ABSTRACT

Central American Capital Markets
El Salvador: Macro-Financial Background

by

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May 1992

This is one of three reports that describe macro-financial conditions in Central American countries, and how these conditions impact on the development of capital markets in each country--the other countries papers are on Costa Rica and Panama. A summary report was also prepared that highlights the similarities and differences among the three countries that appear to have particular relevance for the development of capital markets in the Central American region.

This report reviews the following aspects of El Salvador's macro-financial environment: general structure of the economy, the fiscal situation, the external sector, inflation, monetary, interest rate and credit policies, instruments for monetary policy and capital market development, and taxation in financial markets. The report summarizes its conclusions in terms of *global* policies that directly or indirectly influence the financial sector, and in terms of *specific* policies dealing with the sector.

It identifies three areas of *global* macroeconomic policies which are crucial in providing the necessary conditions for the functioning of financial markets as follows:

(1) a reasonable degree of macroeconomic stability, and more specifically, a low and roughly predictable inflation rate;

(2) government controls and intervention in private markets; and

(3) the status of the government budget, and the financing of the deficit.

The author finds that El Salvador is moving in the right directions in the first two areas. In the third area, he recommends that the government change the composition of expenditures (from subsidies and defense towards both physical and human capital formation), simultaneously with an increase in the revenue from taxation.

The report identifies three areas of *specific* actions more closely related to the necessary conditions for a well functioning financial market as follows:

(1) the process of restructuring the portfolios of banks and other financial institutions, and their re-privatization;

(2) the liberalization of interest rates; and

(3) the formulation of the rules for prudential regulation, and the reorganization of the overseeing agency.

The author offers a few comments in each of these areas, noting that the process of restructuring is the most crucial area in El Salvador at the time the report is written.

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A report to
The United States Agency for International Development
and
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Central American Capital Markets
El Salvador: Macro-Financial Background

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TABLE OF CONTENTS

I.- INTRODUCTION, BACKGROUND AND THE GENERAL STRUCTURE OF THE ECONOMY

1.1.- Introduction

The development of capital markets is a process that takes place over the medium and long run and ultimately rests on the participation of the private markets. The role of government is to provide the necessary conditions for an efficient operation of markets. More precisely, those conditions involve (1) A stable and reasonably predictable macroeconomic enviroment; (2) The absence of policies generating distortions in resource allocation, and (3) The formulation and adequate implementation of rules in prudential regulation of financial institutions. Typically, the necessary changes in policy occur as a series of small steps spanning over a rather long period of time. Therefore, it would seem natural that an account of the relevant macroeconomic backgroound should be primarily concerned exclusively with long run past trends.

In the case of El Salvador, nevertheless, there has been a change of regime. After the country endured almost two decades of poor macroeconomic performance (due to both external shocks, and specially to inappropriate policies), the current administration started to enact a wide program of reforms upon taking office in June of 1989. Twenty months later the core those all-encompassing reforms is showing remarkable consistency, with the basic premises still in place and the operational steps roughly following the initial agenda. These changes not only are taking place rapidly, but, as it is mentioned below, there is convincing evidence that they are credible and believed by the public.

Since, as in many other Latin American countries, the obstacles for financial development arise mostly from inadequate policies rather than more structural conditions, a change in regime to a large extent makes irrelevant many of those past long standing obstacles. Therefore, much of this Macrofinancial Background report will, then, be dedicated to the evaluation of those reforms, their initial results and the assessment of potential problems in each area.

Poor economic performance during the fifteen years preceding 1989 has been the result of adverse internal and international shocks (political instability, a major earthquake in 1986 and high world real interest rates) and faulty economic policies, both at the macro and at the resource allocation levels. At the macroeconomic level, a rising government deficit and increases in domestic credit creation finally forced a hundred per cent devaluation at the end of 1985 (from 2.50 to 5 colones per dollar), after decades of a truly fixed exchange rate system. During 1985, inflation soared from a four-year average of around 12 per cent per year to 33 per cent per year. Although later brought down to around 15 per cent between the end of 1986 and June of 1989, it was at a cost of wide price controls and market repression measures. At the resource allocation level, the price system was severely impaired in its role as an indicator for efficient decision making. Government took control of coffee commercialization, the entire banking system was nationalized and widespread price controls were imposed, including exchange rate controls. The result can be summarized by the rate of growth of real GDP, which between 1985 and 1988 averaged a mere 1.5 % per year.

The administration that took office in June of 1989 started an ambitious program of reforms, and both the scope and the pace of those reforms deserve high marks. On the resource allocation side the following are among the most important of those reforms, either already enacted or in process:

- Price controls have been virtually dismantled.

- Prices of services provided by public enterprises have been adjusted so as to reflect their economic scarcity.

- Starting in September of 1989, a major and still ongoing trade reform was started, with the elimination of all quantitative restrictions, a reduction of the maximum tariff to 50% (subsequently further reduced to 35% and a substantial reduction of tariff categories). Tariff dispersion was greatly reduced, and there is an announced schedule aimed at a tariff ceiling of 20% by mid-1993. In December 1990 El Salvador became a member of GATT.

- The exchange rate market has been unified, and exchange rate controls eliminated.

- A mechanism is in place for the recapitalization and privatization of commercial banks. The mechanism, which includes the liquidation of some banks, received approval in the National Assembly in October 1990.

- A program of privatization of government enterprises, including the National Coffee Institute (INCAFE) and the National Institute of Sugar (INAZUCAR) by October 1992.

- Differential credit and rediscount lines are in the process of virtual elimination.

- Although interest rates are still under government control, nominal interest rates have been adjusted to levels compatible with a non-negative real rate, and a process of gradual liberalization is under way.

• An overhaul of the tax laws is under study, with a plan for the imposition of a value added tax.

At the macroeconomic level,

• A free floating exchange rate regime has been adopted, with adherence to a monetary program that sets stringent limits to domestic credit creation.

• The government budget deficit has been reduced to manageable magnitudes, by following rather strict limits in wage increases, an updating of public service prices and an effort to improve tax collection.

• The domestic debt has been consolidated, and arrears in international payments eliminated. The government of El Salvador seems to have been successful at normalizing relationships with the international financial community: a Stand-by agreement was signed with the IMF in August 1990; in September 1990 agreement was reached with the Club of Paris, and a Structural Adjustment Loan in the amount of 75 million dollars was approved by the World Bank in January 1991.

Not, of course, that the program lacks completely of partial flaws, or that its implementation has taken place without problems. Two setbacks needed to be overcome during 1989: the drastic reduction in world coffee prices as the International Coffee Agreement collapsed (coffee represents roughly half of the country's exports), and a major guerrilla offensive in November. In some areas (the financial sector could be an example) there have been hesitation and some inconsistencies (control of interest rates, in a global program of liberalization), and the pace of reform lacked definition (absence of a specific schedule for financial liberalization). As in any major structural and/or stabilization program, ease of implementation and, eventually, even the final success of the current program in El Salvador depends crucially on its credibility and on short and medium term political constraints.

Concerning credibility, there are at least three positive signs. First, there has been an important response of both traditional and non-traditional exports to the change in the effective exchange rate during 1990. Second, higher real interest rates during the same year prompted an important response of savings and time deposits. Third, there is an increase in private capital inflows.

Concerning political constraints, long term success will jjointly depend on the effectiveness of the poverty alleviation programs and the speed at which the benefits of better policy "trickle down" to the majority of the population.

1.2.- The General Structure of the Economy, and the Medium Run Trends

Tables I-1 and I-2 provide the basic figures on the global structure of the economy, both in absolute real terms and as proportions of GDP, while Table I-3 and Figures I-1 and I-2 give an indication of the trends. Table I-4, which reports the financing of gross domestic investment, clearly indicates the reliance on external financing. In production, roughly, the share of agriculture and mining, secondary production and services has remained rather constant at 25 per cent of GDP for the first two, and 50 per cent for the third. Although agriculture represents one quarter of GDP, it amounts to one third of total exports and provides 40 per cent of total employment (with coffee, sugar cane and cotton being the main items and the export crops). Although recovered from the negative growth rates of 1981 and 1982, the record during the rest of the decade is extremely poor, as a consequence of external shocks, the conflict and inadequate policies. The level of output in 1990, and consequently the level of private consumption, were slightly lower in 1990 than ten years before. The growth of agriculture shows the highest variability during the decade, with strongly negative rates in 1981 and 1982 and 1986. The recovery seen in 1990, likewise, is led by the agriculture sector, both due to favorable physical conditions and a reversal of policy.

Table I-1

Gross Domestic Product by Sector of Origin

(As percentage of total Gross Domestic Product)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP at Market Prices	100	100	100	100	100	100	100	100	100	100	100
Primary Production	25.7	26.2	26.5	25.4	25.7	25.0	24.0	23.9	23.3	23.1	24.0
Agriculture and Rel Sectors	25.6	26.1	26.4	25.3	25.6	24.8	23.9	23.8	23.2	23.0	23.9
Mining	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.1
Secondary Production	24.4	23.9	23.5	23.9	23.6	24.0	24.5	24.8	25.2	25.5	25.0
Manufacturing	17.8	17.4	16.9	17.1	16.9	17.2	17.5	17.6	17.8	18.1	18.0
Construction	3.4	3.1	3.2	3.2	3.0	3.0	3.1	3.4	3.6	3.7	3.1
Utilities	3.2	3.4	3.5	3.7	3.7	3.8	3.9	3.8	3.8	3.8	3.9
Services	49.9	49.8	49.9	50.6	50.7	51.0	51.5	51.3	51.5	51.3	50.9
Transportation and Communic	5.9	5.7	5.7	6.0	6.0	6.0	6.0	5.9	5.9	5.9	6.1
Commercial Services	19.0	17.6	16.4	16.7	16.6	16.3	16.3	16.1	15.9	16.3	16.3
Financial Services	3.1	3.1	3.4	3.4	3.4	3.4	3.5	3.5	3.5	3.1	3.0
Housing	4.0	4.4	4.8	4.9	4.8	4.8	4.8	4.8	4.9	4.9	4.9
Public Administration	10.4	11.5	12.5	12.8	13.1	13.7	14.3	14.4	14.7	14.4	14.2
Other Services	7.5	7.5	7.0	6.9	6.8	6.7	6.7	6.6	6.6	6.6	6.5

Table I-2

Real Aggregate Demand and Supply

As a Percentage of GDP

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
AGGREGATE DEMAND	126.7	126.1	121.7	124.2	124.2	123.8	123.0	122.5	122.0	123.1	121.6
Gross Domestic Expend	101.2	103.2	101.0	99.9	101.2	102.2	104.2	101.9	103.7	108.2	99.5
Consumption	88.7	90.0	88.5	88.6	89.8	91.6	91.5	90.0	89.8	89.7	87.5
private	75.9	75.5	73.2	73.6	74.1	75.2	74.5	73.0	72.7	72.9	71.8
public	12.8	14.5	15.3	14.9	15.7	16.4	16.9	17.0	17.1	16.8	15.7
Gross Investment	12.5	13.1	12.5	11.3	11.4	10.6	12.8	11.9	13.9	18.5	12.0
private	5.8	5.3	5.7	6.2	6.8	8.1	9.5	9.9	9.7	10.0	9.0
public	7.1	7.1	6.1	4.7	4.1	3.7	3.1	3.5	4.0	4.7	3.4
Inventory changes	-0.3	0.6	0.6	0.4	0.5	-1.2	0.1	-1.5	0.2	3.7	-0.5
Exports Goods and Serv	25.5	22.9	20.7	24.3	23.0	21.6	18.8	20.6	18.3	15.0	22.2
AGGREGATE SUPPLY	126.7	126.0	121.7	124.2	124.2	123.8	123.0	122.5	122.0	123.1	121.6
Imports Goods and Serv	26.7	26.0	21.7	24.2	24.2	23.8	23.0	22.5	22.0	23.1	21.6
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Banco Central de Reserva de El Salvador.

6

Table I-3

Real Gross Domestic Product by Sector of Origin
(In Colones of 1962)

(Rates of annual percentage change)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP at Market Prices	-8.28	-5.61	0.80	2.27	1.98	0.63	2.69	1.63	1.06	3.40
Primary Production	-6.36	-4.66	-3.17	3.35	-1.06	-3.08	2.07	-0.95	0.27	7.63
Agriculture and Rel Sectors	-6.42	-4.57	-3.20	3.30	-1.07	-3.10	2.08	-0.95	0.41	7.39
Mining	-2.56	0	-2.63	2.70	0	2.63	12.82	6.82	4.26	-8.16
Secondary Production	-10.21	-7.07	2.54	0.73	3.90	2.50	3.93	3.39	2.40	1.23
Manufacturing	-10.41	-8.38	1.87	1.43	3.62	2.52	3.03	2.94	2.50	3.14
Construction	-15.32	-4.26	2.22	-5.43	4.60	2.20	11.83	7.69	3.57	-12.93
Utilities	-3.77	-2.94	6.06	2.86	4.63	2.65	1.72	1.69	0.83	5.79
Services	-8.47	-5.52	2.25	2.55	2.48	1.64	2.39	2.02	0.56	2.70
Transportation and Communic	-11.34	-6.40	6.21	2.92	1.70	0.56	1.67	2.19	1.07	6.35
Commercial Services	-14.88	-12.03	2.14	1.88	0.41	0.41	1.43	0.40	3.40	3.29
Financial Services	-9.71	5.38	1.02	1.01	3.00	0.97	2.88	1.87	-10.9	1.02
Housing	3.08	2.24	2.19	1.43	1.41	0.69	2.07	3.38	1.96	2.56
Public Administration	1.17	2.89	2.81	4.92	7.03	4.62	3.95	3.58	-1.08	1.53
Other Services	-8.87	-11.50	-1.00	1.01	0.02	0.50	1.99	1.46	1.44	1.42

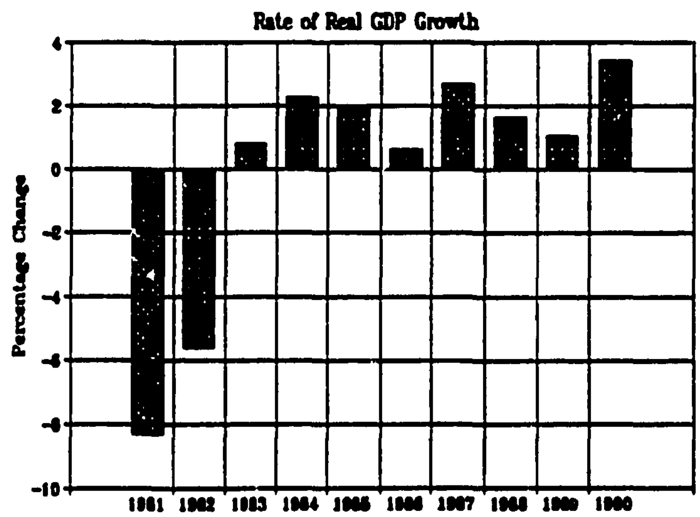

Figure I-1

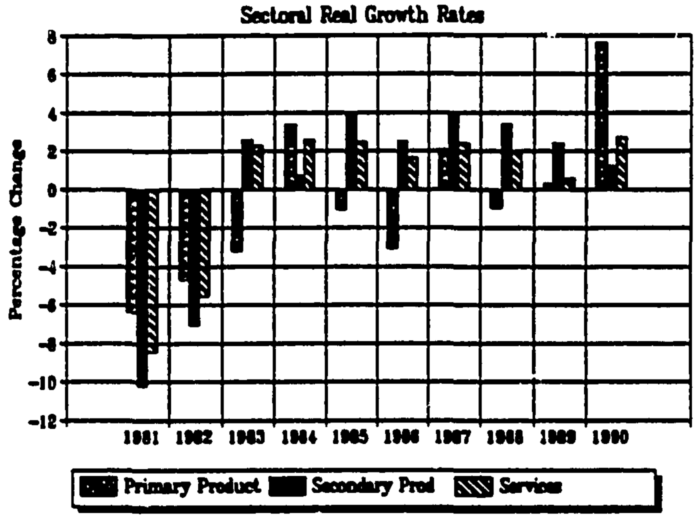

Figure I-2

Table I-4

Investment and Savings

(As percentage of GDP)

	1985	1986	1987	1988	1989
GROSS DOMESTIC INVESTM	10.8	13.3	12.4	12.8	16.2
Private	7.5	10.7	9.4	9.8	12.9
Public	3.3	2.5	2.9	3.0	3.3
SAVINGS	10.8	13.3	12.4	12.8	16.2
Gross Nat Savings	4.4	10.7	7.0	7.8	6.8
Private	4.3	9.3	7.1	8.3	8.4
Public	0.5	1.4	-0.2	-0.5	-1.6
Foreign Savings	6.5	2.6	5.4	5.0	9.4

1.3.- The Financial Sector

In El Salvador, as in many Latin American countries, the bulk of "financial markets" is concentrated in the banking system.[1] There exist an active but small market of government instruments, with the share of private instruments in that market being negligible. Therefore, bank deposits provide with a good indication of the size of the financial sector.[2] Table I-5, which provides the basic information.

There are several impediments both for the development of markets for private and public debt instruments and for a more relevant role of the banking system as an efficient financial intermediary. As mentioned earlier, most of these impediments are the direct or indirect result of policies rather than being "structural" in nature. First, following the nationalization of the banking system at the beginning of the decade, interest rates have been controlled, more often than not at levels that resulted in negative real ex-post rates. Second, inflation, although not too high by Latin American standards, has been highly variable, so that ex-post real rates became difficult to predict. Third, both the conflict and past government policies have conspired to generate a highly uncertain enviroment. The conjunction of all these three elements is, for example, responsibly for the steady decline in the ratio of both demand and savings and time deposits to GDP shown in Table I-5.

Currently, there are three basic areas in which action is needed for the development of financial markets. One is the completion of the process under way to restore financial soundness to banks portfolios and the return of the institutions to the private sector. Another is the liberalization of interest rates. A third area is the formulation and implementation of an adequate set of prudential regulations insuring an appropriate supervision of corporations and financial intermediaries in general.

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[1] The equity market is also of negligible magnitude. See Section V.2.

[2] Strictly, deposits minus reserves is the magnitude that provides a with the appropriate indication of the size of the "financial sector", but for a given level of required reserves, either deposits or total assets give a good idea of changes in the size of the sector over time. See below, Chapter IV, for a discussion of the level of required reserves.

4

Table I-5

Deposits in the Commercial Banking System

(In millions of Colones)

	1985	1986	1987	1988	1989	1990
Money (M1)	2144.0	2584.7	2551.0	2742.7	3163.4	3869.6
Sight Deposits	1064.2	1428.2	1253.0	1416.5	1436.3	2013.3
Savings & Time Deposits	2659.1	3320.6	3608.6	4084.0	4468.6	5885.7
M2	3723.3	4748.8	4861.6	5500.5	5904.9	7899.0
Gross Domestic Product	14330.8	19762.9	23140.6	27365.8	32230.0	41057.0

Ratio of Deposits to Gross Domestic Product

Money (M1)	0.15	0.13	0.11	0.10	0.10	0.09
Sight Deposits	0.07	0.07	0.05	0.05	0.04	0.05
Savings & Time Deposits	0.19	0.17	0.16	0.15	0.14	0.14
M2	0.26	0.24	0.21	0.20	0.18	0.19

II.- THE FISCAL SITUATION

Unlike the case of some other Latin American economies, in El Salvador the fiscal deficit has not traditionally been the "basic engine of policy disarray", although at times it has come dangerously close.[1] By and large, the long term deterioration of tax revenues has been met with expenditures reductions. This helped to avert macroeconomic disaster but more often than not at the cost of cutting outlays in items in which the reduction is easiest in the short run, but most costly in the long run (infrastructure, health and education, i.e., capital formation). Comparison with other countries suggests that in the case of El Salvador the initial strategy for deficit reduction should be an increase in tax revenues (through both a better tax system and improved tax collection), with a change in the mix of expenditures, rather than a fall in the level of expenditures.

The information reported in Table 1, some of which is illustrated in Figures II-1 to II-4, provides the very basics of the past and current fiscal situation. In what follows we first analyze the primary deficit, its components (taxes and expenditures), and its financing. Secondly, we discuss briefly the public sector domestic and external debt, and conclude with some remarks concerning the "government budget constraint" and the behavior of some of its components.

2.1.- The Primary Deficit, its Components and its Financing

The first point to notice is that during the last five years (1986 to 1990) the general pattern has been one of reduction in the share of both tax revenues and expenditures in GDP, with an exception for expenditures between 1987 and 1988. In other words, the deficit is not associated, as in other countries, with an increasing or too large "size" of government, as measured by the ratio of government expenditures to GDP.[2]

A second point to note, that emerges clearly from the graph in Figure II-2, is the relatively minor participation in the total deficit of the "rest

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[1] A clear example is the inflationary episode of 1986, in which the main initial determinant of the inflation rate was given by the rate of monetary growth necessary to finance the widely anticipated level of the forthcoming deficit, before the earthquake that took place in October.

[2] Of course, this is only one measure of the "size" of government, which can indeed be misleading. Another measure, not necessarily associated with large government expenditures, is the degree of "government intervention" and the distortions introduced by regulation (price fixing, intervention in the commercialization process, mandatory barriers to entry, and so on). It is on this account that the "size" of government has been very large in El Salvador.

of the non-financial public sector" (which actually shows surpluses in 1986, 1987 and 1990), vis-à-vis the central government. Non-financial public enterprises, included in this "rest of the non-financial public sector", show in fact modest operating surpluses (about half a percent of GDP). As opposed to the case of many other countries, then, in El Salvador the source of the fiscal deficit is the central government.

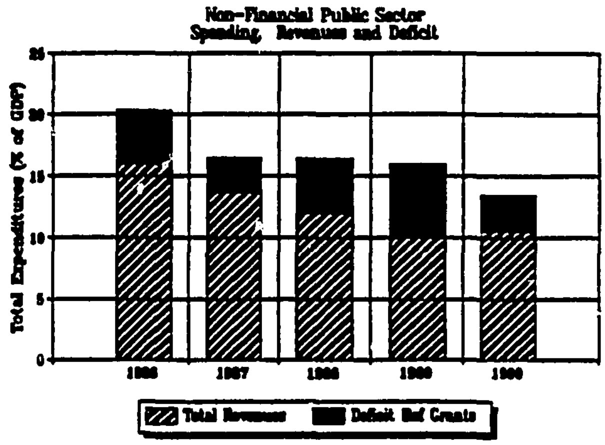

Figure II-1

A third important point is the remarkable fall in the total deficit estimated for 1990, to roughly half in terms of percentage of GDP, made possible partly through a modest increase in tax and other revenues, and mostly through a fall in both current and capital expenditures.

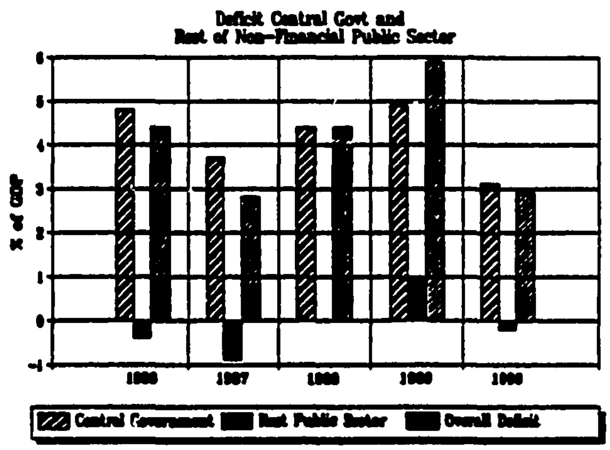

Figure II-2

The fourth point refers to the revenue side of the equation, and is the consistent fall in tax revenues between 1986 and 1989. Indeed, during that period the deficit has increased when expenditures failed to fall in order to match the fall in tax revenues. There are various well known accounts relevant to the fall in tax revenues during each of these years. The first, a key element, is the dependence on the export tax on coffee, and therefore on the price and/or quantities of the crop, mostly responsible for the decline in both 1988 and 1989. Another is weak tax collection. Although this trend shows a reversal in the estimates for 1990, the reversal is not as strong as the tax reform package introduced at the end of 1989 was expected to generate --the reason being partly a delay in the removal of exemptions

Table II-1

Non-Financial Public Sector
(As Percentage of GDP)

	1986	1987	1988	1989	1990 (Estimate)
CONSOLIDATED NON-FINANCIAL PUBLIC SECTOR					
Total Revenue	16.0	13.7	12.1	10.1	10.6
Current	15.9	13.6	12.1	10.1	10.5
Taxes	13.3	10.8	9.2	7.6	7.8
Surplus Public Enterprises	0.3	0.5	0.6	0.5	0.6
Capital Revenue	0.1	0.1	----	----	----
Total Expenditure and Net Lending	20.4	16.5	16.4	16.0	13.5
Current Expenditures	14.5	13.7	12.5	11.7	10.8
Capital Expenditures	5.7	2.7	3.7	4.0	2.6
Current Account Balance	1.4	-0.2	-0.5	-1.6	-0.3
Overall Deficit Before Grants	4.4	2.8	4.4	5.9	2.9
Official Grants	2.0	3.1	1.8	1.9	2.0
Overall Deficit (-) or Surplus (+)	-2.4	0.3	-2.6	-4.0	-0.9
External Financing	1.3	0.8	1.0	1.6	2.5
Internal Financing	1.1	-1.1	1.5	2.4	-1.6
Banking system	-1.4	0.2	-1.6	3.3	-0.1
Non-Bank Financing	0.2	-0.1	-0.3	0.2	-0.1
Floating Debt	3.9	----	1.0	1.0	-0.8
Residual	-1.6	-1.2	2.4	-2.1	-0.6
CENTRAL GOVERNMENT					
Total Revenue	14.6	11.4	10.2	8.2	8.4
Current	14.6	11.4	10.2	8.2	8.3
Taxes	13.3	10.8	9.2	7.6	7.8
Surplus Public Enterprises	0.7	0.1	0.4	0.1	----
Capital Revenue	----	----	----	----	----
Total Expenditure and Net Lending	19.4	15.2	14.6	13.1	11.4
Current expenditure	13.6	12.1	11.5	10.5	9.5
Wages and salaries	7.9	7.7	6.8	6.5	5.8
Goods and services	2.0	1.8	1.9	1.5	1.0
Interest payments	1.3	1.0	0.9	0.9	1.0
Transfers	2.4	1.6	1.9	1.7	1.7
Capital expenditures	4.8	2.5	2.9	2.3	1.9
Net lending	1.0	0.6	0.2	0.3	----
Current Account Balance	0.9	-0.7	-1.3	-2.3	-1.2
Overall Deficit Before Grants	4.8	3.7	4.4	4.9	3.1
Official Grants	1.6	2.9	1.7	1.8	1.9
Overall Deficit (-) or Surplus (+)	-3.2	-0.8	-2.7	-3.1	-1.2
External Financing	1.5	1.0	0.7	0.6	2.1
Internal Financing	1.7	-0.2	2.0	2.5	-1.0
Banking system	-0.9	0.7	-0.6	3.1	0.4
Non-Bank Financing	0.1	----	----	----	-0.1
Floating Debt	3.9	----	1.0	1.0	-0.8
Residual	-1.4	-0.9	1.5	-1.6	-0.5

<u>Sources</u>: Banco Central de Reserva de El Salvador and IMF estimates.

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and lack of improvement in the tax collection process. There are concrete steps to which the GOES seems to be commited in the near future. "Implementation of the action programs to improve tax enforcement and introduce a value-added tax" is one of the conditions for second tranche disbursement (in October-November 1991) of the recently approved World Bank Structural Adjustment Loan, and a value-added tax to be in effect in place of the sales taxes is a condition for the third tranche release of the same loan (in late 1992).

Expenditures, the other element of the deficit equation, which have also been decreasing as a percentage of GDP since 1986. As mentioned before, the effort to contain the deficit on the face of decreasing tax revenues has generated a distortion in the composition of expenditures, away from "investment" expenditures, in a wide sense (building up of human capital, such as education and health, as well as physical capital). The relatively high level of capital expenditures in 1986, of course, is due only to reconstruction efforts following the earthquake of that year. Of course, part of the decrease in expenditures in education, health and infrastructure was accompanied by a rise in national defense as a result of the internal conflict. Figure II-3 shows the composition of total expenditures by the Central Government as percentages of GDP. It is worth to report that the fall in salaries and wages entailed an important fall in the level of real wages in the government sector, with the usual result of the inability to attract and retain skilled personnel.

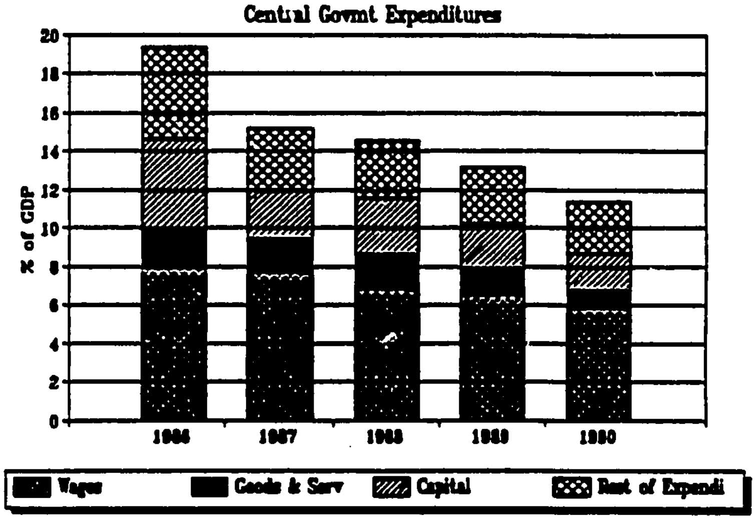

Figure II-3

Figure II-4 succinctly summarizes information concerning the financing of the non-financial public sector deficit, with an indication of the total deficit before and after grants, and internal financing. The latter, which should be interpreted as the "residual", reflects the deficit or surplus (when negative) after external financing. Although the estimates for 1990 indicate that official grants remained at roughly the same level as in 1989, the domestic financing surplus was made possible mostly by the fall in the total deficit but also the increase in external financing by almost 1 per cent of GDP. The basic point (part of which will be taken up again in Chapter IV) is the past consistent reliance on official grants, at a level of almost 2 per cent of GDP, and the magnitude of negative domestic financing in 1990.

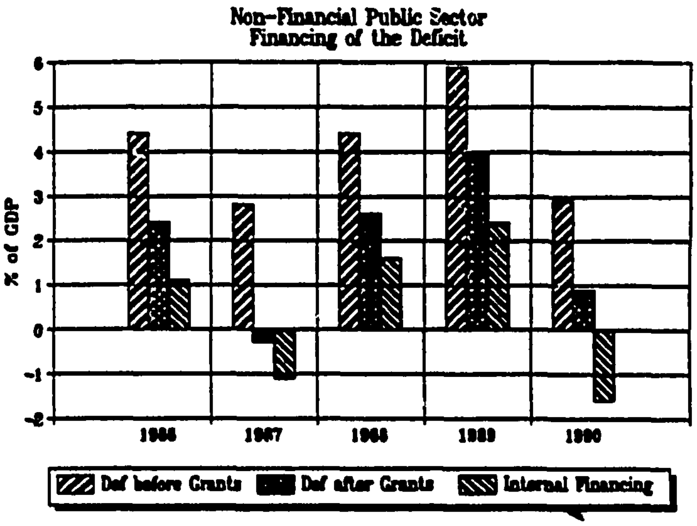

Figure II-4

2.2.- Official Debt and Debt Interest Payments

As important as the primary deficit (and in the case of some countries still more important) is the consideration of official debt and debt interest payments. If an important part of the total deficit is financed by borrowing, interest payments also rise over time. A natural concern is the current and anticipated levels of those payments and their likely impact in the overall government sector (central government *cum* central bank).

Domestic debt, despite the recent increase in the stock of the BEF's (Bonos de Estabilización Financiera) is still rather small compared to external debt. By June of 1990, according to estimations of the BCR, the total of debt instruments outstanding, issued and/or guaranteed by the Public Sector (General Government and BCR) in the hands of the financial system and the public amounted to 3,427 million colones, or 9.3 of GDP, roughly half of which were Bonos de Estabilización Financiera issued by the BCR. Interest payments on the Bonos de Estabilización Financiera, at a 19 per cent per year nominal rate of interest, amounts to .87 per cent of GDP; interest payments on the rest, at nominal rates of around 5 per cent per year, represents a .22 per cent of GDP. It should be kept in mind, though, that given the rate of inflation, even the nominal rate of 19 per cent for the case of the Bonos de Estabilización Financiera yields a real interest rate that was modesly negative in 1990. Of course, the situation can change in an important way following a drastic fall in the rate of inflation.

An additional issue concerning the domestic debt is the anticipated cost of the recapitalization of the six commercial banks and the savings and loans associations before they are privatized. The recapitalization is to be financed by bonds issued by the BCR. The data on the total cost of the recapitalization is rather imprecise, and estimates on the total of non-performing loans have changed over time, but in the average a 1 per cent of GDP over the 10 years period of the bonds issued for recapitalization can be used as a reasonable estimate.[3]

What follows is a very preliminary estimate of interest payments on the official external debt. The ratio of public and public guaranteed external debt to annual GDP estimated for 1990 is around .38. Interest payment for such debt during 1990, if calculated simply by the ratio of estimated interest payment over debt is 4.6 per cent per year.[4] Interest payment for 1990 is estimated at around 1.75 per cent of GDP. Figures II-5 and II-6 present two possible scenarios over the next ten years. The "best" scenario assumes real world interest rates declining at 5 per cent per year (therefore ending at about 2.8 per cent per year after 10 years), and a constant rate of growth of of GDP of 3 per cent per year. The "worst" scenario takes real world interest rates to be increasing at 5 per cent per year (reaching 7.5 per cent at the end of ten years), and a very low constant rate of growth of real GDP, at 1 per cent per year. Figure II-5 shows the behavior of interest rates under these two assumptions. Figure II-6 shows the projected ratios of interest payments to GDP during the ten years, *on the assumption that, starting in the first year, at every year the debt is renewed and increased for the payment of interest*, i.e., on the assumption that during the previous years neither interest nor principal is being paid. If in the "worst" scenario case, for example, if during the first ten years the debt were to be increased at every year by the interest due, and no amortization would take place until then, from the tenth year on it would take 4.6 per cent of GDP to pay the interest. Obviously, this is a very crude calculation, but it serves to illustrate the fact that the external debt does not, *per se*, seem to impose an important constraint in terms of the public sector's finances. This is reinforced by the evidently extreme assumptions of the worst case scenario, and by the fact that the initial interest rate of 4.6 per cent is

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[3] See Chapter IV for a further discussion on the privatization of financial institutions.

[4] Of course, this is a very rough average estimate, as much of foreign debt is in concessional terms, and there is an important interest difference among different creditors.

15

a *nominal* rather than a *real* rate.

2.3.- A Final Comment

As mentioned in the introduction, the government budget deficit has not been, in the case of El Salvador, the motivating factor of distortionary policies and/or the source of fundamental macroeconomic instability. None of the components of the two sides of the "deficit equation" can be singled out, *per se*, as a potential determinant of failure in the stabilization effort. It is still possible to visualize a non-extreme scenario in which deterioration of more than one of those components could generate important problems and eventually force inflationary finance. This could be precipitated, for example, by a drastic fall in official grants, a failure to increase tax revenues with less dependence on trade taxes, and/or a sudden scalation of internal violency and the need to increase defense expenditures.

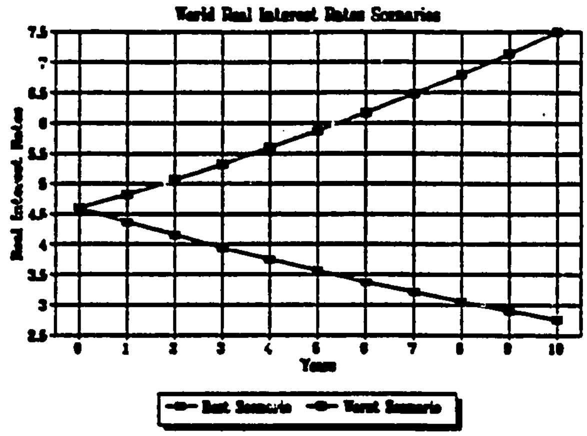

Figure II-5

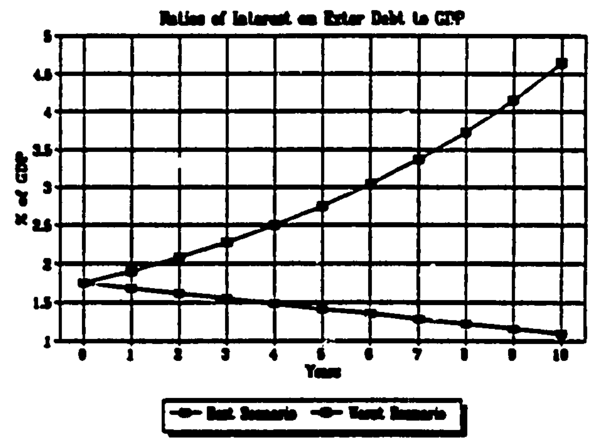

Figure II-6

III.- THE EXTERNAL SECTOR

Recent developments (July of 1989 to present) relevant to the external sector can be summarized as follows:

- The adoption of a floating exchange rate system in 1989, the virtual elimination of exchange controls and the unification of exchange markets;

- The initiation of a major trade liberalization program;

- As a result of the above, and some other domestic liberalization measures, a remarkable response in exports, specially non-traditional exports in 1990. The total increase of exports for this year was 16 per cent.

- An important accumulation of official international reserves during 1990, in part motivated by an increase of 30 per cent in private capital inflows.

- Elimination of external debt arrears, reinitiation of relations with international financial institutions (IMF, IBRD and IDB) and agreement with the Club of Paris.

The first part of this section discusses the institutional set-up and some of the current exchange rate regime, and the issue of the recent behavior of the real exchange rate. The second part examines the behavior of the major components of the balance of payments, and the third part the extent to which the foreign debt may or may not become a binding constraint. Given the purpose of this Macroeconomic Background paper we do not present the details of the trade liberalization program, which is documented in various accessible sources.

3.1.- The Exchange Rate and the Exchange Rate Regime

3.1.1.- The Exchange Rate Regime

Upon assuming office, the Monetary Council (*Junta Monetaria*) decided on July 1989 that the exchange rate in the bank market "would be flexible, and would reflect market demand and supply conditions". In March 1990, following the guerrilla offensive in November 1989, a run on the financial system and a temporary loosening in monetary policy led to the reimposition of exchange controls, but this was quickly reversed. In May 1990, in a new resolution, the Monetary Council eliminated the controls and ruled on what essentially is the current regime, which has the following characteristics.

Besides the participation of the Central Reserve Bank, there are basically two foreign exchange markets, rather well connected and with an almost negligible difference in the rates, the difference between them given by some access restrictions as well as operational market-induced selectivity related to transaction costs:

(i) The Bank Market, in which all operations related to the items included in the trade balance are performed, with the exception of coffee and petroleum. All merchandise export proceeds are to be transacted in the bank market, and most purchases by importers, although they are under no obligation to do so. This is also the main "intervention market", in which the Central Reserve Bank buys or sells foreign exchange in order to smooth out transitory disequilibria.

(ii) Exchange Houses ("casas de cambio"), in which all other transactions take place. Exchange houses, which initially captured the "black market" existing until then, were legalized in May 1990. There are around 50 exchange houses, with 70 branches in different locations across the country. The main source of foreign exchange is given by private remittances from abroad; uses are imports not handled by the bank market, and private acquisitions for traveling, study abroad expenses and miscellaneous. By July 1990 exchange houses handled roughly 20 per cent of private (excluding Central Bank) operations, with the other 80 per cent being operated by the bank market. Commercial banks are permitted to operate exchange houses, and several do so. There is an active "inter-houses market".

The Central Reserve Bank (BCR) participates in the market as follows:

(i) By purchasing foreign exchange proceeds from coffee exports, that by law are to be surrendered to the institution, from official transfers and from public sector loan disbursements;

(ii) By providing foreign exchange for petroleum imports, for imports of goods and services by the public sector and for payment of the external debt;

(ii) By buying or selling foreign exchange in the bank market and/or the exchange houses market, *at the exchange rate determined in those markets*.

The "official" exchange rate to be used by the BCR is determined weekly, as a simple average of the exchange rate in the bank and exchange houses market during the previous five working days. This "official" exchange rate is the one used for purposes of tariff calculations.

Within this regime, there are no effectively binding restrictions on capital movements. Importers and exporters are allowed to maintain bank deposits in US dollars, and the transparency and stability attained so far has allowed what is estimated to be an important decrease in inventories of both foreign exchange and commodities held by importers.

3.1.2.- The Economics of the Floating Exchange Rate Regime, the Role of the Central Bank and the "Real" Exchange Rate

Since the adoption of the floating exchange rate system, the nominal exchange rate has shown what it can be considered an acceptable level of stability, considering the uncertainties brought about by a change in regime, the internal conflict and even the major offensive of November 1989. Of course, at times the BCR has intervened to avoid fluctuations.

Table II-1 Exchange Rate (Colones per US$)
(Monthly Averages, Selling Price)

	Banks 1989	Exchange Houses 1989	Banks 1990	Exchange Houses 1990	Banks 1991	Exchange Houses 1991
January	5.00	5.56	6.63	7.19	8.09	8.11
February	5.00	5.81	6.92	7.59	8.02	8.09
March	5.00	5.87	7.79	8.26		
April	5.00	5.78	7.80	8.13		
May	5.00	5.96	7.73	7.93		
June	5.00	6.19	7.65	7.85		
July	6.60	6.39	7.73	7.89		
August	6.37	6.45	7.83	7.90		
September	6.41	6.46	7.92	8.05		
October	6.43	6.50	8.02	8.15		
November	6.46	6.62	8.11	8.15		
December	6.50	6.79	8.13	8.14		

Until May 1990, the rate for Exchange Houses is the black market rate. Source: Banco Central de Reserva

Table III-1 and Figure III-1 show monthly averages of the selling rate since January 1989, for both the bank and the exchange houses markets. It is clear that the difference between the two markets has narrowed and become negligible.

El Salvador, as other Central American countries, had until the end of 1985 a long tradition of a fixed exchange rate regime, and until shortly before that, of the adjustment mechanism implied by such regime. With the adoption of the floating exchange rate regime in 1989, the monetary authorities seemed to be committed to what can be loosely characterized as a "monetary rule", given by the Monetary Program which is decided annually and periodically revised. In a situation in which at least temporarily the BCR handles a large volume of foreign exchange (both because of official grants and because of the surrender of foreign exchange from coffee exports) it becomes particularly important for the monetary authority to clearly understand the "rules of the game" attached to the new regime, i.e., that official intervention in the foreign exchange market (other than purchases and sales by the BCR as just any other operator in the market), if any, should be restricted to smooth out temporary disruptions. The resolution of the Monetary Council of May 1990, as mentioned above, implicitly empowers the BCR to buy and sell foreign exchange" at the exchange rate determined in the bank or exchange houses markets", presumably for the purpose of such short-term stabilization.

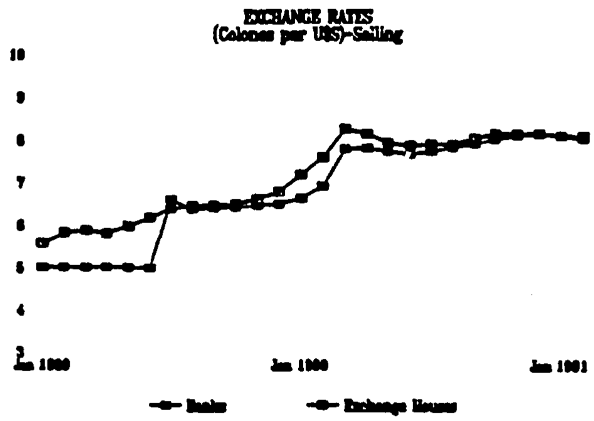

Figure III-1

These remarks are appropriate, in particular, concerning the behavior of the real exchange rate, and the possible attempts by the BCR to influence its medium and long-run level by influencing the nominal rate through intervention in the foreign exchange market. The real exchange rate is an endogenous variable, under either a system of fixed or floating nominal exchange rates. Although its determination, in particular in the short run, responds to rather complex and sometimes not well understood processes, it should be clear that under either nominal rates regime it cannot be controlled except for very short periods, if at all. Of course, at times it is clear that the real exchange rate is not at a long run sustainable level, but this invariably responds to underlying conditions that are not corrected simply by changes in the nominal rate. Trying to do so can be particularly dangerous in the case in which a floating nominal exchange rate regime has been adopted, with the monetary authority actively controlling monetary aggregates. The current monetary authorities seem to understand this point very well, but after an upward change in the level of the real exchange rate during the first part of 1990, a partial reversal during the last six months has caused in El Salvador a concern about the possible beginning of a "Dutch disease" episode, i.e., a "too low" real exchange rate. If this concern translates into attempts to influence the trend of the real exchange rate directly via central bank sales and purchases, a situation could develop in which the monetary authority would not only be trying to control a real variable (the real exchange rate) by means of a nominal variable (the nominal exchange rate), but also trying to control too many nominal variables (the nominal exchange rate and some monetary aggregate).

Figure III-2 shows the behavior of the real exchange rate (defined as the Bank selling rate times the CPI in the USA, divided by the domestic CPI)

20

since January 1989. It seems clear that there has been a "stepwise" increase in the level during the first part of 1990; it is too early to tell the meaning of the gradual reversal since October.

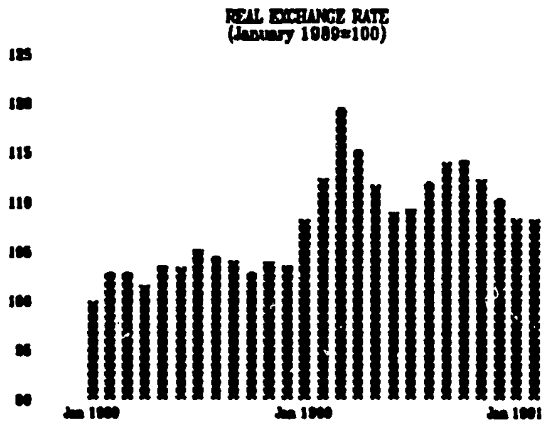

Figure III-2

3.2.- The Balance of Payments

Table III-2 and Figures III-3 and III-4 provide the basic information concerning the recent evolution of the most important item in the external sector accounts.

In general terms, the initial results of the reforms initiated in 1989 began to appear in the preliminary estimations for 1990 for both the current and the capital account.

Items in the current account are depicted in Figure III-3. Both traditional and non-traditional exports show an important increase of 16 per cent, as a reflection of the trade reforms and the increase in the real exchange rate. But trade liberalization also was a cause for an increase in imports by over 8 per cent. The trade account in 1990, then, is a reflection of both a more open trade regime and a strong reaction of exports. The trade balance, as a consequence, worsened slightly. On the other side, changes in net transfers more than compensated the rise in the trade deficit, in spite of the fall of official transfers (AID grants and foreign government transfers), due to the strong increase of nearly 30 per cent in the private inflow of transfers. As a result, the deficit in the decreased by almost 50 million U$S (a 25 per cent decrease).

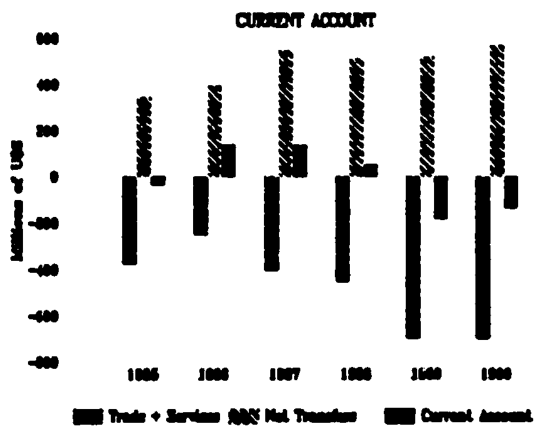

Figure III-3

The capital account showed an impressive performance. Private capital inflows increased by 238 million U$S (from -184 to 172 million U$S), what can be clearly interpreted as an increase in confidence. Also as a result of an increase in bank capital inflows, the capital account increased by 256 million U$S, in spite of a fall of 22 million in official capital inflows.

Table III-2

<u>Balance of Payments</u> (In Millions U$S)

	1985	1986	1987	1988	1989	1990
Total Exports (FOB)	695.1	754.9	590.9	608.8	497.5	580.2
Of which:						
Coffee	463.7	546.8	351.5	358.0	228.6	258.9
Non-Traditional	169.0	161.0	205.0	215.3	244.7	285.4
	62.4	47.1	34.4	35.5	24.2	35.9
Total Imports (CIF)	961.4	934.9	994.1	1006.9	1161.3	1262.4
Trade Balance	-266.3	-180.0	-403.2	-398.1	-663.8	-682.2
Net Services	-114.2	-74.1	-5.7	-58.1	-39.2	-23.0
Net Transfers	343.6	393.1	545.3	508.6	519.2	568.6
Of which:						
Private transfers	113.0	160.5	194.9	221.0	236.8	305.4
Official transfers	206.0	223.5	378.3	287.6	282.4	223.2
Current Account	-36.9	139.0	136.4	52.4	-183.8	-136.6
Capital Account	83.6	-154.3	-85.7	-143.6	139.1	396.5
Private Capital	13.0	-144.3	-18.1	-159.2	-66.3	172.7
Official Capital	106.2	64.0	28.6	62.0	150.2	128.6
Bank Capital	-35.6	-74.0	-96.2	-46.4	55.2	95.2
Overall Balance	46.7	-15.3	50.7	-91.2	-44.7	259.9
Deferred Payments				28.8	69.5	-104.5
Change in Net Int Reserves	46.7	-15.3	50.7	-62.4	24.8	155.4

<u>Source</u>: BCR and AID estimates.

The resulting overall balance, which in 1989 had already improved from the very high deficit in 1988, increased from -45 million U$S in 1989 to 260 million U$S, as shown in Figure III-4. The allocation of this surplus went to a diminution of deferred payments by 104 million U$S and to an increase in net international reserves by 155 million U$S.

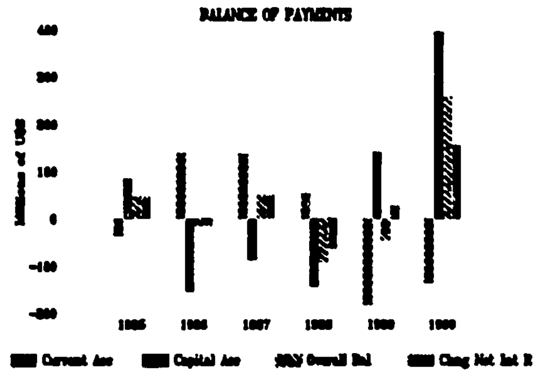

Figure III-4

3.3.- The Global and Government External Debt

The final Report elaborated by the IBRD in January 1991 for the SAL granted to El Salvador contains a projected financing plan through 1995, in which rather conservative estimates for the current account (excluding official grants), clearly indicate that the external sector needs not be an important constraint in the medium run. The plan provides for an important accumulation of reserves during the next five years, assumes no accumulation of arrears, and although a steady decline in official grants is anticipated, gross disbursements by international institutions is expected to compensate for this decline. There are a few observations that could be added to this scenario. First, that the estimates are, and properly so, rather conservative and provided room for unexpected problems, that could be absorbed by a smaller accumulation of reserves (that were at a level of 432 million U$S at the end of 1990). Second, that given the reliance on disbursements from international institutions, either a lack of fulfillment of changes required prior to those disbursements, or unusual delays in the execution of projects could result in bottlenecks. A final, rather general observation, is the need for a distinction between the global "country" constraints vis-à-vis the rest of the world, and the "government" constraints. Fulfillment of the former does not guarantee fulfillment of the latter, and even in the presence of a satisfactory "country" situation, a deterioration of the government asset position can result in the imposition of distortionary policies that may endanger the overall program. In the case of El Salvador, for example, private debt is only 7 per cent of the overall external debt. On the other side, for example, eventual improvements in the current account or in capital inflows do not accrue to government, except to the extend that they generate increases in tax collection or increases in the real demand for money.

- 23

IV.- INFLATION, MONETARY, INTEREST RATE AND CREDIT POLICIES

The following is a characterization of the most important recent events related to monetary, interest rate and credit policies:

- A free floating exchange rate regime has been adopted, with the BCR controlling monetary aggregates. During 1990, credit policy has been reasonably kept in line with the stringent limits set by the monetary program.

- The rate of inflation, which increased by 5 annual percentage points when price controls were lifted in mid-1989, at the time the new administration took office, and which kept rising to reach almost 30 per cent per year following the November 1989 guerrilla offensive, is showing a gradual but consistent reduction since April 1990.

- The legal framework has been established for the recapitalization (or liquidation) and privatization of the banks in hands of the public sector, and for the reorganization of the Superintendency of Banks.

- Nominal interest rates, still controlled by the monetary authority, have been periodically adjusted so as to yield a positive (or less negative) real ex-post rate, and programs are under way for their gradual liberalization.

- The large number of preexisting "rediscount lines" has been practically eliminated, and substituted by a "Fondo de Crédito para Inversiones".

In this Section we examine, first, the recent evolution of the main monetary and credit aggregates, and the behavior of the inflation rate, and second, the institutional and economic situation in the financial sector and credit markets.

IV.1.- Monetary Aggregates, the Inflation Rate and the Floating Exchange Rate System

The inflation rate is of course a basic yardstick for the measurement of monetary policy performance, in particular in a floating exchange rate economy. Before discussing its ultimate causes, the monetary aggregates, it is helpful to have a look at its behavior. Table IV-1, at the end of this chapter, reports the behavior of the Consumer Price Index and the corresponding inflation rate for the period 1980-1990. Figure IV-1 shows the inflation rate since 1985 (measured by changes in the CPI over 12 months). After many years of price stability and a rather strict adherence to the rules of a fixed exchange rate system, at the end of 1985 the first devaluation took place, after several years of balance of payments problems, a segmentation of exchange rate markets and the increasing imposition of exchange controls. During that year the inflation rate rose from 12 to almost 35 per cent per year. After peaking in mid-1986, there was a very gradual decrease to around the 15 per cent level in May-June 1989, largely brought about by the imposition of various controls. Upon elimination of price controls immediately after the new administration took office in June 1989, the annual inflation rate rose 5 percentage points in one month, from 15 to 20 per cent. Following the November 1989 offensive and a temporary increase in liquidity, it reached a peak of almost 30 per cent in April 1990, and since then is showing a persistent decline (it was at a level of 17 per cent in February 1991).

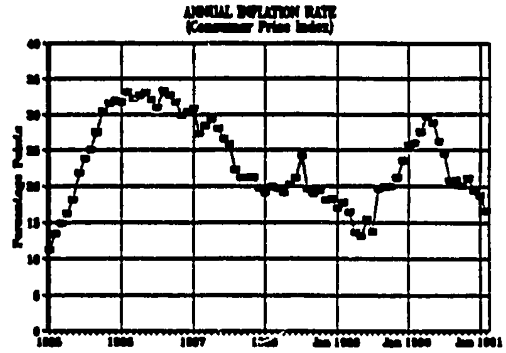

Figure IV-1

IV.1.1.- The Implications of a Floating Exchange Rate System for Monetary Policy

Under a fixed exchange rate system[1] the monetary authority does not control the monetary base, but only the level of one of its components, the stock of domestic assets. The level of the other component of the base, or foreign assets, adjusts so as to keep the base at the level desired by the public. What this means, then, is that the base, and all the monetary aggregates that depend on it, are ultimately determined by the economy and not by the monetary authority. Under a free floating system, as enacted in El Salvador since 1989, the monetary authority "recovers" control of the monetary base and, together with the commercial banking system, determines the stock of the other various monetary aggregates. As mentioned in Section III, in El Salvador the BCR is an important participant in the market for foreign exchange, both because of its role as intermediary in the processing

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[1] By "fixed" we mean not necessarily a *constant* level of the exchange rate over time, but a predetermined *exogenous* path preannounced by the monetary authority. This is, for example, the case of the "tablita" enacted at one time or another in some South American countries. This should be distinguished from the so-called "crawling peg" or "minidevaluations" system, in which the monetary authority continuously changes the nominal exchange rate as a response to events, and as a consequence the path of the nominal rate becomes *endogenous*.

25

of foreign grants and because proceeds from coffee exports must be surrendered to the institution. Therefore, the level of reserves in the BCR (which could strictly be always zero, under a strict non-intervention rule) becomes *de facto* an important counterpart to the level of the monetary base, which the central bank can control as it does the level of domestic assets.

IV.1.2.- The Recent Evolution of the Monetary and Credit Aggregates

Table A-4 in the Annex summarizes the Central Bank, Commercial Banks and Consolidated Banking System accounts, i.e., the main monetary aggregates. Figures IV-1 to IV-5 help to visualize the recent behavior of some of them.

IV.1.2.1.- The Monetary Base, International Reserves and Domestic Credit

The increase in the level of international reserves during 1990, both in the BCR and in commercial banks, was substantial. Total net international reserves in the consolidated banking system were in December 1990 433 million dollars, up 55 per cent from December 1989. Net foreign assets in the BCR increased by 156 million U$S, or 47 per cent, and in commercial banks by 38 million dollars, or 118 per cent.

Domestic credit held by the BCR, both to the consolidated government and to the private sectors, reflected the tightness set by the monetary program. Credit to the overall government sector rose by 13.5 per cent (a 4.9 per decrease in real terms) and credit to the private sector decreased

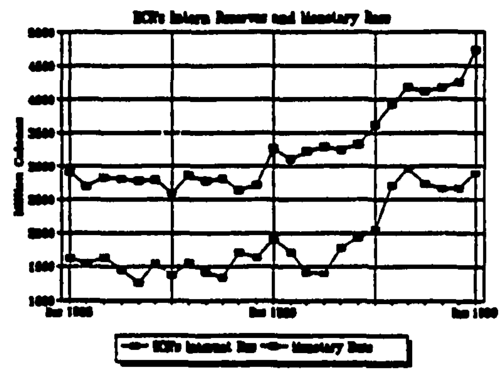

Figure IV-2

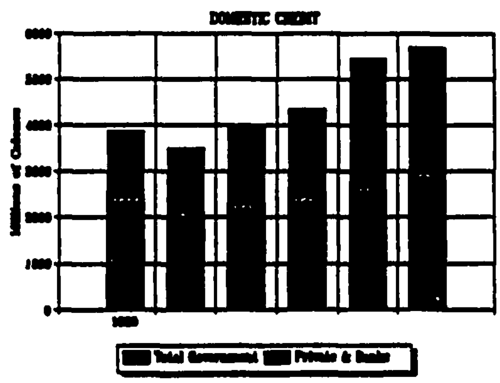

Figure IV-3

by 4 per cent (a 19.5 fall in real terms).[2] Total domestic credit held by the BCR, then, rose by only 12.4 per cent in nominal terms, therefore decreasing in real terms. Figure IV-3 clearly shows the important des-acceleration in the growth of domestic credit.

The monetary base (banks reserves plus currency in circulation), on the other side, rose by an 44 per cent in 1990, generated by a 86 per cent rise in banks reserves, with a 7.5 rise in the currency component.

If the monetary base is taken as the variable that the monetary authority can most directly control under a system of floating exchange rates, and the one that may ultimately influence the level of prices, then the conclusion is that monetary policy has not been stringent as the numbers for domestic assets lead to believe. The growth in the monetary base (and, essentially, in commercial banks reserves) is associated with the growth in the level as is apparent from Figures IV-2 and IV-4. Figure IV-4, plots international reserves *held by the Central Bank* and the monetary base (both in natural logs) and clearly shows this association for 1990, with the exception of the January-May period, after which the relationship between the two comes back to be roughly the same as in December 1989. In other words, the increase in the base (and, more precisely, in bank reserves) has been generated mostly by an increase in foreign assets. We elaborate below on the significance of this point.

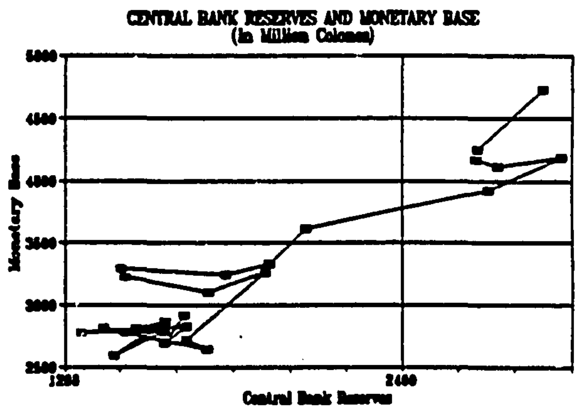

Figure IV-4

[2] Credit to the Central Government in hands of the BCR shows an increase of 43 per cent, but the numbers corresponding to the "Rest of the Public Sector" and to INCAFE/INAZUCAR show a compensatory change. During the last quarter of 1990 the Central Government decided to absorb the debt of the government autonomous institutions (by an amount of roughly 1,000 million colones) and to consolidate the debt with the BCR.

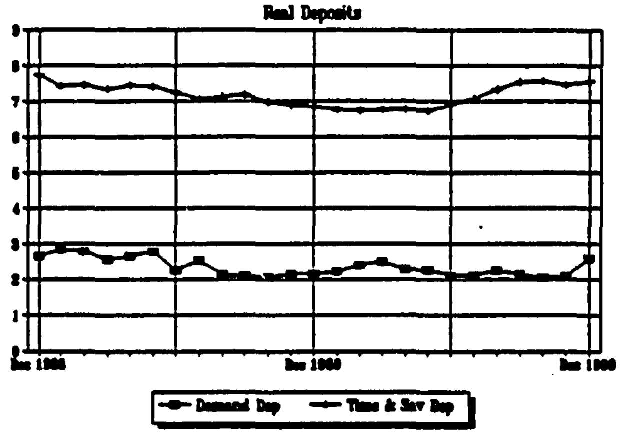

Figure IV-5

IV.1.2.2.- Deposits

As far as Deposits in the hands of the public, shown in Figure IV-5, demand (sight) deposits shows an important increase of 40 per cent, or 18 per cent in real terms (much of it during the last three months of 1990). Equally impressive is the increase in savings and time deposits, which grew by 32 per cent, or a 10.3 per cent in real terms. Although both phenomena are known as "monetization", they clearly respond to two different causes. The first, perhaps to the anticipation of a *fall* in inflation, and therefore in the *nominal* interest rate and in the cost of holding money; the second, by the *increase* in the *real* interest rate brought about by the upward adjustments taking place since 1989 in the rate controlled by the monetary authority. We discuss this point below.

IV.1.3.- Monetary Aggregates and Prices

The relationship between monetary aggregates (such as the base, or M1) and prices is difficult to evaluate at this point, and it will be so for some time if the inflation rate falls substantially. The reason is that a fall in the inflation rate perceived as permanent by the public leads to a higher level of *real* money balances, so that for some time monetary aggregates can be rising at a rate higher than the rate of inflation. This is a well know (although sometimes not correctly understood) phenomenon, that has various consequences. The first is that the connection between the level of monetary aggregates and prices (and between the rate of growth of those aggregates and the inflation rate) transitorily breaks down. The second is that the government can appropriate a *once-and-for-all* stock of resources from the private sector, equal to the *once-and-for-all* increase in the monetary base, that can be used to decrease government debt, or to accumulate foreign exchange reserves, or to finance a deficit for some time. When stabilization (i.e., a permanent fall in the inflation rate) is accompanied by structural changes that raise the anticipated real interest rate, as in the case of El Salvador, the former "monetization" is coupled with an increase in times and savings deposits --another "monetization" that will also allow the Central Bank to acquire resources, commensurate with the reserves required on those deposits. It is important to realize, though, that these changes in the real base are *once-and-for-all* changes, and that the nominal base cannot keep increasing beyond some point without reviving inflationary expectations and even endangering the stabilization effort.

The graph in Figure IV-6 shows the relationship between the monetary base and prices (both in natural logs) during the 24 months of 1989 and 1990. Although there are no sufficient observations for a serious econometric estimate, the pattern seems to be quite characteristic. There are three instances in which prices rise for the same level of the monetary base: until November 1989; from December 1989 until May 1990, and between August and December 1990. The last of these two price increases would seem to be in lagged response to important increases in the base between November and December 1989 and between May and August 1990. But one should notice that price increases for each of these three episodes price increases seem to be decreasing, even for proportional larger increases in the base. What this rather "casual empiricism" suggests is that (i) There is a lagged effect of the monetary base on prices; (ii) A real monetization (i.e., an increase in the real monetary base) is taking place, and will probably continue to take place for some time to the extent that the inflation rate continues to fall and the fall is expected to be permanent. But here again the previous warning (real monetization cannot continue indefinitely.

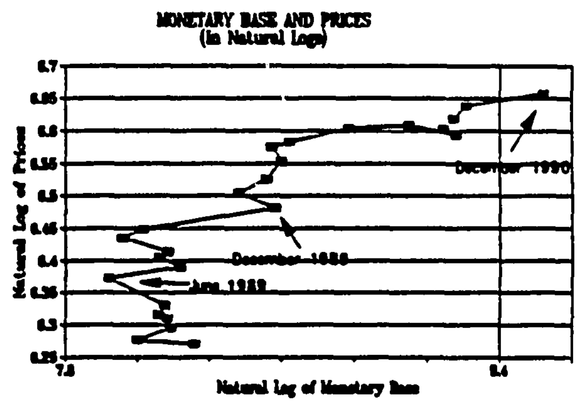

Figure IV-6

A second point to be mentioned is the role of international reserves accumulation by the Central Bank. Under a system of fixed exchange rates, reserve accumulation is associated with (and a consequence of) a *tight* monetary policy, i.e., a relative *fall* in domestic assets. Under a floating exchange rate system, as the one in place today in El Salvador, should be seen as the counterpart of a *loose* monetary policy, i.e., a relative *rise* in the monetary base. Indeed, the monetary authority could eventually decide on a highly inflationary policy, financing the acquisition of foreign exchange with the increases in the monetary base, i.e., with the proceeds of the inflation tax. Monitoring of monetary policy, then, cannot be limited to an emphasis on credit, but to a wider monetary aggregate, such as the monetary base or M1.

IV.2.- The Financial Sector, Credit and Interest Rate Policies

After the nationalization of commercial banks a decade ago, the new administration found an institutional financial sector characterized by a multitude of selective credit (rediscount) lines, an important erosion of banks'assets (with 37 per cent of assets deemed either unrecoverable or difficult to recover) and totally controlled interest rates, at levels that consistently resulted in negative ex-post real rates.

This second part of Section IV discusses (i) the institutional framework and the advances in the process of recapitalization and privatization of banks; (ii) changes in special credit policies, and (iii) recent and projected interest rate policies.

IV.2.1.- The Institutional Framework

After some technical studies performed in 1989 following start of the new administration, the government decided in early 1990 to liquidate three of the nine banks and recapitalize the other six, with a merge of two of them. On the basis of proposals by the Executive Branch, in November 1990 legislation was approved for (i) a restructuring of the bank overseeing agency (Superintendencia de Bancos), (ii) the recapitalization and/or liquidation of banks and savings and loans associations, and (iii) the process of privatization.

Reorganization of the Superintendencia de Bancos provides for independence from the Central Bank, both legal and financial. A condition for the Structural Adjustment Loan granted by the IBRD in January 1991, was the presentation of a program for the improvement of the Superintendencia, with technical assistance financed through USAID.

The recapitalization of commercial banks takes the form of the

vp

acquisition of the non-performing portfolio of commercial banks and savings and loans associations, with the objective of attaining a minimum net worth of ten per cent of the value of total assets for each institution before being sold. The recapitalization operation is to be implemented via the "Fondo de Saneamiento y Fortalecimiento Financiero" created by the law. The non-performing portfolio is to be acquired in exchange for both existing commercial banks'debt to the BCR and by bond issued by the BCR with 10 years maturity and a variable interest rate, equal to the 6 month deposit rate plus two percentage points (originally, those bonds were to be at a 14 per cent fixed rate). The original estimate of the bond issue was 1,400 million colones.

The legal framework for privatization process, to take place with every institution only after the recapitalization process has been concluded, establishes stringent limits on ownership: no person can own more than 5 per cent of the total of a banks'shares --20 per cent for the case of multilateral international institutions. Although the limitation is obviously addressed to avoid possible ownership concentration and to deflect the potential political problem, it certainly decreases the attractiveness of ownership, and may therefore result in a smaller sale price than what otherwise could have been fetched. Another feature of the privatization process is that banks employees and small investors can exercise a first-option right to purchase shares for a period of 120 days after the sale offer. Small shareholders may have access to credit for up to 100,000 colones using the shares as collateral.

IV.2.2.- Special Credit Policies

An important objective of the new administration has been the elimination of the large number of special and differential credit and rediscount lines. Many of those rediscount lines have been eliminated. Essentially, the variety of special rediscount and credit lines has been unified in the "Fondo de Crédito para Inversiones" adopted by the BCR in July 1990. In January 1991, a long and rather detailed directive of the BCR (which also sets the "band" for passive and active bank rates to the general public) establishes the rates applicable to various loans granted by the institution. Some of its most important provisions are: (i) starting immediately, all loans to the public sector will pay the basic active bank rate; (ii) in the medium-term, the objective is a single rediscount rate at least "similar" to the basic passive bank rate; (iii) in the short-run, new loans, including those loans for the harvest of coffee and sugar cane will pay a 22 per cent rate (by the final borrower) and 19 per cent (by the financial intermediary); for other crops those rates will be 20 and 17 per cent, respectively, and

-31

commercial banks'rate for stabilization loans will be two percentage points above the basic active bank rate. The directive also determines the various rates applicable to the of external sources of financing.

A condition for release of the second tranche of the SAL recently granted by the IBRD is the reunification of all short-term credit lines to rates no less than the market rate on three months commercial banks deposits.

IV.2.3.- Interest Rates Policies

With the exception of the interbank interest rate, liberalized in September 1990, active and passive banks interest rates are still controlled by the BCR. Table IV-2, at the end of this chapter, summarizes interest rate regulations. In deciding on the level of those rates, the BCR main concern was to reverse the previous situation in which the low level of nominal rates consistently resulted in negative ex-post real rates. The first revision took place in August 1989, with the understanding that rates would be revised on a quarterly basis. Still, the second only took place in June 1990, presumably due to the instability and the increase in the inflation rate resulting from the episodes of November 1989, the limited run on the banks and the ensuing transitory relaxation of a tight credit policy (from November to December of 1989, the monetary base rose from approximately 2800 to around 3300 million colones, although with a subsequent reduction in the following month to about 3080 million colones).

The most recent directive on general interest rate policy is the resolution adopted by the BCR in January 1991 (which practically reproduces the one adopted in November 1990). The general policy decision is a gradual adjustment towards total liberalization, scheduled to take place in January 1993. The operational counterpart is the establishment of a "band" between the "basic passive" rate (for a 6 months deposit rate) and the "basic active" rate (for instruments with maturity of less than a year) (TIBP and TIBA, respectively), and the scheduling of three revision to take place at fixed dates: immediately, in July 1991 and in July 1992, with total liberalization in January 1993. Effectively immediately (January 1991), the TIBP is set at the level of the annual inflation rate averaged during the previous six months, but *never at a level below 18 per cent*, with the TIBA at 4 percentage points above. For the second revision (July 1991), the TIBP is set at the annual inflation rate averaged during the previous *twelve* months plus [illegible] percentage point, and the TIBA at 5 percentage points above. The third an[illegible] final revision before total liberalization contemplates a TIBP of [illegible] percentage points above the inflation rate during the previous 12 months with a TIBA at 6 percentage points above it.

The predominant and natural concern of the monetary authority has be[illegible]

32

to avoid the previously prevalent situation of a constantly negative interest rate, which discouraged savings and forced credit rationing. The scheme outlined in the previous paragraph has the potential danger of causing the reverse problem, with consequences that can be serious and lasting. In a recent report on interest rate policy in El Salvador[3] we discuss the problem of using past inflation rates for the determination of the nominal interest rate, in particular in cases in which the inflation rate is expected (and hoped) to be falling:

> "What is common about these proposed rules is that they rely entirely on past information (the inflation rate during a past number of periods) or (partially) on an undefined forecast by government. There are several reasons why this is a deficient mechanism... Secondly, to the extent that a forecast of future inflation rates relies significantly on the behavior of past inflation rates, there is a clear danger of sizable forecast errors, *in particular at times at which there are reasons to expect a change in the trend of the inflation rate*. And this is specially worrisome when there are reasons to believe that the inflation rate will fall in the near future, as it is the declared purpose of current monetary policy. An overestimation of the inflation rate in the near future clearly presents the danger of *unduly high* ex-post real interest rates. Although the current concern in El Salvador is the persistence of *too low* a level of real interest rates, the danger of the opposite is clearly present if future inflation rates are overestimated. Even a relatively short period of "too high" ex-post real interest rates can have devastating effects that could not only severely aggravate the precarious portfolio situation of the existing banks, but also place otherwise perfectly viable business firms in a delicate financial position."

Although the directive of the BCR is not too clear in this respect, presumably the TIBP is a *minimum* passive rate and the TIBA a *maximum* rate, so that commercial banks can set passive and active rates within the bank. Yet, with operational costs unlikely to allow a spread less than five per cent per year, it is not difficult to think of possible situations in which a drastic fall of the inflation rate could generate ex-post real interest rates of 15 per cent or more. Quick intervention by the BCR and an unscheduled revision would certainly not eliminate the problem of debts of up to a year maturity already undertaken.

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[3] *Interest Rate Policy in El Salvador*, L.Auernheimer and J.C.Protasi, IMCC, January 1991 (Report prepared for the US Agency on International Development).

37

Table IV-1

Consumer Price Index

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
January	115.3	138.1	153.6	173.6	199.2	221.5	291.7	381.5	454.3	531.5	668.0	793.48
February	117.1	140.3	154.5	174.3	199.6	226.5	301.6	384.1	460.5	541.9	682.8	796.14
March	121.2	141.4	157.8	176.7	202.6	232.8	307.8	395.4	473.1	550.2	701.6	
April	123.9	143.7	159.9	176.8	204.7	237.9	315.8	408.6	486.4	552.9	717.1	
May	126.5	145.0	161.7	179.1	205.3	242.4	322.6	412.9	496.1	561.2	722.9	
June	128.0	147.1	164.1	182.6	205.6	250.5	330.9	418.7	506.9	585.1	737.8	
July	131.0	148.3	164.6	185.6	206.6	255.9	335.3	421.7	523.7	595.6	741.6	
August	131.2	149.1	165.0	190.2	207.6	259.7	346.2	423.2	505.9	605.0	730.3	
September	132.5	150.0	168.8	193.6	208.7	266.1	353.1	427.9	509.0	610.1	736.9	
October	133.6	150.9	169.7	194.1	209.0	272.7	359.3	435.3	519.6	623.6	749.0	
November	134.2	151.3	170.9	198.3	213.4	280.8	364.6	441.8	521.4	631.2	764.3	
December	136.2	152.0	172.3	198.6	217.2	286.6	373.6	446.9	528.3	652.4	778.8	

Montly Inflation Rate, as measured by the CPI

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
January		1.40	1.05	0.75	0.30	1.98	1.78	2.11	1.66	0.61	2.39	1.89
February	1.56	1.59	0.59	0.40	0.20	2.26	3.39	0.68	1.36	1.95	2.22	0.34
March	3.50	0.78	2.14	1.38	1.50	2.78	2.06	2.94	2.74	1.54	2.75	
April	2.23	1.63	1.33	0.06	1.04	2.19	2.60	3.34	2.81	0.48	2.22	
May	2.10	0.90	1.13	1.30	0.29	1.89	2.15	1.05	1.99	1.51	0.81	
June	1.19	1.45	1.48	1.95	0.15	3.34	2.57	1.40	2.20	4.25	2.06	
July	2.34	0.82	0.30	1.64	0.49	2.15	1.33	0.72	3.31	1.80	0.51	
August	0.15	0.54	0.24	2.48	0.48	1.48	3.25	0.36	-3.40	1.58	-1.52	
September	0.99	0.60	2.36	1.79	0.53	2.46	1.99	1.11	0.61	0.83	0.91	
October	0.83	0.60	0.53	0.26	0.14	2.48	1.76	1.73	2.08	2.21	1.63	
November	0.45	0.27	0.71	2.16	2.10	2.97	1.47	1.49	0.35	1.22	2.05	
December	1.49	0.46	0.82	0.15	1.78	2.06	2.47	1.15	1.32	3.37	1.89	

Annual Inflation Rate, as measured by the CPI

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
January		19.77	11.22	13.09	14.74	11.19	31.68	30.78	19.08	17.01	25.67	18.78
February		19.81	10.12	12.88	14.51	13.47	33.14	27.35	19.89	17.69	26.00	16.60
March		16.67	11.60	12.04	14.65	14.90	32.20	28.45	19.65	16.31	27.50	
April		15.98	11.27	10.63	15.77	16.21	32.73	29.38	19.04	13.68	29.70	
May		14.62	11.52	10.82	14.62	18.06	33.07	27.98	20.15	13.14	28.80	
June		14.92	11.56	11.33	12.59	21.83	32.08	26.53	21.08	15.41	26.10	
July		13.21	10.99	12.82	11.31	23.85	31.02	25.76	24.21	13.73	24.50	
August		13.64	10.66	15.33	9.14	25.08	33.30	22.23	19.56	19.58	20.70	
September		13.21	12.60	14.68	7.80	27.49	32.68	21.18	18.97	19.85	20.79	
October		12.95	12.52	14.37	7.67	30.46	31.74	21.15	19.38	20.00	20.11	
November		12.74	13.02	16.02	7.61	31.57	29.83	21.17	18.04	21.04	21.09	
December		11.60	13.42	13.26	9.36	31.94	30.35	19.61	18.23	23.48	19.37	

34

Table IV-2

Regulations on Interest Rates

I.- INTEREST RATES ON LOANS	From 1-1-1983	From 3-1-1985	From 1-21-1987	From 8-1-1989
1.- <u>Banks own resources</u>				
a.- Class A Loans (preferential) 1/				
Less than 3 years)	13.0	15.0	17.0	22.0
Three years or over				
Banks	14.0	16.0	18.0	20.0
Savings & Loans Ass				
Up to 40,000 colones	14.8	15.0	17.0	22.0
Over 40,000 colones	15.0	16.0	18.0	20.0
b.- Class B Loans (regular)				
Less than three years				
Loans to construction comp	17.5	19.5	19.5	22.0
Loans to others	16.5	20.0	20.0	22.0
Three years or over	17.0	21.0	21.0	20.0
2.- <u>With Central Bank Resources</u>				
Preferential rate	13.0	15.0	15.0	17.0
Basic rate	15.0	17.0	17.0	18.8
3.- <u>With Foreign Resources</u>				
Preferencial Rate	At cost	At cost	2/	2/
Market Rate	Free	Free	2/	2/

35

	From 1-1-1983	From 3-1-1985	From 1-21-1987	From 8-1-1989
II.- INTEREST RATES ON DEPOSIT LIABILITIES				
1.- Saving Deposits				
Without previous withdrawal notification (less than 10,000 colones)				
Banks	7.0	7.0	6.0	10.0
Savings & Loans Institutions	8.0	8.0	7.0	11.0
With prior withdrawal notication (10,000 colones and over)				
Banks	7.5	7.5	6.5	11.0
Savings & Loans Institutions	8.5	8.5	7.5	12.0
2.- Special Savings Deposits	11.0	13.0	13.0	13.0
3.- Time Deposits				
60 days	11.5	11.5	14.5	
120 days	11.0	13.0	13.0	16.0
190 days	12.5	15.0	15.0	18.0
360 days and over	13.0	15.5	15.0	18.0
4.- Deposits in Foreign Currency	3/	3/	3/	3/
5.- Certificates of Saving Deposits (Savings and Loans Associations)				
60 days	9.5	11.5	11.5	14.5
120 days	11.0	13.0	13.0	16.0
190 days	12.5	15.0	15.0	18.0
360 days and over	13.0	15.5	15.0	18.0

1/ For coffee producers in small farms, cotton, and basic grains; for small industry and exports outside Central America.

2/ Determined by the Central Bank on the basis of the cost of the foreign loan.

3/ Up to 2 per cent below LIBOR.
Source: Banco Central de Reserva and IMF.

V.- INSTRUMENTS FOR MONETARY POLICY AND CAPITAL MARKET DEVELOPMENT

This Section discusses the question of the mechanisms for the conduct of monetary policy (open market operations, as opposed to reserve requirements and rediscounts) and of capital market development, both in very general terms and specifically with respect to the existing available instruments.

V.1.- Open Market Operations and the Conduct of Monetary Policy

As in most Latin American countries, in El Salvador the instruments for the control of short-term liquidity have been rediscounts and, specially, reserve requirements. These two mechanisms are highly inefficient for such purpose, both because they lack flexibility and because they interfere with optimal resource allocation.[1] In particular under a system of floating exchange rates, in which the central bank is free to determine monetary aggregates, it seems timely to consider the desirability and the possibility of open market operations becoming the main tool for the conduct of monetary policy. In the past, reserve requirements have performed the double role of controlling liquidity and providing additional base for the imposition of the inflation tax. Today there seems to be consensus that reserve requirements (which stand today at 19 per cent, after the elimination of the *additional* 20 per cent marginal requirement) should be uniform and should decrease still further.[2] The use of a single rediscount window for the sole purpose of the central bank performing its role of lender of last resort, rather than for controlling liquidity, seems also to be compatible with the program of reforms of the financial system.

In terms of desirability, the flexibility and resource allocation neutrality of open market operations are powerful arguments. In a recent

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[1] Of course, both required reserve requirements and a rediscount facilities should exist, the first as an instrument to insure a minimum of liquidity and the second for the central bank performing as a "lender of last resort". What is inefficient is their use for the purpose of short-term control of liquidity.

[2] How much lower the "appropriate" level of required reserves should be is not something that can be determined *a priori*. One reference level is, of course, the level of "technical reserves" that on the basis of actuarial calculation would be sufficient to provide sufficient liquidity under "normal" conditions --i.e., in the absence of massive runs.

report[3] it has indeed been proposed that a "market for reserves", or open market operations, be initiated with the double purpose of conducting monetary policy and providing, during the gradual process of interest rate liberalization, a "reference rate" in relation to which the controlled bank rates would be set.[4] The idea is to allow operations that would determine a true freely determined market rate (the "reference rate"), and use this rate for adjusting the level of controlled banking rates. If the adjustment is made by a periodic adjustment of controlled banking rates proportional to the difference between the reference rate and the latter, the factor of proportionality would represent the speed of the adjustment towards total liberalization. The advantage of such procedure is, first, that the information provided by the free market determined reference rate (for example, market expectations) would be used to guide the direction of the adjustment --rather than using predictions by the policy makers. Secondly, if the procedure is made public, the market would possess a clear guide as to the future course of policy.

In terms of possibilities, two relevant questions are institutional capacity and the availability of instruments. Concerning the former, technical assistance would undoubtedly be required, but the initial impression after interviews with personnel at the BCR is that most technicians at the institution are receptive and enthusiastic; indeed, the newly formed unit of Monetary Operations seems to be ideally suited for the task. The more involved question of the existence of instruments is taken up in what follows.

If open market operations are to be the principal tool of short-term liquidity management and of longer term changes in the monetary base, both the existence and the quantity of proper instruments is a concern. Traditionally, in developed countries where open market operations have for many years been the tool of monetary intervention, those operations are performed by the sale and/or purchase of short-term government obligations, such as Treasury Bills. There is no reason, though, why not longer term instruments issued by the treasury or instruments issued by the central banks could not be used. As of June of 1990, according to information from the BCR (Departamento de Valores), the following instruments were outstanding, issued

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[3] *Interest Rate Policy in El Salvador*, L.Auernheimer and J.C.Protasi, IMCC, January 1991 (Report prepared for the US Agency on International Development).

[4] In the proposal of the report, this market would be open to institutions other than commercial banks, such as pension funds, insurance companies and even private individuals through brokers.

by either the central government or the central bank.

Issued by the Central Government:

- Bonos de Conversión y Consolidación de la Deuda Pública Interna Directa Serie "A" (14%), redeemable in 1999, with a circulation of 464 million colones;

- Bonos de Conversión y Consolidación de la Deuda Pública Interna Directa Serie "B" (2, 4 and 6%), redeemable in 2019, with a circulation of 3,278 million colones;

- Bonos Industria Azucarera Serie "B" (9%), with a circulation of 53 million colones;

- Bonos Industria Azucarera Serie "C" (9%), with a circulation of 6.1 million colones.

With the exception of the second, which is in the hands of the BCR, all these instruments are in the hands of commercial banks, insurance companies and the public. Some of they are "nominatives", i.e., non easily transferable, but this can be changed. In addition, there is a variety of instruments not issued by the Central Government, but guaranteed by it. The most important group are the Agrarian Reform Bonds, at 6% interest, redeemable in 2019, with a total circulation of over 500 million colones, of which only 77 million colones are held by the BCR.

Issued by the Central Bank of Reserve:

- Bonos de Estabilización Financiera (BEF's) (19%), with a circulation of 436 million colones;

- Bonos de Estabilización Financiera (BEF's) (10%), with a circulation of 590,000 colones.

All these instruments could potentially be used in open market operations. One question, mentioned before, is whether they are in sufficient number not only for the short-term management of liquidity but also for the long-term compatible with the nominal monetary base required for the growth of the *real* base as the economy grows. At the current level of the base, for example, an annual 5 per cent growth would require the absorption, by the BCR, in the first year, of approximately 230 million colones --an important magnitude vis-à-vis the stocks in circulation outside the BCR reported above. It should be kept in mind, though, that bonds issued by the Central Government are likely to increase *pari passu* with the monetary base. The question of whether that happens or not is a fundamental one, namely, who will acquire the benefits of the positive seigniorage, or the revenues from "money creation" compatible with price stability when the economy grows.

V.2.- Capital Market Development

As in most other "less developed" countries, an active informal capital market exists in El Salvador, and private brokers actively intermediate in all the instruments reported above. Also as in most other countries, private instruments are restricted mainly due to the inadequacy of established effective ways to enforce contracts at low costs, and/or lack of adequate "prudential regulation" concerning, for example, the activities of corporations. As seen in the case of Costa Rica, for example, the establishment of a "Mercado de Valores" has not been sufficient for a high volume of privately issued shares or bonds. In the case of El Salvador, trade in shares is minimal, as is likely to remain low even with the establishment of a formal market, as both supply and demand are restricted (the supply, because of the "family" structure of many corporations; the demand, because of lack of sufficient and effective overseeing of corporations that would make a public offering of shares). In the case of bonds, demand is also restricted, the former due to the costs of enforcing contracts. A typical counterexample is the recent surge of an active market in short-term promisory notes (up to 90 days) by large corporations, a case in which the low enforcement cost seems to be an important factor.

There is an active movement in El Salvador for the establishment of a "Bolsa de Valores" (BV)[5] Legislation has been drafted, and a project on tax treatment is under revision at the BCR. A natural question, in light of the considerations in the previous paragraph, is whether the project should be supported. The answer would seem to be in the affirmative, given the overall reforms in the rest of the financial sector and on interest rates, which should eliminate some of the obstacles for a more active movilization of resources. For some time the volume of shares transacted, as well as private paper, should be expected to be small, but the active informal market in instruments issued and/or guaranteed by the public sector could quickly be transferred to a more transparent market.

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[5] A Bolsa de Valores in fact existed between 1965 and 1974, but disappeared given the very low volume of transactions.

VI.- TAXATION IN FINANCIAL MARKETS

Main characteristics of the tax system relevant for financial markets in El Salvador can be summarized as follows.

• There is, as in many countries, a double taxation on dividends, subject to both the corporation and the personal income tax. Income tax on corporations is progressive, with marginal rates of 10, 20 and 30 per cent. Of course, a progressive income tax on corporate earnings can result in a *regressive* final structure of total personal taxation. A 22 per cent rate is applied to those resident abroad, and 38 per cent when operating through branches. The personal income tax proceeds at marginal rates ranging from 10 to 50 per cent for taxable income over 250,000 colones (about 31,500 U$S).

• Exempt from income taxes are the interest from instruments issued or guaranteed by the public sector, from bank deposits, from foreign assets when the foreign exchange is negotiated through national banks, and "cédulas hipotecarias".

• Both corporations and individuals are subject to a tax on net worth (impuesto al patrimonio neto), with two rates of .5 and 2 per cent. Exempted from the tax are deposits in national credit institutions, shares and Agrarian Reform bonds, as well as bonds issued or guaranteed by Government.

• Not only the interest of instruments issued or guaranteed by the public sector are exempted from the income tax, but all of them, with minor differences, are also exempted of inheritance taxes, net worth tax and "timbres". In many cases it is even stated that they are "exempted from any current tax or any tax to be established in the future". In most cases their coupons on due interest are accepted at face value for all or some taxes.

• A potential problem particularly relevant to financial markets is the "duality" existing between operations at commercial banks and the rest of the market. The former are exempted of "timbre" taxes, deposits exempted from the net worth and capital gains taxes, and interest on those deposits exempted from income taxes. A proposal is under consideration at the Central Reserve Bank exists to grant the same exemptions to instruments negociated through the Bolsa de Valores and properly registered. There are two observations concerning this proposal. The first is whether more exemptions should be granted, rather than working through a uniform treatment. In this case the answer depends on a second-best argument, i.e., whether the preexistence of exemptions for the banking system justifies the granting of one more exemption in a sector that can be seen as a strong substitute. The outcome of the proposal is likely to be the granting of the exemptions for as long as exemptions to banking operations are not eliminated. The second observation is the danger of fictitious registrations at the Bolsa de Valores, what might conceivable be the bulk of transactions.

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VII.- SUMMARY CONCLUSIONS

In a Macrofinancial report as the background for a detailed study of financial and capital markets, it is useful to summarize the important elements in both global policies that directly or indirectly influence the financial sector (or at least the scenario in which the financial sector performs), and those specific policies dealing with the sector.

In terms of global macroeconomic policies there are three areas which, although very general, are crucial in providing necessary conditions for the functioning of financial markets.

(i) The first area is a reasonable degree of macroeconomic stability, and more specifically, a low and roughly predictable inflation rate. Problems associated with highly variable inflation rates (which has been the case in El Salvador between 1980 and 1990) and their effects on financial markets, are well known: the *ex-post* real interest rate becomes a highly unpredictable magnitude, with all the resulting distortions in resource allocation and, more often than not, reduction in the real level of financial transactions, reflecting borrowers' and lenders' aversion to risk. As discussed in this report, the restrictive monetary policy enacted in 1989 seems so far going in the correct direction.

(ii) The second area is the general area of government controls and intervention in private markets. The specific reason why this is particularly relevant for financial markets is that invariably (and El Salvador has not been an exception until 1989) an important area of intervention concerning resource allocation is the credit market. The central bank, instead of addressing its basic role as caretaker of monetary stability, becomes not only provider of credit, but also in charge of administering selective credit, with different rates for different sectors. Here again the steps taken since 1989, if not always sweeping enough, are correct.

(iii) A third area is the status of the government budget, and the financing of the deficit. Although a high government deficit is not necessarily incompatible with a well functioning financial market, if the deficit becomes important there are two dangerous possibilities. First, the usual expedient is to resort to money creation (i.e., borrowing from the central bank) rather than borrowing from the market, with the resulting increase in inflation. Second, there exists a tendency to first increase the base of the inflation tax paid by financial institutions, via increases in reserve requirements. As it is emphasized in the report, the "size of government" in the case of El Salvador, as measured by the level of government expenditures, is not as high as in other Latin American countries, and the deficit has not been traditional the primary culprit of inflation. But, as it is also emphasized in the report, there are possible scenarios in which the deficit could invite inflationary finance. The correct strategy, rather than a reduction in government expenditures, seems to be a change in the composition of expenditures (from subsidies and defense towards both physical and human capital formation), simultaneously with an increase in the revenue from taxation.

There are three areas of specific action more closely related to the necessary conditions for a well functioning financial market.

(i) The first area is the process of restructuring of the portfolios of banks and other financial institutions, and their re-privatization. This is probably the most crucial area at present, and a discussion of its particulars is beyond the scope of this report. We should only mention two points:

(a) A restructuring of the financial institutions portfolios does not necessarily, and in all cases, seems to be as much a necessary condition for Re-privatization as current policy requires. The sale of institutions in the open market should bring about a selling price which, in the evaluation of competitive markets, reflects the status of performing and non-performing loans in the institutions'portfolios.

(b) The opening of the market to new private institutions (and in particular foreign institutions) could occur even before all institutions now in government hands are privatized.

(ii) The second area is the liberalization of interest rates. As mentioned in the report, the question has been studied somewhere else. Here, we should only stress two points:

(a) First, that as importance as the pace at which this liberalization takes place is the adoption of a rule informing the market not necessarily (or only) about time tables, but about criteria, i.e., the manner in which liberalization is going to take place. Resolutions by the central bank anticipating changes for future dates are of very suspected value, as the market realizes that the fulfillment or not of those targets depend on future events.

(b) Second, that the procedure of setting the controlled nominal interest rates for future periods depending on past inflation

-47

rates is a very inappropriate procedure, as discussed at length in Chapter IV.

(iii) Finally, another specific area is both the formulation of the rules for prudential regulation, and the reorganization of the overseeing agency (the Suprintendencia de Bancos). This is certainly an area in which the specific report on financial and capital markets needs to elaborate, keeping in mind that the importance of such regulations and their enforcement will be particularly crucial during and immediately following the re-privatization process.

44

ANNEX

Table A-1

Gross Domestic Product by Sector of Origin

(In Millions of 1962 Colones)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP at Market Prices	3289	3017	2848	2870	2936	2994	3013	3094	3144	3177	3285
Primary Production	845	791	754	731	755	747	724	739	732	734	790
Agriculture and Rel Sectors	841	787	751	727	751	743	720	735	728	731	785
Mining	3.9	3.8	3.8	3.7	3.8	3.8	3.9	4.4	4.7	4.9	4.5
Secondary Production	803	721	670	687	692	719	737	766	792	811	821
Manufacturing	586	525	481	490	497	515	528	544	560	574	592
Construction	111	94	90	92	87	91	93	104	112	116	101
Utilities	106	102	99	105	108	113	116	118	120	121	128
Services	1642	1503	1420	1452	1489	1526	1551	1588	1620	1629	1673
Transportation and Communic	194	172	161	171	176	179	180	183	187	189	201
Commercial Services	625	532	468	478	487	489	491	498	500	517	534
Financial Services	103	93	98	99	100	103	104	107	109	98	99
Housing	130	134	137	140	142	144	145	148	153	156	160
Public Administration	342	346	356	366	384	411	430	447	463	458	465
Other Services	248	226	200	198	200	200	201	205	208	211	214

(As percentage of total Gross Domestic Product)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP at Market Prices	100	100	100	100	100	100	100	100	100	100	100
Primary Production	25.7	26.2	26.5	25.4	25.7	25.0	24.0	23.9	23.3	23.1	24.0
Agriculture and Rel Sectors	25.6	26.1	26.4	25.3	25.6	24.8	23.9	23.8	23.2	23.0	23.9
Mining	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.1
Secondary Production	24.4	23.9	23.5	23.9	23.6	24.0	24.5	24.8	25.2	25.5	25.0
Manufacturing	17.8	17.4	16.9	17.1	16.9	17.2	17.5	17.6	17.8	18.1	18.0
Construction	3.4	3.1	3.2	3.2	3.0	3.0	3.1	3.4	3.6	3.7	3.1
Utilities	3.2	3.4	3.5	3.7	3.7	3.8	3.9	3.8	3.8	3.8	3.9
Services	49.9	49.8	49.9	50.6	50.7	51.0	51.5	51.3	51.5	51.3	50.9
Transportation and Communic	5.9	5.7	5.7	6.0	6.0	6.0	6.0	5.9	5.9	5.9	6.1
Commercial Services	19.0	17.6	16.4	16.7	16.6	16.3	16.3	16.1	15.9	16.3	16.3
Financial Services	3.1	3.1	3.4	3.4	3.4	3.4	3.5	3.5	3.5	3.1	3.0
Housing	4.0	4.4	4.8	4.9	4.8	4.8	4.8	4.8	4.9	4.9	4.9
Public Administration	10.4	11.5	12.5	12.8	13.1	13.7	14.3	14.4	14.7	14.4	14.2
Other Services	7.5	7.5	7.0	6.9	6.8	6.7	6.7	6.6	6.6	6.6	6.5

45

Table A-2

Real Aggregate Demand and Supply
(In Milliones of 1962 Colones)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990 (estim)
AGGREGATE DEMAND	4167.8	3802.7	3464.3	3566.2	3646.0	3707.5	3706.5	3790.1	3836.7	3912.2	3971.4
Gross Domestic Expend	3330.2	3112.3	2875.9	2868.1	2971.6	3059.4	3140.1	3153.5	3259.9	3436.1	3247.3
Consumption	2918.1	2716.1	2520.1	2542.5	2636.3	2742.8	2755.5	2785.1	2823.3	2848.7	2856.9
private	2495.7	2278.8	2084.6	2113.7	2175.3	2250.6	2244.9	2259.2	2284.3	2316.0	2343.0
public	422.4	437.3	435.5	428.8	461.0	492.2	510.6	525.9	539.0	532.7	513.9
Gross Investment	412.1	396.2	355.8	325.6	335.3	316.6	384.6	368.4	436.6	587.4	390.4
private	189.4	161.3	163.7	178.0	199.4	241.9	285.8	306.8	305.1	318.5	294.9
public	232.9	215.4	175.0	135.5	121.4	111.7	94.3	107.9	125.1	150.7	111.3
Inventory changes	-10.2	19.5	17.1	12.1	14.5	-37.0	4.5	-46.3	6.4	118.2	-15.8
Exports Goods and Serv	837.6	690.4	588.4	698.1	674.4	648.1	566.4	636.6	576.8	476.1	724.1
AGGREGATE SUPPLY	4167.8	3802.6	3464.3	3566.2	3646.0	3707.5	3706.5	3790.1	3836.7	3912.2	3971.4
Imports Goods and Serv	878.5	785.8	616.6	695.8	710.4	713.9	694.0	696.6	692.9	735.2	706.4
Gross domestic product	3289.3	3016.8	2847.7	2870.4	2935.6	2993.6	3012.5	3093.5	3143.8	3177.0	3265.0

As a Percentage of GDP

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990 (estim)
AGGREGATE DEMAND	126.7	126.1	121.7	124.2	124.2	123.8	123.0	122.5	122.0	123.1	121.6
Gross Domestic Expend	101.2	103.2	101.0	99.9	101.2	102.2	104.2	101.9	103.7	108.2	99.5
Consumption	88.7	90.0	88.5	88.6	89.8	91.6	91.5	90.0	89.8	89.7	87.5
private	75.9	75.5	73.2	73.6	74.1	75.2	74.5	73.0	72.7	72.9	71.8
public	12.8	14.5	15.3	14.9	15.7	16.4	16.9	17.0	17.1	16.8	15.7
Gross Investment	12.5	13.1	12.5	11.3	11.4	10.6	12.8	11.9	13.9	18.5	12.0
private	5.8	5.3	5.7	6.2	6.8	8.1	9.5	9.9	9.7	10.0	9.0
public	7.1	7.1	6.1	4.7	4.1	3.7	3.1	3.5	4.0	4.7	3.4
Inventory changes	-0.3	0.6	0.6	0.4	0.5	-1.2	0.1	-1.5	0.2	3.7	-0.5
Exports Goods and Serv	25.5	22.9	20.7	24.3	23.0	21.6	18.8	20.6	18.3	15.0	22.2
AGGREGATE SUPPLY	126.7	126.0	121.7	124.2	124.2	123.8	123.0	122.5	122.0	123.1	121.6
Imports Goods and Serv	26.7	26.0	21.7	24.2	24.2	23.8	23.0	22.5	22.0	23.1	21.6
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Banco Central de Reserva de El Salvador.

Table A-3

Non-Financial Public Sector
(As Percentage of GDP)

	1986	1987	1988	1989	1990 (Estimate)
CONSOLIDATED NON-FINANCIAL PUBLIC SECTOR					
Total Revenue	16.0	13.7	12.1	10.1	10.6
Current	15.9	13.6	12.1	10.1	10.5
Taxes	13.3	10.8	9.2	7.6	7.8
Non-Tax	2.3	2.3	2.3	2.0	2.1
Surplus Public Enterprises	0.3	0.5	0.6	0.5	0.6
Capital Revenue	0.1	0.1	----	----	----
Total Expenditure and Net Lending	20.4	16.5	16.4	16.0	13.5
Current Expenditures	14.5	13.7	12.5	11.7	10.8
Capital Expenditures	5.7	2.7	3.7	4.0	2.6
Capital Formation	5.2	2.4	3.6	3.9	2.4
Transfers	0.5	0.3	0.1	0.1	0.2
Net Lending	0.2	0.1	0.2	0.3	----
Current Account Balance	1.4	-0.2	-0.5	-1.6	-0.3
Overall Deficit Before Grants	4.4	2.8	4.4	5.9	2.9
Official Grants	2.0	3.1	1.8	1.9	2.0
Overall Deficit (-) or Surplus (+)	-2.4	0.3	-2.6	-4.0	-0.9
External Financing	1.3	0.8	1.0	1.6	2.5
Internal Financing	1.1	-1.1	1.5	2.4	-1.6
Banking system	-1.4	0.2	-1.6	3.3	-0.1
Non-Bank Financing	0.2	-0.1	-0.3	0.2	-0.1
Floating Debt	3.9	----	1.0	1.0	-0.8
Residual	-1.6	-1.2	2.4	-2.1	-0.6
CENTRAL GOVERNMENT					
Total Revenue	14.6	11.4	10.2	8.2	8.4
Current	14.6	11.4	10.2	8.2	8.3
Taxes	13.3	10.8	9.2	7.6	7.8
Non-Tax	0.6	0.5	0.6	0.5	0.5
Surplus Public Enterprises	0.7	0.1	0.4	0.1	----
Capital Revenue	----	----	----	----	----
Total Expenditure and Net Lending	19.4	15.2	14.6	13.1	11.4
Current expenditure	13.6	12.1	11.5	10.5	9.5
Wages and salaries	7.9	7.7	6.8	6.5	5.8
Goods and services	2.0	1.8	1.9	1.5	1.0
Interest payments	1.3	1.0	0.9	0.9	1.0
Transfers	2.4	1.6	1.9	1.7	1.7
Capital expenditures	4.8	2.5	2.9	2.3	1.9
Net lending	1.0	0.6	0.2	0.3	----
Current Account Balance	0.9	-0.7	-1.3	-2.3	-1.2
Overall Deficit Before Grants	4.8	3.7	4.4	4.9	3.1
Official Grants	1.6	2.9	1.7	1.8	1.9
Overall Deficit (-) or Surplus (+)	-3.2	-0.8	-2.7	-3.1	-1.2
External Financing	1.5	1.0	0.7	0.6	2.1
Internal Financing	1.7	-0.2	2.0	2.5	-1.0
Banking system	-0.9	0.7	-0.6	3.1	0.4
Non-Bank Financing	0.1	----	----	----	-0.1
Floating Debt	3.9	----	1.0	1.0	-0.8
Residual	-1.4	-0.9	1.5	-1.6	-0.5

Sources: Banco Central de Reserva de El Salvador and IMF estimates.

-47

- Annex - 4 -

Table A-4

OPERATIONS OF THE BANKING SYSTEM

	1985	1986	1987	1988	1989	1990	(1990 minus 1989)	% Change
	CENTRAL RESERVE BANK (BCR) (In Millions of Colones)							
Net Foreign Assets	49.0	1208.2	1960.2	1679.5	1972.0	2898.4	926.4	0.470
Net Domestic Assets	4149.0	4900.4	5088.3	5634.9	6547.4	6526.2	-21.3	-0.003
Domestic Credit	3893.2	3513.0	3960.8	4349.9	5458.2	5708.4	250.2	0.046
Central Government	1634.5	1333.3	1417.3	1324.4	2212.8	3784.5	1571.7	0.710
Rest of Public Sector	378.8	382.2	415.4	462.9	-139.9	-812.5	-672.6	4.809
INCAFE/INAZUCAR	437.7	408.0	469.3	671.8	591.8	51.8	-540.0	-0.912
Private Sector	97.5	64.0	54.9	6.7	0.0	0.0	0.0	0.000
Banks	1021.0	957.3	1237.5	1450.8	2315.5	2249.0	-66.5	-0.029
Financial Institutions	323.7	368.2	366.4	433.4	477.9	435.6	-42.3	-0.089
Capital and Reserves	-329.9	-340.7	-351.7	-365.4	-385.8	-1190.1	-804.3	2.085
Other Net Assets	585.8	1728.1	1479.3	1650.3	1475.1	2007.9	532.8	0.361
Government Trust Funds	221.0	452.1	1368.7	1517.7	2088.7	1317.9	-770.8	-0.369
Medium & Long Term Foreign	1947.7	3577.3	3098.6	2774.4	3091.8	3199.5	121.3	0.043
Liab to Commercial Banks	902.3	839.2	1195.5	1596.2	1541.1	2872.5	1331.4	0.864
Liab to Financial Institut	32.5	38.0	55.9	74.3	54.8	135.1	80.3	1.467
Liabilities Private Sector	1094.5	1202.0	1329.8	1351.8	1743.0	1899.6	156.6	0.090
Currency in Circulation	1079.8	1156.5	1298.0	1326.2	1727.1	1856.3	129.2	0.075
Other	14.7	45.5	31.8	25.6	15.9	43.3	27.4	1.723
	COMMERCIAL BANKS AND BANCO HIPOTECARIO							
Net International Assets	429.6	584.0	527.2	349.3	255.5	561.6	306.1	1.198
Reserves	902.3	839.2	1195.5	1596.2	1541.1	2872.5	1331.4	0.864
Net Domestic Assets	4005.3	5310.5	5561.3	6509.1	7820.6	8474.7	654.1	0.084
Domestic Credit	3873.3	4831.8	5295.2	5786.1	5960.4	7229.3	1268.9	0.213
Central Government	181.0	295.6	353.9	261.0	356.2	298.3	-57.9	-0.163
Rest Public Sector	-285.1	-380.0	-504.8	-539.3	-309.6	-414.2	-104.6	0.338
Private Sector	3977.4	4916.2	5346.1	6064.4	5913.8	7345.2	1431.4	0.242
Official Capital and Reserv	-151.4	-152.4	-151.5	-240.3	-274.8	-274.8	0.0	0.000
Others	283.4	631.1	517.6	963.3	2135.0	1520.2	-614.8	-0.288
Medium & Lont Term Liabil	4.6	18.2	9.0	3.2	1.7	1.3	-0.4	-0.246
Financial Institutions	309.0	620.5	690.6	732.9	688.4	849.2	160.8	0.234
Credit BCR	1021.0	957.3	1237.5	1450.8	2315.5	2249.0	-66.5	-0.029
Liabilities Private Sector	4002.5	5137.6	5347.0	6267.7	6611.6	8809.3	2197.7	0.332
Sight Deposits	1059.2	1419.7	1246.5	1411.1	1426.5	2006.9	580.4	0.407
Savings & Time Deposits	2659.1	3320.6	3608.6	4084.0	4468.6	5885.7	1417.1	0.317
In Foreign Exchange	43.0	172.0	254.1	438.4	339.9	579.6	239.7	0.705
Cedulas Hipotecarias	153.7	134.4	124.8	125.8	158.3	122.1	-36.2	-0.229
Others	87.5	90.9	113.0	208.4	218.3	215.0	-3.3	-0.015
	BANKING SYSTEM							
Net International Reserves	479	1792	2487	2029	2228	3460	1232.5	0.553
Net Domestic Assets	7133	9254	9412	10693	12053	12752	699.3	0.058
Domestic Credit	6745	7387	7918	8685	9103	10689	1585.6	0.174
Central Government	1815	1629	1771	1585	2569	4082	1513.8	0.589
Rest of Public Sector	94	2	-89	-76	-449	-1227	-777.2	1.729
INCAFE/INAZUCAR	438	408	469	672	592	52	-540.0	-0.912
Private Sector	4075	4980	5401	6071	5914	7345	1431.4	0.242
Financial Institutions	324	368	366	433	478	436	-42.3	-0.089
Capital and Reserves	-481	-493	-503	-606	-661	-1465	-804.3	1.218
Others	869	2359	1997	2614	3610	3528	-82.0	-0.023
Government Funds	221	452	1369	1518	2089	1318	-770.8	-0.369
Medium & Long Term Liabil	1952	3596	3108	2778	3094	3201	120.9	0.043
Financial Institutions	342	659	747	807	743	984	241.1	0.324
Liabilities to Private Sect	5097	6340	6677	7620	8355	10709	2354.3	0.282
Money (M1)	2144.0	2584.7	2551.0	2742.7	3163.4	3869.6	706.2	0.223
Currency in Circulat	1079.8	1156.5	1298.0	1326.2	1727.1	1856.3	129.2	0.075
Sight Deposits	1064.2	1428.2	1253.0	1416.5	1436.3	2013.3	577.0	0.402
Savings & Time Deposits	2659.1	3320.6	3608.6	4084.0	4468.6	5885.7	1417.1	0.317
Deposits in Foreign Exch	43.0	172.0	254.1	438.4	339.9	579.6	239.7	0.705
Others	250.9	262.3	263.1	354.4	382.7	374.0	-8.7	-0.023

Source: Banco Central de la Reserva, and AID estimates.