El Salvador

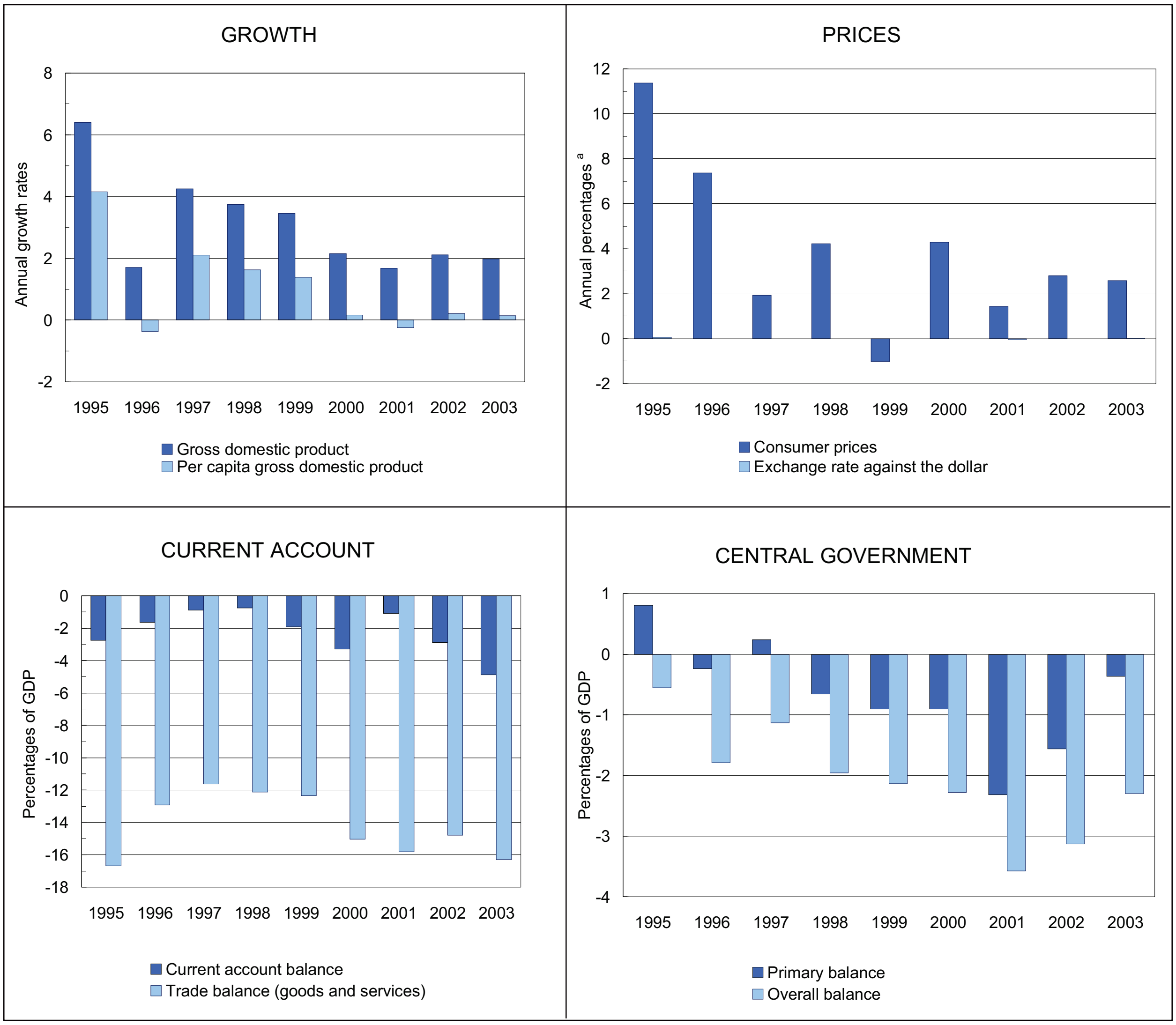
1. General trends

Economic activity in El Salvador grew by 2% in 2003, which meant that per capita GDP remained virtually stagnant for the fourth year running as the government continued to consolidate the dollarization process and wound down public spending on post-earthquake reconstruction. External demand increased moderately for a second consecutive year after a drop in 2001 that marked the end of a lengthy uptrend in *maquila* exports to the United States. The main engine of growth was private consumption, thanks principally to higher real wages, credit and family remittances (which now represent more than 14% of GDP). Public investment spending contracted as the reconstruction programme for repairing damage caused by the earthquakes in 2001 progressed towards completion. Despite a slight upturn in private investment, capital formation showed poor growth for the third consecutive year, undermining competitiveness.

In 2003, the government took measures to tighten public finances in response to an increased fiscal deficit and a sharp rise in borrowing over the previous two years, compounded by pressure exerted by pension payments to civil servants and financial support to the coffee sector. The deficit of the non-financial public sector (NFPS) dropped from 3.3% to 1.3% of GDP but external public debt continued to climb. The macroeconomic climate was remarkably stable thanks to low annual average inflation (2.1%), a low deposit rate consistent with international interest rates, and the deepening of the dollarization process. The current account deficit widened, while the trade deficit was financed almost entirely by family remittances, which came in at US$ 2.105 billion. The government issued US$ 348 million in international bonds, which partly offset the slump in foreign direct investment.

In 2004, GDP is expected to grow by between 1.8% and 2.3% on the strength of private consumption, remittances and *maquila* exports, although that sector's performance will remain subject to United States demand and tough competition from Asian producers. During the first half of 2004, the economic outlook cooled when the general budget for the year failed to pass Congress in the run-up to the presidential elections. Furthermore, the private sector's large external liabilities constitute a potential risk in the face of expected hikes in international interest rates.

Figure 1
EL SALVADOR: MAIN ECONOMIC INDICATORS



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] December-December variation.

2. Economic policy

Now that relative macroeconomic stability has been achieved in a dollarized financial and monetary climate –which is associated with a loss of monetary-policy manoeuvring room– fiscal matters are one of the main areas of concern. During the first half of 2004, Congress failed to approve the annual budget, because of disagreements over key items, such as transfers to municipalities. One of the new Administration's main challenges is therefore to consolidate public finances, which have come under particular pressure from the rising cost of pensions reform and higher public indebtedness. Another challenge that needs urgent attention is the social agenda, particularly shortcomings in health and education coverage, which have led to sharp political and social polarization and grave public safety concerns.

(a) Fiscal policy

Fiscal policy in 2003 was directed at containing the deficit of the non-financial public sector (NFPS), which fell from 3.3% of GDP in 2002 to 1.3% in 2003. Instrumental in achieving this were heavy cuts in capital expenditure and more efficient tax collection. Including the cost of public pensions (which are recorded below the line), however, the deficit was 3% of GDP.

The central government deficit was 2.3% of GDP, eight tenths of a percentage point lower than in 2002, thanks to tighter control on capital spending and higher tax revenue. Tax receipts were boosted by the implementation of monitoring and oversight measures, which included the elimination of exemptions for VAT and income tax, in addition to a general strengthening of tax administration by means of a customs simplification act, amendments to the customs offences act, the introduction of electronic tax filing options and a programme to combat smuggling. Tax revenues thus climbed 8.8%, with the increase being driven by taxes on imports, income and value added, thereby pushing the tax ratio up to 11.6% of GDP in 2003. On the spending side, the government targeted subsidies, made the public-sector labour policy more flexible and implemented public savings and institutional modernization policies. Current outlays expanded by 9.2% and capital expenditure (particularly real investment) dropped by 9.9% to the equivalent of 3.6% of GDP. Earthquake-related reconstruction costs were 1.4% of GDP in 2003, and are expected to fall to 0.6% of GDP in 2004.

External public debt continued to swell in 2003, partly due to the investment programme for reconstruction that is due for completion in 2004. External liabilities climbed by 17.5% in 2003 as a result of the substitution of external for domestic debt (Legislative Decree No. 681) in an attempt to ease short-term pressure on public finances. At the beginning of 2003, the government issued US$ 348 million in 20-year Eurobonds, seeking to take advantage of favourable conditions on international capital markets. Overall, the total debt/GDP ratio stood at the prudential level of 40% set by the Ministry of Finance. Of this, 11.4% was domestic debt and 29% external debt. In relation to exports of goods and services, external debt was up from 104.9% of GDP in 2002 to 117.6% in 2003.

The government plans to issue a further US$ 286 million in bonds in order to bridge the gap in budget financing. Assuming that the budget for the year is approved without major changes, and in the light of lower reconstruction costs, the NFPS deficit is expected to widen to 1.8% of GDP in 2004.

(b) Monetary policy

The consolidation of the dollarization process eased upward pressure on inflation and brought interest rates closer to United States rates. By December 2003, 93.5% of the monetary base had been converted to dollars. In addition to strengthening the regulatory framework of the financial system, at mid-year the authorities took steps to create liquid contingency reserves, thus pushing the level of net international reserves up to US$ 1.906 billion (20% more than in 2002).

In the absence of a lender of last resort, and facing the risk of possible outflows of deposits, the Superintendency of the Financial System imposed new rules on commercial banks requiring them to hold additional contingency reserves amounting to US$ 227 million. The new regulations required a further 6% of reserves on the balance of deposits recorded in May, to be covered with government securities, stocks or bonds, and an additional 3% in liquid foreign exchange.

This means that the net international reserves of the central bank (US$ 1.906 billion) amply cover the liquidity reserves in the system and include a margin capable of sustaining the dollarization process in the event of contingencies. The central bank still carries liabilities in the form of non-redeemable securities (US$ 506 million) from open-market operations conducted prior to dollarization.

The money supply gradually expanded in 2003, with a shift from medium- to short-term deposits. The low level of deposit taking is thought to be due to the existence of a larger range of international investment options. Also, foreign banks that are not based in El Salvador attract funds locally and invest them abroad. The operation of investment funds that deal in Latin American government debt instruments has also affected the banks' ability to attract deposits.

Nominal lending rates continued to decline in 2003, reaching 6.6%, while deposit rates remained at 3.4%. Spreads of nominal and real rates alike were also at all-time lows. Despite this progress, however, sluggish economic growth has meant that unencouraging investment flows are failing to reach the levels that were expected to accompany monetary integration. In 2003, credit to the private sector picked up somewhat (7%), following dramatic drops in 2001 and 2002. This upturn was partly attributable to a decline in foreign business loans in favour of local credit as a result of lower local interest rates. Also, consumer, residential and commercial loans extended by foreign banks not based in El Salvador appear to have increased. There has been a rapid rise in international borrowing by the local private banking system in order to fund lending operations in

Table 1
EL SALVADOR: MAIN ECONOMIC INDICATORS

	1995	1996	1997	1998	1999	2000	2001	2002	2003 [a]
	Annual growth rates [b]								
Gross domestic product	6.4	1.7	4.2	3.7	3.4	2.2	1.7	2.1	2.0
Per capita gross domestic product	4.2	-0.4	2.1	1.6	1.4	0.2	-0.2	0.2	0.1
Gross domestic product, by sector									
Agriculture, livestock, hunting, forestry and fishing	4.5	1.3	0.4	-0.7	7.7	-3.1	-2.6	0.2	-0.6
Mining	6.7	1.0	6.5	5.3	0.4	-4.7	11.7	7.0	4.0
Manufacturing	6.9	1.7	8.0	6.6	3.7	4.1	4.0	2.9	2.8
Electricity, gas and water	5.0	17.1	4.2	6.1	2.7	-2.3	4.6	5.6	4.6
Construction	6.1	2.7	6.2	8.5	-1.8	-3.4	9.6	4.6	3.5
Wholesale and retail commerce, restaurants and hotels	9.9	0.4	2.9	4.0	2.0	3.6	1.9	1.0	1.1
Transport, storage and communications	5.5	1.9	7.7	4.2	9.5	6.1	4.3	3.7	3.1
Financial institutions, insurance, real estate and business services	5.2	2.2	4.4	3.8	3.0	3.0	-0.8	3.4	2.8
Community, social and personal services	5.1	2.4	3.4	1.2	1.0	1.1	-0.5	-0.7	0.9
Gross domestic product, by type of expenditure									
Consumption	9.2	1.6	3.0	2.4	3.4	3.7	3.4	0.6	2.9
General government	7.9	2.8	2.8	2.5	0.4	0.9	4.0	-7.2	-1.1
Private	9.3	1.5	3.0	2.4	3.7	3.9	3.3	1.3	3.2
Gross domestic investment	15.2	-22.1	6.5	22.8	-4.0	2.7	5.2	-1.5	1.9
Exports (goods and services)	13.9	8.7	30.2	6.2	7.1	16.8	-0.4	5.7	4.9
Imports (goods and services)	21.1	-6.1	16.8	9.2	2.7	14.5	4.4	0.5	5.4
	Percentages of GDP								
Investment and saving [c]									
Gross domestic investment	20.0	15.2	15.1	17.6	16.4	16.9	16.7	16.4	16.4
National saving	17.5	13.2	14.2	16.6	14.5	13.6	15.3	13.8	11.9
External saving	2.6	2.0	0.9	0.9	1.9	3.3	1.4	2.7	4.6
	Millions of dollars								
Balance of payments									
Current account balance	-262	-169	-98	-91	-239	-431	-150	-412	-734
Merchandise trade balance	-1 462	-1 242	-1 143	-1 306	-1 356	-1 740	-1 933	-1 871	-2 274
Exports, f.o.b.	1 651	1 787	2 437	2 460	2 534	2 963	2 892	3 021	3 162
Imports, f.o.b.	3 113	3 030	3 580	3 765	3 890	4 703	4 824	4 892	5 436
Services trade balance	-121	-90	-152	-149	-183	-235	-250	-240	-169
Income balance	-67	-90	-163	-163	-282	-253	-266	-323	-408
Net current transfers	1 389	1 254	1 361	1 527	1 582	1 797	2 298	2 023	2 117
Capital and financial balance [d]	410	334	460	394	447	385	-27	288	1 050
Net foreign direct investment	38	-7	59	1 103	162	178	289	496	68
Financial capital [e]	372	341	401	-709	285	207	-316	-208	982
Overall balance	148	165	363	303	208	-46	-178	-124	316
Variation in reserve assets [f]	-148	-165	-363	-303	-208	46	178	124	-316
Other external-sector indicators									
Real effective exchange rate (index: 2000=100) [g]	112.8	104.7	102.3	101.9	100.3	100.0	99.7	99.8	100.9
Terms of trade for goods (index: 1997=100)	106.2	99.5	100.0	97.5	92.3	87.9	85.2	84.5	81.2
Net resource transfer (% of GDP)	3.6	2.4	2.7	1.9	1.3	1.0	-2.1	-0.2	4.3
Total gross external debt (millions of dollars)	2 168	2 517	2 689	2 646	2 789	2 831	3 148	3 987	4 687
Total gross external debt (% of GDP)	22.8	24.4	24.2	22.0	22.4	21.6	22.8	27.9	31.3
Net profits and interest (% of exports) [h]	-3.4	-4.1	-5.6	-5.3	-9.1	-6.8	-7.1	-8.4	-10.0
	Annual average rates								
Employment									
Labour force participation rate [i]	52.4	51.3	50.9	53.5	52.6	52.2	53.3	51.2	53.4
Open unemployment rate [j]	7.6	7.7	8.0	7.5	7.0	6.7	7.0	6.2	6.9
Visible underemployment rate [k]	...	...	...	3.2	3.5	3.4	3.4	4.1	4.5

Table 1 (concluded)

	1995	1996	1997	1998	1999	2000	2001	2002	2003 [a]
				Annual percentages					
Prices									
Variation in consumer prices (December-December)	11.4	7.4	1.9	4.2	-1.0	4.3	1.4	2.8	2.6
Variation in nominal exchange rate (December-December)	0.1	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0
Variation in minimum real wage	0.4	-3.6	-4.3	3.4	2.3	-2.2	-3.7	-1.7	2.1
Nominal deposit rate [l]	...	...	...	...	...	6.5	5.5	3.4	3.4
Nominal lending rate [m]	...	...	...	...	...	10.7	9.6	7.1	6.6
				Percentages of GDP					
Central government									
Current income	12.2	12.8	11.5	11.5	11.2	11.3	11.6	12.2	12.8
Current expenditure	10.4	11.7	10.5	10.8	11.1	11.8	11.5	11.4	11.8
Current balance	1.8	1.0	1.0	0.8	0.1	-0.4	0.1	0.9	0.9
Net capital expenditure	3.0	3.2	2.6	2.9	2.4	2.7	4.1	4.3	3.7
Primary balance	0.8	-0.2	0.2	-0.7	-0.9	-0.9	-2.3	-1.6	-0.4
Overall balance	-0.6	-1.8	-1.1	-2.0	-2.1	-2.3	-3.6	-3.1	-2.3
Public debt	37.3	37.8	36.2	33.3	26.0	27.4	31.1	36.0	38.0
Domestic	14.5	13.4	12.0	11.2	7.9	9.8	12.0	11.7	11.5
External	22.8	24.4	24.2	22.0	18.1	17.6	19.2	24.3	26.5
Interest payments (% of total income)	11.1	12.1	11.9	11.3	11.0	12.1	10.8	12.8	15.1
Money and credit [n]									
Domestic credit [o]	3.5	3.9	4.1	4.3	4.5	4.6	4.9	4.4	4.4
To the public sector	0.0	-0.1	-0.1	-0.2	-0.2	-0.1	0.0	0.0	-0.1
To the private sector	3.6	3.9	4.2	4.5	4.7	4.8	4.8	4.4	4.4
Monetary base and local-currency deposits (M2) [p]	4.5	4.7	4.8	5.1	5.1	5.1	5.1	4.9	4.7

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Preliminary figures. [b] Based on figures in colones at constant 1990 prices. [c] Based on figures in local currency at current prices. [d] Includes errors and omissions. [e] Refers to the capital and financial balance (including errors and omissions), minus net foreign direct investment. [f] A minus sign (-) denotes an increase in reserves. [g] Annual average, weighted by the value of merchandise exports and imports. [h] Refers to net investment income as a percentage of exports of goods and services as shown on the balance of payments. [i] Economically active population as a percentage of the working-age population; nationwide total. [j] Unemployed population as a percentage of the economically active population; nationwide total. [k] Underemployed population as a percentage of the economically active population; urban total. [l] Benchmark rate for deposits of up to 180 days in the financial system. [m] Benchmark rate for 1-year loans in the financial system. [n] The monetary figures are annual averages. [o] Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. [p] Includes foreign-currency deposits.

foreign markets. Unofficial estimates place these banking liabilities abroad at approximately US$ 1.5 billion.

(c) Trade policy

Trade policy was focused on the negotiation and signature of a free trade agreement between Central America and the United States. This agreement broadens the scope of the unilateral preferences granted under the Caribbean Basin Initiative (CBI): in addition to a reciprocal agreement extending market access permits and dispute settlement rights for both parties, it also provides a permanent framework for trade and investment relations, without the time limits stipulated in CBI. The agreement will also cover new forms of trade in services, with the corresponding rules and disciplines for these new investment relations.

The business sector hopes that the free trade agreement will boost exports, investment, growth, employment and technology transfer, particularly in sectors that have apparent relative advantages, such as agriculture, agribusiness and the yarn-textile-clothing chain associated with the *maquila* sector.

(d) Structural reform

The government's efforts in this domain centred on an attempt to move forward with the structural reform of the health sector by restructuring the social security system. This was thwarted, however, by a lack of consensus among the various stakeholders.

Table 2
EL SALVADOR: MAIN QUARTERLY INDICATORS

	2002				2003[a]				2004[a]	
	I	II	III	IV	I	II	III	IV	I	II
Gross domestic product (variation from same quarter of preceding year)[b]	1.3	2.2	2.3	2.5	...	...	...	...	...	...
Merchandise exports, f.o.b. (millions of dollars)	707	747	781	760	803	760	801	772	794	...
Merchandise imports, c.i.f. (millions of dollars)	1 157	1 314	1 331	1 390	1 417	1 411	1 474	1 010	1 458	...
International reserves (millions of dollars)	1 800	1 702	1 571	1 623	1 800	1 687	1 814	1 943	1 937	1 837
Real effective exchange rate (index: 2000=100)[c]	99.3	99.5	99.8	100.5	99.9	101.0	101.2	101.2	101.1	100.1
Consumer prices (12-month percentage variation)	1.7	2.3	1.4	2.8	2.4	1.5	2.2	2.6	3.0	4.6
Average nominal exchange rate (colones per dollar)	8.75	8.75	8.75	8.75	8.74	8.75	8.75	8.75	8.75	8.75
Nominal interest rates (annualized percentages)										
Deposit rate	3.5	3.4	3.4	3.5	3.3	3.4	3.4	3.4	3.4	3.4
Lending rate	7.5	7.1	7.2	6.8	6.6	6.5	6.6	6.6	6.6	6.1
Domestic credit[d] (variation from same quarter of preceding year)	-7.8	-8.7	-8.2	-0.7	0.9	5.8	7.7	8.9	8.5	9.0[e]
Non-performing loans as a percentage of total loans (%)[f]	4.4	4.1	4.1	3.5	3.5	3.3	3.2	2.8	2.7	...

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Preliminary figures. [b] Based on figures in colones at constant 1990 prices. [c] Quarterly average, weighted by the value of merchandise exports and imports. [d] Refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. [e] Data up to April. [f] Refers to total credit extended by the banking system.

3. The main variables

(a) Economic activity

For the fourth consecutive year, the slow recovery of external demand kept economic growth sluggish, notwithstanding a strong upturn in the United States growth rate from mid-2003 on. This was in addition to a decrease in public investment associated with the reconstruction programme following the earthquakes of 2001. The most notable aspect of supply was a sharp (5.4%) increase in its imported component.

One cause for concern in the country's recent economic performance has been a decline in private capital formation, which is one of the reasons why the investment ratio is down to 16% of GDP, despite public spending on post-earthquake reconstruction. Private investment climbed by a mere 2.5% in 2003 which, combined with smaller flows of foreign direct investment, gave an average annual increase of 0.6% over the past three years.

There was expansion, albeit limited, across all the sectors of production except for agriculture, which was down by 0.6% owing to a poor performance by staple grains and a slow recovery in international coffee and sugar prices. The sectors to grow at above-GDP rates were electricity, gas and water (4.6%); mining (4%); construction (3.5%); manufacturing (2.8%), which was driven by clothing manufactures in the *maquila* industry, the financial, real estate and insurance sector (2.8%); and transport (3.1%). The banking and financial system is one of the fastest-growing sectors, with good prospects for growth in 2004, thanks to the expansion of operations into other Central American countries.

(b) Prices, wages and employment

In 2003, the average annual rate of inflation was 2.1%, while December-to-December inflation was 2.6% (the lowest in Central America). On average, food prices went up at almost the same rate as the general index, although they rose more quickly towards the end of the year. Clothing prices continued on their established downward trend (-1.2%).

In the second quarter of 2003, the minimum wage in commerce, services, manufacturing and the *maquila* industry posted a differentiated nominal increase of between 5% and 10%, whereas public-sector wages were not adjusted. Recent years have seen little change in the employment rate, which edged up to 41% in 2003. The nationwide unemployment rate rose from 6.2% in 2002 to 6.9% in 2003, with rural areas continuing to record the highest rates (8.2%). The percentage of poor households nationwide has stood at 36% for the last two years, and the figure is clearly higher in rural areas (46%). There was, however, a slight improvement in extreme poverty figures nationwide, as the percentage of households dropped from 16% in 2002 to 14% in 2003.

(c) The external sector

The balance-of-payments current account deficit widened to almost 5% of GDP, from 2.9% in 2002. Family remittances, at US$ 2.105 billion or 14% of GDP –a figure three times higher than the current account deficit– continued to finance the trade deficit, which was estimated at 15% of GDP. The financial account showed a sharp drop in foreign direct investment, which came to US$ 86.3 million, compared with US$ 470 million in 2002. This investment went mainly to the *maquila* industry, telecommunications, electricity generation and the financial sector.

In terms of the external sector's performance, exports of goods climbed by 4.7%, with exports to countries outside Central America being the fastest-growing. Among traditional exports, coffee sales retreated by 1.4% as part of a trend that has continued for several years now, due to the sluggish recovery of international prices and a contraction in the exportable supply. Sugar and shrimp exports trended upward, albeit too slowly to make up the ground lost in previous slumps. Non-traditional exports posted a modest growth rate of 1.4%, which was substantially lower than the 6.8% recorded in 2002. *Maquila* exports (60% of the total) rose for the second year running (7%), but nonetheless fell short of the performance observed in the second half of the 1990s. In 2004, the *maquila* industry could be weakened by the growing shares of Honduras and Nicaragua in the United States market and mounting competition from China and other Asian countries.

Imports surged by 11% in 2003. An expansion in imports of intermediate goods, which represent 32% of the total, was driven by manufacturing (11.5%), construction materials (11%) –thanks to an increase in private residential construction– and petroleum and fuel (19%). Meanwhile, consumer goods (28% of total imports) swelled by 16.4% as a result of rising family remittances. Imports of durable goods performed particularly well, climbing by close to 48%. *Maquila* imports, which represent 24% of total imports, were up by 7.7%.

Purchases of capital goods, which represent 16.3% of the total, posted a 6.4% increase that was mainly attributable to transport and manufacturing. Capital goods for construction recorded a negative growth rate (-2.4%), as post-earthquake reconstruction projects moved towards completion.