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Report No. 30849-SV

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

AND

INTERNATIONAL FINANCE CORPORATION

COUNTRY ASSISTANCE STRATEGY

FOR

THE REPUBLIC OF EL SALVADOR

April 20, 2005

**Central America Country Management Unit
Latin America and the Caribbean Region**

**International Finance Corporation
Latin America and the Caribbean Region**

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**The Date of the last Country Assistance Strategy for El Salvador was
November 29, 2001**

CURRENCY EQUIVALENTS

1 US Dollar = 8.75 Colones as of January 11, 2005

Fiscal Year:

January 1 – December 31, 2005

SELECTED ACRONYMS AND ABBREVIATIONS

ARENA	National Republic Alliance
BNPP	Bank-Netherlands Partnership Program
CABEI	Central American Bank of Economic Development
CACM	Central American Common Market
CAS	Country Assistance Strategy
CBI	Caribbean Basin Initiative
CDU	Centro Democrático Unido
CEA	Country Environmental Analysis
CEM	Country Economic Memorandum
CFAA	Country Financial Accountability Assessment
CND	Comisión Nacional de Desarrollo
CNSP	National Public Security Council
CPAR	Country Procurement Assessment Review
CSR	Corporate Social Responsibility
DIGESTYC	National Directorate for Statistical and Census
DPL	Development Policy Lending
DR-CAFTA	Dominican Republic - Central America Free Trade Agreement
EDUCO	Community Education Program
EHPM	National Household Survey
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Services
FIRST	Financial Sector Reform and Strengthening
FMLN	National Liberation Front (Frente Farabundo Martí para la Liberación Nacional)
FSAP	Financial Sector Assessment Program
FTA	Free Trade Agreement
FTAA	Free Trade Agreement of the Americas
FUSADES	Salvadoran Foundation for Economic and Social Development
GDP	Gross Domestic Product
GEF	Global Environment Facility
GOES	Government of El Salvador
IADB	Inter-American Development Bank
ICA	Investment Climate Assessment
ICT	Information and Communication Technology
IDA	International Development Agency
IDF	Institutional Development Fund (Institutional Facility Grant)
IFC	International Finance Corporation
IMF	International Monetary Fund
INCAE	Instituto Centroamericano de Administración de Empresas
LAC	Latin America and the Caribbean
MDG	Millennium Development Goal
MIGA	Multilateral Investment Guarantee Agency
MM	Maternal mortality

MOE	Ministry of Education
MOH	Ministry of Health
MSME	Micro, Small and Medium Enterprise
NAFTA	North America Free Trade Agreement
NGOs	Non-Governmental Organization
PAHO	Pan American Health Organization
PCN	Partido de Conciliación Nacional
PDC	Partido Demócrata Cristiano
PER	Public Expenditure Report
PHRD	Policy and Human Resources Development Fund
PPIAF	Public-Private Infrastructure Advisory Facility
PSMP	Public Sector Modernization Program
REDI	Recent Economic Developments in Infrastructure
ROSC	Reports on the Observance of Standards and Codes
SAFI	Integrated financial management system
SIECA	Secretariat for Economic Integration of Central America
SIGET	Superintendencia General de Electricidad y Telecomunicaciones
SMEs	Small and Medium Enterprises
TA	Technical Assistance
UACI	Unidad de Adquisiciones y Contrataciones Institucionales
UNAC	Unidad Normativa de Adquisiciones y Contrataciones
UNAIDS	Joint United Nations Programme on HIV/AIDS
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund
WBG	World Bank Group
WBI	World Bank Institute
WDI	World Development Indicators
WEF	World Economic Forum

IBRD		IFC	
Vice President:	Pamela Cox	Vice President:	Assaad Jabre
Country Director:	Jane Armitage	Director:	Atul Mehta
Task Manager:	Nicolette Bowyer	Manager:	Eduardo Wallentin
Lead Economist:	C. Felipe Jaramillo	Task Manager:	Junko Oikawa

ACKNOWLEDGEMENTS

The World Bank Group greatly appreciates the close collaboration with the Government of El Salvador in the preparation of this CAS.

The team would like thank the entire country team for their contributions and give special thanks to several colleagues in the LAC Region including Todd Crawford, Jessica Poppele, Manuel Sevilla, Ana Lucia Armijos, Ricardo Tejada, Sabine Perrissin, Elizabeth Percesepe-Wallace, Marlene Sims and Sonia Molina as well as SFCR, OPCCE and IMF.

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MAP

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EXECUTIVE SUMMARY

i. Country Context

Since the signing of the Peace Accords in 1991, El Salvador has made substantial progress in consolidating peace and democracy through three electoral cycles, the latest presidential election having been peacefully conducted in March 2004. Despite the country's impressive record of reforms and prudent macroeconomic policies, growth levels slowed in recent years due in large part to external shocks. The new government's plan "Safe Country 2004 – 2009" focuses on sound macro-management, foreign investment promotion, free trade, private sector-led development and a business environment free of exchange rate risk. The new government is also placing greater emphasis on more inclusive growth and pro-poor policies, improving security and reducing vulnerability.

ii. The Bank Group Strategy

The Bank Group's assistance over the four-year period covered by this CAS (FY05-08) proposes a strategic program of lending and non-lending services to support the three main pillars of the government's development plan: (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. Bank Group assistance will include: support for implementation of the existing loan portfolio; new IBRD lending, including a Program of Development Policy Loans and investment operations in selective areas which build upon prior successful implementation of innovative operations in El Salvador; analytical and advisory work, technical assistance, and capacity development programs; and targeted private sector assistance provided by IFC and MIGA.

Support to Pillar I – The main support under this pillar would be a programmatic series of Development Policy Loans (DPLs) and an investment operation to support small and medium-size enterprise (SME) development. IFC would continue to support the Salvadoran private sector enhancing the prospects for competitiveness and growth. Its priorities will include: (i) continuing to assist in the development of the housing sector via financing and technical assistance; (ii) helping to strengthen infrastructure (including power); and (iii) supporting the MSME sector; (iv) promoting sustainable business practices (including corporate governance, environmental and social management, and corporate social responsibility programs). MIGA would support this pillar by facilitating foreign investment.

Support for Pillar 2 - Main support under this pillar would be through the implementation of ongoing operations and the development of two new investment operations for land administration and education. IFC will help improve equity through the on-lending instruments being provided for SMEs, thereby broadening their access to financial markets.

Support for Pillar 3 - The Bank would provide support through ongoing investment projects and three new investment operations for environmental services, social protection and modernization of the State. IFC's work on promoting sustainable business practices will also help enhance both investor and citizen security in El Salvador.

The scale of Bank's financial assistance would be determined by the Government's ability to maintain its high level of performance across the three pillars of the 2004-2009 Strategy. The base case could include up to \$300 million in Development Policy Lending and \$185 million in investment lending. To access increased lending levels, performance will be assessed on progress toward objectives in strategic policy areas (See Table 9). To move into a high case lending scenario, implying up to one additional \$100 million DPL, would require performance on specific fiscal sustainability measures.

iii. Managing Risks

Continued strong performance by the Government is subject to several sources of risk including a deterioration in the external environment, the threat of natural disaster and possible political gridlock. Moreover, El Salvador's current debt burden, approaching 40 percent of GDP, increases its vulnerability to potential shocks. The CAS program aims to manage risks through careful monitoring of progress, scaling fast disbursing lending to policy performance momentum and focusing investment lending on areas which build on El Salvador's previous strong record of innovation, sustained impact and results. Should El Salvador be subject to shocks arising from natural disasters or other external factors a contingency scenario may be called for, which is not considered in this CAS. In that case, the Bank team would develop an alternative program for discussion with the Board.

iv. The following three issues are suggested for Board discussion

(i) Do Executive Directors agree that El Salvador is a good candidate for a series of Programmatic Development Policy Loans as requested by the Government? (ii) Is the set of proposed investment operations an appropriate and strategically selective complement to the DPL series in light of El Salvador's development priorities, support from other development partners and the Bank's comparative advantage? (iii) Do Executive Directors endorse the proposed substantial increase in lending to El Salvador given the country's strong policy performance record, the current attention to improving fiscal responsibility, and its continued low exposure to the Bank?

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I. INTRODUCTION

1. The last Country Assistance Strategy (CAS) for El Salvador for FY02-FY04 was discussed by the Board on November 2, 2001, together with an Earthquake Emergency Reconstruction and Health Services Extension Project to assist with the rebuilding of critical damaged infrastructure following two powerful earthquakes in the first quarter of the year. Appropriately, the primary focus of the government of El Salvador (GOES) in 2001 was to support the reconstruction of the economy within the framework of its long-term development objectives, and this priority was reflected in the Bank's assistance strategy for the country. Over the past 2-3 years, however, considerable progress has been made in addressing the losses and setbacks to the economy wrought by the earthquakes, and attention has shifted squarely to the longer-term development challenges facing El Salvador. In this context, the recently-elected Saca administration, which took office in June 2004, requested that the Bank prepare a new CAS in support of its core development strategy "Safe Country 2004-2009". As a consequence, this CAS is focused on supporting the three main pillars of the government's strategy as follows: (i) accelerating broad-based economic growth and increasing employment; (ii) improving equity through building human capital and enhancing access to basic socioeconomic infrastructure and markets; and (iii) enhancing security and reducing vulnerability.

II. COUNTRY CONTEXT

2. 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 electoral cycles, the latest presidential election having been peacefully conducted in March 2004. On the economic front, El Salvador has been a regional leader in economic reforms. Starting in the early 1990s, successive governments have tackled reforms in a host of key areas including trade liberalization, tax reform, strengthening of the financial sector, and promotion of private participation in telecoms, energy, and pensions. More recently, a decision to dollarize the economy in 2001 has resulted in lower inflation and interest rates and reduced business uncertainty. Since the early 1990s, the country has also invested in schooling, health and other basic services, which, together with the economic reforms, have contributed to rising per capita incomes and a notable reduction in poverty. As a result of this wide-ranging, deep and sustained reform effort since the early 1990s, El Salvador stands out as one of the leaders in reforms in LAC. This is clearly reflected in the Index of Economic Freedom which places El Salvador in 2004 as 24th in a field of 155, second among LAC countries (behind Chile).

3. The re-establishment of peace and the country's sustained economic reform efforts have yielded substantial gains for the population since the early 1990s. Economic growth in the 1990s rebounded to an average annual rate of 4.9% --the second highest in Central America behind Costa Rica -- after a decade of poor performance during the 1980s. Impressive progress was also made in social areas, including in basic education enrollment, infant and maternal mortality, access to reproductive health services and access to safe water. Gains in social indicators reflect not only the fruits of economic growth but increasing public sector attention in these areas, including important reforms and increased budgetary allocations. Remittances from family members working abroad have also helped some families emerge out of poverty. The combined impact of economic growth, human development improvements and the cushion provided to some families by remittances has been a marked decline in poverty. Overall poverty declined significantly (over 27 percentage points) between 1991 and 2002, while extreme poverty was halved in the same period.

4. El Salvador has posted important gains toward meeting most of the Millennium Development Growth targets since 1990 (see Table 1). The extreme poverty target had been met by 2002 and the child mortality target is likely to be achieved before 2015. Projections of school enrollment rates also indicate that El Salvador will be able to achieve universal primary education by 2015. Gender differences in enrollment rates are virtually nonexistent. However, child malnutrition rates remain of concern, and trends in maternal health do not display an unambiguous improvement. While the target for access to water seem likely to be met, recent trends are not encouraging with respect to achieving the target for halting forest degradation.

5. Despite the country's impressive record of reforms and prudent macroeconomic policies, growth levels have slowed down since the second half of the 1990s. The slow down has been in large attributable in large measure to external shocks – both the massive destruction caused by the 2001 earthquakes and unfavorable external economic developments. El Salvador's terms of trade deteriorated in the 1996-2000 period at a rate of about 4 percent per year on average and the recession in the U.S. affected the demand for Salvadoran exports in 2000-2001, severely affecting the country's large maquila sector in particular. The significant decline in the world price of coffee has adversely affected parts of the rural economy since about 2000. More recently, the Salvadoran economy has been negatively affected by the rise in oil prices. As a result of these factors, growth since 2000 has averaged only 2.0%, barely enough to keep per capita incomes roughly constant.

Table 1: Millennium Development Goals¹

Millennium Development Goals 1990-2015	Present Status	1990 MDG Benchmark ²	2002 Estimates ²	2015	
				MDG Goals	Likelihood of achieving results ³
1. Poverty and Hunger <ul style="list-style-type: none"> Reduce extreme poverty by half Reduce malnutrition rate by half 	<ul style="list-style-type: none"> Extreme poverty declined from 31% in 1990 to 15% in 2002. Malnutrition (height for age) in children under 5 decreased from 23.3% in 1993 to 19.6% in 2002. 	31%	15%	15.5%	Completed
		23.3% (1993)	19.6%	11.6%	Unlikely ⁴
2. Achieve universal primary education <ul style="list-style-type: none"> Increase enrollment ratio in primary school to 100% 	<ul style="list-style-type: none"> Net enrollment in basic school increased from 74% in 1990 to 85% in 2002. 	74%	85%	100%	Likely
3. Promote gender equality <ul style="list-style-type: none"> Raise ratio girls/boys in primary and secondary school to 100%. 	<ul style="list-style-type: none"> There are no significant differences between the genders with respect to education. 	100%	101%	100%	Completed
4. Reduce child mortality <ul style="list-style-type: none"> Reduce child mortality in children under 5 by two-thirds 	<ul style="list-style-type: none"> The child mortality rate fell from 60 to 39 per 1,000 live births between 1990 and 2002. 	60	39	20	Likely
5. Improve maternal health <ul style="list-style-type: none"> Reduce the rate of maternal mortality (for each 100,000 live births) by three-fourths. 	<ul style="list-style-type: none"> Trends in maternal mortality (MM) are not clear. The MM rate declined from 158 to 120 between 1993 and 1998, but then rose again to 172 in 2002. That said, there is no evidence of a strong downward trend in maternal mortality. 	158 (1993)	172	40	Unlikely ⁴
6. Combat HIV/AIDS and other diseases <ul style="list-style-type: none"> Have halted by 2015 and begun to reverse the spread of HIV/AIDS and Tuberculosis. 	<ul style="list-style-type: none"> The # of cases of HIV/AIDS increased between 1990 and 2002. The # of cases of Tuberculosis decreased between 1990 and 2002 	96	1597	Halt	Unlikely ⁴
		2,367	1,480	and reverse	Likely
7. Ensure environmental sustainability <ul style="list-style-type: none"> Halve the proportion of individuals without access to an improved water source. Halt forest degradation (% of total land area) 	<ul style="list-style-type: none"> Access to improved water source increased from 66% in 1990 to 77% in 2002. According to WDI (2004), forest area as % of total land decrease from 9% in 1990 to 5.8% in 2001. 	66%	77%	83%	Likely
		9.3%	5.8% (2001)	9%	Unlikely

Source: El Salvador-Poverty Assessment, 2004, based on information from World Development Indicators (WDI, various years); DIGESTYC (using EHPM data, various years); World Bank (WB) staff estimates (using EHPM data, various years); El Salvador National Family Health Survey, FESAL (various years).

1/ Although the background data used in this table may differ from the one presented by the GOES in its 2004 report entitled “*El Salvador, Primer Informe de Avance de los Objetivos de Desarrollo del Milenio*”, the conclusions are the same in terms of the likelihood of achieving the Goals.

2/ Data refers to 1990 or 2002 unless otherwise noted.

3/ Likelihood was determined by extrapolating the linear growth trend observed between the MDG benchmark and the latest available estimate.

4/ Unlikely without increases and improved targeting of pro-poor public expenditures and employment opportunities as envisaged in the Saca’s administration’s strategy which this CAS supports.

III. RECENT DEVELOPMENTS AND KEY CHALLENGES

A. Political Context

6. On March 2004, El Salvador conducted its third presidential election since the signing of the Peace Agreements in 1991. The election took place with the full participation of all political forces, including the former guerrilla movement, which has transformed itself into a legal party, Frente Farabundo Martí para la Liberación Nacional (FMLN). The 38-year-old entrepreneur, Antonio Saca, representing the National Republic Alliance (ARENA) defeated his nearest rival with a solid margin of 57.7% to 35.7%, and took office on June 1. The new President has assumed office with considerable legitimacy, since he was elected with a record turnout of around 60%.

7. The political party ARENA has maintained control of the executive branch of government ever since signing of Peace Agreements but in the 1997 congressional elections it lost its absolute majority in the legislature. In 2000, ARENA lost its position as the largest party in Congress and several of the most important municipal governments to the FMLN. Currently in the 84-member Legislative Assembly the FMLN holds 31 seats, ARENA has 29, the Partido de Conciliación Nacional (PCN) has 14, and the Centro Democrático Unido (CDU) and Partido Demócrata Cristiano (PDC) hold 5 each. The political evolution of El Salvador, and the resulting division of power between the FMLN and ARENA, have increased transaction costs for the Executive Branch, introducing some degree of uncertainty and slowing down the reform process. On the positive side, the fact that, since the 1991 Peace Agreements, El Salvador has been able to conduct municipal and congressional elections with full transparency, legitimacy, and participation of all political parties, indicates robust progress in the process of democratic consolidation.

8. President Saca's administration is perceived, nationally and internationally, as a guarantor of continued commitment to the market-friendly policies and reforms promoted since 1991. The Plan "Safe Country 2004 – 2009" adopted during the campaign by President Saca, and summarized in Figure 1 below, focuses on sound macro-management, foreign investment promotion, free trade, private sector-led development and a business environment free of exchange rate risk. However, the new government is placing greater emphasis on more inclusive growth and pro-poor policies and assigning higher priority to policy consensus with the opposition in the legislature and consultation with the private sector and civil society. The government also views improving security as a key pillar in its development plan. 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, increase transparency and impartial enforcement of the law and building greater public 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.

Figure 1: Government Strategy 2004 – 2009 Safe Country		
<u>Pillar I</u>	<u>Pillar II</u>	<u>Pillar III</u>
Accelerating Broad-Based Equitable Growth and Increasing Employment	Improving Equity through Building Human Capital and Expanding Access to Basic Infrastructure, Assets and Markets	Enhancing Security and Reducing Vulnerability
Government Priorities:		
<p>Ensuring sound macro-management and fiscal responsibility.</p> <p>Deepening insertion in world markets through regional integration and trade.</p> <p>Increasing productivity and competitiveness through improving the investment climate and taking advantage of technology and connectivity.</p> <p>Generating employment and opportunities by supporting SMEs.</p> <p>Improving market regulation and supervision.</p>	<p>Modernizing education and building the knowledge society.</p> <p>Improving quality and universal coverage of health services.</p> <p>Designing local and regional strategies- focused on expanding access to basic infrastructure, promoting agricultural diversification and facilitating private sector investment.</p> <p>Strengthening family assets by facilitating access to housing and expanding land administration and titling efforts.</p>	<p>Making El Salvador a safe country through control and reduction of violence.</p> <p>Ensuring social and economic rights of individuals and businesses by strengthening rule of law.</p> <p>Modernizing public administration and services, in order to improve transparency and efficiency of resource use.</p> <p>Promoting social cohesion and stronger families through a more effective social safety net and improving quality of life at the local level.</p> <p>Enhancing the interest of future generations by protecting the environment.</p>
PROMOTING PARTICIPATION AND CONSENSUS BUILDING PARTNERSHIPS WITH SALVADORANS ABROAD		

9. The work ahead for the government will be challenging as a result of the slow down in economic growth and social progress over the last few years, persistent crime and violence (See Box 1) and the uncertain political environment. The majority of the population expects improvements in the quality of their lives and better access to market opportunities and the election period witnessed some dissatisfaction with key institutions and a degree of reform fatigue. There are some policy or substantive issues where consensus may prove challenging to accomplish such as healthcare reform, privatization,

in particular with respect to energy¹, and in the area of public finances. Avoiding legislative delays and developing a national agenda goes beyond the Executive Branch and is one of the biggest challenges for the government, requiring positive support from political opposition, private sector and civil society at large. President Saca has created a Presidential Commission for promoting consensus on critical issues – e.g., decentralization, tax reform, health reform, and others to be negotiated -- that require national long term commitment and support across party lines. This has already proved possible in the areas of education and tackling crime and violence, for example. The Comisión Nacional de Desarrollo (CND)² will play a key role in building consensus for the adoption of a national vision and agenda for development.

¹ According to opinion surveys conducted by Latino Barometro, in 1998 El Salvador was the third country, out of a group of 17, with the strongest support for privatization but by 2001 support had dropped down dramatically, placing the country in the tenth place out of the same group of countries. In 1998, almost 53% of the population expressed support for privatizations but in 2001 support had been reduced to 25%.

² The CND was created during the Administration of President Calderon Sol, and succeeded in presenting a concrete set of recommendations that were going to be supported by an ambitious four year investment plan during the period 2000-04. CND contribution however was reduced by the polarization of public opinion, the breakdown in dialogue that followed dollarization and the impact of the earthquakes.

BOX 1: VIOLENCE AND CRIME: A CRITICAL CROSS SECTORAL ISSUE

Violence in El Salvador is a critical issue, with significant economic, social welfare, health, and governance impacts. Homicides, crime, youth gang (*Maras*) violence, and domestic assault are widespread and high: seven people are killed every day; the homicide rate, at 45 per hundred thousand, is among the highest in LAC; 90% of Salvadorians feel generally unsafe, and 25% report feeling insecure even when at home. *Maras* are estimated at 20,000 members, and 150 out of 262 municipalities report active youth gangs in their jurisdictions¹.

The persistently high levels of crime and violence has negatively affected the image of the country and the investment climate: a recent survey finds that firms consider it the number one constraint for business operations and investment. Crime and violence in El Salvador also undermines social capital and erodes the assets and incomes of the poor, for example by devaluing property values in insecure neighborhoods, impeding safe access to education (when gangs take over schools) and reducing employment opportunities, particularly at night, because of the dangers of public transportation.

After much internal debate, consensus is emerging on how to tackle the complex social, economic, and political nature of violence and crime in El Salvador, while preserving human rights and civil liberties. The government of President Saca has adopted an integrated strategy (*Plan País Seguro*) that includes:

- **Improvements in the Criminal Justice System: This component focuses on deterrence and control of violence** through a more effective process of arrest, conviction, and punishment. Activities include: a zero-tolerance campaign against crime and violence (*Plan Super Mano Dura*)², support for the Judicial Branch's process of modernization; strengthening of the National Public Security Council (CNSP) and its violence prevention programs; strengthening and modernization of the national police in areas such as crime control and violence prevention ICT system, investigation capacity, training; drug and alcohol control and anti-money laundering systems, penal system reform.
- **Promoting Growth and Employment Creation:** crime and violence are partly the result of social and economic conditions (close to 75% of youth gang members are chronically unemployed). Thus, GOES policies to promote growth, together with improvement of infrastructure and services, creation of local employment and income opportunities, construction of new decentralized training centers and strengthening labor training will contribute to the reduction of crime and violence.
- **Building social capital to prevent crime and violence:** including working with families, communities, and municipalities in the participatory identification of needs of communities affected by violence; improved coverage and quality of education and health services; promoting home ownership; developing a more reliable safety net; providing parks and recreation to low-income barrios; promoting a culture of conflict resolution and curriculum adaptation in schools, together with a referral program for "at risk" youth, and enhanced teacher security.
- **Local and National Dialogue and Consensus Building:** Sustainable peace and development are unlikely without open debate among all actors about the causes as well as the solutions to violence. Participatory processes can also identify local-level solutions to rebuild social capital and citizenship and to address the needs of priority target groups. Important contributions to this effort are expected from the recently created "National Commission on Governance", the National Council on Public Security, the Comisión Nacional de Desarrollo plus, at the local level, municipalities.
- **Creating partnerships for the prevention of crime and violence,** including corporate social responsibility initiatives to improve local services and community infrastructure in areas with high incidence of crime and violence and support for programs to generate youth employment for rehabilitated gang members. The "Consejo Nacional de Seguridad Pública" is coordinating initiatives implemented by government, municipalities, private sector, NGO's, UNICEF, UNDP) and the donor community.

¹The Bank supported a study "The Social and Economic Factors associated with violent crime in El Salvador" prepared by the Instituto Universitario de Opinión Pública de la Universidad Centroamérica José Simeón Cañas.

²The Plan "*Super Mano Dura*" was recently approved in Congress and included amendments to the Penal Code, the Law for the Control of Youth Violence and Crime, and their operational manuals.

B. Economic Performance

10. **Macro Economic Performance.** Since the end of the civil war in 1992, El Salvador has generally maintained a solid track record of macroeconomic policy and structural reform. This record has been characterized by low inflation rates, low fiscal deficits and stable debt levels. In recognition of this record, El Salvador has obtained stable and low-cost access to external financing since the late 1990s, maintaining high credit ratings. In October 2004, El Salvador, along with Chile and Mexico were the only countries in Latin America to boast investment grade ratings by Moody's.

Table 2: El Salvador Key Economic Indicators (1996-2003)
(as % of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001	2002	2003
Real Growth Rates								
GDP growth	1.7	4.2	3.7	3.4	2.2	1.7	2.2	1.8
GDP per capita	1.4	1.5	1.5	1.4	0.2	-0.2	0.3	0.1
Inflation (end of period, % change)	7.4	1.9	4.2	-1.0	4.3	1.4	2.8	2.5
Macro-economic Indicators								
Gross Domestic Investment	15.2	15.1	15.5	16.4	16.9	16.7	16.2	16.6
Gross National Savings	13.5	16.0	16.8	14.5	13.6	15.6	13.3	11.7
Current account balance	-1.7	0.9	-0.7	-1.9	-3.3	-1.1	-2.9	-4.9
Foreign direct investment	0.1	-1.0	7.2*	1.3	1.4	2.1	3.5	0.5
Public Sector Accounts								
Total NFPS revenues and grants	17.3	16.1	15.7	15.7	16.6	15.6	16.1	16.8
Total NFPS expenditures (incl. Pensions)	19.7	17.8	18.4	18.5	19.6	20.0	20.5	20.6
NFPS primary balance	-0.7	-0.2	-1.1	-1.4	-1.5	-3.0	-2.7	-1.7
Overall NFPS balance (with pensions)	-2.4	-1.8	-2.6	-2.8	-3.0	-4.4	-4.4	-3.8
Public Debt								
Total Public Sector Debt	29.4	30.2	27.4	28.1	29.2	34.0	38.7	40.7
O/w Domestic	5.0	6.1	5.4	6.3	6.6	8.8	11.7	11.5
O/w External	24.4	24.1	22.0	21.8	22.5	25.2	27.0	29.2
External Public Debt Service (% of XGS)	16.8	13.0	17.2	18.1	10.1	14.7	17.7	13.3
Memorandum:								
Overall NFPS balance (w/o pensions)	-2.4	-1.8	-2.6	-2.8	-3.0	-3.7	-3.3	-2.1

* Includes privatization proceeds of 6.8% of GDP

Source : Central Bank of El Salvador, Ministry of Finance and Bank estimates

11. After almost a decade of keeping an unchanged level of the exchange rate vis-à-vis the dollar, Salvadorans took the important step of making the dollar legal tender in 2001, a decision which recognized the growing ties of the Salvadoran economy with the United States. The decision also reflected some frustration with domestic interest rate levels, which continued to reflect a sizable exchange rate premium, despite a proven record of solid macro management and ample international reserve holdings. With

dollarization, inflation rates have converged to international levels, and interest rates have dropped to reflect world interest rates plus a country premium. Exports have continued to grow under the new regime, thanks to a flexible labor market and efforts to boost competitiveness, despite depressed external demand and adverse terms of trade. In addition, reduced transaction costs from dollarization have facilitated financial flows, a phenomenon that has strengthened the regional standing of El Salvador's financial sector and explains growing cross border lending.

12. El Salvador's fiscal accounts have shown some deterioration since 2000, as a result of reconstruction investments needed to reestablish infrastructure damaged with the 2001 earthquakes, as well as the need to absorb some of the transitional costs of the pension reform of 1996. Consequently, El Salvador's non-financial public sector deficits have risen since 2000, peaking at 4.4 percent of GDP in 2002. Due to El Salvador's good standing as a sovereign debtor in international markets, much of the fiscal burden has been financed at moderate cost, although at the expense of a rise of about 10 percentage points in NFPS debt in the period 2000-2003, reaching 40.7 percent of GDP by end 2003.

13. On the external side, El Salvador has seen some growth of the current account deficit since 2002, financed mainly by strong inflows of private lending -- through international bond issues and increased lending from commercial banks and other private sources -- as well as FDI flows. Since most of the recent increase can be explained by the need to finance greater fiscal deficits, the shortfall in the current account can be expected to narrow gradually as the new government carries out its fiscal plans. On the other hand, the large trade imbalance of recent years (about 15% of GDP in 2003), financed by the significant flow of remittances from Salvadorans living abroad (see Box 2), is likely to persist into the future. Remittances have exhibited a secular increase since the 1980s and have proven insensitive to cycles in the U.S. economy.

BOX 2: REMITTANCES IN THE SALVADORAN ECONOMY

Large migration flows associated with the intensification of the civil war in the early 1980s, are responsible for the steady growth of remittances which has become the largest source of foreign exchange for the economy of El Salvador. Remittances have increased from an average of 2.6 percent of GDP during the 1980s to 14 percent in 2003. In contrast to other flows of foreign exchange, remittances do not generate undesirable indebtedness cycles and have proven to be remarkably stable. The persistence of these flows, despite the downturn in economic activity in the U.S. in 2001-02, served to cushion the economic shocks that affected El Salvador, including the decline in coffee prices.

The aggregate impact of remittances on the Salvadoran economy has been very significant. In macroeconomic terms, they are the principal source of financing for the growing trade imbalance of recent years, which has risen from less than 7 percent of GDP during the 1980s to 15 percent in 2003. An injection of resources of this magnitude would normally be expected to cause significant macroeconomic effects, including a real exchange rate appreciation and a decline in exports. However, studies have confirmed that El Salvador has managed to maintain its external competitiveness and a healthy export performance, due to a relatively flexible labor market (The World Bank, 2004, CEM).

Remittances reach directly about 14 percent of Salvadoran households, who use about 70 percent of their value to meet consumption needs. Household data suggests that the majority of the direct recipients have been households in the middle and upper deciles, as migration costs and barriers are daunting for the poorest. However, the importance of these flows in total income is highest for the poor. Remittances have become a critical source of income and an important safety net for many Salvadoran families that are subject to swings in incomes.

While remittance flows already exert a strong impact on the Salvadoran economy, creative policies and initiatives could improve their development impact. Senders and recipients should be encouraged to open and use bank accounts, to reduce costs, minimize risks and gain access to credit. Governments can establish incentives to formalize remittance flows and to encourage their use for investment, including for the creation of small enterprises. Hometown associations, working together with local and central governments, and the private sector can play a useful role in aggregating flows to make significant investments in local infrastructure and other public goods.

14. **El Salvador medium-term outlook.** Looking towards the future, there is a pressing need to address the recent build up in public debt as El Salvador continues to be vulnerable to shocks that may require fiscal reaction space (e.g., natural disasters, commodity prices, international recession). The new Saca Administration has made containment of the recent run up in debt levels a top priority. The medium-term plan is designed to lower the deficit and reduce overall debt levels, which are targeted to decline to about 39.2% of GDP by the end of the presidential term (2009) (see Table 3).³ The plan includes significant fiscal adjustment, as the government aims to reduce debt while at the same time absorbing the growing costs of pension reform and creating space for additional growth and social expenditures.

15. In keeping with its track record of prudent macroeconomic planning and acknowledging that vulnerabilities to external shocks still remain, the government's plan is based on conservative projections of 3 percent GDP growth during the period 2005-2009. These projections are an improvement over the average rate of the period 1996-2004 of 2.5 percent, but still low by historical and regional norms. In particular, the Bank's recent Country Economic Memorandum (CEM) predicted that without negative

³ In 2004 total public sector debt is estimated at 44.8 percent of GDP. The difference with the NFPS figures presented in Table 3 is accounted by outstanding net debt of the Central Bank and other public banks.

exogenous shocks, continued implementation of reforms should yield annual growth rates in excess of 4.0 percent. The government hopes that its proposed fiscal plan will allow it to gradually increase public investment levels in growth-inducing expenditures over the medium term, with emphasis on human capital and infrastructure.

16. While higher growth should facilitate continued progress in poverty reduction efforts in El Salvador, it is unlikely to be enough. The new government plan also recognizes that some of the poorest Salvadorans have been unable to take advantage of economic growth over the past decade and a half and require special efforts in terms of improved targeting and additional resources in social programs. To build effectively on past achievements, the government has proposed to implement a social policy aimed at improving access to basic services and developing a safety net for the poorest and most vulnerable households. Despite difficult fiscal constraints, the government plans to increase social spending gradually over the next five years. The efficiency and targeting of social expenditures should also improve as the government proceeds with its program of social sector reforms, particularly in health and water.

Table 3: Medium Term Macroeconomic Scenario
(as % of GDP, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009
Macro-economic Indicators						
GDP growth (% change)	1.8	2.5	3.0	3.0	3.0	3.0
Inflation (end of period % change)	5.5	2.5	2.5	2.5	2.5	2.5
Gross reserves (months of imports)	4.5	4.3	4.3	4.3	4.3	4.3
Foreign direct investment	1.0	1.0	1.5	1.5	1.5	1.5
Public Sector Accounts						
Total NFPS revenues	16.8	17.1	17.0	17.4	17.9	18.4
Current Revenues	16.3	16.6	16.7	17.1	17.6	18.1
Tax revenues	12.2	13.3	13.6	14.1	14.6	15.2
Total NFPS expenditures	19.3	20.1	19.3	18.9	18.9	19.7
Current Expenditure (incl. Pensions)	16.7	16.8	16.3	15.8	15.4	15.0
Capital Expenditures	2.6	3.3	3.0	3.1	3.5	4.7
Overall NFPS balance	-2.5	-3.0	-2.3	-1.5	-1.0	-1.3
Total NFPS Debt	40.5	40.9	40.7	40.3	39.5	39.2
Balance of payments						
Current account balance	-4.4	-4.0	-4.2	-4.3	-4.3	-4.2
Exports of goods	20.4	19.6	19.7	19.6	19.8	20.0
Imports of goods (f.o.b.)	-36.2	-35.6	-35.5	-35.6	-35.5	-35.6
Memorandum Item:						
Gross Domestic Product (\$ million)	15,697	16,474	17,506	18,500	19,550	20,660
Overall NFPS balance (w/o pensions)	-0.7	-0.9	-0.1	0.7	1.2	0.8

Source: Ministry of Finance estimates (base case scenario).

17. The Saca administration has moved speedily with reforms in the fiscal front in its brief time in office. In June 2004, it obtained legal backing for the elimination of early retirement provisions in the pension law (estimated annual savings of about 0.2% of GDP – see Box 3). It also presented a prudent 2005 budget, which includes a freeze on public sector wages and an overall expenditure level consistent with a planned deficit for 2005 of 3% of GDP. In late 2004, the administration obtained legislative approval of a package of fiscal reforms, centered on reducing loopholes, improving tax collection powers and raising excise taxes on cigarettes, alcohol and arms. The package is estimated by the government to yield some 1.2% of GDP in 2005. In addition, the government has announced its intention to pursue further fiscal reforms if necessary in order to gradually raise tax revenues to a target 15.2% of GDP by 2009.

BOX 3: FISCAL COST OF PENSION REFORM.

El Salvador adopted a pension reform in 1996 that replaced the existing pay-as-you-go system with a system of individual retirement accounts. The reform was aimed at improving long-term fiscal sustainability by replacing a system that was projected to yield large and growing deficits in the future by a sustainable one, implying transitional costs as younger Salvadorans move to the private account system while the state keeps the obligation to pay out pensions to older generations. In addition the reform made the conditions for access to benefits more homogenous among workers from the private, and public sectors, and aimed to gradually increase coverage and develop a private savings pool that could form the basis for long term investments.

Managing the transition costs of the pension reform is currently an important challenge in El Salvador, particularly as the country also needs to finance other important social expenditures. The government has adopted several measures to manage these costs, the most important of which was the approval in June 2004 of the elimination of early retirement provisions. This measure should reduce the fiscal costs of the pension system by about 1 percent of GDP over the next five years (2005-2009).

18. **Financial Sector.** El Salvador made impressive progress in strengthening its financial sector in the 1990s with the introduction of new legislation, and consolidation of the banking sector following intense mergers and acquisitions in the latter part of the decade. Development of the banking sector has benefited from free capital flows and low inflation, and the effect of dollarization. In 2000, at the request of the government, the IMF and World Bank carried out a Financial Sector Assessment (FSAP) to assess the stability and performance of the financial sector as a whole. In 2004, they conducted an Update of the FSAP (a summary of findings and recommendations appears in Box 4) to assess progress since 2000 which found that while the country enjoys one of the region's stronger financial sectors, considerable scope exists for tightening prudential standards and reducing contingent liabilities⁴. Capital adequacy requirements need to be raised to meet international standards. In addition, direct contingent liabilities arise from the operation of three public banks for which a new financing structure needs to be developed in which the fiscal cost of this public lending activity is fully and transparently

⁴ According to the latest IMF Article IV consultations under an adverse scenario the equivalent of 4.5% of GDP of contingent liabilities could become an explicit public liability.

funded by existing fiscal resources. Challenges in the development of capital markets are discussed below under the section on the growth agenda.

19. As part of El Salvador's efforts to strengthen its financial sector, a strong Anti-Money Laundering/Combating the Financing of Terrorism regime are also important both in the public and the private sector. Measures on these fronts would deepen the efforts to combat corruption and to foster transparency, which reduces the vulnerability to money laundering and terrorism financing.

BOX 4: FSAP UPDATE - SUMMARY OF FINDINGS AND RECOMMENDATIONS

Main Findings

1. El Salvador has made progress clarifying the roles of the Banco Central de Reserva (BCR) and the Superintendencia del Sistema Financiero following dollarization in 2001.
2. Dollarization has had a positive impact on financial sector stability by mitigating exchange rate risk, lowering interest rates, and diminishing the costs of borrowing from abroad. Indicators on bank soundness suggest that the system weathered the economic downturn quite well.
3. Regulation and supervision of the financial system has been strengthened since 2000, notably in the framework for weak bank resolution and in issuing regulations to combat money laundering.
4. Cross-border lending has increased rapidly in the past few years, and generally appropriate supervisory guidelines have been put in place.
5. Under dollarization, the BCR acts as fiscal agent for the government issuing Treasury securities to smooth out cash-flow for government financing. The BCR continues to issue its own paper to manage the stock of international reserves, because it does not have sufficient government paper for this purpose.
6. The BCR holds the liquidity reserves of individual banks, but it has no commitment to act as lender-of-last-resort, except as an agent of the government in weak bank resolution.
7. El Salvador provides a more friendly environment towards micro lending than most Latin American economies.
8. Corporate credit could benefit from improvements in registration of pledges and execution of claims, diversifying security methods, completing the reform of registries for real estate and immovable assets, and reducing the complexity of judicial enforcement proceedings for execution of both unsecured and secured claims.

Main Recommendations

1. Tighter loan classification and stricter provision is required to improve further the soundness of individual banks.
2. Stronger capacity to conduct consolidated supervision is needed to keep pace with the growth of cross-border banking activity.
3. The BCR needs to replace central bank paper with Treasury bills and capitalize government deposits in order to build up official reserves to cushion systemic liquidity.
4. Approval of the new Securitization Law is required to further stimulate access to credit and to allow for the efficient allocation of credit risk among borrowers, first and second floor financial intermediaries, and investors.
5. Legislation on corporate insolvency should be reviewed to facilitate the reorganization of viable enterprises and/or the liquidation of non-viable ones. The environment for informal corporate restructuring agreements also needs to be improved.

C. Governance

20. El Salvador is implementing a successful process of public sector modernization, streamlining and improving efficiency of key areas of the state. Reforms were started in 1994 and were strengthened in 1999 in order to improve service delivery, address the overextension and centralization of the State, as well as reform outdated and inadequate administrative infrastructures. Important accomplishments in this area include: (i) the successful restructuring of the Ministry of Public Works, transforming it into a policy ministry and spinning off the maintenance activities to the public sector, with significant efficiency gains; (ii) development of a human resources management system for the public sector including the design of tools for selection, evaluation, classification, remuneration and promotion of government employees; (iii) issuance and implementation of modern financial management, procurement, tax, and customs legislation and the introduction of integrated financial management and tax information systems; and (iv) partial decentralization of public services in water and health.

21. Despite significant progress in this area, further efforts to modernize the public sector and strengthen governance are still required to improve the efficiency and transparency of public institutions and address public perceptions. Continued efforts at institutional restructuring in other Ministries, such as Agriculture, are being planned and should provide continued momentum towards increasing efficiency and effectiveness of public institutions. Furthermore, decentralization efforts are still incipient and should be framed within a comprehensive strategy, and certain key legal reforms—such as a new Civil Service Law—are still necessary. The country is also exploring the potential of electronic government initiatives to bring efficiency gains and to improve the access to certain services.

22. The low credibility of the impartiality and efficient functioning of judicial systems is also a major issue. Corruption and lack of transparency in the operations of some public sector agencies are also often cited as problems. (Transparency International ranks El Salvador 51 out of 145, and fifth in LAC after Chile, Barbados, Uruguay and Costa Rica.) According to the Worldwide Governance Research Indicators Dataset,⁵ when compared to the Latin America and the Caribbean average, El Salvador does well in preserving political stability, is around the average in terms of its regulatory framework and promotion of voice and accountability, but shows less than average performance in rule of law, government effectiveness and control of corruption.

23. As regards the financial and procurement reform process, significant improvements in the performance of budget and procurement management institutions have been made. To document the current state of public financial management in the country and propose priorities for action, the World Bank and the IADB carried out in 2004 a Country Financial Accountability Assessment (CFAA) and a Country Procurement Assessment (CPAR). The key findings and recommendations are summarized in Box 5.

⁵ The Governance Indicators, compiled by the World Bank Institute, reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries, as reported by a number of survey institutes, think tanks, non-governmental organizations, and international organizations.

Box 5: CFAA and CPAR - Summary of Findings and Recommendations

The Country Financial Accountability Assessment Report (CFAA) and the Country Procurement Assessment Report (CPAR), prepared jointly with the IADB, analyze the performance and transparency of budget and procurement management institutions and systems in the public sector. The analysis and recommendations contained in these reports seek to identify areas where further improvements in public financial management could help to strengthen fiscal discipline, increase operational efficiency, and improve the country's governance environment.

The analysis concludes that the Government has built strong foundations for well-functioning budget and procurement management systems, with a basis on modern legislation. Still, the widening public sector deficit and deteriorating governance indicators pose important challenges ahead. Accordingly, a detailed set of recommendations has been put forward to the Government – a brief summary follows:

- **Civil service.** Further strengthening of the financial and procurement management institutions will benefit from the implementation of the government's plans for a renovated legal and regulatory framework for human resource management and increased managerial accountability.
- **Budget development.** The sound methodologies used for budget formulation could serve as basis to improve disclosure of extra-budgetary funds, to aggregate and consolidate municipal budget data, to develop a medium term budget framework, to enhance information and indicators on the public investment program, and to bring the budget documentation up to international standards.
- **Tax administration.** The modern revenue administration systems could benefit from stronger coordination among the agencies involved, together with enhancements in the prosecution and sanctioning of tax and customs-related cases.
- **Procurement management.** The significant steps taken with the creation of a central regulatory body (UNAC) and decentralized procurement units (UACIs) can be better sustained through systematic staff training and technical assistance, issuance of regulations to the procurement law, and harmonization of bidding and contract documents.
- **Budget execution.** The integrated financial management system (SAFI) has significantly improved the procedures and information on government spending, but there is still work ahead to develop or consolidate related administrative systems; most notably, the upgrading of the payroll management system, and the development of a comprehensive procurement information system (under the e-Government initiative), coupled with tools to monitor procurement performance.
- **Debt.** Active debt management will require the introduction of continuing programs for skills development in this highly specialized area – such programs to include the capacity to undertake systematic debt sustainability and risk analyses.
- **Internal controls.** Implementation of a more effective internal control and internal audit framework, based upon risk-based approaches, will be key to further guarantee efficiency and legality of public expenditures.
- **Financial reporting and external oversight.** The accounting function, which is properly institutionalized and shows sophisticated advances, could serve as basis for further improvements in the content and accessibility of financial information. Comprehensive financial and procurement audits from the Court of Accounts, together with strengthened legislative oversight, would help fill current gaps in external fiscal control.

Noteworthy recent steps in the public financial management area have been the government adoption of a framework for internal controls consistent with international standards and the issuance of a four year program for the public procurement system.

24. The new government of El Salvador is committed to addressing the governance challenges by strengthening anti-corruption and transparency initiatives, improving personal security through development of programs for the control and prevention of crime and violence, and undertaking further modernization and institution building in the overall public sector. The government is also considering initiatives to continue

strengthening the regulatory frameworks, institutions and public-private contracting protocols that involve the provision of basic services (such as electricity, telecommunications, urban transport services and water). Although significant progress has been made in certain sectors, these initiatives will help the government to consolidate the benefits of the privatization process begun in the 1990s and thus improve the quality of life of its citizens and the competitiveness of its businesses.

25. An important component of the governance challenge—to which the government has also committed itself—is to improve the capacity of the judicial system to properly enforce legislation by strengthening management, adopting a more effective organizational structure and improving the allocation of resources.

D. The Growth Agenda

26. During the 1990s, few countries experienced as much progress as El Salvador in the introduction of first generation reforms, creating a solid market-oriented framework. However, growth levels have been disappointing since the second half of the 1990s. While factors beyond the control of the authorities explain a large share of this result (e.g., commodity prices, natural disasters), there are still some key weaknesses in policies and institutions that need to be addressed. According to the Bank's recent Country Economic Memorandum (CEM), which evaluated positively El Salvador's reform agenda of recent years, key priority areas to reignite growth include (i) further expanding international trade, (ii) improving the investment climate, (iii) addressing remaining bottlenecks in infrastructure, (iv) fostering innovation and adoption of new technology and, (v) increasing the educational level of the population. This section presents an overview of challenges in the first four of these items, with education issues discussed at more length below in the section on human capital.

27. **Trade.** El Salvador and four other Central American countries have negotiated a free trade agreement (DR-CAFTA) with the United States. If implemented, the agreement is expected to bolster trade and investment levels. The Bank's recent analytical work in this area indicates that DR-CAFTA could add at least 0.5% per annum to El Salvador's growth rate. The agreement would yield opportunities to turnaround the recent deceleration in export growth, which has been affected by greater competition from Asian textiles in external markets as well as low prices for coffee and other traditional exports. It is also expected to improve significantly the investment climate, as it contains rules and disciplines for investment relations, anti-corruption, as well as labor and environmental standards. Commitments in these areas are expected to yield improvement in key regulations, as well as a strengthening of local institutions. Greater trade opportunities and a stronger investment climate are expected to boost investment levels, both from abroad and from internal sources, which is the linchpin of the government's plan to reignite growth. The agreement was ratified by the Salvadoran Assembly in late 2004 and is expected to enter into force as soon as it is approved by the U.S. Congress in 2005.

28. DR-CAFTA is likely to enhance market access for some Salvadoran products, while making permanent the unilateral preferences offered in the past through the

Caribbean Basin Initiative (CBI). Little if any trade diversion is expected, since the U.S. has been traditionally the largest natural market for Salvadoran exports, as well as its largest source of imports.

BOX 6: ACTIONS TO MAXIMIZE DR-CAFTA OPPORTUNITIES FOR EL SALVADOR

- **Education and knowledge absorption and generation:** DR-CAFTA is likely to bolster FDI and imports with the capacity to improve technology and productivity. However, to materialize the potential and enhance technological spillovers will require sufficient levels of human capital and an adequate knowledge and innovation system. In education, this means that El Salvador needs to close its 'gap in skills', expanding coverage and quality of its primary and secondary schooling system. In the innovation front, it will need to boost the quality of its institutions of research, increase expenditures on R&D and develop links between public researchers and private sector users. There are important synergies to be exploited between a functioning innovation system and critical higher education initiatives.
- **Institutional development and governance:** El Salvador has achieved considerable progress in the institutional and governance front over the past decade. However, serious deficiencies still exist, particularly in the rule of law and personal security front, as evidenced by corruption, violence and crime indicators. Weaknesses in rule of law are part of the reason for the apparent low growth yield of reforms in El Salvador in recent years. To reap the rewards of DR-CAFTA, continued improvement in institutions is required, especially those aimed to improve the rule of law and fight corruption. This will require substantial local efforts, as such improvements have not been automatic byproducts of North-South free trade agreements.
- **Infrastructure:** While El Salvador has made great strides in modernizing its infrastructure (esp. airports and roads) in recent years, there are deficiencies that need to be addressed, particularly in road networks and ports. The experience of Mexico has shown that the southern provinces have lagged behind the rest of the country in taking advantage of the growth opportunities offered by NAFTA, principally because of low education levels, and weak transport and communications infrastructure. To allow all regions of El Salvador to benefit from DR-CAFTA, strategic investments in infrastructure will be required, with increased emphasis on lagging regions.
- **Macroeconomic management:** Investors should be attracted by El Salvador's record of stable macroeconomic management of recent years. Potential fiscal losses associated with DR-CAFTA will need to be compensated and macroeconomic management strengthened. Within the dollarization framework, the Central Bank's role as lender of last resort to the financial system needs to be bolstered and efforts must be redoubled to ensure compliance with strict prudential norms and regulations. Further fiscal consolidation will also be required in order to pursue effective counter cyclical policies.
- **Trade policy:** In addition to strengthening institutions related to meeting DR-CAFTA commitments in the trade administration sphere, El Salvador is likely to benefit from continuing to pursue its agenda of unilateral, bilateral and multilateral actions to expand trade and broader integration opportunities. Deepening trade and other links with regional neighbors through the CACM will improve allocation of resources in the region and provide economies of scale needed to launch new viable export ventures. Further progress in reaching FTAs with Canada, the European Union and with other Latin American countries through FTAA will further broaden economic integration and minimize any possible trade diversion effects from existing FTAs.
- **Broadening the benefits of DR-CAFTA:** Attention is also required to ensure that benefits of DR-CAFTA are spread across all levels of Salvadoran society. This includes policies to foster development of financial services beyond large companies, so that MSMEs have access to finance. This is likely to require legal and institutional shortcomings regarding the protection of creditor and shareholder rights. Specially targeted programs for low income farmers/laborers may also be needed for those who are likely to be displaced from their current activities, to facilitate a smooth transition to other areas with more growth potential.

Source: The World Bank, CEM, 2004.

29. Complementary actions will be required to ensure that El Salvador takes full advantage of the opportunities offered by DR-CAFTA, and to obtain the anticipated boost in growth rates, as indicated in the Bank's recent analytical work on this topic (see Box 6). Actions will be especially needed in improving the investment climate, addressing critical infrastructural bottlenecks, fostering innovation and raising the

educational level of the labor force. Complementary actions are also needed to ensure that the opportunities of trade are accessible to small and medium size firms, which represent a significant percentage of El Salvador's economy.

30. El Salvador has also advanced in the reduction of institutional barriers to trade in the region by working with partners of the Central American Common Market (CACM) on the terms for creating a customs union. In recent months, Guatemala and El Salvador have been unifying their border customs offices and are advancing on plans to share revenues in order to eliminate customs posts in common borders.

31. **Investment Climate.** In this area, issues that need to be addressed include the poor functioning of some markets, insufficient competition in others, high costs of doing business and further development of capital markets, as described below.

32. *Market performance and regulation of competition.* One of El Salvador's key deficiencies in international competitiveness rankings is the persistence of perceptions of anti-competitive practices in some markets as well as the lack of modern anti-trust and bankruptcy laws. The appropriate functioning of some markets has been impaired by weak enforcement of current norms and the absence of a modern Commercial Code. Market performance is also affected by gaps in the overall regulatory framework and weaknesses in some regulatory agencies. Improvements in the effectiveness of the judicial system is also needed.

33. *Costs of doing business.* Recent reports by the Bank have highlighted the high costs of doing business in El Salvador. In particular, local entrepreneurs still have to endure long and costly processes to establish a new business. Recently, the National Investment Office (ONI) reduced the time to register a foreign business from 8 months to 2 weeks. However the benefits of administrative simplification for starting and operating a business need to be extended to local firms, including SMEs. According to the 2005 Cost of Doing Business Report, El Salvador needs additional efforts in reducing the number of days and the cost of registering new firms.

34. *Development of capital markets:* El Salvador's capital market has benefited from a regionally strong financial sector, generally effective legislation, banking consolidation, unrestricted capital flows and considerable integration of micro-lending institutions to the formal banking sector. However, the banking sector's ability to provide capital to all types of productive activities is constrained by its limited capacity to assume un-diversifiable risks, and by the need to permanently maintain high precautionary liquidity levels. Alternative financing instruments could develop through the securitization of claims on selected investment projects, as banks, brokerage houses, and the Stock Exchange offer the infrastructure required to place those securities in their primary market, and to provide liquidity to them by maintaining an active secondary market. Other areas that require further efforts to improve access to finance more broadly include improving credit analysis for micro lending institutions; introducing more flexible guarantees and more efficient registration of related pledges and execution of claims.

35. **Infrastructure.** Despite progress during the 1990s, and a major reconstruction effort after the 2001 earthquakes, El Salvador still faces challenges in the coverage, quality, access and sustainability of infrastructure services. To move in this front, the country needs to mobilize additional investment resources (public and private) and continue institutional and policy reforms. In particular, the country needs to improve the framework for efficient and equitable provision of infrastructure services, strengthening the institutional capacity of the “Superintendencia General de Electricidad y Telecomunicaciones” (SIGET) and issuing complementary legislation particularly in the energy, telecommunications, water and sanitation, and transport sectors. In addition, as the DR-CAFTA approaches implementation, improved access to market will be a key requirement for the benefits of the treaty to materialize, for which resolution of bottlenecks in road, aviation and port policies will be necessary.

36. In energy, an electricity sector reform program begun in 1996 unbundled the national utility and, in 1998, privatized distribution and generation assets. The privatization program led to investments of approximately US\$850 million in the sector. This has significantly increased coverage and service quality, resulting in a decline in the production losses experienced by Salvadoran firms as a result of power interruptions. However, further regulatory and market structural reforms are needed to ensure competitive behavior and pricing as well as an investment program that keeps pace with demand.

37. In telecommunications, the situation has improved significantly over the past few years, as the liberalization of the telecom market has led to impressive expansion of coverage for telephony and a drop in rates. Nonetheless, El Salvador’s technological competitiveness is impacted by the low level of reliance on information and communications technology illustrated by an unusually low use of the internet. This is likely due to tariff structures that price internet usage out of the market for homes and small businesses. Regulatory and institutional strengthening in this area could help El Salvador to leverage its wide telephony coverage as a basis for more competitive ICT.

38. In water and sanitation, the sector presents a mixed picture in regulation and supervision, and the country is lagging behind neighboring countries in the region, some of them with much lower per capita income, in terms of access to improved water sources. Many agencies from the public sector have jurisdiction over the water sector, resulting in inefficiencies, poor accountability, and lack of a comprehensive policy framework. The situation and performance of the water and sanitation sector has impacts that not only affect public health but reduce the country competitiveness, increasing the cost of doing business and its capacity to attract foreign investments.

39. Through the creation of the road fund (FOVIAL), El Salvador has made significant strides in rebuilding its primary and secondary road network since the 2001 earthquakes. However, it still maintains the lowest level of paved roads in Central America—26 percent. Among those roads less than 60 percent are in good or very good condition. In a survey conducted in 2002 as part of the Investment Climate Assessment, approximately 40% of firms reported losses or damage of goods in transport from plants to consumers. Inefficiencies in the transport and logistics chain generate losses equivalent

to 1.8 percent of total sales. Going forward, the country needs to improve—through both public and private investments—critical roads for international and interregional commerce, including the East and North Corridors, as well as the unpaved rural road network that connects rural areas to the primary roads.

40. One out of every three firms in El Salvador found air transport to be a bottleneck for export competitiveness and FDI. Private investment and a modern management arrangement are also needed to improve cargo services at the Comalapa International Airport. In ports, the national seaport, Acajutla, remains a relatively inefficient public terminal with limited container capacity while most shippers seek access through Honduras. While the government is considering the development of a new port facility with support from Japan, the port reform program has been highlighted in competitiveness studies as a priority for exporters and other shippers and consignees. In all cases, it is clear that actions should go beyond physical infrastructure and deal with the entire logistics chain that increases cost and reduces the capacity to export and the attractiveness of El Salvador for private investment.

41. **Innovation and technology.** El Salvador is trailing in the area of innovation and technology, as diagnosed in the Bank's recent CEM. The country is lagging in its efforts to develop an effective National Innovation System (NIS). By international standards, El Salvador underperforms in innovation outcomes (e.g., patents, scientific publications) as a result of a very low level of R&D investment in comparison to countries of similar size and level of development, despite evidence of high potential rates of return to this type of investment. In addition, the efficiency of the NIS system, measured as the productivity of turning R&D investments into patents, is low in comparison to similar countries. This inefficiency is in great part due to the lack of collaboration between the private sector and research organizations such as universities. El Salvador also performs poorly in international comparisons of technology transfer through FDI.

42. Improving its NIS and levels innovation and technology transfer remains an important challenge in El Salvador going forward. The CEM suggested the following initiatives to improve El Salvador's NIS: (i) improve the capacity of El Salvador to fully benefit from the available stock of knowledge, by emphasizing imports of capital goods and licensing; (ii) enhance the incentive-regime for private R&D to help technology absorption and support gradual technology adaptation; (iii) strengthen public-private partnerships particularly (although not only) in key areas of the economy such as agriculture and teleservices; and (iv) improve coordination, policy-making and effectiveness of public interventions.

E. Poverty

43. El Salvador has made significant progress in reducing poverty since the beginning of the 1990s. The share of the population whose income falls below the poverty line declined by 27 percentage points from 64.4 percent in 1991 to 37.2 percent in 2002, while the fraction living in extreme poverty declined by almost 16 percentage points from 31.2 percent to 15.4 percent during the period. Poverty fell fastest in the first half of the decade and slowed considerably after 2000 – in the face of the coffee crisis, the

earthquakes of 2001, and the slowdowns in the global and domestic economies. Indeed, extreme poverty has barely changed since 2000. Moreover, income inequality, already high by international standards, has increased slightly since the mid-1990s, highlighting the challenges facing El Salvador's poorest families.

44. Several factors are associated with the broad improvements in poverty during the 1990s. Economic growth has been an important force for poverty reduction, and many poor families were able to share in the growth that occurred over the period. Between 1991-2002 period, for example, average incomes of the poor households grew by 3.1 percent a year, not far from the nationwide average of 3.7 percent. Structural changes in employment and household earnings have also contributed to poverty reduction over the period. Specifically, there was a considerable movement of employment and diversification of household incomes out of agriculture over the period, and those households that were able find new, non-agricultural income sources, generally succeeded in raising their living standards over the period.

45. In addition, remittances played an important role in poverty reduction over the period. Indeed, households that received remittances had income levels that were fifty percent higher than otherwise identical households that did not. Only a relatively small proportion of the poor received remittances during the period, however; as such, simulation analysis suggests that the effect of households' own income growth was likely greater than the effect of remittances in reducing poverty. Finally, increased attention to the social sectors, which has tended to be low by international standards, has contributed significantly to increased access by the poor to human services. This, in turn, has contributed to increased economic productivity among young graduates and paved a way toward further reductions in poverty in the future.

46. Although there has been some narrowing of income differentials across departments since the early 1990s, regional and spatial dimensions of poverty remain important. Moreover, recent estimates indicate that poverty in El Salvador continues to be disproportionately a rural phenomenon. According to the recent World Bank Poverty Assessment (2004), roughly half of Salvadorians living in rural areas was poor and a quarter of the rural population was extremely poor in 2002. This compares with about 29 percent of urban population which was poor, and only 9 percent who were extremely poor. While according to official figures only about 40 percent of Salvadorans live in rural areas, 55 percent of all poor people lived in rural areas in 2002 (Box 7). Extreme poverty is particularly concentrated in rural areas; in 2002, nearly two-thirds of all El Salvador's extreme poor lived in rural areas. Along other social dimensions, it is worth noting that there has also been some closing of the gender gap in well-being over time. While, on average, female headed households were significantly poorer than male-headed households in 1991, this was no longer true by 2002.

BOX 7: POVERTY REDUCTION AND THE RURAL-URBAN DIVIDE

To date, poverty analysis in El Salvador has utilized official definitions of rural and urban, which are based on long-standing administrative boundaries. Nonetheless, there is some debate in the development literature as to whether historical administrative definitions are the most appropriate. One alternative definition, used by the European Union and applied to Latin American countries in a new World Bank Flagship report “*Beyond the City: The Rural Contribution in Development in Latin America and the Caribbean*”, defines rural communities in terms of their population density and distance from major urban centers. Under this definition, the spatial distribution of the Salvadoran population – and, thus, the regional characterization of poverty in El Salvador – would differ notably. Only 10 percent of the total Salvadoran population would be characterized as rural, and much of what policymakers now call rural might be characterized as “semi-urban”.

While it is possible to debate the merits of this alternative definition for El Salvador, one potential benefit of this definition is that it serves to highlight rural-urban linkages that will be increasingly important for future poverty reduction in El Salvador. The increasing importance of non-agricultural incomes is already clear from the analysis presented in the Poverty Assessment. Indeed, a key engine for poverty reduction over the last decade has been the structural change of the overall economy toward manufacturing and services and the important diversification of incomes among “rural” (and/or semi-urban) households into non-agricultural activities. This structural movement out of agricultural into non-agricultural enterprises and income is likely to be a major force in poverty reduction in El Salvador in the coming years.

This analysis reinforces several strategic areas of policy reform and investment highlighted in the Poverty Assessment that will be important to reducing poverty in the future. This includes investments in human capital of the poor to enable them to better take advantage of emerging economic opportunities, and investments in rural road and transport infrastructure to strengthen linkages to markets and between the agricultural and non-agricultural economies.

47. El Salvador’s recent successes in reducing poverty have highlighted a new set of challenges for continuing poverty reduction and social progress in the years to come. Economic growth will continue to be a central feature in El Salvador’s efforts to reduce poverty. As such, one key challenge will involve reinvigorating economic growth. A second, and equally important challenge, will be ensuring that the poorest Salvadorans are able to benefit from future economic progress. This is important because while the more moderate (or “relative”) poor did benefit from economic growth since the early 1990s, the poorest, most vulnerable Salvadorans have not been able to take advantage of recent progress. Indeed, while the moderate poor experienced average household income growth of over 3 percent per annum, per capita incomes of the poorest Salvadorans grew only 1.3 percent per year, on average, over the period. This, in turn, has fueled the recent increases in inequality in El Salvador, and raised the prospect of the poorest segment of Salvadoran society being further left behind in the future. The recent World Bank Poverty Assessment for El Salvador (2004) finds that inability of the poorest to take advantage of economic progress is related both to the weak human capital endowments of the poorest, most vulnerable Salvadorans, as well as their continued lack of access to markets and basic services. These factors help to frame the main policy areas for future poverty reduction in El Salvador.

48. Environmental degradation has increased El Salvador’s vulnerability to natural disasters (earthquakes, floods, etc) and is closely related to rural poverty. Low

productivity in production systems and pressures from the population have led to a depletion of natural resources in many rural areas, characterized by soil erosion and degradation, loss of habitat, biodiversity and natural forests, and growing problems in water management and conservation. In order to address these vulnerabilities the new government is developing a national environmental policy and strategy, with broad citizen participation, that would consolidate the regulatory and legal framework and support implementation of measures aimed at watershed recovery, reforestation, decontamination, clean production, management of ecosystems and biodiversity conservation. The government is also considering piloting a system of charges and payments for environmental services that would compensate poor hillside farmers for adopting sustainable agricultural practices and producing positive environmental externalities. This type of program has been successful in reducing rural poverty in a sustainable way in countries such as Costa Rica.

F. Human Capital and Socio-Economic Infrastructure

49. **Education.** Continuing to strengthen the education sector will be central to El Salvador's economic growth and poverty reduction strategies. El Salvador has a strong history of education reforms and a good track record of cost-effective use of resources. El Salvador's education system made positive strides in the 1990s and is now very well positioned in the Central American context. In particular, El Salvador has made considerable progress in raising primary enrollment rates (primary gross enrollment rate over 100% and primary net enrollment rate of about 85%), primary graduation rates (now about 80%) and secondary coverage (gross enrollment rate of about 60%). Additionally, the urban-rural and socio-economic gaps have decreased. It is likely that the country will meet the 2015 Millennium Development Goals for net primary enrollment, share of students that complete the fifth grade, and the universal literacy target for youth. The targets related to gender in primary and secondary education as well as literacy rates have already been met.

50. This performance is the result of a comprehensive education reform which started in the early 1990s and was formally endorsed by the ten year Education plan (1995-2005) which received broad-based support from Salvadoran society. The education reform included several innovative measures, such as: (a) the re-organization of the education cycle into a basic (grades 1 to 9) and a secondary (grade 10 to 11 or 12) sub-cycle; (b) the introduction of a pioneering community-based school management model, called EDUCO, in the rural areas; (b) full teacher certification; (c) the introduction of teachers' selection and accreditation mechanisms and of a team-based merit pay scheme; and (d), more recently, the introduction of multi-grade teaching and distance education in rural areas.

51. Despite these recent achievements challenges remain, particularly with respect to equity, quality, and efficiency. The still-low education indicators--such as standardized assessments and pre-school and secondary education coverage--affect especially students from low income families. Secondary enrollment rates are only about 20 percent among the poor (compared with about 50 percent among the non-poor) and, when the poor do enroll in school, they are less likely to continue to completion (less than 10% of the poor

complete secondary). In addition, while the quality of education is a system-wide challenge in El Salvador, education quality appears to be particularly low in schools attended by the poor. There is a need to increase the value of additional years of education at the lower secondary level where rates of return are very low and improve the relevance of upper secondary education. Therefore the GOES is seeking not only to continue increasing access to secondary education but also to improve its quality and modernize its content. In terms of efficiency, the system needs to find more cost-effective strategies to strengthen and/or expand successful innovations such as community-based education management, multi-grade schooling, distance education, education for overage students, technology centers and extra-curricular programs for youth. Efficiency gains will guarantee better use of proposed additional resources to the sector.

52. Public education spending in El Salvador is still low compared to international standards and to the regional average. Spending is also low relative to El Salvador's per capita income level. The new government of El Salvador has placed education at the centre of its development strategy and is fully committed to supporting educational reform. A new fifteen year Long Term Education Plan with specific preschool, primary and secondary education targets to 2021 - is being prepared using the same national dialogue and consensus process as before; and, in parallel, the government will implement the key activities of the 2004-2009 Education Development Program. The government will focus on key areas, which include improving education quality, providing access for all for secondary education (including poor and rural populations), strengthening secondary education linkages to productivity and technology, and increasing public (and overall) financing for education. Quality improvements will be supported by a strengthened testing and evaluation system. Wider access to secondary will be supported by the consolidation of distance education and demand-side programs, as well as by innovations such as the development of rural school networks. The link with technology will be strengthened by the creation of regional technological poles.

53. **Health.** Continuing to improve Salvadorans' access to healthcare and, through it, their health status, will also be a critical dimension of increasing the human development and well-being of all Salvadorans. During the 1990s El Salvador made progress in life expectancy, infant mortality rates and child immunization. These indicators are now similar or slightly better than LAC, and gaps between the poor and non-poor have closed, at least in some areas. However, the prevalence of chronic child malnutrition has declined more slowly, and basic health and nutrition indicators continue to be significantly lower among the poor than the non-poor. The prevalence of child mortality is fifty two percent higher in rural areas than in urban areas and infant mortality is almost twice as high for low-income families. Fewer than 20 percent of all Salvadorans have access to medical insurance either through the Salvadoran Social Security Institute or through private sources. Less than 10 percent and 3 percent of the moderate and extreme poor, respectively, are insured. Therefore, a major responsibility of El Salvador's Ministry of Public Health (MOH) is to cover the population without insurance. While there have been significant advances in recent years, it is estimated that nearly one-quarter of the population, mostly the poor, still has limited or no access to public health

services. Problems of access have been exacerbated by delays in repairing earthquake damage to hospitals and other health facilities.

54. Continuing to improve basic health outcomes among the poor will require enhanced efforts to ensure access to affordable healthcare among those who lack it, as well as building greater trust in the public health care system through improving the quality of services. This will involve: (i) ensuring that targeted health fee waivers are available, when necessary, to address demand-side constraints among the poor; (ii) assessing ongoing institutional reform and decentralization efforts, streamlining the stewardship and management roles of MOH and SIBASIS⁶ respectively, as well as expanding social security coverage on health; (iii) identifying cost-effective ways of strengthen the outreach and quality of the public health system, particularly at the primary level, and tapping the potential of NGOs and other private providers of health services for the benefit of the poor; (iv) reforming the health sector's human resource policy to ensure a sufficient supply of well-trained health care professionals and quality care, particularly in poor rural areas; and (iv) completing rehabilitation of hospitals damaged by the 2001 earthquakes to ensure safe and adequate supply of secondary and tertiary health services, as well as rationalizing and modernizing the public hospital infrastructure.

55. El Salvador's overall budgetary allocation for health services as a share of GDP is low by regional standards, as are total public outlays (including health programs of the Social Security Institute) on a per capita basis. In contrast to education, there is still no broad consensus on the direction of health sector reforms. The current government has reestablished the political dialogue with health stakeholders and revived the National Commission on Health Reform, after a severe deterioration of the dialogue process during the past few years. A critical element in making sustainable progress in health will be building a national consensus on the way forward in important issues such as progress in the decentralization of public services; public-private partnerships; expansion of health insurance and cooperation between social security and MOH; staffing levels, recruitment and payment policies to health personnel; and enhancement and enforcement of quality and safety of care. Efforts should focus on how to improve the efficiency and equity of resource use, as the government identifies new sources of additional funds to allocate to the sector. Reforms that define a strategic direction, including the appropriate roles for the private as well as the public sector, could pave the way to significant efficiency gains, and thus a greater leveraging of available resources.

56. **Socio-economic Infrastructure.** Access to basic services and to markets is key to expanding the productivity and income and employment generating opportunities of the poor. Over the 1990s, El Salvador made significant progress in increasing access to safe water, sanitary installations, telecoms, and electricity. Important gains were also made in reducing the isolation of poor, rural households and enhancing their access to markets through investments in expansion and improvement of the rural road network.

⁶ SIBASIS (Sistemas Básicos de Salud Integral): Decentralized autonomous networks of MOH facilities providing primary and secondary care to defined geographical areas under unified management.

Average distances and travel times to paved roads and to markets declined substantially for all rural households, and most dramatically for the poorest families.

57. El Salvador has already surpassed the MDG target for urban water and sanitation and rural sanitation coverage and it is likely that by 2015, the target for rural access to water will be met. However, about half the poorest households still lack access to safe water, particularly in rural areas, and pollution has proven to be a serious health threat for consumers. In addition, over 20 percent of the poorest households lack adequate sanitation facilities. The current regulatory system allows for decentralized water provision but provides uneven “rules of the game” across water sector institutions leading to inefficiencies, considerable variability in the quality of water systems, and at times high water costs to the poor who access water through gray market purchases. The sector also suffers from institutional weakness and dispersion: Many agencies from the public sector have jurisdiction over the water sector: the Ministry of Agriculture operates and administers the national irrigation system, the Ministry of Public Health monitors the quality of water for human consumption and industrial production, and the Administracion Nacional de Acueductos y Alcantarillados (ANDA) operates and regulates water and sewage.

58. Reforms were initiated in the 1990’s but set aside because the focus shifted to system reconstruction in the aftermath of the earthquakes. The government has not completed development of a comprehensive policy framework for the water sector, mainly due to fragmentation in the management and control over its many segments. However, technical preparations for a reform of the sector are advanced, with ANDA drafting legislation to open up the market to competition by 2004 and establish a regulatory entity to oversee national water policy. Despite concerns about the capacity of ANDA to lead the reform process the new government is potentially in a strong position to finalize the technical inputs and complete reforms. This could vastly improve access to potable water among the poor.

59. Improved coverage and quality of *rural roads* during the 1990s has contributed to poverty reduction in rural areas, and has given household members access to markets, educational and health centers, water and security. However, the poor still face greater distances and costs associated with accessing services or markets. Average distances to paved roads are still 80-90 percent higher among the extreme poor than the non-poor in rural areas, and average distances to the nearest market are roughly one-third higher among the extreme poor than the non-poor. The government is committed to continue investing in rural roads and is focusing on: (i) expanding and improving the rural road network; (ii) developing a program for the maintenance of secondary and tertiary road networks to ensure sustainability of investments in roads and (iii) continuing development of local and municipal capacity to build and maintain rural road infrastructure.

60. Significant improvements have also been made in coverage and quality of *electricity* service since 1990 particularly in rural areas. The proportion of households in rural areas with electricity increased by 28 percentage points between 1991 and 2002. However, in 2002 almost 29 percent of rural households still did not have electricity.

Strengthening the electricity sector is part of the President's plan "Safe Country". Specific challenges include: continuing to increase coverage in rural areas; the reduction of electricity costs through more efficient generation and distribution, and the improvement of service quality. The sector could benefit from more targeted resource allocation priorities: subsidies should be reduced for those who already have access to electricity to allow more resources to be allocated for the benefit of low-income populations and rural areas lacking service.

61. **Government priorities in poverty reduction.** A key priority of the Saca administration is to address the needs of the poorest Salvadorans who have been unable to take advantage of economic growth over the past decade and a half and who have not, as yet, been able to benefit from traditional sector programs. To build effectively on past achievements, the government has proposed to implement a social policy, based on broad national consensus, aimed at expanding access to markets and basic services, including the coverage and quality of education and health care for the poor, and developing a social safety net for the poorest and most vulnerable Salvadorian families. While improving targeting and the efficiency of public resources are also important, the relatively small size of overall expenditures in these areas indicate the need for additional investment, which will imply difficult trade offs in an environment with extremely tight fiscal limits. The government's medium term plan gives high priority to social expenditures and aims to gradually increase social spending as a percentage of GDP over the next five years.

IV. EVALUATION OF COUNTRY ASSISTANCE STRATEGY FY02-04

62. The World Bank's Board of Directors discussed the last CAS on November 2, 2001, covering the final three years of the Flores administration. The CAS supported three interrelated development objectives: (i) sustaining efforts to reduce poverty and promoting social development; (ii) accelerating growth and developing new opportunities; and (iii) fine tuning the role of the public sector. It proposed lending of US\$270 million over FY02-04, with a base case of five planned operations: *Earthquake Emergency and Basic Health Care Extension* (FY02, \$145 million), *Judicial Reform* (FY02, \$10 million), *Rural Productivity* (FY03, \$25 million), *Environmental Services* (FY04, \$10 million), and *Land Administration II* (FY04, \$30 million). The high case proposed an additional US\$50 million, including further support for *Education Reform* and the *Social Investment and Local Development Fund*. Analytical and advisory services (A&A) were also proposed, including a *Poverty Diagnostic*, a *Decentralization Study*, a *Social Protection Review*, a *Country Economic Memorandum*, a *Country Financial Accountability Assessment* and a *Country Procurement Assessment Report* and follow-up support to a recent *Financial Sector Assessment*.

63. **Country Program Performance Indicators.** Table 4 lays out the indicators developed in the last CAS for measuring Country Program Performance, with significant progress in some areas, while others are lagging. As discussed earlier, growth rates slowed in the last few years, due largely to external shocks. As a result per capita growth rates were lower than planned. However, the targets for the share of households in poverty and in extreme poverty were already met by end 2002. All targets in education

have been met or exceeded, including the increase in net primary enrollment rate, achievement of gender parity in primary enrollments, and rehabilitation of schools damaged by the earthquakes. However, the declines in the rates of infant mortality and malnutrition were lower than expected, and there was little progress in reconstruction of hospitals. The design for the Modernization Plan for the Supreme Court was completed in 2002. Some important measures were taken to improve the investment climate: the time to register a foreign business was reduced from 8 months to 2 weeks, the export matching grant mechanism was successfully launched, and a fuel tax was introduced to finance road maintenance. Concessions of the airport, ports and mail service were not approved, due to the slow-down in reforms as a result of increased political polarization in the latter part of the Flores administration; however, modernization of the airport and ports remain on the agenda of the new government.

Table 4: Country Program Performance Indicators 2002-05

<u>Country Overall Indicators</u>	<u>Results</u>
Per capita growth rate averages 2 percent in 2002-05	For the period 2002-2005 it is expected that per capita GDP will grow by 0.32 percent. In the period 2002-2003, per capita GDP grew 0.25 percent.
Reduction in the share of households in poverty to 35-40 percent by 2005.	By 2002, the share of the <i>population</i> that was poor had declined to 37.2 percent, while the share of <i>households</i> in poverty fell to 30.8% (World Bank Poverty Assessment). According to official GOES estimates, the share of <i>households</i> in poverty was 36.8% in 2002.
Increase in net primary education enrolment rate to pre-earthquakes levels (78 percent) by 2004.	This result has already been exceeded. Primary NER = 85% in 2002.
Reduction of the infant mortality rate to 25 per 1,000 live births by 2005.	In 2002 Under-5 Mortality rate was 31 (a 40% reduction over the last decade). No updated data is available.
Reduction of the number of under weight children by 20 percent by 2005.	Prevalence of child (under-5) chronic malnutrition was 19.6 in 2002 (a reduction of 16% over the last decade). No updated data available. The incidence of underweight declined from 11 to 10% from 1993-2002, a decline of about 9%.
Increase in the amount of foreign investment flows by 20 percent by 2004.	Based on the latest available annual data (2003), Gross Foreign Direct Investment increased by 16.1% since 2001.
<u>Other Indicators of the International Development Goals</u>	
Bring the share of households in extreme poverty to pre-earthquakes levels (16.7 percent) by 2004.	By 2002, the share of the <i>population</i> that in extreme poor had declined to 15.4%, while the share of <i>households</i> in poverty fell to 12.1% (World Bank Poverty Assessment). According to official GOES estimates, the share of <i>households</i> in poverty was 15.8% in 2002.
Girls' school primary enrolment maintained at least at the same level as boys.	Target fully reached. In fact, females do slightly better than boys.
Reduce underreporting of HIV/AIDS cases from 50 to 25 percent by 2005.	Under reporting reduced to 30 percent by 2004
<u>Bank Indicators</u>	
Number of hospitals rebuilt/rehabilitated: 7 hospitals by 2005.	Not yet completed due to delay of the loan's effectiveness. MOH has carried out numerous temporary or partial works to improve the physical condition of the hospitals until they are finally rehabilitated.
Reconstruction/replacement of 413 schools by 2005.	102 secondary schools have been rehabilitated and: more than 1,000 primary school classrooms have been replaced or reconstructed
Completion of the design of the Modernization Plan for the Supreme Court by 2002.	Plan Completed.
Reduced time for complying with foreign investment licensing requirements by 2003.	The time to register a foreign business was reduced from 8 months to 2 weeks. (National Investment Office)
Set up the export matching grant mechanism for 50 firms by 2003.	As of December 2003, 55 firms received export matching grants through the FOEX program (Fomento de Exportaciones)
Approval of a road maintenance financing mechanism and concessions of airport, ports and mail services to the private sector completed by 2004.	Road Maintenance Financing Mechanism: In Oct.2001, Congress approved a gas tax of US\$ 0.20 per gallon to finance FOVIAL, the national road maintenance agency. Concession of Airports: The airport has not been concessioned. It is under the management of an autonomous state entity. Port Concession: The Acajutla Port has not been concessioned so far. For La Union Port, a procurement process for consultancy on the best alternatives for port concession was recently launched. Mail Services Concession: Has not been done.

64. Only two of the five planned projects were delivered during FY02-04: the Earthquake Emergency Reconstruction and Basic Services for US\$192.6 million and Judicial Modernization for US\$18.2 million. This was largely because some of the projects were postponed by the government as it faced severe fiscal constraints in the aftermath of the earthquakes. However project preparation for Land Administration II, Education Reform II, Environmental Services and Social Protection advanced and these operations are included this CAS. Table 5 presents the current IBRD portfolio. The Bank's current lending portfolio in El Salvador includes six projects totaling US\$380.8 million net of cancellation, of which US\$190 million has been disbursed as of December 31, 2004.

Table 5: IBRD Loan Portfolio

CAS Pillar	Project	Key Dates			Amounts in US Millions	
		Approval	Effectiveness	Closing	Total	Undisbursed
Pillar I: Accelerating Equitable Broad-Based growth and Increasing Employment	Land Administration	5-Mar-1997	21-Mar-1997	30-Jun-2005	50.0	0.0
Pillar II: Improving Equity through Building Human Capital and Expanding Access to Basic Infrastructure and Markets	Education Reform	7-May-1998	30-Jun-2000	30-Jun-2005	88.0	16.5
	Secondary Education	28-Aug-1997	20-Aug-1998	31-Dec-2005	58.0	11.4
	Earthquake Reconstruction	4-Dec-2001	11-Sep-2003	30-Apr-2007	142.6	139.4
Pillar III: Enhancing Security and Reducing Vulnerability	Public Sector Modernization	3-Sep-1996	11-Mar-1997	31-Aug-2006	24.0	6.1
	judicial Modernization	1-Aug-2002	8-Mar-2004	31-Dec-2008	18.2	17.4

65. **IBRD Lending.** Overall the results of the Bank's ongoing portfolio in El Salvador has been satisfactory, although project implementation has generally been rather slow and operations have taken longer than expected to disburse fully (See Table 5). Box 8 presents the findings by OED on projects which closed over the last seven years.

**BOX 8: KEY LESSONS ON PORTFOLIO IMPLEMENTATION FROM OPERATIONS EVALUATION
DEPARTMENT (OED)**

The World Bank's Operations Evaluation Department (OED) conducted Implementation Completion Report Reviews for 4 projects which closed between 1998 and 2004: Agriculture Sector Reform and Investment Project, Energy Sector Modernization, Basic Education, and Power Sector Technical Assistance Loan. OED rated the outcome of these projects as "satisfactory" in three cases, and "moderately satisfactory" for the Agriculture Sector Reform and Investment Project. Key lessons include: (i) institutional reforms are more successful when there is unwavering commitment from the government for a sustained period of time and reforms are done incrementally and in sequence; (ii) dialoguing with key stakeholders and gaining consensus on reforms is a critical element to successful implementation of sector reforms; (iii) there may be advantages in packaging institutional reforms and sectoral investments as separate operations to avoid complexity and overloading implementation capacity; and (iv) it is important for smooth project implementation to set up the project executing unit well before loan effectiveness and have it staffed with senior professionals with adequate experience in technical, administrative and legal matters.

66. In key areas of Bank support, El Salvador has been a regional leader, and has successfully piloted innovative approaches that have subsequently been adopted elsewhere. For example the Land Administration project is considered a best practice in the region and throughout the world and has provided an example for a series of similar Land Administration projects in Central America. The Competitiveness Enhancement Technical Assistance Project which closed in June 2004 had great success in supporting the government's program to accelerate private sector development and raise productivity. It was the first of its kind in the LAC region, and its lessons are now reflected in similar projects in Nicaragua, Honduras and Guatemala, as well as in other LAC countries. The Bank has been a major supporter of El Salvador's education sector over the years, and a key partner in the design and implementation of the highly successful EDUCO community-based education program. The EDUCO model is considered a global best practice and was showcased at the Global Forum on Poverty Reduction in Shanghai in April 2004. The Bank-supported Public Sector Modernization project was instrumental in pushing forward very important structural reforms in the public sector. The new CAS will build on these successful programs.

67. The two new projects approved during FY02-04 suffered from significant delays in getting Congressional approval and took virtually two years to become effective. During this time, the Health project has evolved in a more strategic direction and the MOH is now using the project as an opportunity to rationalize and modernize the hospital network. The current objective is not only to restore hospital services to their pre-earthquakes levels, but to make the rehabilitated hospitals more responsive to new demands for expanded basic services, reduce unnecessary hospitalization, implement more efficient modalities of hospital care and introduce modern management policies and systems. With support from the project the MOH has developed a Hospital Master Plan. The MOH has carried out the technical and administrative preparatory work necessary to use faster construction modalities (turn-key and design-build modalities). An assessment of availability of medical equipment is underway, as well as development of construction and equipment standards and environmental assessments. A top priority is a MOH reorganization to strengthen management of public hospitals by setting up decentralized

autonomous units and implementation of performance-based service agreements and territorial health plans. The MOH has also strengthened its technical capacity and toolkit to contract and monitor health services. The package of health services has been refined, its costs updated, NGOs providing health services in remote areas have been assessed, innovative reimbursement mechanisms have been defined, technical standards for the delivery of care have been developed, and monitoring indicators and guidelines produced.

68. Despite the delay in effectiveness of the Judicial Modernization Project, there has been some progress in three key areas: (i) a modernization plan for the judiciary has been completed; (ii) administrative streamlining at the central level is well advanced and regional administration coordinators have been established; and (iii) a citizen information center and a judicial document center has been set up in San Salvador and training needs assessments have been completed.

69. **Non-Lending Services.** Throughout the CAS period the Bank maintained an effective partnership with El Salvador through non-lending services, including Economic and Sector Work, advisory services, conferences and workshops, technical assistance as well as grants for studies and capacity building. In the last two years, the Bank completed five core diagnostic studies: a Country Economic Memorandum (CEM), a Poverty Assessment, a Public Expenditure Review, a Country Financial Accountability Assessment (CFAA); and a Country Procurement Assessment (CPAR). The CFAA and the CPAR were both completed as joint documents with the Inter-American Development Bank (IDB). Other major AAA activities include follow up to the FSAP through technical assistance and capacity building to the Central Bank; the preparation of an education strategy paper; and a study on Disaster Loss Exposure and the Viability of Using Insurance or Catastrophe Bond Instruments for Financial Protection Following Natural Disasters. The Foreign Investment Advisory Service (FIAS) worked with the government and other key stakeholders in an assessment of labor and environmental standards in key export industries in order to strengthen corporate social responsibility programs through strategic collaboration between the private and the public sector. FIAS also assisted in the implementation of an education-focused Corporate Social Responsibility Strategy.

70. In a number of areas the Bank's program of AAA services has helped to build consensus among key stakeholders and to shape the direction of national policies and priorities. For example, the El Salvador Poverty Assessment is part of an ongoing program developed by the Bank in response to a request from the government for assistance in the aftermath of the earthquakes. The first phase included: (i) analysis of poverty in El Salvador and policy advice on how to improve the impact of social policy and social sector spending; and (ii) analysis of vulnerable groups and of existing programs to confront vulnerability, and recommendations on how to strengthen the country's social safety net. The analytical work was accompanied by technical assistance to the statistical agency DIGESTYC to enable analysis of the municipal-level poverty impacts of the earthquakes. The work culminated with the delivery of two policy notes – *Poverty and Social Expenditures* and *Elements to Strengthen the Social Safety Net* - and follow-up discussions with the Economic and Social Cabinets. The first phase provided

an important foundation and generated demand for further analysis and dialogue aimed at strengthening the impact of El Salvador's poverty and social sector policies and programs.

71. The second phase of the program was produced in response to a specific request from GOES for more in-depth analysis in selected areas, including: (i) an update of the poverty profile with special emphasis on the impact of the earthquakes; (ii) a detailed analysis of social sector spending and its impact on the poor – including spending on rural water and roads, as well as on education, health, and social protection; and (iii) an examination of the likely fiscal costs of achieving further poverty reduction and socio-economic progress. The Poverty Assessment team also provided technical assistance and guidance including: (i) support to DIGESTYC as part of broader GOES efforts to construct a municipal-level poverty map and (ii) support to a multi-stakeholder exercise undertaken by the GOES on progress and challenges related to the MDGs.

72. In education, the Bank has carried out analytical work and provided technical assistance to help prepare a comprehensive diagnostic of the sector and define strategic priorities. The Bank recently finalized and disseminated a policy note on the education sector. The Bank also provided support to a multi-stakeholder and multi-donor exercise, led by the Ministry of Education, to produce an integrated diagnostic of the education sector in El Salvador. This diagnostic combines the findings of various local and international organizations in all major areas of the education sector. The Bank helped in all key steps of the process by: (i) providing its own diagnostic of the sector; (ii) helping with the organization of workshops to share the findings/studies of the different organizations; (iii) providing technical assistance for the integration of the studies; and (iv) supporting a final workshop to validate the results of the integrated diagnostic.

73. During the CAS period 02-04, more than 350 representatives from Salvadoran government agencies, civil society organizations, academia, and the private sector participated in World Bank Institute courses, conferences, Global Distance Learning Network dialogues, and other learning programs. Programs in El Salvador included courses on education reform, urban management, health sector reform and environmental management. WBI also organized together with FUSADES a regional conference on knowledge and innovation strategies.

74. **International Finance Corporation (IFC).** IFC's strategy as outlined in the previous CAS was to continue to work with the private sector in support of its recovery and medium term growth, with focus on investments in the country and regional financial and physical infrastructure. Special focus was given to, and opportunities explored, in the financial markets, infrastructure and agribusiness sectors with projects materializing during this period in the first two sectors.

75. Although the private sector in El Salvador still faces many challenges, the investment climate was generally perceived as positive over the last CAS period--owing to reform progress made to date. Reflecting this perception in part, during this period IFC provided a total of \$229.5 million (including \$75 million for participations) for 6 projects in El Salvador. The investments were made in diverse sectors, such as financial

market, infrastructure (power), and retail. In FY04, new commitment activity reached a record high at \$92.5 million (in four projects). As a result of this activity, as of end-FY04, the committed portfolio (of IFC's own account) stood at \$170 million, more than three times the end-FY01 level.

Table 6: IFC Commitments in FY02-04

US\$ million

Sector	IFC	Participants
Finance & Insurance	84.5	--
Utilities	45.0	75.0
Wholesale & Retail	25.0	--
Total	154.5	75.0

76. During the previous CAS period, IFC continued to be very active in the financial sector and supported housing finance, SME finance, microfinance, and a pension fund. IFC provided a mortgage credit line to Banco Agricola to help develop housing finance, which would bring broad social and economic benefits. In addition, with donor

fund support, IFC has been undertaking a study covering El Salvador, Costa Rica, and Panama (where there is a developing primary mortgage market and some secondary mortgage market activity) with the aim to develop a regional platform for creating the primary mortgage market which would subsequently help establish a regional secondary mortgage market. IFC also supported broadening smaller businesses' access to finance with investments in Banco Agricola and Calpia (or currently known as Banco ProCredit). Furthermore, with an equity investment in AFP Confia, one of the leading pension fund administrators, IFC supported the private pension system in El Salvador. This was IFC's second investment in the sector where the Corporation provided advice to the government on the private pension law in the past.

77. As part of Central American regional projects, IFC also supported TUCA (Trans Union Central America), the first private credit bureau that would operate throughout Central America, with an equity investment. The support for private credit bureaus is expected to facilitate the extension of credit to previously underserved segments of the population, in particular small businesses. IFC also provided Banco Cuscatlán de El Salvador with a subordinated convertible loan to be treated as Tier II capital, as part of \$40 million financing package to the Cuscatlán group. Additionally IFC supported with an investment Aureos CA Fund, a private equity fund that acquires minority interests in medium-sized Central American enterprises that would provide appropriate shareholder rights and would pursue a regional integration strategy.

78. IFC's largest investment during this period, including participants, took place in the infrastructure sector. IFC provided a \$110 million loan (including \$75 million from participants) for CAESS and EEO, power distribution companies to finance their capital expenditure program.

79. Finally, IFC also supported the wholesale and retail sector with a long term loan to Metrocentro for the first-phase construction of a multi-purpose complex, which would first develop a shopping mall and later offices, a residential complex, a park, and a hotel. In addition to the rarely available long-term financing, IFC also assisted the company

with technical assistance in enhancing the business skills of its micro and small business tenants (funded by a donor support and the Corporate Citizenship Facility).

80. **Multilateral Investment Guarantee Agency (MIGA).** MIGA began its technical assistance work with El Salvador in late 1999 providing input on the design of PROESA, the national investment promotion agency. From its initial work on the structure and staffing of the agency to the sophisticated promotional systems that have generated important FDI flows for the country, MIGA has been very involved with PROESA. This long term program has achieved substantial results including hundreds of projects that have contributed to employment generation. Moreover new sectors, particularly business process outsourcing, have begun to invest in El Salvador. MIGA has provided technical support including: staff training in promotion techniques, campaign planning and execution, sector selection, and assistance in the creation of a public relations campaign, the role of the Board of Directors, the creation of an aftercare program for existing investors, and many more short interventions at the request of the government. MIGA believes that PROESA is now fully established to execute its mandate. Further technical assistance will be based on ad-hoc client requests as opposed to a structured assistance program.

81. **International Monetary Fund (IMF).** El Salvador maintains a close policy dialogue with the IMF, and does not plan to seek a formal arrangement. At the conclusion of the 2003 Article IV consultation (July 18, 2003), the Executive Board praised El Salvador for its record of fiscal prudence and impressive reforms since the early 1990s, even in the face of the adverse shocks. However, the Directors also noted a fiscal deterioration and sluggish growth in recent years, and encouraged the authorities to address these challenges. In particular, the Directors urged the authorities to build on the credibility of the dollarized regime by strengthening fiscal and financial sector policies, and sustaining the structural reform effort. During the 2004 Article IV consultation discussions (from October 25 to November 10, 2004), the staff encouraged the authorities' ongoing efforts to strengthen the fiscal position and pursue reforms with a view to improving growth prospects and fortifying the economy against shocks. The authorities explained that strengthening tax collections and deepening banking reforms were key policy priorities. A Board meeting to conclude the 2004 Article IV consultation is tentatively scheduled for January 2005.

82. **Aid Coordination.** There is no formal aid coordination mechanism in place for El Salvador (the last CG meeting, chaired by the IDB, was held in March 2001 following the earthquakes) and the government coordinates assistance programs directly with each of its creditors. Inter-American Development Bank (IDB) is El Salvador's main lender, with 19 active projects at present totaling \$679.1 million in earmarked funds. Over the years the Bank has established a broad division of responsibilities with the IDB, and this last CAS period proved no exception, with the IDB taking the lead on road infrastructure; water and sanitation; environmental sustainability and local and urban development projects. In turn the World Bank has taken the lead in assistance to primary and secondary education, land administration and property rights reform, private sector competitiveness, re-establishment of critical health services and judicial reform.

83. The Central American Bank for Economic Integration (CABEI). CABEI has an active portfolio of nine projects of US\$298,2 million in El Salvador. As of June 30, 2004 it had disbursed US\$104.8 million. Looking forward to the new CAS period, CABEI will continue to focus on the first pillar in the government strategy, with large-scale lending operations to improve the country's physical infrastructure – these projects will span ports development, telecommunication networks and nation-wide roads programs. CABEI's lending program will also complement the Bank's support for sustainable rural development projects.

84. The World Bank Group, IDB, CABEI, and other donors' operations and their links to development challenges are shown in the Table 7.

Table 7: Ongoing Donor Activities Supporting the three Government Pillars

Government Strategy 2004-2009	World Bank Group	IDB	CABEI	Other Donors (bilateral programs)
I. Accelerating Broad-Based Equitable Growth and Increasing Employment	IFC's support for utilities, manufacturing, the wholesale and retail sector and the financial markets	<ul style="list-style-type: none"> ▪ Agro-industry Program (US\$24.9m) ▪ Central American Electricity Connection (US\$30m) ▪ Competitiveness (US\$100m) ▪ Fiscal Reform (US\$15.5m) 	<ul style="list-style-type: none"> ▪ Ports Development (US\$25m) ▪ San Salvador Ring Road (US\$62.7m) ▪ Rehabilitation of Paved Roads (US\$52.9m) ▪ San Salvador Central Market (US\$7.4m) ▪ National Roads Program (US\$135m) ▪ Telephone Network (US\$8.3m) 	<ul style="list-style-type: none"> ▪ USAID: Private sector competitiveness; Capacity to implement DR-CAFTA and remove key barriers to trade; SME lending and opportunities. ▪ GERMANY: Productive development (\$US8.7m); Basic infrastructure (US\$7m) ▪ SPAIN: Agricultural and fishing development; Budget support (US\$772m) ▪ JAPAN: Productive development; Basic infrastructure (US\$10.1m); Ports (US\$92.1m)
II. Improving Equity through Building Human Capital and Expanding Access to Basic Infrastructure and Markets	<ul style="list-style-type: none"> ▪ Education Reform (US\$88m) ▪ Emergency Earthquake Reconstruction and Health Services Extension (US\$142m) ▪ Secondary Education (US\$58m) ▪ Land Administration I (US\$50m) 	<ul style="list-style-type: none"> ▪ Education Infrastructure (US\$70.8m) ▪ Education Technology (US\$72.9m) ▪ Sustainable Rural Roads (US\$57.7m) ▪ Local Development Program II (US\$69.8m) ▪ Health Sector Modernization (US\$20.6m) ▪ Housing (US\$70m) ▪ Drinking Water & Sewage (US\$43.6m) 	<ul style="list-style-type: none"> ▪ Sustainable Rural Development (US\$7m) 	<ul style="list-style-type: none"> ▪ IFAD: Rural development (US\$35m) ▪ USAID: Basic education; Health services; HIV/AIDS prevention ▪ European Union: Secondary technical education; Rural development; Reconstruction; School rebuilding; Basic health, local water and sewage; Solid waste; Basic education for women; Housing; Urban and justice Safety; Governance, Housing. ▪ GERMANY: Local development; Social protection; Basic health; Housing (US\$27.1m) ▪ FRANCE: hydroelectric project and rural electrification (US\$3.4m) ▪ SPAIN: Local development; Cultural heritage; Higher education; Employment, Gender; MDGs, Social protection, and M&E; Health system improvement; Housing (US\$14.1m) ▪ JAPAN: Urban safety, Local development, Statistical systems; Technical education; Basic health; Housing (US\$9.6m)
III. Enhancing Security and Reducing Vulnerability	<ul style="list-style-type: none"> ▪ Public Sector Reform Project (US\$24m) ▪ Judicial Reform Project (US\$18.2m) 	<ul style="list-style-type: none"> ▪ Judicial Reform (US\$22.2m) ▪ Sustainable Management of La Cuenca Rio Lempa (US\$14m) ▪ National Program for the Environment (US\$30m) ▪ Decontamination Critical Areas (US\$29.8m) ▪ Strengthening of Regulatory Institutions (US\$3.8m) ▪ Modernization of the Legislative (US\$3.5m) 		<ul style="list-style-type: none"> ▪ USAID: Management and conservation of critical watershed; Social sector investment; Efficiency judicial processes; Alternative Dispute Resolution (ADR) ▪ European Union: Environmental management; Youth delinquency prevention; Environmental education; Contamination programs; Risk mitigation; Civic, Human Rights and NGO programs (US\$39.1m) ▪ GERMANY: Risk management; water (US\$11.6m) ▪ SPAIN: Institutional strengthening; waste management and potable water; financial sector interventions; watershed management (US\$2.5m) ▪ JAPAN: Waste management; agriculture development; watershed management (US\$3.6m)

V. COUNTRY ASSISTANCE STRATEGY FY05-FY08

A. Bank Group Lending and Non Lending Services

85. The Bank Group's assistance over the four-year period covered by this CAS (FY05-08) proposes a strategic program of lending and non-lending services to support the three main pillars of the government's development plan "Safe Country 2004-2009: (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. Bank Group assistance (See Table 8) will include: (i) support for implementation of the existing loan portfolio; (ii) new IBRD lending, including a Program of Development Policy Loans, and investment operations in selective areas where the Bank has global expertise and comparative advantage and which complement the activities of other key development partners; (iii) analytical and advisory work, technical assistance, and facilitation of access by El Salvador to grants administered by the World Bank; (iv) learning and capacity development programs through the World Bank Institute (WBI) and the Global Distance Learning Center (GDLN) and (v) targeted private sector assistance provided by IFC and MIGA. Country Financial Parameters have been prepared for El Salvador and this should facilitate the implementation of the proposed program.

86. The assistance strategy was developed in close partnership with the Government of El Salvador. A workshop on the CAS was held in October 2004, with participation by a broad range of stakeholders including Members of Congress, civil society, think-tanks, private sector representatives and members of the international development community. Participants discussed the findings and recommendations of recent Bank analytical studies and provided input on proposed areas of future Bank assistance. In addition, a series of smaller meetings were held with specific stakeholder groups to solicit their views on how the Bank could best support El Salvador over the next four years. Annex D provides a summary of the key points of the discussions. Overall, responses and views were positive. Participants showed great interest in all the recent diagnostic reports prepared by the Bank, and requested that there be opportunities for more dialogue and feedback throughout the process of preparing future reports. Some stakeholders were concerned about the recent increase in the level and cost of external debt in El Salvador and asked the Bank to help the Government to develop a debt management strategy. In this context, most participants welcomed the proposed Development Policy Lending approach as a way to lower the costs of external financing. There was general support for DPLs as an appropriate way for the Bank to support the country's own development strategy and priorities, as long as efforts continued to strengthen the transparency and effectiveness of budget expenditures.

87. The central component of the Bank's assistance strategy in El Salvador would be a programmatic series of Development Policy Loans (DPL) to support the Saca government's medium term development strategy to accelerate broad based and equitable

economic growth. The DPLs would provide quick-disbursing budget support in line with policy performance that would be synchronized with the government's annual budget and would allow the government to reduce its external financing costs by partially replacing higher cost bonds issued in the international capital markets. El Salvador's past track record of sound macroeconomic management, significant policy and institutional reforms and marked improvements in social indicators, as described earlier in this document, make it a strong candidate to receive DPL assistance. The key areas to be supported by the program of DPLs are summarized in Box 9.

BOX 9: KEY AREAS SUPPORTED BY THE PROGRAM OF DEVELOPMENT POLICY LOANS

- *Accelerating broad-based growth*, including measures to expand international trade, improve the investment climate, increase private participation in infrastructure and build innovation and technological development.
- *Restoring a sound fiscal framework*, including measures to increase tax revenues and strengthen the financial sector.
- *Public sector modernization*, including procurement reform and other measures to improve public financial management and governance.

88. The first DPL which will be submitted together with the Country Assistance Strategy is based on critical prior actions in all three key areas, with a particular focus on actions to improve the fiscal situation and generate the resources needed for additional social spending. It also lays out indicative triggers for the second operation and monitorable indicators of progress towards long-term goals related to the three key areas. The design of key prior actions, triggers and indicators is underpinned by a substantial body of analytic work carried out by the Bank in partnership with the Government of El Salvador over the last few years, including the five core diagnostic reports. The DPL series will support gradual implementation of measures identified in the CFAA and CPAR to enhance governance, transparency and efficiency in public spending. Future DPL operations are expected to shift gradually to focus on the international trade and business environment, drawing on the DR-CAFTA study, the Investment Climate Assessment, the follow up to the FSAP, the REDI and technical assistance to enhance public-private participation in infrastructure. A Country Environmental Analysis will be carried out to review the policy and institutional framework and make recommendations especially in relation to infrastructure policies and trade expansion under DR-CAFTA.

89. As described in the following sections, and summarized in Table 8, the series of DPLs will be accompanied by selective investment lending in key areas where the Bank has global expertise and which build upon prior successful implementation of innovative operations in El Salvador, and which complement activities of other partners. In order to be responsive to the government's needs, and taking into account election cycle considerations, investment lending will be clustered in FY05-07. The CAS also includes a program of regional and country specific AAA (See Box 10).

BOX 10: THE AAA PROGRAM IN EL SALVADOR

Over the last few years, despite the limited level of lending the Bank made a significant investment in the delivery of AAA to El Salvador, including preparation of the five core diagnostic reports, follow up to the FSAP and a Corporate Social Responsibility Framework. The recent Country AAA Assessment for El Salvador by the Quality Assurance Group (QAG) rated the program as highly satisfactory overall, noting that AAA played a central role in the Bank's assistance in El Salvador during FY02-04, allowing the Bank to rebuild its relationship with the client through the provision of knowledge services after a period when the Bank was largely absent from the country. The QAG Assessment found that the AAA program responded to the government's policy agenda, that tasks were timely and took into account the political cycle, and that the work focused on key issues and brought analytical depth that was highly respected by the government authorities and many stakeholders. Overall, the Assessment concluded that the AAA program made a substantial intellectual contribution on the structure of thinking about reforms and in the quality of the debate in the country and that it contributed to a change in the governments approach to poverty reduction. The quality and strategic relevance of the AAA work has also contributed to changing the Government's traditional reluctance to borrow from the Bank and has underpinned the design of the Development Policy Loan Program.

While recognizing the dissemination efforts made - through posting reports on the Internet and organization of large workshops with substantial press coverage - the QAG Assessment recommends more resources for and greater attention to dissemination in the future, in order to move from "presentations" to continuous substantive dialogue and consultation with stakeholders. They recommend that all reports be translated into Spanish to broaden public access and build advocates for policies the Bank would support. Noting that Salvadorians like to be "more than an audience and consultants" the Assessment recommends more effort to develop local partners and engage in one-to-one dialogue outside the government, including with those who may not share the government's and the Bank's views on development.

AAA will continue to be a critical part of the Bank's assistance during FY05-08. Initial focus will be on analytical work to inform the Government's growth agenda, including finalization of the Investment Climate Assessment and the DR-CAFTA regional study in FY05, and the Recent Economic Developments in Infrastructure (REDI) report in FY06. This work will help underpin the dialogue and design of subsequent Development Policy Loans. A Country Environmental Analysis, to be completed in FY06, which will assess the country's environmental institutional set-up and policy framework and make recommendations, particularly in the area of sustainable infrastructure development and implementation of DR-CAFTA. Regional studies on Education (FY05), Shocks and Social Protection (FY05) and Health (FY06) will contribute to the government's efforts to improve equity and develop a more effective social protection strategy. The core diagnostic reports will be updated in FY07 and FY08, with the particular areas of focus to determined in close consultation with the Government and other partners and stakeholders to ensure strategic relevance and avoid duplication.

90. Support to Pillar I – Accelerating broad-based equitable economic growth.

A fundamental element of the government's strategy is the maintenance of a stable macroeconomic framework including fiscal responsibility and further improvements in the investment and business climate and trade policies as the foundation for private sector-led broad-based economic growth. The main support to the government's policy agenda under this pillar would be a series of DPLs as described earlier. The Bank would also provide technical assistance to the government to review the development and implementation of a debt management strategy. In addition to assisting the government in **broadening access to economic opportunities**, an investment project *Ensuring SME participation in DR-CAFTA, US\$10m (FY06)*, would focus on improving critical

elements of the investment climate for SMEs and would complement a fast disbursing budget support operation to enhance competitiveness financed by IADB. An *Investment Climate Assessment (ICA)* FY05, will collect and analyze information and formulate recommendations to overcome the main constraints to investment, productivity growth and exports. A *Recent Economic Developments in Infrastructure Report, REDI (FY06)* will carry out a comprehensive assessment of El Salvador's electricity, telecommunications, transport (roads, ports, airports and urban transport), and water and sanitation sectors. *Technical assistance to Improve Infrastructure through Public-Private partnerships (PPIAF)* is also planned to promote the new infrastructure investment needed to enhance El Salvador's capacity to compete in the global economy and attract foreign investments.

Table 8: IBRD Active Portfolio and Proposed Base Case Bank Assistance Program FY05 - FY08

<u>Pillar</u>	<u>Active Portfolio</u>	<u>FY05</u>		<u>FY06</u>		<u>FY07</u>		<u>FY08</u>	
		<u>Lending</u>	<u>Non Lending</u>	<u>Lending</u>	<u>Non-Lending</u>	<u>Lending</u>	<u>Non Lending</u>	<u>Lending*</u>	<u>Non Lending</u>
Accelerating equitable broad-based growth and increasing employment	Regional IDF Grant for DR-CAFTA Regional BNPP Grant for DR-CAFTA	Development Policy I (\$100 m)	Financial Sector Reform and Strengthening (FIRST) Investment Climate Assessment (ICA) DR-CAFTA Regional Study ROSC (A+A module)	Development Policy II (\$100 m) Ensuring SME participation in DR-CAFTA (\$10 m)	Recent Economic Developments in Infrastructure (REDI) TA to improve infrastructure through public-private partnership (PPIAF) CSR Strategy	Development Policy III (\$100 m)	CEM Update		
Improving equity through building human capital and expanding access to basic infrastructure, assets and markets	Land Administration I Secondary Education Education Reform Earthquake Reconstruction & Health Services Extension	Land Administration II (\$40 m)	Education Strategy (Regional) PSIAs on Tax and Pension Reforms and DR-CAFTA	Education Reform (\$85 m)	Regional HIV-AIDS Grant (\$8 m) Health Strategy (Regional)				Poverty Assessment Update
Enhancing security and reducing vulnerability	Judicial Reform Public Sector Modernization IDF Grant Public Procurement	Environmental Services (\$5 m) and GEF Grant component (\$5 m)	GEF Grant for protected areas (\$5 m) BNPP Regional Grant for MBC GEF Regional Grant for Integrated Ecosystem (\$9 m) Shocks and Social Protection Study (Regional)	Social Protection and Local Development (\$35 m)	Country Environmental Analysis (CEA)	Modernization of the State (\$10 m)			PER/CFAA/CPAR Update
Base Case Total (\$485 m)		\$145 m		\$230 m		\$110 m			

*A fourth DPL of \$100 million is included in the high case lending scenario.

91. Given the challenges and opportunities the Salvadorian private sector faces, IFC's aim is to help it position itself competitively inside and outside the Central American region. IFC is prepared to support local companies to become regional players in the financial and other sectors, and encourage cross-country investments. Complementing the Bank's support to this growth pillar through assistance, such as DPLs and a US\$10 million investment project to improve the investment climate for the SME sector, IFC's activities during this CAS period are expected to focus on supporting the strengthening of the private sector's competitiveness and IFC's priorities will include: (i) continuing to assist in the development of the housing sector via financing and technical assistance; (ii) helping to strengthen infrastructure (including power); (iii) supporting the MSME sector via financing or technical assistance; and (iv) promoting sustainable business practices (including corporate governance, environmental and social management, and corporate responsibility programs). As in other countries in Central America, IFC's support to El Salvador is also provided through regional projects. IFC's priorities in the Central America region include: helping improve physical infrastructure; strengthening and broadening the financial sector, including access to term financing by micro, small and medium enterprises; supporting competitive firms in agriculture, industry and services; and promoting investments from other LAC and emerging market countries into Central America. FIAS has collaborated closely with the Government in the strengthening of an education-based Corporate Social Responsibility (CSR) strategy and is prepared to work with the new administration to assist in making CSR an integral part of its competitiveness strategy.

92. As mentioned previously, MIGA has been assisting PROESA since its inception and has achieved significant results. The systems MIGA has worked to create with PROESA are in place and operational, and El Salvador now has a fully functioning investment promotion agency that has the tools it needs to achieve solid results. MIGA is prepared to respond to specific requests from the Government for further technical assistance. In the area of investment guarantees, MIGA does not have any outstanding coverage. The Agency is actively examining opportunities to provide coverage to foreign operations interested in locating in El Salvador and also able to assist Salvadoran companies as they seek opportunities overseas. MIGA has worked with the government and Central Bank to reduce reserve requirements for Salvadoran banks that lend with MIGA insurance. MIGA expects this to permit Salvadoran banks to expand their financial operations in the Central America region and beyond.

93. To support the government in **deepening insertion in world markets through regional integration and trade**, the Bank is actively involved in the Trade Capacity-Building group for DR-CAFTA and has developed an assistance program that includes analytical and advisory support, as well as grant funds. While El Salvador boasts one of the most open trade regimes in Latin America, DR-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 DR-CAFTA on the poor and to identify potential effects on protected segments. This study would complement the ongoing

regional ESW on the impact of DR-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 through an Institutional Development Fund Grant of US\$ 500,000 administered by SIECA and a regional grant of US\$ 500,000 from the Bank-Netherlands Partnership Program (BNPP).

94. To assist the government in the area of **market regulation and supervision** *Technical Assistance for Financial Sector Assessment (FSAP) follow-up* is planned and support from the Financial Sector Reform and Strengthening (FIRST)⁷ Initiative is envisaged. An *Accounting & Auditing (A&A) module of the Reports on the Observance of Standards and Codes (ROSC)* is planned for FY05 which will to assess the degree to which corporate entities and auditors effectively comply with international accounting and auditing standards.

95. As noted earlier, the Bank recently completed a *Country Economic Memorandum (CEM)* which identified the key constraints to sustained growth and identified priority areas to help promote faster economic growth. The CEM would be updated toward the end of the CAS period in order to measure progress in reaching the Government's development objectives and look forward to future challenges. Analysis would be focused on areas identified by the Government as of specific interest and relevance to El Salvador, for example the informal sector and remittances.

96. **Support for Pillar 2 - improving equity through building human capital and enhancing access to basic socioeconomic infrastructure and markets.** The CAS will support the government's strategy to improve equity through the implementation of ongoing operations, the development of two new investment operations and selected economic and sector work, analytical and advisory services, grants and technical assistance. Complementing the Bank's work, IFC will help improve equity through the on-lending instruments being provided for MSMEs, thereby broadening their access to financial market. In addition, IFC's LAC SME Facility may be tapped on to build capacity of SMEs should it become operational in El Salvador.

97. In order to assist the government in its goal to **modernize education and build a knowledge society**, the ongoing *Secondary Education Project* is working to extend a participatory approach to secondary education, broadening its coverage in rural areas, financing school rehabilitation and maintenance, improving its cost-effectiveness with an enhanced role for the private sector and upgrading the content and relevance of the curricula. An ongoing *Education Reform Project* aims to ensure that at least 90 percent of children complete basic education with emphasis on the poorest rural and urban areas. In terms of new lending, new *Education Reform Project, US\$85m (FY06)* is planned and would support the new long-term education plan of El Salvador. A PHRD project preparation grant will finance key preparatory studies for the education project. The Bank will continue to support the preparation of the long term Education Plan (Plan 2021) by

⁷ This is a multi-donor joint venture undertaken by the World Bank, IMF, the UK, Switzerland, Canada, the Netherlands, and Sweden to provide technical assistance for capacity building and policy development in the areas of financial sector regulation, supervision and development.

helping finalize the integrated diagnostic and supporting a wide consultation process on the priorities of the plan.

98. To assist in the **improvement of the quality and universal coverage of health services**, the ongoing *Earthquake Emergency Reconstruction and Health Services Extension Project* supports the reconstruction of seven major hospitals, the modernization of the Ministry of Health, the improvement of hospital care and the extension of essential health and nutrition services through community-based outreach, and supports selected priority national health issues including detection and control of HIV/AIDS and the most prevalent vector-borne diseases, health waste management and environmental health, community health promotion and education. El Salvador along with the other Central-America countries is the beneficiary of a upcoming *Central America Regional HIV/AIDS Grant Project (FY05 US\$8 million)* that aims to strengthen the regional capacity to monitor the spread of the HIV epidemic through the upgrade of a regional clinical laboratory able to carry out the pathology exams necessary to detect and follow-up HIV/AIDS patients.

99. In order to assist the government in the **strengthening of family assets**, the ongoing *Land Administration I* project is supporting the establishment of a national cadastre and the modernization of the National Property Registry that integrates the land and real estate property registry, the intellectual property registry, the commercial registry, the cadastre and the mapping agency. By the end of 2004, the project was projected to have cadastred 60% of the parcels and transferred all properties into a new computerized property registry, and started providing more efficient and accessible services country wide. An upcoming *Land Administration II, US\$40m (FY05)* project will build on the ongoing program and will focus on the legal base of urban and rural property. It would extend geographically to cover the rest of the country and include two new activities, the training of municipalities in cadastre management and limited urban and rural titling programs in areas of social interest which are not yet titled. In parallel, a GEF-funded operation is being prepared, which would provide up to US\$ 5 million in GEF Grants to fund complementary conservation-related activities.

100. To support the government in the **local and regional development** the upcoming REDI study and PPIAF grant will provide additional data on coverage, quality and access to infrastructure and help support dialogue and consensus building on the sector policy, regulations and institutional reform needed to enhance access to basic infrastructure services, and promote greater participation of the private sector.

101. As noted earlier, the Bank recently completed a Poverty Assessment and Public Expenditure review which provided inputs into the diagnosis of key constraints and identification of priority policy and institutional reforms and investment needs to build human capital and generate growth. These studies would be updated towards the end of the CAS period in order to review progress in reaching El Salvador's development goals. Fiscal measures supported under the proposed CAS lending program 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.

102. Support for Pillar 3 - Enhancing security and reducing vulnerability

Improving security is a key pillar in GOES's development plan. The vision of a "Safe Country" encompasses a broad definition of security, including improved physical safety, increased investor security through initiatives to combat corruption and increase transparency and greater public confidence in public institutions including the judiciary. The government plans to reduce vulnerability through the development of a social protection program for poor households and improvement of environmental and disaster management. The Bank would provide support to the government in reaching its goals through ongoing investment projects and three new investment operations, as well as advisory services, technical assistance and grants in the area of social protection, public procurement and environmental management. IFC's work on promoting sustainable business practices will also help enhance both investor and citizen security in El Salvador.

103. To assist in the **improvement of transparency and efficiency of resource use**, the ongoing *Public Sector Modernization Project* supports El Salvador in implementing a public sector modernization program to define new roles for the public sector and its most important entities, strengthen performance, accountability and transparency for those entities that remain in the public sector, and involve the private sector in the provision of public services. The future *Modernization of the State II, US\$10m (FY07)* project would continue to support the modernization of the state, and the implementation of recommendations made in the recently completed CFAA, CPAR and PER, including assistance for initiatives to combat corruption and further improve transparency, and modernization of local governments and support to the decentralization agenda. An Institutional Facility Grant (IDF) will assist in implementing the Government of El Salvador's public procurement modernization plan.

104. In order to assist GOES in **improving the rule of law**, the ongoing *Judicial Reform Project* supports a plan to enhance the effectiveness, accessibility and credibility of judicial branch. Special attention is given to broadening access to justice by the poor and disadvantaged groups, developing alternative dispute settlement arrangements, improving court procedures and legal assistance programs, enhancing quality services through a new supervision mechanism and developing a judicial career.

105. To support GOES' goals of **enhancing the environment for future generations**, a Pilot *Environmental Services Project* (FY05, US\$5 million) would be prepared to support the design and implementation of an environmental services system that sells services to both the public and private sectors. Pilot activities have already been tested in El Salvador co-financed by the private sector—the only example in the region. A GEF Grant (FY05, US\$5 million) would help set up the legal and institutional framework for this to operate.

106. While DR-CAFTA is expected to improve enforcement of environmental norms and regulations due explicit commitments in the treaty to this effect, future DPL operations are expected to give more emphasis to investments in infrastructure and DR-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. The Bank will work with the government to prepare a *Country Environmental Analysis* (CEA)

to be finalized in FY06. The CEA will develop a sound analytic understanding of the country and sector-wide institutional set-up and policy framework and provide guidance and advice to the national environmental strategy and policy which is being developed. The analysis will be done in close coordination with the REDI diagnostic and preparation of the DPLs to provide the Government with recommendations that would be relevant as it pursues new policies to spur sustainable infrastructure development and expand trade under DR-CAFTA. El Salvador will also benefit from a Central American Regional Grant for US\$2 million from Bank Netherlands Partnership Program (BNPP) for the *Mesoamerican Biological Corridor* which is aimed at consolidating actions taken in Central America to conserve and sustain their natural resources. Special emphasis in the future will be given to finding markets for sustainable products. A Central American Regional GEF Grant, *Integrated Ecosystem Management by Indigenous People and Communities (FY05, US\$9 million)* will help achieve more effective biodiversity conservation in Central America by strengthening the capacity of indigenous communities to protect and manage their natural and cultural resources, and by recuperating and promoting their cultural values and sustainable traditional land use practices.

107. In order to aid the government in **the development of a more effective safety net** the upcoming *Social Protection and Local Development Project, US\$35m (FY06)*, would support the development of a national social policy with a primary objective of developing and implementing a social safety net targeted to the poorest and most vulnerable families in the country. The development of the government's overall social policy is informed by the *Poverty Assessment* and the appropriate chapters of the *Public Expenditure Review*. As mentioned before, the Bank would propose to update these reports towards the end of the CAS period. Also, a Central America-wide study on *Shocks and Social Protection (FY05)* will assess the recent experience of households in coping with external shocks such as the coffee crisis and the efficacy of public programs in protecting households' consumption and human capital development during economic shocks. The study will provide inputs into the Social Protection project, and more broadly will help the government in the development of its overall social policy.

B. Country Financing Parameters

108. The Country Financing Parameters for El Salvador have been prepared and agreed upon by the government (See Annex C). As regards cost sharing the Government has shown strong commitment to and ownership of its development program. Bank-financed projects are fully integrated into the budget and are well aligned with the government's development plans. The Government finances a large share of its social development spending⁸ (about 74% after taking into consideration other multilateral and bilateral disbursements). The Bank's lending program represents a small share of the country's social development spending. Between 2000 and 2003, Bank disbursements have averaged US\$46 million annually – equivalent to 0.3 percent of GDP. This amount represents a small portion of El Salvador Central Government social development spending of about US\$1,095 million or about 7.3 percent of GDP in 2003. Quality of El

⁸ Social Development expenditures were used as a proxy for overall development expenditures as the former represent the vast part of the latter and exact data on overall development expenditures was not available.

Salvador's budget processes are good. Given these factors, the Bank may finance up to 100 percent of costs of individual operations. 100 percent financing is expected to be applied selectively to stay within the overall CAS lending envelope. Specific arrangements would be determined for individual projects, taking into account the project context and the borrower's financing from its own resources of the sector concerned. Land administration and social sector projects (mostly education and social protection) are expected to be in the 70 to 85 percent range while projects with a technical assistance focus (e.g., modernization of the state) could finance up to 100% of the cost.

109. **Recurrent cost financing.** The Bank's current portfolio devotes a relatively modest share of its funds to the financing of recurrent costs ranging from 15 percent (for infrastructure and other projects), to approximately 40 percent for social sector projects. These costs have traditionally been related to project administration (vehicles, equipment and software), teachers salaries and textbooks. Given the nature of projects in the proposed lending pipeline, recurrent cost financing is expected to stay closer to the level and types observed for social sector projects. As discussed earlier, the overall fiscal situation is stable, and is being strengthened under the Government's "Safe Country 2004-2009" plan, which includes measures to increase tax revenues, strengthen the financial sector and reduce external debt ratios. According to the recent CFAA, public investment expenditures (including those financed by Bank projects) are well integrated into the budget formulation and execution cycles. This accomplishment could serve as basis for the Government to begin undertaking systematic calculations of the recurrent spending portion of investment projects and their implications in future current expenditures. More importantly, El Salvador has been a regional leader in key areas of Bank support, maintaining an excellent record of sustainability of Bank-financed projects in areas such as Land Administration, Education, Competitiveness and Public Sector Modernization. Based on the above, no specific country-level limit on Bank-financing of recurrent costs is proposed. In determining recurrent-cost financing for individual projects, the Bank will take into account sustainability issues at the sector and project levels, as well as implied future budgetary outlays.

110. **Local cost financing.** The country's development expenditures are about 7.3 percent of GDP in 2003. The Government's own resources (from taxes, non-taxes, and domestic borrowing) dedicated to cover such development expenditures are approximately 5.6 percent of GDP in 2003; therefore, projected domestic revenues are insufficient to fill the development program gap, which amounts to 1.7 percent of GDP. In addition, the financing of only foreign investment expenditures will not be sufficient to provide required resources to projects. The Bank has been financing significant local costs in El Salvador: disbursements against local costs have accounted for 74%, 90% and 90% of investment lending disbursements in FY02, FY03 and FY04 respectively. This important level of local costs is expected to continue in future investment projects, specially with the land administration, social protection and education projects. Therefore, as the two requirements for Bank financing of local costs are met, the Bank may finance local and foreign costs in any proportion required for individual projects.

111. **Taxes and duties.** The country's tax structure depends basically on revenues from the value added tax (VAT) and the income tax, which generated jointly over 82 percent of

the total in 2003. The VAT rate is 13% and contributes over half of tax revenues, while the income tax rates range from 10 to 30 percent for individuals and is 25 percent for firms. The remainder is collected through import duties (with a 5 percent average tariff at end 2003) and excise taxes on specific products (mostly taxed at a 20 percent rate). Bank-financed projects are taxed at the same rates as the country's normal rates, which are reasonable and non-discriminatory. Therefore, the Bank may finance all taxes and duties associated with its projects. At the project level, the Bank will consider whether taxes and duties constitute an excessively high share of project expenditures.

C. Risks and Lending Cases

112. The CAS program has been designed in close partnership with the Government of El Salvador to respond to financial and development needs identified by the Saca administration as best suited to support from the World Bank Group. **It aims to maximize the Bank's responsiveness to the Government's requests, while minimizing risks** through careful monitoring of progress; scaling fast disbursing lending to policy performance momentum; focusing investment lending on areas where the Bank has established global expertise and which build on El Salvador's previous strong record of innovation, sustained impact and results; and linking the pace of investment lending to continued proactive implementation and problem solving by the Government.

113. The slow down in Government borrowing from the Bank under the previous CAS has reduced Bank exposure to El Salvador from what had been projected under the previous CAS, creating space for the proposed series of Development Policy Loans and a more robust investment lending program. An increase in Bank lending at this juncture would help, at more reasonable cost and consistent with a strategy to diversify financing sources, to bridge the country to a stronger fiscal position -- resulting from reforms in revenue generation and expenditure containment (pension reform measures)-- without sacrificing the Government's commitment to increasing social spending and meeting the needs of the poor.

114. The scale of Bank's financial assistance would be determined by the Government's ability to maintain its high level of performance across the three pillars of the 2004-2009 Strategy, with special attention to fiscal sustainability measures. To access increased lending levels, performance will be assessed on progress toward objectives in the set of strategic policy areas identified in Table 9. **The base case** could include up to \$300 million in Development Policy Lending and \$185 in investment lending, provided progress can be documented (using the indicative indicators in Table 9, or other appropriate measurements). To move into a **high case** lending scenario, implying up to one additional \$100 million DPL, would require performance on the specific fiscal sustainability measures indicated in Table 9. Progress on Table 9 indicators and measures and their relevance to broader policy performance will be assessed in a CAS Progress Report (FY07). In addition, to ensure appropriate scaling of fast-disbursing financial support to policy performance on key fronts, the number and timing of DPLs in both the base and high cases would be further determined by the specific prior actions and triggers included in the DPL documents (which management and the Board would review separately from this CAS).

- Steady policy performance across the three pillars, continuing financial needs, and proactive problem solving in implementation of the investment portfolio would be the basis for support in the **higher end of the base case range; up to \$485 million over 4 years, including \$300 million in a series of 3 fast-disbursing DPLs.** Policy performance would be monitored based on progress toward a few strategically significant policy objectives described in Table 9, including fiscal sustainability, trade policy, social expenditure and basic education targets. These in effect amount to “pre-conditions” for the higher lending range. At the high end of the base case, Bank exposure would increase from about US\$360 million in FY04 to around US\$700 million in FY07.
- Less rapid progress in policy reform, but continued commitment and a lack of action on portfolio implementation issues would be the basis for support in the **lower end of the base case range; \$375 million over 4 years.** In this scenario the program would be limited to two fast disbursing DPLs and one or two investment loans would be postponed until action on project effectiveness were solved. At the lower end of the base case range, exposure would increase to around US\$600 million in FY08.
- Aggressive policy performance would give the Government access to the **high case which would comprise one additional \$100 million DPL in FY08.** This would entail maintaining momentum across the three CAS pillars while demonstrating a reduction in both public sector debt and bringing the NFPS deficit at or below 2%. Additional triggers for a fourth DPL would be elaborated in DPL 3. Bank exposure to El Salvador under the high case would increase to just over \$800 million (constituting less than 1% of the total IBRD portfolio).
- Halting or back-tracking on policy reform would result in a **low-case** scenario. In this case the Bank would seek to reduce its exposure by curtailing further development policy lending. Additional investment lending would be considered on a case-by-case basis based on social need and likelihood of impact.

115. **Continued strong performance by the Government is subject to three sources of risk during the CAS period: possible political gridlock, threat of natural disaster, and a deteriorating external environment which could forestall needed growth.** Moreover, El Salvador’s current debt burden, approaching 40 percent of GDP, increases its vulnerability to potential shocks. Such fiscal vulnerabilities are further compounded by El Salvador’s dollarized regime, which limits potential macroeconomic responses in times of stress. 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. As discussed earlier in this document, the Saca administration is aware of the country’s fiscal vulnerability, has put forward a credible plan to address it and has begun putting the plan into action.

Table 9: Scale of Lending Performance Indicators

(the “high end” and “high case” columns indicate *additional* performance needed for more lending)

<i>Pillar of Government Strategy</i>	<i>Priority areas for development results</i>	<i>Low end of base case</i> (lending of \$375 million, including 2x \$100 million DPL)	<i>High end of base case</i> (lending up to \$485 million, including 3x \$100 million DPL)	<i>High Case</i> (lending up to \$585 million, including 4x \$100 million DPL)
Accelerating Broad-based Growth and Increasing Employment	Fiscal sustainability	Objective: Maintain fiscal performance Indicative indicator: Tax revenues at or above 12.2% of GDP	Objective: Improve fiscal performance Indicative indicator: Tax revenues at or above 13% of GDP	NFPS debt below 40% ¹ of GDP NFPS deficit at or below 2%
	Trade policy	Objective: More open trade regime Indicative indicator: Ratification of DR-CAFTA by end 2005		
Improving Equity Through Building Human Capital and Expanding Access to Basic Infrastructure, Assets and Markets	Access to primary Education	Objective: Maintain primary education performance Indicative indicators: Net enrollment in primary education (NER) of 85% or above Primary completion rate 75% or above	Objective: Steady progress toward universal primary education Indicative indicators: NER of 87% or above Primary completion rate 78% or above	Objective: Steady progress toward universal primary education Indicative indicators: NER of 89% or above Primary completion rate 80% or above
	Social expenditures	Objective: Maintain social expenditures Government’s Indicative indicator: Social expenditures at or above 5.2% of GDP*	Objective: Gradually increase social expenditures Government’s Indicative indicator: 2006 budget consistent with social expenditures of at least 5.4% of GDP*	Objective: Gradually increase social expenditures Government’s Indicative indicator: Social expenditures of at least 5.6% of GDP*
Enhancing Security and Reducing Vulnerability	Households most vulnerable to poverty		Objective: Develop and implement strategy to improve social protection Indicative indicator: Formulate a national strategy for a more effective social protection program	
	Proactive portfolio mgmt.	Proactivity above 50%	Proactivity about 80%	

¹ NFPS debt is defined to include both short- and long-term domestic and external public debt, excluding the net debt of the Central Bank and other public banks. If these unconsolidated data are not available, then the High Case benchmark will be public sector debt (inclusive of net debt of the Central Bank and other public banks) below 47.4% of GDP at end-2007.

* Social expenditures (gastos para Desarrollo Social) as defined in the national budget, excluding transfers for pensions and municipalities.

116. On the political front, a divided Assembly could become an obstacle to important reforms, despite the strong electoral mandate obtained by President Saca. The inability to push through measures to increase tax revenues and control expenditures would likely raise public debt, which could adversely affect investor sentiment and the availability of external finance. Likewise, failure to move on financial sector reform could lead to materialization of contingent liabilities in state-run banks. To date, the Government's approach to consensus building appears to be bearing fruit, but political obstacles to reform can not yet be fully ruled out. Potentially tense relations with the Assembly could also impede prompt ratification of external loans limiting access to funds for social development or forcing use of higher cost financing, as has been the case historically. Two aspects of this CAS mitigate against such an outcome. For the DPL series, through which the bulk of lending is expected to be channeled, the Government expects that concurrent submission of the DPLs and the annual budget to the Assembly will give it the leverage needed for prompt loan ratification. For investment loans, the Government's plan to bunch operations early in its tenure is expected to facilitate timely ratification.

117. As to possible exogenous external risks, many of the same sources of fiscal vulnerability could cloud the horizon, delay the expected recovery and worsen debt dynamics. For 2004, growth is expected to reach only 1.8%. This poor performance is in part related to short-term factors, such as political jitters surrounding the presidential election, delays in government investment plans due to the late approval of the 2004 budget, high oil prices and weakness in maquila exports and investments in anticipation of the scheduled end of textile quotas by 2005 in the United States and other markets which is expected to intensify competition from China and other Asian countries. Going forward, sustained high oil prices or a new international recession could also affect El Salvador's economy, as well as a worsening of the domestic political atmosphere that delays passage of important fiscal initiatives. Early approval of DR-CAFTA, together with continued steady implementation of the Government's plans to improve the investment climate, further strengthen of the financial sector, and increase investments in human capital should provide a new impetus to investment and growth.

118. Finally, the country remains vulnerable to natural disasters (e.g., earthquakes and hurricanes) which can hurt the performance of the economy in the short-term and may require significant unanticipated expenditures 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 position it to better absorb such shocks in the future. Should El Salvador be subject to shocks arising from natural disasters or other external factors, a **contingency scenario** may be called for, which is not considered in this CAS. In that case, the Bank team would develop an alternative program for discussion with the Board.

119. The Government of El Salvador and the Bank have agreed to monitor the program on an annual basis to assess progress which would determine any revisions to the scale and timing of the Bank's lending program. This formal stocktaking would be complemented by periodic policy discussions aimed at identifying areas of strengths and weaknesses and possible assistance needed to maintain momentum toward the Government's planned medium-term outcomes and address possible downside risks.

120. **CAS Results Framework.** The Government of El Salvador and the Bank have agreed to a results framework shown in Annex B1. The results framework was constructed on the basis of El Salvador's development challenges outlined in this proposed country strategy. The monitoring indicators were developed jointly with the Government and Government is fully committed to achieving the results specified. Progress toward the medium-term outcomes, to which the government and all its partners, including the Bank Group, contribute, should be achievable within the CAS period (2005-2008) and will be monitored using intermediate indicators and the Government's own data collection and monitoring and evaluation systems. The results monitoring framework lays out planned lending and non-lending Bank activities which contribute towards specific outcomes during the CAS implementation period. Progress within the framework will be reviewed during periodic joint program reviews between the government and the Bank's country team. It should be noted that the indicators to be monitored are already effectively collected on a regular basis by the Ministry of Finance, the Central Bank and the sectoral line ministries. Bank staff has reviewed the existing systems for data collection and information related to the results identified and found them to be of adequate quality to enable meaningful monitoring of development progress.

James D. Wolfensohn
President

By:

Shengman Zhang

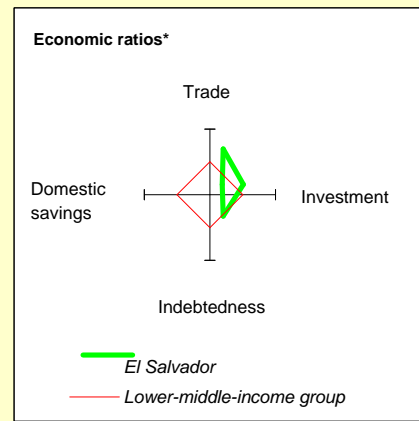
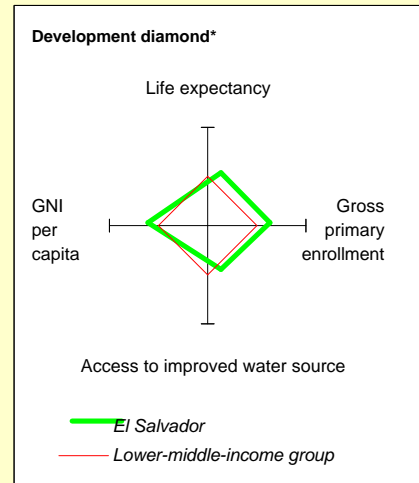
Peter L. Woicke

Washington DC
January 18, 2005

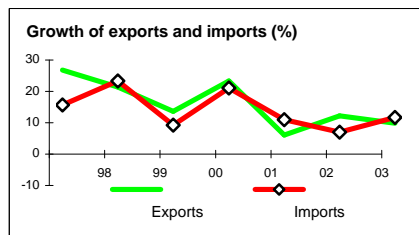
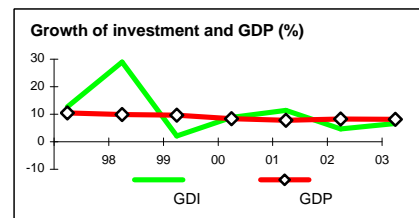
El Salvador at a glance

9/15/04

POVERTY and SOCIAL	El Salvador	Latin America & Carib.	Lower-middle-income		
2003					
Population, mid-year (millions)	6.5	534	2,655		
GNI per capita (Atlas method, US\$)	2,200	3,260	1,480		
GNI (Atlas method, US\$ billions)	14.4	1,741	3,934		
Average annual growth, 1997-03					
Population (%)	1.7	1.5	0.9		
Labor force (%)	2.9	2.1	1.2		
Most recent estimate (latest year available, 1997-03)					
Poverty (% of population below national poverty line)	..	..	..
Urban population (% of total population)	59	77	50		
Life expectancy at birth (years)	70	71	69		
Infant mortality (per 1,000 live births)	33	28	32		
Child malnutrition (% of children under 5)	12	..	11		
Access to an improved water source (% of population)	77	86	81		
Illiteracy (% of population age 15+)	20	11	10		
Gross primary enrollment (% of school-age population)	112	129	112		
Male	114	131	113		
Female	109	126	111		
KEY ECONOMIC RATIOS and LONG-TERM TRENDS					
	1983	1993	2002	2003	
GDP (US\$ billions)	3.5	7.0	14.3	14.4	
Gross domestic investment/GDP	12.1	18.6	16.4	16.6	
Exports of goods and services/GDP	24.5	19.4	26.7	27.6	
Gross domestic savings/GDP	6.6	3.8	1.9	0.8	
Gross national savings/GDP	5.6	15.1	13.7	13.0	
Current account balance/GDP	-5.6	-7.5	-2.7	-3.7	
Interest payments/GDP	2.0	1.7	1.5	2.0	
Total debt/GDP	49.8	29.2	40.8	43.8	
Total debt service/exports	19.8	13.9	7.8	8.5	
Present value of debt/GDP	43.5	..	
Present value of debt/exports	106.5	..	
	1983-93	1993-03	2002	2003	2003-07
<i>(average annual growth)</i>					
GDP	2.8	3.2	2.1	2.0	3.9
GDP per capita	1.3	1.3	0.4	0.2	1.8
Exports of goods and services	0.4	10.6	5.7	3.4	5.0



STRUCTURE of the ECONOMY	1983	1993	2002	2003
<i>(% of GDP)</i>				
Agriculture	31.2	14.0	8.7	9.4
Industry	22.3	28.2	30.3	31.8
Manufacturing	16.6	22.4	23.5	24.5
Services	46.5	57.8	61.0	58.7
Private consumption	77.5	87.6	89.9	87.9
General government consumption	15.8	8.6	8.2	11.3
Imports of goods and services	29.9	34.1	41.2	43.4
	1983-93	1993-03	2002	2003
<i>(average annual growth)</i>				
Agriculture	0.7	0.9	-0.5	6.0
Industry	3.0	4.8	2.8	4.8
Manufacturing	3.2	4.9	2.5	4.0
Services	3.3	3.0	2.3	-0.2
Private consumption	5.2	3.6	1.3	3.6
General government consumption	-4.1	1.9	-7.2	4.2
Gross domestic investment	8.8	2.9	-1.5	0.5
Imports of goods and services	7.9	7.9	0.5	5.2



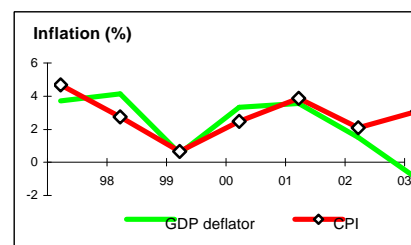
Note: 2003 data are preliminary estimates.

This table was produced from the Development Economics central database.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

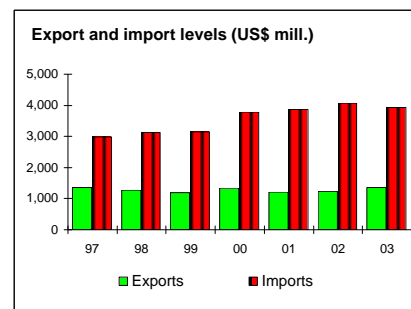
PRICES and GOVERNMENT FINANCE

	1983	1993	2002	2003
Domestic prices				
<i>(% change)</i>				
Consumer prices	13.3	18.6	1.9	2.9
Implicit GDP deflator	10.6	12.8	1.3	-1.2
Government finance				
<i>(% of GDP, includes current grants)</i>				
Current revenue	..	..	11.8	12.4
Current budget balance	..	..	0.4	0.6
Overall surplus/deficit	..	..	-3.9	-3.7



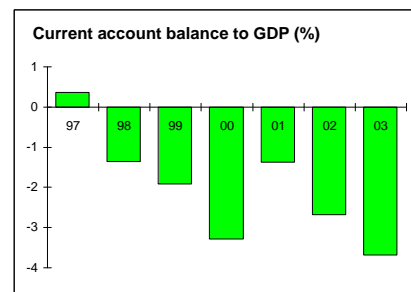
TRADE

	1983	1993	2002	2003
<i>(US\$ millions)</i>				
Total exports (fob)	..	605	1,234	1,357
Coffee	..	235	107	..
Cotton	..	35	44	..
Manufactures	..	309	1,073	1,080
Total imports (cif)	..	1,924	4,082	3,926
Food	..	441	1,198	..
Fuel and energy	..	124	175	..
Capital goods	..	565	883	906
Export price index (1995=100)	..	68	55	55
Import price index (1995=100)	..	88	83	84
Terms of trade (1995=100)	..	77	66	66



BALANCE of PAYMENTS

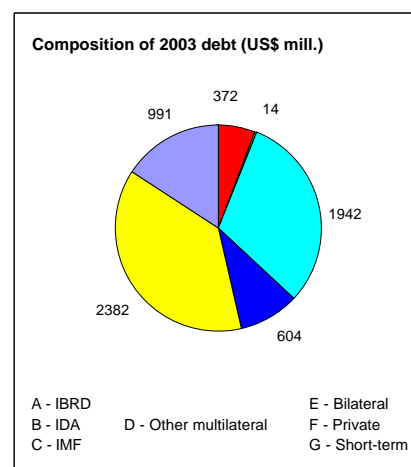
	1983	1993	2002	2003
<i>(US\$ millions)</i>				
Exports of goods and services	912	1,273	3,810	3,980
Imports of goods and services	1,085	2,487	5,887	6,255
Resource balance	-173	-1,213	-2,077	-2,275
Net income	-131	-129	-287	-325
Net current transfers	108	823	1,980	2,069
Current account balance	-196	-519	-384	-531
Financing items (net)	392	663	260	550
Changes in net reserves	-195	-144	124	-19

**Memo:**

Reserves including gold (US\$ millions)	..	645	1,623	1,607
Conversion rate (DEC, local/US\$)	2.8	8.7	8.8	8.8

EXTERNAL DEBT and RESOURCE FLOWS

	1983	1993	2002	2003
<i>(US\$ millions)</i>				
Total debt outstanding and disbursed	1,745	2,033	5,829	6,305
IBRD	106	220	371	372
IDA	26	22	15	14
Total debt service	202	294	453	514
IBRD	14	32	46	54
IDA	1	1	1	1
Composition of net resource flows				
Official grants	158	611	107	..
Official creditors	294	317	164	78
Private creditors	-19	-3	1,211	310
Foreign direct investment	28	16	208	..
Portfolio equity	0	0	0	..
World Bank program				
Commitments	0	93	143	0
Disbursements	7	51	63	38
Principal repayments	6	18	28	38
Net flows	1	33	35	0
Interest payments	8	15	19	17
Net transfers	-8	18	17	-17



Annex B1 -FRAMEWORK FOR MONITORING RESULTS OF THE CAS PROGRAM (FY 2005- 2008)

Longer-Term Development Agenda for El Salvador		Outcomes Influenced by the CAS Program During the four year period		Bank Group Assistance
Strategic and Longer Term Higher Order Country Outcomes	Related issues which hinder the ability to achieve the Higher Order Country Outcomes	Outcomes that the Bank Group expects to influence through its interventions and outcome level indicators	Intermediate Indicators to track implementation towards expected outcomes to which the Bank Group CAS will contribute	Bank Group Activities
Pillar One: Accelerating Broad-based Growth and Increasing Employment				
Reigniting Growth				
Promote Trade Expansion	SMEs unable to compete and establish linkages to export markets	<p>Non maquila exports (excluding coffee) as a share of GDP increase to 9% (from 8% in 2004)</p> <p>Expanded benefits of trade towards SMEs, measured by indicators to be defined as part of project</p> <p>Minimize short-term effects of imports in sensitive sectors</p>	<p>Progress implementing programs to expand benefits of trade towards SMEs could include inter-alia: Infocentros, BONOMYPE, FAT and FOEX; SME association programs; access to new market and business opportunities; and strengthening of Export and Investment promotion agency</p> <p>Conferences and workshops to disseminate findings and promote dialogue on CAFTA policy issues.</p> <p>Launching of programs to facilitate “reconversion productiva” of firms and sectors affected by trade liberalization and the elimination of tariffs</p>	<p>New lending</p> <ul style="list-style-type: none"> • Development Policy Loan series (FY05-08) • Ensuring SME participation in CAFTA (FY06) <p>AAA/Grants</p> <ul style="list-style-type: none"> • CAFTA Regional Study • IDF to strengthen trade and export capacity of SMEs (Regional) • BNPP grant to help SMEs take advantage of CAFTA (Regional) <p>IFC&MIGA</p> <ul style="list-style-type: none"> • MIGA support to PROESA • FIAS competitiveness strategy • IFC possible support for viable service and/or manufacturing projects

Longer-Term Development Agenda for El Salvador		Outcomes Influenced by the CAS Program During the four year period		Bank Group Assistance
Strategic and Longer Term Higher Order Country Outcomes	Related issues which hinder the ability to achieve the Higher Order Country Outcomes	Outcomes that the Bank Group expects to influence through its interventions and outcome level indicators	Intermediate Indicators to track implementation towards expected outcomes to which the Bank Group CAS will contribute	Bank Group Activities
<p>Reigniting Growth</p> <p>Improve Investment Climate</p>	<p>Complex procedure for the creation of business</p> <p>Lack of enforcement of commercial contracts</p> <p>Lack of development of capital markets</p>	<p>FDI flows average at least 1.5% of GDP in the 2005-2008 period</p> <p>Reduce El Salvador's cost (128% of per capita GDP) and time (115 days) needed to start a business to levels similar to those of OECD countries (60.4% of per capita GDP and 70 days)</p> <p>The sum of bank credit to the private sector plus the stock of registered private securities grow at least as much as GDP during 2005-2008</p>	<p><i>Centro de Tramites Empresariales</i> expanded to at least three new locations outside San Salvador</p> <p>Further actions to improve investment climate (consistent with ICA and Cost of Doing Business Survey recommendations)</p> <p>Securitization and Mutual Funds Laws presented to Assembly.</p>	<p>New lending</p> <ul style="list-style-type: none"> Development Policy Loan series (FY05-08) <p>AAA</p> <ul style="list-style-type: none"> Investment Climate Assessment (ICA) <p>FIAS</p> <ul style="list-style-type: none"> FIAS competitiveness strategy
<p>Reigniting Growth</p> <p>Improve Market Performance</p>	<p>Insufficient market regulation and supervision, especially in areas of competition policy, regulation of service providers, and consumer protection</p>	<p>Improvement in World Economic Forum competition or anti-monopoly index</p>	<p>Implementation of Competition Law</p> <p>Actions taken to improve market performance, including the presentation to Congress of Consumer Protection Law.</p>	<p>New lending</p> <ul style="list-style-type: none"> Development Policy Loan series (FY05-08) <p>AAA</p> <ul style="list-style-type: none"> A&A ROSC Investment Climate Assessment (ICA) <p>IFC</p> <ul style="list-style-type: none"> Possible investments in the financial sector Doing business study SME Facility support

Longer-Term Development Agenda for El Salvador		Outcomes Influenced by the CAS Program During the four year period		Bank Group Assistance
Strategic and Longer Term Higher Order Country Outcomes	Related issues which hinder the ability to achieve the Higher Order Country Outcomes	Outcomes that the Bank Group expects to influence through its interventions and outcome level indicators	Intermediate Indicators to track implementation towards expected outcomes to which the Bank Group CAS will contribute	Bank Group Activities
<p>Reigniting Growth</p> <p>Increase Provision of Infrastructure (Public and Private)</p>	<p>Insufficient investment by public and private sector in infrastructure</p> <p>Issues of coverage, quality and access</p>	<p>Completion of critical PPI transactions: Cutuco, Acajutla, Air Cargo Terminal, 2 roads and one in the energy sector</p> <p>Indicators of progress in public investment in infrastructure to be defined in DPL series</p>	<p>Adoption of Plan to improve the air and maritime transport sector's legal and regulatory framework.</p> <p>Actions to improve provision of infrastructure (consistent with REDI recommendations)</p>	<p>New lending</p> <ul style="list-style-type: none"> Development Policy Loan series (FY05-08) <p>AAA/Grants</p> <ul style="list-style-type: none"> Recent Economic Developments in Infrastructure (REDI) TA to improve infrastructure through public-private partnerships (PPIAF) <p>IFC</p> <p>IFC possible support for housing via financing</p>
<p>Supporting Macroeconomic Stability and Fiscal Consolidation</p> <p>Reduce government debt Increase tax revenues</p>	<p>Tax revenue low by regional and global norms</p> <p>Fiscal cost of pension reform</p>	<p>Upgrade of credit ratings by international credit agencies</p> <p>Maintain budget deficit (with pensions) on a downward trajectory in 2005-2008</p> <p>NFPS debt ratio at or below 40% by end 2008</p> <p>Tax revenues at or above 14.5% of GDP by end 2008</p>	<p>Implementation of fiscal reform package approved in 2004</p> <p>Further actions to increase tax revenues, including efforts to incorporate the informal sector into the tax base and to compensate for shortfalls in meeting tax revenue targets if necessary</p> <p>Redesign financing structure of the pension system to contain its fiscal impact</p> <p>Actions to reduce contingent liabilities in public financial institutions</p>	<p>New lending</p> <ul style="list-style-type: none"> Development Policy Loan series (FY05-08) <p>AAA</p> <ul style="list-style-type: none"> PER follow-up CEM update

Longer-Term Development Agenda for El Salvador		Outcomes Influenced by the CAS Program During the four year period		Bank Group Assistance
Strategic and Longer Term Higher Order Country Outcomes	Related issues which hinder the ability to achieve the Higher Order Country Outcomes	Outcomes that the Bank Group expects to influence through its interventions and outcome level indicators	Intermediate Indicators to track implementation towards expected outcomes to which the Bank Group CAS will contribute	Bank Group Activities
Strengthen financial sector	Risks from financial sector contingent fiscal liabilities deriving from financial intermediation from public bank	Stronger financial sector and reduced fiscal risk	Financial Supervision Law presented to Congress consistent with FSAP recommendations related to consolidated supervision and strengthening of supervisory powers New rules implemented on loan classification and provisioning, and on credit-risk administration, consistent with international best practices.	AAA •Financial Sector Reform and Strengthening (FIRST) •FSAP follow-up

Pillar Two: Improving Equity Through Building Human Capital and Expanding Access to Basic Infrastructure Assets and Markets				
Longer-Term Development Agenda for El Salvador		Outcomes Influenced by the CAS Program During the four year period		Bank Group Assistance
Strategic and Longer Term Higher Order Country Outcomes	Related issues which hinder the ability to achieve the Higher Order Country Outcomes	Outcomes that the Bank Group expects to influence through its interventions and outcome level indicators	Intermediate Indicators to track implementation towards expected outcomes to which the Bank Group CAS will contribute	Bank Group Activities
<p>Achieve universal primary education</p> <p>Primary completion of 85% by 2009</p> <p>Net enrollment in primary education of 95% by 2009</p> <p>Improve access and quality of secondary education</p> <p>Net enrollment in secondary education of 55% by 2009</p>	<p>Insufficient public expenditure for education</p> <p>Incomplete coverage especially in poor rural areas</p> <p>Quality varies and needs improvement</p> <p>Low enrollment in secondary education</p> <p>Poor quality of curriculum and school infrastructure</p>	<p>Primary completion rate of 83% by end-2008</p> <p>Quality of education improved</p> <p>Net enrollment in secondary of 53% by end-2008</p> <p>Establishment of Educational Assessment System</p>	<p>Repetition rate in grade 1 of 12% by end-2005</p> <p>Academic performance for evaluation of quality implemented for grade 1</p> <p>Infrastructure rehabilitation targeting EDUCO schools started</p> <p>New modalities of flexible secondary education implemented (distance, mixed and accelerated)</p> <p>Ongoing teacher training</p> <p>Establishment of learning resource centers (CRAs)</p> <p>Rehabilitation of schools started</p>	<p>On-going lending</p> <ul style="list-style-type: none"> Secondary Education Project Education Reform APL <p>New lending</p> <ul style="list-style-type: none"> Education Reform APL II (FY06) <p>AAA</p> <ul style="list-style-type: none"> Education Strategy (Reg)

Longer-Term Development Agenda for El Salvador		Outcomes Influenced by the CAS Program During the four year period		Bank Group Assistance
Strategic and Longer Term Higher Order Country Outcomes	Related issues which hinder the ability to achieve the Higher Order Country Outcomes	Outcomes that the Bank Group expects to influence through its interventions and outcome level indicators	Intermediate Indicators to track implementation towards expected outcomes to which the Bank Group CAS will contribute	Bank Group Activities
<p>Expand coverage of quality health services to 350,000 persons in most deprived areas.</p> <p>10% reduction of underweight children in targeted areas</p> <p>90% of complete child immunization rates in targeted areas.</p> <p>80% of complete prenatal care</p> <p>Containment of HIV infection rates</p>	<p>Lack of access to basic health and nutrition services in poor and rural areas</p> <p>Inadequate hospital infrastructure (bad physical condition, weak management, imbalance of human resources and other inputs, poor coordination with primary health and negative environmental impact).</p> <p>Lack of a socially accepted health reform vision</p>	<p>Improved access to basic health services in targeted areas</p> <p>90% of children under five years receive complete vaccination in targeted areas.</p> <p>80% of pregnant women receive complete prenatal care in targeted areas</p> <p>Improved access to quality hospital services in targeted areas</p> <p>Improve detection and control of HIV/AIDs</p>	<p>150,000 beneficiaries in poor communities with effective access to basic services through private providers, as measured by improved utilization, immunization and prenatal control rates</p> <p>Reconstruction of 7 hospitals</p> <p>At least 7 hospitals with satisfactory environmental health plans functioning</p> <p>25% of HIV positive pregnant women receive treatment</p> <p>Voluntary HIV testing for 50% of women seeking treatment for HIV/AIDs</p> <p>50% of HIV positive women receive treatment</p>	<p>On-going lending</p> <ul style="list-style-type: none"> • Earthquake Emergency Reconstruction and Health Services Project (on-going) <p>Grant</p> <ul style="list-style-type: none"> • Central America Reg. HIV/AIDs project (FY05) <p>AAA</p> <ul style="list-style-type: none"> • Health Strategy (regional)
<p>Improved land tenure security and land transactions</p> <p>Provision of efficient, equitable and accessible land administration services</p>	<p>Underdeveloped land administration system and insufficient titling</p> <p>Insufficient institutional capacity</p>	<p>85% of land parcels cadastered, included and maintained in registry</p> <p>Financial self-sustainability of the National registry Center</p>	<p>Approval of LAP II by Congress</p> <p>Steady execution of the land regularization process</p>	<p>On-going lending</p> <ul style="list-style-type: none"> • Land Administration I Project <p>New lending</p> <ul style="list-style-type: none"> • Land Administration II Project (FY05)

Pillar Three: Enhancing Security and Reducing Vulnerability

Longer-Term Development Agenda for El Salvador		Outcomes Influenced by the CAS Program During the four year period		Bank Group Assistance
Strategic and Longer Term Higher Order Country Outcomes	Related issues which hinder the ability to achieve the Higher Order Country Outcomes	Outcomes that the Bank Group expects to influence through its interventions and outcome level indicators	Intermediate Indicators to track implementation towards expected outcomes to which the Bank Group CAS will contribute	Bank Group Activities
Improved Governance Improve transparency and efficiency of government	Insufficient transparency and efficiency of government	All public sector entities have implemented effective internal controls Increase Transparency International ranking	Launch an e-government strategy Further progress in PFM improvement program (e.g. Ministry of Finance has finalized its project for internal controls systems regulation)	On-going lending <ul style="list-style-type: none"> • Public Sector Reform Project New lending <ul style="list-style-type: none"> • Development Policy Loan series (FY05-08) • Modernization of the State Project (FY07) AAA <ul style="list-style-type: none"> • CPAR/CFAA/PER update
Improve Governance Implement a competitive public procurement regime	Sound procurement law passed in 2002, but non-issuance of implementing regulations has led to inconsistent practices	Government procurement follows international best practice	Issue implementing regulations for Procurement Law Implementation of operational directives for procurement unit (UNAC) and of four-year program for the public procurement system Harmonized bidding documents for use by all public agencies developed	On-going lending Public Sector Reform Project New lending <ul style="list-style-type: none"> • Development Policy Loan series (FY05-08) • Modernization of the State Project (FY07) AAA/Grant <ul style="list-style-type: none"> • IDF for procurement modernization • CPAR update
Improve Governance Improve protection of social and individual rights by ensuring rule of law through judicial reform	Weak judicial systems	Increase in user satisfaction and improved judicial services as measured by citizen confidence in system	Increase in the efficiency in allocation of judicial branch resources	On-going lending <ul style="list-style-type: none"> • Judicial Reform Project

Longer-Term Development Agenda for El Salvador		Outcomes Influenced by the CAS Program During the four year period		Bank Group Assistance
Strategic and Longer Term Higher Order Country Outcomes	Related issues which hinder the ability to achieve the Higher Order Country Outcomes	Outcomes that the Bank Group expects to influence through its interventions and outcome level indicators	Intermediate Indicators to track implementation towards expected outcomes to which the Bank Group CAS will contribute	Bank Group Activities
<p>Reduce vulnerability</p> <p>Social expenditures increased to or at least 5% of GDP by 2009</p> <p>Targeting, coverage, and design of social assistance programs for the poor improved</p>	<p>Insufficient funding to achieve social development objectives</p> <p>Weak targeting of social assistance programs</p>	<p>Social expenditures increased to at least 5.4% of GDP by end 2008</p> <p>Follow-up actions to improve targeting, coverage and design of social assistance programs for the poor</p>	<p>National strategy on social protection formulated</p> <p>Gradual increases in social expenditures</p>	<p>New lending</p> <ul style="list-style-type: none"> • Social Protection and Local Development (FY06) <p>AAA</p> <ul style="list-style-type: none"> • PER (follow-up) • Shocks and Social Protection Study
<p>Better environmental protection</p>	<p>Significant Environmental Degradation</p>	<p>GOES preparation of National Environmental Strategy</p> <p>A system of environmental services piloted</p> <p>Tested and replicable strategy for protected area consolidation and biodiversity conservation</p>	<p>CEA Action Plan, especially for infrastructure and trade expansion</p> <p>Charges and payments for environmental services initiated</p> <p>Two pilot protected areas selected</p> <p>Participatory management plans developed for pilot protected areas</p>	<p>AAA</p> <p>Country Environmental Analysis</p> <p>Lending/ Grant</p> <p>Environmental Services Project (FY05) and GEF Grant Component (FY05)</p> <p>Grant</p> <p>GEF Land Administration and Protected Areas Project (FY06)</p>

CAS Annex B2 - El Salvador
Selected Indicators* of Bank Portfolio Performance and Management

Indicator	2002	2003	2004	2005
Portfolio Assessment				
Number of Projects Under Implementation ^a	7	7	6	6
Average Implementation Period (years) ^b	5.4	5.1	5.6	5.7
Percent of Problem Projects by Number ^{a, c}	0.0	28.6	0.0	0.0
Percent of Problem Projects by Amount ^{a, c}	0.0	40.5	0.0	0.0
Percent of Projects at Risk by Number ^{a, d}	0.0	28.6	0.0	0.0
Percent of Projects at Risk by Amount ^{a, d}	0.0	40.5	0.0	0.0
Disbursement Ratio (%) ^e	32.8	16.9	15.0	1.9
Portfolio Management				
CPPR during the year (yes/no)	No	No	No	No
Supervision Resources (total US\$)	706	790	525	..
Average Supervision (US\$/project)	78	99	75	..

Memorandum Item	Since FY 80	Last Five FYs
Proj Eval by OED by Number	16	3
Proj Eval by OED by Amt (US\$ millions)	460.8	108.5
% of OED Projects Rated U or HU by Number	12.5	0.0
% of OED Projects Rated U or HU by Amt	6.0	0.0

- a. As shown in the Annual Report on Portfolio Performance (except for current FY).
- b. Average age of projects in the Bank's country portfolio.
- c. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).
- d. As defined under the Portfolio Improvement Program.
- e. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: Investment projects only.
- * All indicators are for projects active in the Portfolio, with the exception of Disbursement Ratio, which includes all active projects as well as projects which exited during the fiscal year.

CAS Annex B3
EI Salvador Proposed IBRD Base Case Lending Program ^a

<i>Fiscal year</i>	<i>Project</i>	<i>US\$(M)</i>	<i>Strategic Rewards ^b (H/M/L)</i>	<i>Implementation ^b Risks (H/M/L)</i>
2005	Development Policy I (DPL I)	100.0	H	M
	Land Administration II	40.0	H	L
	Environmental Services Project	5.0	M	H
2006	Development Policy II (DPL II)	100.0	H	M
	Education Reform II	85.0	H	L
	Social Protection and Local Development (FISDL)	35.0	M	M
	Ensuring SME Participation in CAFTA	10.0	M	M
	Total Low end of Base Case	375.0		
2007	Development Policy III (DPL III)	100.0	H	M
	Modernization of the State II	10.0	M	L
	Total High End of Base Case	485.0		

a This table presents the proposed program for the next three fiscal years.

b For each project, indicate whether the strategic rewards and implementation risks are expected to be high (H), moderate (M) or low (L).

CAS Annex B3
EI Salvador - IFC and MIGA Program, FY 2002-2005

	2002	2003	2004	2005
IFC commitments (US\$m)	45.0	17.0	92.5	n.a.
Sector (%)				
Utilities	100	-	-	
Finance & Insurance	-	100	73	
Wholesale and Retail	-	-	27	
Total	100	100	100	-
Investment instrument(%)				
Equity	-	12	8	
Loan	100	88	86	
Quasi-equity (Loan type)	-	-	5	
Total	100	100	100	-

CAS Annex B4
Summary of Nonlending Services - El Salvador

<i>Product</i>	<i>Completion FY</i>	<i>Amount (US\$000)</i>	<i>Audience^a</i>	<i>Objective^b</i>
AAA: Recent completions				
Public Expenditure Review	FY04	...	G, PD, B	KG, PS
Country Economic Memorandum	FY03	...	G, PD, B	KG, PS
Poverty Assessment	FY04	...	G, PD, B	KG, PS
Country Financial Accountability Assessment	FY04	...	G, B	KG, PS
Country Procurement Assessment Review	FY04	...	G, B	KG, PS
FSAP Update	FY04	...	G, B	KG, PS
AAA: Underway				
Recent Economic Developments in Infrastructure	FY06	...	G, PD, B	KG, PS
Financial Sector Reform and Strengthening Study	FY05	...	G, B	KG, PS
Investment Climate Assessment	FY05	...	G, PD, B	KG, PD, PS
CAFTA Regional Study	FY05	...	G, PD, B	KG, PD, PS
Shocks and Social Protection Study	FY05	...	G, PD, B	KG, PS
Education Study (regional)	FY05	...	G, PD, B	KG, PS
AAA: Planned				
ROSC (A+A module)	FY05	...	G, PD, B	KG, PS
PSIAs on Tax and Pension Reforms and CAFTA	FY05	...	G, PD, B	KG, PS
CSR Strategy	FY06	...	G, PD, B	KG, PD, PS
Country Environmental Analysis (CEA)	FY06	...	G, PD, B	KG, PS
Health Strategy (regional)	FY06	...	G, PD, B	KG, PD, PS
<u>IDF Grants</u>				
	<i>Approval FY</i>			
Public Procurement Modernization	FY03	497.0	G, PS	KG, PS
Strengthening Afro Communities. (regional)	FY03	76.7	G, PS	KG, PS
CAFTA Trade Capacity Building (regional)	FY03	100.0	G, PS	KG, PS
<u>Other Grants</u>				
	<i>Approval FY</i>			
GEF - Central America Regional HIV/AIDS	FY05	1,333.3	G, D, B	KG, PS
GEF - National Environmental Management Project	FY05	350.0	G, D, B	KG, PS
PHRD - Social Protection & Local Development	FY05	670.0	G, D, B	KG, PS
PHRD - Education Reform APL II	FY04	400.0	G, D, B	KG, PS
PHRD - Land Administration Project	FY04	549.5	G, D, B	KG, PS
PHRD - National Environmental Management Project	FY02	250.0	G, D, B	KG, PS

a. Government, donor, Bank, public dissemination.

b. Knowledge generation, public debate, problem-solving.

CAS ANNEX B5
El Salvador Social Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1996-2002	Latin America & Carib.	Lower- middle- income
POPULATION					
Total population, mid-year (millions)	4.1	4.8	6.4	524.9	2,408.5
Growth rate (% annual average for period)	2.7	0.8	1.7	1.5	0.9
Urban population (% of population)	41.5	46.6	62.4	76.4	49.4
Total fertility rate (births per woman)	5.8	4.2	2.9	2.5	2.1
INCOME					
GNI per capita (US\$)	490	750	2,110	3,280	1,400
Consumer price index (1995=100)	5	19	128	..	..
Food price index (1995=100)	..	14	125	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Share of income or consumption					
Gini index	..	..	53.2	..	..
Lowest quintile (% of income or consumption)	..	..	2.9	..	..
Highest quintile (% of income or consumption)	..	..	57.1	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (% of GDP)	..	..	3.7	3.4	2.7
Education (% of GDP)	3.2	3.0	2.5	4.5	4.0
Social security and welfare (% of GDP)	..	..	3.2	..	..
Net primary school enrollment rate					
<i>(% of age group)</i>					
Total	66	..	89	94	91
Male	66	..	89	94	92
Female	65	..	89	95	92
Access to an improved water source					
<i>(% of population)</i>					
Total	..	..	77	86	81
Urban	..	..	91	94	95
Rural	..	..	64	65	70
Immunization rate					
<i>(% of children ages 12-23 months)</i>					
Measles	..	71	93	91	78
DPT	..	55	81	88	84
Child malnutrition (% under 5 years)	..	..	12	9	9
Life expectancy at birth					
<i>(years)</i>					
Total	58	61	70	71	69
Male	54	56	67	68	67
Female	62	66	73	74	72
Mortality					
Infant (per 1,000 live births)	111	84	33	28	32
Under 5 (per 1,000 live births)	162	118	39	34	40
Adult (15-59)					
Male (per 1,000 population)	259	410	250	222	212
Female (per 1,000 population)	193	178	148	125	131
Maternal (modeled, per 100,000 live births)	..	..	150	..	..
Births attended by skilled health staff (%)	..	..	..	..	..

Note: 0 or 0.0 means zero or less than half the unit shown. Net enrollment rate: break in series between 1997 and 1998 due to change from ISCED76 to ISCED97. Immunization: refers to children ages 12-23 months who received vaccinations before one year of age.

CAS ANNEX B6
El Salvador - Key Economic Indicators

Indicator	Actual				Estimate	Projected				
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
National accounts (as % of GDP)										
Gross domestic product a	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	10.0	9.0	9.0	8.8	8.5	8.3	8.0	8.0	7.8	7.7
Industry	30.0	30.0	30.0	32.0	33.0	33.0	33.0	33.0	33.0	33.0
Services	60.0	61.0	61.0	59.3	58.5	58.8	59.0	59.0	59.3	59.3
Total Consumption	98.1	99.3	98.8	99.4	98.2	96.3	97.0	95.5	95.0	95.5
Gross domestic fixed investment	16.9	16.7	16.2	16.6	15.8	16.7	17.0	17.5	18.0	18.5
Government investment	2.9	4.4	4.3	3.6	2.3	3.1	3.0	3.1	3.5	3.5
Private investment	14.0	12.3	11.9	13.0	13.5	13.6	14.0	14.4	14.5	15.0
Exports (GNFS) b	27.0	26.0	26.0	27.0	26.0	25.0	26.0	28.0	29.0	29.0
Imports (GNFS)	42.0	42.0	41.0	43.0	40.0	38.0	40.0	41.0	42.0	43.0
Gross domestic savings	1.9	0.7	1.2	0.6	1.8	3.7	3.0	4.5	5.0	4.5
Gross national savings c	13.6	15.6	13.3	11.7	11.2	12.2	13.0	13.5	14.0	14.5
<i>Memorandum items</i>										
Gross domestic product (US\$ million)	13,134	13,813	14,312	14,940	15,697	16,474	17,506	18,500	19,550	20,660
GNI per capita (US\$, Atlas method)	2,000	2,040	2,080	2,230	2,230	2,310	2,410	2,510	2,610	2,715
Real annual growth rates (% , calculated from 1990 prices)										
GDP at domestic prices	2.2	1.7	2.2	1.8	1.8	2.5	3.0	3.0	3.0	3.0
Gross Domestic Income	0.3	1.8	1.6	1.2	1.3	3.1	4.4	3.2	3.2	3.2
Real annual per capita growth rates (% , calculated from 1990 prices)										
Gross domestic product at market prices	0.2	-0.2	0.3	-0.1	-0.1	0.7	1.2	1.3	1.3	1.4
Total consumption	1.7	1.2	-0.2	0.1	-3.6	0.6	1.2	1.0	1.0	1.0
Private consumption	1.9	1.1	-0.2	0.2	-4.6	-0.1	0.4	0.1	0.1	0.1
Balance of Payments (US\$ millions)										
Exports (GNFS) b	3,599	3,568	3,773	3,986	4,011	4,092	4,707	5,345	5,945	6,310
Merchandise FOB	2,900	2,864	3,021	3,162	3,220	3,262	3,461	3,633	3,867	4,120
Imports (GNFS) b	5,573	5,753	5,933	6,429	6,252	6,351	7,074	7,868	8,568	9,050
Merchandise FOB	4,640	4,797	4,892	5,436	5,728	5,906	6,228	6,582	6,943	7,337
Resource balance	-1,974	-2,185	-2,160	-2,443	-2,241	-2,259	-2,367	-2,523	-2,623	-2,740
Net current transfers	1,797	2,298	2,023	2,117	2,544	2,748	2,955	3,133	3,305	3,480
Current account balance	-431	-151	-411	-734	-702	-671	-743	-799	-831	-876
Foreign direct investment	178	289	496	68	150	149	254	268	283	299
Long-term loans (net)	257	54	695	1005	269	416	515	582	599	628
Official	200	620	1270	587	242	563	587	526	450	543
Private	57	-566	-575	418	27	-147	-72	56	149	85
Other capital (net, incl. errors & omissions)	-50	-370	-904	-23	113	116	69	69	69	69
Change in reserves d	46	178	124	-316	170	-10	-95	-120	-120	-120
<i>Memorandum items</i>										
CAB (% of GDP)	-3.3	-1.1	-2.9	-4.9	-4.5	-4.1	-4.2	-4.3	-4.3	-4.2
Real annual growth rates										
Exports (FOB)	16.5	-2.9	4.4	2.2	-0.9	-1.2	4.0	2.9	4.3	4.4
Imports (FOB)	15.9	1.5	0.3	8.6	1.5	0.7	3.6	3.8	3.6	3.8

(Continued)

**EI Salvador - Key Economic Indicators
(Continued)**

Indicator	Actual				Estimate	Projected				
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Nonfinancial Public Sector finance (as % of GDP)										
Total revenues and grants	16.6	15.6	16.1	16.8	16.8	17.1	17.0	17.4	17.9	18.4
Current revenues	15.7	15.2	15.3	16.3	16.3	16.6	16.7	17.1	17.6	18.1
Tax Revenues	11.0	11.1	11.8	12.1	12.2	13.3	13.6	14.1	14.6	15.2
Total expenditures	19.6	20.0	20.5	20.6	19.3	20.1	19.3	18.9	18.9	19.7
Current expenditures (incl. pensions transfers)	16.3	15.5	15.6	16.9	16.7	16.8	16.3	15.8	15.4	15.0
Capital expenditure	3.3	4.5	4.9	3.7	2.6	3.3	3.0	3.1	3.5	4.7
Overall NFPS balance	-3.0	-4.4	-4.4	-3.8	-2.5	-3.0	-2.3	-1.5	-1.0	-1.3
Foreign financing	1.5	4.5	8.7	3.0	1.6	3.1	2.3	1.5	1.0	1.3
Domestic Financing	1.5	-0.1	-4.3	0.8	0.9	-0.1	0.0	0.0	0.0	0.0
Monetary indicators										
M2/GDP	45.9	44.9	42.1	40.1	39.1	37.9	36.9	35.7	34.7	33.5
Growth of M2 (%)	1.0	3.7	-3.1	2.3	2.5	3.0	3.0	3.0	3.0	3.0
Private sector credit growth (%)	1.1	-1.8	7.3	6.9	4.9	5.0	5.0	5.0	5.0	5.0
Price indices(1990 =100)										
Merchandise export price index	117.5	116.0	122.4	128.1	130.4	132.1	140.2	147.2	156.6	166.9
Merchandise import price index	121.3	125.4	127.9	142.1	149.8	154.5	162.8	172.1	181.5	191.9
Merchandise terms of trade index	96.9	92.5	95.6	90.1	87.0	85.5	86.1	85.5	86.3	87.0
Consumer price index (end period, % change)	4.3	1.4	2.8	2.5	5.5	2.5	2.5	2.5	2.5	2.5
GDP deflator (% change)	3.2	3.4	1.4	2.5	4.2	2.5	2.5	2.5	2.5	2.5

- a. GDP at market prices
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.

CAS ANNEX B7
El Salvador - Key Exposure Indicators *

Indicator	Actual				Estimate	Projected				
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt outstanding and disbursed (TDO) (US\$m) a	3,822	4,696	5,539	6,081	6,357	6,738	7,125	7,456	7,722	8,099
Net disbursements (US\$m) b	161	474	364	278	306.5	281.2	150.2	246.2	357.2	369.8
Total debt service (TDS) (US\$m) b	341	369	423	644	600	601	724	602	602	602
Debt and debt service indicators (%)										
TDO/Exports GNFS c	94.2	76.0	67.6	66.0	64.3	63.8	69.6	73.1	78.6	79.3
TDO/GDP	29.1	34.0	38.7	40.7	40.5	40.9	40.7	40.3	39.5	39.2
o/w Domestic	7.5	11.2	10.7	9.1	5.3	4.6	3.9	3.2	2.8	3.1
o/w External	21.6	22.8	28.0	31.6	35.2	36.3	36.8	37.1	36.7	36.1
IBRD exposure indicators (%)										
IBRD DS/public DS	15.7	15.5	12.3	9.6	10.6	10.0	7.9	11.4	11.4	11.4
Preferred creditor DS/public DS (%) d	54.9	58.9	47.9	37.4	51.8	53.3	41.7	..	..	..
IBRD DS/XGS	0.8	0.9	0.8	1.0	1.0	0.9	0.8	0.8	0.8	0.7
IBRD TDO (US\$m) e	309.0	334.0	371.0	372.0	351.0	463.0	589.0	712.0	828.0	935.0
IBRD TDO / TDO (%)	8.1	7.1	6.6	5.6	5.8	7.2	8.7	9.9	11.5	12
IFC (US\$m) f										
Loan and Quasi-equity (Loan type)	42.0	45.0	67.1	73.4	78.2	n.a.	n.a.	n.a.	n.a.	n.a.
Equity and Quasi-equity (Equity type)	3.4	3.2	3.2	5.2	5.2	n.a.	n.a.	n.a.	n.a.	n.a.

* Assumes a 2005 - 2009 CAS envelope of USD 580 million

a. Non Financial Public Sector external debt only.

b. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.

c. "GNFS" denotes "goods and nonfactor services."
Bank for International Settlements.

d. Preferred creditors are defined as IBRD, IDA, IFC, regional multilateral development banks, IMF and Bank of International Settlements.

e. Includes present value of guarantees.

f. Actual data based on fiscal years ending in June of the indicated year. Not including the Participants' account.

CAS Annex B8 - El Salvador
IBRD Operations Portfolio

Closed Projects **30**

IBRD/IDA *

Total Disbursed (Active)	190.0
of which has been repaid	31.1
Total Disbursed (Closed)	585.4
of which has been repaid	414.3
Total Disbursed (Active + Closed)	775.4
of which has been repaid	445.4
Total Undisbursed (Active)	190.8
Total Undisbursed (Closed)	0.0
Total Undisbursed (Active + Closed)	190.8

Active Projects

Project ID	Project Name	<u>Last PSR</u>		Fiscal Year	<u>Amount in US\$ Millions</u>		<u>Difference Between Expected and Actual Disbursements^{aj}</u>	
		Supervision Rating			IBRD	Undisb.	Orig.	Frm Rev'd
		<u>Development Objectives</u>	<u>Implementation Progress</u>					
P050612	Education Reform	S	S	1998	88	16.5	16.5	16.5
P064919	Judicial Modernization	S	S	2003	18.2	17.4	9.6	
P007174	Land Administration	S	S	1996	50	0.0	0.0	0.0
P007164	Public Sector Modernization	S	S	1997	24	6.1	6.1	1.3
P041680	Secondary Education	S	S	1998	58	11.4	11.4	
P067986	Earthquake Reconstruction	S	S	2002	142.6	139.4	-3.1	
					380.8	190.8	40.6	17.9

CAS Annex B8 (IFC) for EI Salvador

EI Salvador
Statement of IFC's
Held and Disbursed Portfolio
(In US Dollars Millions)
As of November 2004

Approval Fiscal Year	Institution Short Name	Held				Disbursed			
		Loan	Equity	QL+QE	Part	Loan	Equity	QL+QE	Part
2001	AFP Crecer	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0
2004	Banco Agricola	50.0	0.0	0.0	0.0	37.0	0.0	0.0	0.0
2001	CAESS/EEO	42.6	0.0	0.0	68.7	29.2	0.0	0.0	46.4
2002/2004	CALPIA	5.0	2.0	5.0	0.0	5.0	2.0	5.0	0.0
1997/2000	CESSA	0.0	2.2	0.0	0.0	0.0	2.2	0.0	0.0
1998/2003	CUSCATLAN-ES	11.1	0.0	15.0	0.0	11.1	0.0	15.0	0.0
2004	Confia AFP	0.0	7.5	0.0	0.0	0.0	6.7	0.0	0.0
2004	Metrocentro	25.0	0.0	0.0	0.0	25.0	0.0	0.0	0.0
1997/1999	SEF IMACASA	0.0	0.2	0.0	0.0	0.0	0.2	0.0	0.0
Total Portfolio:		133.7	12.3	20.0	68.7	107.3	11.1	20.0	46.4

EL SALVADOR: COUNTRY FINANCING PARAMETERS

Item	Parameter	Remarks / Explanation
Cost sharing. Limit on the proportion of individual project costs that the Bank may finance	Up to 100 percent	100 percent financing is expected to be applied selectively to stay within the overall CAS lending envelope. Specific arrangements would be determined for individual projects, allowing technical assistance projects to finance up to 100 percent of the cost if necessary, while land administration and social sector projects are expected to be in the 70 to 85 percent range.
Recurrent cost financing. Any limits that would apply to the overall amount of recurrent expenditures that the Bank may finance	No country-level limit	In determining recurrent cost financing in individual projects, the Bank will take into account sustainability issues at the sector and project levels and implied future budgetary outlays.
Local cost financing. Are the requirements for Bank financing of local expenditures met? Namely that: (i) financing requirements for the country's development program would exceed the public sector's own resources (e.g., from taxation and other revenues) and expected domestic borrowing; and (ii) the financing of foreign expenditures alone would not enable the Bank to assist in the financing of individual projects	Yes	The two requirements are met. The Bank may therefore finance local costs in the proportions needed in individual projects.
Taxes and duties. Are there any taxes and duties that the Bank would not finance?	None	No taxes or duties are currently identified as unreasonable or discriminatory. At the project level, the Bank would consider whether taxes and duties constitute an excessively high share of project expenditures.

Annex D - CAS Consultations with Salvadoran Stakeholders

Consultations on the World Bank's Country Assistance Strategy for El Salvador were held in San Salvador from October 4-6, 2004. The Bank was represented at these consultations as follows: Jane Armitage (Country Director), Nicolette Bowyer (Country Officer), Manuel Sevilla (FPSI Sector Leader), Felipe Jaramillo (Lead Economist and PREM Sector Leader), Ana-Lucia Armijos (Country Economist) and Eduardo Wallentin (Manager, IFC). In addition, David de Ferranti, (Vice President, Latin America and the Caribbean) held a series of small meetings with members of the executive branch, representatives from the different political parties and with the private sector and foundations/think tanks.

The more formal round of consultations on the CAS centered on a one-day workshop attended by approximately 150 participants, including representatives of the executive branch of government, the judicial sector, members of the Salvadoran congress, local governments, academia and think-tanks, foundations, civil society, the international donor community, the private sector and media. During the morning session, the Bank team made presentations on two core diagnostic reports (the *Poverty Assessment* and the *Public Expenditure Review*), followed by a general discussion and a lively question and answer session. The Country Director made a power-point presentation summarizing the Bank Group's current assistance program in El Salvador, together with a brief explanation of the different entities comprising the World Bank Group and its main lending and non-lending instruments and outlining the proposed areas of emphasis for the new CAS for FY05-08. Prior to the meeting, summaries in Spanish of the two core diagnostic reports and of the *Country Economic Memorandum* were posted on the Bank's website, together with a document summarizing the Bank's current portfolio and recent AAA activities in El Salvador, and a tentative list of proposed new lending and non-lending activities.

In the afternoon, a participatory methodology—known as *tecnica Delphi*—was implemented with the help of a local consultant with extensive experience in facilitating dialogue. The methodology allowed for a set of productive and frank discussions with the different stakeholders, aimed at soliciting participants' views on the key development challenges facing El Salvador and on the possible role of the Bank in helping the country to respond to these challenges. Based on the three pillars of growth, equity and security underpinning the Government's development plan "Safe Country", thematic working groups were set up with participants invited to join the thematic group of their choice. Each working group elected a team leader, a rapporteur and a secretary. The groups were provided with a set of core questions (See Box 1) designed to orient and stimulate the discussion, without constraining the scope and content of the dialogue. The groups were extremely well attended, and the discussions were lively and frank, with participants showing a high degree of engagement, technical knowledge and enthusiasm. At the end of the day, each working group made a short presentation highlighting the main points from their discussions. A report on the workshop including the list of the participants, description of the methodology, detailed notes from the discussions of each working

group and a summary of the key points, has been prepared by the local consultant and can be found on the Bank's website at www.worldbank.org/elsalvador .

Box 1 – Set of Questions used with Consultations participants

1. Esta correcto/completo el análisis y las recomendaciones de los estudios presentados por la mañana? Hay nuevos datos o analisis que pueden enriquecer o cambiar las conclusiones? (*Are the analysis and recommendations of the studies presented in the morning correct/complete? Is there any new data or analysis that could enrich or change the conclusions?*)
2. Como mejorar la preparación de los estudios del Banco, buscando otros socios y aprovechando mas el conocimiento salvadoreño o regional? (*How can the preparation of Bank studies be improved, while looking for new partners and taking advantage of Salvadorean and regional knowledge?*)
3. Como ampliar y mejorar la divulgación de los estudios del Banco para contribuir a un debate publico informado? (*How can we improve and expand the dissemination of Bank studies to contribute to an informed public debate?*)
4. Que tipo de estudios serian los mas útiles para El Salvador en el futuro? Cuales son las áreas claves donde se necesita mas investigación? por ejemplo, remesas, sector informal, otros? (*What kind of research studies would be more useful for El Salvador in the future? Which are the key areas where more research is needed? For example, remittances, informal sector, other?*)
5. Hay retroalimentación o sugerencias sobre como mejorar el impacto de la cartera actual y de las operaciones nuevas que están en discusión? (*Is there any feedback or suggestions on how to improve the impact of the current portfolio and of the new operations under discussion?*)
6. Cuales son las ventajas y posibles desafíos con la propuesta de concentrar un gran porcentaje del apoyo financiero futuro del Banco en apoyo presupuestario a través de una serie anual de prestamos de rápido desembolso, apoyando el programa de desarrollo del Gobierno? (*Which are the advantages and possible challenges of the proposal of concentrating a big portion of the upcoming financial support of the Bank on budgetary support, through an annual series of fast disbursement loans, supporting the development programs of the government?*)
7. Cuales son los riesgos principales que El Salvador enfrentaría, y como puede el Banco actuar para reducir o mitigar esos riesgos? (*Which are the main risks that El Salvador would face, and how can the Bank proceed to reduce those risks?*)
8. Que tipo de indicadores y sistemas de monitoreo serian útiles para evaluar el impacto del apoyo del Banco en El Salvador? (*What kind of indicators or monitoring systems would be useful to evaluate the impact of the support of the Bank in El Salvador?*)

Below is a summary of the views expressed by the different groups of stakeholders during the workshop and in other meetings.

Executive branch of government

The Government endorsed the Bank's proposed areas of support, allocation of lending (split between quick-disbursing budgetary support and specific investment projects) and non-lending activities, and the trigger conditions for the different lending scenarios. With respect to the timetable for lending, the government requested that the timing of the Development Policy Loans (DPLs) be aligned with El Salvador's budget cycle so as to allow the National Assembly to approve and ratify DPL2 (and subsequent DPLs) together with the national budget. The Government also confirmed that the proposed areas for Bank investment lending supported key priorities of their development plan, and explained that other development partners were providing support in areas such as agriculture and rural development. The Government requested the Bank's support in its efforts to obtain resources and technical assistance for other areas of strategic importance such as promoting private participation in infrastructure, strengthening the financial

sector, enhancing the development impact of remittances and increasing the productivity of the informal sector. They also requested technical assistance from the Bank to develop a debt management strategy, and expressed interest in tapping the full range of IBRD's financial instruments, possibly in the context of a Master Derivatives Agreement. The Government expressed strong interest in greater involvement by IFC in El Salvador. Finally, the Government requested that the Bank open a small office in El Salvador in order to assist the Government more closely in the implementation of the Bank's program and to strengthen coordination with other stakeholders and partners, especially given the larger proposed assistance package.

International Donor Community

The donors emphasized the need for greater coordination between Cooperation Agencies in El Salvador to promote efficiency in the use of scarce resources. In particular, they noted the need for greater coordination, and where possible, joint preparation of key studies, to avoid duplication and overloading the Salvadoran Government and other stakeholders with multiple reports on the same topics (e.g. growth and poverty reduction), which sometimes reached conflicting conclusions due to different methodologies or definitions. They further agreed that improving the statistical data bases in El Salvador, including carrying out a new Census and Households Living Standards Measurement Survey, was a top priority. Some donors expressed concern that the Bank was not planning new investment operations to support agriculture and rural development. The Country Director explained that the Government had indicated that these areas were already supported by other donors, such as IDB, CABI and IFAD. With respect to the DPLs, while some donors expressed skepticism about the benefits of delinking financial assistance from specific project activities others such as the European Community supported the concept of providing support to the Government's own development program and priorities through quick disbursing budget support.

Civil Society

A broad sample of civil society organizations participated in the CAS consultations (including leaders from organizations advocating on behalf of women, indigenous groups, and other minorities). They reiterated the important role they play in the development of the country. Participants welcomed the opportunity to discuss the diagnosis of the country's key challenges set out in the Bank's core analytical reports. Some participants expressed frustration that they had not received copies of the reports in advance (Spanish summaries of the reports were posted on the web about ten days before the meeting, but clearly some participants had not been able to access them). More generally, participants asked that in the future the Bank engage directly with civil society throughout the entire process of preparing analytical reports, including organizing regular public fora to discuss specific themes, and that opportunities for joint studies be exploited, for example by developing strategic alliances with local academic institutions, professional associations, think-tanks, etc.

Other specific ideas were proposed to enhance the dissemination of Bank reports, including through the web, via videoconferences, mass media, and preparation of less

technical packages for broader dissemination and for use by educational institutions. Many suggestions were made for deeper analysis, including the treatment of gender, issues affecting senior citizens, security/violence, natural disasters and external shocks, structure and costs of external debt, and the impact of migration and remittances. Many participants emphasized the poor quality of the data in El Salvador, including the absence of a recent population or agricultural census, and the need for household surveys.

With relation to the proposed Bank's current and proposed lending program representatives of civil society concluded that the proposed areas of activity were well aligned with the country's development priorities. Many participants expressed interest in getting more information about Bank-financed operations (including via the internet) and recommended that the Bank strengthen the involvement of civil society in the formulation, implementation and evaluation of projects to cost-effective use of resources and that benefits reach the largest number of poor people. Most participants were supportive of the proposal for the Bank to provide budget support to El Salvador through an annual series of DPLs as a way to reduce the costs of external financing and provide an "international seal of approval" for El Salvador's development strategy. While some expressed concern about the fact that DPLs "provide a blank check", most liked the idea that the Bank would be supporting the country's own development program and priorities, and appreciated the speed and flexibility offered by this instrument, while emphasizing the need for continued improvements in the efficiency and transparency of public expenditures and in combating corruption.

Many participants highlighted the need for a small Bank office in El Salvador to ensure more regular communication and continuous dialogue and feedback on both projects and analytical work, to improve coordination and reduce duplication with other members of the international community and to enhance partnerships with local stakeholders.

Members of Congress

Members of Congress representing all political parties agreed on the urgent need to reactivate economic growth and to increase tax revenues to finance basic social and infrastructure investments, while addressing the institutional weaknesses affecting government agencies. Many "diputados" and leaders of some political parties expressed concern about the recent increase and costs of external debt, and requested the Bank to provide technical assistance to the Government to develop an external debt management strategy. On the fiscal side, legislators from the opposition parties expressed their views about the need to adopt a package of fiscal reforms that goes beyond improved tax administration, introducing new taxes to promote equity and increase revenues to finance social and growth related expenditures. They also emphasized the need to build consensus in support of fiscal reform. Other issues that were given priority by "diputados" from the opposition include: dollarization, the situation of the agricultural sector and the potential adverse effects of CAFTA, migration and family remittances.

Members of Congress and the Bank mission discussed the approval and ratification process of new loans, and some delays experienced in past loans. Some key comments

made include: (i) congress would like to be involved in the substance of the loans and their contribution to existing policies; (ii) approval could be facilitated by improved information flows between the Executive and the Legislative during the process of project preparation; (iii) contacts between Bank teams responsible for project preparation and the relevant congressional commissions to inform about future projects early in the preparation cycle could contribute to reduced delays in Congressional approval.

During the conversation, Members of Congress mentioned other issues currently in the legislative and/or political agenda: (i) electoral reform, including campaign financing and the role of the media, (ii) competition and consumer protection, (iii) the organization of new political parties and the need to reduce the risk of polarization. Some “Diputados” expressed interest in the World Bank Institute’s activities in support of parliaments, especially those related to strengthening parliaments’ capacity to oversee the allocation and use of public funds as well as the Parliamentary Network on the World Bank.

Private Sector

The Bank mission met with representatives of different private sector groups, including those associated with FDI firms, large local investors, as well as SMEs. Messages were consistent even though emphases differ across groups. In general, private sector representatives express their satisfaction about the Bank’s increased presence in El Salvador, both in policy dialogue as well as with new lending and technical assistance. The country, according to the private sector, is well-positioned to deal with future challenges because of its stable macroeconomic and financial environment, increased FDI flows and family remittances, and important changes in the political area. New parties are emerging that could lead to less polarization and the strengthening of democracy. Major concerns of the private sector include: restoring growth, reducing poverty in sustainable ways, providing incentives that allow for more productive use of remittances, having clear and strong leadership from the Executive on economic policy. Private sector representatives mentioned other problems that require immediate and urgent actions: crime and violence, employment generation, health reform, urban transport, and the water sector.

CAFTA has all the support of the private sector even though there are concerns about the country’s readiness to compete and succeed under the new scenario and rules. The Government of President Saca is recognized by the private sector for its more participatory style but some suggestions for improving outcomes were made. Most importantly, the private sector considers that consensus building should focus on “how to grow”, “how to finance growth” and finally “how to improve the international image of El Salvador”.