I. ECONOMIC ENVIRONMENT

(1) INTRODUCTION

1. El Salvador's annual GDP growth ranged between 1.7% and 4.2% from 1996 to 2001, reaching its peak in 1997. The preliminary figures for the first half of 2002 show an average growth of 1.7%.[1] Impaired by a number of natural disasters, growth rates during this period were lower than in the early 1990s. Activities that experienced particularly high growth rates include construction, and services such as commerce, restaurants and hotels, financial services, transport, and communications, whereas the contribution of the agricultural sector to GDP and exports has declined considerably. While per capita GDP stood at about US$2,150 in 2001, net transfers from workers abroad meant that gross disposable income per capita stood at US$2,420.

2. Economic policy has been guided by the objective to promote sustained growth by reducing inflation, expanding the role of the private sector, and integrating the economy with the rest of the world. After El Salvador's economy was severely affected by Hurricane Mitch in 1998 and two major earthquakes in 2001, reconstruction also became a major economic policy objective. An important feature of monetary policy has been the entry into force of the Law on Monetary Integration, introducing the US dollar as legal tender in January 2001. This brought about a reduction in financial costs, but has not yet led to a significant increase in credit to the private sector. The fiscal deficit started to grow 1997, reaching 3.6% of GDP in 2001, partly owing to reconstruction. This led the authorities, in 2002, to draw up a strategy in the framework of the draft budget for 2003 for the progressive reduction of the deficit with a view to its elimination by 2006.

3. El Salvador's current account balance posted continuous deficits between 1996 and 2001, mainly caused by a strong deficit in the merchandise trade balance. The slowdown of economic activity led to a narrowing of the deficit in 2001. In contrast to merchandise trade, services have shown only minor deficits. Trade plays an increasingly important role in the Salvadoran economy; in 2001, exports of goods and services accounted for almost 30% of the current GDP, while the share of imports stood at about 43%. El Salvador's main trade (including maquila) and investment partner is the United States.

4. Current transfers from Salvadorans living abroad and foreign aid flows have contributed to keeping the current account deficit under control and have played a major part in financing consumption over the past few years. This, in its turn, has made it possible to maintain a stable level of national savings. The challenge for El Salvador will be to channel a portion of these transfers into boosting the level of savings and investment.

(2) STRUCTURE OF THE ECONOMY

5. With a population density of more than 300 persons per square kilometre, El Salvador is one of the most densely populated countries in the western hemisphere. Annual population growth has been decreasing slightly over the past few years, dropping from 2.1% in 1996 to 1.9% in 2001. This has been accompanied by a strong trend towards urbanization, which increased from 56.9% in 1996 to

[1] Information available online at the website of the Central Reserve Bank of El Salvador: http://www.bcr.gob.sv/indic001.htm.

59.4% in 2001. Although all development indicators have improved, some 39% of the population continued to live in poverty in 2001, and 16% of the population even lives in extreme poverty. Although these indicators are still high, they reflect a substantial improvement in comparison with 1996, when according to the data provided by the authorities, some 52% of the population lived in poverty, and 22% in extreme poverty.

6. The agriculture sector contributed 11.8% to GDP in 2001, down from 14% in 1996. The manufacturing sector, including the maquila industry, increased its contribution to GDP from 21% in 1996 to 24% in 2001. In that same year, services contributed some 62% to GDP. In that percentage, commerce, restaurants and hotels accounted for the largest share, contributing almost 20% to GDP.

7. Since El Salvador's last Review in 1996, various natural phenomena have affected its economy The World Bank has indicated that these disasters have been one of the main obstacles to growth and development.[2] Hurricane Mitch (November 1998) entailed costs of infrastructure repairs and damage to major crops which together were estimated at almost 400 million US$.[3] In January and February 2001, two major earthquakes hit the country, causing damage estimated at US$2.2 billion or 16% of GDP. At a subsequent conference, donors pledged financing in the amount of US$1.3 billion, consisting of US$300 million in grants, US$700 million in new loans on favourable terms, and US$300 million of reprogramming in existing loans. Furthermore, in summer 2001 the worst drought in two decades left an estimated 200,000 people in urgent need for food aid.[4]

(3) MAIN ECONOMIC INDICATORS

(i) Production and employment

8. El Salvador's economy grew at an annual average rate of 2.8% between 1996 and 2001 (Table I.1). Growth rates have been decreasing since 1998, owing to damage caused by Hurricane Mitch in late 1998, two major earthquakes and the global economic downturn in 2001, and low international prices of major export goods. After a 1.8% growth in 2001, the Salvadoran economy grew at an average rate of 1.7% in the first half of 2002 compared to the same period in 2001.

[2] World Bank (2002), El Salvador – Country Assistance Evaluation.

[3] Ministry of Public Health and Social Assistance of El Salvador, National Emergency Committee, *La Tormenta Tropical Mitch en El Salvador: Efectos, Respuesta y Análisis de las Experiencas*, San Salvador, 1999. Estimates based on: Economic Commission for Latin America and the Caribbean, *El Salvador: Assessment of the damage caused by hurricane Mitch; implications for economic and social development and for the environment*, February 1999.

[4] Additional information can be found online at the following website of the World Food Programme: http://www.wfp.org/newsroom/in_depth/central_america_el_salvador.html.

Table I.1
Basic economic indicators, 1996-01

	1996	1997	1998	1999	2000 [a]	2001[a]
I. Gross domestic product (GDP)						
Current GDP (US$ million)	10,315	11,135	12,008	12,465	13,139	13,739
Real GDP, rate of growth (%)	1.7	4.2	3.7	3.4	2.2	1.8
Current GDP per capita (US$)	1,783	1,885	1,991	2,025	2,094	2,148
Gross disposable national income (US$million)[c]	..	12,332	13,372	13,764	14,683	15,477
Net current transfers from abroad (US$million)	..	1,.360.9	1,.526.8	1,.581.5	1,797.1.	2,003.8
Gross disposable national income per capita (US$million)	..	2,088	2,217	2,236	2,340	2.420
Sectoral breakdown (% of current GDP)[b]						
Agriculture	13.5	13.0	12.5	13.0	12.3	11.8
Mining	0.4	0.4	0.4	0.4	0.4	0.4
Manufacturing	21.1	21.9	22.5	22.6	23.0	23.6
Electricity, gas and water	0.6	0.6	0.6	0.6	0.6	0.6
Construction	3.7	3.8	4.0	3.8	3.6	3.9
Commerce, restaurants and hotels	20.1	19.9	19.9	19.6	19.8	19.8
Transport, storage, communications	7.4	7.7	7.8	8.2	8.5	8.6
Financial services	3.0	3.2	3.4	3.7	3.8	3.8
Real estate services	3.4	3.4	3.3	3.2	3.2	3.2
Housing	9.1	8.8	8.7	8.4	8.4	8.0
Communal, social and personal services	5.5	5.4	5.3	5.1	5.1	5.1
Public services	5.8	5.8	5.6	5.5	5.5	5.4
Breakdown by expenditure (% of current GDP)						
Total consumption	97.7	96.6	94.7	95.9	98.2	98.0
Private	88.3	87.5	85.0	85.9	88.3	87.9
Public	9.3	9.1	9.7	10.1	9.9	10.1
Gross fixed capital formation	15.8	16.1	16.6	16.2	16.9	16.5
Private	12.1	12.7	13.2	13.2	14.1	13.4
Public	3.7	3.3	3.5	2.9	2.8	3.1
Change in stocks	-0.6	-1.0	0.9	0.1	0.0	-0.5
Exports of goods and services	21.1	25.9	24.8	24.9	27.3	28.9
Imports of goods and services	33.9	37.6	37.1	37.3	42.5	42.9
Gross national saving	..	14.2	16.6	14.5	13.5	14.7

	1996	1997	1998	1999	2000 [a]	2001[a]
II. Fiscal indicators (% of GDP)						
Revenue	12.9	11.8	11.7	11.3	12.1	12.0
Expenditure	14.9	12.9	13.6	13.5	14.4	15.5
Overall balance	-2.0	-1.1	-2.0	-2.1	-2.3	-3.5
III. Money and prices						
Consumer price index (% change)	7.4	1.9	4.2	-1.0	4.3	1.4
M3 (% change)	20.1	27.5	9.5	9.9	3.3	2.5
Official exchange rate (Colón/US$)	8.75	8.75	8.75	8.75	8.75	8.75
Real effective exchange rate (1990 = 100)	139.5	148.9	152.6	155.6	154.9	163.0
Deposit rate (%, p.a.)	12.0	12.7	10.7	10.7	7.1	3.9
Lending rate (%, p.a.)	16.7	15.7	15.1	15.1	12.2	7.8
IV. Memo items						
Population (million)	5.8	5.9	6.0	6.2	6.3	6.4
Terms of trade (1980 = 100)	107.7	116.6	116.5	109.1	103.0	**[…]**
Net international reserves (US$ million)	1,100	1,462	1,765	1,970	1,891	1,710

.. Not available.

a Preliminary figures
b Excluding imputed banking services, customs duties and value-added tax
c Gross Domestic Product less property income paid to the rest of the world plus net current transfers.

Source: Salvadoran authorities, WTO Secretariat calculations, verified by the Central Reserve Bank of El Salvador.

9. According to Central Bank estimates, per capita GDP increased from some US$1,680 in 1995 to about US$2,150 in 2001. Thanks to the large work force abroad, particularly in the United States, net transfers play an important role, generating a gross disposable income per capita in excess of the GDP per capita. In 2001, gross disposable income per capita stood at US$2,420, 13% higher than GDP per capita.

10. The expenditure composition of El Salvador's GDP is characterized by a relatively high level of private consumption, which is partly financed by remittances from Salvadorans living abroad. In 2001, consumption represented 98% of GDP. Similarly, the marginal propensity to consume is high owing to the effect of the remittances.[5] Thanks to the remittances, it has been possible to maintain a relatively stable national savings rate in spite of the increase in consumption, since average annual growth in disposable national income has exceeded the GDP growth rate for 1997-2001 by more than 0.5%. The national savings rate amounted to 14.5% of GDP in 2001. The authorities have spoken of a need to increase the savings rate, and hope to achieve this thanks in part to the contributions of employees in the new pensions scheme. The private investment rate stood at 13.4% of GDP in 2001.

11. Exports of goods and services have increased their contribution to GDP over the past years (see below). This development of Salvadoran foreign trade would seem to indicate a situation in which merchandise exports have grown in parallel with and complementary to the migration of labour. At the same time, emigration has also led to an increase in consumption through the remittances from abroad, boosting national welfare but at the same time causing an increase in the demand for imports, including goods with compete with domestic production. The challenge for

[5] According to calculations made by the WTO Secretariat on the basis of information supplied by the Central Reserve Bank of El Salvador, for every US dollar increase in gross disposable national income during the period 1997-2001, household consumption increased by US$0.78.

El Salvador will be to consolidate the gains generated by the movement of labour and reorient them towards the medium and long term by ensuring that a growing share of remittances are converted to savings, and channelling these increased savings towards increased investment.

12. Total employment increased from 2.05 million in 1996 to 2.45 million in 2001 (Table I.2). The participation rate in the labour market increased as well and went hand in hand with a slight decrease in the unemployment rate, which stood at 6.9% in 2001. While employment shifted away from agriculture, growth was particularly high in activities such as commerce and hotels, and financial services. Employment in manufacturing declined slightly between 1996 and 2001, from 18% of the total to 17.6%.

13. In El Salvador, micro-enterprises are of great importance to the economy because of their leading role in generating employment. A survey undertaken by the Salvadoran Government in 1999 estimated total employment in the urban informal sector at about 512,000 for that year, equivalent to more than 20% of the economically active population.[6] Urban informal employment was particularly important in commerce, manufacturing, and transport.

Table I. 2
Employment indicators, 1996 – 2001

	1996	**1997**	**1998**	**1999**	**2000**	**2001**
			('000)			
Population	5,787	5,911	6,031	6,154	6,276	6,397
Economically active population	2,227	2,245	2,403	2,445	2.496	2.633
Urban area	1,314	1,335	1,494	1,534	1,568	1.636
Rural area	914	910	909	911	928	997
Employment	2,056	2,067	2,228	2,275	2,323	2,451
			(%)			
Participation rate	38.5	38.0	39.7	39.7	39.8	41.1
Unemployment rate	7.7	8.0	7.5	7.4	7.0	6.9
Employment by sector			(%)			
Agriculture and mining	28.2	26.4	25.1	22.2	21.7	21.9
Manufacturing	18.0	16.1	18.7	18.8	18.7	17.6
Utilities	0.4	0.7	0.4	0.4	0.4	0.4
Construction	6.4	6.7	5.4	5.8	5.1	5.4
Commerce and hotels	19.4	24.6	25.0	25.4	26.3	27.2
Transport	4.4	4.6	4.0	4.4	4.7	4.6
Financial services	1.3	3.0	3.7	3.7	3.8	4.1
General services	21.8	17.8	17.7	19.4	19.4	18.6

Source: Ministry of Economy and Central Reserve Bank of El Salvador.

[6] National Commission for Micro- and Small Enterprises, *Características del Sector Microempresarial Salvadoreño, 1999*, San Salvador, 1999.

(ii) Fiscal policy

14. The formulation of fiscal policy is mainly under the responsibility of the Ministry of Finance. Fiscal policy is directed towards rationalizing and optimizing current expenditure and maintaining public investment levels, giving priority to human development-related areas such as education, health, social security and training of human resources. The share of government spending in GDP has traditionally been relatively low, but has been increasing over the past years, reaching 15.6 % of GDP in 2001, while the share of revenue has remained low and stable (12% of GDP in 2001). This can partly be explained by a relatively high rate of tax evasion. As in the case of smuggling, a number of steps were taken such as the application of the Zero Tolerance Plan and the Special Law for the Penalization of Customs Offences, which include provisions for penal action and the temporary closure of establishments, *inter alia*. El Salvador's fiscal balance has posted increasing deficits since 1997; in 2001, the non-financial public sector deficit amounted to 3.6% of GDP (Table I.3). In 2002, in the framework of the draft 2003 budget, the authorities drew up a strategy to reduce the deficit (see below).

15. While income tax and value-added tax (VAT) have increased in importance as dominant income categories, representing some 27% and 51% of current revenue respectively in 2001 as compared to 25% and 46% in 1997, revenue from customs duties has remained relatively stable in nominal terms since 1997, ranging between US$141 million and US$148 million. Reflecting the decrease of El Salvador's average tariff in recent years and the growing importance of other revenue sources, the share of customs duties in total government revenue has fallen from 12.2% in 1996 to 8.9% in 2001. The ratio between revenue collected from customs duties and merchandise imports was less than 4% in 2001.

Table I.3
Central Government Finances, 1996-2001
(In millions of US$)

	1996	1997	1998	1999	2000	2001[a]
Revenue	**1,330**	**1,312**	**1,401**	**1,414**	**1,585**	**1,650**
Current revenue	1,310	1,286	1,387	1,393	1,489	1,599
Taxes	1,080	1,132	1,209	1,275	1,344	1,449
Income tax	305	323	351	393	429	431
Value-added tax	541	593	650	669	714	809
Consumption tax	57	5,572	47	52	49	49
Property tax and other taxes	14	14	15	14	12	12
Customs duties	163	146	146	148	141	146
Non-tax and other revenue	230	154	178	119	145	150
Capital revenue and donations	**19.5**	**25.9**	**14.6**	**20.8**	**95.8**	**51.8**
Expenditure	**1,540**	**1,438**	**1,636**	**1,681**	**1,884**	**2,143**
Education	231	271	322	330	387	412
Public works	148	171	195	126	120	125
Defence and public security	231	233	260	259	280	287
Public health and social welfare	143	145	177	181	206	201
Agriculture	25	31	43	32	40	26
Balance	**-210**	**-126**	**-235**	**-267**	**-299**	**-493**

a Preliminary data.

Source: Central Bank of El Salvador.

16. Following the earthquakes in 2001, the Legislative Assembly consented to the Government's plan to issue a Eurobond for US$350 million. In 2002, the authorities revised their overall public sector deficit target for 2001-2005 to incorporate reconstruction costs of about 1.5% of GDP per year.

17. Increasing the share of investment expenditure in public spending has been a major objective of fiscal policy in recent years, with a rise from 3.2% of GDP in 1999 to 4.3% in 2001. Since 1996, growth rates in public spending have been particularly high for education (with an annual average of 12% in nominal terms between 1996 and 2001) as well as for public health and social welfare (7%), whereas expenses for public works, agriculture, and defence have stagnated or increased only slightly.

18. In the light of the revised figures presented in the 2003 draft budget, a non-financial public sector deficit of 3.3% of GDP is expected in 2002.[7] The draft 2003 budget aims to reduce current expenditure by 3.6%, excluding education and health, to boost revenue by expanding the tax base, and to maintain the level of indebtedness under control in compliance with the self-imposed precautionary limit of 40% of GDP for the non-financial public sector debt. According to information provided by the Salvadoran authorities, the ratio of public debt to GDP was 36% in August 2002, and is expected to reach 38.8% in 2003. Public investment is expected to reach 4.3% of GDP, 33% of which represents reconstruction expenditures. As regards the improvement of tax collection, a tax reform programme is planned which includes a reform of the Income Tax Law, the reduction or elimination of the VAT exemptions and a streamlining of customs procedures. The authorities consider that there has been a substantial improvement in the reduction of the underlying deficit (excluding the effects of reconstruction expenses in the wake of two earthquakes in 2001) and that it could already be eliminated by 2004. However, an important expenditure component is the financing of the repayment of the growing debt from the former pensions system, which has reached 7.9% of the budget.

(iii) Monetary and exchange rate policy

19. Responsibility for the conduct of monetary policy lies with the Central Reserve Bank of El Salvador (BCR). From 1993-2000, the BCR maintained a monetary policy directed towards controlling inflation by using the exchange rate as an anti-inflationary anchor. However, this considerably reduced the margin of manoeuvre of monetary policy, which was directed towards neutralizing the effect of foreign currency remittances from abroad, and involved the maintenance, for example, of relatively strict non-interest bearing reserve requirements. Furthermore, the fixed exchange rate system failed to eliminate the country-risk perception and ensured that the real interest rates remained high, adversely affecting credit and investment.

20. In response to these difficulties, the US dollar was introduced as legal tender alongside the Salvadoran Colón through the Law on Monetary Integration of 22 December 2000, which entered into force on 1 January 2001.[8] The main objectives of this Law are to contribute to improving financial conditions, to create a healthier and more competitive financial system, to increase the safety of wages and savings, and to contribute to improving the economic institutions. More specific monetary goals included an interest rate decrease, a lowering of the country risk through increased institutional stability, a greater variety of financial instruments and the avoidance of exchange rate crises.

21. In establishing the US dollar as legal tender together with the Colón, the Law on Monetary Integration fixed the exchange rate between the Colón and the US dollar at 8.75, the same rate that had been in place during the seven years prior to the adoption of the Law. The US dollar also became

[7] The budget is available on-line at the Ministry of Finance website at http://www.mh.gob.sv/.

[8] Official information on the Law on Monetary Integration may be found online at http://www.interaction.gob.sv/doc-html/index.html.

the unit of account for the financial system; all its operations and accounting have been dollar denominated since 1 January 2001 when all deposits, credits, pensions and other operations were automatically converted. The authorities consider that the introduction of the dollar as a unit of account for the financial system presents the advantage of eliminating the problem of passive losses through currency conversions.

22. The Law on Monetary Integration prohibits the banks from charging any fees for exchanging US dollar and Colón bills. Salaries, wages and prices can be denominated and paid in US dollars, Colóns or any other currency. During the first six months of 2001, prices had to be labelled in both dollars and Colóns, after which time the Law on Monetary Integration introduced the dollarization of the economy. As at May 2001, over 80% of the currency in circulation was in US dollars. The authorities consider that the dollarization also contributed to the soundness of the financial system.

23. Domestic interest rates decreased considerably in the wake of dollarization. This was in part due to US monetary policy, but also largely to the reduction of the country risk through the elimination of the exchange rate risk. Although since 1996, interest rates have decreased – for instance, average lending rates for Colón-denominated loans of up to one year fell from 16.7% in 1996 to 12.2% in 2000 – they remained high in real terms and well above US interest rates. The adoption of the Law on Monetary Integration provided additional impetus to the decline in interest rates. Since the Law entered into force in January 2001, average lending rates dropped from 11.5% to 7% in July 2002, while deposit rates fell from 6.5% to 3.5%. The spread between interest rates in loans denominated in Colóns and US dollars has also dropped significantly, from more than 5 percentage points during the 1990's to about 1.5 percentage points in 2001.

24. With the entry into force of the Law on Monetary Integration, the functions of the BCR were restructured. According to the authorities, the role of the BCR is now to maintain monetary stability. Although it still retains the function of providing the financial system with working capital, the function of the BCR as a lender of last resort is altered as a result of the Law. The BCR can now engage in repurchase operations only under exceptional circumstances which include sudden contractions in financial system liquidity and cases of *force majeure*. To that end, the BCR plans to maintain a high level of international reserves in excess of the monetary base. The Law also converted the non-interest bearing legal reserve requirement of 20% to an interest bearing liquidity requirement to which banks may resort for their short term liquidity needs. The US dollar liquidity reserves deposited in the BCR by each bank must be proportional to its deposits. The banks also have a liquid assets requirement in proportion to their short term obligations. Assets and liabilities in other currencies have to be matched, or the exchange rate risk exposure has to be hedged.

25. El Salvador does not maintain controls on foreign exchange transactions.

26. The provisions of the Law on Monetary Integration, and in particular the prohibition on issuing new Colóns, have meant that the Central Bank's capacity to influence prices is now limited. The only remaining instruments for influencing demand are fiscal policy and income policy. The money supply had previously been influenced by public sector decisions backed by actions taken by the monetary authorities, and this had an effect on price change. Inflation rates have decreased from double digit rates at the beginning the 1990's to 1.4% in 2001. Accumulated inflation for the first nine months of 2002 reached 2.6%; however, the annual variation for the past 12 months was only 1.4% as of September 2002. The maintenance of a fixed exchange rate and the resulting appreciation in real terms contributed to this reduction by pushing down the cost of imports.

(iv) Balance-of-payments

27. El Salvador's current account registered continuous deficits between 1996 and 2001, which ranged between US$91 million in 1998 and US$431 million in 2000 (Table I.4). In 2001, the current account deficit amounted to US$ 177 million, equivalent to 1.4% of GDP, while in the first half of 2002, it reached US$98 million, 31% higher than the same period of the preceding year. The merchandise trade balance posted a persistent deficit which has shown a widening trend since 1997. In 2001, the merchandise trade deficit amounted to more than US$1.9 billion. At the same time, the current account deficit was contained by a strong and increasing surplus in current transfers, mainly consisting of remittances from Salvadorans living abroad. In addition to private transfers, El Salvador received public and other transfers for a total of US$393 million in 2001.

Table I.4
Balance of payments, 1996-2001
(US$ million)

		1996	1997	1998	1999	2000	2001[a]
I.	**Current account**	**-169**	**-98**	**-91**	**-239**	**-431**	**-177**
	Trade in goods	**-1,433**	**-1,143**	**-1,306**	**-1,356**	**-1,740**	**-1,913**
	Exports	1,788	2,437	2,460	2,534	2,963	2,901
	Imports	3,222	3,580	3,765	3,890	4,703	4,814
	Services	**10**	**-152**	**-149**	**-183**	**-235**	**-2**
	Receipts	10	476	588	641	698	1,076
	Payments	..	628	737	823	933	1,078
	Investment income	**..**	**-163**	**-163**	**-282**	**-253**	**-266**
	Receipts	..	75	111	113	141	169
	Payments	..	238	274	395	394	435
	Current transfers (net)	**1,255**	**1,361**	**1,527**	**1,582**	**1,797**	**2,004**
	Private remittances	1,083	1,200	1,338	1,374	1,751	1,911
	Public transfers and other	172	161	189	208	46	93
II.	**Financial account**	**334**	**665**	**1,063**	**653**	**373**	**343**
	Direct investment	..	59	1,103	162	178	278
	Portfolio investment	..	116	-226	74	-26	34
	Long and medium term debt (net)	334	271	245	368	401	-417
	Other investments	..	219	-59	50	-181	449
III.	**Errors and omissions[b]**	**0**	**-205**	**-669**	**-206**	**-12**	**-344**
IV.	**Overall balance**	**165**	**363**	**303**	**208**	**46**	**178**
V.	**Financing**						
	Reserve balance (increase -)	-165	-363	-303	-208	-46	-178

.. Not available.

a Preliminary figures.
b Included in the financial account until 1996.

Source: Central Bank of El Salvador.

28. In addition to maquila exports, remittances from Salvadorans living abroad, mainly in the United States, constitute an important source of foreign exchange for El Salvador. Net current transfers increased from US$1,390 million in 1995 to just over US$2,000 million in 2001, equivalent to 14.6% of GDP. This strong contribution of foreign financing to national savings makes the

Salvadoran economy vulnerable to changes in the US business cycle. Private remittances represent 96% of net transfers.

29. El Salvador's balance of trade in services features a deficit for most service categories (Table I.5). While the deficits are highest for transport and financial services, particularly insurance, successive, relatively small surpluses have been recorded for tourism and communications.

Table I.5
Trade in services, 1997-2001
(US$ million)

Description	1997	1998	1999	2000	2001
Balance	**-15.0**	**-148.9**	**-182.6**	**-234.9**	**-2.1**
Revenue	**475.8**	**588.4**	**640.6**	**698.4**	**1,075.6**
Transport	180.5	187.5	213.8	248.6	281.8
Travel	149.4	206.2	222.3	216.9	201.1
Communications	78.3	98.3	81.2	86.3	108.8
Construction	1.6	5.7	6.8	14.0	15.6
Insurance	31.7	54.2	66.7	63.1	406.2
Banking	7.7	10.0	12.3	6.7	2.0
Information services	0.0	0.0	0.0-	3.9	0.2
Patent fees (royalties)	0.0	0.0	1.1	2.4	1.2
Personal, cultural and recreational services	0.0	0.0	0.0-	0.6	0.4
Government services	15.5	12.9	20.3	25.3	23.5
Miscellaneous services	11.1	13.6	16.1	30.6	34.8
Expenditure	**627.8**	**737.3**	**823.1**	**933.3**	**1,077.7**
Transport	261.4	324.7	330.9	405	395.9
Tourism	153.1	179.4	168.9	165.2	195.3
Communications	7.4	18.3	20.8	27.2	40.4
Construction	1.7	4.1	8.9	8.2	8.6
Insurance	87.4	89.3	113.5	113.2	173.4
Banking	17.5	16.9	31.4	38.1	40.1
Information services	0.0	0.0	11.8	14.1	9.6
Patent fees	0.0	0.0	20.3	20.5	22.1
Personal, cultural and recreational services	0.0	0.0	0.0.-	1.0	1.3
Government services	13.2	14.1	22.5	21.6	15.8
Miscellaneous services	86.1	90.5	94.1	119.2	175.2

Source: Central Bank of El Salvador.

30. El Salvador's foreign debt increased from US$2.5 billion in 1996 to more than US$3.1 billion in 2001. Net international reserves increased from US$683 million in 1995 to US$1,710 million in 2001, reaching a high point of 1,970 million in 1999.

(4) MERCHANDISE TRADE AND INVESTMENT FLOWS

(i) Composition of trade

31. According to COMTRADE, whose figures do not include maquila exports and imports of related inputs, El Salvador's merchandise exports amounted to US$1,214 million in 2001, up from US$985 million in 1995 (Chart I.1, Table AI.1). El Salvador's most important export products are coffee, sugar, clothing, and textiles. However, the share of coffee in exports fell from nearly 38% in 1995 to 9.5% in 2001. El Salvador's exports of chemicals cover a wide range of products; medicaments are the most important product category. In recent years, El Salvador has succeeded in expanding its exports in various manufactured products such as iron and steel, machinery and transport equipment, and clothing.

32. El Salvador's merchandise imports have increased in nearly all product categories (Table A.I.2). The share of manufacturing imports fell from 72% in 1995 to 66% in 2001, while imports of agricultural products and fuels increased over the same period. Machinery, transport equipment and chemicals account for a large share of manufactured imports. Agricultural imports, making up for over 19% of imports in 2001, include a wide range of food products. Crude petroleum and mineral fuels accounted for 13% of imports in 2001.

33. It should be noted that the exclusion of maquila exports and of imports of related inputs in COMTRADE data results in a strong underestimation of exports in subsectors such as textiles and apparel, as well of imports of necessary inputs. According to Central Bank data, maquila exports amounted to US$1,652 million in 2001, while imports of necessary inputs were US$1,161 million.[9] According to information provided by the Ministry of Economy maquila exports are particularly significant in sectors such as textiles, apparel, and electronic components.[10]

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[9] Central Bank of El Salvador, online at: http://www.bcr.gob.sv/boletin.htm.

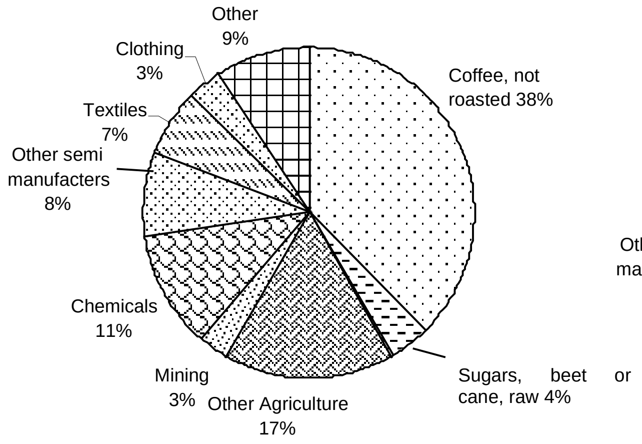
[10] Database of the Ministry of Economy available online at: http://www.minec.gob.sv/default.asp?id=19&mnu=19.

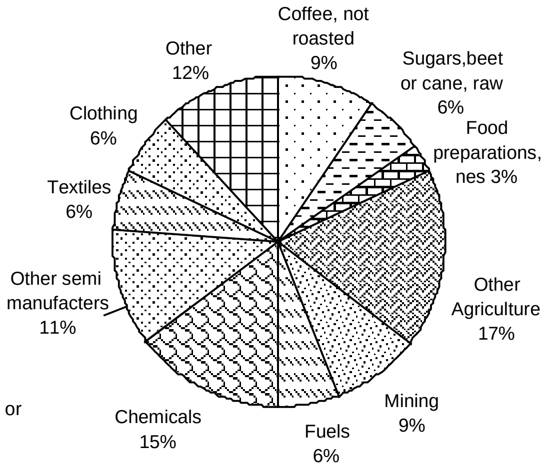
Chart I.1
Merchandise trade by product, 1995 and 2001

%

1995 **2001**

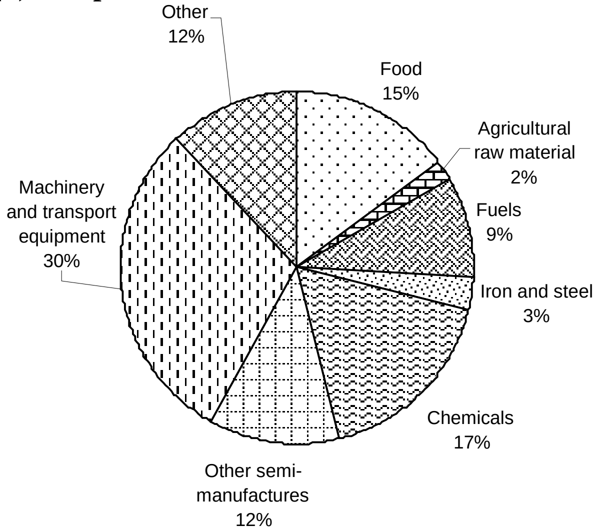
(a) Exports (f.o.b.)

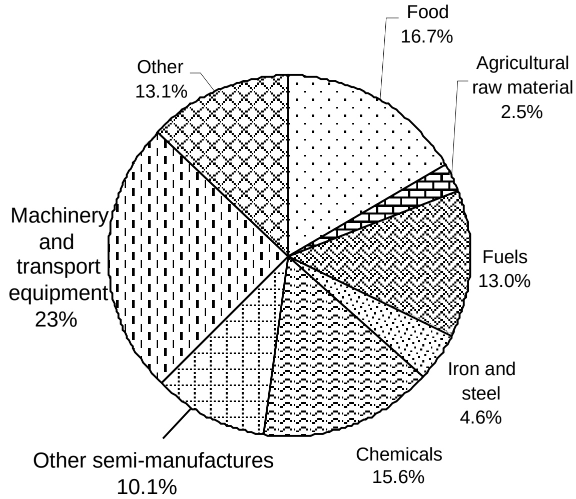




Total: US$ 985.2 million **Total: US$ 1213.5 million**

(b) Imports





Total: US$ 2627.7 million **Total: US$ 3865.6 million**

***Source*: UNSD, Comtrade database.**

(ii) Geographical distribution of trade

34. According to COMTRADE data, El Salvador's main export markets are the other members of the Central American Common Market (CACM) and the United States (Chart I.2). Guatemala was the market for nearly 27% of Salvadoran exports in 2001, up from less than 21% in 1995. The United States and Honduras absorbed 19% and 15% of Salvadoran exports, respectively. While exports to Latin American countries have experienced a clearly increasing trend since 1995, exports to the European Union declined from nearly 31% in 1995 to less than 7% in 2001, largely owing to the decrease in coffee exports. Important European export destinations include Germany, France, and the Russian Federation. (Table AI.3).

35. El Salvador's trading partners have benefited from a growing market and a more open foreign trade regime; most have seen their exports to El Salvador increase in recent years (Table AI.4). The United States is El Salvador's most important trading partner on the import side, although its share fell from 44% in 1995 to 34% in 2001. Over the same period, the combined shares of the Latin American and Caribbean countries rose, from 33% in 1995 to 45% in 2001. Import shares from most European countries have remained relatively stable since 1995, with a combined share of 11% and Germany and Spain being the most important exporters to El Salvador. East Asian countries made up for 8% of Salvadoran imports in 2001, down from 9% in 1995.

36. The inclusion of maquila exports and related imports results in a strong increase in the United States' importance as a trading partner. According to Central Bank data, the United States absorbed more than 65% of El Salvador's merchandise exports and provided more than 49% of imports in 2001.[11]

(iii) Foreign direct investment

37. Foreign investment in El Salvador appears to have been encouraged by new legislation on telecommunications and electricity (Chapter IV(4) and (5)(iii)), which opened these sectors to private competition and foreign capital. Moreover, the enactment of the Investment Law in 1999 abolished most exceptions to national treatment (see Chapter II(3) for details on exceptions).

38. Between 1997 and June 2002, accumulated foreign investment inflow in El Salvador amounted to US$2361.4 million, of which more than US$800 million went to the electricity sector and US$398 million to the communications sector (Table I.6). Other sectors with important FDI inflows include manufacturing, maquila, and financial services. The most important foreign investor during that period was the United States, followed by Venezuela and France.[12]

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[11] Central Bank of El Salvador, online at: http://www.bcr.gob.sv/boletin.htm.

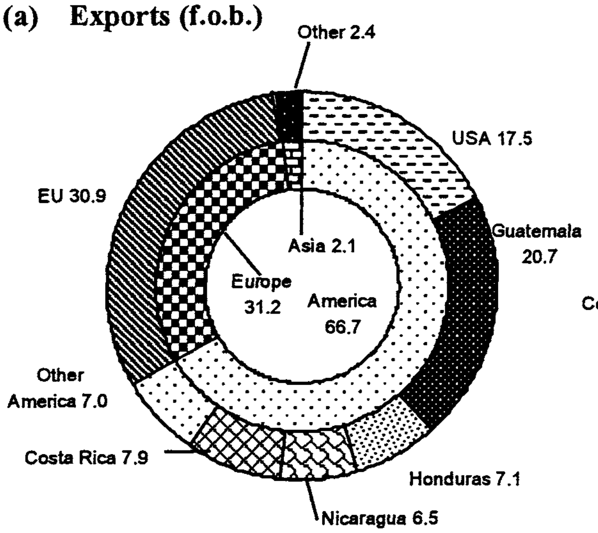
[12] UNCTAD, database on foreign direct investment

Chart I.2 El Salvador
Merchandise trade by partner, 1995 and 2001

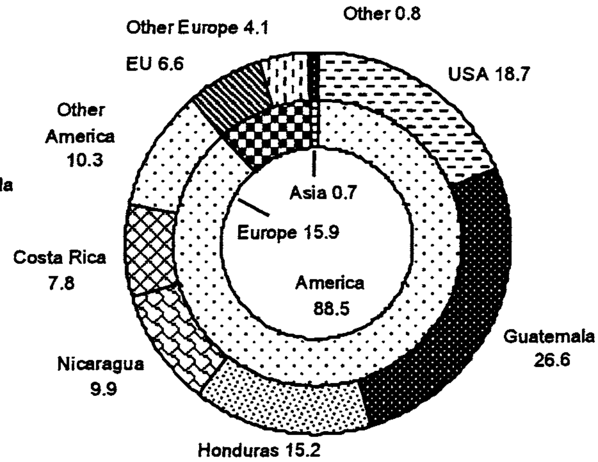
%

1995 | 2001

(a) Exports (f.o.b.)

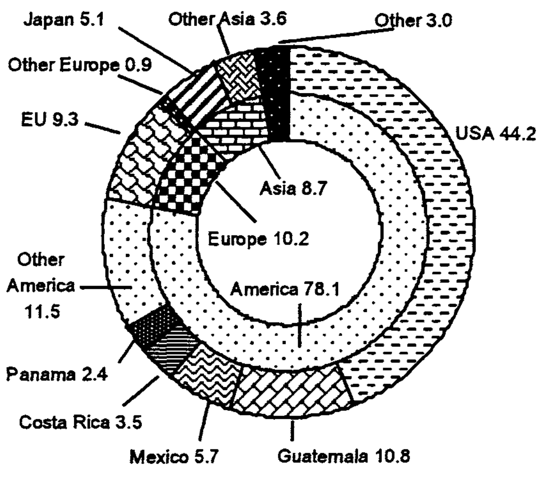


Total: US$ 985.2 million

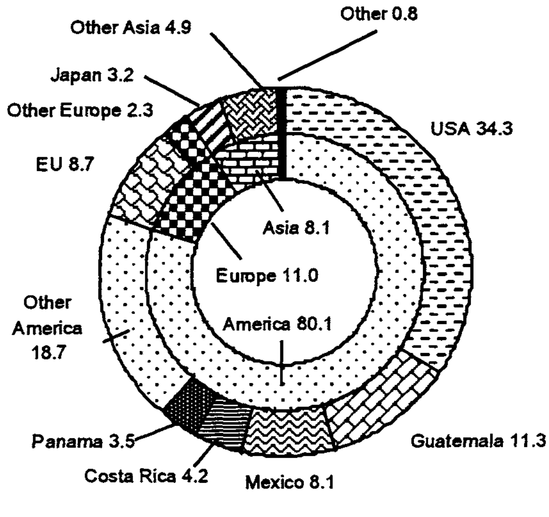


Total: US$ 1213.5 million

(b) Imports



Total: US$ 2627.7 million



Total: US$ 3865.6 million

Source: UNSD, Comtrade database.

Table I.6
Accumulated Foreign Direct Investment by Sector, 1997-2002[a]
(In millions of US$)

	1997	1998	1999	2000	2001	2002[a]
Industry	196.4	286.9	304.6	336.5	389.9	415.4
Trade	106.0	124.6	142.1	169.1	190.2	212.5
Services	54.1	60.3	66.0	70.0	90.0	107.5
Construction	11.1	11.1	11.8	12.2	12.3	12.3
Communications	3.5	254.5	288.6	291.0	352.6	397.7
Electricity	0.0	598.4	723.5	806.9	821.5	821.5
Agriculture and Fishing	..	21.0	21.0	40.0	40.0	40.0
Mining and quarrying	14.0	15.5	0.1	0.1	0.1	0.1
Finance	37.8	77.2	104.6	120.4	161.8	161.8
Maquila	57.2	134.4	137.6	156.9	182.6	192.7
Total	**480.1**	**1,583.9**	**1,799.7**	**1,973.1**	**2,240.9**	**2,361.4**

.. Not available

a June 2002

Source: Central Reserve Bank of El Salvador.

(5) OUTLOOK

39. For 2002, the authorities expect a growth rate of 2 to 3%, an inflation rate ranging between 2 and 3%, and a fiscal deficit of 3.3% of GDP. For 2003, the draft 2003 budget forecasts a GDP growth rate of between 2.5% and 3.5%. The authorities hope that a recovery of the world economy, in particular the United States economy, will act as an engine for growth in 2003. Other elements that should contribute to sustaining growth are: the maintenance of the level of remittances from abroad, increased benefits granted under the Caribbean Basin Initiative launched in 2000, the positive expectations generated by the conclusion and negotiation of free trade agreements, and the potential for the reduction of transaction costs thanks to the efforts made to develop the regional electricity interconnection network, and improvements in the telecommunications sector, ports and the road network. The reduction that has taken place in real interest rates since the introduction of the Law on Monetary Integration should also help to stimulate growth.

40. It is hoped that in this macroeconomic environment, the public sector deficit can be reduced by 1.6% of GDP, bringing the underlying deficit to only 0.2% of GDP.