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El Salvador: 2010 Article IV Consultation and First Review Under the Stand-By Arrangement—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; 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 a combined discussion of the 2010 Article IV Consultation with El Salvador and First Review Under the Stand-By Arrangement, the following documents have been released and are included in this package:

- The Staff Report for the combined 2010 Article IV Consultation and First Review Under the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on July 30, 2010, 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 September 1, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its September 15, 2010, discussion of the Staff Report on issues related to the Article IV Consultation and the IMF Arrangement, respectively.

- A Statement by the Executive Director for El Salvador.

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

Letter of Intent sent to the IMF by the authorities of El Salvador*
Memorandum of Economic and Financial Policies by the authorities of El Salvador*
Technical Memorandum of Understanding*

*Also included in Staff Report

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

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EL SALVADOR

Staff Report for the 2010 Article IV Consultation and First Review Under the Stand-By Arrangement

Prepared by Western Hemisphere Department
(In Consultation with Other Departments)

Approved by Miguel Savastano and Thomas Dorsey

September 1, 2010

EXECUTIVE SUMMARY

El Salvador's economy was severely affected in 2009 by the global slowdown and electoral uncertainty. Real GDP declined, and the public sector deficit and debt increased sharply. The economy is expected to recover gradually over the next couple of years owing to its strong linkages to the United States, inflation is projected to remain low, and the external current account deficit to widen but remain at sustainable levels.

Performance under the IMF-supported program has been good. All end-June performance criteria were met, though progress in the structural area has been mixed. There have been slight delays in announcing subsidy reform, but implementation is still planned by year-end. While some advances have been made in strengthening tax administration, there are delays in enhancing coordination between the internal revenue service and customs. Approval of the financial supervision and regulation law is delayed, and some recommendations of the Financial System Stability Assessment are being proposed as structural benchmarks under the arrangement, which will continue to be treated as precautionary.

The medium-term outlook is generally favorable, but sustained growth will depend on improvements in the investment climate and a durable fiscal consolidation effort.

- Even taking into account the adverse effects of negative supply shocks over the past decade, growth performance in El Salvador has lagged that in the region. This despite lower exchange rate risk and interest rates, and a real effective exchange rate that is in line with fundamentals.
- The full dollarization regime has not changed the structure of the economy nor its response to shocks. Structural improvements are necessary to boost investment and competitiveness and overcome growth sluggishness.
- Reducing the public debt-to-GDP ratio to pre-crisis levels is a key priority, especially in view of the high sensitivity of the debt trajectory to negative output shocks.

El Salvador has accepted the obligations of Article VIII, Sections 2, 3, and 4, and its exchange system remains free of restrictions on the making of payments and transfers for current transactions. The country has maintained a fully dollarized exchange rate system since January 2001.

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I. Background and Overview

1. **The 2010 Article IV consultation and first review under the Stand-By Arrangement (SBA) took place against a background of a moderate recovery of external demand**.[1] Owing to its strong linkages to the U.S. economy, the effects of the 2009 crisis in El Salvador were relatively more severe than in the rest of the region, as consumption, investment, and exports all fell sharply, and real GDP declined by 3½ percent.[2] Economic activity is recovering modestly in 2010.

2. **The government's economic strategy aims at ensuring fiscal and debt sustainability, while safeguarding social spending**. The strategy is underpinned by a continued commitment to the dollarization regime as the key anchor of macroeconomic policy. On March 17, 2010, the Fund approved a 3-year SBA in support of this strategy (with total access of 300 percent of quota), which the authorities are treating as precautionary. President Funes has been able to generate political majorities in Congress to advance key initiatives to bolster his economic strategy, including approval of a tax package in December 2009. However, going forward, forging consensus on future key initiatives and reforms remains challenging.[3]

3. **A key medium-term challenge is to improve the growth performance of the economy, which has lagged that of the region**. Real GDP growth averaged 2.1 percent during the last 5 years, compared with 5.1 percent in the rest of Central America; over the same period, private investment averaged 15 percent of GDP, compared with 21 percent in the region. By end-2008 40 percent of households were living under the poverty line. To address this situation, in mid-2009, the Funes administration put in place its flagship General Anti-Crisis Plan (PGA), which channels spending of about 1 percent of GDP to social programs.[4] To spur growth and investment during the remainder of their term, the authorities plan to undertake fiscal reforms to create space for priority expenditures, assume a more active role in promoting exports, and foster "public private partnerships" to promote investment in

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[1] Discussions took place in San Salvador during July 20–30, 2010. The staff team comprised A. Wolfe (Head), J. Prat, A. Swiston (all WHD), and S. Segal (SPR) and was joined by F. Delgado (Regional Resident Representative) and J. Gramajo (OED) in some of the discussions and by P. Madrid (MCM) to discuss findings of the Financial System Stability Assessment. The mission met with Technical Secretary Segovia, Finance Minister Cáceres, Central Bank President Acevedo, other government officials, congressional and labor leaders, think tanks and private sector representatives.

[2] Box 1 presents a summary of staff recommendations during the previous Article IV consultation in 2008.

[3] Congressional approval for long-term borrowing, for example, requires a two-thirds majority.

[4] The PGA broadened the coverage of a previous conditional cash transfer program to urban populations and includes housing and education components.

infrastructure, including in the electricity and energy sectors. The government is also looking to enhance the role of public banks to support lending to the productive sector.

4. **A recent IMF/World Bank Financial System Stability Assessment (FSSA) confirmed that the Salvadoran financial system withstood the global financial crisis well and was well-capitalized and liquid**. The FSSA recommended enhancements to the legal and regulatory frameworks as well as measures to reduce some remaining vulnerabilities.[5]

II. Recent Economic Developments

5. **Developments in 2010 are broadly in line with projections contained in the March 2010 staff report** (Figure 1).

- **Output**. The economic recovery is gaining strength, albeit at a modest pace. Real GDP fell by only ½ percent (y/y) in the first quarter of 2010 after declining 4.9 percent in the last quarter of 2009. The monthly index of economic activity rose 1.9 percent (y/y) in June, the fourth consecutive monthly gain, and real GDP growth for the year as a whole may be close to the 1 percent envisaged in the program.

- **Prices**. Inflation was zero in 2009, and by July 2010 it had risen to only 1.0 percent (y/y). Core inflation (excluding food and energy) was 0.9 percent in July (y/y), compared with 2.6 percent at end-2009.

- **Trade and remittances**. Exports (in U.S. dollars) declined 16 percent in 2009, but increased by 14 percent (y-t-d) through July 2010. Imports rose by more during the same period (17 percent), though some of the increase reflects higher oil prices (non-oil imports are up 12 percent). Remittances rose by only 2.5 percent (y-t-d) through July (Figure 2).

- **Net capital flows**. Capital account flows are weaker than envisaged at the time of program approval, mainly owing to delays in disbursements from international financial institutions (IFIs). For the year as a whole, net international reserves of the central bank are projected to fall by close to US$200 million compared with an increase of US$100 million projected in the March staff report.

- **Financial system**: Most bank indicators have improved in 2010. Deposits have risen (3½ percent) through June, profitability is recovering, and non-performing loans have leveled off (after increasing significantly in 2009). Liquidity and capital ratios remain well above their pre-crisis levels, due to a shift to low-risk, liquid assets and some capital injections (Figure 3). Credit to the private sector, which fell by 4½ percent in

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[5] The FSSA report is scheduled to be discussed by the Executive Board at the same time as the Article IV staff report.

2009, has continued to decline through mid-2010, though there are indications that lending is resuming in the third quarter.

- **Fiscal**: The performance criteria on the deficit of the nonfinancial public sector for March and June were met with comfortable margins. Restraint on current spending (except for subsidy outlays) and slow implementation of the public investment program were key factors contributing to the overperformance; government revenues were in line with program targets (Figure 4). Performance criteria on public debt flows and on the non-accumulation of payments arrears were also observed.

III. Policy Discussions

A. Macroeconomic Outlook

6. **There was agreement that the medium-term outlook presented in the March 2010 staff request for the SBA remains appropriate**. External demand has picked up as projected, and the domestic economy is recovering slowly, as was envisaged. Real GDP growth continues to be projected at 1 percent in 2010 and 2½ percent in 2011, though downside risks have decreased. Inflation is on track to rise to 1½ percent in 2010, and evolve in line with U.S. inflation thereafter.

Macroeconomic Framework
(In percent of GDP, unless otherwise noted)

		Projections					
	2009	2010	2011	2012	2013	2014	2015
Real GDP growth (percent)	-3.5	1.0	2.5	3.0	4.0	4.0	4.0
Inflation (percent, end of period)	0.0	1.5	2.8	2.8	2.8	2.8	2.8
Contributions to growth (percentage points)							
Domestic demand	-12.8	3.2	4.0	3.6	4.9	5.1	4.9
Net exports	9.2	-2.3	-1.5	-0.6	-0.9	-1.1	-0.9
Nonfinancial public sector balance	-5.6	-4.8	-3.5	-2.5	-2.0	-1.8	-1.5
Primary balance	-3.0	-2.4	-0.4	0.4	1.0	1.1	1.3
Public sector gross debt	49.5	51.2	52.1	51.8	50.6	49.1	47.7
External current account balance	-1.8	-2.8	-3.1	-3.2	-3.2	-3.3	-3.3
Trade balance	-13.5	-15.1	-15.5	-15.4	-15.4	-15.4	-15.3
Workers' remittances receipts	16.4	16.7	17.0	17.2	17.2	17.2	17.2
Gross domestic investment	13.1	12.8	13.3	13.8	14.2	14.5	14.8
Private	10.6	10.2	10.4	10.9	11.3	11.6	12.0
Public	2.5	2.5	2.9	2.8	2.8	2.8	2.9
Gross national saving	11.3	10.0	10.2	10.5	11.0	11.1	11.5
Private	14.4	12.2	11.0	10.0	9.6	9.6	9.6
Public	-3.0	-2.2	-0.8	0.5	1.3	1.5	1.9

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

7. **The medium-term external current account deficit is expected to be somewhat higher than envisaged**. As in the March staff report, the current account deficit for 2010 is expected to rise to 2.8 percent of GDP (from 1.8 percent in 2009), as import growth outweighs that of exports and remittances. Thereafter, however, the deficit is projected to stabilize at around 3.3 percent of GDP (compared with below 3 percent of GDP in the March staff report

owing to a higher projected oil import bill and stable remittances). The current account deficit is expected to be financed by net FDI flows on the order of 2 percent of GDP, net government borrowing for about 1 percent of GDP, and other private capital inflows.

B. Fiscal Policy

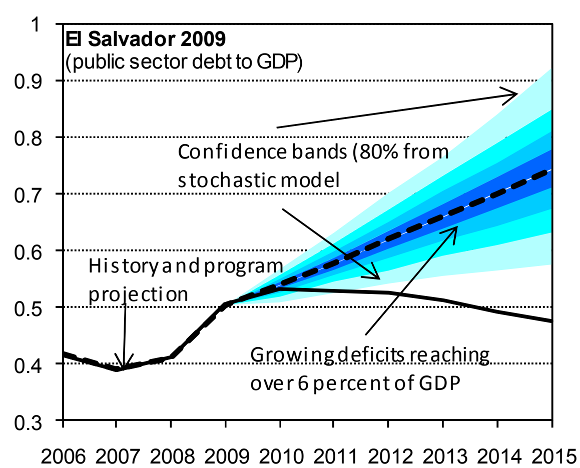
8. **It was agreed that the strategy of gradual fiscal consolidation that underpins the three-year SBA and the projected fiscal stance for 2010 remain appropriate**. The fiscal deficit for 2010 is expected to decline to 4.8 percent of GDP on the back of higher tax revenue (reflecting the recovery of demand and tax measures taken at end-2009) and expenditure restraint. On a cyclically-adjusted basis, this decline would represent a withdrawal of fiscal stimulus of 0.6 percent of GDP; that would be followed by a withdrawal twice as large in 2011, anchored on continued expenditure restraint and subsidy reform.

Fiscal Impulse
(in percent of GDP)

				Projections		
	2007	2008	2009	2010	2011	2012
Nonfinancial public sector overall balance	-1.9	-3.1	-5.6	-4.8	-3.5	-2.5
Primary balance	0.5	-0.7	-3.0	-2.4	-0.4	0.4
Cyclically-adjusted overall balance	-3.0	-3.9	-4.0	-3.4	-2.4	-2.3
Cyclically-adjusted primary balance	-0.5	-1.5	-1.5	-1.0	0.6	0.7
Fiscal impulse 1/	-0.9	0.9	0.1	-0.6	-1.0	-0.1

Sources: Ministry of Finance; and Fund staff estimates.
1/ Defined as the inverse of the change in the the cyclically-adjusted overall balance; a positive figure means fiscal stimulus.

9. **Staff underscored that the gradual fiscal consolidation strategy is fraught with risks and left little scope for slippages**. The fiscal consolidation envisaged for 2010–12 is not expected to result in a significant decline in debt levels. Under the agreed strategy, public debt levels are envisaged to start declining only in 2012. Staff presented a stochastic debt sustainability analysis showing that the debt dynamics in this scenario are highly sensitive to growth and interest rate shocks and policy slippages (Box 2). The authorities recognized these risks, but felt that pushing for a more ambitious fiscal effort could jeopardize the political consensus for fiscal consolidation in general. Nonetheless, they restated their commitment to take all measures necessary to adhere to the deficit targets envisaged under the program.



10. **The near-term fiscal strategy hinges on subsidy reform, continued expenditure restraint, and strengthened tax administration**.

- **Reforming energy subsidies is key**. Subsidies are poorly targeted and a drain on government resources (staff estimates their cost at 1.4 percent of GDP in 2009).[6] Some remedial measures envisaged under the program (e.g., adjusting electricity tariffs) experienced delays, but the authorities have reaffirmed their commitment to reduce subsidies on liquefied gas (LPG) and electricity which would be redirected to other social policies.

- **Strict control of government spending in 2010–11 will be critical**. While revenues are expected to recover gradually (by over 1 percent of GDP in 2011), mainly reflecting gains from tax administration improvements, a recovery in tax collections, especially on the income tax, and a step up in Millennium Challenge Corporation grants, the authorities underlined their commitment to contain government spending. They underscored that outlays on wages, goods and services, and discretionary transfers (excluding energy subsidies) will be kept broadly constant in real terms, which would yield savings of almost 1 percent of GDP in 2011; this will provide space to channel savings from energy subsidy reform to social sectors and infrastructure.

- **Tax administration has improved, but further progress is necessary**. There have been improvements in the areas of auditing and control of large taxpayers, and these are expected to continue in 2011 when steps to enhance coordination between the internal revenue directorate (DGII) and customs (DGA) are completed.

11. **The financing mix of the fiscal deficits in 2010–11 will be somewhat different than anticipated**. Congress has yet to approve several external loans envisaged at the time of program approval, and some of these will only be disbursed in 2011. In view of this, the deficit in 2010 is being financed through the drawdown of government deposits and by placing debt in the domestic market (at very low rates).[7] Staff urged the authorities to seek early congressional approval for the 2011 borrowing program and encouraged them to take advantage of current market conditions to refinance a US$650 million Eurobond that matures in the second half of 2011. The authorities stressed that they are already in discussions with Congress and expect to have full approval of their external borrowing program shortly, and they are working with financial advisors to roll over the Eurobond.

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[6] Water usage and transportation subsidies were reformed in 2009.

[7] By end-2011, government deposits at the central bank are projected to recover in line with original program projections, thereby limiting the impact on the central bank's current liquidity provision capabilities.

Medium-term issues

12. **The authorities' medium-term fiscal strategy hinges on reaching agreement on a fiscal pact to increase government revenue by at least 1½ percent of GDP**. The authorities indicated that discussions on key elements of the pact are moving forward with a broad range of stakeholders. On the revenue side, they are working (with the Fund's technical assistance) on designing measures that would underpin the fiscal pact (including improvements in tax administration, expanding the tax base and, as a final alternative, a possible increase in some tax rates). The authorities were confident that they would reach agreement on a satisfactory fiscal pact by 2012 and were reluctant to shorten the timetable because it could endanger the entire set of reforms. Staff urged the authorities to stand ready to adopt the revenue measures envisaged in the pact should they be needed for meeting the targets in their fiscal strategy.

13. **The authorities are committed to public financial management reforms to support fiscal consolidation**. El Salvador's budget process has several shortcomings, including: (i) a requirement of supermajorities in Congress for approval of long-term financing; and (ii) the absence of a multi-year expenditure framework. The authorities indicated their commitment to remedy these weaknesses. They noted that IMF technical assistance missions are visiting San Salvador in August-September to advise on improving budget management and execution and to design a multi-year expenditure framework (the latter also being supported by the World Bank). In addition, they noted that they had requested a fiscal transparency ROSC (a mission will visit San Salvador in the fourth quarter of 2010).

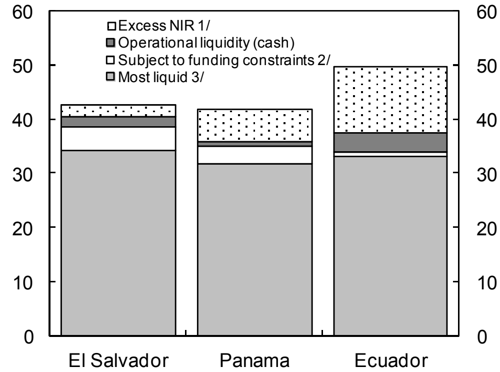
14. **Debt management could be improved**. Public sector debt management is fragmented (with some elements in the ministry of finance and others at the central bank). Staff advised the authorities to consolidate these functions in one unit to avoid duplications and facilitate the design of a consistent public debt strategy. The authorities noted that they are working to improve debt management practices, including through the assistance of an external expert, but did not see a need to consolidate all debt operations under one agency.

C. Full Dollarization and Financial Sector Issues

15. **The authorities reiterated that full dollarization will remain a key anchor of their macroeconomic framework despite its limitations**. Staff discussed the results of a study assessing El Salvador's performance under full dollarization. The study finds that dollarization had reduced exchange rate risk and provided a strong nominal anchor that had secured low inflation. The study also found that the Salvadoran economy's dynamic response to shocks had not been affected by dollarization, although the country had suffered more severe shocks in the post-dollarization period than under the previous fixed exchange rate system (Box 3, Figure 5). The authorities recognized the key role that dollarization had played in preserving macroeconomic stability, but stressed that the inability to use monetary and exchange rate policy to mitigate external shocks imposed non-negligible costs to the adjustment process.

16. **The exchange rate regime's ability to withstand liquidity shocks should be broadened**. While commercial banks' liquid asset holdings are roughly comparable to those in other fully-dollarized economies, the "free" reserves of the central bank, which may be used to meet withdrawals in excess of the reserves of an individual bank, are relatively small. Moreover, there are legal hurdles to channeling reserves or borrowed liquidity to financial institutions with temporary liquidity problems. The authorities agreed that some of the problems regarding liquidity support stem from existing regulations and not from the dollarization regime, and they are considering reforms that would allow the central bank to undertake limited lender-of-last-resort (LOLR) functions, in line with FSSA recommendations.

Commercial Bank Liquidity
(percent of deposits and securities, May 2010)



Sources: IMF, *International Financial Statistics*; and Fund staff calculations.
1/ Net international reserves in excess of commercial bank claims on the central bank.
2/ Commercial bank holdings of central bank and central government securities.
3/ Deposits at the central bank, deposits abroad, and securities abroad.

17. **Staff discussed the main findings of the recent FSSA**. The update found that banking system soundness had improved since the previous FSSA (in 2004), solvency ratios could withstand another moderate recession, and there have been advances in supervisory practices. However, the report also considered that progress in approving key norms had been slow, and recommended enhancements to the legal framework and bank safety net arrangements (Box 4). The authorities were in broad agreement with the findings and recommendations and noted that they were moving forward with key regulations in some areas. They also reiterated their commitment to secure congressional approval of the financial supervision and regulation law that has been with Congress for more than a year.

18. **The new financial supervision and regulation law will create one superintendency in charge of banks, pensions, insurance, and securities, and shift regulatory powers to the central bank**. The new structure for financial sector oversight is expected to reduce supervisory gaps, facilitate consolidated supervision and reduce regulatory arbitrage. The authorities noted that they will ensure that supervisory vigilance is maintained during the merger and that the central bank will issue key norms to enhance supervision. The issuance of norms on corporate governance of commercial banks is being proposed as a structural benchmark.

19. **Staff welcomed the authorities' plans to improve the legal framework of domestic capital markets**. Domestic capital markets are underdeveloped and have played a limited role in financial intermediation, partly owing to shortcomings in the regulatory and supervisory framework. As a first step, the authorities reaffirmed their commitment to obtain congressional approval of the Investment Funds Law (a structural benchmark under the program), which would provide a legal basis and accounting and valuation standards for investment funds. They noted, however, that Congress will consider this bill only after the financial supervision and regulation bill has been approved.

20. **Efforts to bolster the bank resolution framework were also welcomed**. Staff and the authorities agreed that the bank resolution framework should be improved, and that the deposit insurance fund (IGD), financial system supervisor, and central bank should develop mutually-agreed comprehensive procedures, manuals, and standardized contracts. The authorities noted that coordination among domestic regulatory agencies involved in the safety net is improving, and that they are designing a financial stability strategy, as recommended by the FSSA. They also plan to carry out a comprehensive bank resolution simulation exercise in the coming months (a proposed structural benchmark under the program, MEFP ¶5) and are seeking to promote cross-border crisis prevention and management arrangements with neighboring countries.

21. **Staff discussed the authorities' plans to strengthen the role of public banks in El Salvador**. The two-pronged approach consists of: (i) scaling up lending to priority sectors through two existing public banks (with a combined share in banking system assets of around 5 percent as of end-2009), and (ii) converting an existing second-tier bank into a new national development bank (*Banco Nacional de Desarrollo*) that would be in charge of an economic development trust fund (to catalyze IFI and private-sector lending for large projects) and a guarantee trust fund to support private-bank lending. Staff acknowledged that bank lending to certain sectors had become scarce, but highlighted the difficulties in ensuring continued adherence to transparent criteria in state-owned banks and limiting potential fiscal risks. The authorities shared staff's concerns, but indicated that the new entities would not represent a fiscal burden as risks would be contained.

D. Competitiveness Issues

22. **The authorities agreed that the real effective exchange rate appears to be broadly in line with fundamentals**. Staff discussed the results from its assessment, which pointed to a small undervaluation of the real exchange rate (according to the macro balance and external stability approaches) and a somewhat larger (in absolute terms) overvaluation according to estimates from the equilibrium real exchange rate approach (Box 5). The authorities were of the view that the three approaches taken together were an indication that the real effective exchange rate is in line with fundamentals.

23. **Staff stressed that improvements in the investment climate to boost competitiveness should be a key priority** (Box 6). They underscored that domestic and foreign investment remains low both in nominal terms and relative to regional peers. Staff acknowledged that El Salvador generally compares well against other countries in the region under various measures of "doing business" and scores in the top half under a range of "competitiveness" measures, but noted that there are relative weaknesses in certain areas such as security, education and innovation.[8] Lower sub-ranking scores are consistent with firm-level

[8] See the International Finance Corporation's, *Doing Business 2010: Reforming through Difficult Times, El Salvador Country Report,* and the World Economic Forum's *Global Competitiveness Report 2009–10.*

data that cite crime and workforce education as key concerns in El Salvador relative to regional peers. Private-sector representatives agreed that the investment climate had been adversely affected by a deterioration of internal security, though some also cited uncertainties related to the policy direction of the government.

24. **The authorities agreed that addressing the security situation is a priority in the near term, and noted that their economic program contemplates allocating more resources to this area and to education**. They were also confident that public banks would facilitate business start-ups and spur private investment. They stressed that their Five-Year Plan includes proposals to address the aforementioned issues, as well as promoting innovation, modernizing key productive sectors, and increasing regional integration.

E. Downside Risks

25. **A slower recovery and the breakdown of political support for the fiscal consolidation process continue to pose the main risks to the government's strategy**. If either of these risks were to materialize, tighter expenditure restraint would be the only available tool to preserve macroeconomic stability.

- Although risks to the growth forecast are roughly balanced, a prolonged period of low growth or a double-dip recession would result in lower-than-envisaged tax collections and possible untenable pressure on the spending side. As noted in Box 2, the sensitivity of El Salvador's public debt path to adverse growth outturns would result in unsustainable debt dynamics.

- Insufficient political support could endanger the authorities' fiscal strategy, including by delaying approval of IFI loans and stalling further reforms necessary for fiscal consolidation.

26. **The government would need to take additional measures if the above risks were to materialize**. The authorities' strategy provides a solid basis to move forward in a baseline scenario, but they should stand ready to respond to a more adverse scenario. If external financing fails to materialize, or if the government is unable to garner the necessary congressional support for further reforms on the revenue side, spending would need to be reduced to avoid recourse to riskier forms of financing (such as the issuance of short-term debt). An important safeguard in this regard is the authorities' plan to reprioritize the public investment program to identify projects that could be delayed, while minimizing the social impact.

IV. Program Modalities

27. **The main elements of the program approved in March 2010 were ratified for this review**. The authorities and staff reached understandings on the following updates (Table 14):

- **Quantitative performance criteria**: The original indicative targets for end-2010 on the ceiling on the deficit of the nonfinancial public sector (US$1,047 million, 4.8 percent of GDP) and the accumulation of public sector debt (US$1,117 million) were converted to performance criteria. The adjuster for revenue overperformance has been maintained.

- **Structural benchmarks**: Approval of a budget for 2011 consistent with a fiscal deficit of 3.5 percent of GDP was added as a new structural benchmark (SB). The timetable for tax administration improvements regarding coordination between the internal revenue service (DGII) and customs office (DGA) was updated. Approval of the financial supervision and regulation law (originally expected for July 2010) is now expected by end-2010 and included as an SB for the second review. Congressional approval of the investment funds law (originally expected for October 2010) has also been pushed back to March 2011. The arrangement also includes two new SBs for the second review: undertaking a bank resolution simulation exercise, and issuing norms on corporate governance of commercial banks.

- **Consultation clauses**: The two consultation clauses under which the authorities commit to consult with Fund staff and reach understandings on corrective measures remain in force.[9]

28. **The authorities have made progress in addressing the recommendations of last year's safeguards assessment, but vulnerabilities remain**. The most recent safeguards assessment is to be completed in September 2010 and will note that the BCR has made progress in implementing the recommendations of the 2009 assessment in the areas of internal control and legal structure. The authorities have incorporated the recommendations of the 2009 assessment on the legal framework in the financial supervision and regulation law awaiting congressional approval. The principal risk is in the area of financial reporting, where the assessment recommends the adoption of an international financial reporting framework. The assessment also recommends publishing the opinions of external auditors and creating a framework to monitor the implementation of audit recommendations.

V. Staff Appraisal

29. **A modest economic recovery is underway**. Inflation remains contained, the external current account is widening as envisaged, and fiscal consolidation is proceeding appropriately. The precautionary SBA with the Fund has helped bolster investor confidence and financial stability, and performance under the program has been good. All quantitative performance criteria for the first review were met, and progress is being made, albeit more slowly than originally envisaged, on the structural front.

[9] The clauses cover a fall of 10 percent or more in private-sector deposits and banks' short-term external obligations (from their end-June 2010 level) and any system-wide change in commercial bank reserve or liquid asset requirements.

30. **The key medium-term challenge faced by the authorities is to improve the economy's growth prospects**. Poverty remains high, and growth is relatively low, even by regional standards. Improving the investment climate through a continued commitment to macroeconomic and financial stability and the allocation of government spending to more productive areas would be key. Staff welcome the authorities' immediate efforts to mitigate the impact of rising poverty, and their commitment to strengthen financial sector oversight; ensure fiscal sustainability; boost spending on education, security, and infrastructure; and improve the climate for business start-ups.

31. **The authorities' fiscal strategy of gradual fiscal consolidation remains appropriate, but downside risks are not negligible**. The small deficit reduction envisaged for 2010 and 2011 is consistent with the gradual economic recovery currently anticipated. Together with the tax package approved in late 2009 and envisaged improvements in tax administration, the modest recovery should increase tax revenues to the levels implied by the deficit target. The planned reform of energy subsidies should provide the space to increase spending on infrastructure, security, and social programs, including education. Staff welcomed the authorities' intentions to boost investment spending, which has lagged in 2010 and would support medium-term growth prospects.

32. **Sustainability of the public finances over the medium term will require a significant increase in revenue**. Staff continue to support the authorities' strategy to seek a national consensus on a fiscal pact that is to be implemented no later than 2012 and would include a tax reform aimed at increasing tax revenue by at least 1½ percent of GDP. Such a reform would provide a sustainable resource base to finance needed social, security, and infrastructure spending, while ensuring that fiscal deficits decline and the public debt-to-GDP ratio is put on a durable downward path. Accelerating the implementation timetable of the fiscal pact (or the revenue elements thereof) would speed up fiscal consolidation and allow greater expenditure on priority areas in the near term.

33. **Fiscal performance would be enhanced by actions to improve public expenditure and debt management**. Staff welcome the authorities' efforts to address shortcomings in the budgetary process and to bolster public debt management. Staff would urge the authorities to avoid delays in moving forward on their plans to roll over the Eurobond coming due next year.

34. **Dollarization continues to be a cornerstone of macroeconomic and financial stability**. In the almost ten years since El Salvador adopted the U.S. dollar, interest rates have been lower than under the previous regime as exchange rate risk has disappeared, inflation has remained low, and the real exchange rate has remained broadly in line with fundamentals. Moreover, despite frequent and sizable supply-side shocks, the economy´s reaction to shocks has not been significantly different when compared to the previous fixed exchange rate regime. Nonetheless, while banks in El Salvador have liquid asset holdings roughly comparable to the other fully-dollarized economies in Latin America and are solidly placed to withstand moderate shocks, staff would urge the authorities to move expeditiously in improving systemic liquidity management and strengthen their lender-of-last resort capabilities.

35. **Close monitoring of the financial system remains a high priority**. Staff is encouraged by the recent FSSA findings regarding banks' resilience to macroeconomic shocks and the upgrading of supervisory practices. Staff welcomes the authorities' continued pursuit of congressional approval of the financial supervision and regulation law and their intention to continue to strengthen the regulatory framework by: (i) upgrading the bank resolution framework, including through a comprehensive bank resolution exercise; (ii) issuing norms to enhance supervision; and (iii) improving the legal framework of domestic capital markets. Staff caution the authorities to maintain strict oversight of financial markets through the merger of the superintendencies of banks, pensions and securities. Staff also recommend the prompt adoption of measures to ensure that the revamped public sector banks channel credit to the private sector in a transparent manner and without adding to fiscal risks.

36. **A protracted recession or unexpected difficulties in forging a political consensus for the government's fiscal strategy remain the key risks of the program**. Risks to the growth projections are somewhat mitigated by the conservative path for economic recovery that underpins the authorities' program. Faltering political support could endanger the authorities' fiscal strategy by delaying the approval of IFI loans or blocking a consensus-based fiscal pact. So far, though, the administration has been able to move its agenda forward, and its social and economic program is beginning to yield results.

37. **Staff recommend the completion of the first review under the SBA**. Performance under the program has been good, and the authorities' policies appear adequate to meet the targets under the program, support the recovery of the economy, and maintain external stability.

38. **It is proposed that the next Article IV consultation with El Salvador be held in accordance with the July 15, 2002 decision on consultation cycles**.

Box 1. Past Fund Policy Recommendations and Implementation

The previous Article IV consultation with El Salvador (IMF Country Report 09/35) was concluded in the early days of the global financial crisis and highlighted the need to focus on crisis preparedness and structural reforms. At that time, staff recommended a fiscal consolidation strategy to continue lowering the public debt-to-GDP ratio to 30 percent. The onset of the global crisis drastically changed the outlook for El Salvador's economy, and the authorities requested Fund assistance in the form of a precautionary SBA that was approved by the Board on January 16, 2009. Some of the specific recommendations made during the 2008 Article IV consultation were:

- **Financial contingency measures**. Monitor banks' liquidity and their short-term borrowing closely, draw up concrete action plans to deal with stress in the banking system, and negotiate contingent credit lines. *Response: In the context of the precautionary SBA approved by the Fund ahead of the 2009 presidential elections, the authorities secured commitments from the IDB to support the financial sector in the event of adverse shocks. In addition, the government that took office in July 2009 requested a financial system stability assessment (FSSA), which has been completed, and the authorities are developing a strategy to address liquidity-related issues and other recommendations made by the FSSA.*

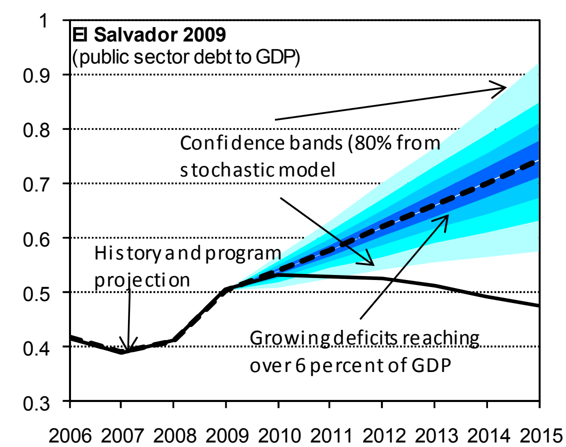
- **Short-term fiscal policy**. Maintain fiscal restraint and seek a political agreement to access long-term financing from IFIs. *Response: The authorities decided to accommodate the cyclical decline in revenues associated with the global downturn, but exercised commendable expenditure restraint during 2009, and redirected spending toward social sectors.*

Structural reforms. Strengthen financial sector regulation and supervision and the sector's ability to confront shocks; improve the efficiency and targeting of subsidies; and implement a parametric reform of the pension system. *Response: Limited progress has been achieved on these fronts. The authorities have submitted financial supervision and regulation legislation to Congress (to consolidate regulation of the financial sector), but Congress has yet to approve the law. In 2009, the authorities were able to eliminate electricity subsidies to corporations, reduce the transport subsidy by 40 percent, and lower water subsidies; further reforms to liquefied gas (LPG) and electricity subsidies are planned for late 2010. The authorities are strengthening tax administration, despite delays in enhancing coordination between the internal revenue service and customs. The authorities recognize the need for pension system reform, but see this as a longer-term concern, while their immediate policy focus has been to protect the economic recovery and lay the basis for fiscal sustainability.*

Box 2. Public Debt Dynamics and Medium-Term Targets

This box presents two exercises related to El Salvador's public debt. First a stochastic debt sustainability analysis (DSA) suggests that subpar economic growth or interruptions to fiscal consolidation would place the public debt on an unsustainable path and pose significant risks to the government's strategy. Second, two approaches to calculate sustainable debt levels shed light on the appropriate medium-term target.

A stochastic DSA suggests that placing El Salvador's public debt on a downward path would require durable fiscal consolidation (compared with the evidence from cross-country historical experience) and is very sensitive to adverse shocks to growth and interest rates. Drawing on Celasun, Debrun, and Ostry (2007), alternative debt paths for El Salvador were obtained based on stochastic projections for key variables—GDP growth, interest rates, and the real effective exchange rate (Figure 6).[1] The results, which are highly dependent on the historical data and relations used, including the relatively passive average policy response to shocks, highlight the sensitivity of El Salvador's debt dynamics to lower-than-projected output and interest rates, with debt levels as high as 75 percent of GDP lying within the 80 percent confidence interval.



The results from the exercise underscore the importance of adhering to the key fiscal commitments under the program, namely firm expenditure restraint and subsidy reform and, starting in 2012, a major tax reform to strengthen the underlying fiscal position. They also point to the need for designing contingency measures in order to contain any deterioration of the fiscal balance should risks materialize.

The optimal debt literature suggests that El Salvador's current level of public debt, at over 50 percent of GDP, is high. Following the "debt intolerance" literature, annual data for 1989–2009 for a sample of middle-income countries was used to calculate public debt levels that would allow El Salvador to improve its creditworthiness and belong to a "debt club" with easier access to market financing (as provided by International Investor Rating). [2] The exercise yields a target debt for El Salvador of 25 percent of GDP. A second approach takes as a starting point a notional maximum debt-to-GDP ratio of 50 percent (the level used as a reference point in the discussions of macroeconomic convergence in the Central American Monetary Council). Subtracting from this level the space that would be needed to absorb contingent liabilities from natural disasters (averaging costs of 3 percent of GDP in El Salvador) and/or financial crises (averaging 12 percent of GDP in the region) yields a debt level for El Salvador of about 35 percent of GDP.

[1] O. Celasun, X. Debrun, and J.D. Ostry (2007), "Primary Surplus Behavior and Risks to Fiscal Sustainability in Emerging Market Countries: A Fan Chart Approach," IMF Staff papers, Vol. 53 (3). The stochastic projections were derived from an unrestricted VAR model, with shocks around the deterministic projection calibrated to match the historical properties of the data. The stochastic projections were then combined with an estimated fiscal policy reaction function to produce 1,000 public debt paths and obtain a "fan chart" for the debt projection.

[2] C. Reinhart, K. Rogoff, and M. Savastano (2003), "Debt Intolerance", Brookings Papers on Economic Activity, No. 1.

Box 3. El Salvador's Economic Performance Under Dollarization

El Salvador's economic performance since the adoption of the U.S. dollar as legal tender has been on many key dimensions not functionally different from its performance under the previous exchange rate regime (a peg to the U.S. dollar). Under dollarization, nominal and real interest rates have been lower, while the costs associated with the lack of independent monetary policy have been mitigated by the economic cycle's close correlation with that of the United States.

There has been no structural change in the economy's response to shocks under dollarization. Using a two-variable (output and inflation) structural VAR model to identify supply and demand shocks, staff estimate that responses to shocks did not change after the adoption of official dollarization in 2001. Under dollarization, the response of inflation to supply shocks has been smaller, but slightly more persistent than under the peg, while the response of output to those shocks under the two regimes has been similar. At the same time, inflation has been less sensitive to demand shocks under dollarization than under the peg, while the opposite has happened with output.

The reduction in exchange rate risk brought about by official dollarization has been beneficial. Staff estimate that adopting the dollar has reduced the exchange rate risk component of commercial bank interest rates by 500 basis points, generating average annual net interest savings to the Salvadoran private sector of about ½ percent of GDP since 2001, and annual savings of about ¼ percent of GDP for the public sector (with interest cost savings of around ½ percent of GDP outweighing the loss of potential seigniorage). These results follow from applying an estimate of the exchange rate risk premium implicit in interest rates under the pegged system (some 4 and 5 percentage points for loans and deposits, respectively), projecting them over the dollarization period, and applying the results to the stocks of credit and deposits.

U.S. monetary policy during official dollarization seems to have had better stabilizing properties on El Salvador's output than did domestic monetary policy under the peg. Staff estimated the output stabilization properties of monetary policy under alternative regimes using simple Taylor rules. During the 1990s, domestic monetary policy tightened in response to higher inflation, and tended to ease when output growth was rising, increasing output volatility. Under official dollarization, changes in the U.S. monetary policy rate have helped reduce the volatility of domestic output.

Using standard pass-through analysis, the transmission of monetary policy rates to commercial bank lending and deposit rates has not been significantly different in the two regimes. The pass-through of interest rates in El Salvador has been similar to Panama's. At the same time, market views of fiscal sustainability (proxied by El Salvador's EMBI spread) and indicators of banking system health have been important factors behind the gap between Salvadoran and U.S. commercial bank interest rates.

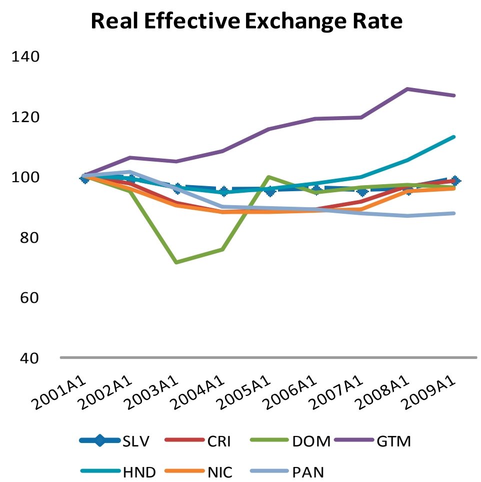
Box 4. Key Recommendations of the FSSA

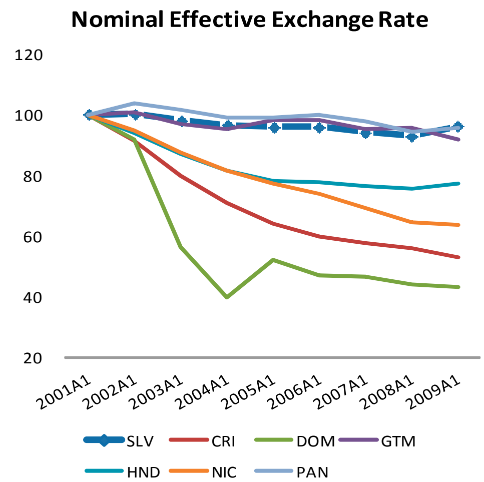
The 2010 FSSA found that El Salvador's financial system had withstood the global financial crisis , and was well-capitalized and liquid. The FSSA report identified several vulnerabilities and areas for further reforms, making the following key recommendations:

- **Financial supervision and regulation law (structural benchmark, SB, for the second review)**. The FSSA supported the draft law currently before Congress, but acknowledged that the merger of three superintendencies and transfer of regulatory authority to the central bank would bring about challenges. At the same time, it noted that the law should provide an explicit mandate for financial stability; broaden and clarify the powers and improve the governance and independence of the Financial System Superintendency (SSF); and increase accountability. The FSSA also proposed addressing some gaps in the current draft legislation, including on strengthening the legal protection for supervisors and augmenting the remedial action powers of the SSF in the early preventive stages..
- **Comprehensive liquidity and banking crisis resolution arrangements**. The FSSA noted the constraints posed by official dollarization and urged the authorities to develop a comprehensive policy to provide liquidity support to the financial system in situations of stress. A key pillar of this policy would be the formation of a comprehensive liquidity policy which could include a fund that pools liquid resources from banks (similar to the one in Ecuador). The FSSA also recommended easing some legal restrictions on the central bank to channel its own reserves or borrowed funds to banks and noted that coordination among safety net providers should be strengthened by developing mutually-agreed strategies on financial stability and banking crisis resolution.
- **Investment Funds Law (SB for the third review)**. The FSSA encouraged the approval of the draft law, welcoming its potential to broaden the investor base and help develop domestic capital markets.
- **Norms on key financial sector risks**. Noting that the SSF had initiated an ambitious project to move toward risk-based supervision, the FSSA observed that regulation in several areas was lacking, including on corporate governance, credit risk, liquidity risk, market risk, and operational risk. Draft regulations in several areas were well-advanced, and the FSSA recommended their prompt implementation.
- **Enhancements to bank resolution and deposit insurance**. The FSSA recommended reforms to bring bank resolution practices and the deposit insurance scheme in line with international best practices, including: increasing the target level and sources of funding for the deposit insurance fund, eliminating the requirement to notify a bank three days prior to the suspension of operations, setting the least-cost criterion as the measure of the maximum deposit insurance support, and allowing the removal of a bank's board upon commencement of judicial intervention. These recommendations are being considered by the authorities.

Box 5. Exchange Rate Assessment

El Salvador's real effective exchange rate (REER) has remained relatively stable during the last decade, reflecting the absence of a domestic currency beginning in 2001 and relatively low and stable rates of inflation.





CGER-based assessment. An assessment of El Salvador's exchange rate based on the three CGER methodologies suggests that (as of end-2009) there is no evidence of misalignment.[1] Two approaches under CGER, the Macroeconomic Balance and the External Sustainability methodologies, suggest a small undervaluation, while the Equilibrium Real Exchange Rate methodology suggests an overvaluation of about 6-7 percent.

	Macroeconomic balance	Equilibrium real exchange rate	External sustainability
CA norm	-3.2%		-2.9%
CA projection (1)	-2.9%		-2.9%
CA gap	-0.3%		0.0%
Elasticity	-12.8%		-12.8%
RER gap (2)	-2.7%	6.7%	-0.3%

(1) Based on a projected CA deficit of 3.5% in 2015, adjusted for forecast change in the REER

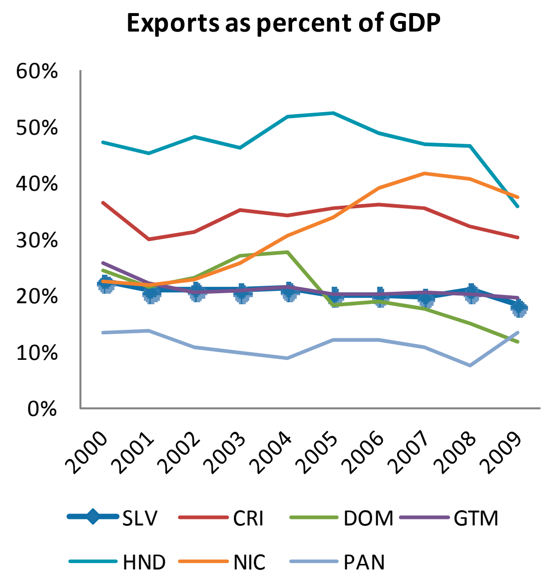
(2) Depreciation (+ = appreciation) needed to close the gap between the CA norm and CA projection

Impact of remittances. Given large remittance inflows to El Salvador, it may be necessary to adjust the CGER methodology to account explicitly for the influence of remittances on household consumption. If in equilibrium, spending on imports moves in tandem with remittances, the current account norm would be unaffected by remittance flows. However, if households decide to save the entire remittance inflow, the current account norm would be impacted one-for-one by remittance flows, thereby lowering the calculated current account norm deficit.

[1/] Analysis applies regression estimates provided in IMF Occasional Paper 261.

Box 6. Competitiveness in El Salvador

Export performance. Despite far-reaching reforms to the trade and investment regimes, exports in El Salvador remained stable at about 21 percent of GDP, from 2001–2009, some 5–9 percentage points of GDP below the average of its regional peers. Trends in exports have persisted despite their changing composition and varying degrees of export concentration.



Investment levels. Investment rates, domestic and foreign, have remained low despite far-reaching reforms. These low investment rates have contributed to lagging competitiveness and low overall rates of economic growth. Domestic investment, averaging around 17 percent of GDP over the past 20 years, is below the Latin American average of 20 percent of GDP and Central American average of 21 percent of GDP.

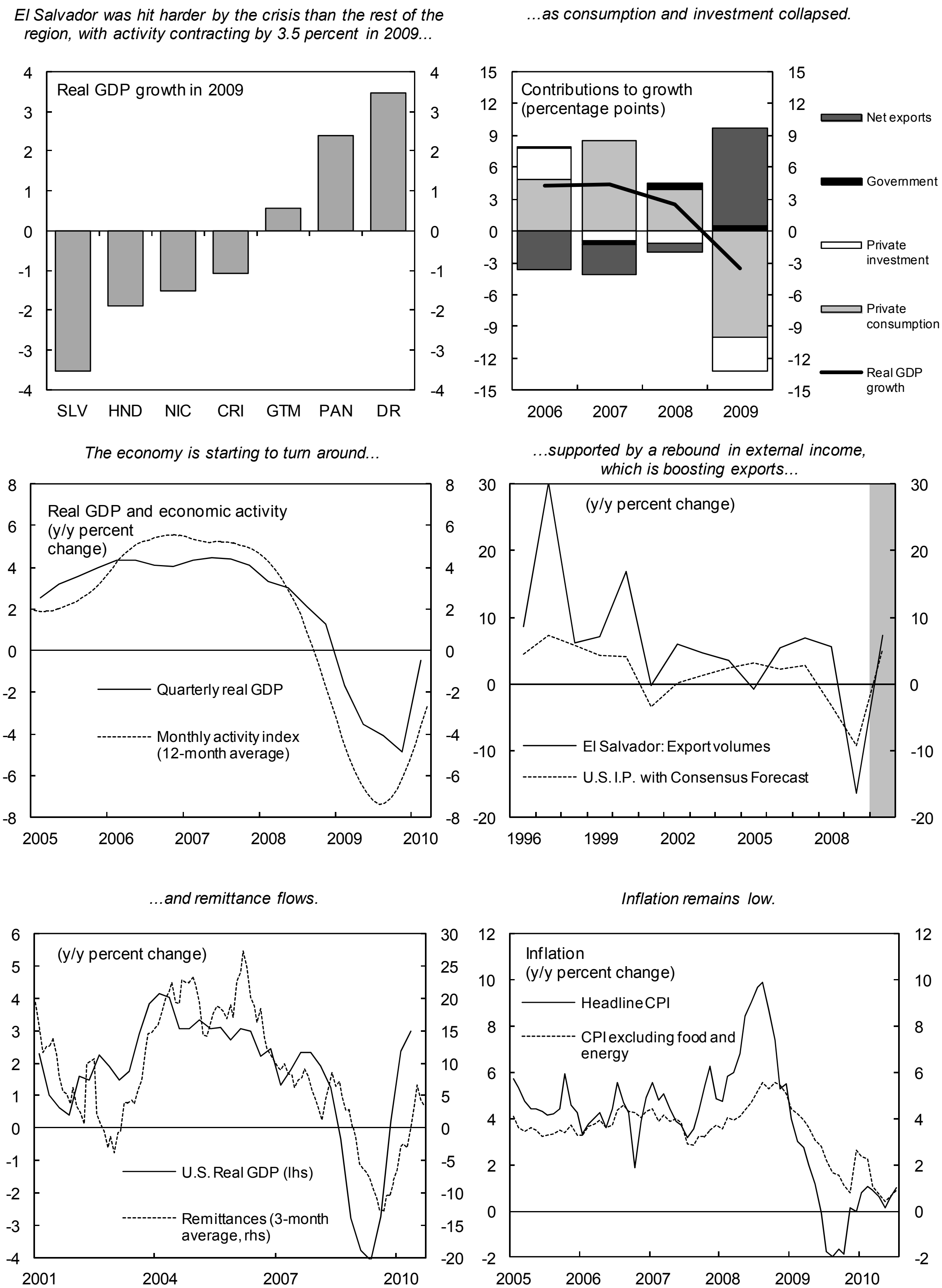
Investment climate. Investment remains low even though several indicators of El Salvador's investment climate, including the World Bank's Doing Business Indicators and the World Economic Forum's Global Competitiveness Indicators (GCI), compare favorably with El Salvador's regional peers. At the same time, component rankings reveal some relative weaknesses, including in the area of security. El Salvador also ranks in the bottom half for innovation, and below Costa Rica, Panama and the Dominican Republic for higher education. These component rankings are consistent with firm-level data collected by the World Bank that highlight specific areas that individual firms deemed to be problematic. Crime and workforce education are two such key areas. Improving the investment climate will require a strategy to overcome the shortcomings in these areas.

Country rankings	GCI 2009–2010	"Doing Business" 2010
Costa Rica	55	122
Panama	59	78
El Salvador	**77**	**85**
Guatemala	80	111
Honduras	89	142
Dominican Republic	95	87
Nicaragua	115	118

Selected component scores	El Salvador	Regional average
Security	3.28	4.04
Primary education	3.94	4.09
Higher education/training	3.48	3.58
Innovation	3.36	3.51

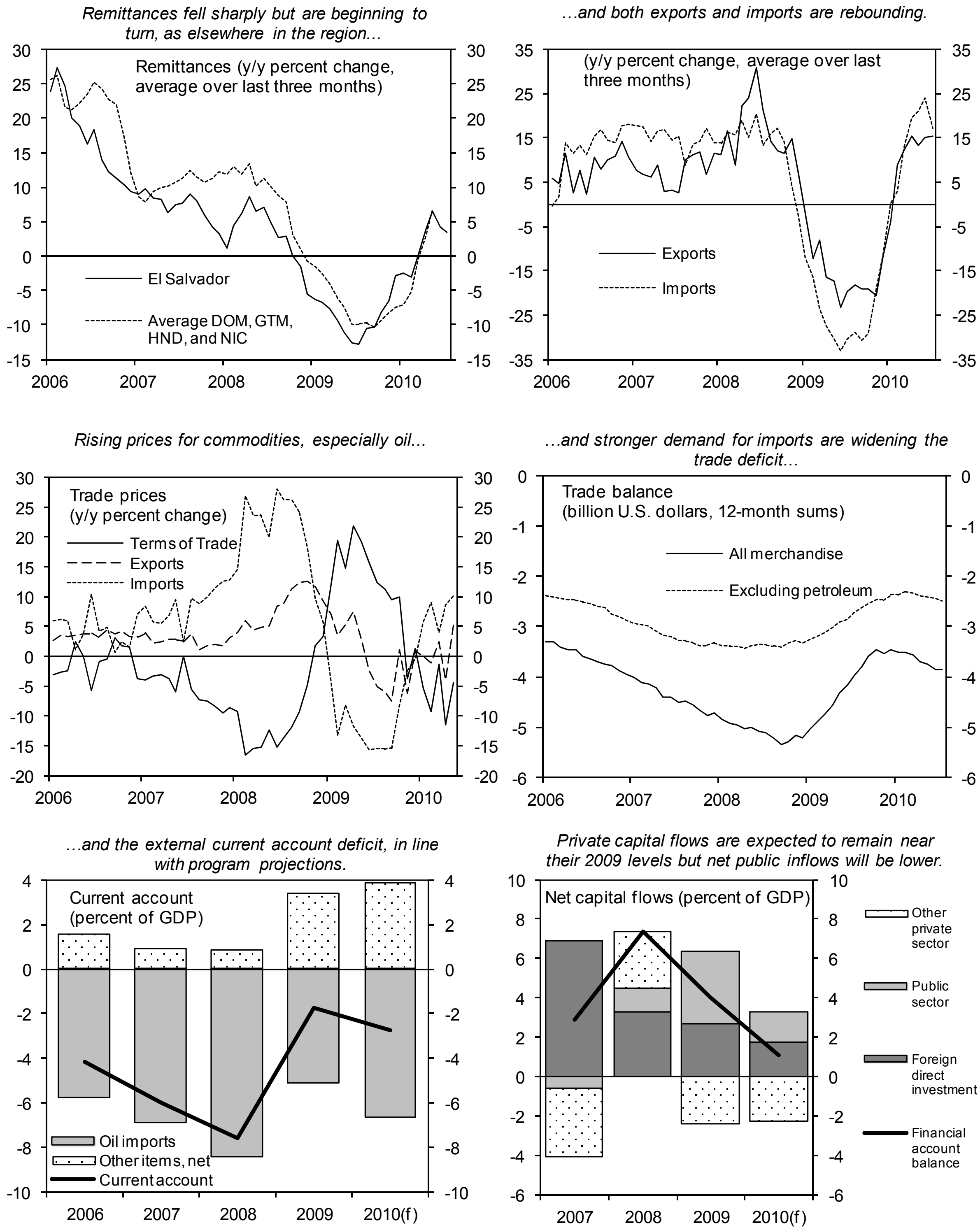
GCI rank out of 133 countries; Doing Business rank out of 183 economies
Selected components, GCI (higher score = stronger performance)

Figure 1. El Salvador: Economic Activity and Inflation



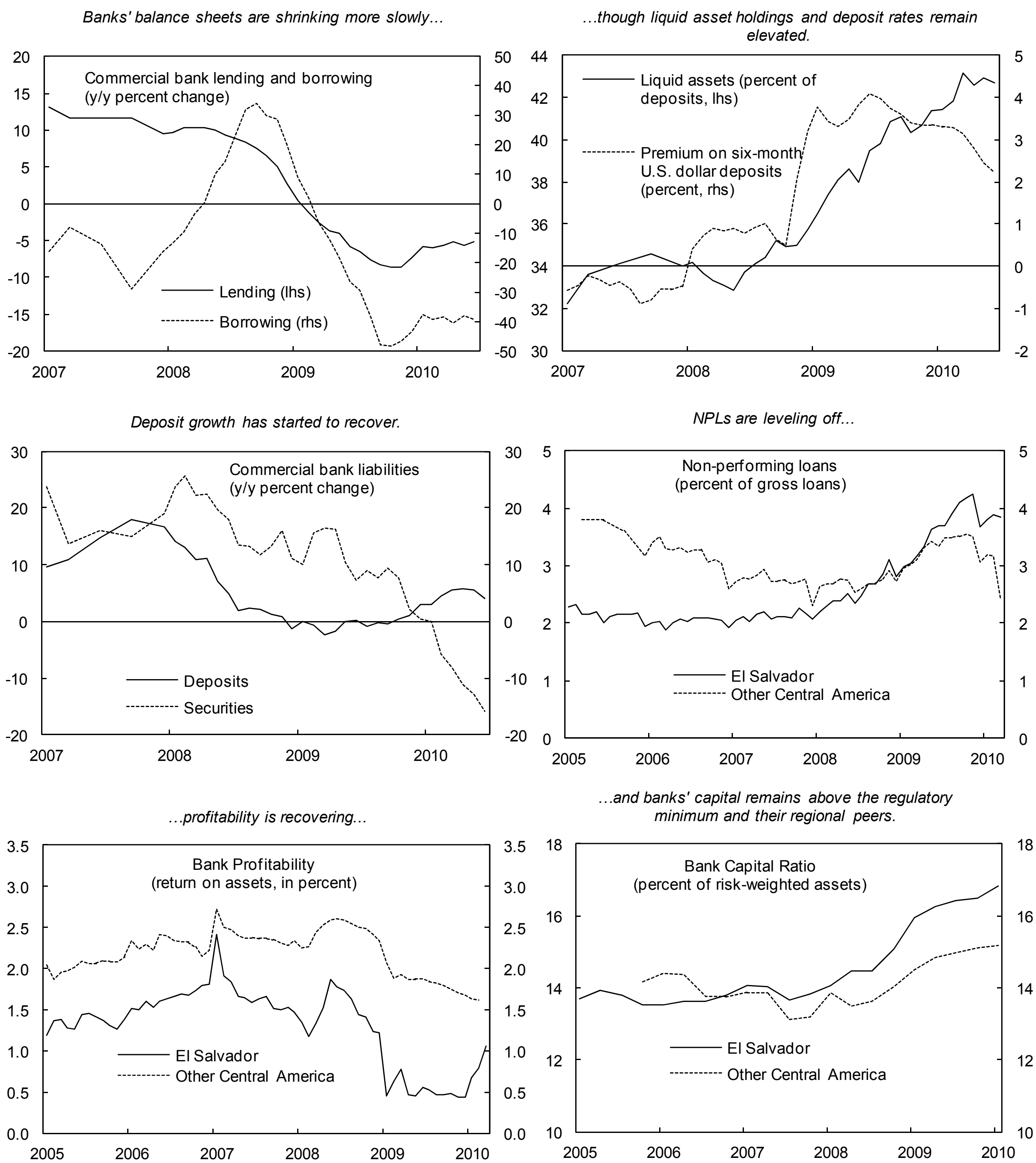
Sources: Central Reserve Bank of El Salvador; Haver Analytics; and Fund staff calculations.

Figure 2. El Salvador: Balance of Payments Developments



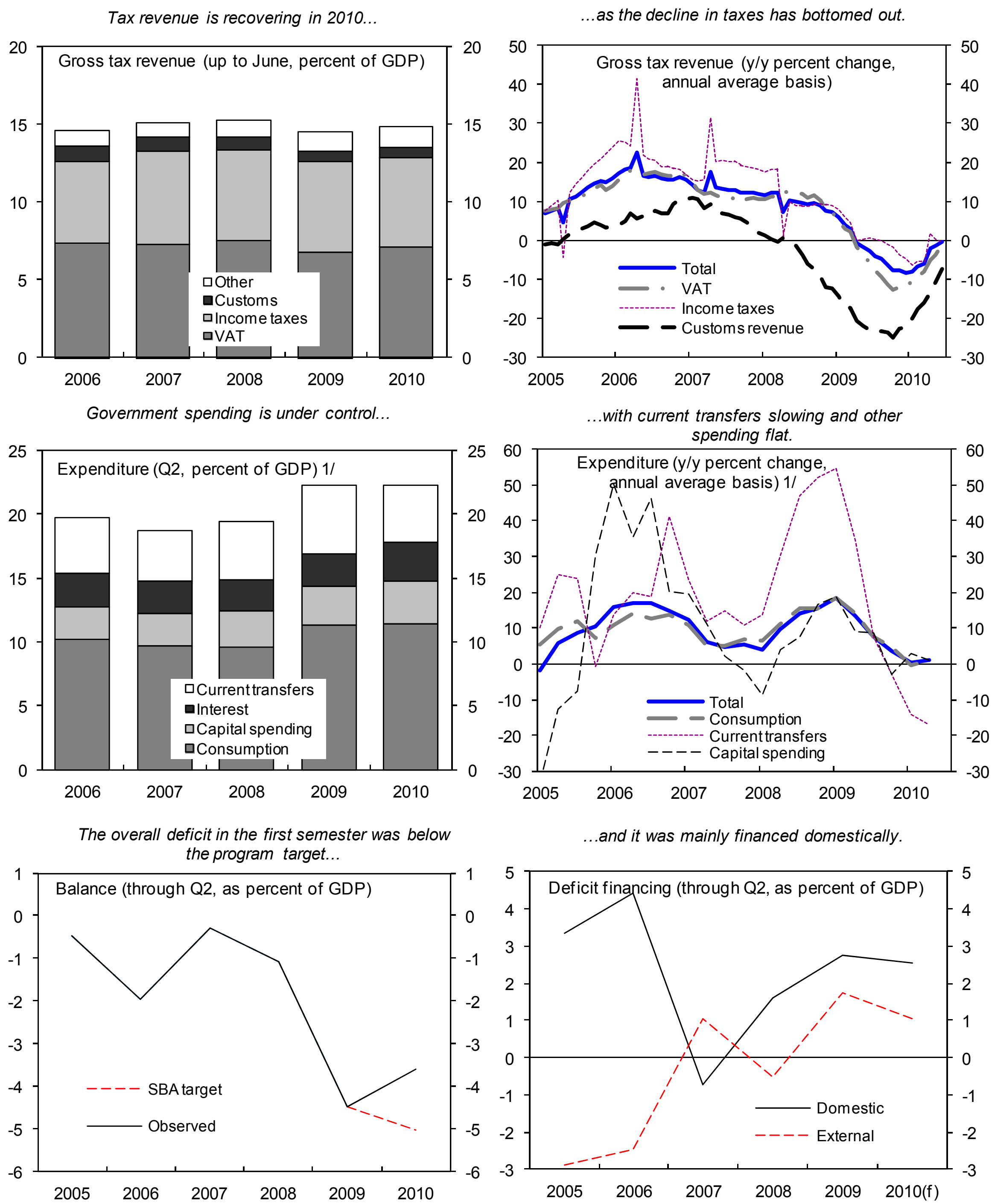
Sources: Central Reserve Bank of El Salvador; Haver Analytics; National sources; and Fund staff calculations.

Figure 3. El Salvador: Financial Sector Developments



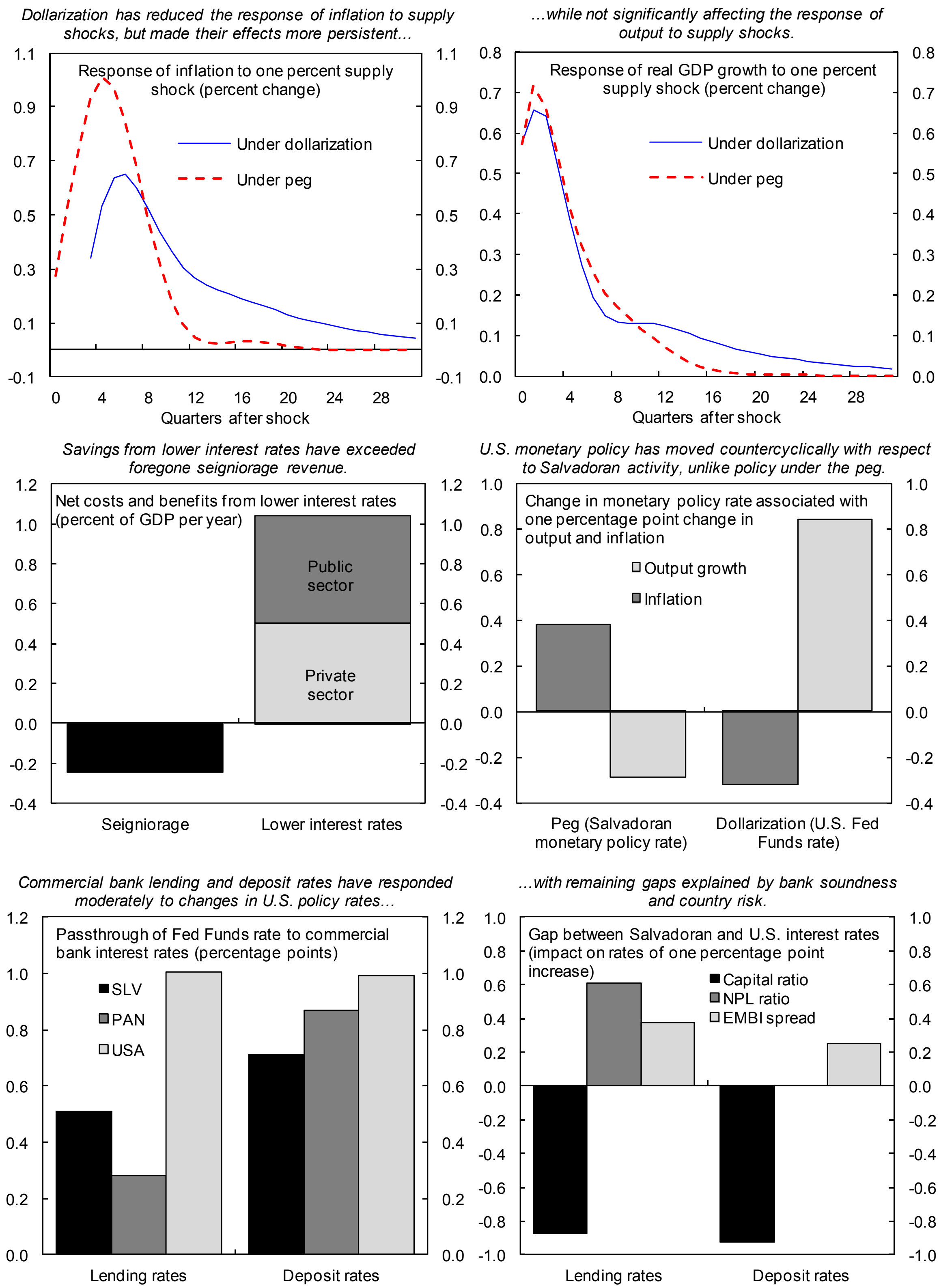
Sources: Financial System Superintendency; Central Reserve Bank of El Salvador; Haver Analytics; and Fund staff calculations.

Figure 4. El Salvador: Fiscal Developments



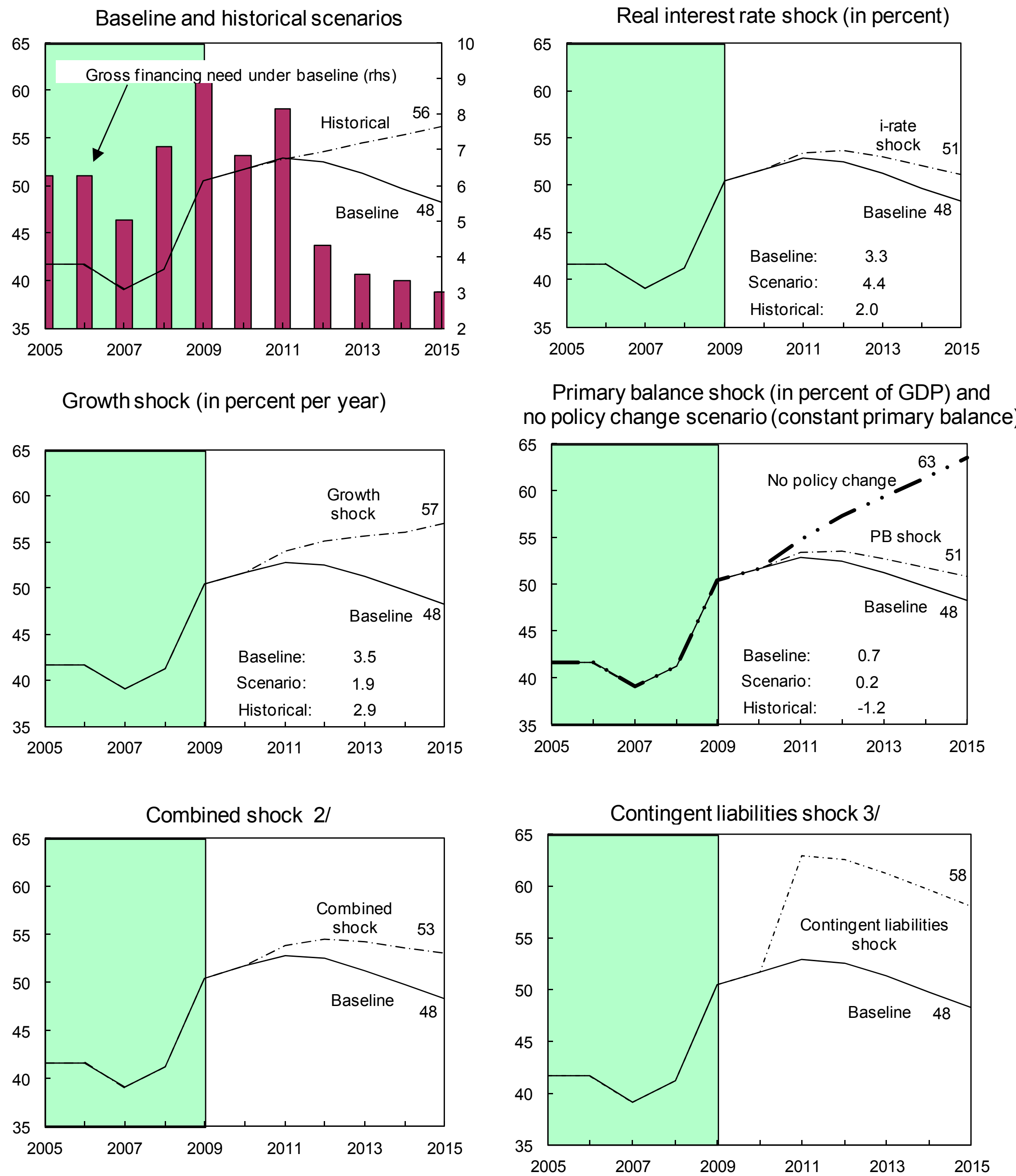
Sources: Ministry of Finance; and Fund staff calculations.
1/ Includes VAT refunds and income tax refunds in current transfers.

Figure 5. El Salvador: Economic Performance Under Dollarization



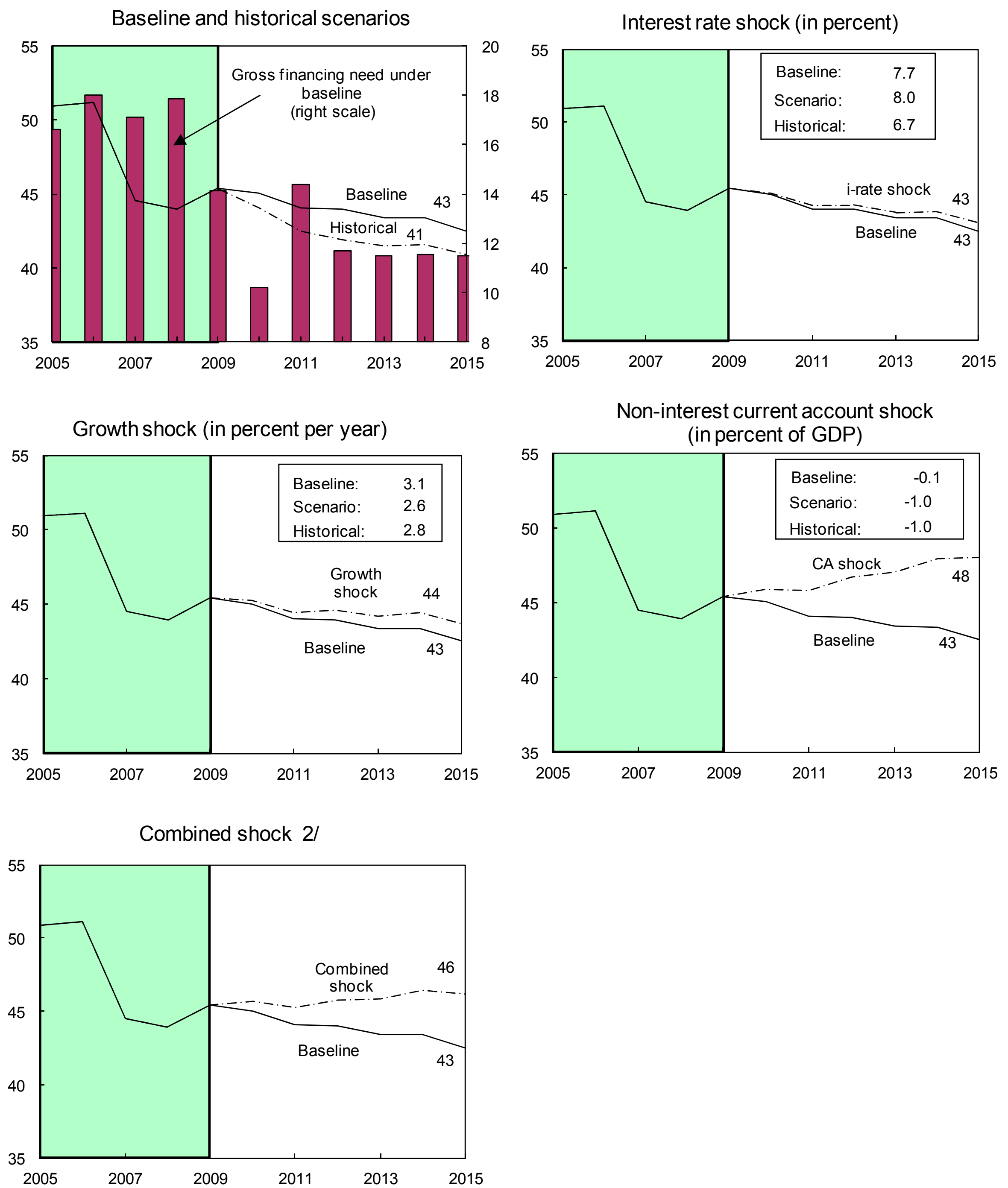
Source: Fund staff calculations.

Figure 6. El Salvador: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and Fund staff estimates.
1/ Shaded areas represent actual or estimated data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ Ten percent of GDP shock to contingent liabilities occurs in 2011.

Figure 7. El Salvador: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and Fund staff estimates.
1/ Shaded areas represent actual or estimated data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Table 1. El Salvador: Selected Economic Indicators

	2007	2008	2009	2010		2011	
				SBA 1/	Projection	SBA 1/	Projection
	(Period average; annual percent change, unless otherwise stated)						
Income and Prices							
Real GDP	4.3	2.4	-3.5	1.0	1.0	2.5	2.5
Consumer prices (end of period)	4.9	5.5	0.0	1.5	1.5	2.8	2.8
GDP deflator	4.2	5.9	-1.0	2.3	2.3	2.5	2.7
External Sector							
Exports of goods and services, volume	6.9	5.5	-16.4	2.5	7.2	3.9	6.2
Imports of goods and services, volume	8.4	4.7	-23.3	5.8	8.9	4.5	6.6
Terms of trade	-5.7	-10.2	11.8	-3.5	-2.1	-1.2	1.1
Real effective exchange rate (+ is appreciation)	-0.5	0.5	1.6	…	…	…	…
External sovereign bond (spread, basis points)	163	388	378	…	...	…	...
	(Percent of GDP, unless otherwise stated)						
Money and Credit							
Credit to the private sector	42.8	41.3	41.3	41.5	39.6	42.7	39.6
Broad money	47.1	43.9	47.0	46.9	46.4	47.0	46.2
Interest rate (time deposits, percent)	4.7	4.2	4.5	…	…	…	…
External Sector							
Current account balance	-6.0	-7.6	-1.8	-2.7	-2.8	-2.8	-3.1
Trade balance	-20.1	-19.9	-13.5	-14.7	-15.1	-15.0	-15.5
Exports (f.o.b. including *maquila*)	19.8	20.9	18.3	18.2	19.6	18.6	20.5
Imports (f.o.b. including *maquila*)	-40.0	-40.7	-31.8	-32.9	-34.7	-33.6	-36.1
Services and income (net)	-4.3	-5.1	-5.2	-5.1	-5.1	-5.1	-5.4
Transfers (net)	18.4	17.3	16.9	17.1	17.5	17.3	17.8
Foreign direct investment	6.9	3.3	2.7	0.9	1.7	1.1	1.8
Nonfinancial Public Sector							
Overall balance	-1.9	-3.1	-5.6	-4.7	-4.8	-3.5	-3.5
Primary balance	0.5	-0.7	-3.0	-1.7	-2.4	-0.5	-0.4
Of which: tax revenue	13.4	13.1	12.4	13.2	13.2	13.9	13.9
Gross Public Debt 2/	39.1	41.2	49.5	52.2	51.2	51.9	52.1
Of which: external public debt 2/	24.3	23.8	26.3	30.5	27.0	29.7	27.7
Gross Nonfinancial Public Sector Debt	38.8	39.7	48.5	51.0	50.0	50.8	51.0
External public debt service 2/							
(percent of exports of goods and services)	12.3	9.6	11.7	12.0	11.0	24.5	21.9
National Savings and Investment							
Gross domestic investment	15.9	14.9	13.1	13.6	12.8	13.6	13.3
Public sector	2.1	2.4	2.5	2.7	2.5	2.7	2.9
Private sector	13.8	12.5	10.6	10.8	10.2	11.0	10.4
Gross domestic saving	9.9	7.3	11.3	10.9	10.0	10.8	10.2
Public sector	0.5	-0.3	-3.0	-1.9	-2.2	-1.0	-0.8
Private sector	9.4	7.6	14.4	12.8	12.2	11.8	11.0
Net Foreign Assets of the Financial System							
Millions of U.S. dollars	2,134	2,035	2,857	3,044	2,846	2,673	2,787
Percent of deposits	22.5	21.7	28.7	29.6	29.0	25.6	27.2
Memorandum Items:							
Net *maquila* exports	2.8	2.9	3.1	3.0	2.8	3.0	2.8
Nominal GDP (billions of U.S. dollars)	20.4	22.1	21.1	22.3	21.8	23.4	23.0

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

1/ IMF Country Report No. 10/82.

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

Table 2. El Salvador: Balance of Payments

(In US$ millions)

	2006	2007	2008	2009	Projections 2010	2011	2012	2013	2014	2015
Current Account	**-783**	**-1,221**	**-1,682**	**-373**	**-605**	**-715**	**-785**	**-836**	**-931**	**-988**
Merchandise trade balance	-3,533	-4,105	-4,394	-2,845	-3,292	-3,566	-3,744	-3,989	-4,285	-4,558
Export of goods (f.o.b.)	3,759	4,039	4,611	3,861	4,269	4,710	5,082	5,485	5,916	6,402
General merchandise	1,983	2,235	2,683	2,373	2,698	3,046	3,328	3,647	3,992	4,388
Goods for processing	1,775	1,804	1,928	1,488	1,571	1,665	1,753	1,838	1,924	2,014
Import of goods (f.o.b.)	-7,291	-8,144	-9,004	-6,706	-7,561	-8,276	-8,826	-9,474	-10,200	-10,961
General merchandise	-6,148	-6,907	-7,723	-5,867	-6,600	-7,244	-7,738	-8,334	-9,007	-9,712
Goods for processing	-1,143	-1,237	-1,282	-839	-961	-1,032	-1,087	-1,139	-1,193	-1,249
Services	-192	-291	-584	-425	-501	-550	-577	-616	-649	-683
Income	-531	-576	-536	-664	-621	-695	-780	-836	-924	-1,017
Of which: interest on public debt	-342	-315	-245	-257	-274	-304	-348	-368	-391	-429
Current transfers	3,472	3,750	3,832	3,561	3,809	4,096	4,315	4,605	4,926	5,270
Financial and Capital Account	**1,151**	**732**	**1,714**	**975**	**415**	**796**	**989**	**1,075**	**1,316**	**1,231**
Capital account	97	151	80	130	182	171	101	96	95	95
Public sector financial flows	497	-115	277	785	343	471	269	239	524	286
Of which: disbursements	901	205	577	1,076	638	1,400	547	488	791	578
Of which: amortization	-404	-320	-300	-291	-295	-929	-278	-249	-267	-292
Private sector financial flows	557	697	1,357	60	-110	154	619	739	697	850
Foreign direct investment	267	1,408	719	562	378	402	462	526	595	667
Portfolio investment	777	-196	138	781	-183	10	48	64	69	75
Other	-488	-515	500	-1,284	-305	-258	109	149	33	108
Errors and Omissions	**-311**	**821**	**302**	**-173**	**0**	**0**	**0**	**0**	**0**	**0**
Change in Reserves (- = increase)	**-72**	**-280**	**-334**	**-429**	**190**	**-82**	**-204**	**-238**	**-385**	**-243**
					(In percent of GDP)					
Current Account	**-4.2**	**-6.0**	**-7.6**	**-1.8**	**-2.8**	**-3.1**	**-3.2**	**-3.2**	**-3.3**	**-3.3**
Merchandise trade balance	-18.8	-20.1	-19.9	-13.5	-15.1	-15.5	-15.4	-15.4	-15.4	-15.3
Export of goods (f.o.b.)	20.0	19.8	20.9	18.3	19.6	20.5	20.9	21.1	21.3	21.5
Net maquila exports	3.4	2.8	2.9	3.1	2.8	2.8	2.7	2.7	2.6	2.6
Import of goods (f.o.b.)	-38.9	-40.0	-40.7	-31.8	-34.7	-36.1	-36.3	-36.5	-36.7	-36.9
Petroleum and products	-5.8	-6.9	-8.4	-5.1	-6.7	-7.2	-7.2	-7.0	-6.8	-6.6
Services	-1.0	-1.4	-2.6	-2.0	-2.3	-2.4	-2.4	-2.4	-2.3	-2.3
Income	-2.8	-2.8	-2.4	-3.1	-2.8	-3.0	-3.2	-3.2	-3.3	-3.4
Current transfers	18.5	18.4	17.3	16.9	17.5	17.8	17.8	17.7	17.7	17.7
Financial and Capital account	**6.1**	**3.6**	**7.8**	**4.6**	**1.9**	**3.5**	**4.1**	**4.1**	**4.7**	**4.1**
Capital account	0.5	0.7	0.4	0.6	0.8	0.7	0.4	0.4	0.3	0.3
Public sector financial flows	2.7	-0.6	1.3	3.7	1.6	2.1	1.1	0.9	1.9	1.0
Private sector financial flows	3.0	3.4	6.1	0.3	-0.5	0.7	2.5	2.8	2.5	2.9
Foreign direct investment	1.4	6.9	3.3	2.7	1.7	1.8	1.9	2.0	2.1	2.2
Portfolio investment	4.1	-1.0	0.6	3.7	-0.8	0.0	0.2	0.2	0.2	0.3
Other	-2.6	-2.5	2.3	-6.1	-1.4	-1.1	0.4	0.6	0.1	0.4
Merchandise Trade (f.o.b.)					(annual percent change)					
Exports (nominal)	9.1	7.5	14.1	-16.3	10.6	10.3	7.9	7.9	7.8	8.2
Volume	5.3	4.8	5.5	-16.2	8.6	7.9	5.8	6.1	6.1	6.2
Price	3.5	2.5	8.2	0.0	1.8	2.2	2.0	1.8	1.6	1.9
Imports (nominal)	14.2	11.7	10.6	-25.5	12.8	9.5	6.6	7.3	7.7	7.5
Volume	9.3	2.8	-8.2	-16.7	8.4	8.3	5.1	5.9	6.2	6.0
Price	4.5	8.6	20.4	-10.6	4.0	1.1	1.4	1.3	1.3	1.4
Terms of trade	-0.9	-5.7	-10.2	11.8	-2.1	1.1	0.5	0.4	0.3	0.5
Memorandum Items										
Gross international reserves (US$ million)	1,908	2,198	2,545	2,987	2,797	2,879	3,083	3,321	3,706	3,949
in months of imports (excluding maquila) 1/	2.7	2.8	4.3	4.5	3.8	3.7	3.7	3.7	3.8	3.8
in percent of total short-term external debt	150	171	166	256	234	234	237	242	252	257
External debt (in percent of GDP)	51.1	44.5	43.9	45.4	45.0	44.0	44.0	43.4	43.4	42.5
Of which: public sector debt	27.3	24.3	23.8	26.3	27.0	27.7	27.3	26.4	26.6	25.8
Of which: private sector debt	23.8	20.2	20.2	19.2	18.1	16.4	16.7	17.0	16.8	16.7
External public debt servicing (US$ million)	746	635	545	548	569	1,233	626	617	657	721
percent of exports of goods and services	15.6	12.3	9.6	11.7	11.0	21.9	10.3	9.4	9.4	9.5
Gross external financing requirement (US$ million)	3,376	3,487	3,945	2,984	2,226	3,251	2,800	2,954	3,320	3,378
percent of GDP	18.0	17.1	17.8	14.1	10.2	14.2	11.5	11.4	11.9	11.4

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

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

Table 3. El Salvador: Operations of the Nonfinancial Public Sector
(In US$ millions)

	2007	2008	2009	2010		2011	
				SBA 1/	Projection	SBA 1/	Projection
Revenue and Grants	**3,484**	**3,732**	**3,400**	**3,884**	**3,745**	**4,272**	**4,223**
Current revenue	3,422	3,679	3,291	3,702	3,621	4,059	4,008
Tax revenue	2,720	2,886	2,609	2,940	2,881	3,256	3,195
Nontax revenue	590	619	573	634	637	654	687
Operating surplus of the public enterprises	111	174	109	128	103	150	127
Capital revenue	0	0	0	0	0	0	0
Official grants	62	53	109	182	123	213	215
Expenditure	**3,880**	**4,415**	**4,571**	**4,931**	**4,789**	**5,091**	**5,017**
Current expenditure	3,312	3,754	3,929	4,123	4,107	4,284	4,194
Wages and salaries	1,409	1,528	1,659	1,769	1,767	1,825	1,819
Goods and services	728	823	874	959	887	979	899
Interest	507	520	531	661	521	712	692
Current transfers	667	884	865	735	931	768	784
Nonpension payments	348	563	519	374	580	383	398
Pension payments	319	321	346	361	350	386	386
Capital expenditure	568	661	642	808	683	807	823
Primary Balance	**111**	**-164**	**-640**	**-387**	**-524**	**-107**	**-102**
Overall Balance	**-396**	**-683**	**-1,171**	**-1,047**	**-1,045**	**-819**	**-794**
Financing	**396**	**683**	**1,171**	**1,047**	**1,045**	**819**	**794**
External	**-115**	**277**	**785**	**760**	**343**	**159**	**471**
Disbursements	205	577	1,076	1,036	638	1,086	1,400
Amortization	-320	-300	-291	-276	-295	-927	-929
Domestic	**511**	**407**	**386**	**288**	**702**	**660**	**323**
Central bank	146	26	-293	44	387	360	-1
Banking system	43	93	239	-43	24	-41	-16
Private sector 2/	335	357	401	286	291	341	340
Other	-13	-69	39	0	-5	0	0
Memorandum Items:							
Current balance	110	-75	-638	-421	-485	-225	-186
Pension balance	-304	-306	-333	-348	-338	-374	-374
Gross financing needs	1,027	1,567	1,962	1,474	1,489	1,896	1,873
Implicit nominal interest rate (in percent)	6.5	6.5	5.8	6.2	5.0	6.1	6.2
Gross Nonfinancial Public Sector Debt	7,905	8,779	10,244	11,246	10,901	11,706	11,696
Total public sector debt (gross) 3/	7,966	9,104	10,449	11,611	11,163	12,137	11,957
Total public sector debt (net) 3/ 4/	7,106	8,354	9,332	10,539	10,433	11,425	11,226
Nominal GDP	20,377	22,107	21,101	22,260	21,796	23,388	22,953

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

1/ IMF Country Report No. 10/82.
2/ Includes financing for education, health, and pension trust funds.
3/ Includes gross debt of the nonfinancial public sector and external debt of the central bank.
4/ Public sector gross debt less government deposits held at the central bank or commercial banks.

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

(In percent of GDP)

	2007	2008	2009	2010		2011	
				SBA 1/	Projection	SBA 1/	Projection
Revenue and Grants	**17.1**	**16.9**	**16.1**	**17.4**	**17.2**	**18.3**	**18.4**
Current revenue	16.8	16.6	15.6	16.6	16.6	17.4	17.5
Tax revenue	13.4	13.1	12.4	13.2	13.2	13.9	13.9
Nontax revenue	2.9	2.8	2.7	2.8	2.9	2.8	3.0
Of which: pension revenue	0.1	0.1	0.1	0.1	0.1	0.0	0.1
Operating surplus of the public enterprises	0.5	0.8	0.5	0.6	0.5	0.6	0.6
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Official grants	0.3	0.2	0.5	0.8	0.6	0.9	0.9
Expenditure	**19.0**	**20.0**	**21.7**	**22.2**	**22.0**	**21.8**	**21.9**
Current expenditure	16.3	17.0	18.6	18.5	18.8	18.3	18.3
Wages and salaries	6.9	6.9	7.9	7.9	8.1	7.8	7.9
Goods and services	3.6	3.7	4.1	4.3	4.1	4.2	3.9
Interest	2.5	2.4	2.5	3.0	2.4	3.0	3.0
Current transfers	3.3	4.0	4.1	3.3	4.3	3.3	3.4
Nonpension payments	1.7	2.5	2.5	1.7	2.7	1.6	1.7
Pension payments	1.6	1.5	1.6	1.6	1.6	1.6	1.7
Capital expenditure	2.8	3.0	3.0	3.6	3.1	3.5	3.6
Primary Balance	**0.5**	**-0.7**	**-3.0**	**-1.7**	**-2.4**	**-0.5**	**-0.4**
Overall Balance	**-1.9**	**-3.1**	**-5.6**	**-4.7**	**-4.8**	**-3.5**	**-3.5**
Financing	**1.9**	**3.1**	**5.6**	**4.7**	**4.8**	**3.5**	**3.5**
External	**-0.6**	**1.3**	**3.7**	**3.4**	**1.6**	**0.7**	**2.1**
Disbursements	1.0	2.6	5.1	4.7	2.9	4.6	6.1
Amortization	-1.6	-1.4	-1.4	-1.2	-1.4	-4.0	-4.0
Domestic	**2.5**	**1.8**	**1.8**	**1.3**	**3.2**	**2.8**	**1.4**
Central bank	0.7	0.1	-1.4	0.2	1.8	1.5	0.0
Banking system	0.2	0.4	1.1	-0.2	0.1	-0.2	-0.1
Private sector 2/	1.6	1.6	1.9	1.3	1.3	1.5	1.5
Other	-0.1	-0.3	0.2	0.0	0.0	0.0	0.0
Memorandum Items:							
Current balance	0.5	-0.3	-3.0	-1.9	-2.2	-1.0	-0.8
Pension balance	-1.5	-1.4	-1.6	-1.6	-1.5	-1.6	-1.6
Gross financing needs	5.0	7.1	9.3	6.6	6.8	8.1	8.2
Implicit nominal interest rate (in percent)	6.5	6.5	5.8	6.2	5.0	6.1	6.2
Gross Nonfinancial Public Sector Debt	38.8	39.7	48.5	50.5	50.0	50.1	51.0
Total public sector debt (gross) 3/	39.1	41.2	49.5	52.2	51.2	51.9	52.1
Total public sector debt (net) 3/ 4/	34.9	37.8	44.2	47.3	47.9	48.9	48.9
Nominal GDP (million U.S. dollars)	20,377	22,107	21,101	22,260	21,796	23,388	22,953

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

1/ IMF Country Report No. 10/82.
2/ Includes financing for education, health, and pension trust funds.
3/ Includes gross debt of the nonfinancial public sector and external debt of the central bank.
4/ Public sector gross debt less government deposits held at the central bank or commercial banks.

Table 5. El Salvador: Operations of the Nonfinancial Public Sector
(In percent of GDP)

					Projections					
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Revenue and Grants	**17.1**	**17.1**	**16.9**	**16.1**	**17.2**	**18.4**	**19.0**	**19.5**	**19.7**	**19.9**
Current revenue	16.8	16.8	16.6	15.6	16.6	17.5	18.5	19.3	19.4	19.7
Tax revenue	13.3	13.4	13.1	12.4	13.2	13.9	15.0	15.8	16.0	16.4
Nontax revenue	2.9	2.9	2.8	2.7	2.9	3.0	2.8	2.8	2.7	2.6
Of which: pension revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Operating surplus of the public enterprises	0.6	0.5	0.8	0.5	0.5	0.6	0.6	0.7	0.7	0.7
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Official grants	0.2	0.3	0.2	0.5	0.6	0.9	0.5	0.2	0.2	0.1
Expenditure	**20.0**	**19.0**	**20.0**	**21.7**	**22.0**	**21.9**	**21.5**	**21.5**	**21.5**	**21.4**
Current expenditure	16.9	16.3	17.0	18.6	18.8	18.3	18.0	17.9	18.0	17.9
Wages and salaries	7.0	6.9	6.9	7.9	8.1	7.9	7.9	7.9	7.9	7.9
Goods and services	3.8	3.6	3.7	4.1	4.1	3.9	3.8	3.8	3.8	3.8
Interest	2.4	2.5	2.4	2.5	2.4	3.0	3.0	3.0	3.0	2.8
Current transfers	3.6	3.3	4.0	4.1	4.3	3.4	3.3	3.3	3.2	3.3
Nonpension payments	1.7	1.7	2.5	2.5	2.7	1.7	1.7	1.6	1.6	1.6
Pension payments	1.9	1.6	1.5	1.6	1.6	1.7	1.7	1.7	1.6	1.6
Capital expenditure	3.1	2.8	3.0	3.0	3.1	3.6	3.5	3.5	3.5	3.6
Primary Balance	**-0.5**	**0.5**	**-0.7**	**-3.0**	**-2.4**	**-0.4**	**0.4**	**1.0**	**1.1**	**1.3**
Overall Balance	**-2.9**	**-1.9**	**-3.1**	**-5.6**	**-4.8**	**-3.5**	**-2.5**	**-2.0**	**-1.8**	**-1.5**
Financing	**2.9**	**1.9**	**3.1**	**5.6**	**4.8**	**3.5**	**2.5**	**2.0**	**1.8**	**1.5**
External	**2.7**	**-0.6**	**1.3**	**3.7**	**1.6**	**2.1**	**1.1**	**0.9**	**1.9**	**1.0**
Disbursements	4.8	1.0	2.6	5.1	2.9	6.1	2.3	1.9	2.8	1.9
Amortization	-2.2	-1.6	-1.4	-1.4	-1.4	-4.0	-1.1	-1.0	-1.0	-1.0
Domestic	**0.3**	**2.5**	**1.8**	**1.8**	**3.2**	**1.4**	**1.4**	**1.1**	**-0.1**	**0.6**
Central bank	-0.3	0.7	0.1	-1.4	1.8	0.0	0.0	-0.2	0.0	-0.3
Banking system	0.4	0.2	0.4	1.1	0.1	-0.1	0.0	-0.1	-0.2	-0.5
Private sector 1/	-0.1	1.6	1.6	1.9	1.3	1.5	1.5	1.4	0.2	1.4
Other	0.2	-0.1	-0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items:										
Current balance	0.0	0.5	-0.3	-3.0	-2.2	-0.8	0.5	1.3	1.5	1.9
Pension balance	-1.8	-1.5	-1.4	-1.6	-1.5	-1.6	-1.6	-1.6	-1.6	-1.6
Gross financing needs	6.3	5.0	7.1	9.3	6.8	8.2	4.3	3.5	3.3	3.0
Implicit nominal interest rate (in percent)	6.3	6.5	6.5	5.8	5.0	6.2	6.0	6.1	6.3	6.1
Gross Nonfinancial Public Sector Debt	39.4	38.8	39.7	48.5	50.0	51.0	50.7	49.6	48.2	46.8
Total public sector debt (gross) 2/	41.7	39.1	41.2	49.5	51.2	52.1	51.8	50.6	49.1	47.7
Total public sector debt (net) 2/ 3/	36.5	34.9	37.8	44.2	47.9	48.9	48.8	47.6	46.3	44.8
Nominal GDP (million U.S. dollars)	18,749	20,377	22,107	21,101	21,796	22,953	24,284	25,972	27,802	29,732

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

1/ Includes financing for education, health, and pension trust funds.
2/ Includes gross debt of the nonfinancial public sector and external debt of the central bank.
3/ Public sector gross debt less government deposits held at the central bank or commercial banks.

Table 6. El Salvador: Summary Accounts of the Financial System

	2007	2008	2009	2010 SBA 1/	2010 Projection	2011 SBA 1/	2011 Projection
	(End of period stocks; millions of U.S. dollars)						
	I. Central Bank						
Net Foreign Assets	**2,167**	**2,248**	**2,594**	**2,802**	**2,420**	**2,570**	**2,501**
Net international reserves	2,198	2,541	2,985	3,076	2,795	2,845	2,877
Of which : "Free" NIR 2/	50	169	573	597	149	192	155
Net Domestic Assets	**580**	**544**	**204**	**272**	**580**	**632**	**579**
Nonfinancial public sector	465	521	222	269	609	629	608
Claims	812	839	836	836	836	836	836
Deposits	347	318	614	567	227	207	228
Commercial banks	0	0	0	0	0	0	0
Nonbank financial institutions	355	255	265	265	274	265	274
Nonfinancial private sector	0	32	15	0	0	0	0
Other items (net)	-240	-264	-298	-262	-302	-262	-302
Central Bank Backed Liabilities	**2,745**	**2,791**	**2,797**	**3,074**	**3,000**	**3,202**	**3,081**
Liabilities to other depositary corporations	2,044	2,258	2,250	2,316	2,281	2,416	2,356
Other liabilities	702	533	548	758	719	786	725
	II. Commercial Banks						
Net Foreign Assets	**39**	**-98**	**376**	**334**	**476**	**194**	**336**
Net Domestic Assets	**9,681**	**9,944**	**9,665**	**10,259**	**9,770**	**10,951**	**10,402**
Net claims on nonfinancial public sector	-36	12	139	208	163	167	147
Net claims on the financial system	2,504	2,591	2,734	2,797	2,777	2,920	2,873
Claims on the private sector	8,617	8,985	8,572	9,112	8,509	9,852	8,962
Other items (net)	-1,404	-1,644	-1,780	-1,857	-1,679	-1,987	-1,579
Liabilities to the Private Sector	**9,719**	**9,845**	**10,041**	**10,594**	**10,246**	**11,145**	**10,738**
Deposits	8,641	8,646	8,841	9,302	9,088	9,819	9,525
Other	1,078	1,199	1,200	1,292	1,158	1,326	1,213
	III. Financial System 3/						
Net Foreign Assets	**2,134**	**2,035**	**2,857**	**3,044**	**2,846**	**2,673**	**2,787**
Net Domestic Assets	**7,186**	**7,478**	**6,698**	**7,306**	**7,116**	**8,231**	**7,642**
Nonfinancial public sector	464	610	446	555	859	878	847
Credit to private sector	8,726	9,134	8,717	9,231	8,639	9,980	9,098
Other	-2,004	-2,266	-2,465	-2,479	-2,382	-2,627	-2,303
Liabilities to the Private Sector	**9,320**	**9,513**	**9,555**	**10,351**	**9,962**	**10,903**	**10,430**
Broad money	9,601	9,709	9,908	10,444	10,111	10,986	10,594
Money	1,765	1,789	2,024	1,898	2,152	1,984	2,180
Quasi-money	7,836	7,921	7,884	8,546	7,959	9,002	8,414
	(Percent changes relative to previous year's broad money)						
Net domestic assets	8.1	3.0	-8.0	3.3	4.2	8.8	5.2
Nonfinancial public sector	2.4	1.5	-1.7	0.0	4.2	3.1	-0.1
Credit to the private sector	8.6	4.2	-4.3	5.2	-0.8	7.2	4.5
Liabilities to the private sector	17.1	2.0	0.4	4.5	4.1	5.3	4.6
	(Percent of GDP)						
Credit to the private sector	42.8	41.3	41.3	41.5	39.6	42.7	39.6
Liabilities to the private sector	45.7	43.0	45.3	46.5	45.7	46.6	45.4
Memorandum Items:	(Annual percent change, unless otherwise stated)						
Financial system credit to the private sector	8.8	4.7	-4.6	6.0	-0.9	8.1	5.3
Private sector deposits in commercial banks	17.4	0.1	2.3	4.4	2.8	5.6	4.8
Commercial bank liquidity deposits at central bank (percent of total deposits)	23.5	25.9	25.0	24.4	24.6	24.1	24.3

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

1/ IMF Country Report No. 10/82.

2/ Free NIR are defined as the difference between the central bank's net international reserves, which include government deposits, and its liquid liabilities with domestic residents.

3/ Includes nonbank financial institutions not included elsewhere.

Table 7. El Salvador: Selected Vulnerability Indicators

(In percent of GDP, unless otherwise indicated)

	2005	2006	2007	2008	2009	Proj. 2010
Fiscal Indicators						
Overall balance of the nonfinancial public sector	-3.0	-2.9	-1.9	-3.1	-5.6	-4.8
Primary balance of the nonfinancial public sector	-0.8	-0.5	0.5	-0.7	-3.0	-2.4
Gross public sector financing requirement	6.3	6.3	5.0	7.1	9.3	6.8
Public sector debt (gross) 1/	41.7	41.7	39.1	41.2	50.4	51.8
Public sector external debt	26.0	27.3	24.3	23.8	26.3	27.0
External interest payments to total fiscal revenue (percent)	11.8	10.7	9.0	6.6	7.6	7.3
External amortization payments to total fiscal revenue (percent)	13.8	12.6	9.2	8.0	8.6	7.9
Financial Indicators						
Broad money (percent change, end-of-period)	6.3	12.4	17.5	1.1	2.0	2.4
Private sector credit (percent change, end-of-period)	10.8	9.6	8.8	4.7	-4.6	-0.6
Ratio of capital to risk-weighted assets	13.5	13.8	13.8	15.1	16.5	…
Ratio of loans more than 90 days past due to total loans	1.9	1.9	2.1	2.8	3.7	…
Ratio of provisions to total loans	2.4	2.2	2.5	3.1	4.0	…
Ratio of provisions to loans more than 90 days past due	126.6	116.1	120.0	110.4	109.9	…
Return on average equity	11.8	14.6	11.3	8.7	2.8	…
Return on average total assets	1.2	1.5	1.2	1.0	0.3	…
Loans as percent of deposits	100.4	103.8	97.4	101.4	91.3	…
Ratio of liquid assets to total deposits	33.5	32.3	34.0	35.7	41.3	…
External Indicators						
Exports of goods and services (percent change, 12-month basis)	2.4	8.7	8.3	9.3	-16.9	9.7
Imports of goods and services (percent change, 12-month basis)	6.1	13.9	12.5	11.1	-25.1	12.3
Current account balance	-3.5	-4.2	-6.0	-7.6	-1.8	-2.8
Capital and financial account balance	5.1	6.1	3.6	7.8	4.6	1.9
Gross international reserves (millions of U.S. dollars)	1,833	1,908	2,198	2,545	2,987	2,797
Months of imports of goods and services, excluding maquila	3.0	2.7	2.8	4.3	4.5	3.9
Percent of short-term debt	101	150	171	166	256	234
Percent of gross external financing requirements	64	57	63	65	100	126
Percent of broad money	25.2	23.4	22.9	26.2	30.1	27.6
Total public external debt service	4.1	4.0	3.1	2.5	2.6	2.6
Total external debt to exports of goods and services (percent)	199	201	176	172	204	191
External interest payments to goods and services exports (percent)	16.6	15.4	16.2	13.1	17.1	15.6
External amortization to goods and services exports (percent)	52.5	52.8	38.4	34.1	46.5	35.2
REER, depreciation is negative (percent change, end-of-period)	2.4	-0.2	-2.3	6.6	-2.8	…

Sources: Central Bank of El Salvador; Ministry of Finance; Financial System Superintendency; and Fund staff estimates.

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

Table 8. El Salvador: Public Sector Debt Sustainability Framework, 2005-2015

(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing primary balance 8/**
1	**Baseline: Public sector debt 1/**	**41.7**	**41.7**	**39.1**	**41.2**	**49.5**	**51.2**	**52.1**	**51.8**	**50.6**	**49.1**	**47.7**	**-0.4**
	o/w foreign-currency denominated	41.7	41.7	39.1	41.2	49.5	51.2	52.1	51.8	50.6	49.1	47.7	
2	Change in public sector debt	-1.9	0.0	-2.6	2.1	8.3	1.7	0.9	-0.3	-1.2	-1.5	-1.4	
3	Identified debt-creating flows (4+7+12)	-0.6	-0.2	-1.4	0.0	7.5	3.2	0.9	-0.3	-1.4	-1.5	-1.7	
4	Primary deficit	0.8	0.8	-0.5	0.7	3.0	2.4	0.4	-0.4	-1.0	-1.1	-1.3	
5	Revenue and grants	16.0	16.5	17.1	16.9	16.1	17.2	18.4	19.0	19.5	19.7	19.9	
6	Primary (noninterest) expenditure	16.8	17.3	16.6	17.6	19.1	19.6	18.8	18.6	18.5	18.5	18.6	
7	Automatic debt dynamics 2/	-1.4	-1.0	-0.8	-0.7	4.5	0.8	0.4	0.1	-0.4	-0.4	-0.4	
8	Contribution from interest rate/growth differential 3/	-1.4	-1.0	-0.8	-0.7	4.5	0.8	0.4	0.1	-0.4	-0.4	-0.4	
9	Of which contribution from real interest rate	-0.1	0.6	0.8	0.2	3.0	1.3	1.6	1.6	1.5	1.5	1.5	
10	Of which contribution from real GDP growth	-1.3	-1.6	-1.7	-0.9	1.5	-0.5	-1.2	-1.5	-1.9	-1.9	-1.8	
11	Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
12	Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13	Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3)	-1.3	0.2	-1.2	2.1	0.8	-1.5	0.0	0.0	0.2	0.0	0.3	
	Public sector debt-to-revenue ratio 1/	260.5	252.7	228.6	244.0	307.3	298.1	283.1	272.9	259.5	249.7	240.1	
	Gross financing need 5/	**6.3**	**6.3**	**5.0**	**7.1**	**9.3**	**6.8**	**8.2**	**4.3**	**3.5**	**3.3**	**3.0**	
	in millions of U.S. dollars	1076.4	1173.2	1026.9	1567.3	1961.7	1489.2	1872.8	1045.5	913.5	921.6	898.4	
	Scenario with key variables at their historical averages 6/						**51.2**	**52.0**	**52.8**	**53.7**	**54.5**	**55.5**	**-0.5**
	Scenario with no policy change (constant primary balance) in 2010-2015						**51.2**	**54.1**	**56.6**	**58.7**	**60.7**	**62.9**	**-0.5**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	3.3	4.2	4.3	2.4	-3.5	1.0	2.5	3.0	4.0	4.0	4.0	
	Average nominal interest rate on public debt (in percent) 7/	5.5	6.3	6.5	6.5	5.8	5.0	6.2	6.0	6.1	6.3	6.1	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.0	1.8	2.3	0.6	6.9	2.7	3.5	3.3	3.3	3.3	3.3	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	5.5	4.5	4.2	5.9	-1.0	2.3	2.7	2.7	2.8	2.9	2.8	
	Growth of real primary spending (deflated by GDP deflator, in percent)	6.7	7.9	-1.6	9.1	4.8	3.3	-1.4	1.4	3.8	4.0	4.4	
	Primary deficit	0.8	0.8	-0.5	0.7	3.0	2.4	0.4	-0.4	-1.0	-1.1	-1.3	

1/ The table covers gross debt of the nonfinancial public sector plus external debt of the central bank.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

7/ Derived as nominal interest expenditure divided by previous period debt stock.

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

Table 9. El Salvador: External Debt Sustainability Framework, 2005-2015

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Debt-stabilizing non-interest current account 5/
Baseline: External debt	**50.9**	**51.1**	**44.5**	**43.9**	**45.4**	**45.0**	**44.0**	**44.0**	**43.4**	**43.4**	**42.5**	**-1.7**
Change in external debt	-1.1	0.2	-6.6	-0.6	1.5	-0.4	-1.0	-0.1	-0.6	0.0	-0.9	
Identified external debt-creating flows (4+8+9)	-3.0	-1.4	-5.0	0.9	1.2	-0.4	-0.9	-1.1	-1.7	-1.6	-1.7	
Current account deficit, excluding interest payments	0.1	1.0	2.6	4.9	-1.3	-0.2	0.1	0.1	0.1	0.1	0.0	
Deficit in balance of goods and services	17.8	19.9	21.6	22.5	15.5	17.4	17.9	17.8	17.7	17.7	17.6	
Exports	25.5	25.5	25.4	25.6	22.3	23.6	24.6	25.0	25.2	25.3	25.5	
Imports	43.3	45.3	46.9	48.1	37.8	41.0	42.5	42.8	42.9	43.0	43.2	
Net non-debt creating capital inflows (negative)	-2.3	-1.4	-6.9	-3.3	-2.7	-1.7	-1.8	-1.9	-2.0	-2.1	-2.2	
Automatic debt dynamics 1/	-0.8	-0.9	-0.7	-0.8	5.1	1.5	0.7	0.7	0.3	0.4	0.5	
Contribution from nominal interest rate	3.5	3.2	3.3	2.7	3.0	2.9	3.0	3.1	3.2	3.2	3.3	
Contribution from real GDP growth	-1.6	-2.0	-2.0	-1.0	1.6	-0.4	-1.1	-1.2	-1.6	-1.6	-1.6	
Contribution from price and exchange rate changes 2/	-2.7	-2.2	-2.0	-2.5	0.5	-1.0	-1.2	-1.2	-1.2	-1.2	-1.2	
Residual, incl. change in gross foreign assets (2-3)	2.0	1.6	-1.6	-1.5	0.3	0.0	-0.1	1.0	1.1	1.6	0.9	
External debt-to-exports ratio (in percent)	199.5	200.8	175.6	171.8	204.1	190.6	179.4	176.0	172.5	171.6	166.5	
Gross external financing need (in millions of US dollars) 3/	**2,858**	**3,376**	**3,487**	**3,945**	**2,984**	**2,226**	**3,251**	**2,800**	**2,954**	**3,320**	**3,378**	
in percent of GDP	16.6	18.0	17.1	17.8	14.1	10.2	14.2	11.5	11.4	11.9	11.4	
Scenario with key variables at their historical averages 4/						**44.1**	**42.6**	**42.2**	**41.9**	**42.1**	**41.6**	**-2.4**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.3	4.2	4.3	2.4	-3.5	1.0	2.5	3.0	4.0	4.0	4.0	
GDP deflator in US dollars (change in percent)	5.5	4.5	4.2	5.9	-1.0	2.3	2.7	2.7	2.8	2.9	2.8	
Nominal external interest rate (in percent)	7.3	6.9	7.1	6.6	6.6	6.7	7.0	7.5	7.7	8.0	8.2	
Growth of exports (US dollar terms, in percent)	2.4	8.7	8.3	9.3	-16.9	9.7	9.5	7.6	7.7	7.6	7.9	
Growth of imports (US dollar terms, in percent)	6.1	13.9	12.5	11.1	-25.1	12.3	9.0	6.5	7.2	7.4	7.2	
Current account balance, excluding interest payments	-0.1	-1.0	-2.6	-4.9	1.3	0.2	-0.1	-0.1	-0.1	-0.1	0.0	
Net non-debt creating capital inflows	2.3	1.4	6.9	3.3	2.7	1.7	1.8	1.9	2.0	2.1	2.2	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

5/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 10. El Salvador: External Financing Requirements and Sources

(In US$ millions)

	2007	2008	2009	2010		2011	
				SBA 1/	Projection	SBA 1/	Projection
Gross Financing Requirements	**3,487**	**3,945**	**2,984**	**2,785**	**2,225**	**3,169**	**3,296**
Current account deficit	1,221	1,682	373	606	604	661	760
Debt amortization	1,986	1,929	2,182	2,087	1,810	2,740	2,455
Public sector	320	300	291	276	295	927	929
Private sector	1,665	1,629	1,891	1,811	1,516	1,813	1,526
GIR accumulation	280	334	429	92	-190	-232	82
Gross Financing Sources	**3,487**	**3,945**	**2,984**	**2,785**	**2,225**	**3,169**	**3,296**
Public sector disbursements	205	577	1,076	1,036	638	1,086	1,400
Private sector net inflows	3,282	3,368	1,908	1,749	1,587	2,083	1,896
Foreign direct investment	1,408	719	562	203	378	248	402
Other	1,874	2,649	1,347	1,546	1,209	1,835	1,495

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

1/ IMF Country Report No. 10/82.

Table 11. El Salvador: Indicators of Fund Credit

(In units indicated)

	Projections 1/					
	2010	2011	2012	2013	2014	2015
Prospective Fund credit 2/						
In millions of SDRs	321.2	406.8	492.5	476.4	299.8	117.8
In percent of exports of goods and services	9.6	11.1	12.4	11.2	6.5	2.4
In percent of public sector external debt	8.4	9.8	11.4	10.6	6.2	2.4
In percent of gross reserves	17.6	21.7	24.5	22.0	12.5	4.6
In percent of quota	187.5	237.5	287.5	278.1	175.0	68.7
Repurchases and charges due from existing and prospective drawings						
In millions of SDRs	2.1	5.0	6.1	44.3	182.4	185.2
In percent of exports of goods and services	0.1	0.1	0.2	1.0	4.0	3.7
In percent of public sector external debt service	0.6	0.6	1.5	10.7	41.5	38.4
In percent of gross reserves	0.1	0.3	0.3	2.0	7.6	7.3
In percent of quota	1.2	2.9	3.6	25.8	106.5	108.1

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

1/ The arrangement is being treated as precautionary and El Salvador does not currently have any credit outstanding with the Fund.

2/ End of period.

Table 12. El Salvador: Purchase Schedule and Terms Under the Stand-By Arrangement

Date	Conditions for purchase	Purchase			
		Million SDR	Million US$ 1/	Percent of Quota	Percent of Total Access
March 17, 2010	Board approval of the SBA	171.3000	259.17	100.00	33.33
May 17, 2010	Performance criteria based on end-March 2010	21.4125	32.40	12.50	4.17
September 15, 2010	First review, based on end-June 2010 performance criteria	107.0625	161.98	62.50	20.83
November 15, 2010	Performance criteria based on end-September 2010	21.4125	32.40	12.50	4.17
March 15, 2011	Second review, based on end-December 2010 performance criteria	21.4125	32.40	12.50	4.17
May 16, 2011	Performance criteria based on end-March 2011	21.4125	32.40	12.50	4.17
September 15, 2011	Third review, based on end-June 2011 performance criteria	21.4125	32.40	12.50	4.17
November 15, 2011	Performance criteria based on end-September 2011	21.4125	32.40	12.50	4.17
March 15, 2012	Fourth review, based on end-December 2011 performance criteria	21.4125	32.40	12.50	4.17
May 15, 2012	Performance criteria based on end-March 2012	21.4125	32.40	12.50	4.17
September 17, 2012	Fifth review, based on end-June 2012 performance criteria	21.4125	32.40	12.50	4.17
November 15, 2012	Performance criteria based on end-September 2012	21.4125	32.40	12.50	4.17
March 8, 2013	Sixth review, based on end-December 2012 performance criteria	21.4125	32.40	12.50	4.17
Total 2/		513.9000	777.50	300.00	100.00

Source: Fund staff estimates.

1/ SDR/US$ exchange rate of 0.660962 as of July 23, 2010.
2/ May not reflect the sum of individual lines because of rounding.

Table 13. El Salvador: Quantitative Performance Measures

(in millions of U.S. dollars)

	2009	2010						2011	2012
	end-Dec.	end-Mar.		end-Jun.		end-Sep.	end-Dec.	Indicative	
	Actual	SBA 1/	Actual	SBA 1/	Actual	SBA 1/	SBA 1/	end-Dec.	end-Dec.
Performance criteria									
Overall balance of the nonfinancial public sector	-1,171	-300	-204	-475	-301	-700	-1,047	-800	-625
Gross debt of the public sector (flows) 3/	1,162	339	-212	468	-54	729	1,117	895	625

Continuous performance criteria

Standard continuous performance criterion of zero-ceiling on non-accumulation of external debt service arrears by the nonfinancial public sector. 4/

Continuous zero-ceiling on non-accumulation of domestic payment arrears by the nonfinancial public sector. 5/

Consultation clauses

If at any point during the arrangement, the sum of private-sector bank deposits and external short-term bank liabilities, should be less than US$7,555.4 million (i.e., ten percent below the end-June 2010 level), a consultation clause will be triggered and the authorities will contact Fund staff to discuss possible remedial actions. 6/

If at any point during the arrangement the authorities consider it necessary to modify the reserve requirements or liquid asset requirements, a consultation clause will be triggered and the authorities will contact Fund staff to discuss such actions. 7/

1/ IMF Country Report No. 10/82.

2/ Adjusted upward if observed tax revenues are higher than projected, as defined in TMU ¶7.

3/ Adjusted upward for any debt placed for prefinancing that would result in an equivalent increase in BCR deposits, until the pre-financed liability (or liabilities) mature.

4/ For the purpose of the program ceiling, external nonfinancial public sector debt-service arrears are defined as unpaid debt service payments by the non-financial public sector to nonresidents beyond 30 days after the due date.

5/ For the purpose of the program ceiling, domestic payment arrears of the nonfinancial public sector are defined as unpaid obligations overdue by more than 60 days.

6/ For definition of private sector deposits and external liabilities, see TMU ¶8.

7/ For reference rates of reserve and liquid asset requirements, see TMU ¶9.

Table 14. El Salvador: Structural Measures

	Test date		Status
	Original 1/	Rephased	
Structural benchmarks			
Tax Administration			
Publication of strategic plan for the modernization of both DGII and DGA.	Apr. 30, 2010	Sep. 30, 2010	Pending
Enhance coordination in the tax collection process across agencies. 1/	Apr. 30, 2010	Feb. 28, 2011	Pending
Strengthen the large taxpayers office at the DGII. 1/	June 30, 2010	n.a.	Done
Consolidate the authority of the audit department at the DGII and improve its auditing capacity. 1/	Dec. 31, 2010	n.a.	Done
Subsidy Reform			
Finalize plans to improve the targeting of subsidies for electricity, water, and liquid propane gas.	May 30, 2010	Oct. 31, 2010	Pending
Implement plans to improve the targeting of subsidies for electricity, water, and liquid propane gas.	Oct. 31, 2010	Dec. 31, 2010	Delayed
Budget and Tax Policy			
Approve budget for 2011 consistent with deficit of 3.5 percent of GDP.	Dec. 31, 2010		New
Implement revenue measures yielding 1.5 percent of GDP.	June 30, 2012		
Financial System			
Congressional approval of financial supervision bill containing following elements: i) Merge the supervisory entities for banks, pensions, and the stock exchange. ii) Enhance the autonomy of the merged supervisory institution. iii) Strengthen legal protection for supervisors. iv) Strengthen cross-border consolidated supervision. v) Empower the central bank to be the sole regulator of the financial system.	July 31, 2010	Dec. 31, 2010	Pending
Congressional approval of investment funds law containing following elements: i) Create clear legal framework for investment funds. ii) Specify accounting and asset valuation rules. iii) Set terms for investor entry and exit.	Oct. 31, 2010	Mar. 31, 2011	Delayed
Conduct test bank resolution exercise	Feb. 28, 2011		New
Issue corporate governance norms for the banking system.	Feb. 28, 2011		New

1/ A description of the steps needed to meet this benchmark is in paragraph 10 of the TMU.

Attachment I. Letter of Intent

San Salvador, September 1, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C., 20431

Dear Mr. Strauss-Kahn:

1. The global slowdown caused by the world financial crisis severely affected El Salvador's economy during 2009. International trade flows, remittances, and private capital flows declined, taking a heavy toll on domestic economic activity and tax collections. The Government of El Salvador, with the support of the International Monetary Fund (IMF) and other international financial institutions, has worked resolutely to shield the domestic economy—especially the most vulnerable sectors—from the impact of the crisis, while pursuing macroeconomic policies to safeguard macroeconomic stability in El Salvador's dollarized economy.

2. The economy weathered the crisis and is starting to recover, in line with the improved global environment. Real GDP in the first quarter of 2010 fell by only ½ percent (y/y) after declining almost 5 percent in the last quarter of 2009. Exports and imports are experiencing double-digit growth, reflecting a strengthening of external and domestic demand, and remittances are recovering. While bank credit has been slow to pick up, deposits are increasing, and the banking system remains highly liquid and well-capitalized.

3. The Government of El Salvador remains committed to its strategy of ensuring fiscal and financial sustainability while safeguarding social spending. In line with the goals outlined in our letter of March 1, 2010, we have been implementing poverty-reducing programs and are making progress in improving the targeting of critical government expenditure (especially energy subsidies), consistent with our policy framework of putting the fiscal deficit and public debt ratio on a durable downward path. We are also moving ahead with key reforms in the financial sector to strengthen its oversight and bolster its resilience to shocks.

4. The attached Memorandum of Economic and Financial Policies (MEFP) updates the policies of the Government of El Salvador for 2010–12 outlined in the MEFP dated March 1, 2010. In support of our economic program, we request completion of the first review of the 3-year Stand-By Arrangement (SBA) with El Salvador approved on March 17, 2010. Our intention is to continue treating the arrangement as precautionary. We believe the SBA will continue providing critical support for our commitment to sound macroeconomic policies, help anchor the confidence of depositors, investors, and creditors, and provide potential access to liquidity support for the financial system, if the need were to arise.

5. We believe that the policies described in the attached MEFP are sufficient to meet the objectives of our program and stand ready to take additional measures that may be needed for this purpose. We maintain our commitment to consult with the Fund in advance of any revisions to the policies described in the MEFP, as well as the adoption of additional measures, in accordance with IMF policies on such consultations. Consultations with Fund staff would also occur in the event of a significant decline in the sum of private sector deposits and short-term external liabilities of the banking system, or if the need were to arise to change the reserve requirements or the liquid asset requirements currently applicable to the banking system. We will continue to comply with all obligations of Article VIII of the IMF's Articles of Agreement and will maintain our close dialogue with IMF staff on our economic policies after the expiration of the arrangement, for as long as there are any outstanding purchases in the upper credit tranches. Program implementation will continue to be monitored through semi-annual reviews, with the second review to be completed on or after March 15, 2011. The performance criteria and structural benchmarks under the program are set out in Tables 2 and 3 of the attached MEFP.

6. We authorize the IMF to publish this Letter of Intent and its attachments, and the related staff report.

Sincerely yours,

/s/	/s/
Carlos Cáceres Minister of Finance	Carlos Acevedo President, Central Reserve Bank of El Salvador

Attachment II. Supplement to the Memorandum of Economic and Financial Policies

1. **Recent economic developments**. Economic activity has been broadly in line with projections at the time of the approval of the Stand-By Arrangement (SBA). The contraction in real GDP moderated to -0.5 percent (y/y) in the first quarter of 2010 (compared with -4.9 percent in the last quarter of 2009), and the index of economic activity rose 1.9 percent (y/y) in June driven by increases in manufacturing, financial services, and retail trade. Remittances rose 2.5 percent through July. Inflation remains contained, at 1.0 percent (y/y) in July.

2. **Program performance**. All quantitative performance criteria for end-March and end-June 2010 were met. Plans for liquid propane gas subsidy reform have been finalized and will be in effect by end-December 2010. The large taxpayers unit at the Domestic Tax Administration Directorate (DGII) has been strengthened and is expected to audit 80 of the 100 largest taxpayers during 2010. The authority of the auditing department at the DGII has been consolidated, and a risk-management approach to taxpayer selection for audits is being adopted. The strategic plan for the modernization of both the DGII and the General Customs Administration Directorate is in progress, and the process of enhancing coordination in the tax collection process across the two agencies has begun. The Financial Sector Supervision and Regulation Law is undergoing changes in the legislative discussions on the bill, and approval is expected by end-December 2010.

3. **Macroeconomic framework**. The outlook for 2010 and 2011 remains broadly unchanged from the time of the approval of the SBA. The macroeconomic framework continues to assume a gradual recovery, with real GDP growth projected at 1 percent in 2010 and 2½ percent in 2011. Inflation projections are unchanged at 1½ percent in 2010 and 2¾ percent in 2011, in line with inflation in the United States. The external current account deficit is expected to be slightly higher than previously projected, at 2.8 percent in 2010 and 3.1 percent in 2011. Our program will be anchored on strict adherence to official dollarization and a prudent fiscal policy.

4. **Fiscal policy**. Fiscal policy will continue to be aimed at reducing gradually the non-financial public sector (NFPS) deficit and placing public debt on a firm downward path, while shifting spending toward social programs and investment in key sectors. The proposed deficit targets during the 2010–12 program period, take place against the backdrop of a moderately-paced recovery of economic activity, and are expected to take the non-financial gross public sector debt ratio to 51 percent of GDP; thereafter, the ratio is expected to decline steadily to 46.8 percent by 2015. These targets are broadly the same as those laid out at the time of program approval. Key elements of our fiscal strategy include the following:

- *Fiscal targets for 2010.* We will continue to maintain the NFPS deficit in 2010 at or below US$1,047 million (4.8 percent of GDP), while limiting the increase in the stock of gross public sector debt to at most US$1,117 million—consistent with our projected end-year NFPS debt-to-GDP ratio of 50 percent of GDP.

- *Budget for 2011*. Congressional approval of a budget for 2011 consistent with an NFPS deficit of no more than 800 million (3.5 percent of GDP) will be a new structural benchmark under the program for end-December 2010. This deficit target will imply a reduction of more than 1 percentage point of GDP in the overall deficit from the expected 2010 outturn, and demonstrates our firm commitment to fiscal consolidation. In addition, the 2011 budget will reallocate spending away from poorly-targeted energy subsidies to key social programs.

    - *Increased spending on social programs*. The anti-crisis program that we adopted in June 2009 has helped mitigate the effects of the economic slowdown on the most vulnerable populations and will be maintained at 2010 levels (1 percent of GDP) in 2011.

    - *Subsidy reforms*. With subsidies projected to cost about 1.4 percent of GDP in 2010, we have placed a high priority on completing the broad-based reform of all such expenditures that we began in 2009. By end-October, we will have made public a plan to bring liquid propane gas (LPG) prices closer to market rates, while still protecting the most vulnerable through a consumption subsidy (see ¶11 of the attached Technical Memorandum of Understanding, TMU). We will also adjust electricity tariffs to residential customers with an average monthly consumption above 99 kWh to more closely reflect market prices (see TMU ¶12). These reforms are expected to free resources of about 0.3 percent of GDP in 2011 that would be redirected toward other social spending.

- *Saving of revenue over-performance*. We maintain our commitment to save a portion of any revenue overperformance (as detailed in TMU ¶7), while allowing the rest to be used toward key social spending.

- *Medium-term fiscal strategy*. We are improving the transparency and planning of government operations by implementing a medium term strategy of fiscal consolidation. Our efforts started with the publication of our 2010–14 government program (***2010–2014 Plan Quinquenal de Desarrollo***). Beginning with the 2011 budget, we will introduce a medium-term budget framework that will seek consistency between short-term and medium-term objectives, including a fiscal framework consistent with our medium-term objectives of putting the NFPS deficit and public debt ratio on sustainable downward trajectories. Key to our efforts will be the implementation by end-June 2012, at the latest, of a fiscal pact to be developed in consultation with a broad range of stakeholders that aims at an increase in government revenues of 1½ to 3 percent of GDP over the medium term.

- *Financing*. We expect to cover the bulk of our financing needs during 2010–12 with external resources of relatively long maturity. We have firm commitments from the World Bank, IADB, and the Central American Bank for Economic Integration for more than US$800 million of disbursements through end-2011. Additionally, in June 2010 we placed a 15-year, US$200 million bond on the domestic market at very favorable terms.

5. **Financial sector policy**. The government is committed to continue preserving and protecting the soundness and stability of the Salvadoran banking system and is adopting reforms to enhance its resilience and increase the efficiency of financial intermediation.

- *Consultation clauses and financial system vigilance*. If we were to consider it necessary to modify either the reserve requirements or the liquid asset requirements currently applicable to the banking system (see TMU ¶9), we would consult with IMF staff on such a change. In addition, if at any point during the program period we were to observe a significant decline in the sum of external short-term liabilities of banks and total private sector deposits held in the banking system (as defined in TMU ¶8), we would evaluate the appropriate policy response in consultation with IMF staff. To test the mechanics of our bank resolution framework, strengthen coordination among agencies, and enhance procedures, we will conduct a bank resolution exercise test in the coming months (structural benchmark under the program for end-February 2011 and described in TMU ¶15).

- *Structural reforms*. We will seek congressional approval of the Financial Sector Supervision and Regulation Law by end-December 2010 (see TMU ¶13). We will also seek congressional approval by end-March 2011 of the Investment Funds Law (see TMU ¶14). We will issue norms to strengthen corporate governance of the banking system by end-February 2011 (structural benchmark under the program, see TMU ¶16).

6. **Safeguards assessment**. The recommendations of the safeguard assessment of the central bank (BCR) that was completed in May 2009 are being implemented. The BCR has modified the charter of the auditing committee to appoint an independent member as its chair, define the qualifications of its members, and has been authorized to contract an external expert to assist it in carrying out its responsibilities. It is also reviewing monetary submission data at program test dates and published full financial statements on its website.

7. **Program monitoring**. Quantitative performance criteria will continue to be monitored on a quarterly basis and program reviews will continue to be on a semiannual basis. The phasing of access under the arrangement and the schedule of reviews are set out in Table 1. The quantitative targets and performance criteria for end-September 2010 and end-December 2010, as well as indicative targets through end-December, 2012 are set out in Table 2. The structural benchmarks of the program are set out in Table 3.

Table 1. El Salvador: Purchase Schedule and Terms Under the Stand-By Arrangement

Date	Conditions for purchase	Purchase Million SDR	Million US$ 1/	Percent of Quota	Percent of Total Access
March 17, 2010	Board approval of the SBA	171.3000	259.17	100.00	33.33
May 17, 2010	Performance criteria based on end-March 2010	21.4125	32.40	12.50	4.17
September 15, 2010	First review, based on end-June 2010 performance criteria	107.0625	161.98	62.50	20.83
November 15, 2010	Performance criteria based on end-September 2010	21.4125	32.40	12.50	4.17
March 15, 2011	Second review, based on end-December 2010 performance criteria	21.4125	32.40	12.50	4.17
May 16, 2011	Performance criteria based on end-March 2011	21.4125	32.40	12.50	4.17
September 15, 2011	Third review, based on end-June 2011 performance criteria	21.4125	32.40	12.50	4.17
November 15, 2011	Performance criteria based on end-September 2011	21.4125	32.40	12.50	4.17
March 15, 2012	Fourth review, based on end-December 2011 performance criteria	21.4125	32.40	12.50	4.17
May 15, 2012	Performance criteria based on end-March 2012	21.4125	32.40	12.50	4.17
September 17, 2012	Fifth review, based on end-June 2012 performance criteria	21.4125	32.40	12.50	4.17
November 15, 2012	Performance criteria based on end-September 2012	21.4125	32.40	12.50	4.17
March 8, 2013	Sixth review, based on end-December 2012 performance criteria	21.4125	32.40	12.50	4.17
Total 2/		513.9000	777.50	300.00	100.00

Source: Fund staff estimates.

1/ SDR/US$ exchange rate of 0.660962 as of July 23, 2010.

2/ May not reflect the sum of individual lines because of rounding.

Table 2. El Salvador: Quantitative Performance Measures

(in millions of U.S. dollars)

	2009	2010						2011	2012
	end-Dec.	end-Mar.		end-Jun.		end-Sep.	end-Dec.	Indicative	
	Actual	SBA 1/	Actual	SBA 1/	Actual	SBA 1/	SBA 1/	end-Dec.	end-Dec.
Performance criteria									
Overall balance of the nonfinancial public sector	-1,171	-300	-204	-475	-301	-700	-1,047	-800	-625
Gross debt of the public sector (flows) 3/	1,162	339	-212	468	-54	729	1,117	895	625

Continuous performance criteria

Standard continuous performance criterion of zero-ceiling on non-accumulation of external debt service arrears by the nonfinancial public sector. 4/

Continuous zero-ceiling on non-accumulation of domestic payment arrears by the nonfinancial public sector. 5/

Consultation clauses

If at any point during the arrangement, the sum of private-sector bank deposits and external short-term bank liabilities, should be less than US$7,555.4 million (i.e., ten percent below the end-June 2010 level), a consultation clause will be triggered and the authorities will contact Fund staff to discuss possible remedial actions. 6/

If at any point during the arrangement the authorities consider it necessary to modify the reserve requirements or liquid asset requirements, a consultation clause will be triggered and the authorities will contact Fund staff to discuss such actions. 7/

1/ IMF Country Report No. 10/82.

2/ Adjusted upward if observed tax revenues are higher than projected, as defined in TMU ¶7.

3/ Adjusted upward for any debt placed for prefinancing that would result in an equivalent increase in BCR deposits, until the pre-financed liability (or liabilities) mature.

4/ For the purpose of the program ceiling, external nonfinancial public sector debt-service arrears are defined as unpaid debt service payments by the non-financial public sector to nonresidents beyond 30 days after the due date.

5/ For the purpose of the program ceiling, domestic payment arrears of the nonfinancial public sector are defined as unpaid obligations overdue by more than 60 days.

6/ For definition of private sector deposits and external liabilities, see TMU ¶8.

7/ For reference rates of reserve and liquid asset requirements, see TMU ¶9.

Table 3. El Salvador: Structural Measures

	Test date
Structural benchmarks	
Tax Administration	
Publication of strategic plan for the modernization of both DGII and DGA.	Sep. 30, 2010
Enhance coordination in the tax collection process across agencies. 1/	Feb. 28, 2011
Consolidate the authority of the audit department at the DGII and improve its auditing capacity. 1/	Dec. 31, 2010
Subsidy Reform	
Finalize plans to improve the targeting of subsidies for electricity, water, and liquid propane gas.	Oct. 31, 2010
Implement plans to improve the targeting of subsidies for electricity, water, and liquid propane gas.	Dec. 31, 2010
Budget and Tax Policy	
Approve budget for 2011 consistent with deficit of 3.5 percent of GDP.	Dec. 31, 2010
Implement revenue measures yielding 1.5 percent of GDP.	June 30, 2012
Financial System	
Congressional approval of financial supervision bill containing following elements: i) Merge the supervisory entities for banks, pensions, and the stock exchange. ii) Enhance the autonomy of the merged supervisory institution. iii) Strengthen legal protection for supervisors. iv) Strengthen cross-border consolidated supervision. v) Empower the central bank to be the sole regulator of the financial system.	Dec. 31, 2010
Congressional approval of investment funds law containing following elements: i) Create clear legal framework for investment funds. ii) Specify accounting and asset valuation rules. iii) Set terms for investor entry and exit.	Mar. 31, 2011
Conduct test bank resolution exercise	Feb. 28, 2011
Issue corporate governance norms for the banking system.	Feb. 28, 2011

1/ A description of the steps needed to meet this benchmark is in paragraph 10 of the TMU.

Attachment III. Technical Memorandum of Understanding

1. **This Technical Memorandum of Understanding (TMU) describes the understandings** reached between the authorities of El Salvador and IMF staff for monitoring performance under the Stand-By Arrangement (SBA). In particular, it defines concepts employed in measuring the quarterly fiscal and debt quantitative performance criteria; the continuous performance criteria on external debt and domestic payments arrears; the adjuster for the overperformance of tax revenues; triggers for consultation clauses; structural benchmarks; and reporting requirements under the SBA.

A. Quantitative Performance Criterion on the Fiscal Balance of the Non-Financial Public Sector

2. **The nonfinancial public sector (NFPS) comprises** the central government, the rest of the general government (Instituto Salvadoreño del Seguro Social (ISSS), municipal governments, public hospitals, the national university, and other decentralized agencies), and the non-financial public-sector enterprises (Comisión Ejecutiva Hidroeléctrica del Río Lempa (CEL), Comisión Ejecutiva Portuaria Autónoma (CEPA), Administración Nacional de Acueductos y Alcantarillados (ANDA), and Lotería Nacional de Beneficiencia (LNB)).

3. **The overall balance of the NFPS is measured on a cash basis from below the line**, defined as: (a) net domestic financing of the NFPS; *plus* (b) net external financing of the NFPS; *plus* (c) proceeds from exceptional sources such as, but not limited to, proceeds from privatization or licenses and concessions, (see Table A1). The components of NFPS financing are defined and measured as follows:

(a) **The net domestic financing of the NFPS is defined** as the sum of: (i) the increase in net claims of the domestic financial system on the NFPS, excluding government bonds initially sold abroad; (ii) the net increase in the amount of public sector short-term paper (LETES) and bonds held outside the domestic financial system and the NFPS, excluding bonds initially sold to nonresidents; and (iii) floating debt of the NFPS due to expenditure operations and tax refund payments.

(b) **The net external financing of the NFPS** comprises: (i) disbursements of external loans; plus (ii) receipts from the issuance of government bonds abroad and LETES held by nonresidents; minus (iii) cash payments of principal (current maturities of loans, bonds, and LETES); minus (iv) cash payments of external arrears (principal and interest); minus (v) debt buy-backs or other prepayments of debt (at market value); minus (vi) debt-equity swaps accounted at the market value of these papers; and minus/plus (vii) the increase/decrease in other net foreign assets of the non-financial public sector.

(c) **Proceeds from exceptional sources** such as, but not limited to, privatization, the sale of licenses, and the granting of concessions are defined as: (i) the cash payments received by the Treasury from the sale of state-owned assets; plus (ii) debt-equity swaps, accounted at market values. Also included are up-front payments received by the Treasury for the granting of concessions for public services and capital leasing agreements.

B. Performance Criterion on Debt Flows Contracted by the Public Sector

4. **The performance criterion measures the sum of debt contracted by the non-financial public sector** (as defined in paragraph 2) in the year, which shall apply to all flows of gross external debt as specified in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-00/85); all domestic gross debt flows; and any new debt with a sovereign guarantee. The debt ceiling will be adjusted upward for any borrowing by the non-financial public sector, domestic or external, raised for prefinancing purposes that would result in an equivalent increase in deposits at the central bank (BCR), until the pre-financed liability (or liabilities) mature.

C. Non-Accumulation of External Debt or Domestic Payments Arrears

5. **The NFPS will not accumulate any external debt arrears during the program period**. For the purpose of this performance criterion, an external debt payment arrear will be defined as a payment by the NFPS that has not been made within thirty days after falling due under the contractual agreement, unless specified otherwise. The performance criterion will apply on a continuous basis.

6. **The NFPS will not accumulate any domestic payments arrears during the program period**. For the purpose of this performance criterion, a domestic payment arrear will be defined as an obligation by the NFPS that has not been paid within sixty days after falling due under the contractual agreement, unless specified otherwise. The performance criterion will apply on a continuous basis.

D. Adjuster for Overperformance of Tax Revenue in 2010

7. **In the event that net tax collections exceed the program baseline of** US$2,203 million as of end-September 2010 or US$2,881 million as of end-December 2010, the performance criterion on the overall balance of the NFPS will be raised by 50 percent of any such excess.

E. Consultation Clauses

8. **Floor on the sum of total bank deposits of the private sector and external short-term liabilities of banks**. These are defined, respectively, as deposits of the private sector in commercial banks, and external liabilities of commercial banks with an original maturity of up to one year.[1] If at any point during the arrangement, the sum of private-sector bank deposits and

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[1] The definition consists of the sum of line items 211 (*DEPOSITOS)* and 212108 (*PRESTAMOS PACTADOS HASTA UN AÑO PLAZO—ADEUDADO A ENTIDADES EXTRANJERAS*) of the balance sheets of banks as

(continued)

external short-term bank liabilities should be less than US$7,555.4 million (i.e., ten percent below the end-June 2010 level), a consultation clause will be triggered, and the authorities will contact Fund staff to discuss possible remedial actions.

9. **The reserve requirements and liquid asset requirements of the banking system are defined in current regulations** (at about 22 percent and about 3 percent, in effective terms, respectively). [2] If at any point during the arrangement the authorities consider it necessary to modify the reserve requirements or liquid asset requirements, a consultation clause will be triggered, and the authorities will contact Fund staff to discuss those measures.

F. Structural Benchmarks

10. **The authorities will publish their strategic plan for the modernization of the Domestic Tax Administration Directorate (DGII) and the General Custom Administration Directorate (DGA) by end-September 2010** (structural benchmark, rephased from April 30, 2010). The plan will outline steps to enhance coordination in the tax collection process across agencies, including the migration of the DGII and DGA toward the same IT platform so that there can be communication between the databases of the two units.

11. **The reform of the liquid propane gas subsidy** will introduce a new tariff structure and a new targeted subsidy to assist the most vulnerable.

12. **The reform of the electricity subsidy** will reflect the adjustment of tariffs of consumers that average more than 99 kWh per month, so that charges will more closely reflect the costs of generation, in line with the existing price determination formula.

13. **The Financial System Supervision and Regulation Law will contain the following elements**: (i) the merger of the supervisory entities for banks, pensions, and the stock exchange; (ii) enhanced functional autonomy of the new supervisory institution; (iii) stronger legal protection for supervisors; (iv) provisions to strengthen cross-border supervision through improved information sharing; and (v) invest the Central Bank to be the consolidated financial system regulatory authority.

14. **The Investment Funds Law will contain the following elements**: (i) a clear legal framework for investment funds; (ii) accounting and asset valuation rules for investment funds; and (iii) terms for investor entry and exit.

15. **The test bank resolution exercise will meet the following criteria**: (i) will be conducted by the Financial System Safety Net institutions: Superintendency (SSF), the Deposit

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compiled by the Superintendency of the Financial System on a weekly basis; minus the lines noted in Table A2, which represent public sector deposits and accrued interest. As of June 30, 2010, (the agreed baseline date) the sum of private sector bank deposits and external short term liabilities of banks was US$8,394.9 million.

[2] The regulations on reserve requirements and liquid asset requirements are NPB3-06 and NPB3-11.

Insurance Fund (IGD) and the BCR; (ii) will be applied to one licensed commercial banks operating in El Salvador at the time the exercise is conducted and its impact over the banking system; and (iii) will result in a detailed report that will be shared among participating regulatory agencies.

16. **The issuance of norms to strengthen corporate governance of commercial banks will include the following components**: (i) rules governing the functioning, structure, composition, and duties of boards of directors; (ii) requirements for committees formed by boards of directors, including audit and risk committees; (iii) shareholders' rights, including voting power in proportion to their share of ownership, access to and rules for annual shareholders' meetings, and requirements for information sharing among shareholders; (iv) transparency guidelines; and (v) guidelines on conflicts of interest within financial conglomerates.

G. Reporting Requirements

17. **To facilitate monitoring of program implementation, the government of El Salvador will prepare and send to the IMF**, by e-mail or by fax, monthly data and reports within six weeks following the end of the preceding month, and quarterly data and reports within six weeks after each test date, unless specified otherwise. Such data will include (but are not limited to) the following:

(a) The Central Bank of El Salvador will provide on a monthly basis the comprehensive monetary survey and the central bank balance sheet (electronic file);

(b) The Central Bank of El Salvador will provide on a daily basis the total bank deposits in commercial banks with a lag of at most three working days;

(c) The Central Bank of El Salvador will provide on a weekly basis the balance sheets of individual banks and the total banking system, as well as detailed information on their liquidity positions, with a lag of at most five working days;

(d) The Central Bank of El Salvador will provide quarterly balance of payments data in electronic format with a lag of a quarter;

(e) The Ministry of Finance will provide monthly data on tax revenue with a lag of at most five working days;

(f) The Ministry of Finance will provide monthly data on revenue and the execution of expenditure for the central government and the rest of the general government (ISSS, the municipal governments, public hospitals, the national university, and other decentralized agencies) with a lag of at most four weeks, and quarterly data on revenue and the execution of expenditure for the four non-financial public sector enterprises (CEL, CEPA, ANDA, and LNB);

(g) The Ministry of Finance will provide monthly information on the financing of the nonfinancial public sector and stock of debt of the NFPS (as defined above) as specified in the table attached to this TMU;

(h) Indicators and other statistical data on recent economic developments, such as the household consumer price index, will be provided as they become available. In addition, the central bank will provide its quarterly reports on economic activity with a lag of at most a quarter;

(i) The authorities will provide a status report on the implementation of the structural reforms specified in Table 3 of the Memorandum of Economic and Financial Policies attached to the Staff Report of August [31], 2010; and

(j) The authorities will provide to IMF staff any other information that the latter may deem necessary for the effective monitoring of the Stand-By Arrangement.

Table A1. El Salvador Financing of the Non-Financial Public Sector

	2010			
	March	**June**	**September**	**December**
A. Net domestic financing of the non-financial public sector (NFPS)				
i. Net claims of the financial system (1+2+3)				
1. Net credit of commercial banks to the NFPS:				
a. Credits				
b. Liabilities				
2. Net credit of the BCR to the NFPS:				
a. Credits				
b. Deposits				
3. Net credit of the non-bank financial institutions to the NFPS 1/				
a. Credits				
b. Liabilities				
ii. Stock of NFPS liabilities (including Letes) held outside the domestic financial system and the NFPS 2/				
iii. Floating debt				
B. Net external financing				
i. Multilateral development banks (IADB, WB, CABEI)				
a. Disbursements				
b. Amortizations				
ii. Bilateral creditors				
a. Disbursements				
b. Amortizations				
iii. Financial institutions				
of which : bonds				
of which : LETES				
iv. Other				
C. Privatization and concessions				
D. Non-financial public sector overall balance (A+B+C)				
Memorandum:				
Stock of LETES in circulation				
Disbursements				
Amortization				

Sources: Ministry of Finance; Fund staff estimates.

1/ Includes trust funds: (FOSEDU, FOP).
2/ Includes amortization of ISTA bonds.

Table A2. Public-Sector Deposit Account Numbers

Public Sector Accounts

2110010101, 2110010102, 2110010201, 2110010202, 2110020101, 2110020102, 2110020201, 2110020202, 2111010101, 2111010102, 2111010201, 2111010202, 2111020101, 2111020102, 2111020201, 2111020202, 2111030101, 2111030102, 2111030201, 2111030202, 2111040101, 2111040102, 2111040201, 2111040202, 2111050101, 2111050102, 2111050201, 2111050202, 2111060101, 2111060102, 2111060201, 2111060202, 2111070101, 2111070102, 2111070201, 2111070202, 2111080101, 2111080102, 2111080201, 2111080202, 2111130101, 2111130102, 2111130201, 2111130202, 2111140101, 2111140102, 2111140201, 2111140202, 2111990101, 2111990102, 2111990201, 2111990202, 2112010101, 2112010102, 2112010201, 2112010202, 2112020101, 2112020102, 2112020201, 2112020202, 2112030101, 2112030102, 2112030201, 2112030202, 2112040101, 2112040102, 2112040201, 2112040202, 2114010101, 2114010102, 2114010201, 2114010202, 2114020101, 2114020102, 2114020201, 2114020202, 2114030101, 2114030102, 2114030201, 2114030202, 2114040101, 2114040102, 2114040201, 2114040202, 2114050101, 2114050102, 2114050201, 2114050202, 2114060101, 2114060102, 2114060201, 2114060202, 2114070101, 2114070102, 2114070201, 2114070202.

Accrued Interest

2110019901, 2110019902, 2110029901, 2110029902, 2111019901, 2111019902, 2111029901, 2111029902, 2111039901, 2111039902, 2111049901, 2111049902, 2111059901, 2111059902, 2111069901, 2111069902, 2111079901, 2111079902, 2111089901, 2111089902, 2111139901, 2111139902, 2111149901, 2111149902, 2111999901, 2111999902, 2112019901, 2112019902, 2112029901, 2112029902, 2112039901, 2112039902, 2112049901, 2112049902, 2114019901, 2114019902, 2114029901, 2114029902, 2114039901, 2114039902, 2114049901, 2114049902, 2114059901, 2114059902, 2114069901, 2114069902, 2114079901, 2114079902.

Attachment IV. Informational Annex

I. Relations with the Fund
As of June 30, 2010

I. **Membership Status**: Joined March 14, 1946; Article VIII

II. **General Resources Account**:

	SDR million	%Quota
Quota	171.30	100.0
Fund holdings of currency	171.30	100.0
Reserve position in Fund	0.00	0.00

III. **SDR Department**:

	SDR million	%Allocation
Net cumulative allocation	163.81	100.0
Holdings	163.81	100.0

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: [3]

Type	Approval date	Expiration date	Amount approved (SDR million)	Amount drawn (SDR million)
Stand-By	Mar 17, 2010	Mar 16, 2013	513.90	0.00
Stand-By	Jan 16, 2009	Mar 16, 2010	513.90	0.00
Stand-By	Sep 23, 1998	Feb 22, 2000	37.68	0.00

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
		2010	2011	2012	2013	2014
Principal	0.00	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00	0.00

VII. **Implementation of HIPC Initiative**: Not Applicable

[[3] Provide information on the three most recent financial arrangements, including Contingent Credit Lines, beginning with the current arrangement, if any.]

VIII. **Safeguards Assessments:**

The Central Bank of El Salvador (BCR) is subject to an update safeguards assessment under the current Stand-By Arrangement (SBA). The safeguards assessment associated to the SBA approved on January 16, 2009 was finalized in May 2009, and an update for El Salvador's new SBA, approved on March 17, 2010, was completed on August 20, 2010. The 2010 assessment found that the BCR has made progress in addressing safeguards recommendations in the areas of internal control and legal structure. The update concluded that efforts to adopt an international accepted accounting framework (e.g., IFRS) should be intensified, and recommended the publication of the audit opinions of the independent audit firm and more systematic monitoring of audit recommendations.

IX. **Exchange Arrangements**:

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 C 8.75 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.

X. **Article IV Consultation**:

The 2008 Article IV consultation was concluded on November 12, 2008 (SM/08/326). The next Article IV consultation with El Salvador will be held in accordance with the July 15, 2002 decision on consultation cycles. The current Article IV consultation was delayed due to a change in government in 2009, albeit, engagement has been fluid in the context of a formal IMF program that spanned two administrations.

XI. **FSAP Participation and ROSCs**:

An FSAP Update was conducted in 2010. The report is to be considered by the Executive Board on September 15, 2010. A fiscal ROSC was conducted in 2002 and a data module ROSC was conducted in 2003.

XII. **Technical Assistance**:

Department	Dates	Purpose
Statistics	August 2010 August 2009	Quarterly national accounts by expenditure and new base year for national accounts.
Statistics	August 2010	Producer price index.
Statistics	September 2009	Regional harmonization of government finance statistics.
Monetary and capital markets	December 2008	Crisis prevention and resolution.
Fiscal	August 2010	Options for tax reform.
Fiscal	August 2010	Medium-term budgeting.
Department	**Dates**	**Purpose**
Fiscal	August 2009	Revenue impact of planned tax reform.
Fiscal	December 2008	Macrofiscal and distributional implications of subsidy reform.
Fiscal	December 2008	Options for tax reform and strengthening tax administration.
CAPTAC-DR resident expert	2009–2010, various dates	Customs administration.
CAPTAC-DR resident expert	2009–2010, various dates	Domestic revenue follow-up and implementation.
CAPTAC-DR resident expert	May 2010	Regional harmonization of international investment position statistics.
CAPTAC-DR resident expert	April–May 2010	External sector statistics.

XIII. **Resident Representatives**: None

II. Relations with the World Bank

1. The IMF's El Salvador team led by Andy Wolfe (Mission Chief) has met on various occasions with the World Bank's El Salvador team led by Laura Frigenti (Country Manager) to address macro critical structural reforms and to coordinate the two teams' work for the period September 2010–August 2011.

2. The teams have agreed that El Salvador's main macroeconomic challenges are achieving a durable fiscal consolidation, including by increasing revenues as a percent of GDP, and improving the investment climate to boost the growth performance of the economy. Reducing the public debt-to-GDP ratio to pre-crisis levels is a key priority, especially in view of the high sensitivity of the debt trajectory to negative output shocks.

3. Based on this shared assessment, the teams have identified five structural reform areas as macro critical, in view of their central role in achieving fiscal consolidation and sustained growth.

- **Subsidy reform:** Reduce the need for budgetary transfers to pay for subsidies on electricity and liquefied gas (LPG), in conjunction with maintaining subsidies to the most vulnerable users. At present, electricity and LPG subsidies are poorly targeted, and are estimated to represent a drain on government resources equal to 1.4 percent of GDP in 2009.[4] Reform of energy subsidies would provide fiscal space to accelerate spending on infrastructure, security, and social programs, including education.

- **Tax reform:** Boost tax revenue by at least 1½ percent of GDP. Such a reform would establish a sustainable resource base for financing needed infrastructure, security, and social outlays while ensuring that fiscal deficits decline and the public debt-to-GDP ratio is put on a durable downward path.

- **Public financial management reform:** Implement reforms to address shortcomings in El Salvador's budget process, including: (i) a requirement of super majorities in Congress for approval of long-term financing; and (ii) the absence of a multi-year framework. These weaknesses reduce the authorities' ability to execute the investment budget, with negative consequences for long-term growth.

- **Financial sector reform:** Strengthen the regulatory framework by: (i) addressing deficiencies in the bank resolution framework; (ii) issuing norms to enhance supervision; and (iii) improving the legal framework for El Salvador's capital markets.

- **Investment climate reform:** Improve the growth performance of the economy. Domestic and foreign investment in El Salvador remains low both in nominal terms and

[4] Water usage and transportation subsidies were reformed in 2009.

as compared with regional peers. Relative weaknesses in areas such as security, education, and innovation likely impact negatively on investment and growth.

4. The teams agreed to support the authorities' work in these areas with the following division of labor:

- **Subsidy reform:** The authorities have reaffirmed their commitment to reduce electricity and LPG subsidies in the context of the current IMF program and have committed to make public a plan to bring LPG prices closer to market rates, while still protecting the most vulnerable through a consumption subsidy. They will also adjust electricity tariffs to residential customers with an average monthly consumption above 99 kWh to more closely reflect market prices.

- **Tax reform:** The authorities are working toward a fiscal pact that would be implemented no later than 2012 and would include a tax reform aimed at boosting revenues by at least 1½ percent of GDP, a goal that has been incorporated as a structural benchmark in the current IMF program. The Fund is providing technical assistance on the design of revenue measures that would underpin the increase, including the possible increase in tax rates.

- **Public financial management reform:** An IMF technical assistance mission visited San Salvador in August to advise on improving budget management and execution and was joined by a World Bank mission to work on designing a multi-year expenditure framework. The World Bank is planning additional technical assistance focused on strengthening tax collection agencies, modernizing public financial management and enhancing public sector transparency. The operation is backed by a loan that is awaiting congressional approval. In addition, a Fund mission will visit San Salvador in late September 2010 as part of a fiscal transparency ROSC.

- **Financial sector reform:** The 2010 update to El Salvador's Financial Sector Stability Assessment (FSSA) conducted by the World Bank and IMF found the financial system had withstood the global financial crisis and was well-capitalized and liquid. At the same time, the FSSA noted several vulnerabilities and opportunities for structural reforms. Some of these elements, including congressional passage of the financial supervision and regulation law and passage of an investment funds law, are incorporated as structural benchmarks in the current IMF program. The authorities are also considering reforms that would allow the central bank to undertake limited lender-of-last-resort (LOLR) functions, in line with FSSA recommendations.

- **Investment climate reform:** To spur growth and investment during the remainder of their term, the authorities plan to undertake fiscal reforms to create space for priority expenditures, assume a more active role in promoting exports, and foster "public private partnerships" to promote investment in infrastructure, including in the electricity and energy sectors.

The teams have the following requests for information from their counterparts:

- The Fund team requests to be kept informed of progress in the above macro critical structural reform areas. Timing: as needed.

- The World Bank team requests to be kept informed of progress in the above macro critical structural reform areas. Timing: as needed.

5. The attached table lists the teams' separate and joint work programs during September 2010–August 2011.

World Bank and Fund Planned Activities in Macro Critical Structural Reform Areas
September 2010–August 2011

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. World Bank Work Program	Public Finance and Social Sector DPL		Sep. 2010
	Income Support and Employability Project		Dec. 2010
	Sustaining Social Gains for Economic Recovery		Dec. 2010
	Fiscal Management and Public Sector Performance T.A. loan		Dec. 2010
	Local Government Strengthening Project		Nov. 2010
	Development Policy Loan with a CAT DDO		Jan. 2011 (board approval)
	Health Sector and Governance Project		Feb. 2011 (board approval)
	Public Finance DPL		Mar. 2011 (board approval)
2. Fund Work Program	TA provision: National accounts (STA);	TA missions: Aug. 2010	TA reports: Aug. 2010
	Producer price index (STA);	Aug. 2010	Aug. 2010
	[Budget management and execution (FAD)];	Sep. 2010	Sep. 2010
	[Design of revenue measures (FAD)]	Oct./Nov. 2010	Oct./Nov.2010
	Staff visit for second review under the Stand-By Arrangement	Feb. 2011	Mar. 2011
	Article IV consultation	Jul./Aug. 2010	Sep. 2011

III. Relations with the Inter-American Development Bank

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

1. As of mid-August 2010, the IDB has pending disbursements for US$281.9 million, which correspond to public-sector guaranteed loans and which are mostly concentrated on six programs in four sectors.

El Salvador: Relations with the Inter-American Development Bank

(As of August 11, 2010, in millions of U.S. dollars)

A. Operations

Sector	Commitments	Amount Disbursed	Amount Undisbursed
Urban Dev. And Housing	69.3	69.0	0.3
Health	60.0	-	60.0
Water and Sanitation	92.9	71.3	21.6
Public Finance	200.0	-	200.0
Total	**422.2**	**140.3**	**281.9**

B. Loan Transactions

	2003	2004	2005	2006	2007	2008	2009	2010E
Disbursements	97.4	52.0	91.6	100.2	96.1	288.1	487.3	122.0
Repayments	73.6	96.2	97.3	88.9	90.5	104.8	278.3	114.2
Net lending	**23.8**	**-44.2**	**-5.7**	**11.29**	**5.6**	**183.3**	**209**	**7.8**
Interest and charges					62.3	67.3	67.8	62.8
Subscriptions and contributions					-	-	-	1.2
Net transfer	**23.8**	**-44.2**	**-5.7**	**11.29**	**-56.6**	**116**	**141.2**	**-56.2**

2. For the rest of 2010 and 2011, the Bank will work on the preparation of nine loans (US$415 million) in the areas of public finance (US$100 million), water and sanitation (US$70 million), roads and transportation (US$85 million), urban development and housing (US$70 million), social development (US$55 million), modernization of the state (US$5 million), and export promotion (US$30 million).

IV. STATISTICAL ISSUES

<table>
<tr><th colspan="2">I. Assessment of Data Adequacy for Surveillance</th></tr>
<tr><td colspan="2">General: Data provision is adequate for surveillance.</td></tr>
<tr><td colspan="2">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 update the series to 2005 weights. The project also envisages the publication of quarterly national accounts by expenditure, which are currently available on only an annual basis.</td></tr>
<tr><th colspan="2">II. Data Standards and Quality</th></tr>
<tr><td>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.</td><td>A data ROSC was published in December 2004.</td></tr>
</table>

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of August 20, 2010)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	Jul 10	Aug 10	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Jul 10	Aug 10	M	M	M		
Reserve/Base Money	Jun 10	Jul 10	M	M	M	O, LO, LO, LO	LO, O, O, O, LO
Broad Money	Jun 10	Jul 10	M	M	M		
Central Bank Balance Sheet	13 Aug 10	20 Aug 10	W	W	M		
Consolidated Balance Sheet of the Banking System	13 Aug 10	20 Aug 10	W	W	M		
Interest Rates[2]	13 Aug 10	20 Aug 10	W	W	W		
Consumer Price Index	Jul 10	Aug 10	M	M	M	O, O,LNO, O	LNO, LO, O, O, LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Jun 10	Jul 10	M	M	M	LO, LO, LNO, LO	LO, O, LO, LO, NO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Jun 10	Jul 10	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Jun 10	Jul 10	M	M	M		
External Current Account Balance	Mar 10	Jun 10	Q	Q	Q	O, LO, LNO, LO	LO, LO, O, O, LO
Exports and Imports of Goods and Services	Jun 10	Jul 10	M	M	M		
GDP/GNP	Mar 10	Jun 10	Q	Q	Q	LO, LNO, LNO, LO	LNO, LNO, LO, O, LO
Gross External Debt	Mar 10	Jun 10	Q	Q	Q		
International Investment Position[6]	Mar 10	Jun 10	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 discount 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) and state and local governments.
[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 December 2004 and based on the findings of the mission that took place during August 12–28, 2003) 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, statistical techniques, assessment and validation of source data, assessment, and revision studies.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/134
FOR IMMEDIATE RELEASE
September 23, 2010

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2010 Article IV Consultation with El Salvador

On September 15, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with El Salvador.[5]

Background

The Salvadoran economy was severely affected in 2009 by the global economic slowdown. International trade flows, remittances, and private capital flows declined, taking a heavy toll on domestic economic activity and tax collections. Economic activity declined by 3.5 percent in 2009, and inflation was zero. As a result, tax revenue declined sharply, and the non-financial public sector deficit widened to 5.5 percent of gross domestic product (GDP). Bank deposits continued to increase despite the global crisis and election-related uncertainty. Asset quality deteriorated and bank profitability declined as a result of the economic downturn, but the financial system weathered the shock well.

Economic recovery is underway. Exports, imports, and remittances are all increasing, and economic activity has been growing since early this year. Economic growth is expected to reach 1 percent in 2010, and inflation is forecasted to remain low at around 1.5 percent. The current account deficit is expected to widen modestly to 2.75 percent of GDP from 1.75 percent of GDP in 2009, as domestic demand recovers. Tax revenue is rising and the fiscal deficit is narrowing. Most bank indicators have improved in 2010, as deposits continue to rise, profitability is recovering, non-performing loans have leveled off, and liquidity and

[5] 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. 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.

capital ratios remain well above their pre-crisis levels. In this light, the authorities are treating their 36-month Stand-By Arrangement as precautionary.[6]

Fiscal policy has focused on mitigating the impact of the economic downturn on the most vulnerable, within the context of maintaining a sustainable medium-term debt path. Savings from reform of electricity, transportation, and water subsidies have been redirected toward the authorities' anti-crisis plan, which entails spending of about 1 percent of GDP per year to improve social conditions and poverty alleviation. Tax revenue has increased, owing to the effects of the December tax package and the economic recovery, while spending has remained contained. The non-financial public sector deficit is expected to end the year at 4.75 percent of GDP, and narrow further in the medium term as fiscal consolidation efforts and the economic recovery take hold.

As required by IMF procedures for cases of exceptional access, an Ex Post Evaluation (EPE) of El Salvador's experience with the exceptional access Stand-By Arrangement approved in January 2009 was also reviewed by the Executive Board. The EPE focused on program objectives and design, as well as key lessons from the experience. The report found that the Stand-By Arrangement, which the authorities treated as precautionary, contributed to preventing a crisis at the time of political transition, while acknowledging the program quickly went off track due to the global crisis. Lessons learned include that large precautionary financing packages, where appropriate, can help to prevent crises; and that an approach that includes the candidates' public endorsement of the program's main objectives can help maintain confidence around the time of elections.

Executive Board Assessment

Executive Directors commended the authorities for their economic strategy and good performance under the Stand-By Program. Directors noted that El Salvador's economy is gradually recovering after having been severely affected by the global crisis and that the medium-term outlook is also generally favorable. Further strengthening the economy's growth prospects and reducing poverty will depend on a durable fiscal consolidation effort and improvements in the investment climate through continued commitment to macroeconomic and financial stability. Timely implementation of structural reforms will also be important.

Directors supported the authorities' strategy of gradually consolidating the public finances as the economic recovery takes hold, while striking a reasonable balance between starting fiscal consolidation and supporting the recovery, while maintaining adequate social and public investment spending. Undertaking determined revenue-raising measures, including

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[6] The Stand-By Arrangement, with total access of SDR513.9 million (about US$777.5 million) was approved on March 17, 2010 (see Press Release No. 10/95)

strengthening tax administration, and accelerating the reform of energy subsidies will be consistent with these objectives.

Directors emphasized the need to place debt-to-GDP ratio on a firm downward path and stressed the importance of the timely enactment of a fiscal pact and continued expenditure restraint. They welcomed the authorities' efforts to develop a medium-term expenditure framework and encouraged them to strengthen debt management practices.

Directors noted that dollarization has served the economy well and helped maintain macroeconomic stability. They also noted staff's assessment that the real effective exchange rate is broadly in line with fundamentals and stressed that it is important to take measures to boost competitiveness.

Directors were encouraged that the Salvadoran banking system is liquid and well-capitalized but noted that further reforms aimed at enhancing its stability will be critical to strengthen its resilience. They called for swift approval of the Financial Sector Supervision and Regulation Law and supported the plans to bolster the corporate governance of banks and to upgrade the bank resolution framework. Directors encouraged the authorities to limit the fiscal risks involved in increasing the role of public banks in the provision of credit.

Directors welcomed the opportunity to review El Salvador's experience with the 2009 exceptional access Stand-By Arrangement. They supported the key messages of the ex post evaluation report that the Arrangement contributed to reducing uncertainty during the political transition and that access to sizable external financing and the endorsement of program objectives by the leading presidential candidates, helped maintain depositors' confidence and signal policy continuity.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

El Salvador: Selected Economic and Financial Indicators

	2006	2007	2008	2009	Proj. 2010
Income and Prices (change in percent)					
Real GDP	4.2	4.3	2.4	-3.5	1.0
Consumer prices (end of period)	4.9	4.9	5.5	0.0	1.5
GDP deflator	4.5	4.2	5.9	-1.0	2.3
External Sector (change in percent)					
Exports of goods and services, volume	5.4	6.9	5.5	-16.4	7.2
Imports of goods and services, volume	9.4	8.4	4.7	-23.3	8.9
Terms of trade	-0.9	-5.7	-10.2	11.8	-2.1
Real effective exchange rate (+ is appreciation)	0.4	-0.5	0.5	1.6	…
	(Percent of GDP, unless otherwise stated)				
Money and Credit					
Credit to the private sector	42.8	42.8	41.3	41.3	39.6
Broad money	43.6	47.1	43.9	47.0	46.4
Interest rate (time deposits, percent)	4.4	4.7	4.2	4.5	…
External Sector					
Current account balance	-4.2	-6.0	-7.6	-1.8	-2.8
Trade balance	-18.8	-20.1	-19.9	-13.5	-15.1
Exports (f.o.b. including *maquila*)	20.0	19.8	20.9	18.3	19.6
Imports (f.o.b. including *maquila*)	-38.9	-40.0	-40.7	-31.8	-34.7
Services and income (net)	-3.9	-4.3	-5.1	-5.2	-5.1
Transfers (net)	18.5	18.4	17.3	16.9	17.5
Foreign direct investment	1.4	6.9	3.3	2.7	1.7
Nonfinancial Public Sector					
Overall balance	-2.9	-1.9	-3.1	-5.6	-4.8
Primary balance	-0.5	0.5	-0.7	-3.0	-2.4
Gross Public Debt 1/	41.7	39.1	41.2	49.5	51.2
Of which: external public debt 1/	27.3	24.3	23.8	26.3	27.0
Gross Nonfinancial Public Sector Debt	39.4	38.8	39.7	48.5	50.0
External public debt service 1/					
(percent of exports of goods and services)	15.6	12.3	9.6	11.7	11.0
Domestic Saving and Investment					
Gross domestic investment	17.0	15.9	14.9	13.1	12.8
Gross domestic saving	12.8	9.9	7.3	11.3	10.0
Net Foreign Assets of the Financial System					
Millions of U.S. dollars	1,398	2,134	2,035	2,857	2,846
Percent of deposits	16.8	22.5	21.7	28.7	29.0

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.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 10/347
FOR IMMEDIATE RELEASE
September 20, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes First Review of El Salvador's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) has concluded the first review of El Salvador's performance under its 36-month Stand-by Arrangement. The main objectives of El Salvador's economic program under the arrangement are to bolster economic recovery, reduce poverty, preserve financial stability, and secure debt sustainability. The Stand-By Arrangement was approved on March 17, 2010 in the amount equivalent to SDR513.9 million (about US$781 million). The Salvadoran authorities intend to continue treating the arrangement as precautionary (see Press Release No. 10/95).

Following the Executive Board discussion of El Salvador on September 15, 2010, Mr. Naoyuki Shinohara, Deputy Managing Director and Acting Chair, made the following statement:

"The Salvadoran economy continues its gradual recovery from the global downturn and the medium-term outlook is also generally favorable. Over the longer term, further strengthening the economy's growth prospects and reducing poverty, while safeguarding fiscal sustainability, requires a comprehensive strategy, including measures to raise revenues, structural reforms aimed at enhancing the business climate, and higher private investment.

"The authorities' Fund-supported economic program seeks to consolidate gradually the public finances as the economic recovery takes hold. The authorities' strategy for 2011, which includes strengthening tax administration to increase revenues as well as reforming energy subsidies, will create space for high-priority social spending and public investment while lowering the fiscal deficit to 3.5 percent of GDP.

"Beyond 2011, timely enactment of a fiscal pact, which includes measures to raise revenue on a durable basis, and continued adherence to expenditure targets in the authorities' program will be critical to sustain fiscal consolidation, placing the debt-to-GDP ratio on a firm downward path.

"Continued commitment to the dollarization regime has been the cornerstone of macroeconomic and financial stability. While the Salvadoran banking system is liquid and well-capitalized, it would benefit from further reforms aimed at enhancing its resilience. Approving the Financial Sector Supervision and Regulation Law, bolstering the corporate governance of banks, and upgrading the bank resolution framework will be key to this objective. Limiting the fiscal risks associated with the provision of credit by public banks will also be necessary," Mr. Shinohara said.

Statement by Ramón Guzmán, Executive Director for El Salvador
September 15, 2010

We would like to thank staff for their comprehensive set of papers and for the constructive dialogue with our authorities. They broadly agree with Staff's assessment and recommendations.

Ex Post Evaluation of Exceptional Access Under the 2009 Stand-By Arrangement.

Given that we agree with staff's analysis, we would like to make the following comments for emphasis only:

1. As expressed in several opportunities, we consider the 2009 Stand-By Arrangement as a successful case of IMF's support. The authorities, as well as economic agents, were concerned that sudden banking deposits outflows around the time of presidential elections could have a significant effect in a small, open and fully dollarized economy, given previous experience. In that sense, as staff rightly points out, the main objective of the program was to prevent a crisis of confidence by sending a signal of policy continuity and by securing a liquidity buffer in case risks materialized.

2. Although we cannot evaluate what the case would have been without a program, we can be sure the program was successful in the sense that the country did not experience a crisis and it preserved financial stability during the election and transition periods, despite the effects of the global crisis. Moreover, sovereign spreads remained stable and in line with those in the region.

3. Another factor that contributed to the success of the program was the engagement of both presidential candidates with its main objectives, reflected in their public statements.

4. Although we agree with staff that a more conservative initial macroeconomic framework would have been useful to avoid deviations, we believe the program was well designed considering the information available and the prevailing uncertainty about the duration and magnitude of the global crisis at the time of approval (January 2009).

5. We should not forget that the Salvadoran program was a pioneer of the High Access Precautionary Arrangements (HAPAs). As such, the Salvadoran experience was instrumental for other countries in the region which gained access to similar programs after the reform of the Fund's toolkit in March 2009.

6. Finally, we believe that the program's main objectives (to prevent deposit flight, preserve macroeconomic stability, and boost the economy's resilience to shocks), were satisfactorily accomplished.

First Review Under the Stand-By Arrangement and 2010 Article IV Consultation

We believe the SBA has provided crucial support to the authorities in their commitment to sound macroeconomic policies and helped anchor confidence of depositors, investors and creditors. It has also provided an important liquidity buffer to support the dollarized financial system in case negative shocks occur.

As Staff mentions, performance under the SBA has been good. All the quantitative performance criteria for end-March and end-June were met.

In the structural area, plans for liquid propane gas subsidy reform have been finished and will be in effect by end-2010; the large tax-payers unit has been strengthened, and a risk-management approach to taxpayer selection for audits is being adopted. The strategic plan for the modernization of the Domestic Tax Administration Directorate and the General Customs Administration Directorate is in progress, and the process of enhancing coordination across the two agencies has begun. The financial sector supervision and regulation law is up for congressional approval, which is expected by end-December 2010.

New structural benchmarks for the second review were established, including a budget for 2011 consistent with a fiscal deficit of 3.5 percent of GDP, the undertaking of a bank resolution simulation exercise, and the issuance of norms on corporate governance of commercial banks.

Recent Developments

Although at a modest pace, the economic recovery is gaining terrain. In the first quarter of 2010 GDP fell only 0.5 percent (y/y) after declining 4.9 percent in the last quarter of 2009. The monthly index of economic activity rose 1.9 percent in June 2010 (driven mainly by increases in manufacturing, financial services and retail trade), in line with the envisaged 1.0 percent GDP growth for the end of the year.

Prices have remained stable during 2010. In July 2010, headline inflation was 1.0 percent (y/y), while core inflation observed a reduction from 2.6 percent at the end of 2009 to 0.9 percent in July 2010.

International trade has been recovering in 2010 after observing a significant decrease in 2009. As of July 2010 (y-t-d), exports observed an increase of 14 percent and imports rose by 17 percent. Remittances have recovered modestly: as of July 2010 (y-t-d) they increased by 2.5 percent.

Capital account inflows are weaker than envisaged, owing mainly to delays in disbursements from IFIs. That situation may lead to a decrease of US$200 million in net international reserves (compared with an increase of US$100 million projected in the program).

Regarding the financial system, deposits have risen, profitability is improving and non-performing loans have stabilized. Liquidity and capital ratios are well above those observed before the crisis. Notwithstanding, as in many other countries in the region, credit to private sector reactivation remains a challenge.

Macroeconomic Outlook

The outlook for 2010 and 2011 remains broadly unchanged since the approval of the SBA. We continue assuming a gradual recovery, with real GDP growth projected at 1.0 percent in 2010 and 2.5 percent in 2011.

Inflation projections are unchanged at 1.5 percent in 2010 and 2.75 percent in 2011. The current account deficit is expected to be 2.8 percent in 2010 and 3.1 percent in 2011, slightly higher than previously projected

Economic and Social Program

Our authorities' macroeconomic program will be anchored on strict adherence to official dollarization and a prudent fiscal policy while safeguarding social spending. In that context, they have implemented poverty reduction programs and are making progress on improving targeting of critical government expenditure (particularly energy subsidies), in line with their policy framework of taking the fiscal deficit and public debt ratio on a sustained downward path. Our authorities have also moved ahead with key reforms in the financial sector aimed at strengthening oversight and bolster resilience to shocks.

Fiscal Policy

For 2010, fiscal policy will continue to be aimed at reducing gradually the NFPS deficit to 4.8 percent of GDP (5.6 percent in 2009), while protecting spending on social programs and investment in key sectors.

For 2011, as mentioned, our authorities are seeking congressional approval of a budget consistent with an NFPS deficit of no more than 3.5 percent of GDP, implying a reduction of more than one percentage point of GDP with respect to the expected 2010 outturn, making evident our authorities' commitment to fiscal consolidation. Moreover, the 2011 budget will reallocate spending away from poorly-targeted subsidies to key social programs.

The envisaged deficit targets for 2010 and 2011 take place against the backdrop of a moderately-paced recovery of economic activity and are expected to take the non-financial gross public sector debt ratio to 51 percent of GDP in 2011; thereafter, the ratio is expected to decline steadily to 46.8 percent of GDP by 2015.

<u>Saving of revenue overperformance</u>. If tax revenues were to exceed those projected under the program in 2010, authorities will use up to 50 percent of the excess revenue to increase spending in social programs, with the remainder allocated to meet the adjusted performance criterion on the overall balance of the non-financial public sector.

Medium-term fiscal strategy. The authorities are improving transparency and planning of government operations by implementing a fiscal consolidation medium- term strategy. Their efforts started with the publication of the 2010–14 government program (*Plan Quinquenal de Desarrollo*). Beginning with the 2011 budget, authorities will introduce a multi-year expenditure framework that will seek consistency between the short-term and medium-term objectives of putting the NFPS deficit and public debt ratio on a sustainable downward trajectory. Key to this effort will be the implementation of a fiscal pact (by end-June 2012) to be achieved through intensive consultation with a broad range of stakeholders with the objective, among others, to increase government revenues over the medium term between 1.5 and 3.0 percent of GDP through 2015.

Financial Sector

The authorities are committed to preserving and protecting the soundness and stability of the Salvadoran banking system, and are adopting reforms to enhance resilience and increase the efficiency of financial intermediation.

Authorities will seek congressional approval of the Financial Sector Supervision and Regulation Law by end-December 2010 (a structural benchmark under the program). The bill strengthens financial sector supervision by merging supervisory entities for banks, pensions, and the stock market. It enhances the autonomy of the merged institution; empowers the Central Reserve Bank of El Salvador (BCR) to be the only regulator of the financial system; and it provides legal protection for supervisors. In addition, the bill bolsters cross-border consolidated supervision by permitting the superintendency of the financial system to share information on local operations with foreign supervisors.

Authorities will also seek congressional approval of the Investment Funds Law (a structural benchmark under the program) by end-March 2011. The law aims at facilitating financial intermediation by creating a clear framework for investment funds, specifying accounting and asset valuation rules, and setting the rules for investor entry and exit.

Financial System Stability Assessment (FSSA). We noted that the main findings of the updated FSSA confirm improvement of the banking system soundness since the FSSA in 2004, with solvency in good stance and advances in supervisory practices. The authorities are in broad agreement with the findings and recommendations of the FSSA and have been taking actions to attain the recommended enhancements to the legal framework and bank safety net arrangements, including securing congress approval of the Financial Sector Supervision and Regulation Law, and the Investment Funds Law. They also plan to carry out a comprehensive bank resolution simulation exercise by February 2011.

Competitiveness

There is agreement between staff and authorities that real effective exchange rate appears to be broadly in line with fundamentals. Our authorities also agree that investment remains low relative to other countries in the region and recognize that there is room to improve the business climate in areas such as security, education and innovation. They are clear that addressing the security situation is a priority in the short term; therefore their economic and social program contemplates to allocate more resources to this area and to education. They are also considering proposals to promoting innovation, modernizing key productive sectors and increasing regional integration.

Economic Growth Challenge

Our authorities agree with staff that a key medium-term challenge is to improve the economy's growth performance. To stimulate growth and investment during the rest of its administration, the government plans to assume a more active role in promoting exports and foster public-private partnerships to stimulate investment in basic infrastructure.

The government is also evaluating how to enhance the role of public banks to support lending to private sector, which remains subdued. Our authorities believe that a more active role of public banks can help to spur that credit. The envisaged measures are based on the premise that public banks' participation has to be transparent and without a significant fiscal burden.

Downside Risks

We share staff's view that a slower economic recovery in the US – given the close linkages of El Salvador with the US economy – and a breakdown of political support to the fiscal consolidation process are the main risks to the authorities' strategy. Although the risks are broadly balanced, our authorities are aware that were those risks to materialize, in absence of political support to revenue measures, authorities will have to reduce spending to avoid forms of financing that could endanger debt sustainability.

Finally, we believe that the envisaged policies are adequate to meet the objectives of the authorities' economic and social program and we are certain that authorities stand ready to take additional measures (in consultation with the Fund) that should be necessary for that purpose. We also think that the SBA will be instrumental to preserve El Salvador's macroeconomic stability and to help support economic recovery during the following years.