TRIP REPORT FROM EL SALVADOR

Arnold C. Harberger

University of California, Los Angeles

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My recent trip to El Salvador spanned the period 29 April-5 May 2007. My base during this period was in the offices of USAID, but more than half my time was spent on meetings elsewhere -- in the offices of FUSADES, in the meeting rooms of the Radisson Hotel, in the Central Bank, at the UNDP headquarters in San Salvador, at the offices and lecture halls of ESEN, etc. Most of my time in these meetings was spent receiving orientation concerning the recent history and present state of the Salvadoran economy. The purpose of these briefings was to give me as good and up-to-date information base as possible, for the major presentation that took place on Wednesday, 2 May, at a meeting sponsored by USAID and FUSADES. My remarks at that meeting are summarized in a separate document, “Observations on the Salvadoran Economy”, and will not be repeated here.

In this document I present some further, more informal impressions, plus some remarks on a few topics not covered in “Observations”. The absolutely first thing to say about my trip was the general impression of economic prosperity that one gets upon arriving in the country. Automobiles clog the streets more than ever before, and one is surprised to see how many of them are new or of very recent vintage. The stores and shopping centers are well stocked with goods from all over the world, and are well populated with shoppers. Restaurants abound, and appear to be prospering. My hotel was bustling with guests, meetings, conventions, etc.

All this is easy to understand once one takes into account the great importance of remittances. Broadly speaking, the receipt of remittances becomes “effective” for the economy only when that receipt leads to an excess of total spending over total production. That phenomenon, in turn, carries with it the signs of prosperity that one was observing.

One phenomenon that is worth noting is that real wages apparently have not risen very much, in spite of El Salvador's prosperity. One can only speculate about the economic forces underlying this -- but one thing seems very clear. The flood of migration from Guatemala, Honduras and Nicaragua into El Salvador has approximately matched the flood of Salvadorans to the United States. Hence the tightness of the labor market that we would expect from such a big exodus simply did not appear -- the outflow being substantially offset by the new inflow of people. Add to this the downward pressure on low-end manufactures stemming from the huge surge of Chinese and other Asian exports of this type (see the section on "The China Syndrome in my "Observations" paper), and you probably are getting pretty well along in explaining the sluggishness of unskilled and semi-skilled wages in El Salvador.

It is interesting to speculate on exactly what groups are hardest hit by the whole congeries of recent developments. My own best guess would be that Salvadoran low-income families who are not recipients of remittances from abroad would constitute one big category. Perhaps one would find another among the immigrant workers from the rest of Central America -- though these people are probably significantly better off than they were back home, say, in Guatemala or Honduras.

Political Uncertainty

One of the principal brakes on the growth process in El Salvador in recent years has been the element of political uncertainty. By this I do not mean uncertainty concerning which party will win the next election. One finds that type of uncertainty in almost every successful modern democracy. The uncertainty to which I refer is uncertainty about whether the framework of laws, regulations, enforcement procedures, etc., under which an economy is currently operating will, as a result of the next election, be totally overturned or at the very least undergo major negative change.

I have for a number of years made a major effort to recognize and praise the left-wing parties of a growing number of countries, as those parties one after another abandoned their old platforms (reflecting varying degrees of collectivism and populism) and made strong moves to embrace the policy lessons that economic science has to offer. Felipe Gonzales in Spain, Bob Hawke in Australia, Carlos Menem in Argentina, Tony Blair in England, and a string of concertacion presidents (Aylwin, Frei, Lagos, and Bachelet) in Chile are excellent representatives of the type of transition I am referring to. Basically their move has been to embrace rather than fight the market economy. Their thought has been to allow the process of growth to flourish rather than placing impediments in its path.

The problem in El Salvador lies apparently with the FMLN. Strangely, when they were belligerents in the country's civil strife, they appear to have had the sympathy of a number of competent professional economists. What appears to have happened is that after renouncing belligerency and becoming a political party, they have shunned the advice of these economists, even to the point of expelling some (all?) of them from their ranks.

The result is an FMLN organization that is more ideological in its positions, less heedful of the lessons of economics, and obviously more of a danger, as perceived by those contemplating investments in the country. The problem is one of great worry and heightened uncertainty for these investors (foreigners and Salvadorans alike). Not knowing what a victorious FMLN would do, after the next elections, investors chose to limit the amounts of capital they were willing to commit to the country. This accounts for the low rate of investment that we see in El Salvador. Indirectly, it may also account for the high rate of return on capital that has prevailed in the country for quite some time. Clearly, if the rate of investment had been significantly higher over the past ten or fifteen years, El Salvador's capital stock would be a lot larger today. This would have given rise to a lower equilibrium real rate of return on this capital stock.

The Rate of Return to Capital

In the meeting with representatives of the Economics Ministry, the main presentation was done by Juan Carlos Rivas. In addition to giving a panoramic view of the income and outlays of the government and of key demographic and social indicators, he brought to the table a significant updating of earlier work on the nation's real stock of reproducible capital, and on its estimated rate of return. I believe this work is an important contribution to the understanding of the Salvadoran economy; thus I will present a synoptic version here.

As background, I can report on the results of a study that I did, in 1993, of the rate of return in what I called the "reduced private sector". This sector was defined as the whole economy, minus the government sector, minus the residential housing sector. It had a real rate of return of a little over 20% in the early 1970s. This dropped to about 17% in the middle 1970s, then fell to 6-7% as the civil conflict erupted. By the late 1980s, however, it was up around 20% once again, and with the arrival of peace it boomed to over 30% in the early 1990s. A later study by Juan Carlos Rivas followed up on my work. He found that this "reduced private sector" rate of return stayed above 30% up through 1996.

A later study by the Economy Ministry measures the rate of return to all capital in the economy (including infrastructure capital and housing). This rate of return was reported at around 20% in the late 1990s, declining to a little over 17% in the period 2001-2003. I attempted a rough calculation of the rate of return to capital in the "reduced private sector", using data from the Economy Ministry study and other sources. On this basis I obtained a real rate of return of close to 25% for the "reduced private sector" for the most recent years that were covered.

Readers should not place much weight on this particular number. The time is ripe for a very careful study of capital and the rate of return, so as to improve our understanding of the entire capital market situation of El Salvador. The main point that I would like to emphasize here is that the observed real rate of return to capital remains high in El Salvador, in spite of its high degree of integration with the world capital market and in spite of the package of liberalizing reforms that have been put into place over the past 15 years or so. One contributing factor that helps explain this high rate of return is the political uncertainty that potential investors perceive and undoubtedly take into account as they make their investment decisions; indeed, often decide not to invest because of the perceived uncertainty. Dare one hope for a "conversion" of the leadership of El Salvador's political opposition to an embrace of sound economic principles, even as they promise such items as better education, better health care, and greater opportunity for those in the lower socioeconomic strata?

A Note On Dollarization

The subject of dollarization is not an easy one. To begin with, readers should recognize that it can be good for some countries and not for others, and that within any one country it can be good during some periods and problematical during others.

Before entering into details, let me state at the outset that I believe that up to now El Salvador has only reaped benefits from its decision to dollarize. It is clear that interest rates have moved downward -- close to international levels -- as a result of dollarization. This stems from international and Salvadoran investors perceiving much lower country risk (and effectively zero currency risk). [[[Question: do you want to note here that the decline in country risk counteracts to some extent the high political risk you discuss in the section above as the reason for low rates of private investment and consequent continued high return to private capital?]]] As a consequence, more outside money has come to the Salvadoran capital market, and less Salvadoran money has diversified into foreign accounts and holdings, than would have been the case without dollarization. As a consequence it is likely that investment in this country has been a point or two higher than it would have been, causing the average growth rate in the post-dollarization period to be perhaps as much as a half a point higher than it might have been without the dollarizing move.

These good words about dollarization can easily lead readers to think that it might well be good for everybody, everywhere and all the time. But that is not the case. It all goes back to the endless debate between proponents of fixed and advocates of flexible exchange rate systems. There are good arguments for both sides and against both sides, and there are certainly many real-world situations in which a country could opt for either system without much cost.

In the traditional debate proponents of fixed exchange rates argued that the discipline of such a system was a useful safeguard operating to dampen the temptation of policymakers to follow an inflationary course. (This assumes, of course, that inflation is kept under control in the country [e.g., the U.S.] to whose currency the peg is attached.) Here the evidence is clear from the experience of the Central American countries, and of countries in Africa and Asia that maintained ties to the British pound or the French franc. In general, during the periods in which fixed exchange rates were successfully maintained, these countries' inflations stayed low -- pretty much following the rate of world inflation as reflected through their partner currency. A disadvantage of fixed exchange rates comes from the difficulty of the authorities to deal with speculative attacks and other situations that call for devaluation of the currency. It is hard to tell when a devaluation is in fact called for by the underlying circumstances; fixed-rate authorities must in any case steadfastly deny any consideration of the alternative of devaluation, even up to the very last minute. Meantime, speculators reading the evidence can start to bet on devaluation, leading to a run on the currency that will always be hard, often impossible to stop. The tighter is the "fix" in a fixed-rate system, the smaller becomes the risk connected with capital flight and speculative attacks. Thus, from this point of view a currency board (in which in principle the only financial asset held by the board [or Central Bank] is the partner currency) is better than just a plain fixed exchange rate, and, of course, dollarization (or its equivalent for Euros or pounds) is even better. But these systems lose out in circumstances where a devaluation is really the best policy option.

What is the alternative to devaluation when the fix cannot be broken? Standard economics tells us that price deflation will accomplish the same goal. A huge drop in the world price of a major export like oil or copper, or a quick reversal of a big inflow of capital (say because of the results of an election, or the prospect of a particular electoral outcome) -- both these events can easily call for the real exchange rate to depreciate by 50%. If we define that rate as $E\bar{p}^*/\bar{p}_d$, where E is colones per dollar, $\bar{p}^*$ is the world price index of tradable goods (measured in dollars) and $\bar{p}_d$ is the general price level of the country concerned, one can think of the needed adjustment to be an upward move (depreciation) of that real exchange rate. If the rate is flexible, E can readily move from 5 to 7.5 colones per dollar, thus accomplishing most of the task. But under a hard fix of the exchange rate, the general price level of the country would have to go down from, say, index 100 to index 66.7. There is no case of any such adjustment having been successfully accomplished under a fixed-rate system; except perhaps in times of substantial world inflation, when the increase of $(\bar{p}^*/\bar{p}_d)$ was accomplished mainly through a rising $\bar{p}^*$.

Three important episodes for which serious deflationary adjustment was allowed to proceed under fixed exchange rates were: a) the United Kingdom in the 1920s, b) Chile in 1981-82 and c) Argentina in the years leading up to its major currency crisis of 2001-02. In each of these cases the economy suffered through a spate of serious economic depression, and in each of these cases the end result was in any case a devaluation of the nominal exchange rate. The reason why there are few examples of long and painful suffering while adjustment is being made to a major negative balance-of-payments shock, is that most countries do not wait as long as the U.K. or Argentina, before they devalue, nor do they permit the unemployment rate to reach 25% or more (as it did in Chile) before biting the bullet and opting for devaluation.

To my mind this disadvantage of fixed exchange rate systems is real and ever present. But different countries face very different odds of it happening. Panama, the standard bearer for dollarization in this hemisphere, is a wonderful example. Its major source of foreign exchange revenue has from the very beginning been connected with the Panama Canal. And I'd be surprised if there is any country in the world that faces a lower probability than Panama, of a major decline in its regular flow of foreign exchange earnings. It is as if Panama had from the beginning been vaccinated against a major negative balance-of-payments shock.

El Salvador is not in the situation of Panama. Back when coffee was its major source of foreign exchange earnings, it was quite in the opposite category, being highly vulnerable to a sharp fall in the world price of coffee. To some degree that vulnerability still exists, but to a much lesser degree owing to the huge decline in the relative importance of coffee as a source of foreign exchange. To my mind, the whole panorama has changed dramatically with the huge rise in the importance of emigrant remittances. I have argued[1] that these are unlikely to fall substantially, in any short period of time. Thus, quite fortuitously, the flood of remesas has reinforced the positive benefits of dollarization and reduced its major vulnerability. At this level of observation, the decision to dollarize seems to have been a good one, not only looking at the experience up to now (which is clearly positive) but also looking to the future and taking due account of potential downside risks.

[1]See my “Observations in the Salvadoran Economy,” USAID (June, 2007).