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# TRADE POLICY REVIEW

# EL SALVADOR

# Report by the Government

Pursuant to the Agreement Establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establising the World Trade Organization), the policy statement by the Government of El Salvador is attached.

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# I. INTRODUCTION

1. The progress and development achieved by El Salvador in the recent period is the fruit of a sustained effort lasting more than 12 years. By defining a clear vision for the future with appropriate objectives, the country has dealt successfully with the challenges posed by the armed conflict and gradually achieved macroeconomic, political and social stability.

2. In 1989, the Government's chief priority was to find a peaceful solution to the armed conflict. Accordingly, it entered into negotiations with the guerrilla movement which culminated in the signature of peace accords in 1992. This process has been hailed as world exemplar of transition from a state of armed conflict to a situation of democracy and peace, achieved through political will.

3. At the same time, the Government introduced a number of economic stabilization and adjustment measures, supported by reforms aimed at establishing a market-economy model.

4. The first democratically elected government since the signing of the peace accords took office in 1994. Much of its five-year term was devoted to consolidating peace and implementing and enforcing the Accords that had been signed, which cost the country about US$2.457 billion. Despite all the benefits that flowed from this, the economic effort and opportunity cost in terms of investment for social development were considerable.

5. El Salvador also required far-reaching reforms to provide better conditions for economic growth and investment, and social improvements for its population. To this end, a reform programme was developed to strengthen the State in its subsidiary role and as facilitator of private-sector investment, emphasizing the reconstruction and expansion of basic infrastructure.

6. With the foundations for the country's economic, social and political growth consolidated, since 1999 the present Government, through its "New Alliance" plan, has been focusing its efforts on achieving sustainable economic growth, based on more active participation in international trade and on increased productivity. Growth in exports, attraction of foreign investment and diversification of both products and markets, are among the factors expected to boost development and help consolidate sustainable democracy – the basic tools for eradicating poverty.

# II. SOME OF THE MOST IMPORTANT ACHIEVEMENTS

## (1) MODERNIZATION OF THE STATE

7. In 1996 the country embarked upon a public-sector modernization programme, whose key elements included privatization of public services, concessions and State decentralization. The programme resulted in the merger and closure of a number of public institutions (for example, Public Safety, Justice and the Interior were all merged to form a Ministry of Governance), in order to maximize resources, generate synergies and increase efficiency in the provision of services. The Public Administration Procurement and Contracting Law (LACAP) was passed in 2000, consolidating all laws regulating this area at the municipal and central government levels into a single piece of legislation. This made government procurement and contracting more transparent in all public institutions at every level of government.

8. In the infrastructure sector, a Law on Telecommunications was passed that promoted private-sector participation in the provision of public telecom services, and encouraged development of a competitive telecommunications market with a view to achieving efficient world-class services at competitive prices. Following privatization of the national telecommunications firm, foreign investment in the communications sector has increased by 84 per cent since 1998. The opening up of

the sector has made it possible to increase the number of fixed-line operators from one to nine; and, as a result, the number of fixed phone lines has grown by 84 per cent in just four years. The mobile telephony segment currently has four operators, and the number of subscribers has risen from 137,000 in 1998 to 908,000 in 2002 – an increase of 560 per cent.

9. Reforms were also introduced to restructure the electric-power sector. The General Electricity Law, promulgated in 1996, separates the industry into four segments: generation, transmission, distribution and marketing; and it introduces competition in generation, as well as in the large volume energy consumption market and at the retail level through brokers. Following privatization of the five distributors (CAESS, DEL SUR, AESCLESSA, EEO and DEUSEM) along with the thermal power generation plants in 1998, the generation and distribution segments are both now open to private-sector investment. Over US$350 million has been invested in the sector as a whole, including thermo-electric expansion projects, refurbishment of hydroelectric plants, rehabilitation of transmission systems and the creation of new distribution lines in rural areas. In 2002, construction was completed on the 93 km transmission line providing electric power interconnection between Honduras and El Salvador. This is the first project in the Electrical Interconnection System for Central America (SIEPAC).

10. As part of the effort to improve and modernize the country's infrastructure, particularly in the transport sector, the road transport system was reorganized by the launching of a new public passenger transport system. In May 2002 the Highway Fund (FOVIAL), financed through a special tax on gasoline consumption, was set up to improve the efficiency of preventive maintenance on the country's roads. By September that year, the FOVIAL routine maintenance programme was covering over 4,000 km of highways across the country, representing about 80 per cent of the entire network.

11. In October 2002 the Legislative Assembly approved bidding documents to place management and operation of the country's busiest port (Acajutla) in private-sector hands, under a 25-year concession. The contract requires the concession-holder to undertake a series of infrastructure investments, and to streamline and modernize port facilities. In addition, a program to revive port activity in the eastern part of the country has begun, with a view to promoting and facilitating international trade. A new port, to be built in the department of La Unión, will be placed under private-sector management and is expected to play a key role in creating a development pole in that area.

12. In the financial sector, the Insurance Companies Law entered into force in 1996, regulating the constitution and functioning of such enterprises, along with the activities of insurance brokers. The aim of the legislation was to safeguard the rights of the public and guarantee competition, transparency and security in the system. In March 2001, Fitch Ratings classified 69 per cent of the country's insurance companies within the category-A range. The profitability of the sector grew from 5.5 per cent in March 2001 to 11.13 per cent in March 2002.

13. In addition, in late 1996 the Pension Saving System Law came into effect and the Pensions Superintendency was created, to form the pillars of a new private pension system. The basic mission of this innovative system is to provide pensioners with an adequate income, funded from contributions paid into individually owned accounts. By March 2002, about 939,000 workers were affiliated to the new system, covering 36 per cent of the economically active population.

14. In 1999 a new Banks Law was passed to enhance the security and soundness of the financial system, based on international principles of banking regulation and supervision. Within the framework of its multilateral commitments, El Salvador participated in the negotiations on financial services and accepted the Fifth Protocol to the General Agreement on Trade in Services (GATS),

incorporating this into national legislation through Legislative Decree 653, of 13 March 1999. These improvements to sectoral regulation partly explain why firms such as Fitch Ratings see the Salvadoran financial system as one of the most modern in Central America, having rated 67 per cent of the country's banks in the category-A range in March 2002.

### (2) COMPETITIVENESS

15. El Salvador has made major efforts to attract local and foreign investment, with a view to boosting the country's economic and social development by creating jobs and raising productivity. In the legal framework, reforms were made to the Trade and Commercial Registry Laws, and a new Investment Law was passed providing greater transparency to local and foreign investors alike. The regulatory framework for investments in El Salvador is completed by provisions negotiated within bilateral, regional and multilateral agreements. El Salvador is a member of the World Bank's Multilateral Investment Guarantee Agency (MIGA); to date it has signed 24 bilateral investment agreements, of which 16 have entered into force.

16. The National Investment Office (ONI) was established as part of the Ministry of the Economy, in order to facilitate the installation and operation of local and foreign investments and reduce the time needed for investment formalities. The ONI operates as a single window through which investors, both local and foreign, can complete all the relevant procedures through a new centralized management system. The following institutions participate in this: the National Registration Centre, the Ministry of Finance, the Salvadoran Social Security Institute, the Superintendency of Corporations and Business Enterprises, the Ministry of the Interior, the Directorate-General of Statistics and Censuses, the Ministry of Foreign Affairs and the Ministry of the Economy. At the same time, the National Commission for the Promotion of Investment in El Salvador (PROESA) was created in 2000, with a mission to promote El Salvador's image abroad and attract foreign investment into the country. This Commission identifies potential investors and helps them look for business opportunities in El Salvador, providing them with information, contacts and the necessary services to guide them in carrying out the investment. The Commission is headed by the Vice President of El Salvador, supported by the Ministers and Vice-Ministers of the Economy and Foreign Affairs, together with entrepreneurs from the private sector.

17. El Salvador has made significant progress in the intellectual property domain, with the aim of strengthening both local and foreign investments. In 2000, the country submitted to a voluntary review of compliance with its obligations under the TRIPS Agreement. At the present time, the Government, acting through the Ministry of the Economy, is working to modernize secondary legislation on this subject, for which it has approved a new Law on Trademarks and Other Distinctive Signs. In late 2002, El Salvador won the Cyber Champion Award for Latin America, which is given to countries or individuals that have taken steps to ensure legal use of software. The award was accepted by the Vice President of the Republic.

18. In addition to focusing on attracting foreign investment, the Government is also working through the Ministry of the Economy to nurture greater competitiveness in the different productive sectors, in order to create conditions for an expansion of exports. This will be achieved by diversifying the export basket and strengthening productive capacity among small and micro-enterprises, together with export partnerships and effective promotion. Technical assistance programmes are currently being carried out through the Inter-American Foundation (IAF). Activities include cooperative fishing ventures; assistance for small-scale farmers; and activities to improve the environment by creating alternative systems for solid waste management and establishing small environmental groups in the communities of San Salvador, Ilopango and Mejicanos.

### (3) FISCAL AND MONETARY POLICY

19. Despite a number of economic difficulties faced in the international domain during these last four years, and bearing in mind recent natural disasters (including hurricane Mitch in 1998 and two earthquakes in 2001), El Salvador's macroeconomic performance has outstripped that of other Latin American countries. While its real GDP grew by an average of 2.5 per cent between 1999 and 2001, the regionwide figure amounted to just 1.6 per cent.

20. In the fiscal policy domain, significant progress has been made in reforms to the tax system, aimed at expanding the taxpayer base and bolstering tax receipts. This has begun to yield positive results: both value added tax (VAT) and income tax increased their share of total tax revenue in 2001, jointly accounting for 86 per cent of total revenues received. There is also less reliance on receipts from customs duties, which in 2001 represented just 10 per cent of total tax revenue, compared to 15 per cent in 1996.

21. As part of the modernization of tax administration, the Ministry of Finance introduced a KAIZEN-ISO 9000 quality and continuous improvement system in several of its dependencies, including the Directorate-General of Customs Revenue as from 1999. Implementation of the new system has generated benefits such as continuous improvement of operational procedures, standardization of services, elimination of bureaucratic procedures and discretionary staff actions; and customs clearance procedures have also been streamlined.

22. In 1999, the *Teledespacho* system was developed to enable customs users to submit goods declarations electronically in advance of the cargo's arrival in the country. Then in February 2002 a full on-line tele-clearance system was installed on the Internet, which cuts time spent filling out the customs declaration form by 30 minutes per client. The greatest benefit of the system, however, is that declarations can be submitted 24 hours a day, 365 days per year.

23. In the public expenditure domain, recent years have seen greater emphasis placed on the social development areas. Social expenditure funded out of the national budget between June 2001 and May 2002 was up by US$111 million on the previous period – an increase of 15.5 per cent. Expenditure has been targeted mainly on education programmes aimed at reducing the illiteracy rate, and also on health and local development programmes.

24. At the same time, poverty indices have been cut substantially from their 1996 level of 52 per cent. Nonetheless, despite the reduction achieved in 2001 (39 per cent), it remains a national priority to lower poverty rates still further.

25. In keeping with the emphasis on social expenditure, an educational reform programme (EDUCO) was implemented with major participation by communities and parents, gaining plaudits from the World Bank. In 1995 the Healthy School Programme was inaugurated. Apart from serving students' didactic needs, this also satisfies some of their basic nutrition and health requirements, thereby helping to reduce school dropout rates. The educational reform has also managed to cut the illiteracy rate from 17.2 per cent in 2000 to 15 per cent in 2001, by providing basic literacy courses to 360,000 people.

26. Until 2000, the Central Reserve Bank (BCR) pursued a monetary policy aimed at controlling inflation. This achieved considerable success: from a level of 20 per cent in the early 1990s, inflation has not exceeded 4.3 per cent since 1998, and fell as low as 1.4 per cent in late 2001. Low inflation increases welfare and reflects the macroeconomic stability achieved by El Salvador in recent years. One of the most important monetary policy achievements was Law on Monetary Integration, which established the US dollar as legal tender throughout the country as from 1 January 2001. The main

objectives of this legislation are to eliminate exchange-rate risk and concomitant currency crises, create a sounder and more competitive financial system, protect wages and savings, and encourage investment through lower interest rates. The latter have fallen substantially since the start of monetary integration, and are currently the lowest in the region.

## (4) FOREIGN TRADE

27. As a result of the policy of trade openness pursued by the country in recent years, trade has increased substantially, especially in certain sectors of the economy. Exports grew from 21.1 per cent of GDP in 1996 to 28.9 per cent in 2001, while imports expanded from 33.9 per cent to 42.9 per cent in the same period. El Salvador's main trading partners are the other Central American countries, while the United States is its leading partner outside the region.

28. Although agriculture continues to account for a large proportion of El Salvador's foreign sales, the export basket has diversified, partly as a result of international factors such as sagging prices among its main export products (coffee and sugar). Coffee exports slumped from 37.6 per cent of the total in 1995 to 9.5 per cent in 2001, and the importance of this economic sector has diminished. Despite a steep drop in domestic production and investment in this sector, major efforts are being made to find new ways to achieve added value and export speciality varieties (gourmet and organic) to take advantage of market premiums on such types of coffee.

29. Sugar output has fluctuated sharply since 1996; after growing by nearly 7 per cent in 1999, production then declined by over 13 per cent in the two following years. In order to guarantee fairness, rationality and transparency throughout the production chain, the Government worked with the private sector in drafting the bill for the current Sugar Agro-Industry Production, Industrialization and Marketing Law. Although Central America applies a technical standard requiring sugar sold to the region to be fortified with vitamin A, in El Salvador there is no licence for importing the product.

30. As part of the effort to open up new markets for Salvadoran exports, free trade agreements have played an increasing role in the economy since 1996. As a result of the free trade agreement with Mexico which came into force in March 2001, exports to that country rose from US$9.9 million in September 2000 to US$16.7 million a year later. By September 2002, the figure had climbed by a further 39 per cent to US$23.2 million.

31. A free trade agreement with the Dominican Republic came into force in October 2001. While exports to that country amounted to US$8.6 million in 2001, they have since grown by 93 per cent to total US$16.6 million in 2002.

32. The free trade agreement with Chile entered into force on 1 June 2002. From El Salvador's point of view, its greatest benefit is the access it gives to a market of 15 million people, which is expected to result in increased exports and job creation.

33. El Salvador has recently ratified a free trade agreement with Panama, which could come into force during the first half of 2003. In the meantime, the two countries apply the Preferential Trade Agreement signed on 11 August 1970.

34. In short, El Salvador signed four trade agreements between March 2001 and June 2002, of which three have already entered into force. Keenly aware of all the benefits derived from these, the Government is persisting with its policy of openness by negotiating a free trade agreement with Canada; and in January 2003 it will start negotiations for one with the United States, its main trading partner outside the region.

### (5) FREE TRADE ZONES

35. Development of El Salvador's free trade zones has been a key element in terms of job creation, promotion of foreign investment and exports, and diversification of the country's development poles. The increase in the number of free trade zones has been directly proportional to the benefits they have generated. By late 2001, as many as 81,200 direct jobs had been created in free zones, of which 80 per cent were occupied by women. A further 162,400 indirect jobs were created during the same period.

36. Central Bank data for 2001 show that exports from the maquila industry were up by 116 per cent from their 1996 level, while imports of the inputs needed by this industry grew by 111 per cent during the same period.

### (6) TRADE OPENNESS

37. El Salvador is a member of the Central American Common Market (CACM), along with Costa Rica, Guatemala, Honduras and Nicaragua. Since 1996, the Central American integration process has undergone major changes, particularly with ratification and implementation of the Guatemala Protocol to the General Treaty on Central American Integration. In 2002, most imports from the region were subject to a zero tariff, except for certain products such as coffee, sugar, alcohol, distilled alcoholic beverages and petroleum products.

38. As part of the process of furthering Central American integration, El Salvador has been working with Guatemala to establish a customs union; Honduras and Nicaragua joined this effort in June 2000, followed by Costa Rica on 20 June 2002. Concrete steps taken have included harmonization of the common external tariff among CACM countries at 76.45 per cent.

39. In March 2002, the regulatory part of a Central American Treaty on Investment and Trade in Services was signed; lists of reservations to this treaty were being negotiated in September 2002. In addition, an agriculture agreement and a treaty on procurement are currently under negotiation.

40. El Salvador is an active participant in the negotiations for the Free Trade Area of the Americas (FTAA). This initiative was launched in December 1994 with the aim of progressively eliminating barriers to trade in goods and services; negotiations are scheduled to be completed in 2005.

41. El Salvador also participated in the Doha Ministerial Conference in November 2001, where it was agreed to extend the free-zone schemes for an additional period to end in 2010. In addition, an extension was requested for the scheme covering the Law for the Reactivation of Exports, which allows for the drawback of 6 per cent of f.o.b. value on exports outside Central America.

## III. VISION FOR THE FUTURE AND NEW CHALLENGES

42. To make progress on a sustainable basis, it is not sufficient to focus on past achievements; El Salvador needs to work hard to consolidate them, and at the same time set objectives for the future that address the country's priority needs.

43. Fiscal policy objectives will be to optimize current expenditure and maintain levels of investment – the latter being targeted on education, health, local development, social security and human capital formation, among other sectors. A concurrent aim is to increase fiscal revenue, which will entail expanding the tax base by combating evasion, and improving the efficiency and quality of tax administration.

44. Aware of this reality, El Salvador is increasingly working towards greater trade openness, which in the short run encourages exports, but in the medium and long-term helps combat poverty on a sustainable basis. The country also intends to continue fulfilling all commitments assumed under bilateral, regional and multilateral treaties.

45. To take maximum advantage of the benefits of free trade, conditions need to be created to improve competitiveness in all sectors of the economy. This essentially involves promoting and diversifying investments and exports by creating a favourable business climate; providing major support for small and medium-sized enterprises and microenterprises to help them become more competitive and take advantage of the benefits that openness offers; improving the training of human resources; and fostering technological innovation, which, despite progress over the last few years, remains a major challenge for the future.

46. With its "New Alliance" programme, the Government aims to promote progress and consolidate democracy through efforts targeting employment, security, solidarity and future vision. To this end, it will continue to foster competitiveness in the different sectors, in order to expand exports. As security is a key factor for attracting investment, work is under way to strengthen public and legal security in the country. Lastly, the Government's vision for the future is to achieve environmentally-friendly sustainable development and integration with Central America and the rest of the world.