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PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: AB1275

Operation Name	Programmatic Broad-Based Growth Development Policy Loan
Region	LATIN AMERICA AND CARIBBEAN
Sector	Central government administration (100%)
Project ID	P093133
Borrower(s)	GOVERNMENT OF EL SALVADOR
Implementing Agency	MINISTRY OF FINANCE
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1. Country and Sector Background

El Salvador is a middle income country with a strong track record of policy reforms and sound macroeconomic management. Since the signing of the Peace Accords in 1991, following a 12-year civil war, El Salvador has made substantial progress in consolidating peace and democracy through three successful electoral cycles. On the economic front, the country has been a regional leader in economic reforms. Since the early 1990s, successive governments have tackled reforms in a host of key areas including trade liberalization, tax reform, financial sector strengthening, and private participation in telecoms, energy, and pensions. The 2001 decision to dollarize the economy has resulted in lower inflation and interest rates and reduced business uncertainty. During this period, successive governments have also invested in education, health and other basic services. The sum of these measures, together with ongoing economic reforms, have contributed to an overall increase in the country's per capita income and a notable reduction in poverty. The country's economic growth in the 1990s rebounded to an average annual rate of 4.9% (the second highest in Central America behind Costa Rica). El Salvador also made impressive progress on the social front achieving marked improvements in the rates of basic education enrollment, infant and maternal mortality, access to reproductive health services, and access to safe water. Overall poverty declined significantly between 1991 and 2002 (over 27 percentage points), while extreme poverty was halved in the same period. This impressive decline is mainly due to the combined impact of economic growth and wide scale investment and improvements in human development.

Since early 2000, a series of external shocks have impacted negatively on growth. Two earthquakes in 2001 damaged economic infrastructure and required large scale emergency and reconstruction efforts that are expected to be complete in 2005. The pronounced downswing in coffee prices that began in 1999 has depressed conditions in rural areas, while the global recession of 2000-02 has affected the demand for the country's non-traditional exports. More recently, high oil prices have contributed to a slow recovery in 2004. The result has been slow growth, barely keeping up with population growth since 2000, as well as a run up in debt levels, due to the need for reconstruction outlays and the absorption of transition costs from pension reform.

The administration of President Antonio Saca, elected in April 2004, is aggressively addressing growth and fiscal challenges with special emphasis on reaching the poor through a comprehensive development

program known as the “Safe Country” program. This program consists of three pillars: growth, equity, and security. It focuses on sound macro-fiscal management, foreign investment promotion, free trade, private sector-led development and a business environment free of exchange rate risk. The government is also placing greater emphasis on equitable growth and pro-poor policies, and plans to gradually increase social spending as a share of GDP over the next five years, with a particular focus on improving the coverage and quality of education. The vision of a “Safe Country” encompasses a broad definition of security, including improving physical safety through programs to combat and prevent crime and violence; increasing investor security through initiatives to combat corruption; increased transparency and impartial enforcement of the law; and strengthening overall confidence in public institutions, including the judiciary. The government is also committed to reducing vulnerability, giving priority to enhanced social protection and safety net programs for the poorest and most vulnerable households.

2. Operation Objectives

This Development Policy Loan (DPL) is part of a programmatic series of four DPLs intended to support the Government's medium term development strategy to accelerate broad based and equitable economic growth and to contribute to the Government's objectives of (i) reigniting growth, particularly through increased private investment and trade, (ii) reinforcing macroeconomic stability and strengthening fiscal sustainability, and (iii) increasing the efficiency and transparency of public sector management. This first DPL would support actions in each area. The first area would include policies to expand trade opportunities and improve the investment climate. The second area would highlight measures related to expanding tax revenues and reducing the fiscal burden of pension reform. The third area supports public sector modernization efforts, with emphasis in the areas of procurement, e-government and public financial management. Future DPL operations are expected to focus more intensively on the growth agenda (trade, business environment, public-private participation in infrastructure) while maintaining attention to transparency and efficiency in public spending.

3. Rationale for Bank Involvement

The Country Assistance Strategy (CAS) for El Salvador will lay out a strategic program of lending and non-lending services to support the Government’s development agenda: (i) to accelerate broad-based, equitable economic growth and increase employment; (ii) to improve equity through building human capital and expanding access to socioeconomic infrastructure, assets and markets; and (iii) to enhance security and reduce vulnerability. The proposed loan, the first in a programmatic series of four annual DPLs, is intended to support broadly the government’s reform efforts, following new Bank guidelines for budget support operations for the case of well performing middle income countries. It relies on upfront action instead of ex-post conditionality and allows for flexibility in follow up operations by recognizing that changing policy environments are difficult to anticipate.

The proposed loan presents a significant opportunity to develop a closer relationship with a regional reform leader. Policy dialogue in El Salvador is bound to enrich the Bank’s experience in dealing with an advanced reformer facing second generation issues, which should prove invaluable for upgrading its assistance to other countries. A programmatic series of DPLs, synchronized with the Government’s annual budget, is expected to facilitate congressional negotiations by demonstrating broad support for the government’s plan and cost savings with respect to financing alternatives. If successful, this would break with the pattern of lengthy approval delays that have become common for the Bank’s investment projects in El Salvador.

4. Financing

The proposed loan in the amount of $100 million is the first in a programmatic series of four DPLs totaling $400 million. This first DPL is expected to be submitted for legislative approval in the first quarter of 2005.

The Government has expressed its preference to align the presentation of future DPLs with the country's budget cycle. To accommodate this request, the second DPL would be presented in July 2005. The third and fourth DPL would be presented to the Board by July 2006 and July 2007, respectively.

5. Institutional and Implementation Arrangements

The DPL will be implemented by the Technical Secretariat of the Presidency and the Ministry of Finance. In addition, other agencies which will play an important role include: the Central Bank and the Ministry of the Economy.

6. Benefits and Risks

Benefits – The proposed DPL is an appropriate vehicle to simultaneously support fiscal needs, policy reform, and the Bank's relationship with El Salvador.

- *Meeting fiscal needs*: Board approval of this loan and its related disbursement in early 2005 would not only help the government's to meet its objective of diversifying its financing sources but to secure financing on more favorable terms. This would support the government's goal of fiscal stabilization and efficient spending.

- *Endorsement of sound policy and vehicle for dialogue*: The majority of the reforms undertaken for this DPL were discussed with the Bank and were influenced by joint analytical work, including the PER, the CEM and the CAFTA regional ESW. The proposed DPL would serve to recognize reform achievements to date. Timely support by the Bank would also be important toward forming the basis for strong engagement with the new government on forward-looking policy actions within the framework of a new CAS. The Letter of Development Policy indicates the new administration's commitments on a range of issues where the Bank has or will support. The DPL would secure overall continuity of the Bank's policy dialogue with El Salvador while strengthening the Bank's reputation as a reliable development partner.

Risks – The long-term success of the proposed operation faces various risks, which can only be partially addressed in the context of this operation and the new CAS.

- *Fiscal risk:* El Salvador's current NFPS debt burden—nearly 40 percent of GDP—increases its vulnerability to potential shocks. As rating agencies have increasingly voiced over the past year, a credible plan to address the fiscal area is required to prevent a deterioration of El Salvador's hard earned creditworthiness. The new administration is aware of the country's fiscal vulnerabilities, and is putting a credible plan in place to address them.

- *Political risk:* A divided Assembly could become an obstacle to important reforms, despite the strong electoral mandate obtained by President Saca in April 2004. The inability to approve measures to increase tax revenues and control expenditures would likely raise public debt, which could adversely affect investor confidence and the availability of external financing. Likewise, failure to make progress on financial sector reforms could weaken the sector's soundness and could lead to an eventual materialization of contingent liabilities. Although the government's approach to

consensus building appears favorable, political obstacles to reform can not yet be fully ruled out. Tense relations with the Assembly could also potentially impede prompt ratification of external loans, including this DPL, limiting the Government's access to funds for social development or forcing the use of higher cost financing. The Government expects that the concurrent presentation of DPLs with the budget (or, in this case, soon thereafter) will increase the prospects for approval.

- *External risk:* Sustained high oil prices or a possible international recession could negatively affect El Salvador's economy and worsen its debt dynamics. The end of textile quotas by 2005 in the United States and other markets, which could intensify the competition from China and other Asian countries, could potentially negatively impact the economy. However, the country has experienced a series of plant closures and job losses over the past year, suggesting that El Salvador may have already adjusted to this regime change.

- *Natural disaster risk:* The country is vulnerable to natural disasters (e.g., earthquakes and hurricanes) which could hurt the performance of the economy in the short-term, thereby requiring significant unanticipated financing for emergency assistance and reconstruction. The government's focus on improving fiscal responsibility and restoring broad-base growth, while building a stronger social safety net, should better position El Salvador to absorb such shocks in the future.

7. Poverty and Social Impacts and Environment Aspects

Given that the policy actions supported by this loan are not expected to have significant negative impacts on poverty or social aspects, a PSIA will not be required prior to disbursement. While El Salvador boasts one of the most open trade regimes in Latin America, CAFTA could eventually affect the welfare of some segments of Salvadoran society that still benefit from some residual protection. Admittedly, these potential impacts would take some time to materialize, as Central American negotiators obtained lengthy grace periods (5 to 10 years) and gradual phase out periods for sensitive commodities (up to 20 years). However, a PSIA will be undertaken to assess the expected impact of CAFTA on the poor and to identify potential effects on protected segments. This study would complement the ongoing regional ESW on the impact of CAFTA in Central America (scheduled for delivery in FY05) and ongoing work to support programs that ensure that small and medium enterprises can also benefit from the benefits of the agreement.

Fiscal measures supported under this operation are not expected to exert significant impact on the poor. To confirm this conclusion, a PSIA on fiscal and pension issues will be conducted during 2005. The analysis will focus on the distributive impact of recent changes to the Salvadoran tax code and pension regime.

The proposed loan does not support measures that are expected to exert significant impacts on the environment. Nevertheless, future DPL operations are expected to give more emphasis to investments in infrastructure and CAFTA is expected to lead to greater levels of trade and investment, which could pose some challenges to El Salvador's capacity to manage potential environmental risks. While CAFTA is expected to improve enforcement of environmental norms and regulations due explicit commitments in the treaty to this effect, the Bank will work with the government to prepare a *Country Environmental Assessment* to be finalized in FY06. The Assessment would develop a sound analytic understanding of the country and sector-wide institutional set-up and policy framework and provide guidance and advice to the government's national environmental strategy and policy, currently under development. The Assessment will be done in close coordination with the planned *Recent Economic Developments in Infrastructure Report* diagnostic to provide the government with particular recommendations that would be relevant as it pursues new policies to spur sustainable infrastructure development. It will also pay

special attention to needs that may arise out of the expansion of trade and investment that is expected after CAFTA implementation.

8. Contact point

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