenditure associated with the emergency and reconstruction activities

Figure 1
EL SALVADOR: MAIN ECONOMIC INDICATORS



Source: ECLAC, on the basis of official figures.

increased the non-financial public sector's fiscal deficit to 3.7% of GDP, as the tax ratio remained virtually stagnant. Real public investment grew substantially and was channelled primarily into the reconstruction and rehabilitation of roads and infrastructure. Other components of domestic demand, however, were very weak. Although interest rates on both loans and deposits declined significantly, and were among the lowest in the region, they did not succeed in stimulating a higher level of domestic spending. Private investment fell by just over 2%, so that gross fixed investment did not change. Meanwhile, private consumption stagnated.

Public spending on damage repairs revived activity in infrastructure construction, which proved to be the most dynamic sector after two consecutive years of decline. Mining and manufacturing also experienced above-average growth. At the same time, an increase in imports of intermediate goods for these activities resulted in a widening of the trade deficit.

Inflation was very low; the annual average was 3.8% and the December-to-December index was 1.4%. Despite the significant increase in public spending on reconstruction investment, consumer prices did not rise, owing to the weakness of private domestic demand in the areas of both consumption and investment. The drop in international oil prices was also of considerable help in curbing inflation.

The authorities are projecting GDP growth of about 3% in 2002 as a result of moderate export growth, mainly in the maquila sector, although family remittances are expected to continue to increase as well. They are also projecting a low inflation rate and a current-account deficit of close to 3.3% of GDP. The budget approved for 2002 provides for a 13% increase in relation to the preceding year and gives priority to public investment outlays to continue the reconstruction work.

2. Macroeconomic policy

The main features of the economic policy implemented in 2001 were the adaptation of monetary policy to the process of dollarizing the economy and the expansion of public expenditure for the reconstruction of areas damaged by the earthquakes. Both issues had an impact on public finances, which were one of the most serious macroeconomic problem areas.

Other actions were aimed at strengthening the process of structural reform to create better conditions for investment and development. The authorities completed the privatization of State-owned enterprises, especially in the areas of telecommunications and electric power, and the process was consolidated with the operation of pension fund administrators. In the institutional area, the Central Reserve Bank was reformed, a public investment system was established, the Superintendency of the Financial System was strengthened and the Superintendency of Securities was created.

(a) Fiscal policy

El Salvador's fiscal accounts deteriorated with respect to their situation in 2000; current income showed only modest growth, and the Government increased its level of debt in order to finance the rehabilitation and reconstruction of infrastructure damaged by the earthquakes. These outlays further undermined the fragile position of public finances, which had also been strongly affected by the financial costs associated with the change in the social security regime and the pension system. The non-financial public-sector deficit was equivalent to 3.7% of GDP, compared to 3% in 2000, while the central Government deficit was equivalent to 3.6%.

The use of additional public funds to finance the emergency and reconstruction work raised the central Government's level of expenditure by 14%. Capital expenditure swelled by 65% owing to the exceptional increase in physical investment (113%). Meanwhile, current expenditure grew slowly (2.5%), even though payroll expenses declined by 3.5% as a result of a 7.5% cut in the staffing table. Most of the financial impact of this measure will be felt in 2002.

Total revenues increased by 4%, owing to the 8% rise in tax receipts. Income from indirect taxes grew by 11% owing to higher VAT receipts. In an effort to raise revenues, the authorities imposed a new US$ 0.20-a-gallon gasoline tax starting in November. These revenues will be used to finance the reconstruction of roads through the Road Maintenance Fund. Income tax stagnated as a result of the economic slowdown, the effect of the earthquakes and an increase in tax avoidance and evasion.

Table 1
EL SALVADOR: MAIN ECONOMIC INDICATORS

	1993	1994	1995	1996	1997	1998	1999	2000	2001[a]
	Annual growth rates [b]								
Growth and investment									
Gross domestic product	7.4	6.1	6.4	1.7	4.2	3.8	3.4	2.2	1.8
Per capita gross domestic product	5.1	3.8	4.2	-0.4	2.1	1.6	1.4	0.2	-0.1
Gross domestic product, by sector									
Goods	-1.4	4.1	6.0	1.7	5.1	4.4	4.4	1.0	2.8
Agriculture	-2.6	-2.4	4.5	1.3	0.4	-0.7	7.7	-3.1	-2.1
Mining	10.6	10.9	6.7	1.0	6.5	5.3	0.4	-4.7	12.0
Manufacturing	-1.5	7.4	6.9	1.7	8.0	6.6	3.7	4.1	4.2
Construction	3.6	11.5	6.1	2.7	6.2	8.5	-1.8	-3.4	10.0
Basic services	6.8	5.9	5.5	2.9	7.4	4.4	9.0	5.5	3.0
Electricity, gas and water	9.4	4.7	5.0	17.1	4.2	6.1	2.7	-2.3	4.2
Transport, storage and communications	6.6	6.0	5.5	1.9	7.7	4.2	9.5	6.1	2.9
Other services	3.9	6.3	7.2	1.5	3.5	3.3	2.1	2.6	0.7
Commerce, restaurants and hotels	6.4	8.6	9.9	0.4	2.9	4.0	2.0	3.3	1.6
Financial establishments, insurance, real estate and business services	2.7	5.4	5.2	2.2	4.4	3.8	3.0	2.7	-0.6
Consumption	7.7	7.5	9.2	1.6	3.0	2.4	3.4	3.6	0.2
General government	1.0	3.0	7.9	2.8	2.8	2.5	0.4	0.9	1.1
Private	8.4	8.0	9.3	1.5	3.0	2.4	3.7	3.8	0.2
Gross domestic investment	10.0	14.2	15.2	-22.1	6.5	22.8	-4.0	2.4	-5.3
Exports of goods and services	30.1	8.4	13.9	8.7	30.2	6.2	7.1	17.2	11.9
Imports of goods and services	21.3	15.0	21.1	-6.1	16.8	9.2	2.7	14.5	3.3
	Percentages of GDP [c]								
Gross national income	109.1	112.5	113.9	110.1	109.9	108.5	107.2	105.9	105.6
Gross domestic investment	17.4	18.7	20.0	15.7	16.0	18.8	17.5	17.4	16.3
National saving	15.6	18.2	17.8	14.1	16.0	16.8	15.4	13.8	15.3
External saving	1.7	0.5	2.2	1.6	0.0	2.0	2.1	3.6	1.0
	Percentages								
Employment and wages									
Labour force participation rate [d]	...	53.4	52.4	51.3	50.9	53.5	52.6	52.2	53.3
Open unemployment rate [e]	9.9	7.7	7.6	7.7	8.0	7.5	7.0	6.7	7.0
Real minimum wage (index: 1995=100) [f]	101.5	99.6	100.0	96.4	92.2	95.3	97.5	95.4	91.9
	Growth rates								
Prices (December-December)									
Consumer prices	12.1	8.9	11.4	7.4	1.9	4.2	-1.0	4.3	1.4
Wholesale prices, excluding coffee	1.4	5.0	9.2	4.4	-5.1	-4.1	4.2	4.5	...
Wholesale prices, including coffee	2.7	10.5	6.7	4.9	-2.0	-6.6	4.1	2.0	...
External sector									
Terms of trade (index: 1995=100) [c]	63.7	81.0	100.0	93.6	94.1	91.7	86.9	82.7	80.2
Nominal exchange rate (colones per dollar) [f]	8.70	8.73	8.75	8.76	8.76	8.76	8.76	8.76	8.75
Real effective exchange rate for imports (index: 1995=100)	113.7	106.6	100.0	92.9	92.0	91.2	92.0	92.6	92.0
	Millions of dollars								
Balance of payments									
Current account	-123	-18	-262	-169	-98	-91	-239	-431	-177
Trade balance (goods and services)	-1,013	-1,212	-1,581	-1,333	-1,295	-1,455	-1,539	-1,975	-1,915
Exports	1,367	1,639	2,044	2,203	2,913	3,048	3,175	3,662	3,977
Imports	2,381	2,851	3,625	3,536	4,208	4,502	4,714	5,636	5,892
Capital and financial accounts [g]	181	131	408	334	460	394	447	385	-1
Overall balance	...	113	147	165	363	303	208	-46	-178
Variation in reserve assets (- indicates an increase)	...	-113	-147	-165	-363	-303	-208	46	178

Table 1 (concluded)

	1993	1994	1995	1996	1997	1998	1999	2000	2001[a]
					Percentages				
External debt									
Gross debt									
(as a percentage of GDP)	28.4	25.4	22.8	24.4	24.2	22.0	22.5	21.9	22.9
Net interest									
(as a percentage of exports) [h]	6.7	4.4	3.4	4.1	5.6	4.4	5.6	5.1	4.6
					Percentages of GDP				
Central government									
Current income	11.1	11.8	12.9	13.4	12.3	11.6	11.2	11.3	11.6
Current expenditure	11.3	11.5	11.1	12.4	11.3	10.8	11.1	11.7	11.5
Saving	-0.2	0.3	1.8	1.0	1.0	0.8	0.1	-0.4	0.1
Capital expenditure (net)	3.2	2.5	3.2	3.2	2.3	2.8	2.4	2.6	4.1
Financial balance	-1.5	-0.8	-0.5	-2.0	-1.1	-2.0	-2.1	-2.3	-3.6
Non-financial public sector balance	-1.6	-0.6	-0.1	-2.5	-1.8	-2.6	-2.8	-3.0	-3.7
					Growth rates				
Money and credit									
Monetary balance of banking system									
Net international reserves	13.7	10.3	-4.5	30.3	31.9	35.2	14.3	0.0	0.8
Net domestic credit	45.5	26.2	15.0	17.5	20.5	5.7	9.2	8.9	2.3
To public sector	3.8	-27.5	-15.8	3.5	-8.3	...	...	...	259.2
To private sector	37.5	27.1	30.4	22.0	27.7	13.2	6.0	4.9	-2.7
Money (M1)	12.4	10.2	4.4	17.5	-1.9	8.6	13.5	-6.0	10.4
Local currency savings									
and time deposits	38.0	22.8	9.7	17.5	23.7	12.5	10.1	5.3	3.9
M2	37.7	20.9	10.2	18.6	21.7	12.3	10.4	6.4	9.9
Dollar deposits	1.7	58.3	18.4	45.7	41.4	14.3	13.3	5.8	...
					Annual rates				
Real interest rate (annualized, %)									
Deposit rate	-3.0	2.6	4.0	3.8	6.9	7.6	10.2	6.8	1.7
Lending rate	0.5	7.5	8.3	8.0	11.0	12.2	14.9	11.3	5.6
Equivalent interest rate in									
foreign currency [i]	15.3	13.5	13.5	14.0	12.8	10.3	10.7	9.3	6.0

Source: ECLAC, on the basis of official figures.
[a] Preliminary figures. [b] Based on constant 1990 colones. [c] Based on constant 1995 dollars. [d] Percentages of the working-age population. [e] Percentages of the economically active population. [f] Real minimum wage in the manufacturing and services sectors in San Salvador. [g] Includes errors and omissions. [h] Refers to net interest as shown in the balance of payments, divided by exports of goods and services. [i] Interest rate on deposits, deflated by the variation in the exchange rate.

The measures adopted to strengthen finances included the entry into force of the Tax Code in January, the reform of the law simplifying customs procedures and the elimination of the income tax deduction of 75,000 colones of profit income. In addition, securities were issued, interest rates were renegotiated and short-term debt was converted to long-term debt.

The public sector's external debt increased by 11%, raising the balance to US$ 3.15 billion, or 23% of GDP. With congressional authorization to raise the level of debt to up to 40% of GDP, in mid-year the Government placed US$ 350 million in bonds, with a 10-year term and an average rate of 8.6%, on international markets. Ninety per cent of the country's external liabilities were incurred by the central Government, 6% by financial and non-financial public entities and the remaining 4% by the Central Reserve Bank. This financing comes primarily from multilateral sources, followed by bilateral sources and commercial banks.

(b) Monetary and exchange-rate policy

With the Monetary Integration Act in effect as from January, the United States dollar was adopted as legal tender and the exchange rate was set at 8.75 colones to the dollar. The Central Reserve Bank's policy during the year consisted of maintaining sufficient net international reserves to cover the entire monetary base. The authorities issued securities to advance this process.

This new system formalized the situation of a fixed

Table 2
EL SALVADOR: MAIN QUARTERLY INDICATORS

	1999				2000				2001 [a]				2002 [a]
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I
Gross domestic product [b] (change from same quarter of preceding year)	3.9	3.4	4.6	1.8	2.2	2.3	2.2	2.0	1.6	1.6	1.9	2.2	1.9
Consumer prices (12-month variation, %)	1.9	-1.3	1.4	-1.0	0.5	3.6	3.3	4.3	4.9	3.5	3.3	1.4	1.7
Exports (millions of dollars)	641	633	620	619	767	743	730	710	741	703	739	895	713
Imports (millions of dollars)	989	1,039	1,040	899	1,122	1,233	1,265	1,328	1,230	1,312	1,273	1,239	1,158
International reserves (millions of dollars)	1,870	1,902	2,022	2,004	2,030	1,938	2,033	1,922	1,863	1,953	1,837	1,741	1,800
Real effective exchange rate [c] (index: 1995=100)	90.9	92.1	92.3	92.9	93.0	92.8	92.3	92.2	91.2	91.9	92.1	92.8	91.8
Real interest rates (annualized, %)													
Deposit rate	7.9	12.1	10.5	10.3	9.9	7.0	5.8	4.4	1.3	1.7	2.1	1.8	-2.7
Lending rate	12.6	16.7	15.2	15.1	14.9	11.5	10.3	8.6	5.6	5.6	5.7	5.6	1.1

Source: ECLAC, on the basis of official figures.
[a] Preliminary figures. [b] Based on figures at constant domestic prices. [c] Refers to exchange rate for imports.

exchange rate which had continued de facto since 1993. By April, 65% of the money in circulation and on deposit had already been converted to dollars. The law authorizes the Central Reserve Bank to finance the recently established Deposit Insurance Institute, which acts as a lender of last resort.

When the local currency is no longer put into circulation, under the dollarization initiative, cash reserves will become the Central Reserve Bank's main liability. Money issuance will be reduced as progress is made with the currency substitution. To this end, the Central Reserve Bank carried out open-market operations and used negotiable liquidity certificates as Bank securities issued at the LIBOR rate. This action generated quasi-fiscal financial costs that put further pressure on the fiscal deficit. The placement of US$ 350 million in bonds helped to boost international reserves. However, net international reserves amounted to just US$ 1.71 billion at the end of the year –10% less than their 2000 level– and were equivalent to three and a half months' worth of imports.

With the entry into force of the Monetary Integration Act, the financial system began to use the dollar as the unit of account. As exchange-rate risk was reduced, average interest rates on new loans in dollars moved downward. There was no expansion of credit to the private sector, however, owing to the slowdown in economic growth and the lack of business investment. Presumably, firms are obtaining financing from international banks or offshore banking institutions.

The combination of lower interest rates, higher levels of liquidity and the application of the Monetary Integration Act reversed the growth in non-performing loans observed in the banking and financial system over the past few years, reducing the non-performing loan portfolio by 19.2%.

(c) Trade policy

Trade policy gave priority to the negotiation of international trade agreements. The free trade agreements with Mexico and the Dominican Republic came into force and those with Chile and Panama continued in operation. The entry into force of the free trade agreement between Mexico and the Northern Triangle (El Salvador, Guatemala and Honduras) resulted in an expansion of trade.

Future negotiations include agreements with the United States, Canada, the European Union and Taiwan Province of China. The extension of the free zone regime until 2010 was a vitally important development.

3. The main variables

(a) Economic activity

The low level of economic growth in 2001 reflected slack demand for traditional exports and for maquila products in the United States market, the effects of the two earthquakes, the steep fall in the market value of coffee and the drought, which affected the production of basic grains. Other determining factors were the loss of regional competitiveness owing to the depreciation of the Guatemalan quetzal and the deterioration of public safety, which discouraged investment. On the other hand, the rise in family remittances and the increase in public investment for reconstruction prevented the rate of GDP growth from sinking even lower.

After the earthquakes, economic activity began to recover in April, especially in non-traditional and maquila exports. For the year as a whole, the fastest-growing sectors were construction and mining (11%-12%), followed by electric power, water and gas and manufacturing, at around 4%. In contrast, commerce grew only slightly (1.6%) and there was less activity in agriculture, for the second year in a row, and in financial services.

The agricultural sector continued its pattern of contraction. Its poor performance was due to the slump in international coffee prices, which reduced the value of coffee exports by 61%. Coffee accounted for 20% of agricultural output and generated more than 158,000 permanent jobs. In 2001, the effects of the two earthquakes and the damage caused by the drought in June and August resulted in losses of more than US$ 600 million.

The manufacturing industry grew by 4%, a rate similar to that of the preceding year. The sector's growth was led by industrial services provided to the maquila sector (6%), machinery and metal and chemical products, petroleum and rubber products and wood and paper; all these sectors grew by about 5%. The growth of the food, beverage and tobacco sector was slower than in previous years (3%).

The construction sector grew more briskly (10%); activity was concentrated in the development of infrastructure projects for the rehabilitation and reconstruction of bridges, highways, roads, schools and hospitals destroyed by the earthquakes at the beginning of the year. In addition, 243,698 temporary homes and 13,802 permanent homes were built, 5 hospitals and 1,700 schools were rehabilitated and 1.5 million square metres of debris were removed in order to restore 29 points of connection with the road network.

(b) Prices, wages and employment

Economic policy focused primarily on curbing inflation in the context of supply problems caused by the earthquakes and the drought; as a result, the country had the lowest inflation rate in Central America. The average annual growth of the consumer price index (CPI) was 3.8% and the December-to-December rate was 1.4%. The downward trend in the last quarter reflected the decline in fuel prices and the elimination of the diesel subsidy, as well as increases in the price of clothing and miscellaneous items and in the rates charged for electric power.

Nominal wages in agriculture, industry, commerce and services have remained unchanged since the second half of 1998. Given the effects of inflation, real wages are lower than they were in 2000. In contrast, the minimum wage in the construction sector was increased by 5% as from July, so that its purchasing power improved slightly.

The unemployment rate stood at 6.1% in November, which was lower than the rate of 6.6% recorded in November 2000. Open unemployment declined in both urban and rural areas. The underemployment rate was estimated at 28%.

(c) The external sector

The weakening of the global economy, especially the United States economy, was manifested through trade channels, resulting in a decline in merchandise exports. In addition, expenditure on reconstruction led to increased imports and widened the trade gap, which was equivalent to 14% of GDP. Thanks to a steady stream of family remittances, which financed the full amount of the trade gap and totalled an estimated US$ 1.91 billion, the current-account deficit was kept down to US$ 177 million. Remittances grew by more than 9% over the year and were 16% higher than the value of maquila exports.

Maquila was once again the main export sector, accounting for 58% of total exports, but its meagre performance made it the least dynamic component of the entire external sector. This activity grew by only 2.6%, compared to 21% the year before.

Traditional exports were down by 42% and non-traditional exports climbed by 3%. Coffee sales plummeted by 61%; the amount of coffee exported, at approximately two million quintals, was 39% less than in 2000. In view of this situation, steps were taken to increase the value added and the quality of this crop by developing organic and ecological coffee. In addition, the Government set up an US$ 80-million emergency fund, restructured US$ 350 million in debt through an environmental trust (FICAFE) and offered US$ 50 million in supplementary farm credit.

Sugar exports grew vigorously (75%), as did shrimp exports (25%). As their share of the total export structure is very small, however, these increases could not compensate for the overall decline in traditional exports. Exports to Central America, which represented 25% of the total, slipped by 2%.

Total imports increased by 1.6%, driven in particular by intermediate goods (5%) and consumer goods (4.5%). Capital goods imports fell by 6%, after having risen by 17% in 2000. Purchases of construction materials were the most dynamic component (32%), owing to reconstruction activities and projects. Imports of intermediate goods for manufacturing increased by 8%, while those for agriculture contracted by 2%, especially with respect to oil and fuels (-20%), owing to the drop in international prices. In relation to imports of consumer goods, non-durables expanded by 5.5% and durables contracted by 2.5%. Lastly, increases were recorded in imports of capital goods for construction (29%), manufacturing (23%) and agriculture (18%), and decreases in those related to transport (14%).