DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

BUFF/ED/22/7

CONFIDENTIAL

January 18, 2022

Statement by Mr. Moreno and Mr. Cartagena Guardado on El Salvador
Executive Board Meeting
January 24, 2022

On behalf of El Salvador's authorities, let us convey their gratitude to the Board, Management, and staff for the timely response to the COVID-19 pandemic, including the RFI approved in April 2020, the allocation of SDRs, which was used to strengthen the country's international reserves position, and for the permanent and close dialogue that staff has held with El Salvador. We want to extend our appreciation to the Mission Chief, Ms. Alina Carare, and her team, for their continued and candid engagement as trusted advisors to El Salvador, including several meetings per month with authorities since the RFI approval.

Context and Recent Developments

El Salvador started the pandemic with a relatively sound economic position, albeit with high debt levels. The relatively high population density (the highest in the Central American region) has made managing the pandemic more challenging. El Salvador has been a dollarized economy since 2001, with a relatively favorable pre-pandemic macroeconomic scenario fostered by a sound macroeconomic position and financial policies. On average, from 2016 until 2019, El Salvador registered economic growth of 2.5 percent, low yearly average inflation of 0.4 percent for the same period, a moderate fiscal deficit of 2.9 percent of GDP, and a current account deficit of 2.0 percent of GDP. At the end of 2019, its debt-to-GDP ratio was 71.3 percent, which included a significant liability from the private pension scheme.

During the pandemic, the accommodative fiscal policy protected businesses and households. The swift policy measures adopted by the Salvadorian authorities during the first year of the pandemic were instrumental not only in fighting the virus, but also in maintaining the proper functioning of the health system infrastructure to effectively respond to the new waves of the pandemic in 2021. The authorities took measures to protect households and businesses, and devoted financial resources to ensure an adequate supply of vaccines once they were available. These efforts required an increase in spending at a time when the economy was contracting. The debt-to-GDP ratio increased by an estimated 17.9 percentual points in 2020, of which 37.6 percent was explained by

expenditures to fight the pandemic, 36.5 percent by the economic contraction (following a fall in GDP of 7.9 percent), and the remaining 25.8 percent was explained by other factors (such as natural growth of pension liabilities and interest service, and the one-time purchase of computers for students), according to Central Bank estimates.

The swift policy response and significant vaccination rate explain the low degree of contagiousness and fatalities. By December 2021, 71 percent of the population over six years old was fully vaccinated (with two doses), surpassing the authorities' target of 70 percent. Alongside with the advances in vaccination and low levels of contagiousness and fatalities, the population maintains strong preventive and voluntary measures such as the use of face masks, social distancing, and hand-sanitary measures in public areas. Authorities have already assured the supply of vaccines to close the vaccination gap, including booster vaccination, in the first half of 2022 (by December 2021, 17.2 percent of the population over the age of six years had already received the booster vaccine).

El Salvador registered a vigorous economic growth rebound in 2021. The high vaccination rates and preventive individual measures led to a vigorous economic recovery in 2021, including in sectors that required human contact and interactions like services. According to the authorities' forecasts, the Salvadorean economy grew 10.3 percent in 2021, supported by a strong growth in remittances (26.6 percent increase, year over year, to December 2021), which boosted private consumption. As a result, investment is expected to increase (9.2 percent) and exports to rise (26.5 percent), while imports will also grow by 25 percent year on year and public consumption by 7 percent in real terms. It is worth noting that in the case of imports of goods, 44 percent were intermediate and maquila goods, and 18.1 percent were capital imports, which will continue to boost economic dynamism in 2022.

The economy will continue to recover above its potential in 2022. After the vigorous rebound of 2021, the Salvadorean economy is expected to grow by 4 percent, according to authorities' estimates, exceeding the potential growth and supported by the dynamism of private consumption, investments, and external demand. The continued and fruitful actions that authorities are taking to promote tourism with programs such as *Surf-City* will contribute to the dynamism of the service sectors and economic growth in 2022. Other measures, such as cutting red tape and facilitating external trade and commerce and the Trust *FIREMPRESA,* will continue to be helpful in providing financing to small and medium-sized enterprises affected by the pandemic shocks. The increase in the minimum wage in the middle of 2021 has provided support for consumption and some release for some of the most vulnerable segments of the population considering the pressures of inflation.

Efforts to maintain Fiscal Sustainability

Revenue mobilization efforts have been successful. Tax revenues have increased 17.3 percent through December 2021, owing to the economic recovery and administrative actions implemented by the Ministry of Finance, compared to the same pre-pandemic period of 2019. The anti-evasion and anti-smuggling plan that the authorities have implemented includes weekly reporting of tax evasion cases to the specialized unit of the General Attorney. This has been supported by a memorandum of

understanding signed by the Ministry of Finance and the General Attorney to strengthen cooperation in the fight against tax crimes and evasion in May of 2021. In addition, the improvements in the tax collection systems to facilitate the payment of fiscal obligations and administrative and technological developments have supported these efforts.

Additional resources were needed in 2020 and 2021 for priority areas. Despite the positive revenue mobilization outcomes, the overall fiscal deficit was higher than the pre-pandemic average (2021: -5.8 percent of GDP; 2017-2019: -2.8%), although lower than during the first pandemic year (2020: -10.1 percent). Among other factors, this is explained by the increase in health expenditure and the necessary resources to reduce crime and insecurity that for years have been a binding constraint for growth.

The authorities are committed to changing the debt trajectory to a downward path. Authorities have agreed on the need for fiscal consolidation and are taking decisive measures. On the expenditure side, the Salvadorean Congress approved a reduction of transfers from the central government to municipalities (provinces) in November 2021 and created a specialized entity to support municipalities in the execution of larger investment and infrastructure projects benefiting from economies of scale (it started operations in January 2022) and increasing efficiency in public projects. The authorities will continue with the anti-evasion and anti-smuggling plans and are assessing other revenue and expenditure measures to be implemented in the short and medium term to change the trajectory of the public debt to a sustainable downside trajectory. Authorities are also undertaking measures to strengthen the public financial management framework and have agreed to the publication of the risk reports.

Financial Resilience and Inclusion

Preserving financial resilience continues to be a priority. The country has built a sound banking system and regulation with a large presence of international players, which allowed it to enter the crisis with a strong position. In terms of total assets, foreign-owned banks account for 86.4 percent of the banking system as of November 2021. The banking system continues to have a broad base of domestic deposits, financing 88.3 percent of total loans. At the same time, NPLs are relatively low (2 percent by November 2021) and were adequately provisioned (around 159 percent of NPLs and 3.2 percent of total loans), while the COVID loan portfolio has decreased to 9.2 percent of total loans by November 2021 (of which 27.7 percent of that amount is the consumption portfolio and 16.9 percent, micro and small enterprises), with banks constituting voluntary provisioning for a large part of that portfolio. Banks' solvency registered at a sound 14.9 percent by the end of November 2021, above the minimum limit required by local regulation (12 percent).

Boosting financial inclusion is a key short-term economic target for El Salvador. El Salvador continues to boost financial inclusion by enhancing financial literacy and increasing digitalization. The Central Bank and the Superintendence of the Financial System launched the Financial Innovation Office in December 2021, with support from the Interamerican Development Bank, to support private

initiatives that foster and accelerate the use of financial technologies to facilitate access and use of financial services for more Salvadorans. The Central Bank has also continued strengthening the retail payment systems through a new public Automated Clearing House (ACH), facilitating real-time retail transfers 24 hours a day, 365 days a year for customers with access to electronic banking. This new public ACH, which started operations in June 2021, has reached an average weight of 27.7 percent of the total retail payments (30.4 percent by number of operations and an equivalent of 25 percent of 2021 GDP) just in the seven months since the start of operations. This broader scope of real-time retail payment systems is a good foundation for increasing the efficiency of the financial channels.

Digitalization will be fundamental to extending financial services to the informal sector and the unbanked population. According to a Central Bank survey, only 23 percent of the population had a bank account in 2016 and, in addition, 49.1 percent of the country's total employment in urban areas was in the informal sector by 2020, according to the Households and Multiple Purposes Survey. Using mobile phone technology for transfers, remittances, and retail payments is a key economic policy to boost productivity and inclusion. This is particularly important in a country where one-quarter of households received remittances in 2020 and where this transfer accounted for 25 percent of GDP in 2021.

The authorities are using mobile phone technology to rapidly boost financial inclusion. El Salvador is taking advantage of these opportunities to promote financial inclusion through innovative technological means, benefiting from the large number of mobile phones and the population's increasing access to the internet. According to official statistics, 94.1 percent of total households had access to mobile phones in 2020, and 26.9 percent of households had access to the internet. In this vein, authorities launched an app called "*Chivo*" in September 2021 that runs on mobile phones or other devices with access to the internet to facilitate transfers and payments in US dollars (by default) or Bitcoins, for which the country made Bitcoin legal tender, keeping dollars as the unit of account for all the transactions. The government incentivized the use of this 'app' at the beginning by providing a one-time transfer of USD $30 to each Salvadorean that downloaded the 'app', which at the end was reflected in household consumption in economic activity and assumed the cost of convertibility to provide a fee-free resource for transactions using the app through a trust that feeds the needs of purchases of Bitcoins for convertibility within the *Chivo* app ecosystem.

Results so far have proven fruitful for financial inclusion. The new *Chivo* system has increased its participation in the retail market of payments with transactions that were equivalent to an average of 17.3 percent of the total number of operations in both ACH systems between October and December and was instrumental in channeling $44 million in familiar remittances in just the first three months of operation with much lower or no-fees compared with traditional banking channels. Besides the financial inclusion that this measure has expanded, authorities have taken into consideration in its development the AML/CFT requirements as all the transactions can be traceable and identifiable, given that the *Chivo* App requires a phone number, as well as an electronic copy of national IDs and a face picture. The authorities are committed to continuing monitoring the developments and risks of

Chivo and Bitcoin as the system evolves and agree that regulation and oversight of these services can be strengthened.

Reforms Agenda

El Salvador is in an ongoing structural reform process to increase productivity. The country is developing measures to facilitate investments and convert the energy supply to renewable sources to lower energy costs and raise productivity. A power plant with private investments estimated at USD 1.2 billion will start operations in 2022, generating energy with natural gas, reducing fossil fuel dependency. In addition, authorities are expecting to produce new geothermal energy from volcanoes in the next few years following exploration investments that are currently in operation. In 2021, 82.1 percent of domestically generated energy originated from renewable sources on average, and with ongoing investments, the figure is expected to rise to 100 percent by 2023 (imported energy accounted for 18.9 percent of total energy supply). This will have a positive impact by reducing energy prices and benefiting competitiveness.

Closing technological gaps in public schools is an ongoing process. As an additional measure to strengthen digital transformation in schools, the government has been providing one laptop to each student in public schools. By the end of 2021, 70 percent of all public sector students in grades 4th to 9th had benefitted from a government-provided laptop; and the gap for these grades, as well as 1st to 3rd grades, is expected to be closed in 2022. This was a one-time expenditure in the budget for 2021–2022, which will foster digitalization and access to electronic means for approximately 1.3 million public sector students and provide an enhanced foundation for rising productivity and better jobs in the future.

The safer environment for the whole population is boosting confidence and new businesses, tourism, and economic activity. The "*Plan de Control Territorial*" helped to have more specialized and better equipped police to fight organized crime and drug trafficking. These efforts were instrumental in achieving a significant reduction in crime and insecurity; for instance, the homicide rate has been reduced in 2021 by 67 percent of what was the rate in 2019, which is a strong improvement, according to official statistics.

The authorities remain committed to strengthening competitiveness by improving the business environment, as well as governance, AML/CFT, and anti-corruption frameworks. Authorities are updating the AMF/CFT framework to include virtual assets in the scope of the law; the draft law is expected to pass Congress in the second half of this year. Most recently, in early January, the Ministry of Finance, the General Attorney, the Superintendent of Financial System, and the Ministry of Security signed an agreement to strengthen cooperation to fight anti-money laundering and tax crimes. The Central Bank has also embarked on an action plan to implement strengthening measures following recommendations provided by the Fund in the Safeguards Assessment of 2020.

Fund capacity development remains key to supporting capacity building. As outlined in the staff report's Informational Annex, El Salvador has actively engaged in the use of Fund technical assistance, including on fiscal and customs efficiency, revenue mobilization, and financial regulation and supervision. This capacity building has been instrumental in strengthening technical capacities and the advice has been helpful in shaping proposals for policy measures and will continue to be critical for the success of the authority's policy agenda.

The decisive measures that authorities are implementing to promote a safer country, more digital with deeper financial inclusion, a better business environment for investment, and more renewable and lower-cost energy sources are instrumental medium-term targets with on-going targets that are contributing to a sustainable recovery. These measures complement the commitment of the authorities to a sound macroeconomic policy based on fiscal discipline and financial stability and resilience.

The authorities of El Salvador appreciate the close and permanent dialogue with the Fund.