Board Meeting of March 6, 1997
Statement by Roberto Jimenez-Ortiz

El Salvador - Country Assistance Strategy

Substantial progress has been made in the political front of El Salvador in the past years. Since the signing of the peace agreements in 1992, two democratically elected governments have maintained a strong commitment to economic and social reform in El Salvador. Prudent economic management that dates back to even the worst years of the civil conflict have laid a very stable macroeconomic foundation. Economic growth has been maintained with an average annual rate of over 6.7 percent over the period 1992-1995; public sector deficits have been contained to an average of 3% of GDP since 1992, despite the high cost associated with the peace accords, with low inflation. Fiscal deficit was 1.9% of GDP in 1996.

The peace agreements of 1992 established a National Reconstruction Plan (PRN) that includes land transfer to ex-combatants, agriculture and microenterprise credit, training and technical assistance for start-up businesses, scholarships for education, etc. The total cost of the PRN reached the amount of Colones 21 billion (US $2.4 billion), equivalent to more than one-fifth of the 1996 GDP. Foreign grants financed about one-third of the PRN, with the rest of the funds coming from the government’s current revenues (45% of the total cost) and multilateral loans (21%).

In 1996, two major rating agencies raised El Salvador’s rating for long-term foreign currency debt and long-term long currency colones to BB and A, respectively (the country has a better sovereign credit risk than most of the Latin America countries). The rating agencies attribute their strong rating of El Salvador to exchange rate stability since 1991 “with very low intervention from the Central Bank,” “single-digit inflation, regional trade agreements with openness to foreign direct investment flows, and net foreign debt of 14.5 percent of GDP, which is “substantially lower than the average for BB-rated countries”.

The banking sector, according to the rating agencies is seen as particularly efficient by regional standards. Intermediation spreads are tight (about 2% points below the Latin America average), regulatory controls are prudent, asset quality is good, and the percentage of the population with checking or saving accounts is high. But, there is still considerable room for improvement in this area. One of the main challenges in the financial sector since privatization of the banks was
achieved in 1991, and the successful implementation of the wide-ranging banking reforms and regulatory framework overhaul, is to obtain higher levels of savings. The savings rate, although on an increasing trend, is still low (17% of GDP).

Extensive economic liberalization has occurred in the country over these past few years. One of the challenges is how to tackle the microeconomic foundations of development in order to build a truly competitive economy that will create prosperity, knowing that macroeconomic improvements are not enough. The Bank has been a valuable ally in providing timely advisory services and pulling outside sources of knowledge and information in many areas. Meetings between Bank staff and the economic cabinet have been frequent and fruitful.

Some of the major constraints facing the country are: substantial sectors of population living in poverty, narrow productive base, the export base of the country is still narrow, a large trade deficit, slow-to-materialize foreign direct investment and the need to substantially improve the productive infrastructure. War-related damages totalling some US$1.5 billion.

While keeping the macroeconomic situation in balance, the current government has committed itself to undertake aggressive structural economic reforms in order to achieve a rapid globalization of the economy. One of the pillars of the current economic goals is to build upon policies that will substantially raise the competitiveness of the economy -- not only incorporating the country in the global economy -- these policies must involve competitiveness for all. This will be achieved by transforming the country's into one of the most flexible and competitive private-sector driven economies in Latin America. Even though the current investment regime is among the most liberal in the world (in the 1997 Index of Economic Freedom done by the Heritage Foundation, El Salvador ranked third in Latin America after Chile and Panama); and the few remaining restrictions -- on telecommunications and energy -- are to be eliminated with the forthcoming privatizations, there are further steps being taken to push this aggressive agenda, including: further reducing tariffs from an already low average of 6%; (a reduction of tariffs to between 1%-6% by 1999 is expected); upgrading infrastructure and government services to top international standards; investing in an increasingly better-educated, higher skilled work force; and generally improving the business environment by lowering the cost of doing business. The major dilemma for globalization that the Salvadoran economy faces toward this goal is the building of firms and to enhancing the quality and sophistication of its business environment. The Government’s vision is to advance the economy from a comparative to a competitive advantage.

According to the economic program 1995-99, the economic and social platform for the remainder of the century is based on an ambitious array of structural reforms and a quality shift in its spending priorities. The immediate impact of the reforms on the less favored groups of society has been mixed so far. Notwithstanding the inevitable cost exerted by the adjustment process upon the poor, social indicators have begun to improve over the past five years, although admittedly at a slow pace. Infant mortality was cut almost in half between 1989-1994; the illiteracy rate fell from 30% to 23% during the five-year period; and 80% of households in urban areas had access to drinkable water in 1994, versus just over 75% in 1989. Poverty levels fell by 12% points between 1991-95.
The Government’s intention is to concentrate spending in the social areas and basic infrastructure in the coming years, and to achieve broad social and political consensus for its medium-term economic program, including the privatization plans -- now in progress -- of most public assets. Social spending occupied 3.5% of GDP and it absorbed 25% of the consolidated central government total outlays in 1995. It is expected to increase its share to 50% by 1999 inasmuch as defense expenditures have substantially declined since the end of the war.

The government estimates an annual growth of 4-5 percent for 1997 with an inflation rate of about 6 percent. The implementation of the reconstruction program outlined in the peace agreements has substantially progressed according to the original schedule.

The most immediate challenge facing Salvadoran society is to reach the necessary consensus to implement its ambitious program without jeopardizing any of the sectors affected by the reforms. The privatization of the telecommunications company, the electrical power monopoly, and the pension system is the unequivocal backbone of the reform strategy and the government has invested much of its political capital in the sales proceeding of these entities as expected. Revenues from privatization could reach 15% of GDP over the next two years. The government intends to use these resources for social and infrastructure spending and direct debt reduction. The pension system will be converted from the current pay-as-you-go system into a fully funded system where individual accounts are managed by private sector funds. The reform is expected to substantially increase the coverage of the population above its current 16%.

The decentralization of public services is also a part of the state modernization program with increasing private-sector participation. This has been successfully tested in the area of education with the Bank-funded program of EDUCO since 1991. This program delegates the administration of education in rural areas to parent associations. It has helped to increase the total schooling rate by 10 percentage points over the past four years, while the number of employees in the Ministry of Education was reduced to 1,000 in 1996 (from 7,000 before EDUCO). In addition, 60% of secondary education is now in private hands, consistent with the government’s objectives of focusing scarce resources on primary education as a high priority toward social development.

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The government understands that the thrust of the reforms in the medium-term will depend on its ability to convey the expected benefits to society. Inputs from the private sector and the trade unions have been valued, leading in some cases to changes in the pace of reform. The outlook for the country is the continuation of economic reform, resulting in a noticeable improvement of the social conditions of the country. It is necessary to keep in mind that low inflation, prudent fiscal policies, a low debt burden and an historic commitment to the timely payment of its external debt have been a tradition that have kept El Salvador as one of the most stable economies of the region.
The process of privatization in telecommunications and energy distribution will be completed in the coming months, followed by seaports and airports by the end of the year. In the longer term, an improvement in credit standing is expected as the government keeps the momentum of its liberalization program through the course of a business and electoral cycle. (Legislative Assembly and Municipal elections on March 16th and Presidential elections in March 1999). A more competitive export sector, via lower inflation and higher investment in tradables will be the key to reducing balance of payments vulnerabilities, while sustaining an annual real GDP growth in the 4%-5% range.