I. THE ECONOMIC AND TRADE ENVIRONMENT[1]

(1) Major Features of the Economy

1. El Salvador is located on the Pacific coast of Central America, Guatemala lies to the north, Honduras to the east and Nicaragua to the south; the country has no access to the Atlantic coast. It has an area of 21,000 km^2. In 1995, population amounted to about 5.8 million; with an average growth rate of 2.2 per cent during 1990-1995 (Table I.1).[2]

Table I.1
Basic economic and social indicators, 1970-95

	1970	1985	1990	1991	1992	1993	1994	1995
Population (thousands)	3,588.0	4,739.0	5,172.0	5,278.0	5,380.0	5,479.0	5,641.0	5,768.0
Urban population (% of total)	39.4	42.7	44.4	44.9	45.3	45.8	45.0	46.2
Total labour force (thousands)		1,653.0	983.0	1,952.0	1,933.0	2,002.0	2,113.0	2,136.0
Labor force, female (%)	20.4	25.1	25.1	25.1	25.2	25.2	33.0	…
Total fertility rate (births per woman)	6.3	…	…	…	3.8	4.0	3.8	…
Infant mortality rate (per thous. live births)	103.4	…	…	…	46.0	45.0	42.0	56.0
Life expectancy at birth (years)	57.6	…	…	…	66.3	67.0	67.0	64.0
GDP (1987, US$ million)								
- GDP at market prices	3,559.3	4,458.3	4,906.1	5,097.5	5,324.1	5,595.5	6,020.8	9,710.0
- GDP per capita	992.0	940.8	948.6	965.8	989.6	1,021.3	1,067.3	1,683.0
Share of GDP (%) (based on current prices)								
- Agriculture	28.4	18.2	11.2	10.2	9.4	8.6	14.0	…
- Industry	23.3	21.9	23.3	23.9	24.2	25.0	24.0	…
- Manufactures	18.8	16.4	18.6	18.7	18.8	19.0	…	…
- Services	48.2	59.9	65.5	65.9	66.4	66.5	62.0	…
Annual growth rate average (%)								
- Agriculture	…	-2.5	7.4	-0.1	9.0	0.5	3.0	3.7
- Industry	…	-2.2	1.1	5.9	1.4	4.3	5.3	7.0
- Manufactures	…	-2.5	3.0	4.9	6.0	7.8	…	…
- Services	…	-1.5	2.8	4.0	5.5	7.6	7.3	6.3
Share in employment (%)								
- Agriculture	…	…	7.4	35.8	34.8	32.9	28.0	27.0
- Industry	…	…	23.0	18.1	18.0	19.0	20.1	19.7
- Services	…	…	69.6	46.0	47.2	48.1	51.9	53.3
Unemployment								
- Total	…	17.0	10.0	8.7	9.3	9.9	7.7	7.7
- Urban	…	17.7	10.0	7.9	8.2	8.1	7.0	7.0
- Rural	…	16.1	…	9.7	10.6	12.0	8.7	8.6

Table I.1 (cont'd)

[1]Data used in this Chapter were the most recent available at the time of completion of drafting of this report in September 1996.

[2]World Bank (1996).

	1970	1985	1990	1991	1992	1993	1994	1995
School enrollment ratios (%)								
- Primary school enrollment ratio	85	…	…	76	78	88.7	…	73
- Primary school enrollment ratio, female	83	…	…	77	79	80	…	…
- Secondary school enrollment ratio	22	…	…	25	…	…	…	…

… Not available.

Source: World Bank, World Tables, 1993, (STARS, version 2.5); Ministry of External Relations; World Development Report (1996); and the Inter-American Development Bank.

2. El Salvador is one of the most densely populated countries in the Western Hemisphere, so that labour is abundant relative to land and capital. Despite the country's tropical location, El Salvador is not endowed with regular rainfall, or with suitable land for certain crops. Nevertheless, exports of traditional agricultural goods such as coffee and sugar are important. However, other sectors, such as the textile industry, have gained in importance, benefiting from the availability of labour and export promotion régimes (Chapter III(3)). El Salvador has not yet fully exploited its ocean resources; today the only marine product that is being exploited in any major way is shrimp (Chapter IV).

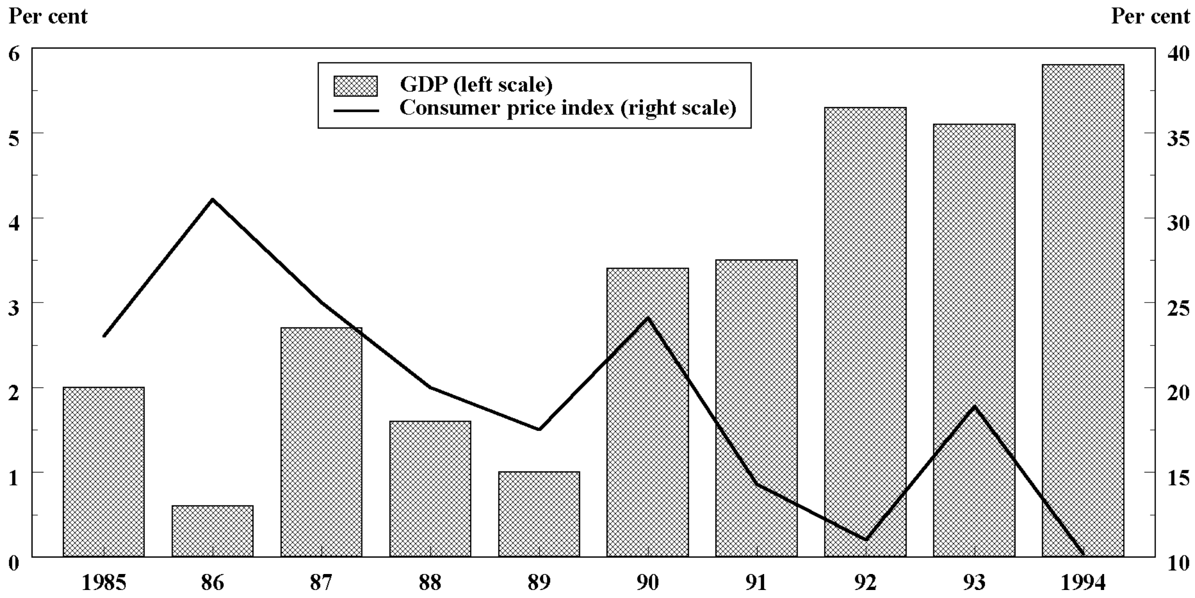
3. El Salvador is a middle-income country; in 1994 GDP amounted to US$6,020 million. Per capita GDP amounted to some US$1,067 in 1994, having grown of at an average rate of 2.2 per cent during 1985-1994.[3] Since 1990, following the end of ten years of armed conflict and as a result of major economic reforms, real GDP has been growing steadily, with real growth reaching almost 6 per cent in 1994 (Chart I.1). More Central Bank data indicate that the real GDP grew at 6.1 per cent during 1995. Despite this robust performance, the authorities consider that even higher rates of growth are needed to consolidate peace and to alleviate poverty. Irrespective, these respectable rates of growth already seem to have translated into a general improvement in the well-being of the population. For instance, life expectancy increased from 62 years in 1987 to 67 years in 1994; infant mortality decreased from 103 children per thousand live births in 1970 to 50 in 1987, and continued declining to 42 deaths per thousand live births in 1994.[4] However, the trickle-down effects of prosperity have not yet been felt widely since access to some basic services such as health services, secondary education, safe water and sanitation seems to be limited.[5] There is a perceived need to increase investment in human capital.

[3]World Bank (1996).

[4]World Bank (1996).

[5]UNDP (1996).

Chart I.1
Growth in real GDP and consumer price index, 1985-94



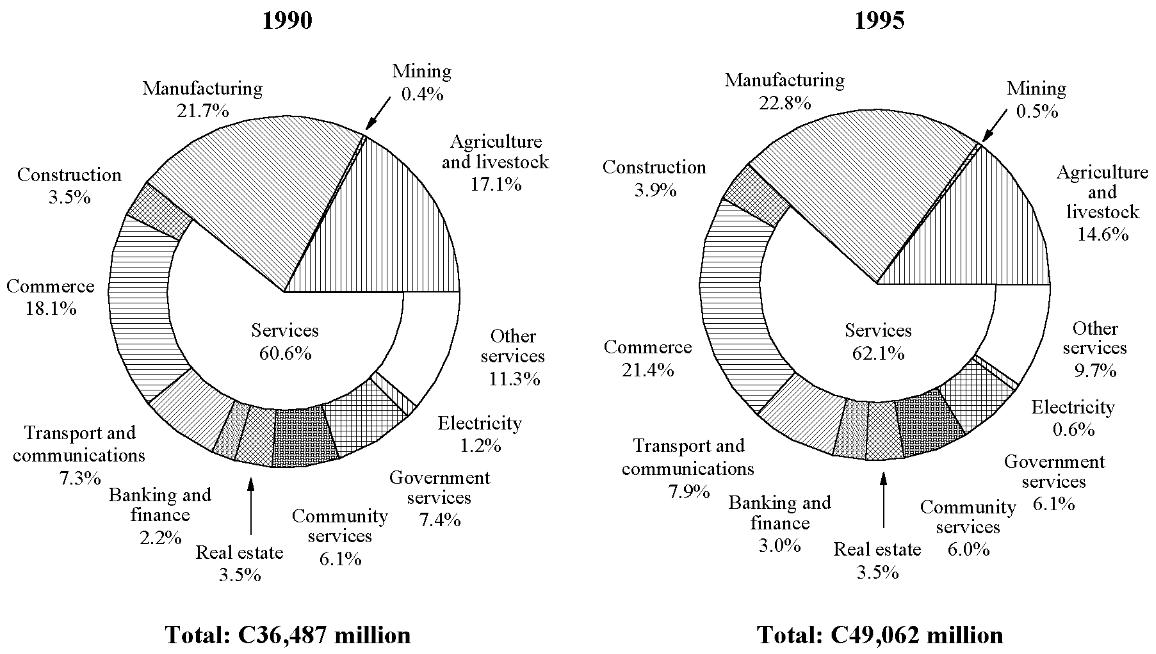
Source: World Bank, World Tables (1994/95).

4. Traditionally, El Salvador has been considered an agricultural country. However, since 1970 the contribution of services to GDP has been greater than that of agriculture, while the importance of the manufacturing sector has also been increasing. In 1990, the contribution of agriculture to GDP was only 17 per cent, and this declined to some 15 per cent in 1995 (Chart I.2). The low growth in agricultural activity can be partly attributed to the deleterious effect of the armed conflict in the rural areas, which led to wide spread disinvestment. The agrarian reform of the beginning of the 1980s, contrary to expectations, also seems to have had a negative impact on agriculture; a new reform, begun in 1992, is starting to reactivate agricultural production (Chapter IV(2)). The higher growth of the manufacturing sector is partly related to the growth of production for export under the reform programme (discussed below), in particular the production of clothing, which is mainly produced in the free zones for export to the United States. This development of exports, which is relatively new in El Salvador, has benefited from the abundant supply of labour, the country's proximity to the United States and trading arrangements in the sector (Chapter IV(3)).

5. Table I.2 shows the importance of the informal sector which gained importance in El Salvador during the armed conflict. This sector is receiving particular attention in the authorities' general campaign against tax evasion and the enforcement of the Law to Promote and Protect Intellectual Property Rights (*Ley de Fomento y Protección a la Propiedad Intelectual*) (Chapter III(4)).

Chart I.2
Sectoral distribution of GDP, 1990 and 1995

Per cent and constant 1990 prices



Source: Government of El Salvador.

Table I.2
Relative shares of the formal and informal sectors in productive activities, 1989 and 1994
(Per cent)

Activity	1989		1994	
	Formal	Informal	Formal	Informal
Agriculture	50.4	49.6	32.8	67.2
Mining	100.0	0.0	71.5	28.5
Industry	52.5	47.5	52.5	47.5
Electricity	95.0	5.0	100.0	0.0
Construction	51.4	48.6	55.0	45.0
Commerce	22.1	77.9	29.4	70.6
Transport	41.2	58.8	46.3	53.7
Financial Institutions	93.3	6.7	96.3	3.7
Services	74.34	25.7	73.6	26.4

Source: Government of El Salvador.

6. In terms of employment, the most important sector is the services sector, which in 1995 employed more than 50 per cent of the total labour force (2.1 million workers), followed by agriculture and manufacturing. Despite the decline in agricultural activity, almost 30 per cent of the labour force

is engaged in agriculture, since some of the non-traditional crops are labour intensive (Table I.1). The rate of registered unemployment has been decreasing since 1992 as economic activity has increased; in 1995 unemployment was estimated at some 7.7 per cent. However, under-employment remains an important problem, reaching in 1995, 22 per cent.[6]

7. International trade is important for a small economy such as El Salvador, and this has grown further since the change towards greater outward orientation at the beginning of the decade. Despite this re-orientation, the remittances of Salvadorians living abroad continues to be a major source of foreign exchange for El Salvador. The civil war resulted in a massive emigration of Salvadorians, mainly to the United States, and, while this caused some alleviation of domestic population pressures and resulted in a large inflow of private remittances, it also entailed a substantial loss of human capital. During 1985-1994, remittances amounted to an average of 90 per cent of total private transfers to El Salvador.[7]

8. The impact of the inflow of remittances on the Salvadorian economy has been beneficial both at the micro- and macro-levels, but the remittances have also rendered macroeconomic management somewhat more difficult. First, most remittances are received by poor urban and rural families, and provide a critical safety net for these groups. However, these resources are used mainly for consumption and not for investment.[8] There is, therefore, a need to develop further financial instruments and institutions to better capture these resources (Chapter IV(4)). Second, while these private capital inflows have financed the current account deficit for several years, such abundant foreign exchange flows have also contributed to inflationary pressures, real exchange rate appreciation and external sector vulnerability (see below).

9. Major constraints to the development of the economy are the poor condition of infrastructure and the shortage of an educated and skilled labour force.[9] The available infrastructure and the low productivity of the labour force undermine the efforts of the private sector to become more competitive. To succeed in the new development strategy of export-led growth, resources need to be invested in infrastructure and human capital. In consequence, expenditure has been re-directed towards these areas since the end of the war and the process of privatization of some State-owned institutions has been initiated.

(2) Recent Economic Developments

(i) The reform programme

10. The economic reform programme started in 1989, prior to the conclusion of the civil war, and included a macroeconomic stabilization package and radical structural reforms, which are still being implemented. The new Government that took office in mid-1994 continued the same policies, stating its commitment to strong economic growth and low inflation, while deepening structural reforms, increasing reliance on the market and reducing poverty. The results have been positive: financial imbalances have been reduced, economic growth has resumed and inflation has decreased. The rate

[6]Data supplied by the Government of El Salvador.

[7]Secretariat calculations using World Bank data.

[8]World Bank (1995).

[9]These deficiencies were identified in World Bank (1995).

of growth of real GDP has increased from 1 per cent in 1989 to 6.2 per cent in 1994, while inflation has fallen from 17.5 per cent to 10 per cent in the same period (Table 1.3). More recent data provided by the authorities show that the growth rate reached 6.1 per cent in 1995 while inflation increased to 11.4 per cent in that year.

11. The macroeconomic reforms covered fiscal, monetary and exchange rate policy. The fiscal reform aimed at rationalizing government expenditure and increasing tax collection. Monetary policy aimed at controlling inflation, while exchange rate policy aimed at maintaining a stable nominal exchange rate. At the same time, reforms regarding the financial and foreign exchange markets included: (i) the unification of the exchange rate and the elimination of exchange controls; (ii) the liberalization of interest rates and elimination of credit rationing; (iii) the privatization of banks and other financial institutions; and (iv) the opening up of foreign exchange houses.

12. Trade reform has also taken place so that most non-tariff barriers have been eliminated; tariffs have been reduced from an average of 20.4 per cent in 1989 to 10.1 per cent today. Tariff rates, which today generally range from 5 to 20 per cent (with exceptions), are to be reduced to a range of 0 to 15 by 1999 (Chapter III).

Table I.3
Economic performance, 1985-94
(Per cent)

	1985	1989	1990	1991	1992	1993	1994
				Annual rates of real growth			
GNP and domestic absorption							
Gross national product	-1.7	1.4	3.3	3.9	5.3	5.4	8.3
GDP at market prices	-1.8	1.0	3.0	3.9	4.4	5.1	6.2
Private consumption, etc.	-1.9	1.6	2.3	2.5	2.5	4.2	10.6
General gov't consumption	3.1	-1.2	0.9	4.4	0.2	-1.5	-14.9
Gross domestic investment	-5.1	26.1	-29.2	22.5	25.5	6.0	10.0
Fixed investment	-3.5	9.0	-17.3	18.9	24.1	10.3	10.3
Resource balance							
- Exports of goods & NF services	-5.0	-13.5	44.1	-1.6	11.2	14.4	0.9
- Imports of goods & NF services	-4.1	6.1	0.4	4.2	13.1	6.8	6.0
Competitiveness indicators (change)							
- GDP deflator	20.2	16.6	23.7	12.0	9.9	14.9	7.7
- Consumer price index	23.0	17.5	24.1	14.3	11.0	18.9	10.2
Monetary survey							
- Money plus quasi-money (M2)	16.0	11.1	-18.0	20.3	14.3	33.6	23.4
- Money as means of payment (M1)	10.1	12.5	-23.3	16.6	13.7	23.8	5.1
				Per cent			
Interest rates							
Deposit rate	12.50	16.25	18.00	16.11	11.51	15.27	13.57
Lending rate	14.00	18.50	21.17	19.67	16.43	19.42	19.03

Table I.3 (cont'd)

	1985	1989	1990	1991	1992	1993	1994
				Share of GDP			
Private consumption, etc.	81.2	82.9	88.0	87.5	89.0	88.5	86.8
General gov't consumption	15.5	12.2	11.3	11.0	10.6	9.7	9.4
Gross domestic investment	10.8	15.3	11.8	13.8	16.2	16.3	17.8
Fixed investment	12.0	13.3	11.8	13.5	15.7	16.2	17.7
Gross domestic saving	3.3	4.9	0.7	1.5	0.5	1.8	3.8
Fiscal balance							
Government current revenue	…	11.6	12.4	13.0	13.6	13.7	15.2
Government current expenditure	…	13.4	12.8	13.8	13.4	13.0	13.3
Government capital expenditure	…	4.9	2.5	4.1	6.7	4.6	4.3
Overall balance (- Deficit)	…	-4.7	-0.4	-2.8	-4.6	-1.6	-0.6

… Not available.

Note: GDP and componants at 1987 prices. Growth rate for 1985 calculated with data from 1980-1985.

Source: World Bank, World Tables, (STARS, version 2.5). Fiscal balance data from Inter-American Development Bank.

(ii) Supply and demand

13. After a slowdown in the economy during the late 1970s and the early 1980s the Salvadorian economy started to recuperate, showing an important acceleration in the growth rate of GDP after 1990. Higher growth can be attributed to the macro-reforms undertaken in 1989 and to the subsequent Peace Accords. As shown in Chart 1.3, growth was mainly led by the services sector, associated with a construction boom after the war.

14. Private consumption has consistently been the major component of demand, which has markedly increased since 1989 following years of repressed demand during the war and stimulated by high inflows of remittances. The contribution of net exports to demand has traditionally been either negative or negligible. This pattern seems to be continuing, despite efforts made by the Government to promote exports (Chapter III(3)). The contribution of investment and government consumption has been positive but minor relative to consumer demand.

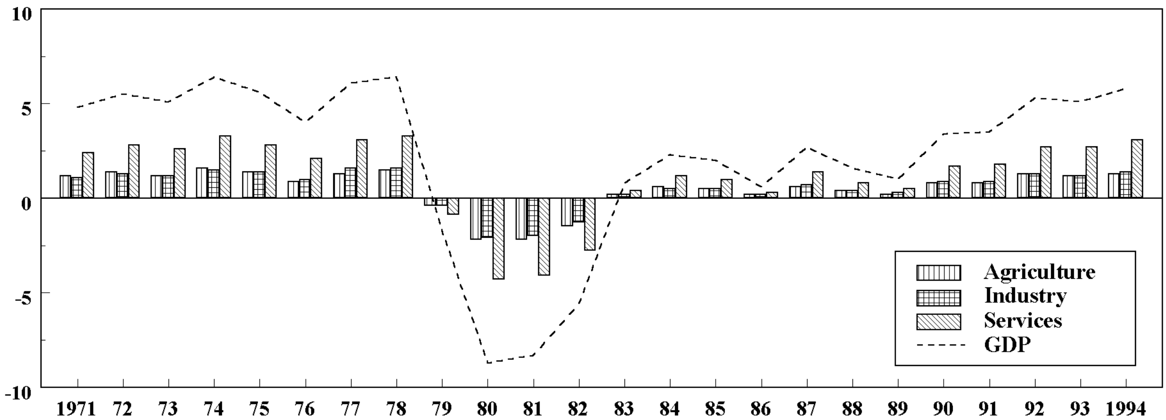
15. Both savings and investment declined as a percentage of GDP during the war, and have yet to recover to pre-war levels. After a sharp decline in 1979 (the start of the war), the rate of investment was stable during the 1980s and has been showing an upward trend since the beginning of the 1990 (Chart I.3). However, the rate of savings has showed a more erratic pattern, and, since the early 1990s, has remained in single digits (Table I.3). These low levels of domestic savings seem insufficient to finance the investment required to continue the reconstruction of the economy and the development of human capital.[10]

[10]El Salvador has relied on external aid to finance growth and additional resources are needed to meet the commitments of the Peace Accords. The expected reduction of external financial support means that there is a need rely more on domestic savings to finance these expenditures.

Chart I.3
Selected indicators of macroeconomic development, 1971-94

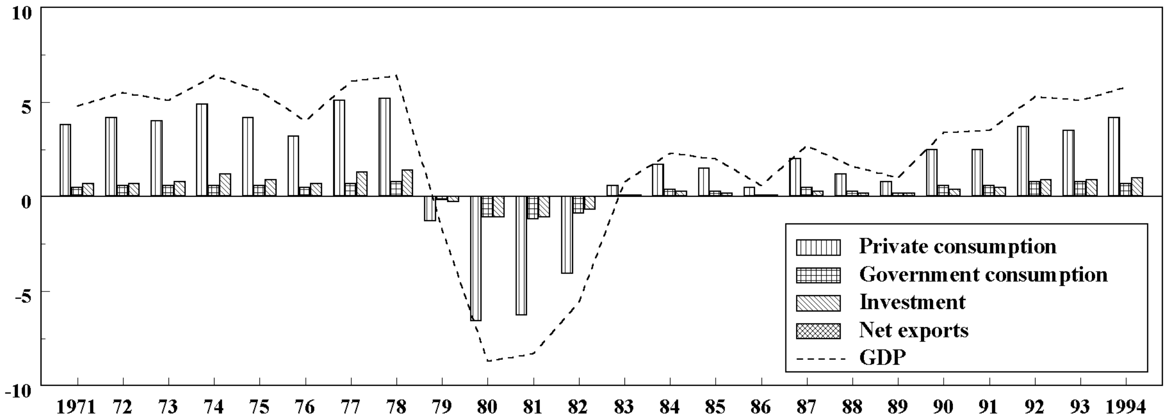
(a) Contribution of supply components to growth

Per cent



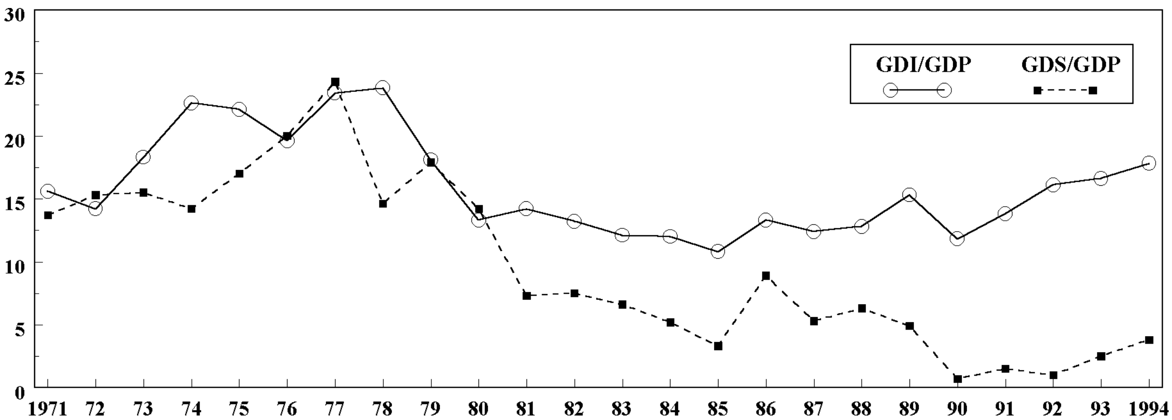
(b) Contribution of demand components to growth

Per cent



(c) Savings and investment

Per cent



Source: World Bankk, World Tables, STARS version (1995).

(iii) Public finances

16. There has been a clear improvement in fiscal performance, mainly attributed to the reforms of 1989, with a continued decline in the fiscal deficit from 4.7 per cent of GDP in 1989, to less than 1 per cent in 1994 (Table I.3); according to the authorities the deficit declined further in 1996 and is close to being in balance. This positive performance has contributed to macroeconomic stability and reduced inflationary pressures.

17. The fiscal reforms include a tax reform, the reduction and re-direction of expenditures and the modernization of the State. Thus, the authorities have indicated that the reduction in the deficit was caused by an increase in the tax collection as well as a decrease in expenditure. Receipts of official development assistance and medium- and long-term credits have also contributed to reduce the fiscal deficit.

18. The tax reform, which began in 1989, simplified the tax system so that only a few universal taxes remain in place. The main elements of the reform were: (i) the elimination of tax and duty exemptions; (ii) the simplification and decrease of income tax; (iii) the elimination of export taxes; (iv) the elimination of the patrimony and inheritance tax; (v) the reduction of tariff rates; and (vi) the substitution, in 1992, of the stamp tax by a value-added tax (VAT). In 1992, the only remaining taxes were the VAT, some specific taxes on cigarettes and liquor[11], income tax and import duties.

19. The VAT is a universal tax of 13 per cent for all dutiable goods and zero per cent for exports, except that basic goods and some services are exempt from this tax.[12] In 1995, the VAT was increased from 10 to 13 per cent, contributing to the decrease in the fiscal deficit. While this had a negative effect on the rate of inflation in 1995, the authorities indicated that inflation is stable and subject to a declining trend.

20. The structure of tax revenues has changed substantially in recent years (Table I.4). First, the collection of import duties has increased since 1989 despite the reduction in tariffs. This can be attributed to the elimination of non-tariff restrictions to imports, the better collection of duties and a reduction in smuggling. Second, VAT has now became the major source of revenues. The authorities stated that tax evasion was still a problem despite the efforts made to enforce payment of tax collection.[13]

[11]These specific taxes are levied on both domestically produced and imported products. For imported goods the tax is levied upon the c.i.f. value plus the tariff.

[12]Exemptions include: beans, rice, maize, and milk; medicines; and services such as health, education, public transport, financial services, electricity, water and sewerage services.

[13]A Fiscal Crime Law, approved on June 1995, amends the Criminal Code (*Código Penal*) and the Criminal Procedures Code (*Código de Procedimiento Penal*) in matters regarding tax evasion.

Table I.4
Central Government current revenue, 1986-94
(US$ million; and per cent)

	1986	1987	1988	1989	1990	1991	1992	1993	1994
Current revenue (US$ million)	574.1	541.5	554.0	518.8	414.7	526.3	568.1	783.4	993.0
					Percentage				
(a) Total tax revenue	89.9	93.0	91.4	94.7	96.1	95.4	93.7	93.4	90.0
Taxes on income	15.1	20.7	20.2	22.4	21.8	22.6	20.4	18.5	20.7
Taxes on wealth	2.0	4.0	4.3	4.6	3.8	4.0	3.2	2.2	2.0
Taxes on transfer of properties	1.2	1.6	2.1	2.2	2.2	2.3	2.9	1.5	1.5
Taxes on exports	33.6	16.4	13.6	5.1	7.7	5.2	0.5	0.1	0.0
of which coffee	33.3	15.9	13.3	4.8	7.6	5.2	0.5	0.1	0.0
Taxes on imports	7.1	9.6	7.7	12.1	14.0	15.1	16.3	14.5	14.5
Consumption taxes	9.7	12.2	15.6	16.6	14.3	13.3	11.3	8.5	7.0
Taxes on services	1.4	1.9	1.8	1.6	1.5	1.5	1.1	0.6	0.8
Stamp tax	19.2	26.0	25.5	29.5	30.2	30.8	24.6	3.1	2.1
Value-added tax	0.0	0.0	0.0	0.0	0.0	0.0	13.0	42.4	39.9
Other taxes	0.6	0.7	0.4	0.8	0.7	0.7	0.4	1.9	1.5
(b) Non-tax revenue	10.1	7.0	8.6	5.3	3.9	4.6	6.3	6.6	10.0

Source: Government of El Salvador.

21. The modernization of the State should have reduced fiscal expenditure by reducing the size of the public sector and by making it more efficient.[14] Indeed there was an initial reduction in fiscal expenditure in 1989, caused by a reduction in investment in infrastructure and social spending rather than a decrease in current expenditure (i.e., salaries and wages). Current expenditure has been fairly stable since 1989, while revenues have risen and the deficit has fallen. More recent data suggest that the fiscal deficit has been practically eliminated in 1995 (Table I.3).

22. The Government goal is to re-direct expenditure towards education, housing, and basic health services, increasing expenditure in human capital to 50 per cent of the total budget. However, to meet these social goals while decreasing the reliance on foreign resources, there is need to increase public savings by enforcing compliance of tax payments, and by continuing the modernization of the public sector to improve efficiency and reduce other current expenditure of the Government.

(iv) Monetary policy

23. The reform of the financial sector included the privatization of banks, and other financial institutions and strengthening of bank supervision, the liberalization of the interest rates and credit allocation, and the elimination of exchange rate controls. The Central Reserve Bank (*Banco Central*

[14]The modernization of the public sector includes decentralization, privatization, revision of the regulatory framework, reform of the pension system and procurement.

de Reserva, BCR) has been given greater autonomy. Today, the rôle of the BCR is purely monetary, concentrating on controlling inflation and managing the exchange rate, while its position as a provider of credit both to the public and private sector has become negligible. The BCR by law is not allowed to finance the public sector and financing to the private sector has been reduced only to a limited number of activities.

24. The two main objectives of the BCR have been to maintain a stable inflation rate and a stable nominal exchange rate in view of high foreign exchange flows (i.e., workers remittances), which have put pressure both on inflation and the exchange rate. Open market operations are the main policy instrument.

25. The BCR has been largely successful in bringing down inflation from 24 per cent in 1990 to 10 per cent in 1994. However, in 1995, despite restrictive monetary policies, inflation increased to 11 per cent; this increase seems to be related to the rise in the VAT rate to 13 per cent. Given the targeting of nominal exchange rate stability, it is important to achieve further reduction in the rate of inflation to a rate comparable with that of El Salvador's major trading partners, otherwise the real exchange rate will rise and the competitiveness of the country's exports will suffer.

26. The BCR set both deposit and lending interest rates up to 1990 when interest rates were progressively liberalized, and today interest rates are set by the market, with very few lines of credit being subsidized.[15] Once interest rates were de-controlled, credit controls were also eliminated. The Central Bank stopped allocating credit by economic activity and transferred the provision of medium- and long-term credit to the private financial institutions.

27. The sterilization policies aimed at containing monetary expansion and maintaining a stable nominal exchange rate have put pressure on interest rates. Both nominal lending and deposit rates have remained well above 10 per cent, as shown in Table I.3. According to the authorities, interest rates increased further after mid-1995, but decreased in 1996. The continuing reform of the financial system should further reduce interest rates (Chapter V(4)). In addition, improved banking supervision would reduce risk, which should also contribute to the reduction of interest rates.

(v) Exchange rate developments

28. During 1981-1985 El Salvador had three foreign exchange markets, the official market, the parallel market and the important black market (*mercado extrabancario*), where most remittances were exchanged. In 1986, the parallel and the official market were unified, while the black market continued to exist. However, the spread between the official exchange rate and that set on the black market increased, and it became more difficult to enforce exchange rate controls. Thus, in 1989 the reforms of the foreign exchange market included: (i) the unification of the exchange rate; (ii) the elimination of exchange rate controls; (iii) the liberalization of the capital account (1991); and (iv) the opening up of exchange houses.[16]

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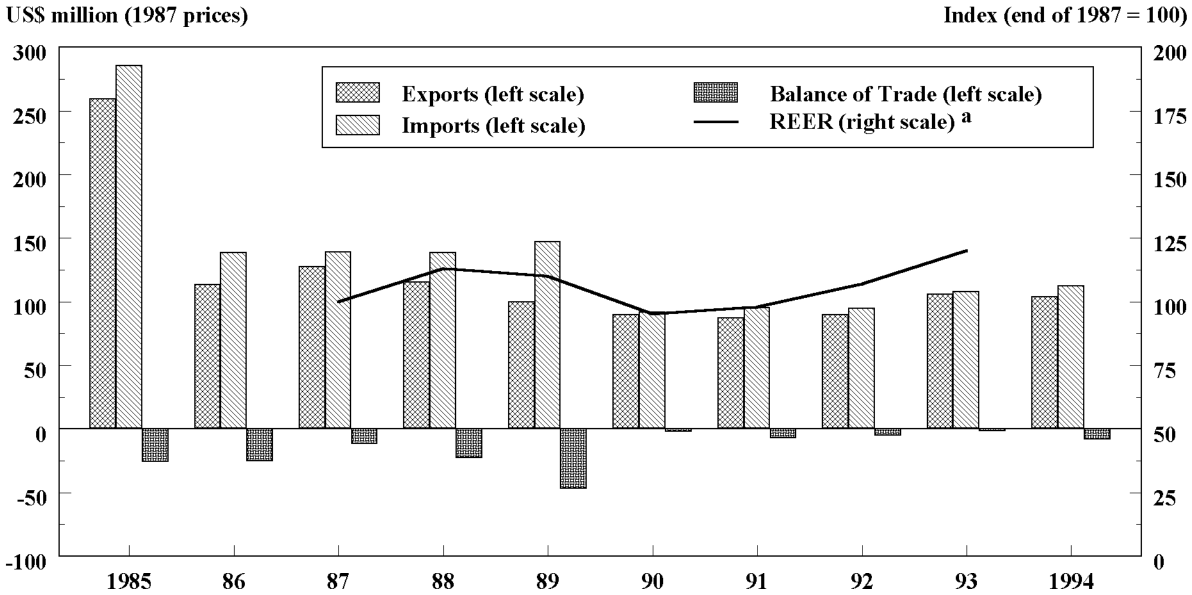
[15] According to the authorities, subsidized credit remains available only for education, reconstruction of the eastern part (*zona oriental*) of the country and areas affected by the earthquake of 1986, and environmental projects such as re-afforestation.

[16] Ramírez (1993).

29. Since the reforms, El Salvador has adopted a flexible exchange régime. However, the Government's goal is to maintain nominal exchange rate stability, with the Central Reserve Bank intervening when required to maintain this target.

30. Chart I.4 shows that the real effective exchange rate has been appreciating since 1990. This has led to complaints from exporters who consider that the official exchange rate policy undermines their competitiveness. However, producers of manufactured goods, who rely heavily on imported inputs, claim that a devaluation would be damaging to the industrial sector, particularly since competition in the sector has increased as a result of tariff reductions.[17]

Chart I.4
REER index and trade in goods and non-factor services, 1985-94



a An increase (decrease) indicates appreciation (depreciation).

Source: Information Notice Systems; and World Bank, World Tables (1994/95).

(vi) Balance of payments

31. The current account in El Salvador has run a deficit for several years; the merchandise trade balance has been in deficit, while the services trade balance has shifted between deficit and surplus (Table I.5). Growth in both exports and imports resumed after the war in line with economic activity, but imports have grown at a faster rate than exports. In 1995, imports increased faster than the average, since importers, anticipating the increase in the VAT, accumulated inventories; the increase caused the current account to reach a deficit of US$275.6 million.

[17]However, a real depreciation of the currency should discourage imports of final goods, curtailing competition.

Table I.5
External performance, 1989-95
(US$ million)

	1989	1990	1991	1992	1993	1994	1995
Merchandise trade balance	-654.5	-682.2	-818.0	-990.3	-1,056.2	-1,324.7	-1,691.1
Exports f.o.b.	497.5	580.2	588.0	597.5	731.7	1,249.3	1,661.3
Imports f.o.b.	1,152.0	1,262.4	1,406.0	1,587.8	1,787.9	2,394.6	3,118.7
Services net balance	-39.2	-23.0	-21.1	15.1	-211.8	21.6	26.0
Non-factor services balance	25.7	36.7	34.0	35.8	36.0	113.5	121.9
Factor services balance	-64.9	-59.7	-55.1	-20.7	-247.8	-91.9	-95.9
Official transfers	282.4	223.2	178.5	226.5	220.3	284.1	194.4
Private transfers	236.8	345.4	542.8	707.9	823.2	1,001.1	1,195.1
Current account balance	-174.5	-136.6	-117.8	-151.5	-78.8	-17.9	-275.6
Private capital	-125.6	222.8	125.7	85.7	147.9	100.9	225.5
Official capital	150.1	1.1	25.2	161.1	129.8	176.8	123.5
Other capital n.i.e	56.0	-0.8	-84.9	-29.9	-73.4	-116.7	73.2
Capital account balance	80.5	223.1	66.0	216.9	204.3	161.0	422.2
Overall balance	-93.0	-86.0	-52.0	65.4	125.5	143.1	146.6
Memorandum items							
Terms of trade (Index 1987= 100, US$ based)	106	99	100	88	89	…	…
External debt	2,077.8	2,146.5	2,180.3	2,261.3	2,011.6	…	…
Foreign exchange reserves	265.9	414.8	287.2	422.1	536.2	649.3	721.2

… Not available.

Source: Central Bank; International Monetary Fund; World Bank, World Tables, STARS version; and WTO Secretariat calculations.

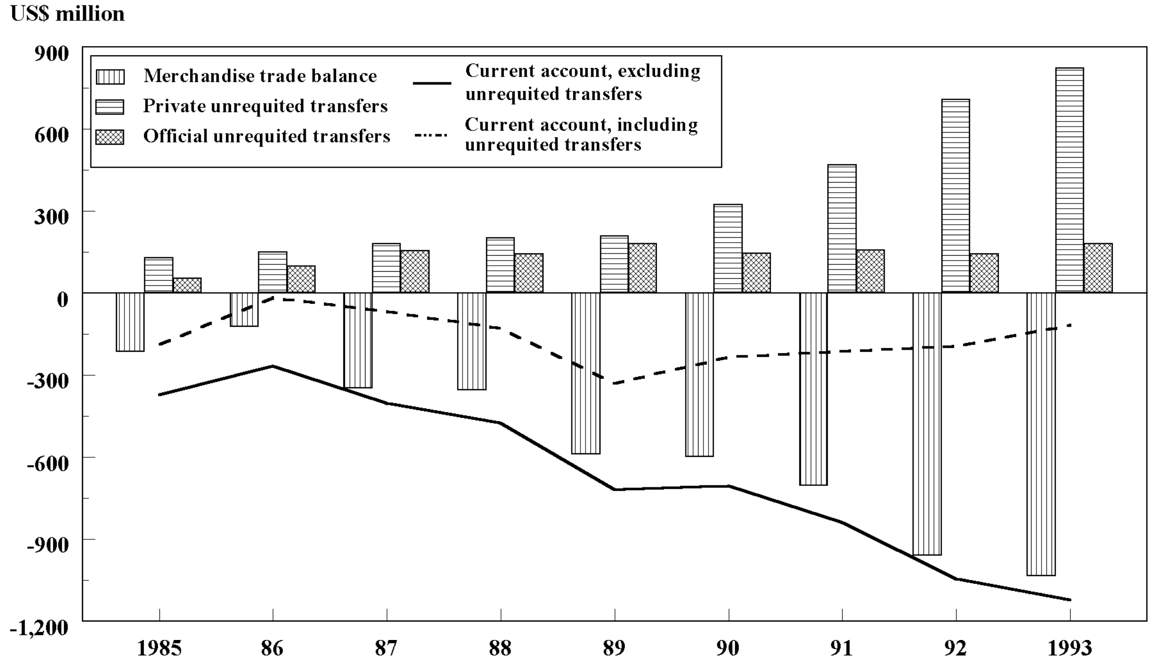
32. Exports have also increased, mainly from the free-zones and tax-free areas; exports from the zones increased from US$198 million in 1992 to US$656.7 million in 1995.[18] However, traditional (especially coffee) and non-traditional exports also increased in this period.

33. Chart I.5 shows the importance of private transfers (of which the majority are remittances) and of official transfers in financing the current account deficit. Private transfers have been increasing continuously since the early 1980s, becoming in some years the most important source of foreign exchange for El Salvador. Official transfers, although not as abundant, have been a stable source of financing since 1985.

34. The balance on the capital account has been positive since 1989. After a substantial private capital outflow in 1989, private capital started to flow back into the country. While official capital inflows decreased in 1990 at the end of the war, they again increased after the signature of the Peace Accords to help finance peace-related expenditure. Foreign exchange reserves continued to increase, mainly because of the inflow of remittances.

[18] Data supplied by the Government of El Salvador.

Chart I.5
Balance of payments, 1985-93



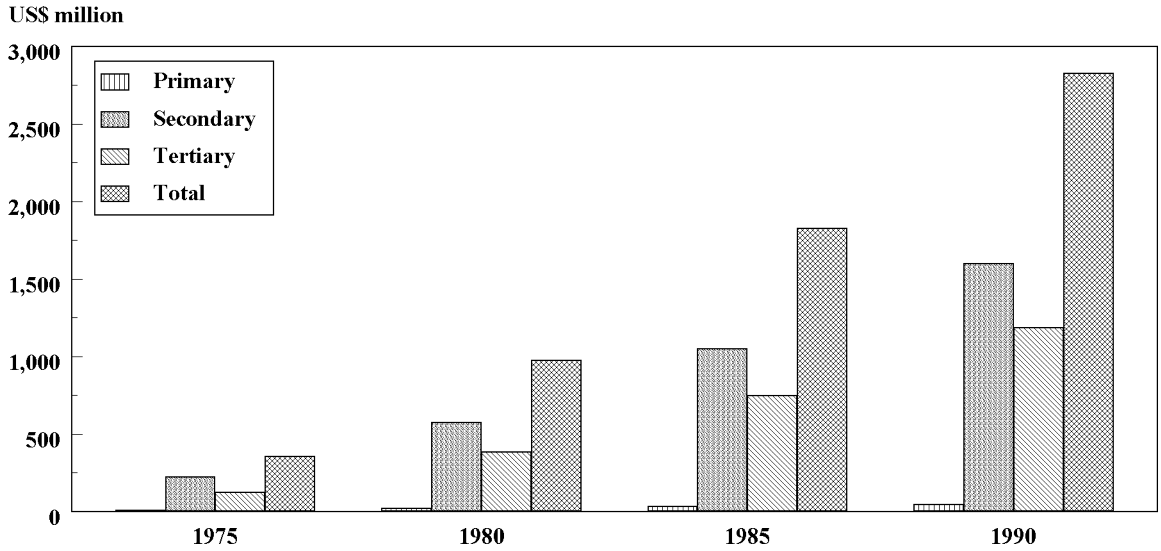
Source: International Monetary Fund, Balance of Payments Statistics (1994).

35. External debt has also been an important factor in the external accounts of El Salvador. In 1990 external debt amounted to some 45 per cent of GDP, but it was reduced to 23 per cent by 1995 following renegotiations during 1990-93 with the commercial banks and the Paris Club as well as through the cancellation of the United States' and Canadian debt. Overall, the renegotiation meant a reduction of US$700 million in total external debt. In addition, El Salvador repaid US$129.3 million of foreign debt during 1995.[19]

36. Foreign direct investment in El Salvador increased substantially from 1975 to 1990 (Chart I.6). Cumulative inflows increased from less than US$500 million in 1975 to almost US$3,000 million in 1990. Historically, the sector that has attracted most foreign capital has been the secondary (industrial) sector followed by the tertiary (services) sector. However, cumulative investment in industry decreased from 63.1 per cent in 1975 to 56.5 per cent in 1990, while investment in services increased from 35.3 per cent to 42 per cent. The primary sector has not attracted much foreign investment. Since the opening up of the capital account in 1990, no figures for foreign direct investment have been available, since investors tend not to register at the Ministry of Economy (Chapter II). However, this does not necessarily mean that foreign investment has decreased in importance. On the contrary, the opening up of the economy and solid macroeconomic performance should be more conducive to foreign investment than before.

[19]Data supplied by the Government of El Salvador.

Chart I.6
Foreign direct investment cumulative inflows by sector, 1975-90



Note: Data calculated on the basis of cumulative flows of FDI since 1970.
Data on inward investment have been estimated based on cumulative flows of FDI registered with the Ministry of Economy since 1961.

Source: UNCTAD, World Investment Directory (1994).

(3) Composition and Direction of Trade

(i) Composition of trade

37. Trade in goods and services as a share of GDP fell from a peaked 52 per cent in 1980 to below 40 per cent in 1989 (Chart I.7). As a result of efforts made to open the economy and promote exports, the ratio of trade to GDP has since recovered, reaching 48 per cent in 1994.[20]

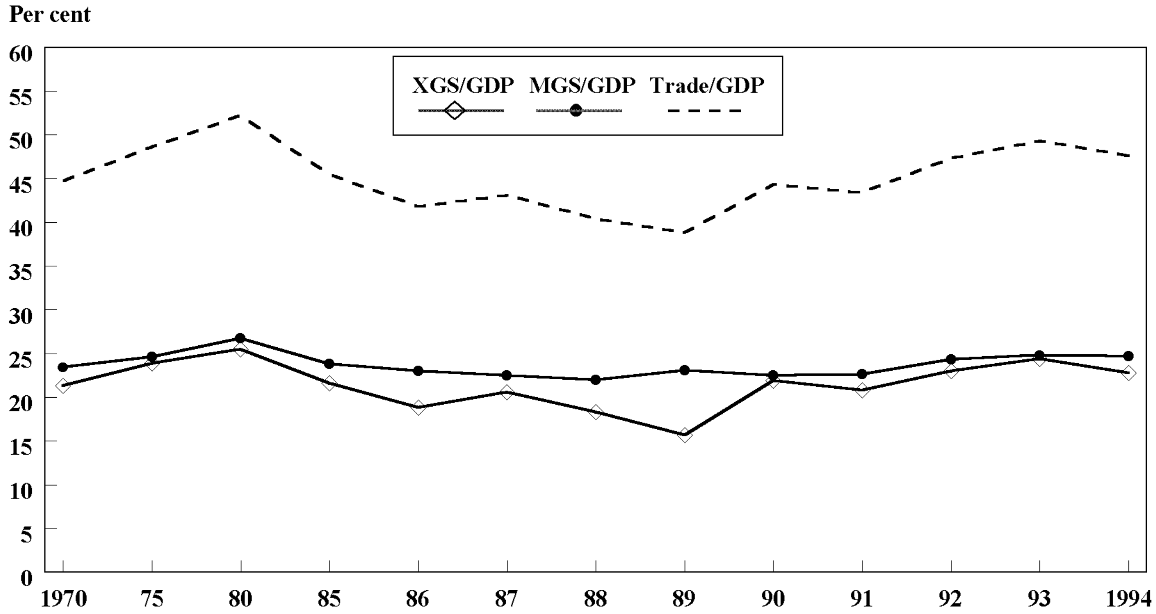
38. There has also been some variation in the structure of trade in recent years (Chart I.8 and Tables AI.1 to AI.4). El Salvador has traditionally been an exporter of agricultural goods; in 1975, out of total exports the share of agriculture amounted to some 70 per cent, of which coffee represented more than 30 per cent. Agricultural exports remain important, although they decreased to 50 per cent of total exports in 1994. The decrease took place mainly after 1990, following the nationalization of major agricultural exports, and when the effects of agrarian reform of the 1980s become evident (Chapter IV.2); the production of cotton, in particular, which had been a major agricultural export, has ceased. Exports of chemicals and other manufactured goods have increased, mainly to the Central American Region. Chart I.8 shows that the contribution of textiles to total exports has been decreasing; this is attributed to the fact that these data do not take into account exports originating

[20]The authorities estimate that the contribution of trade to GDP increased from 49 per cent in 1975 to 59 per cent in 1995.

in the free-trade zones and tax-free areas, where most textiles and clothing are now produced. In fact, exports originating in the free-trade zone, and hence textiles and clothing exports, have been increasing rapidly, reaching US$ 656.7 million in 1995 compared to US$198 million in 1992.

39. The composition of imports has remained more stable, imports of manufactured goods amounting to 71 per cent of total imports in 1994 (Table AI.1). Imports are mainly intermediate and capital goods to be used in the Salvadorian industry, which is largely an assembly industry. However, according to the authorities, imports of final goods have been increasing because of the reduction in tariffs.

Chart I.7
Trade in goods and non-factor services as shares of GDP, 1970-94



Note: XGS and MGS denote exports (X) and imports (M) of goods and non-factor services.

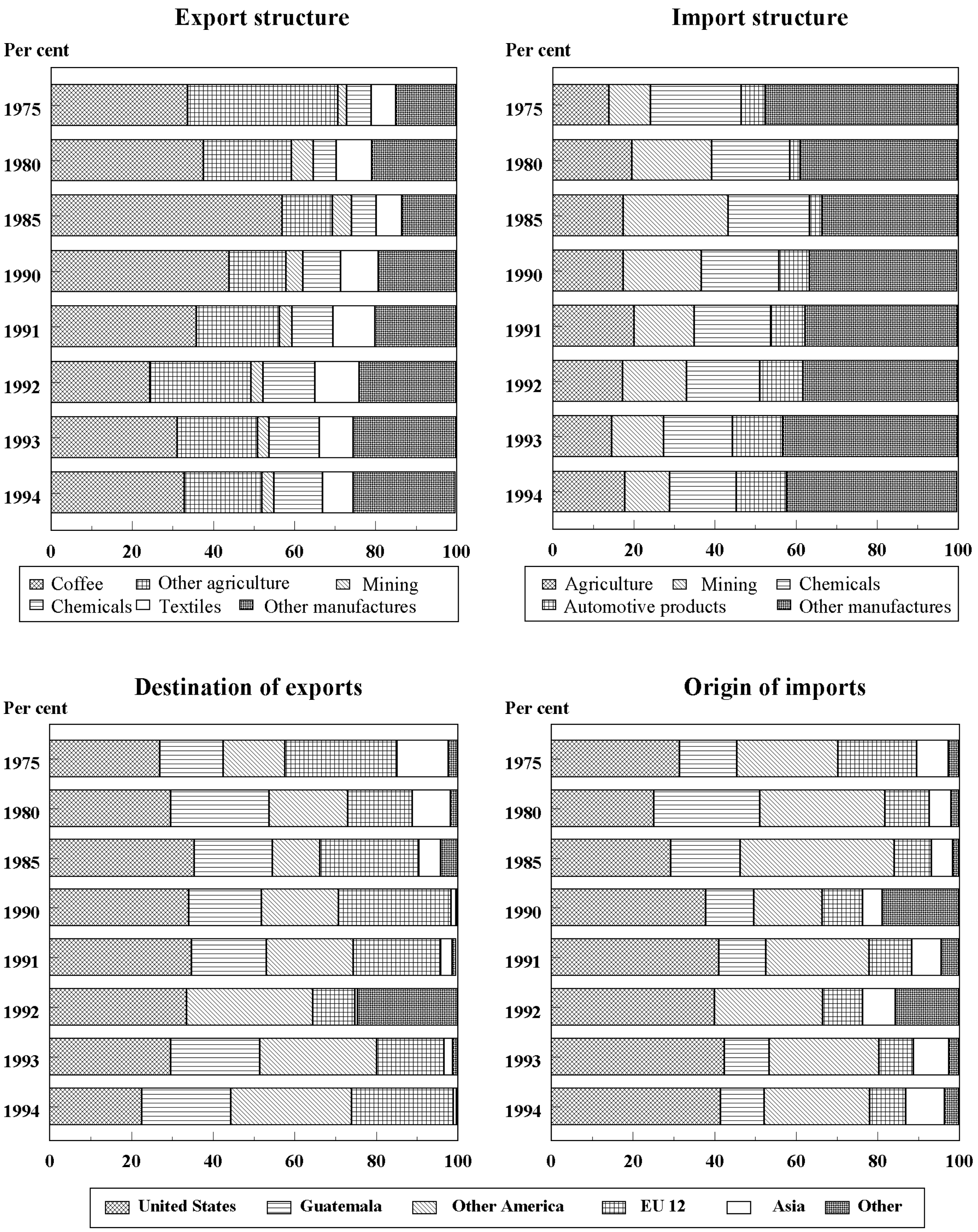
Source: World Bank, World Tables, STARS version 2.5.

(ii) Direction of merchandise trade

40. Despite trade liberalization and efforts to promote non-traditional exports to markets outside the Central American Region, there has been no appreciable change in the geographical pattern of trade in recent years. El Salvador's most important trading partner is the United States, followed by the Central American countries, and the European Union (EU).

41. Although the share of merchandise exports to the United States appear to have decreased in recent years to 22.6 per cent in 1994 (Table AI.3), these data do not take into account exports originating in the free zones, that are directed mainly to the United States. Apart from textiles and clothing exports from the zones, El Salvador mainly exports agricultural goods to the United States and the EU, while exports of manufactured goods are directed mainly to the Central American Region.

Chart I.8
Composition and direction of trade, 1975-94



Note: 1992 trade data with Guatemala is not available.

Source: UNSTAT, Comtrade database.

(4) Outlook

42. The Government plans to continue the policies adopted since 1989, placing special emphasis on accelerating growth, controlling fiscal expenditure, increasing tax collection, and maintaining stability of both the inflation rate and the exchange rate. The goal is to create a stable macroeconomic environment in order to promote domestic and foreign investment and to integrate the country more fully into the global production chain by lowering the costs of operating in the country. Further efforts need to be directed at improving infrastructure and reducing bureaucratic procedures (Chapter II). The authorities plan to continue reducing the size of State ownership through accelerated privatization, while strengthening the public sector rôle as a regulatory and facilitator of private sector development. By reducing the size of the public sector, resources can thus be re-directed into much-needed fixed investment.