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El Salvador and the IMF

Press Release:
IMF Executive Board Approves Precautionary Stand-By Arrangement for El Salvador of About $800 Million
January 16, 2009

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El Salvador: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

January 7, 2009

The following item is a Letter of Intent of the government of El Salvador, which describes the policies that El Salvador intends to implement in the context of its request for financial support from the IMF. The document, which is the property of El Salvador, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

The Authorities' Letter of Intent

San Salvador, January 7, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C., 20431

Dear Mr. Strauss-Kahn:

1. El Salvador's economy has performed well in recent years. Sound macroeconomic policies and structural reforms have delivered high economic growth, a declining public debt-to-GDP ratio, and low and stable inflation. The global financial turmoil of 2008, however, has tightened external financing conditions considerably. These developments, combined with uncertainties surrounding the domestic electoral cycle during 2009, could have adverse effects on market confidence. Against this backdrop, the Government of El Salvador is determined to continue implementing sustainable macroeconomic policies and measures to safeguard domestic financial stability.

2. The attached Memorandum of Economic and Financial Policies (MEFP) presents the plans and policies of the authorities of El Salvador for 2009. In support of this economic program, El Salvador requests a Stand-By Arrangement (SBA) from the International Monetary Fund totaling SDR 513.9 million (300 percent of quota), covering the period through March 31, 2010. Our intention is to treat the arrangement as precautionary. We expect that the SBA would support the authorities' commitment to continued sound macroeconomic policies, anchor investor and depositor confidence, and provide potential access to liquidity support for the financial system, if the need were to arise. The leading presidential candidates have publicly expressed their support for the main elements of the program, including the importance of maintaining macroeconomic stability.

3. We believe that the policies described in the attached MEFP are sufficient to meet the objectives of our program, and stand ready to take additional measures that may be needed for this purpose. We will consult with the Fund in advance of any revisions to the policies described in the MEFP, as well as the adoption of additional measures, in accordance with IMF policies on such consultations. Consultations with Fund staff would also occur in the event of a significant decline in the sum of total deposits and external banking system liabilities with an original maturity of up to one year (relative to its level as of end-November 2008), and the necessary response would be agreed in the context of IMF program reviews. We will continue our close dialogue with IMF staff on our economic policies after the expiration of the arrangement, for as long as there are any outstanding purchases in the upper credit tranches. During the program, we will continue to comply with all obligations of Article VIII of the IMF's Articles of Agreement.

4. Program implementation will be monitored through four quarterly reviews, with the first review to be completed on or after May 29, 2009. The performance criteria and structural benchmarks under the program are set out in Tables 2 and 3 of the MEFP.

5. We authorize the IMF to publish this Letter of Intent and its attachments, and the related staff report.

Sincerely yours,

/s/	/s/
William Handal Minister of Finance	Luz María de Portillo President, Central Reserve Bank of El Salvador

Attachments

Memorandum of Economic and Financial Policies of the Authorities of El Salvador

I. Background and Program Objectives

1. The Salvadoran economy has performed well in recent years, reaping the benefits of prudent macroeconomic policies and sustained structural reforms. Fiscal consolidation led to a reduction in the public debt-to-GDP ratio, and the country experienced the highest growth rates in over a decade during 2006–2007, which in turn helped reduce poverty and improve social conditions. El Salvador's strong macroeconomic fundamentals helped the country weather the external shocks of 2008, including a sharp increase in commodity prices and a slowdown in global growth.

2. The current turmoil in world financial markets and the global growth slowdown entail risks for the outlook in 2009. Growth is projected to slow to 2.5 percent, due to the weak economic activity in major trading partners and the slowdown in remittances, while inflation and the external current account deficit are expected to decline (to 3¾ percent and 2¾ percent of GDP, respectively) partly as a result of significantly lower oil prices. Reflecting its close integration with global markets, the domestic financial system has been affected by the global financial crisis; in recent months the growth in bank deposits has stalled, credit growth has slowed, and interest rates have risen. In addition, the country will hold two national elections (for congress and president) in the first half of 2009, with attendant uncertainties about the conduct of macroeconomic policies.

3. To mitigate these risks, we have designed a program aimed at preserving macroeconomic stability during 2009 and boosting the economy's resilience to external shocks. The program aims to: (i) bolster confidence by maintaining sound macroeconomic policies; (ii) upgrade the regulatory and supervisory framework of the banking system; and (iii) increase the liquidity buffers of the financial system.

4. Within this context, the program will focus on preventive and contingency measures, in particular, in the financial system. The measures will be anchored on strict adherence to El Salvador's monetary regime of official dollarization and a prudent fiscal policy, while expanding social programs to mitigate the impact of the global growth slowdown. Financial system policies will concentrate on enhancing readiness to detect and respond resolutely to signs of stress in the banking system.

A. Fiscal Policy

5. Fiscal policy during 2009 will continue to target an increase in social spending and in the share of investment expenditure. The overall deficit of the nonfinancial public sector (including public pension expenditure) will not exceed 2.8 percent of GDP, down from an estimated 2.9 percent in 2008. Although the projected deficit and growth slowdown, and additional disbursements from multilateral development banks, will increase the ratio of the

nonfinancial public sector debt plus external obligations of the Central bank over GDP to 42 percent of GDP in 2009, compared to 40 percent in 2008, the increase will be modest and transitory, and the debt-to-GDP ratio is expected to resume its downward path starting in 2010. The measures that will ensure the attainment of the fiscal deficit target for 2009 will include:

- ***Improvements in tax policy and administration***. Including through the modernization of customs, the strengthening of collection procedures on tax-arrears, and improvements in tax auditing and enforcement.

- ***Better targeting of subsidies***. By October 2009, we will eliminate the electricity subsidy to nonresidential customers. We will continue to focus other subsidies to low income groups. We expect these measures to yield at least 0.3 percent of GDP during 2009.

- ***Strict control of current expenditure of the central government***. This will be achieved through the application of an "Austerity Policy" that the Ministry of Finance will issue shortly to central government institutions.

- ***Expanding priority social expenditures***. We will accelerate the expansion of our targeted cash transfer program (Red Solidaria) to cover the 100 poorest municipalities, and implement other targeted social programs for health, education, and mitigation of damages from tropical storms.

- ***Higher public investment***. We will expand hydroelectric capacity through the construction of a new power plant at El Chaparral and increase capital spending in a number of areas, including education and health.

6. **Financing:** The bulk of the financing of the nonfinancial public sector deficit during 2009 is expected to come from external sources. Building on a political agreement recently reached in congress, we will secure new long-term loans from the World Bank and the IADB for a total of US$950 million over the next three years. Of this total, US$650 million will be set aside to amortize external bonds coming due in 2011 and the remainder will be used to increase social spending; about US$100 million of this additional spending will take place during 2009.

B. Financial System Policy

7. El Salvador's banking system is well capitalized and liquid, with capital adequacy and liquidity ratios well above their regulatory minima. Financial policies during 2009 will aim at preserving the soundness and stability of the banking system, while adopting reforms to enhance its resilience. We have designed a plan to deal with financial stress that includes stepped-up procedures to monitor banks' liquidity and short-term borrowing activities, and the quick adoption of remedial measures in the event of pressures in banks' balance sheets.

8. We also have enacted (as a prior action to the SBA) a regulation to enhance the functioning of the interbank market, which should facilitate the allocation of liquidity among banks by making the central bank a clearing house for these transactions. We will maintain the current level of reserve requirements of the banking system (as detailed in the accompanied Technical Memorandum of Understanding (TMU)) throughout the program period (22 percent). In addition, we intend to maintain the current level of liquid asset requirements (6 percent) through June 1, 2009, when the new government is scheduled to take office. If developments in the banking system suggest the need to lower the liquid asset requirements for the overall banking system before June 1, we would inform IMF staff ahead of time.

9. To further enhance the resilience of the financial system to situations of stress, we will seek congressional approval of the Financial Sector Supervision and Regulation Law by May 15, 2009. The bill aims to strengthen financial sector supervision (structural benchmark) by merging the supervisory entities for banks, pensions, and the stock market; enhancing the autonomy of the merged institution; and providing legal protection for supervisors. In addition, the bill strengthens cross-border consolidated supervision. We will continue to request from the IMF, among others, technical assistance to strengthen financial system regulation and supervision, including the monitoring of liquidity.

10. If during the program period we were to observe a significant decline in the sum of total deposits and external banking system liabilities with maturities of up to a year (as defined in the accompanying TMU), we would evaluate the appropriate policy response in close consultation with IMF staff.

II. Safeguards Assessment

11. We recognize the importance of completing an updated safeguards assessment of the central bank of El Salvador before the first review of the Stand-By Arrangement. To facilitate this, we have authorized the central bank's external auditors to provide IMF staff with all necessary information, including management letters for 2005–2008, and to hold discussions directly with IMF staff. We also commit to receiving a safeguards mission and to providing that mission with all necessary information requested without delay, including information related to correspondent banks and foreign reserve placements.

III. Program Monitoring

12. The program will cover the economic policies for 2009 and will be monitored through quarterly reviews, with a prior action, quarterly and continuous quantitative performance criteria, and structural benchmarks. The phasing of access under the arrangement and the review schedule are set out in Table 1 of this memorandum; the quantitative targets and performance criteria for end-March 2009, end-June 2009, end-September 2009, and end-December 2009, are set out in Table 2; and the prior actions criteria and structural benchmarks are set out in Table 3. The definition of the quarterly

quantitative performance criteria, the structural benchmarks, and the special consultation clause described in this memorandum are further specified in the accompanying TMU.

Table 1. El Salvador: Purchase Schedule and Terms Under the Stand-By Arrangement

		Purchase			
Date	Conditions for purchase	Million SDR	Million US$ 1/	Percent of Quota	Percent of Total Access
January 16, 2009	Board approval of the SBA	342.60	529.32	200.00	66.67
May 29, 2009	First review, based on end-March 2009 performance criteria	42.825	66.16	25.00	8.33
September 15, 2009	Second review, based on end-June 2009 performance criteria	42.825	66.16	25.00	8.33
December 15, 2009	Third review, based on end-September 2009 performance criteria	42.825	66.16	25.00	8.33
March 15, 2010	Fourth review, based on end-December 2009 performance criteria	42.825	66.16	25.00	8.33
Total		513.90	793.98	300.00	100.00

Source: Fund staff estimates.

Table 2. El Salvador: Quantitative Performance Measures for 2009

	2009 Program (In millions of U.S. Dollars)			
	end-March	end-June	end-September	end-December
Performance criteria				
Overall balance of the non-financial public sector (cumulative floor)	-150	-201	-427	-669
Continuous performance criterion				
Standard continuous performance criteria on zero-ceiling on non-accumulation of external debt service arrears by the non-financial public sector. 1/				
Indicative target				
Total bank deposits plus external short-term bank liabilities (floor)	8,303	8,303	8,303	8,303

Source: Fund staff estimates.

1/ For the purpose of the program ceiling, external non-financial public sector debt-service arrears are defined as unpaid debt service payments by the non-financial public sector to nonresidents beyond 30 days after the due date.

Table 3. El Salvador: Structural Measures for 2009

Prior action

Implement regulation to increase effectiveness of central bank intervention in interbank lending market.

Structural benchmarks

Maintain prudential reserve requirements of banking system, currently at about 22 percent in effective terms (continuous).

May 15

Passage of financial supervision and regulation bill containing following elements:

i) Merge the supervisory entities for banks, pensions and the stock market
ii) Enhance the autonomy of the merged supervisory institution
iii) Strengthen legal protection for supervisors
iv) Strengthen cross-border consolidated supervision.

Source: Fund staff estimates.

Technical Memorandum of Understanding

1. **This Technical Memorandum of Understanding (TMU) describes the understandings** reached between the authorities of El Salvador and IMF staff for the monitoring of performance during the requested Stand-By Arrangement. In particular, it defines (a) the quarterly quantitative performance criterion; (b) the adjusters for the quantitative performance criterion; (c) indicative targets; (d) the consultation mechanism related to total deposits in the banking system plus external bank liabilities with an original maturity of up to one year; and (e) the reporting requirements of the authorities to IMF staff.

A. Quantitative Performance Criterion on the Overall Fiscal Balance

2. **The nonfinancial public sector (NFPS) comprises the central government**, the rest of the general government (Instituto Salvadoreño del Seguro Social (ISSS), the municipal governments, public hospitals, the national university, and other decentralized agencies), and the nonfinancial public sector enterprises (Comisión Ejecutiva Hidroeléctrica del Río Lempa (CEL), Comisión Ejecutiva Portuaria Autónoma (CEPA), Administración Nacional de Acueductos y Alcantarillados (ANDA), and Lotería Nacional de Beneficiencia (LNB)).

3. **The overall balance of the NFPS is measured on a cash basis from below the line**, defined as (a) net domestic financing of the NFPS; plus (b) net external financing of the NFPS; plus (c) proceeds from exceptional revenues such as, but not limited to, proceeds from privatization or licenses and concessions, as defined in the attached Table A1. The components of the NFPS financing will be defined and measured as follows:

(a) **The net domestic financing of the NFPS** is defined as the *sum* of: (i) the increase in net claims of the domestic financial system on the NFPS, excluding government bonds initially sold abroad; (ii) the net increase in the amount of public sector bills (Letes) and bonds held outside the domestic financial system and the NFPS, excluding bonds initially sold to nonresidents; and (iii) floating debt of the NFPS due to expenditure operations and tax refund payments.

(b) **The net external financing of the NFPS** comprises (i) disbursements of external loans; *plus* (ii) receipts from the issuance of government bonds abroad and Letes held by nonresidents; *minus* (iii) cash payments of principal (current maturities of both loans, bonds and Letes); *minus* (iv) cash payments of arrears (principal and interest); minus (vi) debt buy-backs or other prepayments of debt (at market value); minus (vii) debt-equity swaps accounted at the market value of these papers; and minus/plus (viii) the net increase/decrease in other foreign assets of the nonfinancial public sector.

(c) **proceeds from exceptional revenue** such as, but not limited to, proceeds from privatization, the sale of licenses, and the granting of concessions. These would be defined as (i) the cash payments received by the Treasury from the sale of state-owned assets; plus (ii) debt equity swaps, accounted at market values. Also included are up-front payments received by the Treasury for the granting of concessions for public services and capital leasing agreements.

B. Adjuster for the NFPS Deficit

4. **The quarterly performance criteria on the overall balance of the NFPS for 2009**, as described in Table 2 of the MEFP, can be adjusted downward by a maximum of US$50 million contingent on available external financing from the World Bank and/or the IADB, and/or other multilateral or official bilateral creditors.

C. Indicative Targets

5. **Floor on the sum of total bank deposits and external short-term bank liabilities**. These are defined, respectively, as total deposits in commercial banks, and external short-term bank liabilities of commercial banks with an original maturity of up to one year.[1] For the duration of the arrangement, this cumulative amount of the total deposits and external short-term bank liabilities, i.e., the "sum" should be equal to, or higher than, US$8303 million.

6. **The reserve requirements of the banking system as stated in current regulations**[2] (currently at about 22 percent in effective terms) will be maintained throughout the program period. In addition, the current level of liquid asset requirements (6 percent) will be maintained through June 1, 2009, when the new government takes office.

D. Provision of Information and Consultation Clauses

7. **If the sum of bank deposits and external short-term bank liabilities fall below the level stated in paragraph 5 above**, the authorities will consult with IMF staff on an appropriate policy response and reach understandings on corrective measures for consideration by the IMF at the next scheduled review.

8. **If developments in the banking system require lowering the liquid asset requirements (currently at 6 percent)**, the authorities will inform IMF staff before announcing the change.

[1] The definition consists of line items 211 (*DEPOSITOS)* and 212108 (*PRESTAMOS PACTADOS HASTA UN AÑO PLAZO—ADEUDADO A ENTIDADES EXTRANJERAS*) of the balance sheets of banks as compiled by the Superintendency of the Financial System on a weekly basis.

[2] Regulations on liquid reserve requirements NPB3-06, NPB3-11 and Resolution of the Superintendency of the Financial System, issued on June 25, 2008, titled "Medidas Contingenciales para Prevenir Problemas de Liquidez."

E. Reporting Requirements

9. **To facilitate monitoring of program implementation, the government of El Salvador will prepare and send to the IMF**, by e-mail or by fax, monthly data and reports within six weeks following the end of the preceding month, and quarterly data and reports within six weeks after each test date, unless specified otherwise. Such data will include (but are not limited to) the following:

(a) The central bank of El Salvador will provide to the IMF on a monthly basis the comprehensive monetary survey and the central bank balance sheet (electronic file);

(b) The authorities will provide to the IMF on a daily basis the total bank deposits in commercial banks with a delay of at most three working days;

(c) The authorities will provide to the IMF on a weekly basis the balance sheets of individual banks, as well as detailed information on their liquidity positions, at most five working days after the end of the week;

(d) The central bank of El Salvador will provide quarterly balance of payments data in electronic format with a lag of a quarter;

(e) The Ministry of Finance will provide to the IMF data on revenues and the execution of expenditures for the central government, rest of the general government (Instituto Salvadoreño del Seguro Social, the municipal governments, public hospitals, the national university, and other decentralized agencies), and the four nonfinancial public sector enterprises (CEL, CEPA, ANDA, and LNB) with a lag of four weeks for the first review, except for ISSS and CEL where these data might be available at the most with a six week lag, but six weeks for the remaining reviews;

(f) The Ministry of Finance will provide the IMF with information on the financing of the nonfinancial public sector (as defined above) as specified in the table attached to this TMU with a lag of four weeks for the first review (except for ISSS and CEL where these data might be available at the most with a six week lag) for the remaining reviews; these data will be provided with a maximum of six weeks lag;

(g) Indicators and other statistical data on recent economic developments, such as the household consumer price index. In addition, the central bank will provide its quarterly reports on economic activity with a lag of a quarter;

(h) A status report on the implementation of the structural reforms specified in Table 3 of the Memorandum of Economic and Financial Policies attached to the letter of January 7, 2009; and

(i) The authorities will provide the IMF staff with any other information that the latter may deem necessary for the effective monitoring of the Stand-By Arrangement.

Table A1. El Salvador Financing of the Non-Financial Public Sector

	2009			
	March	June	September	December
A. Net domestic financing of the non-financial public sector (NFPS)				
i. Net claims of the financial system (1+2+3)				
1. Net credit of commercial banks to the NFPS:				
a. Credits				
b. Liabilities				
2. Net credit of the BCR to the NFPS:				
a. Credits				
b. Deposits				
3. Net credit of the non-bank financial institutions to the NFPS 1/				
a. Credits				
b. Liabilities				
ii. Stock of NFPS liabilities (including Letes) held outside the domestic financial system and the NFPS 2/				
iii. Floating debt				
B. Net external financing				
i. Multilateral development banks (IADB, WB, CABEI)				
a. Disbursements				
b. Amortizations				
ii. Bilateral creditors				
a. Disbursements				
b. Amortizations				
iii. Financial institutions				
of which : bonds				
of which : LETES				
iv. Other				
C. Privatization and concessions				
D. Non-financial public sector overall balance (A+B+C)				
Memorandum:				
Stock of LETES in circulation				
Disbursements				
Amortization				

Sources: Ministry of Finance; Fund staff estimates.

1/ Includes trust funds: (FOSEDU, FOP).
2/ Includes amortization of ISTA bonds.