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September 14, 2010

**Statement by Mr. Callesen and Mr. Holmberg on El Salvador
(Preliminary)
Executive Board Meeting 10/89
September 15, 2010**

Taking note of the fact that all end-June performance criteria have been met, we support the conclusion of the first review under the precautionary Stand-By Agreement for El Salvador. We concur with staff's conclusions in the ex-post evaluation of the 2009 SBA, and also with the analysis of the current situation. Policy proposals provided in the inspirational set of papers provided seem broadly appropriate.

Having suffered from strong knock-on effects from the global financial crisis in 2008-2009, the economy of El Salvador is now slowly recovering. However, it is still uncomfortably close to a tipping-point where debt dynamics could spin out of control, and policy focus needs to change accordingly. Any further unpleasant growth surprises or just barely moderate slippage in fiscal consolidation could too easily undermine confidence in the public sector's potential to handle its' significant debt burden. For El Salvador, the unfortunate propensity to be struck by natural disasters and the continued high dependency on the uncertain fortunes of the US economy (i.a. through remittance and trade flows) constitute two areas of particular risks for short-term growth prospects. Reducing deficit and debt levels going forward is thus of the highest priority, and we welcome the authorities' strong commitment to maintain fiscal prudence, as noted in the comprehensive statement of Messrs. Guzmán and Gramajo-Marroquín. We tend to agree with staff that fiscal consolidation plans could have been more frontloaded given the risks, but we also note that an ambitious and thus sustainable tax reform needs broad consensus and cannot easily be rushed through the appropriate channels. It seems, though, that there is significant scope for expenditure savings from reformed energy subsidies. We also take comfort from the sensibly balanced policy mix being pursued by authorities to enhance medium-term growth. Given that poverty is entrenched at a high level, we particularly commend efforts to safeguard and increase key social spending in this process.

We note that the authorities and staff seem to have slightly differing views on the feasibility of strengthening the role of publicly owned banks to bolster lending to priority sectors. Given underdeveloped domestic capital markets with currently very low rates of credit growth and the more limited toolkit available to authorities under a dollarized system, we find the

authorities' plans interesting. *According to staff, which would be the key measures needed to limit risks to transparency and contingent fiscal liabilities from such endeavors? Could staff indicate whether they have been asked to support efforts in this area through technical assistance?*

We urge authorities to comprehensively and expeditiously implement the broad set of recommendations coming out of the interesting FSSA, including the approval of the delayed Financial Supervision and Regulation Law, and support their inclusion as structural benchmarks under the arrangement. Seeking to raise the current low level of net international reserves in excess of commercial bank claims on the Central Bank should also be a key priority for authorities, in order to strengthen resistance to liquidity shocks.