Euler Hermes Economic Research

Country Report

El Salvador

Beware of external liquidity shortages

General Information

GDP	USD23.787bn (World ranking 99, World Bank 2012)
Population	6.3 million (World ranking 106, World Bank 2012)
Form of state	Republic
Head of government	Salvador Sánchez Cerén (FMLN)
Next elections	2015, legislative

Strengths

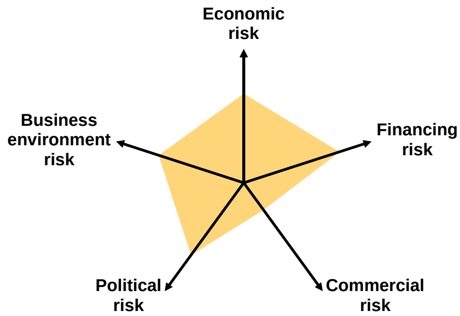
- Inflation is contained
- Government stability
- Good record of structural reforms
- Dollarized economy

Weaknesses

- Sluggish growth prospects over medium to long term
- Fiscal deficit and debt remain high
- Corruption remains prevalent, including in state institutions
- Vulnerable to external shocks because of dollarization of the economy
- High dependence on remittances

Country Rating

B2



Source: Euler Hermes

Trade Structure

By destination / origin (% of total)

Exports		Rank		Imports
United States	45%	1	38%	United States
Guatemala	13%	2	11%	Guatemala
Honduras	9%	3	7%	Mexico
Nicaragua	5%	4	5%	Honduras
Germany	4%	5	5%	China

By product (% of total)

Exports		Rank		Imports
Apparel & clothing	34%	1	17%	Petroleum products
Coffee, tea, cocoa, spices	9%	2	13%	Textile
Sugar and honey	5%	3	4%	Cereals
Misc. manufactures	5%	4	3%	Misc. manufactures
Paper	5%	5	3%	Plastics

Sources: Chelem, UNCTAD (2012)

Economic Overview

Structurally slow growth

El Salvador suffers from structurally low growth rates. The economic recovery after the 2008-2009 crisis has been particularly sluggish when compared to its peers. The average growth over 2010-2013 stands at +1.7%, among the lowest in the region. However, this Central American nation maintains one of the best records for structural reforms (including trade liberalization, improvements in the fiscal system, and privatization of many state holdings), although violence, crime and drug-trafficking remain important challenges.

The activity remained weak in 2013 as real GDP expanded by +1.7% after +1.9% in 2012. The rebound in investment (+9.7%, driven by the renewal of the vehicle fleet of public transport) was not enough to offset the sharp slowdown of private consumption (+0.4% after +2.9% in 2012). Euler Hermes expects however a slight acceleration in household spending in 2014, on the back of increased remittances inflows. Also, investment should continue to show strong growth after the approval in late 2013 of a public-private partnership law and by the launch Fomilenio II, a cooperation program with the United States that aims to support investment, increase growth and reduce poverty. All in all, Euler Hermes expects the economy to grow by +2.2% in 2014 and by +2.5% in 2015.

Consumer prices are anchored by the dollarization of the economy effective since 2001. On average, consumer prices only grew by +0.8% in 2013, after +1.7% in 2012. Higher food prices and an upward adjustment in electricity rates were completely offset by a decrease in prices of services. Notably, the approval of Medicines laws (which regulates medicine prices) triggered a downward on health costs. Inflation rate is expected to stand close to +2% on average in 2014 and 2015.

Weak public finances

Implementing effective measures of fiscal adjustment appear complicated. Despite the consolidation program adopted in early-2013 (which included limiting wage increases and job creation in the public sector), the current expenditure of the government grew by +6.6%, driven by social spending (health and education). Moreover, pension spending continues to weigh heavily on the budget, accounting for around 2% of GDP. On the revenue side, several improvements in tax collection led to an increase of +8% of tax revenues. However, this good performance was partly offset by less foreign donations and lower benefits of public companies, while subsidies on electricity and water continued to be a drag on the budget. All in all, total public revenues grew by +3%. The fiscal deficit narrowed only slightly to -3.7% of GDP (after -3.9% in 2012), but is expected to widen again and reach -4.5% in 2015. New measures of fiscal consolidation

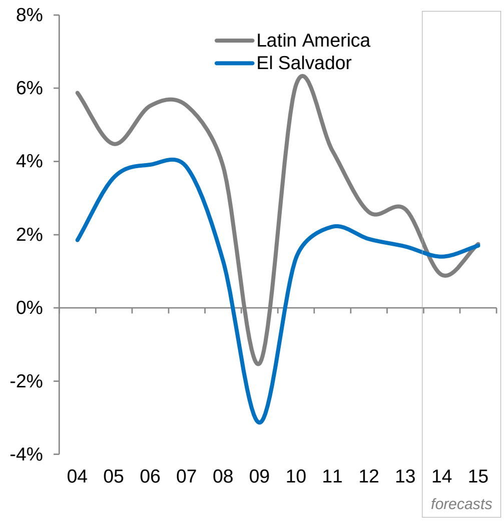
Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	1.9	1.7	2.2	2.5
Inflation (%, yearly average)	1.7	0.8	2.0	1.9
Fiscal balance* (% of GDP)	-3.9	-3.7	-4.2	-4.5
Public debt* (% of GDP)	55.2	55.5	57.5	58.8
Current account (% of GDP)	-5.1	-5.4	-6.2	-6.1
External debt (% of GDP)	55.8	51.9	54.3	56.7

** Central Government*

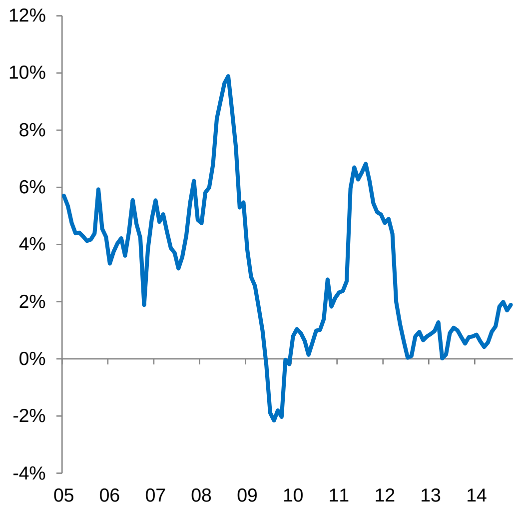
Sources: National sources, IHS, Euler Hermes

GDP growth (%)



Sources: National sources, IHS, Euler Hermes

Inflation rate (y/y, %)



Sources: National sources, IHS, Euler Hermes appear difficult to be adopted as the newly elected President lacks of majority in the congress.

Amidst low growth, it will be hard to bring down high government debt which stands at 57.5% of GDP and is expected to increase in 2015 and 2016. However, the government is in talks to draft a fiscal responsibility rule which would bring total public debt to below 50% of GDP over 10 years.

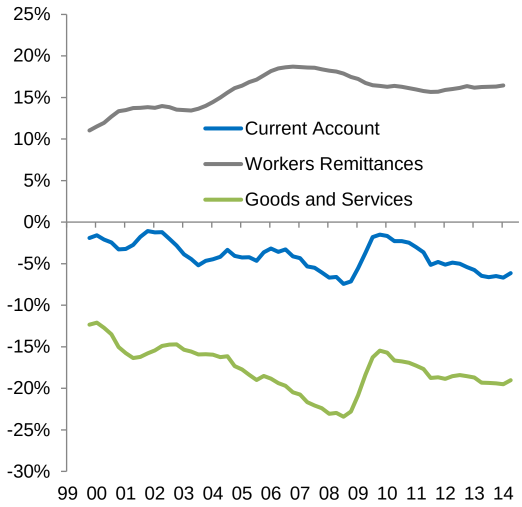
Beware of liquidity shortages

The financial situation is fragile and remains exposed to external shocks and volatility. The huge deficit in the balance of goods and services (-19.4% of GDP in 2013) is only partly offset by workers' remittances inflows (16% of GDP). The current account deficit tallied -5.4% of GDP in 2013 (down from -2.5% in 2010) and is not expected to improve significantly in 2014. Although the economic recovery in the US (45% of exports) should support exports and remittances inflows, the increase of imports should be larger due to ongoing investment projects although slightly eased by the fall in oil prices (oil accounts for 17% of total imports).

Since the economy is dollarized, the amount of liquidity in the economy depends on USD inflows. However, given the persistent external deficit and the relatively low level on FDI inflows (which covered less than 10% of the current account deficit), liquidity tensions cannot be ruled out. Notably, the expected tightening of the monetary policy in the U.S. in coming months could impact negatively liquidity in El Salvador, restricting financing conditions and hampering economic activity. The foreign exchange reserves held by the Central bank have been on a downward trend since 2012 as they have been partly implemented to finance the external deficit. Import cover stands currently at 3.1 months, which is relatively low for the region.

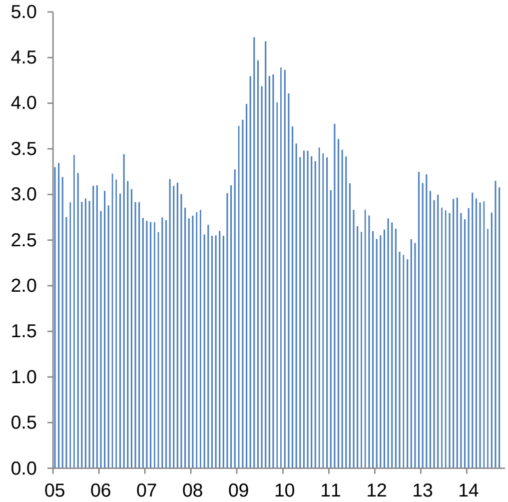
External debt is relatively high as a proportion of GDP (above 50%) and in relation to export earnings as well (192%). The growing public and private foreign debt levels are a source of some concern because they make the country increasingly vulnerable to global financial-market sentiment.

Current account breakdown (% of GDP)



Sources: National sources, IHS, Euler Hermes

Foreign exchange reserves import cover (months)



Sources: National sources, IHS, Euler Hermes

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