EL SALVADOR

1. General trends

After contracting by 3.1% in 2009, the economy of El Salvador picked up slightly in 2010, growing by 1.4%.[1] This performance was the result of an upturn in the export sector, driven by external demand for manufactured goods. Domestic demand had only a limited impact on growth, owing to the slow recovery of employment and remittances, as well as low levels of lending to the private sector.

Increased activity and a nearly 25% hike in the oil bill widened the current account deficit from 1.5% of GDP in 2009 to 2.3% in 2010. The deficit was financed with capital transfers and multilateral finance. The non-financial public sector (NAPS) deficit, which includes pensions and trust funds, narrowed from 5.7% to 4.3% (from 3.9% to 2.7% excluding pensions and trust funds) reflecting the impact of the tax reform implemented in late 2009 and the containment of spending, including the targeting of subsidies, within the framework of the arrangement with the International Monetary Fund (IMF).

Assuming that external demand remains buoyant and lending to productive enterprise picks up, ECLAC projects growth of 2.5% for 2011. More robust domestic demand, in conjunction with higher international food and fuel prices, will broaden the current account deficit to an estimated 4%. The authorities are targeting an NFPS deficit of 3.5% of GDP or less, with a view to starting to reduce the balance of public debt, which reached 55.5% of GDP in 2010.

2. Economic policy

(a) Fiscal policy

In the interest of achieving public debt sustainability, fiscal policy in 2010 was directed towards reducing the NFPS deficit within the framework of the arrangement with IMF, while protecting social spending.

The tax reform adopted in December 2009 expanded tax receipts, albeit not by as much as the 0.7% of GDP originally anticipated. Thanks to the reform and the economic upturn, the tax burden rose by 9.1% in real terms, thus expanding from 12.6% of GDP in 2009 to 13.6% in 2010.

Savings made by targeting electricity consumption subsidies and improving the public debt profile allowed the government to slow spending growth to 2.1% in real terms in 2010, compared with 2.8% in 2009. The resources freed up by subsidy targeting (0.4% of GDP) have been channelled towards social programmes, in particular the *Comunidades Solidarias* ("communities in solidarity") conditional transfer programme and the *Casa para Todos* ("housing for all") scheme for building low-cost housing.

These measures resulted in the NFPS fiscal deficit contracting from 5.7% to 4.3% of GDP, comfortably achieving the target agreed upon with IMF (4.8% of GDP). The deficit was financed largely from external funds, in particular from the World Bank, the Inter-American Development Bank (IDB) and the Central American Bank for Economic Integration (CABEI), as well as a US$ 200 million local-market bond issue.

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[1] In March 2011, the Central Reserve Bank of El Salvador published revised GDP and balance-of-payments figures for 2005-2010. Unless stated otherwise, this country note uses the revised figures.

After jumping from 45.4% to 54.1% of GDP between 2008 and 2009, total public debt edged up to 55.5% at the end of 2010. At the same time, the maturity profile of domestic debt has improved: between 2009 and 2010, total short-term domestic debt shrank from 2.1% to 0.9% of GDP, while medium- and long-term debt went up from 20.3% to 22.4% of GDP during the same period. In January 2011, the government issued a 20-year bond for US$ 650 million, which, together with US$ 500 million in multilateral finance, covers the country's financing needs for 2011.

The 2011 budget calls for an NFPS deficit equivalent to 3.5% of GDP, which means that total public debt as a proportion of GDP will start to fall as of 2011, although it will remain above 50% until 2013. The NFPS deficit target is based on the assumption that improved economic performance and various administrative measures introduced to strengthen revenue-raising capacity, such as increased cooperation between the customs and domestic tax authorities, will expand the tax burden from 13.6% of GDP in 2010 to 14% in 2011.

On the spending side, the wage rise for civil servants on low wages and the expansion of the payroll in social sectors are expected to push spending up by around 0.2% of GDP. A similar increase is expected in public investment, with resources targeting infrastructure and agricultural development projects in particular.

(b) Financial policy

Interest rates fell throughout 2010. The nominal lending rate for loans of up to one year came down from 8.42% in December 2009 to 6.59% in December 2010, or by 4.3 percentage points in real terms. During the same period the nominal deposit rate fell by half to end 2010 at 1.8%, a negative rate of 0.3% in real terms.

Despite the lower interest rates and the relatively solid situation of the Salvadoran banking system (whose 17.58% capitalization rate comfortably exceeds the required 12% and which, despite a slight increase in the default rate to 3.94%, has ample (107.86%) loan-loss provisions), lending to the private sector contracted for the second consecutive year, with a fall of 3.9% in real terms. On the basis of the pattern seen in the final quarter of 2010, lending to the private sector is expected to scale up gradually throughout 2011.

Although deposit rates were down, the nominal balance of deposits grew by 4.8%, which allowed the banking system to maintain a liquidity ratio of 42.3%, much higher than the required 17%, while at the same time improving its debt profile by paying down the outstanding balance and lengthening its maturities.

In January 2011, the legislative assembly adopted legislation on supervision and regulation of the financial system. The act names the central bank as the sole body responsible for financial regulation and strengthens its capacity to serve as a lender of last resort. The act also consolidates the supervision of the entire financial sector under one body. Throughout 2011, the authorities are expected to continue migrating towards risk-based supervision. Lastly, a bill on investment funds is under discussion in the legislative assembly and is expected to be made law towards the end of the year.

(c) Other policies

The government has launched a scheme to boost economic activity in the framework of the country's five-year development plan for 2010-2014. The initiative is structured around measures to stimulate specific sectors, which will be financed through the creation of a development banking system.

Those measures include a production development law, which aligns export incentives with the rules of the World Trade Organization, and plans to provide strategic support to the agricultural and tourism sectors. In addition, the authorities have announced that they will submit to the legislative assembly a bill on the promotion of public-private partnerships on infrastructure projects.

Although the details remain to be worked out in the legislative assembly during the year, the plans to establish a development banking system are based on the creation of three investment vehicles: (i) the National Development Fund, which will provide credit to micro-, small and medium-sized enterprises in labour-intensive industries; (ii) the conversion of the Multisectoral Investment Bank into the Development Bank of El Salvador, which will extend long-term credit to strategic productive sectors; and (iii) the Salvadoran Guarantee Fund, which will support small businesses.

With the aim of reducing the risk of fiscal contingencies, these vehicles will be subject to the same prudential measures applicable to the rest of the Salvadoran banking system. This means that the rates charged must reflect operating costs and that the guarantees offered will be treated for accounting purposes as part of total public debt. Financing will come from government capital allocations (US$ 65 million for the National Development Fund and US$ 20 million for the Salvadoran Guarantee Fund), as well as bond issues of up to US$ 300 million.

3. The main variables

(a) Economic activity

In the second quarter of 2009 GDP contracted by 4.1% year-on-year; thereafter the rate of contraction began to ease and growth re-entered positive territory in the first quarter of 2010. The pace of growth has not risen above 1.5% since the second quarter of 2010, which brought growth for the year overall to just 1.4%.

The momentum of the recovery was limited by two factors. First, despite better employment conditions, private consumption, which had plummeted by 10.3% in 2009, climbed only 2.3% in 2010 because of the weak recovery of remittances, which accounted for 16% of GDP. Although this proportion was similar to the average for 2000-2009, it lagged almost two GDP points behind pre-crisis remittance flows. And second, the 8.5% drop in lending to the construction sector, coming on top of the 7.4% contraction in 2009, constrained expansion in gross fixed capital formation which, after falling by 5.4% and 19.2% in 2008 and 2009, respectively, grew by a mere 1.6% in 2010.

By sector, agriculture performed well with a 3.4% expansion following the impact of poor weather conditions in late 2009. A major contributing factor in this outcome was the rise in international prices of sugar and coffee. Manufacturing, which contracted by 3% in 2009, grew by 2.2% on the back of renewed demand from the United States. Services as a whole gained a modest 1.2%, reflecting still weak domestic demand. Construction contracted for the fourth consecutive year, by 6.3%.

Growth of close to 2.5% is projected for 2011, as improved remittance flows fuel private consumption. Investment will also be more buoyant in 2011, thanks to an upturn in lending to the private sector. Although exports of goods and services are expected to continue the strong performance posted in 2010 (up 12.3% in real terms), the external sector will make a negative net contribution given the impact of increased imports.

(b) Prices, wages and employment

Inflation patterns in 2010 reflected trends in international food and fuel prices. The upturn in domestic demand was too modest to exert additional pressure on domestic prices and the 12-month inflation rate at the end of the year stood at 2.1%, while average inflation was 1.2%.

Year-on-year inflation for food and non-alcoholic beverages has remained stable since the fourth quarter of 2010; however, since the second quarter of 2011, higher fuel prices (following the targeting of subsidies on gas consumption) have led to a hike in the 12-month inflation rate, which reached 6.7% in May. Reflecting international food and fuel prices, the year-on-year inflation rate is expected to finish 2011 at about 5%.

Although during 2010 the number of private sector workers contributing to the Salvadoran Social Security Institute rose by more than 25,000 (4.6%), their total number at the end of 2010 (567,142 workers) still fell short of pre-crisis levels (583,717 workers in July 2008). Almost half of all formal jobs created in 2010 were in the manufacturing sector, reflecting heavy external demand.

The results of the 2010 household survey are still not yet available but, given the relative improvement in formal employment, it is estimated that in 2010 labour force participation exceeded the 63% recorded in 2009 and the unemployment rate fell from the 7.3% posted in 2009.

With regard to wages, the average wage of private sector workers contributing to the Salvadoran Social Security Institute rose by a mere 1.5%, while the average salary of public sector workers went up by 0.4%, both in real terms. In order to reduce persistent disparities in public wages, at the beginning of 2011 the wages of public sector employees earning under US$ 1,000 per month were increased by 10%; in addition, it was announced that the minimum pension would be brought into line with the minimum wage.

(c) The external sector

Thanks to rising external demand, goods exports grew by 16.4% in 2010, after a 16.7% nominal contraction in 2009. Non-traditional exports led the field with an increase of 16.1%.

However, the upswing in goods exports was insufficient to offset the 16% rise in imports, which reflected increased imports of consumer and intermediate goods (up 11.1% and 22.5%, respectively). As a result, the trade deficit widened by two percentage points of GDP to stand at 17.5%.

The income balance deficit narrowed from 2.7% to 1.8% of GDP as the reduction of portfolio liabilities in both the public and private sectors lowered debt servicing costs. Workers' remittances edged up a mere 1.3% in 2010 after tumbling 9.5% in 2010, reflecting the still high rate of Hispanic unemployment in the United States. The transfers surplus rose slightly as a proportion of GDP, from 16.7% to 17%.

Reflecting these factors, the current account deficit went from 1.5% of GDP in 2009 to 2.3% of GDP in 2010. Financing for the deficit came from capital transfers, mainly from the Millennium Fund (FOMILENIO), an entity created by the Government of El Salvador to administer cooperation funds provided by the United States to develop the north of the country, as well as the net effect of deleveraging in the Salvadoran banking system and disbursements of multilateral financing.

Up to the third quarter of 2010 the government was using international reserves to finance the current account deficit because of delays in the disbursement of funds from international financial institutions. As a result reserves, which had stood at US$ 2.985 billion in late 2009, equivalent to 28.7% of M2, dwindled by US$ 453 million, to a level equivalent to 24.4% of M2 in September. The reserve level rose again somewhat in the last quarter to US$ 2.882 billion (27.7% of M2), which represented a decrease of 3.4% with respect to the year-earlier period.

As export and import prices climbed by 2.9% and 7.0%, respectively, El Salvador's terms of trade fell by an average of 3.8% in 2010. Although this contrasts with the average gain of 3.2% seen in 2009, the 2009 figure was attributable mainly to the fall in import prices, with average export prices remaining constant over the period.

The overall real effective exchange rate depreciated by 2.1% on average in 2010 because most of El Salvador's trading partners experienced relative currency appreciation with respect to the United States dollar. The real exchange rate against the dollar fell by 0.8% mainly because of the inflation differential with the United States.

The agricultural sector should continue to benefit from recent rises in coffee and sugar prices. Manufacturing exports, especially maquila, will be driven by the stimulus provided by United States demand. Nevertheless, given the likelihood that international food and fuel prices will remain high in 2011, a current account deficit of about 4% of GDP is projected for the year.