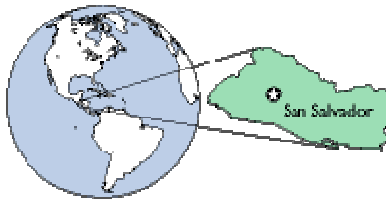


COUNTRY REVIEW

El Salvador



19 November 2009

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EULER HERMES COUNTRY RISK GRADE: B

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Effective transition from civil war to fully functioning democracy that incorporates former rebels.
- A track record of pro-business, market oriented policies.
- Formal dollarisation mitigates inconvertibility risk and is not inappropriate given strong economic linkages with the US.
- Adequate banking system.
- Above average Structural Business Environment.

Weaknesses

- Political system remains polarised between right-wing Arena party and left-wing FMLN—can complicate policymaking and with left-wing now in power some risk of radicalisation.
- Heavy reliance on a narrow base of export earnings—coffee, maquila and workers remittances—and dependence on US business cycle.
- Relatively low growth of real GDP per capita.
- Relatively low proportion of current account covered by FDI.
- High public and external debt-GDP ratios.

Country Risk Assessment

Ratings	El Salvador		Median Grade B	Costa Rica	Peers	
	Latest	Previous			Namibia	Uruguay
Systemic Political Risk:	P3+	P2-	P2-	P2+	P2-	P2+
Systemic Economic Risk:	E4	E4	E4	E4	E4	E4
ME rating:	ME4	ME4	ME4	ME4	ME4	ME4
<i>Structure</i>	4.2	3.3	5.0	2.3	6.0	4.0
<i>Policy</i>	3.8	2.9	4.0	5.8	6.0	5.6
<i>Solvency</i>	3.8	3.8	2.5	1.3	1.0	3.8
<i>External Liquidity</i>	4.2	4.8	3.7	4.8	2.3	3.2
SBE rating:	SBE3	SBE3	SBE3	SBE3	SBE3	SBE3
COUNTRY GRADE:	B	B	B	B	B	B

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	San Salvador
Population:	6.13 mn (2008)
GDP:	USD 22115 mn (2008)
Currency:	US Dollar
Form of state:	Republic
Head of government:	President Mauricio Funes
Next elections:	2014

Major Industries (% of GDP at market prices, 2008)

Agriculture, forestry & fishing	12.7%
Manufacturing	21.4%
Utilities	2.0%
Construction	4.1%
Services	59.9%

Global Assumptions

	2009	2010
Real GDP grth (% yr/yr) *	-3.9	0.9
Inflation (% , av) *	-0.1	1.3
Dated Brent (USD/b)	61	72
* Major economies		

Main Exports (% of total, 2008)

Traditional	7.4%
Coffee & products	5.7%
Sugar	1.7%
Non-traditional	50.3%
Maquila	42.4%

Main Imports (% of total, 2008)

Consumption goods	30.5%
Intermediate goods	42.6%
Capital goods	13.7%
Maquila	13.1%

Lead Export Markets (% of total exports, 2007)

US	51.0%
Guatemala	13.6%
Honduras	11.2%
Nicaragua	5.5%

Lead Import Markets (% of total imports, 2007)

US	35.7%
Mexico	9.8%
Guatemala	8.6%
China	4.7%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	18,654	20,373	22,115	21,385	22,240
Population (mn)	6.08	6.11	6.13	6.15	6.17
GDP per capita (USD)	3,068	3,334	3,608	3,477	3,605
Real GDP growth (% yr/yr)	4.2	4.7	2.5	-2.5	2.0
Inflation (% , eop)	4.9	4.9	5.5	-1.0	2.0
Fiscal balance (% of GDP)	-1.1	-0.3	-1.0	-4.0	-3.3
Current account balance (% of GDP)	-3.6	-5.8	-7.2	-1.2	-3.3
External debt/GDP (%)	55.0	48.1	48.3	51.6	51.4
External debt/Exports of goods & services (%)	117.5	104.9	106.7	127.6	122.1
Interest payments/Exports of goods & services (%)	9.6	8.7	6.7	7.8	6.6
Foreign exchange reserves (USD mn)	1,815	2,110	2,443	2,750	2,750
Import cover (months)	2.5	2.6	2.7	4.1	3.5
Exchange rate assumption	USD is currency				
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Overall stability has been good since the end of a 12-year civil war in 1992 and the risk of a return to armed conflict is low, although there remains a strong right/left split and the centre has not gained sufficient critical mass to break down this polarity. Nonetheless, El Salvador has moved successfully from military state to parliamentary democracy, absorbing into the democratic process the political incarnation of the former rebel groups—the left-wing Frente Farabundo Marti para la Liberacion Nacional (FMLN)—which has become one of the two main political parties. There have been three presidential and five legislative elections since 1992.

The conservative, right-wing Alianza Republicana Nacionalista (Arena) held the presidency continuously from 1989 until elections in March 2009, which were won by Mauricio Funes of FMLN. President Funes was elected as a moderate, but it remains to be seen if he can resist the pressure from the more radical left-wing of his party. However, FMLN with 35 out of 84 seats does not have a working majority in congress, which should limit more radical legislation—though it could also complicate the passage of any legislation in this term—and the necessary two-thirds majority for constitutional change will be difficult. Nonetheless, there are clear precedents elsewhere in the region of presidents adopting a more radical left stance as the term progresses followed by attempts to change the constitution via referendum. This is a risk, though the most likely scenario is that the strength of the opposition will require a balance nearer the centre, limiting any leftward lurch, at least in the near-term. The rise in violent crime also remains a serious concern.

In the near-term the authorities have adopted a pragmatic policy approach recognising the need to prioritise economic stability with the early adoption in the global crisis of a 15-month IMF stand-by programme in January 2009, which was extended to a USD800mn three-year programme in September 2009. President Funes has also committed to maintain dollarization and to pay the public debt.

Internationally, although the Funes administration has re-established ties with Cuba and will probably move closer to Venezuela particularly with the US, the President has committed to maintain existing trade agreements. El Salvador was the first country to implement the US-Central American Free Trade Agreement (DR-CAFTA). Also with workers remittances so important to the economy and most of the workers located in the US, the government has a strong incentive in the near-term at least to attempt a balance between the US and Venezuela.

Economic Stability

The economy is heavily dependent on traditional primary commodity exports (coffee and sugar) the maquila sector (imports assembled into added value products for re-export) and remittances from workers abroad. Remittances, mainly from workers in the US, have become increasingly important and in 2008 were the equivalent of 17% of GDP and 37% of export earnings. As around 50% of goods exports go to the US as well, the local economy is strongly influenced by the US business cycle. Natural disasters (tropical storms, earthquakes) further limit economic performance. Domestic savings are low and another important constraint on growth. Since the end of the civil war successive governments have implemented market-oriented structural reforms that have encouraged trade liberalisation, privatisation and foreign investment, but annual average growth of real per capita GDP over the past decade has been a relatively low 1.5%. The World Bank classifies El Salvador as a lower middle income economy.

Real GDP grew at annual average 4% pace in 2004-07, but slowed to 2.5% in 2008 and probably will contract by around 2.5% in 2009, before returning to growth of around 2% in 2010. On the supply side manufacturing, construction and most services have contracted sharply in H1 2009, with only agriculture continuing to grow. Demand for maquila output and workers remittances have been hit hard by the US recession and, along with the fall in credit growth has had a sharply negative on consumption and investment in 2009. As these constraints are expected to ease in 2010 a modest upturn should become evident.

At the beginning of 2001 under the Monetary Integration Law the US dollar (USD) was adopted as legal tender and all financial system accounting was converted to USD. The central bank ceased to print new currency notes and coins and was no longer able to extend direct credit to financial institutions. Consequently, dollarisation means that the authorities have no independent control of monetary policy, which is determined by the US Fed and interest rates can be expected to move in line with those in the US, though with a significant risk premium, which has widened since the global

financial crisis. Inflation, which hit 9.9% yr/yr in August 2008, has turned into deflation with the CPI falling by 1.6% in October 2009. As global food and energy prices have stabilised, after falling sharply in Q4 2008 and Q1 2009, and domestic demand begins to recover inflation should return in 2010 but remain subdued.

Private sector banks are all at least partly foreign-owned, which, along with high lending rates has reduced credit growth, but the banking system is weathering the global financial crisis relatively well. Prior credit growth was moderate and the lending/deposit ratio is 84%. Nonetheless, NPLs are rising as asset quality has deteriorated. There is also no lender-of-last resort, as a result of the adoption of the USD, so the system is reliant on supervisory and regulatory controls.

In 2003-08 the fiscal deficit (non-financial public sector) was between 0.3 and 1.1% of GDP, accompanied by small primary fiscal surpluses. These enabled the public debt-GDP ratio to fall from 47% at end-2003 to 44% at end-2008. Revenues dropped sharply in the first nine months of 2009, however, while spending continued to increase and the overall deficit will widen to around 4% in 2009 and the public debt-GDP ratio will rise to almost 50% where it should remain in 2010. In 2010 the fiscal deficit should narrow to around the reported 3.3% target agreed with the IMF. Some tax raising measures are under discussion, though these will need to be the subject of political consensus given the make-up of congress and strong domestic demand should boost revenues.

Given the strong linkages with the US, dollarisation seems appropriate for El Salvador, though it does require flexibility in domestic markets and strict control of fiscal deficits in the absence of an active monetary policy. President Funes has not indicated that he intends to change the present currency regime. The system is under some pressure, but the exchange rate is not seriously overvalued and FX reserves and the banking system have held up reasonably well. However, as the public debt ratio has risen sharply, the s will require fiscal deficit containment. Nonetheless, the administration will find it difficult to fulfil election pledges on public spending/welfare and meet the fiscal deficit requirements embedded in the IMF programme, though the latter does allow for some expenditure switching to expand welfare programmes.

The external current account deficit widened to 7.2% of GDP in 2008, as imports grew rapidly while remittances growth slowed. However, with the sharp decline in domestic demand in 2009 and global energy prices, imports have fallen sharply and by more than the large fall in export earnings, which include a 10% drop in family remittances in the first ten months of the year. As a result we expect the current account deficit to narrow to 1.2% of GDP in 2009. In 2010 imports are likely to pick-up more than exports and the deficit could widen to 3.3%. Net FDI flows are less than 50% of GDP. Total FX reserves amount to 120% of the sum of our projected current account deficit for 2010 plus principal repayments on medium-term plus projected short term debt outstanding at end-2009. Reserves also more than cover the monetary base. Formal dollarisation minimises inconvertibility and currency risk.

The external debt as a proportion of GDP was a high 48% at end-2008 and probably will exceed 50% in 2009-10. External debt as a proportion of export earnings is a more modest 128% and interest payments as a proportion of export earnings are 8%.

Structural Business Environment

The Structural Business Environment is generally sound, ranking above average in our assessment, but falling short of the strongest ratings overall (74th out of 210 countries assessed). Based on data and definitions from the World Bank's 2008 Doing Business Survey, of ten areas surveyed Paying Taxes, Starting a Business, Dealing with Construction Permits, Employing Workers and Protecting Investors, were weaker areas, ranking below average, but none were very weak. The World Bank Institute's Governance Research Indicator puts regulatory quality and control of corruption above average, but rule of law below average for the Latin American region, with a similar pattern against the lower middle income group of countries. Transparency International's Corruption Perception Index, 2009, assigns El Salvador a score of 3.4—on a scale of 1 (bad) to 10 (good)—and a ranking of 84 out of 179 (just below Guatemala, India and Panama). As a broad measure of the pro-business environment The Heritage Foundation 2009 Index of Economic Freedom ranks El Salvador 33 out of 179.

Charts

