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August 17, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: El Salvador - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with El Salvador, which 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. (73319), or Mr. Elson, ext. (74328).

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INTERNATIONAL MONETARY FUND

EL SALVADOR

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the
1983 Consultation with El Salvador

Approved by Eduardo Wiesner and Manuel Guitian

August 16, 1983

The Article IV consultation discussions with El Salvador were held in San Salvador from June 20 to July 1, 1983.1/ The Salvadoran representatives included the Ministers of Finance and of Economy; the President of the Central Reserve Bank; and officials of the Central Reserve Bank, the ministries, and various government agencies and enterprises. The staff representatives were Messrs. Caiola (Head), Di Tata, Hernandez, Lizondo (all WHD), and Miss Cabrera (secretary-WHD). The mission was assisted by Mr. Albertelli, the Fund resident representative to El Salvador.

I. Recent Economic Developments and Performance Under the Current Stand-By Arrangement

During the three-year period through 1981, the economic and financial position of El Salvador deteriorated markedly. Political instability and armed conflict prevailing in the country and in the region eroded private sector confidence and, together with the emerging world economic recession and the deteriorating terms of trade, led to a sharp decline in economic activity. The authorities' attempt to maintain economic activity by means of expansionary demand policies led to large external imbalances and fueled capital flight, and the balance of payments recorded a cumulative overall deficit of around US$560 million over the three-year period 1979-81.

In 1982 the authorities framed an economic program designed to contain the decline in production and to begin to replenish the international reserve position of the Central Reserve Bank. The objectives of the program were to be achieved through the pursuit of restrained demand management policies, some adjustment of the exchange rate through the formalization of a parallel exchange market, and an increase in domestic interest rates. Targets were established for the overall balance of payments (inclusive of external payments arrears), and limits were set for the net domestic assets of the Central Reserve

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

Bank and for the net credit of the banking system to the nonfinancial public sector through the end of 1982. This program was supported by a one-year stand-by arrangement for SDR 43 million that was approved on July 16, 1982; the full amount available under that arrangement has been purchased.

El Salvador's performance under the stand-by arrangement was generally satisfactory despite a continuation of weak underlying economic conditions in the country. Contrary to program projections, real GDP and foreign trade flows declined in 1982 for the fourth straight year, owing to further disruptive effects of armed conflict, continued weakness of private sector confidence, severe weather problems, and unfavorable international economic conditions. At the same time, domestic inflationary pressures were weaker than had been anticipated, mainly because of a lower rate of imported inflation than estimated in the program. As of the end of 1982, El Salvador was in compliance with all but one of the applicable quantitative performance criteria that had been established for the first half of the stand-by period. The intention to reduce the stock of external payments arrears by US$21 million by the end of December 1982 was not met (although the arrears were reduced somewhat for the first time in three years), as the Central Reserve Bank had to repay more short-term foreign liabilities than had been envisaged under the program. Notwithstanding the failure to observe the arrears commitment, the overall balance of payments target (including arrears as a foreign reserve liability) for the end of 1982 was achieved, as the unplanned reduction in short-term foreign liabilities of the Central Reserve Bank more than offset the deviation with respect to the target for arrears. External arrears were reduced during the first semester of 1983 through payments in cash, in medium-term bonds, and by transfers to the parallel market. Thus, El Salvador's rights to purchase under the stand-by arrangement were restored.

The Government's economic program for 1983 called for a continuation of the policies initiated early in 1982. The program aimed at a strengthening of the balance of payments through: (a) a further reduction in the domestic financing of the overall deficit of the nonfinancial public sector; (b) a continued deceleration in the rate of domestic bank credit expansion, consistent with the achievement of a small surplus in the overall balance of payments (including payments arrears); (c) a flexible policy in respect of domestic interest rates, geared toward the maintenance of positive rates in real terms; and (d) a further enlargement of the scope of the parallel exchange market, with the aim being an eventual reunification of the exchange market.

These policies were based on the assumption that real GDP would not decline further in 1983, after a 5 percent drop in 1982, as a recovery in agriculture, construction, and services was expected to offset a reduction in output in other sectors. Domestic inflation was expected to remain unchanged from 1982 to 1983 at about 11 percent. To reduce the central government deficit from 7 percent of GDP in 1982 to

5-1/2 percent in 1983, the Salvadoran authorities submitted to Congress a tax package that was to be part of the 1983 budget and was to yield around ₡ 200 million, or the equivalent of 2 percent of GDP on an annual basis. In the external sector, the deficit in the current account of the balance of payments was estimated at US$175 million, or somewhat larger than in 1982, as both the trade and the service accounts deficits were expected to increase marginally in 1983. The capital account was projected to show a net inflow of US$230 million (compared with US$193 million in 1982), reflecting a combination of faster use of public sector loans and a reversal of private capital movements from an outflow to an inflow. On this basis, it was expected that the net international reserves of the Central Reserve Bank would increase by US$10 million in 1983 and that most outstanding external arrears would be paid off during the year.

II. Summary of the Discussions

1. General economic environment

Short-term economic prospects for El Salvador remain poor and real GDP is expected to stagnate in 1983 although a further decline cannot be ruled out. Private investment in real terms is roughly one fourth what it was five years ago, and there is little to suggest that it will start to recover soon. Although there are no official estimates, unemployment is believed to be high, and it has been exacerbated by a large number of refugees from the regions affected by the fighting. Domestic inflation, at about 12-1/2 percent a year, continues to be relatively high by Salvadoran standards.

In 1980 the Salvadoran Government undertook measures that affected ownership and control of land, banks, and the export of coffee and sugar. The land reform provided for expropriation of properties and their distribution to farmers or cooperatives.1/ The nationalization of banks was intended to eliminate the concentration of credit to a few people and enterprises. The nationalization of foreign trade placed the marketing of coffee and sugar exports under the control of state autonomous agencies.

Phase I of the land reform affected about 17 percent of total agricultural land and involved about 8 percent of farm families (two thirds of which were organized in cooperatives). The properties expropriated were producing more than half of the sugarcane and about two fifths of the cotton. About 30,000 farmers have been the beneficiaries under

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1/ The land reform envisaged the expropriation of estates of over 100 hectares (Phase I and Phase II) and the granting of ownership titles to all tenant farmers for the land they rented (Phase III). Phase I (expropriation of all estates over 500 hectares) and Phase III were implemented. Phase II (expropriation of estates of 100 to 500 hectares) is still pending.

Phase III of the land reform, receiving plots that average about 1.7 hectares. This land is mostly dedicated to basic grains for local consumption.1/

According to the Salvadoran representatives, the experience of the agrarian reform so far has been mixed, partly because of factors that are not directly related to the reform itself. Apart from the initial negative impact on production to be expected from any comprehensive land reform, production of cotton (the product most affected by the reform) has dropped sharply as the area under cultivation has been halved since 1978. This was attributed to several factors. In some instances redistributed lots were too small to afford an adequate living to farmers, with the result that cultivation of cotton has been abandoned for basic grains. This shift has been also encouraged by a drop in demand for cotton by the local textile industry (because of difficulties in exporting to the other members of the Central American Common Market), as well as by deficiencies in technical assistance and supervision in the use of fertilizers, insecticides, and machinery. Cotton planting also has been adversely affected by attempts by former owners to regain possession of expropriated properties and by interferences from the guerrillas. Investment in the agricultural sector as a whole has also dropped because of uncertainties regarding the implementation of Phase II of the agrarian reform, the difficult political situation, and the problems encountered in purchasing imported machinery and other inputs.

In some circles, the drop in agricultural production has been attributed entirely to the agrarian reform and to the uncertainties that it has created in the agricultural sector, but other factors--such as the disruption caused by the armed conflict--may have played an even more important role in the setback suffered by agriculture.

The Salvadoran representatives were of the opinion that a reassessment of the land reform was required, but this would not imply a rolling back of the redistributions already made; in this connection they emphasized the positive features of the land reform, particularly the social aspect. The implementation of Phase II has been delayed pending, among other things, the approval of a new political constitution that is expected to provide guidelines in regard to property rights in general. It was noted that the agencies in charge of the land reform needed strengthening both at the technical and financial levels. Altogether, the authorities believed that the next stage would be one of consolidation of the reforms already made.

To emphasize that the agrarian reform had been only one of several factors that had caused the downward trend in economic activity, the Salvadoran representatives pointed out that the production of coffee (El Salvador's most important export product) has been affected by a

1/ Details on the agrarian reform were provided in SM/82/68 (4/9/82); IBRD, El Salvador: Updating Economic Memorandum (1/21/83); and Checchi and Co., Agrarian Reform in El Salvador (January 1983).

reduction in international quotas and depressed prices. Manufacturing output and commerce have declined at a faster rate than agricultural production, as these sectors have suffered from the armed conflict, lower external and internal demand for Salvadoran products, and serious difficulties with the other members of the Central American Common Market because of use of quantitative limitations, defaults in payments, and disruption in transportation.

2. Domestic economic policies

Fiscal performance in 1983 is expected to be weaker than had been planned originally. Central government revenues this year are now estimated at ₡ 1.24 billion, compared with ₡ 1.46 billion projected in the budget document. The shortfall is mostly attributable to the delay in the enactment of the tax package (it was enacted in June rather than at the beginning of January), the failure to approve certain other revenue measures which had been contemplated in the budget, and a decline in coffee export taxes because of a drop in prices. On the expenditure side, the budget called for total expenditures (excluding foreign-financed investment outlays and external amortizations) of ₡ 1.78 billion. Some budgetary appropriations (particularly for defense, repair of war damages, and wages and salaries) have been or are expected to be increased, but the authorities were confident that some other expenditure could be cut so that the overall budgeted amount would not be exceeded. On this basis, it was estimated that the central government deficit to be financed from domestic resources would amount to nearly ₡ 480 million in 1983, compared with less than ₡ 360 million indicated in the original budget document and ₡ 400 million in 1982 (Table 1). In addition, the domestically financed deficit of the autonomous agencies and state enterprises is estimated to amount to about ₡ 70 million in 1983, or about the same as in 1982. So far the projected deviation in fiscal performance has not been reflected in central bank credit expansion, as payments have been delayed and floating debt has increased.

In reviewing fiscal prospects for the remainder of the year, the Salvadoran authorities were of the view that their room for action on the revenue side was very limited because it was most unlikely that additional tax measures would be approved by Congress before the end of the year.1/ On the expenditure side, a special commission has been established to set priorities and to reduce projected outlays to a minimum; however, any net savings probably would be quite small, since most expenditure commitments had already been made and, as already indicated, some budget overruns appeared possible. The authorities were planning to continue with their policy of restraining payments to contain use of central bank credit, and they were exploring the possibility of selling some government properties. Nevertheless, it was their view that the public sector's dependence on foreign assistance (mainly in the form of use of local counterpart funds generated by sales of surplus agricultural commodities under the PL 480 program) and central bank credit would increase during 1983.

1/ Elections are expected to take place in late 1983 or early 1984.

Table 1. El Salvador: Central Government Operations 1/

(In millions of colones)

	1980	1981	1982	1983 Budget	1983 Proj.2/
Revenues	1,016	1,096	1,105	1,457	1,244
Expenditures	1,539	1,787	1,744	1,974	1,953
Current	1,077	1,233	1,347	1471	1,461
Capital	457	512	396	503	492
Net lending	5	42	1	--	--
Overall deficit	-523	-691	-639	-517	-709
External financing	127	257	236	161	231
Disbursement	(136)	(268)	(258)	(194)	(264)
Amortization	(-9)	(-11)	(-22)	(-33)	(-33)
Internal financing	396	434	403	356	478
Central Reserve Bank	(396)	(430)	(421)	(356)	(478)
Other	(--)	(4)	(-18)		

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

1/ On a cash basis.
2/ Revenue projections are based on Fund staff estimates; expenditure projections were provided by the Salvadoran authorities and were adjusted for outlays financed by extrabudgetary loans and for expected disbursements of U.S. assistance under PL 480.

Looking ahead to 1984, the Salvadoran representatives were confident that the life span of the tax measures, which were approved in June 1983 and are supposed to expire at the end of this year, would be extended through 1984. They were also studying the possibility of replacing the stamp tax with a sales tax or a value-added tax, but these modifications required congressional approval which was not likely to be forthcoming soon. On the expenditure side, they expected higher military outlays in 1984, in addition to the general wage increase for public employees that is being contemplated for next year.

Alternative ways to increase fiscal revenues were explored by the Salvadoran authorities with the mission. Additional government revenues could be raised by transferring more transactions from the official market to the parallel market. Also, certain proceeds from traditional exports could be transferred to the parallel market, together with the adoption of an export tax. Import duties might be calculated on the basis of the exchange rate at which imports payments are being effected, rather than on the basis of the official exchange rate. The Salvadoran representatives said that in their view these measures would require congressional approval and also would be subject to delays in present circumstances.

The limited recourse to central bank credit by the public sector during the first five months of 1983 made room for an acceleration of the banking system's credit to the private sector and to nonbank financial intermediaries (from a 5-1/2 percent increase during 1982 to 14-1/2 percent during the 12 months ended in May 1983). Since accrual of financial resources to the banking system has slowed down appreciably (from 12 percent to 9 percent over the same periods), this more rapid expansion of private bank credit has been financed by the Central Reserve Bank.

Demand for bank credit can be expected to continue to be quite strong for the remainder of the year. It is reported that numerous enterprises are not in a position to repay their outstanding debts, and there are indications that they will ask for some form of relief. In June 1983 the Central Reserve Bank had authorized a scheme for the refinancing of certain commercial bank loans to the private sector; under the scheme, the borrower would repay the loans over four years at a subsidized interest rate. The state-owned coffee trading company, in addition to having accumulated inventories, has been buying coffee at prices above those prevailing in the world market, and it is thus incurring losses that will need to be covered from credits or by the Treasury. Finally, as was mentioned above, the public sector may require bank financing in the period ahead.

Notwithstanding these pressures, the Salvadoran authorities were of the view that overall credit expansion could be kept within the limits of their credit program. However, they recognized that the successful implementation of their credit program hinged on a drastic reduction of coffee stocks which have been accumulated during the last few years. Liquidation of these stocks will depend upon the conditions in the world coffee market. Also, they agreed with the mission that prompt action to reduce the rate of growth of credit to the private sector was required.

Following an across-the-board increase in early 1982, interest rates have since remained unchanged. Interest rates paid on savings deposits range between 8 percent and 9 percent, and those on time deposits range between 11 percent and 12-1/2 percent, depending on the maturity (there is no interest rate limit on time deposits above 180 days). The Salvadoran representatives were of the view that the increase in interest rates last year had a beneficial effect on the accrual of financial resources to the banking system. But this effect could not be quantified because data were distorted by the accumulation of deposits related to the lack of foreign exchange for import payments. The Salvadoran authorities also noted that decisions on how residents would invest their financial assets were affected by the volatile political situation, especially the repercussions of armed conflict and the fears of further nationalization.

The Salvadoran authorities were considering the possibility of establishing a closer control over the operations of the financial sector. In late 1982 the Central Reserve Bank had imposed legal reserve requirements on the commercial banks' trust funds that hitherto were reported in the contingency accounts of the banks. These trust funds were equivalent to over 9 percent of total bank liabilities to the private sector at the end of 1982, compared with 6-1/2 percent a year before. Operations of nonbank financial intermediaries also have been expanding rapidly, and their outstanding credit to the private sector is now equivalent to one third of total financial system credit to that sector. The question of expanding the control of the authorities over the financial system has become more pressing because of the deterioration in the structure of the portfolio of the nonbank financial intermediaries.

As regards price and wage policies, since the beginning of 1981 domestic prices of basic grains, sugar, medicine, and educational services have been frozen. Also, rents for lower-income housing were lowered at that time, and then frozen. These price controls are expected to be maintained at least through the end of 1983. According to the Salvadoran authorities, compliance with the legal guidelines was stricter in 1981, but it has progressively weakened in more recent years. They admitted that in several instances controls were difficult to enforce and could be circumvented by taking advantage of loopholes in the decrees.

All wages and salaries were frozen at the beginning of 1981, and a 10 percent increase was authorized for 1982 for all sectors, except for central government employees. Minimum wages have remained frozen at the end of 1980 level. According to available statistics (confirmed by surveys conducted by the authorities), enterprises have adhered to the wage guidelines and, in general, wage adjustments have been lower than those authorized by the Government. From 1980 to 1982, wages rose on average by 4-1/2 percent. In the agricultural sector, nominal wages were actually reduced in 1982. According to the authorities, demand for wage increases have been moderated by unemployment and the awareness that in some instances increases in wages could result in the bankruptcy of firms. Notwithstanding the application of wage controls, the Central Government's wage bill has been rising at a relatively fast rate (by 18 percent from 1980 to 1982, and by a further 12 percent in 1983). This rise was attributed by the authorities both to an increase in government employment (as a measure of coping with the unemployment problem) and to an expansion in the size of the armed forces, and was not the result of salary increases.

3. External policies

The current account deficit of the balance of payments is projected to widen from US$170 million (4-1/2 percent of GDP) in 1982 to about US$210 million (5 percent of GDP) in 1983, reflecting a small drop in exports and a modest rise in imports (Table 2). The weakness of exports is mostly attributable to a decline in coffee export receipts because of lower prices and a reduction in El Salvador's quota under the International Coffee Agreement; the reduction in coffee export earnings has been offset in part by a rise in sugar exports. The foreign market for cotton is now relatively strong, but cotton planting is at some risk because of actions by the guerrillas. The projected rise of imports (a 6.5 percent increase in U.S. dollar terms over 1982) would stem from some growth in external assistance; there is a question, however, about the likely value of trade credits that might be obtained by the private sector and the value of imports financed in this way. The import projection aassumes a 15 percent drop in the value of petroleum product imports. The deficit in the services account is projected to remain basically unchanged from 1982 to 1983. The weakening of the trade account is expected to be offset in part by an increase in foreign donations, mostly from the United States in the form of budget support grants and sales of surplus agricultural commodities under the PL 480 program.

In the capital account, the balance of payments projections envisage a net use of medium- and long-term foreign loans by the public sector in an amount similar to that of 1982, as well as the renegotiation by the Central Reserve Bank of various short-term liabilities due to foreign commercial banks and to Venezuela. Private capital movements are difficult to project because of the uncertain political situation. These movements are generally channeled outside the official exchange market and finance imports and the working capital needs of enterprises.

At present, external transactions are being handled through several channels. The official exchange market, where the colon is pegged at ₡ 2.5 per U.S. dollar, has as receipts traditional exports (coffee, cotton, sugar, shrimps, and lobsters), some services, cash grants from abroad, and loans to the public sector; on the demand side it covers essential imports, some services, and payments relating to the public and registered private external debt. About 70 percent of the exports to, and some 60 percent of imports from, other Central American countries are being handled through the Central American Clearing House, and they are transacted at the official exchange rate. Other transactions with Central America are being handled through the parallel exchange market, barter, and the illegal free market. Imports financed by foreign official grants and by loans to the public sector are also valued at the official exchange rate.

According to exchange regulations, the official channels just referred to were expected to handle more than 90 percent of exports and about 85 percent of imports, but the data for 1982 were at variance

Table 2. El Salvador: Balance of Payments

(In millions of U.S. dollars)

	1979	1980	1981	1982	Proj. 1983 1/
Goods, services, and transfers	21	31	-250	-170	-209
Exports, f.o.b.	1,132	1,075	798	700	687
Imports, c.i.f.	-1,041	-962	-985	-883	-940
Investment income (debit)	-102	-102	-117	-137	-148
Other services (net)	-19	-29	-6	-10	-3
Transfers (net)	51	49	60	160	195
Capital movements, n.i.e.	-128	-363	112	193	364
Public sector	59	76	178	158	153
Drawings on loans	(75)	(97)	(193)	(178)	(180)
Amortizations	(-16)	(-21)	(-15)	(-20)	(-27)
Central Reserve Bank, n.i.e.	31	65	55	47	123
Debt rescheduling	(--)	(--)	(--)	(--)	(94)
Other (net)	(31)	(65)	(55)	(47)	(29)
Other banks	-2	-46	-31	29	--
Other (including net errors and omissions)	-216	-458	-90	-41	88
Special transactions 2/	6	7	6	--	--
Subtotal	-101	-325	-132	23	155
External arrears in the official exchange market	--	41	25	-5	-61
Net international reserves (increase -)	101	284	107	-18	-94
Foreign assets	124	67	9	-36	18
Debt rescheduling	--	--	--	--	-94
Other liabilities	-23	217	98	18	-18

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

1/ The 1983 balance of payments projections are based on the assumption that (a) the central bank net international reserves remain unchanged, excluding the rescheduling on a medium-term basis of some short-term liabilities; (b) all external arrears in the official exchange market are either paid off or transferred to the parallel exchange market by the end of 1983; and (c) exports and imports reach the levels projected by the Central Reserve Bank. Thus, other capital movements are a balancing item rather than an independent estimate.

2/ Allocation of SDRs and transactions with international nonmonetary organizations.

with these expectations, with surrendered export receipts considerably lower than suggested by the data provided by the customs services. The Salvadoran authorities were investigating the reasons for these differences.

The parallel exchange market is managed by the commercial banks. The exchange rate in this market is not determined by market forces but is set by the banks on the basis of various indicators; thus far, during 1983, the rate in this market has been at about ₡ 3.95 per U.S. dollar (selling). This market is expected to handle all export proceeds not passing through the official market, as well as nonessential imports and most services. However, the value of transactions actually recorded in this market is relatively small. Exporters of nontraditional products may deposit foreign exchange proceeds into special dollar accounts that may be used for specified payments abroad or to sell to commercial banks at the parallel exchange rate. No details are available on the volume of operations covered by these accounts, but there are suggestions that it could be sizable. All other transactions, including transactions which were not handled in the parallel market for lack of foreign exchange, are effected in an illegal free market, where the exchange rate has been fluctuating in the range from ₡ 4.50 per U.S. dollar to ₡ 5.00 per U.S. dollar.

Given the external payments pressures faced by the country, the Salvadoran authorities intended to continue transferring transactions from the official market to the parallel market, looking ahead to an eventual de facto reunification of the exchange rates. Thus, remittances of profits were transferred to the parallel market at the beginning of June. The impact of the formalization of the parallel exchange market in 1982 (and the resulting depreciation of the colon in that market) has been to reverse the appreciation of El Salvador's effective exchange rate which had started in 1980 (Chart 1).

Nevertheless, under present legislation the room for maneuver by the monetary authorities was somewhat limited in the exchange field; for example, central bank intervention in the parallel exchange market would require congressional approval. A draft bill providing greater flexibility in this field has been submitted to the Congress, but it was uncertain when or whether it would be approved. The authorities said they had some questions whether an outright depreciation of the colon would provide much help in respect of major traditional exports, such as coffee and sugar, since these are limited by international quotas. They noted, however, that a depreciation of the colon, combined with the introduction of export taxes, would help considerably in dealing with their fiscal problems.

With regard to external payments arrears, the transfer of operations to the parallel exchange market and the sale of medium-term dollar-denominated government bonds to potential buyers of foreign exchange in the official market helped to reduce outstanding arrears from US$61 million at the end of 1982 to US$34 million at the end of June 1983. With further steps along these lines, the problem of arrears would be nearing a solution.

The Salvadoran authorities noted that settlement of transactions with other Central American countries had been subject to various difficulties. Under the terms of the Central American Common Market agreement, trade operations among Central American countries are handled through a clearing house, with periodic settlements in convertible exchange among central banks. In practice, some central banks have been accumulating high debts, and they had been slow in settling their accounts. As a result, operations are increasingly being channeled outside the clearing house. Also, trade within the region had been disrupted by political problems.

The outstanding public external debt of El Salvador (including medium- and long-term debts of the central bank) amounted to US$1.1 billion at the end of 1982. About 47 percent of the outstanding debt was due to international agencies and 40 percent to foreign governments and government agencies. Only some 13 percent of the total was due to foreign commercial banks. Most of the debt is on concessionary terms, and its servicing (interest and principal) is equivalent to about 8 percent of exports of goods and services and to 1-1/2 percent of GDP. The authorities drew attention to the relatively good profile of the external debt and the high concessionary terms of new borrowing; they noted that El Salvador had little access to foreign credits on commercial terms in present circumstances.

III. Exchange Practices Subject to Fund Approval

El Salvador maintains the following exchange practices subject to Fund approval under Article VIII:

1. Multiple currency practices arising from (a) a dual exchange market comprising an official market in which the value of the colon is pegged at ₡ 2.50 per U.S. dollar and a parallel market where the value of the colon is set by the commercial banks on the basis of certain indicators; and (b) mixing rates applied to proceeds of certain nontraditional exports.

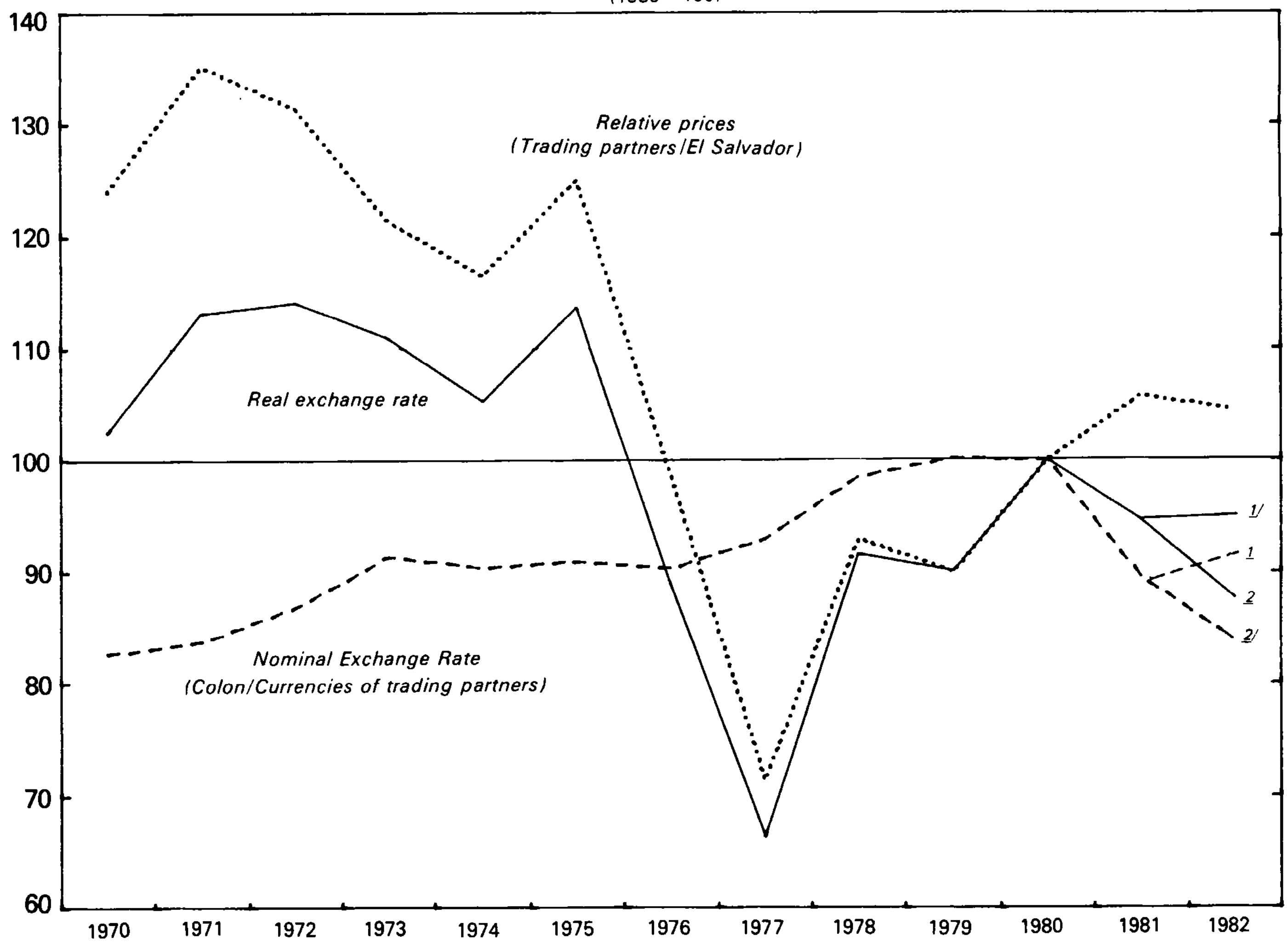
2. Exchange restrictions arising from (a) limits on payments effected in the parallel market through purchases of foreign exchange from commercial banks for certain invisibles (insurance premiums and other service payments of a personal nature up to a maximum of US$2,000 per person per year); (b) a 100 percent deposit requirement on requests made to the Central Reserve Bank for foreign exchange for medical treatment abroad; and (c) a 10 percent advance deposit requirement on import payments (through the official market) in excess of US$2,000 related to letters of credit or bank drafts (cobranzas). In addition, certain external payments arrears are also subject to Fund approval.

CHART 1

EL SALVADOR

EFFECTIVE EXCHANGE RATE, 1970-82

(1980 = 100)



Source: IMF, *International Finacial Statistics.*

[1] Using a weighted average between the official exchange rate and the parallel market exchange rate during 1982.

[2] Using only the official rate throughout the period 1970-82.

IV. Staff Appraisal

In recent years El Salvador's economic performance has deteriorated. Real GDP has dropped by 23 percent since 1979, domestic inflation has remained at relatively high levels, unemployment has risen, and the balance of payments situation has weakened. This poor performance stems from the armed conflict that has been going on for the last three years, the world recession, and the shrinkage of the Central American Common Market.

The armed conflict has affected almost all sectors of the Salvadoran economy. Infrastructure has been damaged, communications have been disrupted, and some parts of the population have had to be relocated. Private investment has dropped to a very low level and is unlikely to recover for some time. The decline of the Central American Common Market has had adverse repercussions on the manufacturing sector, which had been fostered by, and was geared to, the rest of Central America.

Medium-term prospects are difficult to assess in present circumstances. It is uncertain how long the armed conflict--with its disruptive impact on economic activity--will continue. Subsequently, the cost of reconstructing the destroyed infrastructure is likely to involve substantial costs for El Salvador. Presidential elections are scheduled for around the end of the year and, thus, it would appear that the Salvadoran authorities have a very limited horizon in regard to their economic policies.

Nevertheless, during the last 12 months the Salvadoran authorities were able to implement a set of financial policies that have produced positive results. It would be regrettable if that momentum was to be lost by a relaxation of policies in the period up to the forthcoming elections. It should be noted that substantial external assistance is expected to be available, helping to support the balance of payments while adjustment measures are adopted and implemented. Thus, there is an opportunity to facilitate the transition to the Government that is to take office next year.

Fiscal performance remains weak and presents the greatest threat to any stabilization effort. Government revenues are falling short of original projections, in large measure because of the delay in the implementation of tax measures (which moreover were not adopted in their entirety). Fully offsetting action on the expenditure side apparently will not be feasible because commitments had been already made on the basis of the original budget and requests for additional expenditures are still being brought forward. As a result of these slippages, the overall deficit may turn out to be considerably higher than had been planned. Neither the use of counterpart funds generated by foreign assistance (which will have to be diverted from other programs) nor an accumulation of unpaid bills represents a solution to the fiscal problem. What is required is the firm adoption of tax measures and a closer scrutiny of government spending on the basis of clearly defined priorities. A close monitoring of fiscal performance would enable the authorities to adopt corrective measures in a timely manner.

The authorities have judged that the Congress is unwilling to adopt new tax measures at this time. Nevertheless, it is clear that an additional revenue effort is required if a significant increase in inflationary pressures is to be avoided. Indeed, work has to start now if the coming year's budget is to be adequate to the tasks. The revenue plans, together with the priority list of expenditures, should be prepared so they can be a part of--and be approved with--next year's budget. At the same time, the prices of goods and services sold by the state agencies and enterprises should be revised as needed to lessen the rest of the public sector's dependence on central government transfers.

An improvement of fiscal performance would facilitate the implementation of adequate credit and monetary policies. The persistence of a large fiscal deficit to be financed by the Central Reserve Bank would require a drastic curtailment of credit to the private sector if the monetary policy objectives of the central bank are to be achieved. Developments have demonstrated the responsiveness of private financial holdings to interest rates. Thus, even though there are other factors that affect the willingness of Salvadoran residents to hold domestic financial assets, the importance of interest rates in this regard should not be dismissed.

El Salvador's exchange system is unduly complex and is characterized by inefficiencies. The failure of the parallel market to function as had been intended and the resort by the private sector to other channels, including an illegal exchange market, have been disappointing. Nevertheless, it should be emphasized that the scope of the official market has been reduced and the colon has been depreciated de facto, probably even more than it would have been if exchange regulations had been strictly enforced.

In present circumstances, the strategy of the authorities to continue transferring operations out of the official market with a view to achieving equilibrium in that market is clearly advisable. It is also clear that substantial weight needs to be given to market forces in the determination of the exchange rate in the parallel market. This would reduce inefficiencies and diminish the incentives to effect transactions in the illegal exchange market.

The exchange system as presently implemented involves multiple currency practices and restrictions that are subject to Fund approval. The staff would encourage the authorities to continue their policy of transferring transactions from the official market, with a view to simplifying the system and eventually working toward a reunification of the exchange markets. In the meantime, no approval of El Salvador's exchange restrictions and multiple currency practices is being recommended at this time.

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

Fund Relations with El Salvador
(As of July 1, 1983)

Date of membership:	March 14, 1946.		
Status:	Article VIII.		
Quota:	SDR 64.5 million.		
Fund holdings of Salvadoran colones:		Millions of SDRs	Per Cent of Quota
	Total	177.4	275.0
	Of which:		
	Credit tranche purchases	48.4	75.0
	Compensatory financing facility	64.5	100.0
Trust Fund loan disbursements (second period):	SDR 19.70 million.		
SDR Department:		Millions of SDRs	Per Cent of N.C.A.
	Net cumulative allocation	24.99	100.00
	Holdings	0.01	0.04
Gold distribution:	29,953.989 fine ounces.		
Direct distribution of profits from gold sales:	US$5.6 million.		

Exchange rate: The value of the colon in the official exchange market is pegged at ₡ 2.50 per U.S. dollar (selling). The value of the colon in the parallel market fluctuates and was quoted at about ₡ 4.00 per U.S. (selling) dollar in mid-July.

Technical assistance: Since September 1982, a staff member has been assigned as resident representative of the IMF in El Salvador. Also, a request for technical assistance in the area of bank supervision is being considered by the Central Banking Department and one for technical assistance in the area of tax reform is being reviewed by the Fiscal Affairs Department.

Last consultation (Article IV): The 1981 Article IV consultation was concluded by the Executive Board on July 16, 1982 (EBM/82/99).

El Salvador--Basic Data

Area and population	
Area	20,987 sq. kilometers
Population (mid-1980)	4.5 million
Annual rate of population increase (1975-80)	2.9 per cent
GDP (1982)	SDR 3,321 million
GDP per capita (1980)	SDR 610
Origin of GDP (1982)	(per cent)
Agriculture	26
Manufacturing	16
Construction	3
Transport storage and communications	6
Commercial services	20
Government	12
Other	17
Ratios to GDP (1982)	
Exports of goods and services	23.6
Imports of goods and services	32.6
Central government revenues	12.1
Central government expenditures	19.0
External public debt (end of year)	22.1
Saving	7.1
Investment	12.8
Money and quasi-money (end of year)	33.5

Annual changes in selected economic indicators	1980	1981	1982
		(per cent)	
Real GDP	-9.0	-9.3	-5.1
GDP at current prices	3.8	-1.8	4.2
Domestic expenditure (at current prices)	3.0	7.4	4.5
Investment	(-36.3)	(18.3)	(7.7)
Consumption	(11.1)	(6.1)	(4.0)
GDP deflator	14.0	8.3	9.8
Wholesale prices 1/ (annual averages)	18.8	14.8	6.0
Consumer prices (annual averages)	17.4	14.7	11.7
Central government revenues	-14.8	7.9	0.8
Central government expenditures	19.1	16.1	-2.4
Money and quasi-money	4.7	5.9	16.5
Money	(7.5)	(-3.2)	(6.5)
Quasi-money	(1.3)	(18.0)	(27.3)
Net domestic assets 2/	31.6	25.6	27.7
Credit to public sector (net)	(15.5)	(15.8)	(13.6)
Credit to private sector	(14.9)	(-1.1)	(9.3)
Merchandise exports (f.o.b., in U.S. dollars)	-5.0	-25.8	-12.2
Merchandise imports (c.i.f., in U.S. dollars)	-7.6	2.3	-10.3

Central government finances	1980	1981	1982
	(millions of colones)		
Revenues	1,016	1,096	1,105
Expenditures	1,539	1,787	1,744
Current account surplus	-63	-144	-242
Overall surplus or deficit (-)	-523	-691	-639
External financing (net)	127	257	236
Internal financing (net) 3/	396	434	403

Balance of payments	(millions of U.S. dollars)		
Merchandise exports (f.o.b.)	1,075.4	798.0	700.4
Merchandise imports (c.i.f.)	-962.1	-984.6	-883.0
Investment income (net)	-83.8	-100.0	-119.4
Other services and transfers (net)	1.1	36.2	132.2
Balance on current and transfer accounts	30.6	-250.4	-169.8
Official capital (net)	141.5	232.7	205.1
Private capital (net) and errors and omissions	-501.1	-144.7	-13.3
Special transactions and arrears on international payments 4/	47.9	30.4	-4.6
Change in net official international reserves (increase -)	284.4	107.1	-17.7

International reserve position	December 31 1981	December 31 1982	May 31 1983
	(millions of SDRs)		
Central Reserve Bank (gross)	66.8	103.8	111.8
Central Reserve Bank (net)	-206.3	-201.6	-193.4
Rest of banking system (net)	41.3	17.4	37.9

1/ Excludes coffee.

2/ In relation to the stock of liabilities to the private sector at the beginning of the period.

3/ Includes residual.

4/ Includes payment arrears of US$41.0 million in 1980 and US$24.5 million in 1981; and decrease of US$4.6 million in 1982.