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Trade Policy Review Body

TRADE POLICY REVIEW

EL SALVADOR

Report by the Secretariat

This report, prepared for the second Trade Policy Review of El Salvador, has been drawn up by the WTO Secretariat on its own responsibility. The Secretariat has, as required by the Agreement establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), sought clarification from the Government of El Salvador on its trade policies and practices.

Any technical questions arising from this report may be addressed to Mr Angelo Silvy (tel. 739 5249), Mr Karsten Steinfatt (tel. 739 6759) or Mr R. Valdés (tel. 739 5346).

Document WT/TPR/G/111 contains the policy statement submitted by the Government of El Salvador.

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SUMMARY OBSERVATIONS

(1) INTRODUCTION

1. Since its previous Trade Policy Review in 1996, El Salvador has continued to liberalize and modernize its trade and investment regimes, in the context of institutional stability and steady economic growth. Tariffs have been lowered and limited use is made of non-tariff measures. Export processing zones (EPZs) have been used to help counter the anti-export bias still present in the trade regime. New laws have been passed with respect to foreign investment, customs procedures, government procurement, and several key service activities; competition legislation is under consideration. The U.S. dollar was introduced as legal tender in 2001, which has left fiscal and incomes policies as the main macroeconomic instruments.

2. El Salvador participates actively in the multilateral trading system, and increasingly so in preferential agreements. Although it has become closely integrated in the global economy, market and product diversification are limited. External balances rely heavily on exports of clothing and remittances from Salvadorans abroad, and on the relationship with the United States. Thus, it would be useful for El Salvador to increase the predictability of its access to the U.S. and other markets, and to lock in its own reforms through new multilaterally agreed commitments. In due time, it will also be crucial to reconsider the role of EPZs which, although large job generators, distort the structure of incentives between exporters and other producers. Addressing such distortions, and inefficiencies in certain service activities, would help to accelerate the modest growth rates of recent years; this, in turn, would help achieve the improvements in living standards that El Salvador has striven for over the last decade.

(2) ECONOMIC ENVIRONMENT

3. GDP per capita in 2001 was some US$2,150, while personal disposable income stood at some US$2,420, reflecting the effect of remittances. Boosting GDP growth is of utmost importance as close to 40% of the population still lives in poverty. The authorities are counting on growth being supported by continued economic reforms, closer integration in Central America, and by the conclusion of bilateral free-trade agreements (FTAs) with other partners, notably the United States.

4. Subsequent to the cessation of the internal strife in the early 1990s, economic reform has been successful in stabilizing the economy and reducing inflation. However, GDP expanded at a relatively modest annual average rate of 2.8% between 1996 and 2001. Moreover, the pace of GDP growth has tended to fall: in the first half of 2002, annualized growth was 1.7%. Growth in 2001 and 2002 was affected by natural disasters and by the economic slowdown in the United States on account of El Salvador's export exposure to this market and of the reliance on remittances from Salvadoran workers.

5. Consumption expenditure is high, almost equal to GDP, while investment remains low. Remittances from Salvadoran workers abroad, in particular in the United States, topped US$2 billion or 14% of GDP in 2001. Remittances have become ever more important and finance a large share of consumption. They have also helped to keep national savings stable. A challenge for El Salvador is to channel part of these remittances to achieve a higher level of savings that can then be used to finance higher investment.

6. Trade has an increasingly important role in the economy; the share of exports and imports to GDP has increased to about 70% during the period under review. Among the main exports, those from the maquila (in-bond) industry, mostly clothing, have been increasing the fastest, while exports of key traditional products such as coffee have faltered. The current account of the balance *of payments has shown a deficit since 1996 due to a substantial merchandise trade deficit. The trade deficit is traditionally accompanied by a small investment income deficit, both of which have been largely offset by remittances from abroad.*

7. Through the Law on Monetary Integration, El Salvador introduced the U.S. dollar as legal tender in January 2001, and within a few months the economy was almost completely dollarized. This arrangement replaced the fixed exchange rate system used between 1993 and 2000, which was successful in reducing inflation to 1.4% in 2001. Interest rates have fallen substantially, which is expected to contribute to fostering GDP growth.

8. The fiscal deficit has been increasing in the last few years, reaching 3.3% of GDP in 2001, partly linked to the reconstruction efforts as a consequence of the natural disasters. In response, the authorities have devised a strategy to gradually reduce the deficit and to achieve balance by 2006.

(3) TRADE AND INVESTMENT POLICIES

9. El Salvador attaches great importance to the WTO, in part to bring stability and predictability to its own liberalization initiatives, and participates actively in it. Apart from numerous notifications, El Salvador has submitted several communications to WTO Members, participated in the negotiations on financial services and on telecommunications, and accepted the Agreement on Information Technology. Under Article XIII of the Marrakesh Agreement, El Salvador does not apply the WTO Agreements to China; nor does it, in principle, grant China MFN treatment. Since 1996, El Salvador has been directly involved in two disputes in the WTO, both as a plaintiff, together with other countries; it has reserved its third party rights on three occasions.

10. El Salvador participates increasingly in preferential trade agreements. It is a member of the Central American Common Market and, since 1996, has entered FTAs with Chile, the Dominican Republic, Mexico, and Panama. El Salvador is negotiating an FTA with Canada, plans to start negotiations for an FTA with the United States in 2003, and is engaged in the FTAA initiative. El Salvador's growing number of FTAs complicates the formulation and management of its trade policy, an important consideration given the limited human resources it has available to handle these issues.

11. Since 1996, El Salvador's trade and investment legal framework has undergone significant change. New laws have been passed with respect to customs procedures, electricity, and services such as banking, telecommunications, and air and maritime transport. An investment law passed in 1999 eliminated most restrictions to national treatment. Foreign investment seems to have received a boost in particular from liberalization in the telecommunications and electricity sectors. Other sectors benefiting from substantial foreign investment inflows are the maquila industry and financial services.

(4) MARKET ACCESS IN GOODS

12. El Salvador has taken steps to simplify and expedite customs procedures. In addition, it has applied the WTO Customs Valuation Agreement since March 2002, except with respect to the valuation of a limited number of used products for which customs authorities rely on minimum values, in accordance with a waiver granted by the WTO.

13. El Salvador maintains a mostly liberal market access regime for goods. Tariffs are the main instrument of border protection. The average applied MFN rate is 7.4%; the average for non-agricultural is 6.7%, while for agricultural products (WTO definition) it is 12%. The tariff structure exhibits significant escalation. All tariffs are bound; most are bound at a ceiling rate of 40%, thus there is a *large gap between applied and bound rates, which can undermine the predictability of market access conditions.*

14. Under its Uruguay Round Schedule of Concessions, El Salvador may use tariff quotas with respect to several agricultural products. Up to 1999, imports of all such products took place at the in-quota rate; in 2000, a tariff quota was introduced for cheddar cheese.

15. El Salvador administers a system of "under-supply quotas" for certain goods (in practice, agricultural products). Under this system, when domestic producers are unable to meet internal demand for a product, firms may import a certain quantity of the good in question duty free provided they also purchase the same good from domestic producers.

16. As a member of the Central American Common Market (CACM), El Salvador offers duty-free treatment to the majority of imports originating in other CACM member countries. Imports from Chile, the Dominican Republic, and Mexico, with which El Salvador has signed FTAs, also benefit from preferential treatment.

17. The use of non-tariff measures as instruments of protection appears to be limited. With the exception of the licensing regime that applies to imports of certain bags, concerns about security, health, and environmental protection appear to underlie most other import controls and prohibitions. There are few technical regulations and their development seems to be conducted under conditions of transparency. Two WTO members have raised concerns about El Salvador's sanitary and phytosanitary measures but no formal complaints have been lodged. El Salvador has never applied anti-dumping or countervailing duties, nor has it implemented safeguard measures.

(5) OTHER MEASURES AFFECTING TRADE

18. Two export promotion schemes operate in El Salvador. The first consists of a "drawback" of 6% of the f.o.b. value of all exports not destined for outside the CACM area, except those of coffee, sugar and shrimp. The second scheme exempts firms located in EPZs from import duties and other taxes. Both schemes have been notified to the WTO as export subsidy programmes eligible for an extension of the transition period established in Article 27.4 of the Agreement on Subsidies and Countervailing Measures.

19. El Salvador does not have government-sponsored export insurance or guarantee programmes. Its development bank offers several financing schemes aimed at supporting private sector activities, including exports. El Salvador is not a party to the Plurilateral Agreement on Government Procurement. A new law, which could stimulate competition in the domestic government-procurement market, came into effect in 2000. While the law does not grant preferences to local suppliers, it leaves the participation of foreign firms in the bidding process to the discretion of the contracting entities.

20. Except in the telecommunications sector, no significant changes have taken place with respect to competition legislation since El Salvador's last Review. During the past few years, the authorities have been working on drafting a competition law; such a law might improve the level of competition in the domestic market, which appears to be low.

(6) SECTORAL POLICIES

21. Agriculture's contribution to El Salvador's GDP has been declining, to some 12% in 2001, but the sector still employs around 35% of the working population. The main agricultural exports, coffee and sugar, have been exposed to adverse market conditions and various natural phenomena. This has triggered a particularly severe crisis in the coffee industry with significant concomitant social and economic effects in rural areas. Although the stated aim of

El Salvador's agricultural policy is to increase the sector's competitiveness and foster its integration into the local and world economies, the level of protection granted to cheese, white corn, rice, and pork meat has increased since 1996.

22. The share of manufacturing in GDP had increased to 23%, fuelled largely by the expansion of output in EPZs. Although EPZs have become important sources of foreign exchange and employment their activity is largely concentrated around textile and clothing production. They have limited backward linkages with local enterprises, which diminishes the possibility of raising levels of domestic value added. In addition, the dependence of EPZ exports on the U.S. market increases the vulnerability of the Salvadoran economy, both to the U.S. business cycle and to potential changes in unilateral trade preferences.

23. Services contributed just under two thirds of GDP in 2001; with many such activities have undergone significant liberalization and structural changes since 1996. Liberalization has gone well beyond El Salvador's WTO commitments, which are relatively limited. El Salvador's trade policy regime would gain in predictability if the autonomous liberalization undertaken in recent years were bound multilaterally. Increased market access has not necessarily resulted in a substantial increase of foreign participation, due in part to the small size of the market and to limited investment possibilities.

24. Since 1996, the electricity industry has undergone a process of structural reform and privatization, although transmission remains a state monopoly. A new Electricity Law was passed in 1996. In the same year, a regulatory body was created to oversee both the electricity and the telecommunications sectors. In telecommunications, a law adopted in 1997 also opened the market. The state enterprise was privatized and competition appears to have increased markedly.

25. New laws with respect to banking, financial intermediation and insurance were introduced during the period under review. The recent banking law brought more stringent capital requirements and strengthened supervision; it also guaranteed national treatment to foreign financial institutions. The introduction of the Law on Monetary Integration in 2001 also had implications with respect to the functioning of the financial sector. Despite recent liberalization, the participation of foreign firms remains relatively limited, and steps have had to be taken to minimize the exposure of the banking system to under-performing loans granted to coffee producers.

26. El Salvador introduced new laws with respect to air and maritime transport in 2001 and 2002, respectively. Both laws contain elements of deregulation and reinforcement of competition, and open up these activities to foreign service providers.