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November 5, 1984

To: Members of the Executive Board

From: The Secretary

Subject: El Salvador - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with El Salvador.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Caiola (ext. (5)8634).

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EL SALVADOR

# Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives
for the 1984 Article IV Consultation with El Salvador

Approved by E. Wiesner and Manuel Guitian

October 31, 1984

The Article IV consultation discussions with El Salvador were held in San Salvador from July 25 to August 10, 1984.1/ The Salvadoran representatives included the Ministers of Finance, Agriculture, External Trade, Economy, and Labor; the Vice-Minister of Planning; the President of the Central Reserve Bank; and officials of the ministries, Central Reserve Bank, and various government agencies and enterprises. The staff representatives were Messrs. Caiola (Head-WHD), de Rosa (WHD), Sanchez-Ugarte (FAD), Umana (WHD), and Ms. Sierks (Secretary-BCS).

## I. Recent Developments and Performance Under the Last Stand-By Arrangement

During the three-year period through 1981 there was a sharp decline in economic activity in El Salvador, with real GDP declining by nearly 18 percent over the period. Underlying this weak performance was an erosion of private sector confidence, arising from political instability and armed conflict, whose effect on the economy was compounded by the world economic recession. The authorities' attempt to stimulate economic activity in this setting by means of expansionary demand policies facilitated capital flight and led to large external imbalances. The overall balance of payments registered a cumulative deficit of around US$600 million over the three-year period 1979-81.

In 1982 the authorities framed an economic program which was designed to replenish the international reserve position of the Central Reserve Bank and to create the conditions for a better economic performance more generally. The main objectives of the program were to be achieved by means of a restrained demand policy, some adjustment of the exchange rate through the formalization of a parallel exchange market, and an increase in domestic interest rates. This program was supported by a one-year stand-by arrangement for SDR 43 million (67 percent of El Salvador's quota at the time), which was approved on July 16, 1982.

1/ El Salvador has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement.

El Salvador's performance under the stand-by arrangement was generally satisfactory despite a continuation of weak underlying economic conditions and the unsettled political situation in the country. El Salvador was in compliance with all the performance criteria 1/ and purchased the full amount available under the stand-by arrangement.

Contrary to what had been assumed, however, real GDP declined by 5 1/2 percent in 1982 (Table 1). The decline in economic activity was finally arrested in 1983. Notwithstanding the unsettled situation of the country, some progress was made in reducing inflation, reflecting both the tightening of demand policies and the moderation of inflation in El Salvador's trading partners. The annual average increase in consumer prices was held to about 12 1/2 percent in 1982-83, compared with 16 percent in 1980-81. The increase in wage costs was held well below the prevailing rate of inflation. Although the authorities relaxed somewhat their wage guidelines in 1982, the pressure for wage increases was moderated by unemployment, and by the awareness on the part of labor that in some cases increases in wages could result in the bankruptcy of firms.

Table 1. El Salvador: Selected Economic Indicators

(Annual percentage changes)

| | 1979 | 1980 | 1981 | 1982 | 1983 | Est. 1984 |
|---|---|---|---|---|---|---|
| Real GDP | -1.7 | -8.7 | -8.3 | -5.6 | -- | 1.6 |
| Real investment | -37.8 | -32.0 | -3.9 | -14.9 | 3.9 | -- |
| Consumer prices (average) | 12.1 | 17.4 | 14.7 | 11.7 | 13.1 | 14.5 |

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

The central government overall deficit (before U.S. budget support assistance) declined from 9 1/4 percent of GDP in 1981 to 7 1/2 percent in 1983 (Table 2). Taking into account an increase in the U.S. budget assistance, domestic financing of the government deficit dropped sharply in 1983, although there was some accumulation of floating debt. This improvement of the fiscal situation took place even though revenues fell short of the amount budgeted in 1983 because of delays in the implementation of a tax package; moreover, the tax package that eventually

1/ A temporary deviation in regard to the quantitative limit on external arrears at the end of 1982 was rectified during the first quarter of 1983.

emerged contained fewer measures than had been originally contemplated. Total government expenditures were kept below budgeted amounts in 1983, as the result of a tight control over current expenditure, and total outlays declined slightly in real terms. Capital outlays rose in relation to GDP in 1983, reflecting in part the need to repair infrastructure damaged by the guerrilla activity; nevertheless, capital outlays remained well below the level achieved in 1981.

Table 2. El Salvador: Central Government Operations 1/

(As percent of GDP)

| | 1980 | 1981 | 1982 | 1983 | Est. 1984 |
|---|---|---|---|---|---|
| Revenues, excluding foreign grants | 11.4 | 12.7 | 12.4 | 13.1 | 13.0 |
| Expenditures | 17.6 | 21.9 | 21.1 | 20.5 | 20.2 |
| Current | 12.5 | 15.3 | 16.7 | 15.4 | 17.0 |
| Capital | 5.0 | 6.6 | 4.4 | 5.1 | 3.2 |
| Overall deficit, before foreign grants | -6.2 | -9.2 | -8.7 | -7.4 | -7.3 |
| Foreign grants | -- | 0.6 | 2.8 | 3.5 | 2.3/3.2 2/ |
| Overall deficit | -6.2 | -8.6 | -5.9 | -3.9 | -5.0/-4.1 2/ |
| External financing | 2.0 | 4.7 | 2.6 | 2.9 | 1.7 |
| Use of loans | 2.1 | 4.9 | 2.9 | 3.3 | 2.4 |
| Amortizations | -0.1 | -0.2 | -0.3 | -0.4 | -0.7 |
| Internal fiancing | 4.2 | 3.9 | 3.3 | 1.0 | 3.3/2.4 2/ |
| Central Reserve Bank | 4.4 | 4.4 | 2.0 | -0.5 | 2.5/1.6 2/ |
| Other banks | -- | 0.6 | -- | 0.4 | -- |
| Changes in floating debt | 2.5 | 1.7 | 1.0 | 1.8 | 1.1 |
| Other | -2.7 | -2.8 | 0.3 | -0.7 | -0.3 |

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

1/ Budgetary and extrabudgetary operations.
2/ The amount of U.S. budget assistance to be received in calendar year 1984 is still under discussion.

After an expansion of 17 percent in 1982, the net domestic assets of the banking system rose by less than 4 1/2 percent in 1983 (Table 3). This outcome reflected the slower growth in credit to the public sector and a weak demand for credit by the private sector. Thus, notwithstanding a slowdown in the accrual of private financial savings to the banking system, the net international reserves of the Central Bank (adjusted for rescheduling of short-term debt) rose by US$70 million in 1983.

Table 3. El Salvador: Summary Accounts of the Banking System

(Percentage changes) 1/

| | 1980 | 1981 | 1982 | 1983 | Est. 1984 |
|---|---|---|---|---|---|
| Net international reserves | -20.6 | -8.1 | 0.4 | 14.1 | -3.3/-0.6 2/ |
| Net dometic assets | 24.2 | 23.2 | 16.9 | 4.3 | 15.4/12.7 2/ |
| Credit to Central Government, net | 13.7 | 12.6 | 5.9 | -0.5 | 7.4/4.7 2/ |
| Credit to rest of public sector, net | 1.1 | 1.0 | -1.2 | 1.3 | 1.7 |
| Credit to private sector 3/ | 14.3 | 12.6 | 8.6 | 2.5 | 4.4 |
| Other, net | -5.0 | -3.0 | 3.5 | 1.0 | 1.9 |
| Other foreign liabilities 4/ | 6.1 | 5.7 | 5.0 | 9.5 | 0.3 |
| Of which: rescheduled from short-term | ... | 0.3 | 1.3 | 6.8 | 2.5 |
| Liabilities to private sector | -2.5 | 9.4 | 12.3 | 8.9 | 11.8 |
| Money | 3.4 | -1.7 | 3.9 | -1.7 | 1.7 |
| Quasi-money | -5.9 | 11.1 | 8.4 | 10.6 | 10.1 |

Sources: Central Reserve Bank; and Fund staff estimates.

1/ In relation to liabilities to private sector at the beginning of the year.
2/ Depending on the level of U.S. budget support to be received in calendar year 1984.
3/ Including credit to nonbank intermediaries.
4/ Medium- and long-term foreign liabilities; allocation of SDRs; valuation adjustments; and government trust funds.

The improvement in El Salvador's balance of payments position in 1982-83 reflected in part the increase in financial assistance (mainly in the form of grants) from the U.S. Government (Table 4); the availability of grants made it possible to reduce the current account deficit from 6 1/2 percent of GDP in 1981 to 2 percent in 1983. Both exports and imports continued to be sluggish in 1983, and interest payments increased. During 1982 El Salvador's outstanding external arrears remained virtually unchanged, but in 1983 arrears were reduced by US$33 million, to US$55 million by the end of the year. Also, a degree of exchange rate flexibility started to be practiced in 1982-83 with a gradual expansion of the parallel market.

Table 4. El Salvador: Balance of Payments

(In millions of U.S. dollars)

| | 1980 | 1981 | 1982 | 1983 | Est. 1984 |
|---|---|---|---|---|---|
| Goods, services, and transfers 1/ | 28 | -265 | -239 | -236 | -294 |
| Exports, f.o.b. | 1,075 | 798 | 700 | 736 | 816 |
| Imports, c.i.f. | -962 | -985 | -857 | -892 | -1,011 |
| Interest payments | -65 | -60 | -84 | -94 | -113 |
| Other | -20 | -18 | 2 | 14 | 14 |
| U.S. grants | 3 | 35 | 108 | 161 | 150/190 |
| Subtotal | 31 | -230 | -131 | -75 | -144/-104 |
| Capital movements, n.i.e. | -387 | 68 | 128 | 165 | 56 |
| Public sector, net | 79 | 174 | 120 | 149 | 91 |
| Financial system, net | 2 | 11 | 92 | 25 | -21 |
| Private capital (including net errors and omissions) | -468 | -117 | -84 | -9 | -14 |
| Total | -356 | -162 | -3 | 90 | -88/-48 |
| Changes in external arrears | 57 | 36 | -5 | -33 | ... |
| Refinancing of arrears through bonds | -- | -- | 25 | 13 | -- |
| Rescheduling of short-term debt | 15 | 3 | 16 | 94 | 38 |
| Net international reserves (increase -) | 284 | 123 | -33 | -164 | 50/10 |

Sources: Central Reserve Bank; and Fund staff estimates.

1/ Excluding U.S. grants.

## II. Summary of the Discussions

### 1. General economic environment

Notwithstanding some recent positive developments in regard to economic growth, the financial situation of El Salvador remains weak. This weakness reflects in large measures the political situation of El Salvador and of the region more generally. The representatives of the new Administration, which took office in June 1984, felt that as long as the military conflict persisted, private investment would continue to be depressed and unemployment would stay relatively high. The severe damages to the infrastructure in recent years and the constraint in resources for investment indicated that economic recovery at best would be slow. The authorities expected the economy to stage a modest but broadly based recovery in 1984, with real GDP increasing by about 1 1/2 percent--the first positive growth in the last six years.

In these circumstances, the authorities' strategy was aimed at achieving a certain degree of political and economic stability, that would facilitate an early solution of the armed conflict. In the economic area, the strategy called for a strengthening of the productive sector, both traditional and nontraditional, and a reduction of unemployment. For this purpose, the authorities' efforts were aimed at fostering a recovery of confidence of the private sector and strengthening some policy instruments.

The authorities were of the view that economic growth would depend on private sector activity. Accordingly, they were studying ways and means to harmonize relations between the public and the private sector, as well as between entrepreneurs and workers, and to support those enterprises that were willing to expand production and carry out new investments. They agreed that to achieve a more productive allocation of resources, the public sector would need to reduce its deficit. In addition, they noted, price controls would need to be used only sparingly, to deal with instances of speculative price increases or in the event of artificial scarcities of commodities.

The Salvadoran representatives said that the experience with the land reform 1/ had been mixed. They were of the view that a reassessment of the land reform was needed, but they did not wish to imply any rollback of the redistributions already made. They saw the need to provide more technical assistance to farmers, to improve basic infrastructure (particularly irrigation and rural roads) and to achieve a more effective distribution of rural credit. Both the Agrarian Reform

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1/ The land reform envisaged the expropriation of estates of over 100 hectares (Phase I, over 500 hectares, and Phase II, between 100 and 500 hectares) and the granting of ownership titles to all tenant farmers for the land they rented (Phase III). Phase I and Phase III were implemented. Phase II, which was still pending, has been superseded by the approval of the new political constitution.

Institute (ISTA) and the cooperatives established under the aegis of the reform required substantial administrative improvements. In addition, the channels for the commercialization of crops needed to be reviewed, in order to remove existing bottlenecks.

The Salvadoran representatives indicated that by the middle of 1983 the land reform affected an area equivalent to 28 percent of the country's cultivated land. According to Article 105 of the newly approved Constitution, privately-owned land cannot exceed 245 hectares, and properties exceeding this limit will need to be reduced within the next three years.

## 2. Fiscal policy

Notwithstanding the reduction of the central government deficit achieved under the 1982-83 stabilization program, the fiscal situation remained a source of concern. In particular, some basic underlying trends were not favorable, and the dependence on U.S. budget support assistance had come to be substantial.

In recent years, central government revenues have been falling short of the amounts budgeted. In 1983, central government receipts grew in relation to GDP because of a large increase in the stamp tax in June 1983 and certain nonrecurrent extrabudgetary revenues. Even though the higher stamp tax will be collected on a full year basis in 1984, revenues may decline in relation to GDP, reflecting in part poor tax administration. The poor response of revenues affects both direct and indirect taxes.

Current expenditures of the Central Government were maintained at about 16 percent of GDP in 1981-83 but are estimated to rise to 17 percent in 1984, with increases in almost all categories of outlays. Wages and salaries were frozen from the beginning of 1981 until June 1984, but the total wage bill increased somewhat in relation to GDP because of the expansion of the armed forces. In 1984, wages and salaries are projected to be some 27 percent above the 1983 level, reflecting a further expansion of the armed forces and a 21 percent general salary increase granted in June. (It may be noted that consumer prices rose by 51 percent from the end of 1980 to June 1984.) Outlays for goods and services also have increased rapidly because of military spending; interest payments have risen threefold since 1980; and transfer payments (both current and capital) have averaged about 4 1/2 percent of GDP a year in 1980-84. In 1984, additional budgetary appropriations were incorporated in the budget to reflect transfers to the rest of the public sector to pay for the salary increase, nonrecurrent spending connected with the elections, and subsidies to coffee producers.1/ By contrast, investment outlays have been declining in relation to GDP, in spite of rising expenditures for repairs to damaged infrastructure.

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1/ No decision has been taken yet whether these subsidies to coffee producers will be in the form of lower taxes, transfers through the state-owned coffee company, or direct government payments to producers.

In regard to the financing of the central government operations the dependence on foreign budget support has grown and domestic floating debt has been accumulated in recent years. The Central Government relied on substantial financing from the Central Bank in the period 1980-82, and it appears that it will need to rely on such financing again this year.

In the absence of corrective measures, prospects in the fiscal field for 1985 are worrisome. Revenues are expected to drop once more in real terms, whereas current expenditures may be expected to continue to rise as a result of a full-year impact of the general salary increase, expansion of the armed forces and the associated additional military spending, and higher interest payments. The authorities recognized the general weakness of the fiscal situation and agreed that measures were needed to reduce the government deficit. They said that it would probably not be possible to do much to affect the outcome of the 1984 budget, but they were studying various means to strengthen the 1985 budget.

The Salvadoran representatives were of the view that room for action in regard to revenues was rather limited in light of the circumstances of the country. They felt that an increase in income taxes would risk adverse effects on the incipient economic recovery, while adjustments in indirect taxes would show up in domestic prices and have repercussions on wages and salary pressures. Tax evasion and delays in the payment of taxes were widespread, according to the authorities, and therefore they planned to improve tax administration and to increase penalty interest rates on delinquent taxpayers. At the same time, the authorities were seeking to curb government expenditures.

The staff observed that actions along the lines just described, although needed, were not likely to reduce the fiscal defict in a meaningful way. Given the size of the fiscal imbalance, the time needed to study and implement new tax measures, and the constraints in regard to defense-related expenditures, the mission pointed out that a reform of the exchange system would help to bolster revenue and to cut certain outlays. Increasing use of the parallel market, and collection of import taxes on that basis would raise revenues. Moreover, greater exchange rate flexibility would make it possible to end the subsidization of exports. In addition, prices and tariffs charged for public services should be adjusted to reduce the dependence of the rest of the public sector on transfers from the Central Government.

### 3. Monetary and credit policy

According to the Salvadoran representatives, the basic objectives of the monetary policy has been to support economic activity without fueling inflationary and balance of payments pressures. Adherence to this aim had come under strain in 1984 as the result of the need to finance the fiscal deficit. Moreover, a number of private enterprises have continued to experience difficulties in repaying outstanding bank loans, at the same time that they had required additional credit to carry out their operations.

The net domestic assets of the banking system were estimated to expand in the range of 13 percent to 15 1/2 percent in 1984 (depending on the level of external assistance to support the budget), in relation to the stock of private financial assets at the beginning of the period, following an increase of about 4 1/2 percent during 1983. Much of the increase in the rate of bank credit expansion would go to the public sector, although credit to the private sector would grow also at a somewhat faster rate than in 1983.

In past years, the Central Reserve Bank had supplemented the resources at its disposal by relying on medium- and long-term foreign loans for relending to the private sector. This year the Bank has successfully negotiated two lines of credit (for a total of US$100 million) with the Inter-American Development Bank, but repayment of loans contracted earlier is expected to result in a net contraction of such credits.

In these circumstances, the efforts of the authorities have been directed to improving controls over credit expansion and to encouraging the growth of financial savings in the banking system. Interest rates were increased across-the-board in early 1982, and this increase had a beneficial effect both on the growth of financial savings to the banking system and on the structure of these savings. In March 1984, some interest rates were lowered, although the most representative rates (i.e., on savings deposits of more than 60 days and up to 180 days) had remained unchanged at 11 percent to 12 1/2 percent. However, real interest rates, which were positive in 1982, have become slightly negative in 1983-84 in the face of rising domestic inflation. The authorities were of the view that this revision of the interest rates would not affect negatively the rate of growth of banking system liabilities to the private sector, which are projected to grow by 12 percent in 1984 compared with 9 percent in 1983. In any event, the authorities were planning to keep the interest rate structure under close scrutiny, and to introduce revisions whenever they appear needed. The authorities noted, however, that in the political circumstances of the country, factors other than interest rates often had major repercusions on savings and how it was allocated.

To improve the control over the credit operations of the commercial banks (which, although nationalized, continue to operate as independent institutions), the coverage of the legal reserve requirements was extended to include private trust funds that hitherto had not been subject to reserve requirements. To deal with the problem arising from frozen portfolios of several commercial banks, the monetary authorities had authorized the rescheduling of these credits over 25 years, subject to an interest rate rising from 9 1/2 percent to 18 1/2 percent (on average, the interest rate would be 16 percent for the period as a whole) and a 5 percent renewal fee.

## 4. Price and wage policy

As regards price and wage policies, since the beginning of 1981 domestic prices of basic grains, sugar, medicines, and educational services have been frozen. Also, rents for lower-income housing were lowered at that time and then frozen. The rise in the rate of price increase in 1983-84 reflected in part the increase in the stamp tax; even though the authorities had not authorized passing to the consumer the full impact of the tax increase in the case of certain commodities. The authorities recognized that compliance with the legal guidelines had not been observed in all occasions. In certain instances, the controls were difficult to enforce and could be circumvented by taking advantage of loopholes in the decrees. Nevertheless, the authorities were reluctant to do away with the price controls for fear that a rise in consumer prices (particularly for foodstuffs) would spur demands for wage increases.

All wages and salaries (including minimum wages) were frozen at the beginning of 1981. A 10 percent increase was authorized in 1982 for enterprises and entities that were deemed to be financially able to grant such an increase. Salaries for central government employees and minimum wages were not increased at that time. In June 1984, public and private wages were increased by 21 percent; minimum wages for the agriculture sector remained unchanged at the end-1980 level, while minimum wages for manufacturing, construction, services, and municipal workers were raised by about 19 percent. As a result of the June increase, nominal wages over the period 1980-June 1984 have increased on average by close to 25 percent for the private sector as a whole, and by 30 percent for the public sector. Based on these figures, wages in real terms have declined by some 25 percent since 1980.

## 5. External policies

The deficit in the current account of the balance of payments, excluding U.S. assistance, is estimated at about 6 1/2 percent of GDP in 1984, compared with 6 percent in 1983. More than one half of the deficit just mentioned for 1984 is expected to be financed by U.S. grants. Net capital inflow is estimated to slow down considerably this year, reflecting a rise in amortizations, a lower use of project loans, and difficulties in El Salvador's negotiation of new foreign credits. The overall balance of payments (defined to include changes in the net international reserves, arrears, and renegotiation of foreign debts) is projected to shift from a surplus of US$90 million in 1983 to a deficit of US$50-90 million in 1984; the decline in the net international reserves would be considerably smaller since the Central Reserve Bank has renegotiated on a medium-term basis US$40 million owed to Guatemala.

Prospects for the period ahead for El Salvador's major export commodities are not particularly favorable. Exports of coffee are limited by quotas under international agreements (exports outside the quota are made at a large discount). Moreover, domestic production has been declining in recent years because of cutbacks in the use of fertilizers and insecticides. The minimum guaranteed producer prices have been increased to a level that, according to the authorities, should cover production costs and adequate profits to most producers, but such prices involve a subsidy.1/ Cotton exports have been affected adversely by decline in production, reflecting a sharp drop in the area under cultivation, sluggish demand for Salvadoran textile products, both for domestic consumption and for exports, and disruptions caused by the armed conflict. To stimulate production of cotton, the authorities have set minimum producer prices that, as in the case of coffee, are expected to cover production costs but also appears to involve subsidies.

Since 1980, exports to the rest of Central America have declined both in volume and as a percent of total exports, reflecting the volatile political situation of the region, financial difficulties faced by other Central American countries, and disputes surrounding the exchange rate to be applied to these exports as well as the settlement of the balances under the regional clearing arrangement. Nontraditional exports to countries outside Central America are expected to be stimulated by the provision that their proceeds may be sold in the parallel exchange market, but they still represent only 10 percent of total exports.

Grants from the United States have been growing since 1981, and during the period 1982-84 were in the range of 3-4 percent of GDP. In addition, El Salvador has received assistance in the form of loans from governments, military assistance (not included in the balance of payments), and the rescheduling of short-term debt on a medium-term basis. This assistance has fluctuated over the years and future flows are likely to depend on factors largely beyond the control of the authorities.

At present, foreign exchange transactions are being handled through at least four channels: the official market, where the U.S. dollar is quoted at ₡ 2.5 per U.S. dollar; a special exchange rate, equivalent to at least 70 percent of the parallel exchange rate, for certain imports of goods and services from Central America;2/ a parallel market, where

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1/ Coffee and cotton are sold at a minimum guaranteed price to two state enterprises, which are handling the commercialization of these two commodities. Under present exchange rate regulations, the total domestic cost for coffee and cotton (i.e., minimum guaranteed producer prices, processing costs, and taxes) is higher than the colon equivalent of the export price. The differential will be covered either by the Central Government or the Central Reserve Bank.

2/ In September 1983, certain imports of goods and services were transferred from the official to the parallel exchange market. In March 1984, as a result of negotiations, those imports that originated from Central America were removed from the parallel market to be settled at a newly created special exchange rate.

the exchange rate is de facto fixed by the commercial banks at about ₡ 4 per U.S. dollar; and a black market, where the U.S. dollar is quoted at about ₡ 4.20.

The official market handles most of the proceeds from traditional exports (coffee, cotton, sugar, and shrimp); imports that are given priority; all public sector services; servicing (payment of interest and capital) of public and publicly guaranteed external debt; and certain authorized private services and capital movements. The parallel market, where only commercial banks and the Mortgage Bank are permitted to operate, handles exports of coffee to new markets; some cotton exports (up to US$19 million for the crop year 1984-85); 80 percent of exports of shrimp; exports of nontraditional products; nonessential imports from outside the Central American area; receipts from, and payments for, personal services and transfers; certain remittances of profits; and certain private capital movements.

Transactions have been transferred periodically from the official market to the special and to the parallel markets but not as rapidly as is suggested by payments pressures. Thus, the official market still handles 85 percent of the exports and about 80 percent of the imports, and not only has been registering a substantial deficit, but also has given rise to an accumulation of external arrears.

The large differential between the official and the parallel exchange rates has encouraged over- and underinvoicing of trade, delays in the surrender of foreign exchange, pressure from various sectors to obtain more favorable exchange rate treatment, and smuggling. In general, these several factors point to a misallocation of resources. The intention of the authorities has been to increase, albeit gradually, the scope of the parallel market. However, this aim has not been pursued in a systematic basis, and it has not always been well coordinated with other policies. Thus, recent decisions to shift exports from the official to the parallel market, or to retain them in the former market, often have been taken without full consideration to the level of minimum guaranteed prices and other domestic costs. As a result, exports of coffee and cotton will involve heavy subsidization. After negotiations with certain partner countries, imports from these countries have been retained in the official market or in a special market. All in all, the parallel market has not been playing its intended role, and excess demand is still reflected in the official market rather than being absorbed by the parallel market.

The authorities have sought to transfer additional transactions to the parallel market, but in some instances their efforts have been blocked by legal restraints. Thus, a request to transfer imports of oil for the production of gasoline could not go forward because domestic prices of gasoline can be revised only by Congress in the event of an increase of international oil prices. Notwithstanding these obstacles, the monetary authorities intended to make periodic transfers so as to increase the share of imports in the parallel market to at least 40 percent of total imports. To avoid pressures from individual sectors, the authorities also have been giving consideration to making transfers on an across-the-board basis rather than through actions that affect individual commodities.

According to staff estimates, the real effective exchange rate of the Salvadoran colon may have appreciated by 17 percent over the last four years through mid-1984 and by 8 percent in the last 12-month period ending June 1984, because of the more rapid increase of domestic inflation relative to that of trading partners (Chart 1). There are, however, some serious limitations in these calculations due to the lack of details on operations being transacted at specific exchange rates, as well as shortcomings in regard to price indices of both El Salvador and some of its major trading partners.

The mission impressed upon the authorities the need to follow a more flexible exchange rate policy as a means to narrow the fiscal deficit and to restore external equilibrium. The mission pointed out the serious shortcomings of the present exchange rate policy. Transfers to the parallel market have been too limited to restore external equilibrium, while at the same time they may have fueled speculation and increases in domestic prices. The large spread between the two exchange rates has created many distortions. Altogether, the mission concluded that the sooner the exchange system was unified the more beneficial it would be for El Salvador.

External arrears in the official market have been at times reduced either by issuing dollar-denominated bonds in lieu of payments, or by transferring transactions to the parallel market. Nevertheless, external arrears in the official market have ranged from US$55 million to US$95 million since the end of 1980.

El Salvador's outstanding public external debt (including debt of financial intermediaries) amounted to about US$1.7 billion at the end of 1983 (including US$0.25 billion of short-term debt), and it is expected to show only a modest change during 1984. In relation to GDP, the outstanding debt has shown only minor variations since the end of 1982, and its maturity structure has actually improved as El Salvador has made use of medium- and long-term loans, and has renegotiated short-term debts on a medium-term basis. About 85 percent of the external debt is due to governments or international institutions, and it carries relatively favorable terms as regards interest rates, maturities, and grace periods. Nevertheless, debt service (interest and amortization) as a ratio of exports of goods and services has been rising rapidly, from 11 percent in 1981 to 24 1/2 percent in 1984, and it is expected to increase to more than 30 percent in 1985. This rapid growth has reflected both the coming to the end of grace periods on most loans as well as the general sluggishness of exports.

## III. Exchange Practices Subject to Fund Approval

The exchange system currently in effect involves the following multiple currency practices and exchange restrictions subject to Fund approval under Article VIII:

1. Multiple currency practices arising from the operation of a three-tier exchange market system--comprising of: (a) an official rate of ₡ 2.50 per U.S. dollar, (b) a parallel rate, which in principle should fluctuate according to market forces but in practice is set by the commercial banks and which has remained virtually unchanged at ₡ 4.00 per U.S. dollar (selling) over the last two years, and (c) a special rate for payments of certain imports of goods and services from the rest of Central America, which is at least 70 percent of the parallel rate, or about ₡ 2.80 per U.S. dollar.

2. A multiple currency practice arising from mixing rates applied to the surrender of proceeds from shrimp exports.

3. Exchange restrictions arising from: (a) limits US$2,000 per person per year on payments for certain invisible transactions of a personal nature effected through purchases of foreign exchange from the commercial banks at the parallel rate; (b) a 100 percent deposit requirement on requests for official foreign exchange for medical treatment abroad; (c) a 10 percent advance deposit requirement on many import payments in either official or parallel exchange markets in excess of US$2,000 when related to letters of credit or bank drafts (cobranzas); and (d) payments arrears on private sector imports, debt service, and certain invisible payments.

## IV. Medium-Term Scenario

In the present circumstances of El Salvador, it is very difficult to develop a quantitative medium-term balance of payments scenario. The present armed conflict is affecting production as well as investment, and at the same time El Salvador is depending heavily on foreign assistance which is being committed on a year-by-year basis. Two medium-term scenarios might nevertheless be considered.

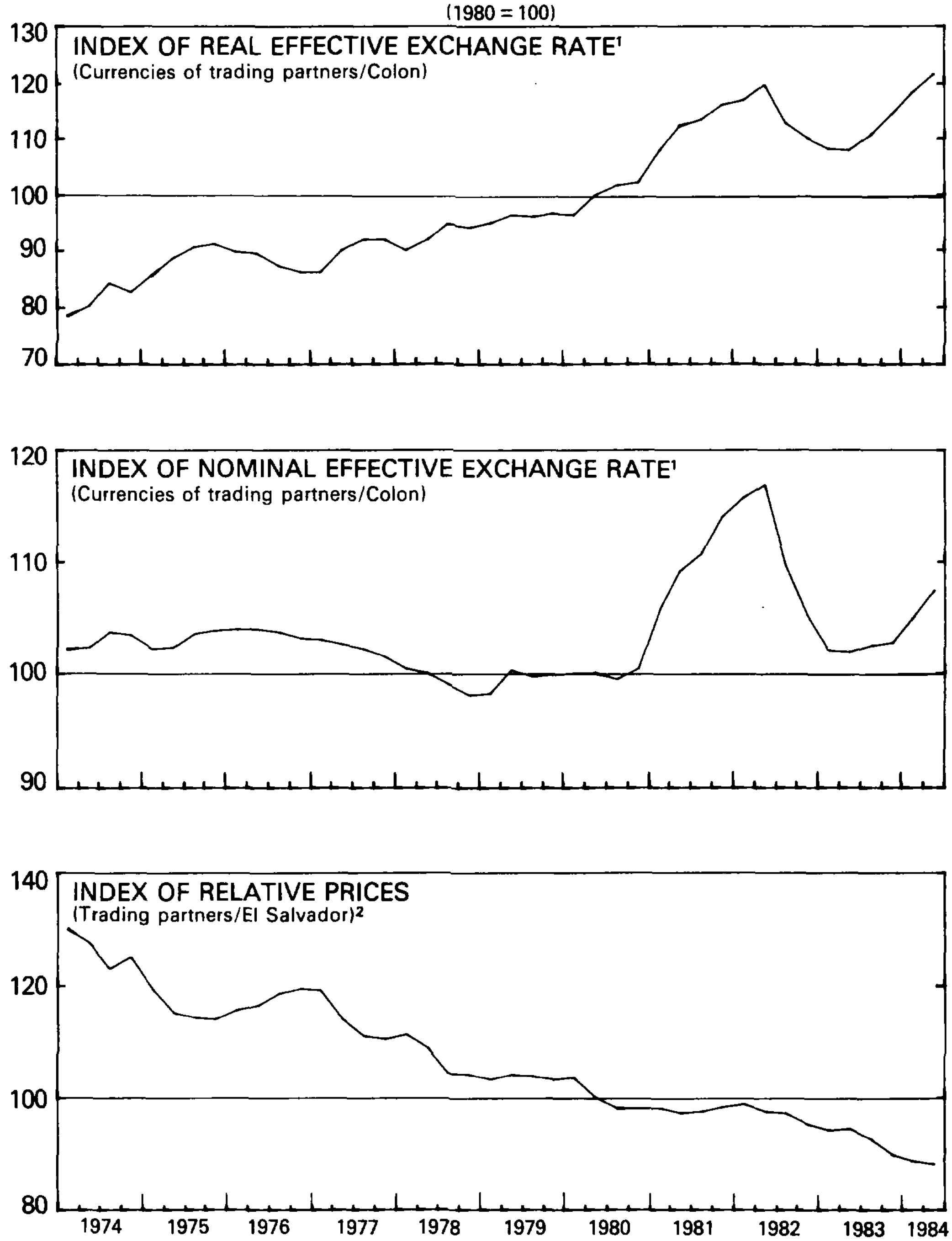
In the event that the present armed conflict should continue, El Salvador's economy would continue to face most of the present problems. In particular, private investment could be expected to remain quite sluggish; public investment would concentrate on repairs to the damaged infrastructure; social problems, arising from the displacement of population from regions in conflict would continue; and demands for expenditure on defense would persist. In this scenario, the prospects for El Salvador's economy are cloudy, and dependence on foreign assistance, for both economic and military purposes, would likely continue.

CHART 1

EL SALVADOR

# INDICES OF EFFECTIVE EXCHANGE RATES, (END OF QUARTER)

(1980 = 100)




Sources: IMF, *International Financial Statistics;* and Fund staff estimates.

[1]A rise(fall) in the index reflects an appreciation (depreciation) of the Colon.
The index is based on trade weights for 1980 representing about 90 percent of trade with partner countries.
Beginning August 1982, a weighted average of the official and parallel exchange rate of the colon was used.

[2]Relative prices were measured by consumer price indices.

In the event that the armed conflict should cease, the uncertainties that are depressing private investment would diminish. Also, production and exports might be expected to stage recoveries. Nevertheless, even in this more optimistic scenario, El Salvador would be subject to significant pressures on resources. The Government would be faced with the task of rebuilding the severly damaged infrastructure, and there would be a need to reincorporate the armed forces into the labor force. The return of misplaced population to their places of origin would alleviate certain urban social problems and help raise production, but some skilled workers who left the country in recent years might not return to El Salvador.

## V. Staff Appraisal

El Salvador has had to deal with a particularly difficult situation in recent years because of the armed conflict in the country, the world recession, and the shrinkage of the Central American Common Market. Economic activity has dropped (real GDP in 1984 is estimated to be only four fifths of that of 1979), the rate of price increase has moved up, and the balance of payments has weakened. The armed conflict has affected all sectors of the Salvadoran economy. Infrastructure has been heavily damaged, some parts of the population have had to be relocated, private investment has dropped, and defense expenditures have absorbed substantial resources.

Given El Salvador's difficult economic circumstances, and the likelihood that such difficulties may continue for some time, the policies of the authorities need to be aimed at (a) seeking insofar as possible to improve resource use, and (b) reducing El Salvador's dependence on foreign assistance. Regarding the former, it is very important that the authorities define clearly their priorities so as to maximize the use of the limited resources available, particularly since certain claims on resources--such as defense and repairs of war damages--need to be accommodated and may continue to be quite important for some time. Regarding the latter, it is recognized that in present circumstances El Salvador is in need of foreign assistance, but there is some danger that access to such assistance may delay the implementation of domestic corrective measures.

In 1982-83 El Salvador implemented a stabilization program that, in spite of the difficult circumstances of the country, yielded certain positive results. In the appraisal of the 1983 Article IV consultations, the staff encouraged the authorities to continue with their stabilization efforts and not to lose the momentum that had been gained in 1982-83. There have been some slippages since that time as a result of the political process (elections and change of government) and it would be regrettable if these slippages were to continue and efforts to stabilize the economy were to slacken. The staff's view is that the fiscal area, interest rates, and the exchange system require the immediate attention of the authorities.

The government deficit has been growing over time and it is expected to widen further in 1984 and in 1985. At the same time, dependence on foreign assistance to support the budget has been rising. Notwithstanding the inflexibility that exists in regard to certain outlays, the authorities need to strengthen their efforts to narrow the fiscal gap. Revenues could be raised through the adjustment of specific taxes--the 1983 tax package showed that there is room for action in this area--and revision of prices of goods and services sold by state agencies and enterprises. Such pricing policies would assist in the effort to curb central government transfers to the rest of the public sector, and steps might be taken more generally to make government agencies more self-sufficient in terms of their finances. Also, action by the authorities to expand the scope of the parallel market would provide fiscal relief by contributing to an increase of revenues and the reduction of certain outlays.

An improvement of fiscal performance would facilitate the implementation of more adequate credit and monetary policies. However, interest rate policy can help strengthen monetary management. Developments in the past few years have demonstrated the responsiveness of private financial holdings to changes in interest rates. Thus, even though there are other factors that affect the willingess of Salvadorn residents to hold domestic financial assets, the importance of interest rates in this regard should be recognized.

The exchange system has become very complex and it is clearly not conducive to an effective allocation of resources. The existing large spreads between rates, the accumulation of arrears, and the susceptibility to pressures from individual sectors indicate clearly that the present exchange system is not working satisfactorily. The transfers made so far to the parallel market, and the intentions of the authorities in this regard, are steps in the right direction. So far, however, too little has been accomplished in this regard. The staff would urge the authorities to take steps to accelerate the process of reunification of the exchange system.

In view of developments in the exchange system and the present lack of assurances in regard to the timing of simplification and unification of the exchange system, approval of El Salvador's exchange restrictions and multiple currency practices is not recommended at this time.

It is recommended that the next Article IV consultation with El Salvador be held on the standard 12-month cycle.

# El Salvador - Fund Relations
(As of October 15, 1984)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership Status

(a) Date of membership: March 14, 1946
(b) Status: Article VIII

## A. Financial Relations

| II. General Department | | | Millions of SDRs | Percent of Quota |
|---|---|---|---|---|
| (a) Quota: | | | 89.0 | |
| (b) Total Fund holdings of colones: | | | 200.5 | 225.3 |
| (c) Fund credit: | Total | | 111.5 | 125.3 |
| | of which: | Credit tranche | (47.0) | (52.8) |
| | | CFF | (64.5) | (72.5) |
| | | EAR | (--) | (--) |
| (d) Reserve tranche position | | | -- | -- |
| (e) Current Operation Budget | | | -- | -- |
| (f) Lending to the Fund: | | | -- | -- |

III. Stand-by Arrangement and Other Facilities

(a) Current stand-by arrangement: None

(b) Previous stand-by arrangement:
(i) Duration: July 16, 1982 to July 15, 1983
(ii) Amount: SDR 43 million
(iii) Utilization: SDR 43 million
(iv) Undrawn balance: --

(c) Special facilities
Compensatory financing: SDR 32.25 million, approved by the Executive Board on July 15, 1982 and purchased on July 21, 1982; and SDR 32.25 million, approved by the Executive Board on July 27, 1981 and purchased on July 30, 1981.

| IV. SDR Department | Millions of SDRs | Percent of allocation |
|---|---|---|
| (a) Net cumulative allocation: | 25.0 | 100.0 |
| (b) Holdings: | 0.06 | 0.002 |
| (c) Current Designation Plan: | -- | -- |

V. Administered Accounts

(a) Trust Fund Loans
   (i) Disbursed (second period) 19.7
   (ii) Outstanding --

(b) SFF Subsidy Account: not applicable.

VI. Overdue Obligations to the Fund: None.

## B. Nonfinancial Relations

VII. Exchange rate arrangement: The representative exchange rate for the Salvadoran colon is the official rate which is pegged at ₡ 2.50 per U.S. dollar (selling). There are also: (1) a parallel exchange rate, which in principle should fluctuate according to market forces but in practice is set by the commercial banks, and which has remained virtually unchanged at around ₡ 4.00 per U.S. dollar since August 1982; and (2) a special rate (since March 1984), equivalent to at least 70 percent of the parallel exchange rate (₡ 2.80 per U.S. dollar), for payments of certain imports of goods and services from the rest of Central America.

VIII. Last Article IV Consultation: June-July 1983, completed by the Executive Board on October 5, 1983 (EBM/83/147). This consultation was conducted after a 14-month cycle.

IX. Technical Assistance: None.

X. Resident Representative/Advisor: None.

## El Salvador--Basic Data

| | |
|---|---|
| **Area and population** | |
| Area | 20,987 sq. kilometers |
| Population (mid-1984) | 5.0 million |
| Annual rate of population increase (1980-84) | 2.4 percent |
| Unemployment rate (1984) | 30 percent |
| **GDP (1984)** | SDR 4,234 million<br>US$4,359 million<br>¢ 10,898 million |
| **GDP per capita (1984)** | SDR 847 |

| | 1981 | 1982 | 1983 | Est. 1984 |
|---|---|---|---|---|
| | | (percent) | | |
| **Origin of GDP at current prices** | | | | |
| Agriculture | 25 | 23 | 21 | 20 |
| Manufacturing | 16 | 15 | 16 | 16 |
| Construction | 3 | 3 | 4 | 4 |
| Transportation and communications | 4 | 4 | 4 | 4 |
| Government | 11 | 12 | 12 | 12 |
| Commerce | 24 | 24 | 24 | 25 |
| Other | 17 | 19 | 19 | 19 |
| **Ratios to GDP** | | | | |
| Exports of goods and nonfactor services | 27.6 | 23.7 | 23.2 | 22.7 |
| Imports of goods and nonfactor services | 33.6 | 28.6 | 27.6 | 27.6 |
| Current account of the balance of payments | -6.7 | -3.7 | -1.9 | -3.3 |
| Central government revenues and grants | 13.3 | 15.2 | 16.6 | 15.3 |
| Central government expenditures | 21.9 | 21.1 | 20.5 | 20.2 |
| Central government savings | -2.6 | -4.3 | -2.3 | -4.1 |
| Central government overall surplus or deficit (-) | -8.6 | -5.9 | -3.9 | -5.0 |
| External public debt (end of year) | 25.6 | 31.9 | 37.6 | 35.9 |
| Gross national savings | 6.5 | 5.8 | 6.9 | 5.9 |
| Gross domestic investment | 14.2 | 12.6 | 13.0 | 12.7 |
| Liabilities to private sector (end of year) | 35.8 | 38.8 | 39.1 | 38.8 |
| **Annual changes in selected economic indicators** | | | | |
| Real GDP per capita | -10.4 | -7.9 | -2.2 | -0.9 |
| Real GDP | -8.3 | -5.6 | -- | 1.6 |
| GDP at current prices | -3.0 | 3.7 | 8.0 | 12.6 |
| Domestic expenditure (at current prices) | 4.8 | 2.4 | 7.5 | 13.1 |
| Investment | (4.1) | (-8.1) | (11.3) | (10.2) |
| Consumption | (4.9) | (4.1) | (6.9) | (13.6) |
| GDP deflator | 5.7 | 9.8 | 8.0 | 10.8 |
| Consumer prices (annual averages) | 14.7 | 11.7 | 13.1 | 14.5 |
| Central government revenues and grants | 13.3 | 18.5 | 17.7 | 3.6 |
| Central government expenditures | 20.9 | -0.1 | 4.9 | 11.1 |
| Liabilities to private sector | 9.4 | 12.3 | 8.9 | 11.8 |
| Money | (-3.2) | (8.1) | (-3.8) | (4.1) |
| Quasi-money | (18.0) | (28.6) | (18.8) | (16.4) |
| Net domestic assets 1/ | 23.2 | 16.9 | 4.3 | 15.4 |
| Credit to public sector (net) | (13.6) | (4.7) | (0.8) | (9.1) |
| Credit to private sector | (4.6) | (10.4) | (7.9) | (5.5) |
| Merchandise exports (f.o.b., in U.S. dollars) | -25.8 | -12.3 | 5.2 | 10.9 |
| Merchandise imports (c.i.f., in U.S. dollars) | 2.3 | -13.0 | 4.1 | 13.4 |

| Central government finances | 1981 | 1982 | 1983 | Est. 1984 |
|---|---|---|---|---|
| | (millions of colones) | | | |
| Revenues and grants | 1,151 | 1,364 | 1,605 | 1,663 |
| Expenditures | 1,893 | 1,891 | 1,983 | 2,204 |
| Current account surplus or deficit (-) | -225 | -384 | -223 | -443 |
| Overall surplus or deficit (-) | -742 | -527 | -378 | -541 |
| External financing (net) | 406 | 233 | 280 | 180 |
| Internal financing (net) | 336 | 294 | 98 | 361 |
| **Balance of payments** | (millions of U.S. dollars) | | | |
| Merchandise exports (f.o.b.) | 798 | 700 | 736 | 816 |
| Merchandise imports (c.i.f.) | -985 | -857 | -892 | -1,011 |
| Investment income (net) | -100 | -129 | -139 | -158 |
| Other services and transfers (net) | 57 | 155 | 220 | 209 |
| Balance on current and transfer accounts | -230 | -131 | -75 | -144 |
| Official capital (net) | 174 | 120 | 149 | 91 |
| Financial system capital (net) | 11 | 92 | 25 | -21 |
| Private capital (net) and errors and omissions | -117 | -84 | -9 | -14 |
| Overall balance (deficit -) | -162 | -3 | 90 | -88 |
| Change in net official international reserves (increase -)2/ | 126 | -17 | -70 | 88 |
| Net change in arrears (reduction -)3/ | 36 | 20 | -20 | ... |

| International reserve position | June 30 1983 | Dec.31 1983 | June 30 1984 |
|---|---|---|---|
| | (millions of SDRs) | | |
| Central Reserve Bank (gross) | 119.6 | 154.9 | 134.2 |
| Central Reserve Bank (net) | -181.6 | -55.6 | -61.5 |
| Rest of banking system (net) | 39.2 | 49.7 | 67.3 |

1/ In relation to the stock of liabilities to the private sector (including liabilities to nonmonetary financial institutions) at the beginning of the period. Excludes contra-entry of SDR allocations.

2/ For balance of payments purposes, excludes the effect of conversion of short-term liabilities to medium term (US$3.2 million in 1981, US$16.7 million in 1982, US$94 million in 1983, and US$37.7 million in 1984).

3/ Net of refinancing through government dollar bonds (US$24.9 million in 1982 and US$12.8 million in 1983).

## El Salvador - Statistical Issues

### 1. Coverage, Currentness, and Reporting of Data in IFS

| | | Latest Data in October 1984 IFS |
|---|---|---|
| Real Sector | - National Accounts | 1983 |
| | - Prices | May 1984 |
| | - Production | n.a. |
| | - Employment | n.a. |
| | - Earnings | n.a. |
| Government Finance | - Deficit/Surplus | May 1984 |
| | - Financing | May 1984 |
| | - Debt | May 1984 |
| Monetary Accounts | - Central Bank | June 1984 |
| | - Deposit Money Banks | June 1984 |
| | - Other Financial Institutions | n.a. |
| External Sector | - Merchandise Trade: Values | December 1983 |
| | - Merchandise Trade: Prices | Q4 1982 |
| | - Balance of Payments | 1982 |
| | - International Reserves | August 1984 |
| | - Exchange Rates | August 1984 |

During the past year, the reporting of data for inclusion in IFS has been timely.

### 2. Outstanding Statistical Issues

Prices

The wholesale price indices have a 1955 base year which needs to be updated.

Government Finance

The data in the 1983 GFS Yearbook relate to budgetary central government only. This presentation can be improved by expanding the coverage of the data to include transactions of extrabudgetary units and social security funds.

Monetary Accounts

The statistics for the Central Bank and deposit money banks are current, and reflect improvements implemented after two Bureau of Statistics' technical assistance missions in 1981. The introduction of an IFS section on

Nonmonetary Financial Institutions was also recommended during the mission, but the Bureau of Statistics has not yet received data from the authorities in this area. During the present mission some refinements were introduced in the Central Bank's accounts regarding the treatment of foreign financial assistance.

Merchandise Trade

The trade indices are outdated, base 1965 = 100, and uncurrent; the currentness and quality of these indices needs to be improved.