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Statement by Mr. Guerra and Mr. Chicas Cienfuegos on El Salvador
Executive Board Meeting
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On behalf of El Salvador's authorities, we convey their appreciation to the Mission Chief, Mr. Raphael Espinoza, and his team for the engagement and candid discussions during the Article IV consultation.

El Salvador has been a *de jure* dollarized economy since 2001, which reduces the policy options during a period of constant shocks. Before the pandemic, on average from 2015 to 2019, the economy grew 2.4 percent in a context of low inflation (0.4 percent), a moderate fiscal deficit of 3.0 percent of GDP, and a current account deficit of 2.2 percent of GDP. In terms of public debt, in 2019 the debt-to-GDP ratio registered 69.9 percent, which included around 20 percent of GDP from the pension system. The pandemic generated a drop in economic growth (-8.2 percent), but decisive efforts by President Nayib Bukele's government to support the economy, such as a successful COVID-19 vaccination campaign (as of December 2022, 85 percent of the population has been vaccinated), led to a faster than expected recovery.

Recent Developments

The economy of El Salvador is growing above its historical average, notwithstanding continuous external shocks. GDP grew 10.3 percent in 2021, exceeding expectations and surpassing the pre-pandemic level in that year. In 2022, the commodity price shocks and the tightening of global monetary conditions were headwinds for the economy, but decisive efforts by the authorities to reduce red tape, improvements in the business climate, and a historical reduction in crime supported an estimated economic real growth rate of 2.8 percent, above potential output growth. Private demand increased 4.4 percent, supported by strong job creation (5.8 percent in the formal sector) and a continuous remittance inflow (3.2

percent). Private investment grew at an estimated rate of 5.6 percent, and exports of goods and services rose 8.9 percent, while imports of goods and services increased 4.9 percent.

The external commodity shocks have pushed inflation above its historical average but have remained in single digits. El Salvador has registered low inflation levels in the last few years, averaging 0.4 percent in the period 2015-2019. The recovery from the pandemic and the oil shock in 2021 raised inflation to 6.1 percent in December 2021. The multiple commodity shocks and the spillovers from the war in Ukraine elevated inflation to an unseen rate of 7.8 percent in June 2022, driven mainly by food prices. The authorities established a temporary fuel subsidy (ending in December 2022), a subsidy for the consumption of liquefied petroleum gas (ending in May 2023), and some actions to monitor prices and the conditions under which sales of basic goods are made. The subsidies and administrative measures that were oriented to protect consumers have allowed the country to maintain an inflation rate in single digits, one of the lowest in the Latin American region. In February 2023, inflation continued to moderate, reaching 6.8 percent year-over-year, according to official statistics.

The risks associated with Bitcoin have not materialized. The legal tender status of Bitcoin has not negatively affected the economy or the stability of the financial system of El Salvador. In this vein, the risks stated in the previous Article IV consultation have not materialized. It is worth noting that banks do not have any exposure to Bitcoin on their balance sheets. Since the adoption of Bitcoin as legal tender, the authorities have issued different norms to create an effective regulatory framework. The Rules of Procedure of the Bitcoin Law determined that all Bitcoin service providers must be registered at the Central Bank, the Superintendency of the Financial System is in charge of supervision, and Bitcoin providers must follow the guidelines of the Anti-Money Laundering Law. Improving and adapting the regulatory framework is an ongoing process that the authorities will continue to support. The adoption of Bitcoin has helped El Salvador become known around the world, contributing to increase tourism. In 2022, international visitors reached 2.5 million, a 79 percent annual increase, contributing to a more dynamic economy.

The authorities are committed to honoring all the public debt. El Salvador has paid all its public debt on time, contrary to some speculations about a default in early 2023. The Eurobond 2023 was paid out in January 2023 as scheduled, as were all other debt obligations. This was a clear demonstration of the authorities' commitment to their obligations, and it will continue to be a priority in the coming years. Furthermore, the authorities are working to improve debt management and have taken actions to reduce the concentration of debt service obligations in a short period of time.

Economic Outlook

The economy will continue growing above its potential. According to the authorities´ estimates, the GDP will grow 2.9 percent in 2023, above the estimated potential growth of 2.2 percent; however, this performance is not expected to generate excessive pressures on prices due to the dollarization scheme of the economy and the high imported component of El Salvador's inflation. It is projected that inflation will be lower in 2023, in line with the trajectory of commodity prices, such as oil, and the inflation rate in the United States. The economic drivers will be private consumption, investment, and export of services in a context of an unprecedentedly improved security environment. Private consumption will be supported by higher employment levels and positive remittance inflows (projected at 23.6 percent of GDP given the strengthening of the labor market in the USA). Furthermore, the reduction in crime will favor an increase in leisure activities, which will boost production and employment in other activities such as trade and services in the formal and informal sectors. Investment will be boosted by both the public and private sectors. The government will increase the development of strategic infrastructure. The *Dirección de Obras Municipales (DOM)* will continue providing infrastructure to municipalities (despite its recent creation, the DOM has a budget execution rate of about 100 percent). The private sector's participation, the efforts to reduce red tape, and the dynamic domestic economic activity generated by the improvements in the security situation will continue bolstering investment. It is projected that the construction sector will continue to be one of the most dynamic sectors (in February 2023, the Directorate of Construction Procedures was launched to facilitate construction projects), supported by investments in real state by the diaspora (according to the BCR, around 45 percent of investments made in El Salvador by Salvadorans living in the USA are concentrated in real state). The effective policy of tourism promotion, such as *Surf City,* will generate an increase in international events in El Salvador, boosting exports of services.

Fiscal Policy

The authorities' efforts to reduce tax evasion have generated an important increase in tax revenues. The Ministry of Finance is committed to substantially reducing tax evasion through the implementation of the Anti-Evasion Plan and the Anti-Smuggling Plan, which have generated additional revenues of US$1.4 billion (around 4.4 percent of GDP) since their implementation. Modernization is one of the priorities for tax management. In this vein, with the support of the IDB, the Electronic Invoicing System was launched in December 2022 with the aim of strengthening tax administration and facilitating the compliance of tax obligations. The measures implemented have been reflected in tax receipts exceeding the pre-pandemic level, reaching 20.7 percent of GDP in 2022 from 18.3 percent registered in 2019.

The authorities are exploring other revenue and expenditure measures to sustain improvements in fiscal performance but underscore that, at this stage, an increase in the VAT rate is not considered due to possible negative effects on household consumption and economic growth.

Fiscal prudence in 2022 allowed for improvements in public finances. The economic performance and the implementation of administrative measures by the Ministry of Finance generated an outstanding increase in fiscal revenues in 2022. According to the Ministry of Finance's statistics, tax collection increased 12.6 percent, mainly due to an increase in income tax of 25 percent and in the VAT of 8.4 percent. However, current expenditure increased only 2.7 percent due to expenditure growth restraints on public salaries. The primary balance, including pensions, registered a surplus of 2 percent of GDP, above pre-pandemic levels. The fiscal deficit decreased substantially to 2.7 percent of GDP, compared with the rates registered in 2020 (10.1 percent of GDP) and 2021 (5.6 percent of GDP).

Public debt has decreased in the last two years, notwithstanding multiple external shocks. The authorities' commitment to improve public finances has allowed a decline in public debt in the last two years. Relevant resources were necessary to protect the population during the pandemic, especially to finance health expenditures, resulting in an increase in public debt that reached 87.9 percent of GDP in 2020. However, revenue measures and expenditure constraints allowed a reduction in public debt to 81.0 percent of GDP in 2021, and it is estimated at 76.2 percent of GDP in 2022 (in 2019, the ratio accounted for 69.9 percent of GDP), despite the temporary subsidies implemented to cushion the pass-through of international commodity price shocks to domestic prices.

Reform Agenda

The authorities continue applying measures to reduce red tape in order to facilitate private investment. El Salvador is committed to boosting private investment to increase potential growth, the productivity of the economy, and generate better job opportunities for the population. In the last few years, the authorities have implemented different measures to eliminate red tape, which have contributed to improving business sentiment and favoring private investment expectations. Private investment is estimated to end 2022 at 20.3 percent above the pre-pandemic level in real terms. Recently, the National Strategy for Trade Facilitation 2023–2027 was launched with the aim of improving competitiveness, boosting private investment, and generating more inclusive economic growth. Despite the global context, the improvements at the national level will favor continued increases in private domestic investment in the coming years.

El Salvador has achieved an unprecedented reduction in crime, supporting better economic perspectives. Different studies have consistently highlighted that the elevated level of crime and violence was one of the main constraints to higher growth rates in El Salvador. Decisive efforts and the implementation of the *Plan Control Territorial* by President Nayib Bukele have reduced crime and violence to an unprecedented level. The homicide rate per 100,000 inhabitants was 18.1 in 2021, but in 2022 the rate declined to 7.8 (a 56.8 percent drop in terms of the number of homicides), which implied that 2022 was the safest year in recent history (as a reference, the homicide rate was 105 in 2015). The reduction in crime is a factual issue that all the economic players highlight, and it is generating more economic activity in the country, especially in areas previously dominated by gangs. In this regard, the authorities consider that the reduction in crime will generate higher private investment and consumption due to the reduction in security costs and extortion payments by enterprises and households, and at the same time will generate higher tax collection, contributing to better fiscal performance.

Financial Sector Policies

The financial system maintains a resilient position. One of the strengths of El Salvador is the healthy position of its financial system over the last decades, which has allowed it to withstand recent shocks without affecting the stability of the system. Institutions finance their lending operations predominantly with domestic deposits (loans as a percent of deposits accounted for 100.3 percent as of December 2022), which reduces the effects of the tightening of global monetary conditions on domestic interest rates. The NPL remained low at 1.8 percent with adequate provisions (around 2.8 percent of total loans and 152.7 percent of NPL). The solvency of financial institutions remained sound, accounting for 15.4 percent by December 2022, above the regulatory minimum of 12 percent. Bank exposures to public debt accounted for 11 percent of total assets at the end of December 2022, a ratio below the average exposure in the region.

El Salvador continues implementing measures to promote financial inclusion and facilitate transactions in the economy. In 2022, the National Financial Education Strategy was launched, which aims to develop the financial capabilities of the population through specific strategies for all the target segments. Furthermore, the BCR performed the National Survey on Access and Use of Financial Products and Services as well as the National Financial Capabilities Survey, which have provided updated information on the progress of financial inclusion in the country. The BCR continued boosting electronic transactions through a home-made automated clearing house called *Transfer 365,* which allows immediate transfers to all the financial institutions by e-banking at any time and at no cost. As of December 2022, *Transfer 365* has mobilized more than US$13.8 billion (around 48

percent of GDP) and generated financial savings for the population of around US$21.5 million. In June 2022, the BCR added two new services: *Transfers 365 Móvil,* which allows transactions using an associated phone number to a bank account, and *Transfer 365 Business,* which focuses on high-value transactions required by companies. The central bank is working on expanding the services of Transfer 365, which will increase the efficiency of the financial system to boost higher economic activity and reduce poverty, thus fulfilling the mandate of President Nayib Bukele that the "public must be better than private".

Governance

The authorities are committed to continuing to improve the governance and AML/CFT framework. Efforts to improve the alignment of the national legislation with the UN Convention Against Corruption, G-20 High-Level Principles on Asset Disclosure, and FATF standards are progressing. The alignment of the Criminal Code and the Act of Illicit Enrichment of Public Officials to international standards is almost finished. With the advisory of the United Nations Office on Drugs and Crime, a revised Anti-money Laundering legislation is being drafted in order to meet FATF standards and expand the scope of the AML/CFT framework. The draft includes additional guidelines for Virtual Asset Service Providers, and it is planned to be sent to the Assembly once the findings of the country's national risk assessment are incorporated. The Financial Intelligence Unit is building higher operational capacity through trainings with foreign institutions, such as the FBI, and hiring specialized personnel in technology to be able to analyze and track suspicious transactions, including operations in the crypto ecosystem.

A new Public Procurement Law was enacted by the Assembly that contains elements recommended by the IMF. In February 2023, a new Public Procurement Law (PPL) was approved, which will contribute to improving the operational management of government procurement and provide new tools to establish control and auditing measures. The PPL creates the Single Registry of State Suppliers, establishes the creation of a National Public Procurement System (SINAC), and puts in place the information requirement on the beneficial owners of the bidding entities as was recommended by the IMF. It is expected that the new law will generate savings for the public finances.

The Central Bank is progressing in implementing the recommendations of the Safeguard Assessment 2020. The BCR is strengthening its governance by implementing the recommendations of the safeguard assessment. The adoption of a policy for the selection and rotation of external auditors, the reconstitution of the Audit Committee, the development of a strategy to eliminate quasi-fiscal operations, and an external quality evaluation of the Department of Internal Audit were met. In February 2023, the internal audit of the BCR

achieved quality certification by a European institution, which highlights that all the processes conform to the IIA's International Standards for the Professional Practice of Internal Auditing and the Code of Etic. Regarding the adoption of the IFRS, the BCR has continued implementing its Adoption Plan approved in 2021 through communications with the central banks of the region to know their IFRS implementation processes and building internal capacities.

Conclusion

The authorities are implementing decisive measures to improve internal conditions and generate a more positive macroeconomic framework. The external environment is generating headwinds, but the exceptional improvement in security is eliminating one of the most relevant growth restrictions of the last decades, which could produce a new starting point for El Salvador. Efforts to improve the business environment, the security, the regulatory framework, and reduce the red tape will continue, as well as the commitment to implement adequate macroeconomic policies that guarantee financial stability, sustainable public debt, financial inclusion, and inclusive economic growth.

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