

Country Report *El Salvador*

1. Structural data:

Geographical extension:	21,041 km ²
Population size:	6.1 million
Population density:	291 inhabitants / km
Per-capita GDP (2009):	approx. USD 3,500
Currency:	US dollar*
Exchange rate (22 nd March):	USD/EUR 1.366



* The US dollar has been legal tender since 2001. The old currency, the colón (SVC), has almost disappeared from circulation.

2. Political situation:

The country has made unmistakable progress in social and economic terms since the bloody civil war came to an end in 1992. However, political polarisation has still not been completely overcome. At least the former guerrilla movement FMLN has transformed itself into a left-wing popular party and its opposite number, the extreme-right-wing ARENA movement, into a conservative party in the interim. At the presidential elections held in March of last year, a representative of FMLN was victorious for the first time, namely Mauricio Funes. However, the “lurch to the left” which had been feared in the wake of this (according to the constitution, the head of state in El Salvador also conducts the affairs of government) failed to materialise: on the foreign-policy front, Mr. Funes is taking his bearings more by the moderate policy of his Brazilian counterpart “Lula” than by the radical tack being pursued by Venezuela’s president Chávez. The close ties with the USA have not been impaired by the resumption of diplomatic relations with Cuba. In terms of economic policy too, Mr. Funes has not, as yet, departed from a relatively free-market line and has come out in favour of dollarisation. Furthermore, he is devoting himself increasingly to the task of fighting poverty, which is particularly rampant in rural regions, and social inequality. However, his plans to increase spending on health care and education are being thwarted by the worsening budgetary situation. On the whole, Mr. Funes usually proves to be more moderate than his own party. The FMLN also emerged victorious from the parliamentary elections held at the beginning of last year; however, with 35 out of a total of 84 seats, it failed to attain an absolute majority and is therefore compelled to negotiate and make compromises with the other parties. Its position has been strengthened by the schism within ARENA, which had originally picked up 32 seats but lost 12 deputies in the course of quarrels about the party’s political alignment.

3. Macroeconomic development:

The country's economic structure has changed in recent decades: even though the agricultural sector still contributes roughly 13% to the gross domestic product (the principal products under cultivation being coffee and sugar), its importance has waned in favour of the service sector in particular, which now generates virtually 60% of GDP. The liberalisation of the financial sector since the 1990s has played a decisive role in this respect. A number of major banks are now doing business in El Salvador, with foreign institutions having a predominant presence. Industry, which is thin on the ground, is largely based on commission processing ("maquiladora") – i.e. on the further processing of imported goods which are subsequently re-exported. However, this sector has been having to contend for some years now with heavy competition from Asia. So as to improve the conditions for an autonomous industrial development, the government, with the participation of foreign interests, has been channelling increasing investment into infrastructure expansion.

Where aggregate economic output had grown by an average of 2.7% per annum in the decade from 1998 to 2008, a setback in the economic catch-up process was sustained last year: in inflation-adjusted terms, the gross domestic product was 2.9% down on the previous-year level in the first three quarters of the year, for which data is already available. And the contraction will hardly be less pronounced on a whole-year view either. The slump in private consumption bears particular responsibility here: this depends to a great extent on the remittances ("remesas") from the numerous Salvadorians living and working abroad, especially in the United States. Due to the economic crisis in the USA, a year-on-year decline in "remesas" was recorded for the first time in 2009. By contrast, the slump in cyclical activity has been cushioned by higher government consumption and by the positive net-export position.

On the other hand, the country's heavy dependency on the US economy, which is gradually getting back into its stride again, provides the main arguments suggesting that El Salvador will return to a positive growth path in the course of the present year. For one thing, almost half of Salvadorian exports are absorbed by the US market, and, for another, the already-mentioned remittances of migrant workers – which account for approximately 16% of the gross domestic product – are a significant factor driving private-consumption expenditure. If the baseline effects of the negative trend in 2009 are also factored into the equation, economic growth in the vicinity of 2% can be anticipated again in the present year.

The decision to adopt the US dollar as legal tender in 2001 has noticeably enhanced price stability, bringing EL Salvador one of the lowest inflation rates in Central America for years on end. Since then, inflationary risks caused by an (excessively) expansionary monetary policy have been ruled out. Inflationary pressure is now mainly triggered by fiscal stimuli and by the trend in the world-market prices of the most important im-

ported goods (which are no longer influenced by exchange-rate effects). The largest role in this context is played by food and fuels, which continue to dominate the basket of goods used to calculate inflation, even though their share has fallen from nearly 50% to below 40% since the latest adjustment. The sharp spike in prices in the food and energy spheres provides the background for the unusually high inflation rate of 7.2% registered in 2008. Things looked very different, by contrast, last year when the global economic slowdown and lower raw-material prices helped to keep inflation at only 0.6%. Indeed, consumer-price inflation was actually in negative territory in the second half of the year by comparison with the same period in 2008. The rate of change will probably accelerate to slightly less than 2% on an annual average in the present year.

4. Foreign trade:

Foreign trade is determined above all by the “maquiladoras”: roughly 40% of merchandise exports (and 12% of merchandise imports) were attributable to this sector last year. The most important traditional export products, coffee and sugar, claimed a share of about 6% and about 2%, respectively, in 2009. Not only energy sources and many foodstuffs but also (indeed above all) consumer and capital goods have to be imported. As a result, the trade account is customarily marked by heavy deficits: the import volume was roughly twice as high as the export volume every year from 2006 to 2008. Admittedly, the deficit narrowed to some extent last year: where merchandise exports were down by 15%, merchandise imports plummeted by more than 20%. Thanks to the improved trade-account position, the current-account deficit also proved lower in 2009 in spite of the decline in “remesas”, moving down to approximately 3% as a proportion of the gross domestic product (after 7.2% in 2008). The prospects for foreign trade hinge above all on the future cyclical trend in the United States; accordingly, a pick-up in exports is on the cards for 2010.

A little over 46% of Salvadorian merchandise exports (including products from maquiladoras) were shipped to the USA last year. El Salvador’s next two biggest customer countries, some way behind and with a share of around 14% each, are the neighbouring states of Guatemala and Honduras. Trade with the latter countries has been facilitated since 1963 by the Central American Common Market, to which Costa Rica also belongs. Free-trade agreements also exist inter alia with the USA, Mexico, Columbia and Chile. Moreover, negotiations regarding a free-trade agreement have also been going on since 2007 between the EU and the nations of Central America. El Salvador is hoping that this will help it to diversify its export markets and to reduce its dependency on the United States.

5. Financial status:

Since dollarisation, which has involved the country dispensing with the option of running a monetary policy of its own, a solid fiscal policy has become even more impor-

tant. After years when new borrowing was relatively moderate, the budget deficit shot up in 2009 to 5.3% as a proportion of the gross domestic product on account of the government's attempts to bridge the troubled economic waters with the help of an anti-cyclical deficit-spending policy. In order to lastingly improve the state of public finances, a government programme was recently launched, providing for a tax reform, reductions in subsidies, an improvement in tax administration and greater transparency over the coming two years. The implementation of this programme is being supported by the Inter-American Development Bank (IDB) with a loan worth USD 200 million. In January of last year, at the height of the global financial crisis, the IMF granted El Salvador a stand-by loan to the tune of some USD 800 million to protect the country against financial turbulence. This stand-by arrangement is due to expire at the end of this March but is going to be immediately replaced by a new one, of almost the same magnitude, which the IMF approved on 19th March. As a consequence, liquidity bottlenecks will probably continue to be avoided, especially since it proved possible to further increase the stock of foreign-currency reserves to USD 2.9 billion by year-end 2009. Admittedly, this is counterbalanced by gross foreign indebtedness of more than USD 10 billion.

6. Assessment:

A liberal economic policy, geared to free trade, further infrastructure expansion, a relatively solid financial sector and progressive regional integration are "asset-side items" with respect to the country's future development. However, El Salvador still lacks competitiveness by international standards, partly because of low education levels and comparatively low quality standards. More-highly-qualified workers frequently migrate to foreign countries, especially to the USA. The high degree of social inequality promotes a high level of crime, often in connection with drug trafficking. Here, as well as in the budgetary-consolidation field, is where the government's priorities lie in the coming years. At least the gross domestic product should once again generate positive growth rates from 2010 onwards.

Completed on 23rd March 2010

Author:
Hans Hercksen
Tel: +49/89/2171-21323
hans.hercksen@bayernlb.de

Editorial staff:
Country Risk and Sectoral Analysis
Economics and Research
research@bayernlb.de
www.bayernlb.de

Corporate address:
Bayerische Landesbank
Brienner Straße 18
D-80277 München
Tel: +49/89/2171-21751
Fax: +49/89/2171-21329