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TRADE POLICY REVIEW

El Salvador

Report by the Secretariat

This report, prepared for the first 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.

Document WT/TPR/G/23 contains the policy statement submitted by the Government of El Salvador.

Note: This report is subject to restricted circulation and press embargo until the end of the meeting of the Trade Policy Review Body on El Salvador.

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SUMMARY OBSERVATIONS

(1) Introduction

1. Since 1989, at the end of ten years of internal conflict, El Salvador has been following macro-economic stabilization and structural adjustment programmes, which have seen growth increase to 6.5 per cent and inflation falling to around 11 per cent in 1995. The economy has been liberalized through trade reforms and domestic de-regulation, reducing the anti-export bias of the previous trade and industrial policy régime. The new economic environment, together with the ongoing modernization of trade laws and regulations, have created opportunities for investment which are necessary to pave the way for stable long-term growth.

(2) General Economic Developments

2. The progress achieved under the reform programme has allowed El Salvador to start rebuilding its economy after the conflict. Increased investment in infrastructure and in human capital has been achieved, inter alia, by the rationalization of expenditures, as part of a wide-ranging fiscal reform aimed at cutting government expenditure and increasing tax collection. These measures have resulted in a reduction of the fiscal deficit from 4.7 per cent in 1989 to less than 1 per cent of GDP in 1995.

3. Under the fiscal reform, the tax system has been simplified so that only a few taxes of general application remain in place (VAT, income tax and the tariff). The VAT has become the most important tax. Export taxes and sectoral tax incentives have been abolished; the only remaining tax incentives are those provided under the free-trade and tax-free areas régime and drawback system.

4. Cut-backs in expenditure have been achieved principally by reducing the rôle of the State. Thus, key sectors of the economy have been, or are in the process of being, privatized. The marketing boards in charge of coffee, sugar and cotton, the three traditional agricultural exports, have lost their monopoly power; in the financial sector all but one bank has been privatized; and Antel, the profitable public telecommunications monopoly, is in the process of being privatized, as are some services at the main airport and port.

5. As part of the wider economic deregulation, the exchange rate has been unified, exchange controls have been eliminated and the capital account has been liberalized. Interest rates are now essentially set by the market and credit rationing has been abolished. The Central Reserve Bank's main objective is to control inflation, a task which is complicated by large inflows of remittances from Salvadorians working in the United States. While inflation has been substantially reduced, it still exceeds international levels so that, taken together with the policy to maintain a stable nominal rate of exchange with the U.S. dollar, there has been a real exchange rate appreciation since the beginning of the 1990s. Persistent trade deficits are more than offset by the remittances and, more recently, by private capital inflows.

6. The Government has acted to facilitate foreign investment in the economy. FDI is allowed in all sectors in El Salvador, with very limited areas reserved for nationals. A new law is being drafted to simplify and expedite the process of registration and legalization of investment, and the opening up of a one-step window to simplify investment procedures is envisaged in the near future. El Salvador does not apply any trade-related investment measures.

(3) El Salvador in World Trade

7. El Salvador's trade is concentrated both in goods and in markets. Its major markets are the United States, mainly for agricultural products and clothing (the latter generally assembled in free zones); the European Union (EU), also for agricultural products; and the Central American countries, for industrial goods.

8. The concentration in trade can be attributed to three factors. First, El Salvador benefits from duty-free privileges in the United States under the Caribbean Basin Initiative and the EU under the Generalized System of Preferences. Second, the free zones have specialized in the assembly of clothing to be exported to the United States under the off-shore assembly programme, another preferential régime. Third, intra-regional trade is important because of the Central American Common Market (CACM).

9. There is concern about the lack of export diversification. While the United States preferential sugar quota and off-shore assembly régime provide benefits to El Salvador, they also inhibit diversification in production and trade; resources that might be put to other uses are allocated to the production of sugar and the clothing industries located in the free zones. In addition, the real appreciation of the currency in recent years has also become a constraint on broadening the export base because of the loss in competitiveness for Salvadorian exports.

(4) Trade Policy Objectives

10. El Salvador's trade policy objectives include moving toward a more outward-oriented trade régime, strengthening and increasing overseas market access for Salvadorian products, and deepening the integration of El Salvador in the world economy. It has pursued these objectives through its unilateral reform programme, as well as through regional, bilateral and multilateral trade and investment negotiations. Regional trade negotiations at the Central American level and within the framework of the Free Trade Area for the Americas (FTAA) are seen as very important, but El Salvador has also intensified its participation at the multilateral level through the WTO.

11. El Salvador acceded to the GATT in 1991, but did not participate in any of the Tokyo Round Agreements. It became a member of the WTO in May 1995, participating in all Multilateral Trade Agreements but not in the Plurilateral Agreements. The Government intends to implement the WTO Agreements within the time periods available to developing countries.

12. As an international treaty in El Salvador, the WTO Agreements constitutionally take precedence over any conflicting domestic legislation; however, the authorities are progressively introducing amendments aimed at bringing specific laws into line with the provisions to the WTO. For example, new legislation has been approved since the entry in force of the WTO in the areas of rules of origin, anti-dumping and safeguard procedures, while areas that still require attention include customs valuation.

13. The Central American Common Market (CACM) is the centrepiece of El Salvador's regional trade relations, and El Salvador has put special emphasis in revitalizing the CACM. In this context, a process of convergence has been engaged towards the CACM common external tariff, negotiated in 1993, and common legislation exists in several areas, including customs valuation, intellectual property, and dumping and countervailing measures.

14. El Salvador, together with Guatemala and Honduras, is negotiating a free trade agreement with Mexico; it is also participating in the negotiations to establish a Free Trade Area for the Americas, and has also signed *bilateral investment agreements with several countries.*

(5) Institutional Framework

15. Principal responsibility for trade policy lies with the Ministry of Economy, which absorbed the previous Ministry of Trade in 1989. Within the Ministry, the Trade Policy Directorate, created in 1994, has responsibility for formulating, implementing and reviewing trade policy, as well as negotiating trade agreements. Initiatives in specific areas affecting trade may be proposed by any relevant ministry but must be approved by the Economic Committee, formed by the President, Vice-President, various Ministers and the President of the Central Reserve Bank.

16. There is no independent body to provide the Government with formal advice regarding trade policies. Nevertheless, the private sector, through producer groups and research institutions, provides advice to the Government on an informal basis.

(6) Evolution of Trade Policies and Instruments

17. Since 1989, El Salvador has progressively rationalized and reduced its tariffs. Whereas, prior to 1989, applied m.f.n. rates ranged from 5 to 290 per cent, they now range from 1 to 30 per cent, with an unweighted average of 10.1 per cent in 1995. Few duties are higher than 25 per cent. It is planned to reduce the range of applied tariffs to 0 to 15 per cent by 1999; this seems feasible since, as noted above, El Salvador does not rely on trade taxes to finance its fiscal deficit. In fact, in spite of the reduction in tariffs, duty collection has increased because of the whole process of liberalization and a decrease in smuggling. Despite the reduction in tariffs, escalation persists, providing certain Salvadorian industries with higher effective protection than is evident from the moderate nominal rates.

18. El Salvador bound most of its tariffs on accession to the GATT in 1990 and extended its binding coverage to 100 per cent in the Uruguay Round, albeit at "ceiling" rates, generally at 40 per cent, which are substantially higher than those currently being applied.

19. Most non-tariff barriers have been eliminated. Authorization is required for the importation of sugar, import licences remain only for jute sacks and salt, and import controls remain for the duty-free entry of some sensitive products from other members of the CACM. These procedures have not been notified to the WTO Secretariat and appear to lack transparency. Licence procedures have yet to be developed for the implementation of tariff quotas under El Salvador's WTO tariffication commitments for agriculture.

20. Anti-dumping, countervailing and safeguard procedures derive from Central American legislation, which the authorities believe to be WTO-consistent. Only one countervailing action has been reported in the last five years.

21. Customs procedures are at present being modernized, but, while normal processing time seems moderate, delays at customs are reportedly a concern to imports.

22. El Salvador currently applies international standards, but national standards, based on international standards, are now being developed.

23. To promote production of non-traditional exports for markets outside Central America, a duty drawback system has been established and the free-zone and tax-free area régimes have been reformed. The duty drawback scheme is based on a fixed re-imbursement equivalent to 6 per cent of the f.o.b. value. There are no explicit export subsidies.

24. Export procedures have been substantially streamlined by the opening-up of *a one-stop window where all documents are processed. Export taxes have been eliminated. Export controls remain only for subsidized diesel and gas for domestic consumption. A special export document showing a quota entitlement is required for preferential sugar exports to the United States and textiles and clothing exports subject to quotas in importing countries. Export permits are required for certain products, including Portland cement, clinker and sugar cane to ensure domestic availability. Coffee exports are covered by the retention plan of the Association of Coffee Producing Countries.*

25. Most domestic price controls were abolished in 1989, and, in practice, only certain petroleum products are now subject to price controls.

26. Other than the constitutional prohibition on monopolies and regulatory provisions in certain services areas, there is no explicit legislation to regulate competition conditions in the Salvadorian market and there is no competition authority.

27. In 1993 a law regarding intellectual property rights came into force. Enforcement of this law has been difficult because of insufficient resources and a lack of awareness that the law is being infringed. However, the Government has been making efforts to enforce the law, and, when cases have been brought to their attention, the authorities have taken action.

(i) <u>Sectoral developments</u>

28. The agricultural, industrial and services sector have been undergoing a process of adjustment in El Salvador as the past protectionist, state-controlled régime has been dismantled and market forces have become more relevant. The agricultural sector, traditionally important, suffered badly in the 1980s as a result of the armed conflict, an ill-advised land reform and the creation of marketing boards. Certain crops such as cotton, formerly an important export, seems to have totally disappeared. However, agricultural production is now being re-activated as a result of reforms undertaken since 1992, such as the guaranteeing of land property rights, the privatization of marketing boards and the elimination of export taxes. El Salvador has also promoted the production of non-traditional export crops for markets outside Central America.

29. Salvadorian industry, developed under an import-substitution strategy to serve the Central American market, has faced difficulties in adjusting to the new trading environment. Those industries, including textiles and clothing, that have been able to develop and compete in markets outside the Central American region, continue to receive high effective tariff protection in the home market. Industries that have availed themselves of the benefits provided by the free-zone and tax-free area régimes have been successful, and the number of industries under these two régimes has been increasing. Exports from the free-zones and tax-free areas have risen to some 40 per cent of the total in 1995, and they continue to increase.

30. The services sector is the largest sector in El Salvador, and its importance has increased since the beginning of the 1990 because of the growth in construction. Today, the Government is engaged in a process of reconstructing and renovating infrastructure such as roads, ports and airports, which are essential for trade. The rôle of the State in other services sectors has become secondary because of the privatization programme.

(7) <u>Conclusion</u>

31. Since 1989, the objective of the Salvadorian authorities has been to create an efficient and diversified economy, driven by export-led growth. The solid growth since the reform is testimony to the success of the macroeconomic stabilization, the extensive trade liberalization and the deregulation policies pursued. However, the real appreciation of the exchange rate in the face of substantial financial *inflows (mainly remittances) creates difficulties for export development and diversification.*

32. Providing a stable macroeconomic environment is a sine qua non for sustaining or even accelerating growth and development, as the authorities would wish, but this needs to be supported by continuing the liberalization of the economy. In this regard, efforts are being made to update the legal framework, speed up customs operations, facilitate trade and investment and enforce the intellectual property rights law. Consideration should also be given to the more active promotion of competition in the domestic market. Efforts need to continue in rebuilding and further developing the physical and services infrastructure of the economy, as well as deepening the human capital base, to eliminate the constraints that weaknesses in these areas impose on development efforts.