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**INTERNATIONAL BANK FOR RECONSTRUCTION AND
DEVELOPMENT
PROGRAM DOCUMENT
FOR A
PUBLIC FINANCE AND SOCIAL SECTOR
DEVELOPMENT POLICY LOAN
IN THE AMOUNT OF US\$450 MILLION
TO
THE REPUBLIC OF EL SALVADOR**

December 10, 2008

**Central America Country Management Unit
Latin America and Caribbean Region
International Bank for Reconstruction and Development**

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REPUBLIC OF EL SALVADOR—FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

The US Dollar is the current currency in El Salvador

WEIGHTS AND MEASURES

Metric System

SELECTED ACRONYMS AND ABBREVIATION

AAA	Analytical and Advisory Services
ARENA	National Republic Alliance Party
BCR	Central Reserve Bank
CABEI	Central American Bank for Economic Integration
CAFTA	Central American Free Trade Agreement
CAS	Country Assistance Strategy
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment
CPS	Country Program Strategy
DGA	Customs
DGII	Tax administration office
DR-CAFTA	Dominican Republic-Central America Free Trade Agreement
EU	European Union
FDI	Foreign Direct Investment
FMLN	Farabundo Marti National Liberation Front Party
FY	Fiscal Year
GDP	Gross Domestic Product
IDB	Inter American Development Bank
IMF	International Monetary Fund
LAC	Latin America and the Caribbean
MDBs	Multilateral Development Banks
NFPS	Non-Financial Public Sector
PER	Public Expenditure Review
PFM	Public Financial Management
SAFI	Integrated Financial Management System

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Republic of El Salvador—Public Finance and Social Sector Development Policy Loan

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LOAN AND PROGRAM SUMMARY

Republic of El Salvador Public Finance and Social Sector Development Policy Loan

Borrower	Republic of El Salvador
Implementing Agency	MINISTRY OF FINANCE
Financing Data	<i>IBRD Loan Amount:</i> USD 450 million <i>Terms:</i> Commitment linked fixed spread loan, denominated in US dollar, with level repayments of principle payable in 30 years (including 5 of grace period). The Borrower wishes to maintain all risk management options embedded in the loan and has requested an Automatic Rate Fixing arrangement. The front en fee is .25 percent of the total amount, financed out of the loan proceeds.
Operation Type	Two tranche DPL: USD 200 million/USD 250 million
Main Policy Areas	The DPL is designed to assist the government in addressing fiscal issues and support continued institutional and social sector reforms. The DPL will contribute to the government's main policy objectives by supporting actions aimed at: (i) expanding fiscal space for priority spending and improve targeting of public spending; (ii) improving public expenditure management and fiscal transparency; and (iii) maintaining steady improvements in social protection and education.
Key Outcome Indicators	<p>I. Expanding fiscal space for priority spending and improving targeting of existing public spending by:</p> <ul style="list-style-type: none"> ○ Increasing tax collection from 14.1 to 15 percent of GDP ○ Reducing the amount of untargeted public subsidies by 40 percent with respect to July 2008 <p>II. Improving public expenditure management and fiscal transparency through:</p> <ul style="list-style-type: none"> ○ The establishment of a multi-year budget preparation and review process and associated results based framework ○ The establishment of a Fiscal Transparency Portal providing access to public finance and budget information. <p>III. Maintaining steady improvements in social protection and education by:</p> <ul style="list-style-type: none"> ○ Expanding the Conditional Cash Transfer Program, <i>Red Solidaria</i>, to cover 120,000 households. ○ Improving the performance (as measured by test scores) of the lowest ranking schools by 3 % by 2011. ○ Increasing secondary education enrollment by about 28,000 students, about half of that number in non-formal programs.

<p>Program Development Objective(s) and Contribution to CAS</p>	<p>The main objectives of the Public Finance and Social Sector DPL are to: (i) help El Salvador strengthen medium-term fiscal sustainability; (ii) support good governance and transparency in the use of public resources; and (iii) maintain steady improvements in social protection and education.</p> <p>As such, the proposed Public Finance and Social Sector DPL, though not specifically identified in the 2005 Country Assistance Strategy (CAS), is fully consistent with the objectives of Bank engagement laid out in the CAS. This engagement was structured around three pillars: (i) accelerating broad-based growth (including promoting macro stability and fiscal consolidation), (ii) improving equity and human capital, and (iii) enhancing security and reducing vulnerability.</p>
<p>Risks and Risk Mitigation</p>	<p>The operation is subject to four main risks:</p> <p>The principal risk to the proposed DPL derives from the highly polarized political climate in El Salvador which could affect program implementation following the Congressional and Presidential elections in January and March 2009. This risk is mitigated to a large extent by the consultation process followed in the preparation of this DPL which included both the main political opposition, a wide range of civil society groups and private sector organizations.</p> <p>On the macroeconomic front, the main risk derives from the global financial crisis and more specifically from a deep and prolonged global deceleration. This risk is mitigated by the design of the program and by recent steps taken by the authorities to enhance crisis preparedness.</p> <p>The operation is also susceptible to risks deriving from natural disasters as the country is highly vulnerable to multiple natural disasters risks that can pose a significant threat to economic growth and fiscal stability and can also delay the government’s program. This risk is mitigated by the government’s focus on improving fiscal responsibility while building a stronger safety net to better absorb such shocks.</p> <p>Finally, as suggested by the discussion of political risks above, the design of the DPL as a 2-tranche operation carries some inherent risk that second tranche benchmarks may not be met as currently agreed due to changing circumstances in El Salvador or exogenous shocks (including natural disasters). The team will maintain a close engagement with the government to minimize the risks to disbursement of the second tranche and ensure the satisfactory completion of the program.</p>
<p>Operation ID</p>	<p>PE-P114910-LEN-BB-SV</p>

EL SALVADOR
PUBLIC FINANCE AND SOCIAL SECTOR DEVELOPMENT POLICY LOAN

I. INTRODUCTION

1. *This program document describes a two-tranche Public Finance and Social Sector Development Policy Loan (DPL) for US\$450 million equivalent to the Republic of El Salvador.* The operation supports the government's program for addressing fiscal and related public finance management issues and for maintaining and/or enhancing the poverty and social gains achieved over the past decade. The Public Finance and Social Sector DPL, together with a parallel US\$500 million loan from the Inter-American Development Bank (IDB), is also integral to El Salvador's strategy for improving the country's debt profile by increasing the proportion of longer-term, lower-cost loans from multilateral development banks in the overall public debt. The next sections of this document lay out the political and socio-economic context within which this DPL was developed, followed by a detailed description of the loan and its associated benefits and risks.

II. COUNTRY CONTEXT

2. *Following a 12-year civil war which ended in 1991, El Salvador has made tremendous progress in consolidating peace and democracy through free and fair national and local-level elections, but politics are characterized by a high level of polarization – in turn affecting the reform agenda.* The national political stage is dominated by two main political parties -- the pro-business National Republic Alliance Party (ARENA) and the left-leaning Farabundo Marti National Liberation Front Party (FMLN), which derives from the former guerrilla movement. ARENA has consistently held the executive branch of government since peace was re-established in the country but recent elections (2003 and 2006) have divided power in the National Assembly between ARENA and the FMLN, giving the latter the possibility to block decisions which require a two-thirds majority for passage, such as significant institutional reforms and approval of foreign loans involving a sovereign guarantee. The next elections (Assembly and Municipality) are scheduled for January 2009. They will be followed by the March 2009 presidential election with the transfer of power following about two months later.

3. *The country's political transformation was accompanied by major structural economic reforms and stable macro policies.* Starting in the 1990s, successive administrations have undertaken significant stabilization and modernization efforts. Structural reforms have included trade liberalization, financial sector strengthening, re-privatization of the financial sector and other state enterprises, comprehensive tax reform, pension reform, and improvements in the competitiveness environment for private investment. The adoption of the US dollar as legal tender in 2001 resulted in lower inflation, reduced business uncertainty and lowered interest rates. With a strong commitment to an outward-oriented development strategy, El Salvador was the first country to ratify in its legislature the Dominican Republic-Central America Free Trade Agreement (DR-CAFTA) with the United States. As a result of these sustained reform efforts, El Salvador stands out as a leader in reforms in the Latin American Region, along with Chile and Peru.

4. ***The robust reform program led to high rates of growth (averaging about 6 percent per annum) during the 1990s, but growth slowed down in the first years of the current millennium, before picking up again in the last two or so years.*** Between 2000 and 2004, growth slowed to about 1.8 percent per year on average, reflecting, *inter alia*, the global slowdown following 9/11, a devastating earthquake in 2001, the impact of the “coffee crisis” on the value of agricultural output as well as a reduction in private investment, associated with the political uncertainty in the run-up to the 2004 presidential elections. Growth picked up again in the latter half of 2005, reaching 4.7 percent in 2007 –its highest level in about a decade. The rebound in growth was the result of stronger agricultural activity, increases in tourism and more dynamic financial and commercial sectors. In 2007, 48.2 percent of total exports were non-traditional compared with 39.7 percent just three years earlier, suggesting rapid diversification and reduced economic vulnerability. In addition, Foreign Direct Investment (FDI) reached 7.2 percent of GDP, related in part to the acquisition of three major banks by foreign corporations. More details on recent economic developments, including macroeconomic developments and policies are provided in Section III below.

5. ***The relatively strong economic performance since the reestablishment of peace was accompanied by substantial declines in poverty as well as improvements in access to basic and social services.*** Economic growth, coupled with reforms in some key sectors and increases in social sector spending in the second half of the 1990s, contributed to substantial reductions in poverty and improvements in basic socioeconomic indicators over the period. Indeed, the poverty headcount (for both overall and extreme poverty) fell by nearly one half since the end of the conflict. By 2007, about 34.6 percent of Salvadoran households were poor, including about 15.4 percent extremely poor households (versus 64.4 percent and 31.2 percent in 1991). In addition, access to basic services, including safe water and sanitation, has increased; and core health outcomes, such as life expectancy, infant and child mortality, and child nutrition have all improved. In several areas, including in basic education, infant mortality, and access to potable water, the gaps between the poor and the non-poor have also declined over the period. School enrollment levels have risen dramatically – from 75 percent and 25 percent in 1991 to 94 percent and 64 percent of the age-group for primary and secondary respectively in 2006. However, the education sector faces at least two major challenges that need to be overcome. One is the need to improve quality across all education levels – as evidenced by primary completion rates of only 68 percent (about 15 percent lower than the LAC average). The other challenge concerns the need to further increase access to secondary education where enrollments still lag LAC averages.

6. ***The current administration, in office since June 2004, has made good progress in moving forward its reform agenda, but emerging challenges associated with present global economic conditions compounded by the debt profile could threaten gains or hinder continued progress.*** The government’s program for the period 2004-2009 was built on three main pillars: (i) accelerating broad-based, equitable economic growth and increase employment; (ii) improving equity through building human capital and expanding access to socioeconomic infrastructure, assets and markets; and (iii) enhancing security and reducing vulnerability. As a result of good performance, and despite a difficult political situation, progress has been made in each of these priority areas, with development targets being exceeded in many instances. In the medium-term, however, the country faces pressures on the fiscal front particularly in 2011 as a

result of the unfavorable debt profile that year, in turn affecting the country's ability to make continued steady socio-economic progress in the medium-term. Moreover, as mentioned above, unfavorable external factors (including economic slowdown, financial market instability and high food and fuel prices, declining remittance growth) are already beginning to have a dampening effect on growth and there is concern that poverty and social gains could be threatened going forward. Indeed, there is some evidence of a slight increase in poverty between 2007 and 2008, likely a direct result of the high cost of staple food commodities.

7. *In this context, and given the proximity of national elections, the Saca administration, the presidential candidates and representatives of the two main political parties (ARENA and FMLN) have come together to design a focused program of external borrowing and internal reforms to try to ensure sustained progress on social service provision and the strengthening of public institutions.* Recent developments, medium-term prospects and the country's agreed strategy for meeting emerging challenges are described further in Section III below, as they form the background to the proposed Public Finance and Social Sector DPL.

III. RECENT DEVELOPMENTS AND EMERGING CHALLENGES

A. Recent Macroeconomic Developments and Medium-Term Outlook

8. *El Salvador's macroeconomic management has traditionally been sound and continued improvements have been apparent in the past 3 or so years, including substantial declines in the public sector deficit and the ratio of public debt to GDP over 2005-2007.* As Table 1 shows, progress in containing the country's non-financial public sector deficit has been especially significant, with the deficit falling to 1.9 percent of GDP in 2007, from a peak of 4.4 percent of GDP in 2001 and 2002. Notably, the primary balance showed a surplus -- of 0.5 percent of GDP in 2007 -- for the first time in more than a decade. The observed fiscal consolidation is largely due to strong revenue performance. -- tax revenues increased by 2 percentage points of GDP since 2003, reaching 14.1 percent of GDP in 2007. This trend has continued through the first half of 2008, with tax revenues growing at an annualized rate of 9 percent. In parallel with the increase in revenues and the reduction of the deficit, the ratio of public debt to GDP fell from a high of 43.5 percent of GDP in 2005 to 41.9 percent of GDP in 2007. In addition, inflation remained under control --at an average of 4.7 percent per annum-- throughout the period. As discussed above (paragraph 4), these favorable factors enabled a pick-up in growth rates, reaching 4.7 percent in 2007.

9. *On the external front, El Salvador's relatively high current account deficit expanded somewhat -- to 5.5 percent in 2007 -- but stability continued to be ensured by high and growing capital and remittance inflows.* Exports and imports increased considerably following the effectiveness of CAFTA-DR in 2006 and the already-large trade deficit (17.2 percent of GDP in 2005) reached 20 percent of GDP in 2007. Exports grew strongly by 19.4 percent, in part due to a recovery in maquila exports (15 percent growth), and imports rose by 18.9 percent, driven largely by the rising cost of fuel. Indeed, the value of fuel imports rose by 37 percent, despite significant reductions in fuel import volumes. Strong capital inflows, in part related to the sale of three major domestic banks to foreign buyers in 2007, helped finance the current account deficit,

as did the significant flow of remittances from Salvadorans living abroad. Remittances have increased from an average of 2.6 percent of GDP during the 1980s to 18 percent of GDP in 2007, displaying remarkable stability despite the downturn in economic activity in the U.S in 2001-2003. These inflows continue to be an important driving force behind consumer spending, although they are offset by falling terms of trade.

Table 1. El Salvador Key Economic Indicators 2004-2007
(percentage of GDP, unless otherwise indicated)

	2004	2005	2006	2007
Income and prices				
GDP growth (% change)	1.9	3.1	4.2	4.7
GDP per capita (% change)	0.0	1.3	2.5	3.0
Inflation (cpi end of period % change)	5.4	4.3	4.9	4.9
Investment and savings				
Gross domestic investment	16.2	15.7	16.1	16.3
Gross domestic savings	12.2	12.4	12.6	10.8
Consolidated public sector accounts				
Total revenues and grants	16.5	16.5	17.2	17.1
Total tax revenues	12.5	13.3	13.4	14.1
Total expenditure	18.9	19.5	20.1	19.0
Current expenditure	16.6	16.8	17.0	16.3
Capital expenditure	2.3	2.7	3.1	2.8
Primary balance	-0.8	-0.8	-0.5	0.5
Overall balance	-3.0	-3.0	-2.9	-1.9
Public debt				
Total debt	42.1	43.5	42.0	41.9
O/w External	30.2	29.2	30.6	26.4
External public debt servicing (% of exports)	20.7	15.9	14.7	14.2
Balance of payments				
Current account balance	-4.0	-3.3	-3.6	-5.5
Trade balance	-16.8	-17.2	-19.0	-20.0
Exports (including maquila)	21.1	20.2	20.2	19.8
Imports (including maquila)	38.0	37.4	39.1	39.8
Foreign direct investment	2.3	3.0	1.0	7.5
Remittances	16.1	17.7	17.6	18.1
Memorandum item:				
Nominal GDP (billions of US dollars)	15.8	17.1	18.7	20.4

Source: Ministry of Finance, Central Bank and IMF and World Bank staff estimates.

B. Macroeconomic Outlook and Debt Sustainability

10. *Until recently the 2008–12 growth outlook for El Salvador was broadly positive, but growth projections have now been revised downwards as a result of the continued global financial turmoil and the likely deeper economic slowdown in the US.* Initial estimates had foreseen a gradual slowdown to about 4 percent GDP growth in 2008-2009, with a recovery to about 4.5 percent by 2011. However, in light of the continued financial turbulence in the US and the emerging evidence that indicates that it is translating to the real US economy (the main commercial partner of El Salvador), growth projections have been lowered to reflect a decline in export performance, tightening domestic credit markets and a slow down in remittances growth (remittances in August 2008 were 2.1 percent lower than in August 2007). Growth is now

projected at 3 percent in 2008 and at 2.6 percent in 2009, with a recovery to 4 percent expected only by 2012 (Table 2). A debt sustainability analysis is provided in Annex 2. The analysis shows that the projected average annual primary surplus of 1.3 percent of GDP during 2009-2013 would allow for a gradual decline in the debt-to-GDP ratio to 32.7 percent of GDP by about 2013.

11. *Exogenous factors – mainly the rise in global food and fuel prices – are also exerting substantial inflationary pressures on the Salvadoran economy.* After having peaked at 5.4 percent in 2004, inflation moderated considerably in 2005-2007, averaging 4.7 percent for the period. In recent months, however, inflation has begun to rise -- with the consumer price index reaching a level of 7.4 percent in October 2008 and the cost of the basket of goods and services consumed by the poor reaching its highest point in August at 11.9 percent (compared with 3.4 in July 2007). Most of this increase is explained by the evolution of food and oil prices, with food inflation alone reaching 17.5 percent. As a result, inflation is likely to be around 7.5 percent for 2008, but it is expected to moderate in the coming years, returning to levels of around 3 percent by 2011 assuming a decline in food prices after 2008 and a moderation in oil prices in the medium-term.

Table 2 Medium Term Macroeconomic Scenario: Base Case
(percentage of GDP, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013
Income and prices						
GDP growth (% change)	3.0	2.6	3.0	3.5	4.0	4.5
Inflation (cpi end of period % change)	7.5	6.0	4.0	3.0	3.0	3.0
Investment and savings						
Gross domestic investment	16.6	14.6	15.3	15.8	16.8	17.6
Gross domestic savings	10.1	9.2	10.0	11.0	12.5	13.5
Consolidated Public Sector						
Total revenues and grants	17.5	17.7	18.6	18.6	18.7	18.7
Total tax revenue	14.1	14.1	14.5	14.9	15.1	15.1
Total expenditures	19.8	19.9	20.0	19.6	19.3	19.2
Current expenditure	17.0	17.1	16.7	16.5	16.2	16.1
Capital expenditures	2.8	2.8	3.3	3.1	3.1	3.0
Primary balance	0.0	0.2	1.1	1.4	1.9	1.9
Overall balance	-2.3	-2.2	-1.3	-1.1	-0.5	-0.5
Public Debt						
Total debt	40.5	40.4	38.8	37.1	34.9	32.7
O/w external	24.1	22.0	20.7	19.2	17.9	16.7
External public debt servicing (% of exports)	9.5	9.6	9.8	18	10.4	9.7
Balance of Payments						
Current account balance	-6.1	-5.4	-5.3	-4.8	-4.3	-4.0
Trade balance	-20.3	-18.5	-17.7	-16.9	-16.4	-16.0
Exports of goods (f.o.b)	20.5	19.9	19.8	19.9	19.7	19.4
Imports of goods (f.o.b.)	40.8	38.4	37.5	36.8	36.1	35.4
Foreign direct investment	2.9	2.9	2.9	2.9	2.9	2.9
Remittances	17.2	16.5	16.0	15.6	15.4	15.1
Memorandum Item						
Nominal GDP (billions of US dollars)	22.3	23.9	25.7	27.5	29.6	32.0

Source: Ministry of Finance, Central Bank and IMF and World Bank staff estimates.

12. ***The banking sector in El Salvador remains well-capitalized and is not showing signs of stress, though there has been some tightening of credit.*** During the past 24 months the largest Salvadoran Banks were acquired by foreign banks and now about 95 percent of bank assets are in foreign hands. Currently, capital adequacy ratios are at levels comparable to -- if not higher than -- those observed before the current financial turmoil and well above the regulatory minimum of 12. The system is also relatively liquid with net liquid assets to short-term liabilities of 34.4 percent. However, the combined effect of the expected growth slowdown and lower remittances growth could lead to an increase in non-performing loans and bears close monitoring. Moreover, as mentioned in paragraph 10 above, the global financial turmoil has led to some tightening in domestic credit markets. The month of July witnessed a decline of 1.2 percent in the real rate of growth of credit to the private sector with respect to July 2007. This decline in domestic credit reflects both lower demand for credit due to uncertain economic conditions and reduced credit availability due to the tighter funding conditions and higher borrowing costs faced by commercial banks.

13. ***Risks to the medium term outlook include the possibility of domestic liquidity problems resulting from a worse than expected external environment in 2009.*** El Salvador is an officially dollarized economy and as such the balance of payments is self-stabilizing, so that declines in dollar inflows would result in higher interest rates and declines in purchasing power. Moreover, standard vulnerability indicators appear adequate so far (e.g. the stock of gross official reserves is projected at 165 percent of total short term debt for end 2008). However, a deteriorating external environment could make it harder for the government to meet its short-term financing needs as both public and private sectors compete from a reduced pool of resources. The loan proposed in this document, as well as similar support from IDB, form part of the government's strategy to help insure against a fiscal crisis in the short-term.

14. ***The authorities are responding to the current global environment by redoubling efforts to maintain macroeconomic stability and to contain potential risks from exogenous and domestic shocks.*** El Salvador has reiterated its commitment to maintaining the strong fiscal performance of 2007 while expanding some social programs to mitigate the impact of high commodity prices. El Salvador is also addressing the pressures emerging from the need to roll the outstanding stock of short-term debt instruments (LETES) by negotiating access to long-term multilateral financing from the World Bank, the Inter American Development Bank (IDB), and the Central American Bank for Economic Integration (CABEI). With respect to the financial sector and in line with IMF recommendations, the country introduced in July 2008 a temporary 3 percent liquidity asset requirement on banks to support the liquidity of the financial sector ahead of the elections. The monetary authorities are also negotiating external lines of credit for the Central Bank and working on the preparation of action plans to face potential stress situations in the financial sector. More generally, El Salvador is also exploring with the IMF the possibility of a precautionary Stand-By Arrangement.

15. ***In the medium-term, El Salvador's main challenge is to protect critical poverty reducing and growth enhancing expenditures from adverse fiscal pressures resulting from several domestic factors.*** These include:

- **Pension reform costs** -- 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 with an individual capitalization system for younger Salvadorans, implying transitional costs as social security contributions moved to private accounts while the state remains obligated to pay out pensions to older generations. To face mounting transition costs of the pension reform, the Saca administration pushed through parametric reforms to eliminate early retirement, thereby generating savings of 1 percent of GDP between 2005 and 2009. Despite this reform, net outlays required to finance the transition are expected to average about 1.6 percent of GDP per year over the period 2009-2012.
- **Cost of Energy Subsidies** – rising oil prices have caused the cost of energy subsidies to nearly double since end-2007 to an estimated 2.5 percent of GDP in 2008. About half of the subsidy is directed to electricity consumption (by both businesses and residential consumers) via below-market tariffs, a third to liquid gas and the remainder to public transport. Overall, the electricity and liquid gas subsidies are poorly targeted and a comprehensive reform is needed to improve both efficiency and targeting of the public transport subsidy.
- **Debt profile** – added to the impact of the growth slowdown and the pension reform, El Salvador’s medium-term fiscal situation will be further complicated by the need to amortize a bond series known as Eurobond 2011. As a result, debt service would more than double in 2011 – reaching almost \$1.4 billion or 4.9 percent of GDP for that year versus average annual debt service costs of under \$650 million during 2008-2010. This, in turn, would tighten the Government’s capacity to maintain core public spending for the social sectors and infrastructure.

16. *On the whole, even though the economy is entering a downturn and there are significant risks to the short-term outlook associated with the difficult external environment, economic fundamentals are solid and provide an adequate basis for Bank development policy lending.*

IV. THE GOVERNMENT’S PROGRAM

17. *Recognizing the potential implications of the projected medium term fiscal scenario for growth and poverty reduction, the Government had led a process, in conjunction with the political opposition and civil society, to develop a focused strategy and related program of actions to address the fiscal situation and maintain socio-economic progress.* Given that its implementation will straddle two administrations (elections are scheduled for March 2009) and involve legislative action in some instances, the strategy and program have been carefully negotiated and agreed with a range of political actors (including the main opposition party – FMLN) as well as key civil society institutions and private sector organizations. The program, which is supported by the Public Finance and Social Sector DPL, involves both immediate actions to protect households from the impact of commodity price shocks and reduced remittance income as well as medium term initiatives aimed at creating more fiscal space, increasing

efficiency and transparency in the use of public resources and maintaining the pace of social sector reform efforts.

18. *El Salvador's short-run strategy to protect vulnerable households from the impact of high commodity prices is focused on expanding or developing an effective, well-targeted safety net.* The safety net, paid for mainly through cuts in non-priority public spending and revenue increases through improved tax administration, involves six main elements as follows:

- expanding *Red Solidaria -- a conditional cash-transfer program* – targeted to households with children living in the country's poorest municipalities
- increasing allowances for *Alianza para la Familia -- a tax credit program* – which supports the consumption of lower middle class working families and increases access to health and education services (by expanding social security benefits for maternal services and eliminating charges for secondary education in public schools).
- *reducing import tariffs* on wheat and agricultural inputs to help contain food costs and maintain domestic food production
- increasing the *public transport subsidy* to avoid increases in tariffs
- supporting agricultural production through *distributing improved seeds and fertilizers* to the country's small farmers
- granting a selective *increase in wages to the lowest-paid public servants* at an estimated annual cost of 0.2 percent of GDP

Despite the additional spending associated with these programs, the authorities' 2009 budget has a deficit target of 2.2 percent of GDP. This is feasible, owing in part to the recent reform in the electricity subsidy for firms and increases in tax collection due largely to improvements in administration as well as a newly-adopted tax on international telephone calls.

19. *With respect to the medium term, a major focus of the agreed strategy is to expand fiscal space via a three-pronged approach – i.e., continued improvements in tax collection via buttressed administration and policy changes, elimination of costly untargeted subsidies in the energy sector and adjustments to the public debt composition.* The effort to raise tax revenues aims to increase the tax-to-GDP ratio by about 1 percent (to 15 percent of GDP) by 2013. *Inter alia*, this would be achieved by (i) strengthening the internal auditing capacity of the tax administration unit; (ii) vigorously identifying and prosecuting tax evaders through the criminal investigation unit; and (iii) deploying a system of cross-checks between tax information and customs valuation procedures. In addition, new legislation would be developed to introduce an ad valorem tax on alcoholic beverages either in place or in addition to of the current excise tax, and introduce additional tax measures, such as a new specific tax to vehicles, to partially offset the reduction in tariffs and duties associated with CAFTA-DR. The government will also continue to implement tax administration measures to fight tax evasion by providing the customs of Acajutla, San Bartolo and Comalapa Airport with x-ray machines and weight controllers to strengthen their control capabilities.

20. *In parallel with the efforts to raise revenues, steps are being taken to reform the costly system of untargeted energy subsidies*, beginning with reductions in electricity subsidies for the non-residential sector. Total elimination of the non-residential electricity subsidy would itself yield savings equivalent to about 0.4 percent of GDP per year, with better targeting of the

residential subsidy contemplated for 2010-2011, as part of the effort to yield further savings. The proposed reforms are expected to yield reductions in spending of about 0.6 percent of GDP per year and would help pay for an expansion of the well-targeted *Red Solidaria* and other efficient social programs as well as support continued public investment, particularly for economic infrastructure. The public electricity company, CEL, would also be able to expand its investment program, thereby helping to address the growing energy needs of businesses.

21. ***The third key element of the Government's program to expand fiscal space involves improving access to, and the profile of, budget financing.*** To date, El Salvador has relied heavily on short-term debt instruments –LETES—to cover for cash-flow requirements. However, the overall financial situation provoked unexpected increase in interest rates for such short-term financing with negative implications for the term structure of public debt and macro vulnerability. Moreover, as discussed in paragraph 15, there is an urgent need to plan for the rollover of the Eurobond 2011, which could mean a ballooning of debt service payments in that year. In this context, Government has reached agreement with the political opposition to restore El Salvador's access to long-term finance (approval of which requires a 2/3 majority in Congress) from Multilateral Development Banks (paragraph 14). Thus far, agreement has been reached on a credit line with CABEI, and on a new development policy loan with the IDB. This DPL, complemented by lending of \$500 million from IDB, thus forms a key part of the strategy for expanding fiscal space and improving the country's debt profile to reduce vulnerability.

Box 1. Public Debt Management and Domestic Debt Market Development

Recognizing the challenges associated with its unfavourable debt service profile, El Salvador has been making efforts to improve its public debt management capacity, in part with technical assistance from the Bank's Banking and Debt Management Department. The objective of the assistance was to develop a sound framework for the design of short, medium and long-term debt management and domestic market development strategies in El Salvador. The assistance also aimed at building institutional capacity within the Ministry of Finance. The project was developed in three stages: (i) gathering and organization of debt related background information; (ii) development of a cash-flow simulation model and scenario analysis; and (iii) design of a strategic framework for debt management.

The Bank's support helped the country to get a better understanding of the evolution of the public debt over the last 10 years, identified bottlenecks and opportunities for the development of the domestic public debt market, and provided the Ministry of Finance with an analytical tool for cost and risk analysis of the tradeoffs of different debt strategies. It has also provided support for the setting up of a better structured Debt Management Office and particularly strengthened capacities of mid-level officials. Remaining challenges to further develop government's capacities in this area include: (i) consolidation of the analytical capacity of the middle office; (ii) formalization of a debt management strategy, including a strategy for domestic debt market development; (iii) production of a periodic risk and compliance report on public debt management; and (iv) establishment of a high level public debt committee.

22. ***Complementary to the efforts to expand fiscal space, the medium-term program agreed to by the Government and the political opposition includes accelerated efforts to further strengthen public financial management (PFM) and increase the transparency of government spending, building on the solid accomplishments achieved to date.*** These objectives (increasing

fiscal revenues while also improving public sector transparency and efficiency) are mutually reinforcing, as perceived public sector inefficiencies and lack of information on how public resources are used is often an important factor in public opposition to an expansion in the tax base. A recent assessment of the current situation in El Salvador, undertaken jointly by the Bank and IDB, determined that the country's PFM system already possesses a number of strengths, such as a sound legal and institutional framework for managing and monitoring revenue and expenditure budgets, cash flows and balances, and debt. In addition, the country's integrated financial management system (SAFI), conceived not only as a technological platform but as a set of rules, processes, and skills, has contributed to fiscal discipline by providing timely information on the implementation of the budget and enforcing expenditure, increased operational efficiency by streamlining and standardizing processes, buttressed internal and external controls through safeguards and audit trails, and enabled greater transparency by allowing the timely issuance of budget execution and other fiscal reports.

23. ***Going forward, the agreed program focuses on further strengthening of public resource management with particular emphasis on expanding the integrated financial management system (SAFI), adhering to established international norms where appropriate, increasing the transparency of public spending (including procurement) and improving budget processes.*** In this latter regard, a key goal is to move towards a medium-term and results-based budget framework, with particular emphasis on the "bottom-up" preparation of costed strategic plans and ensuing investment programs, consistent with the "top-down" fiscal framework. A second goal relates to the further expansion of SAFI to additional central government agencies, decentralized public institutions and public enterprises. This expansion allows effective coverage and control of about 95 percent of central government spending, leaving only transfers to municipalities to be executed outside the system. On the control side, the government has recently taken a major step by adopting international standards (COSO framework) and has put in place internal regulations to further stimulate effective operation of internal control units in all public institutions. This step is critical to completing the PFM cycle by using internal controls to provide timely feedback to public sector operations.

24. ***Beyond improving expenditure management and controls and in recognition of the importance of adequate and proactive disclosure, the plan also encompasses a number of actions to facilitate public dissemination of critical aspects of public financial management.*** A state-of-the-art public procurement dissemination tool (COMPRASAL) has already been successfully implemented and is now recoding and publicizing all central government procurement activities including bidding processes and contracts. COMPRASAL has allowed enhanced transparency and credibility of public sector performance with respect to an area commonly perceived as most vulnerable to mismanagement and corruption. It is expected that, with the support of the Bank, the government will develop and implement in the coming months, the necessary applications and procedures to further automate bidding processes and convert COMPRASAL into a fully transactional tool. With this same aim, the government has also completed and launched a parallel application to disclose all public sector payments, which, in turn, limits discretionary behaviors on the part of public servants managing such payments, and enhances confidence among users and vendors when interacting with public sector institutions.

25. ***Further development of the transparency and freedom of information agenda is deemed critical in view of existing negative perceptions and mistrust among other stakeholders***, particularly members of the legislature, the media and specialized non-government groups. The transparency and freedom of public information agenda has gained support among these groups and the government is now prepared for a more comprehensive and structured response. Legislation to guarantee access to public information is currently being discussed as part of the political campaign for 2009 elections and both major parties have expressed their support for such an initiative. It is expected that, within the next two years, the government will have established its normative framework and developed institutional capacity to make all public sector information available and accessible to the public. In terms of transparency, the external audit reports on the content of state entities' financial statements, and the legislative examination of financial and audit information, are also subject to improvement. The introduction of the international COSO framework for internal controls, and of government audit standards for the internal audit function, will therefore be complemented with pertinent information systems to assess their actual performance. Finally, the Ministry of Finance expects to launch a new Fiscal Transparency Portal to broaden the dissemination of interim reporting on public finance and investment programs and enable customized queries from citizens. In the interim, steps are already underway to enhance the accessibility of information in both the annual budget law and the annual state financial management report by incorporating certain elements from international practice, under a plan to reach convergence in the medium term. A final step in the agreed transparency agenda is a plan to introduce requirements and procedures that would make public all available aggregate data on municipal budgets and their execution.

26. ***The third leg of the Government's program focuses on expanding opportunities for vulnerable groups with an emphasis on (i) expanding coverage of targeted social protection programs and (ii) expanding access to, and quality of education***. With respect to the first of these priorities, the main focus is on expansion of the *Red Solidaria* program (paragraph 18) to cover the poorest municipalities in the country. The Bank was a key partner in the design and implementation of this program, providing support for institutional design and sustainability, sharing international best practice on similar conditional cash transfer efforts in other countries and supporting the development of an ongoing impact evaluation effort to allow for recalibration of the program as needed. There is currently wide consensus that the program is fulfilling its main objectives of supporting the consumption of poor rural households and increasing the access of their children to basic health, nutrition and education services. Indeed, an independent evaluation found that the program is among the best in the region, along with Brazil and Chile. Moreover, the expansion of *Red Solidaria* in rural areas has been accompanied by significant increases in the availability of public health and education services, thereby facilitating access to and, utilization of, these services. In this context, the current Government strategy is to aggressively expand the program, according due attention to maintaining its key design features, with the aim of covering 100 municipalities by 2011-2012. There is also now increasing concern about addressing urban poverty in a systematic way and the Government is developing a plan to support poor urban households, in part with assistance from the Bank and other external partners.

27. ***Besides strengthening social protection, the agreed program focuses on improving the coverage and quality of education at primary and secondary levels***. As noted previously (paragraph 5), El Salvador has made good progress in expanding access to primary education

with 94 percent of children now enrolled in school. Quality, however, remains an issue, particularly in schools in poor areas, where students have more limited educational support at home. In order to improve primary education outcomes, the Government has undertaken a systematic learning assessment at the primary level and, based on its findings, has developed a comprehensive strategy to address learning outcomes at the lowest performing schools (8 percent of all public primary schools) including: (a) a monitoring system to assess teachers' performance; (b) a peer-collaboration program to replicate successful experiences among public schools; (c) enhanced distribution of education material; and (d) a training program for teachers. The Cabinet has recently approved the new strategy and its effectiveness will be systematically monitored via standardized tests. At the secondary level, there is concern about both access and quality – especially since only 50 percent of children now attend secondary school and testing reveals that performance is especially poor at the lower secondary level. To help promote higher enrollment in secondary education, Government has approved a plan to eliminate fees and developed an innovative program – termed EDUCAME – which aims to provide secondary education to young people who have already abandoned the formal education system and are now participating in the labor force. The program, which offers flexible modalities for completing the secondary curriculum – including, *inter alia*, web-based distance learning, accelerated secondary programs and “flex-time” courses – is already being implemented in about 160 municipalities and will be extended to 200 municipalities by 2011. To address continuing quality issues in secondary education the focus is on fully equipping secondary school classrooms in accordance with standards set by the Ministry of Education. The number of these fully equipped classrooms (“*secciones*”) is set to increase over the program period with the addition of 200 more “*secciones*” to the 2007 base of 2866.

28. ***Although not addressed in this operation, the Government has also expanded primary health care coverage*** to more than 500,000 additional households through the World Bank Hospital Reconstruction and Health Services Expansion Project. This expansion has utilized the same targeting criteria set by the *Red Solidaria* design, and has thus been successful in covering the country's poorest municipalities.

29. ***The above medium-term program constitutes a reasonable and pragmatic approach to strengthening the fiscal issues facing El Salvador and to maintaining the hard-won social and institutional progress achieved since the early 1990s.*** The priorities included in the plan are focused and achievable and are consistent with the findings of several Bank analytical reports including the Public Expenditure Review (FY05), the Country Fiduciary Assessment (FY06), the Poverty Assessment (FY04) and the initial findings of a Poverty Update to be finalized in FY09. Indeed, despite limited lending (for reasons discussed further in Section V below), the Bank has maintained an active dialogue with the El Salvadoran authorities in each of the above areas for several years and has played a role in bringing to bear global experience in the design of key program features. The Public Finance and Social Sector DPL, which will support the implementation of the above national program, is described further in Section V below.

V. THE PROPOSED OPERATION

30. *The proposed Public Finance and Social Sector DPL, though not specifically identified in the 2005 Country Assistance Strategy (CAS), is fully consistent with the objectives of Bank engagement laid out in the CAS.* As described in the February 2008 CAS Progress Report, only about 20 percent of the CAS base case envelope of \$485 million was committed because five operations -- including DPL lending -- approved by the Bank, failed to achieve the 2/3 majority needed for approval by El Salvador's divided National Assembly (paragraph 2). In this context, and given continued political tensions between the two main parties, it was determined that work should not go forward on the remaining lending operations identified in the CAS (due to the low likelihood of Congressional approval) although the country's performance on development outcomes and commitment to the agenda supported by the DPL series (Annex 4) warranted a move to the high case of the CAS.

31. *Despite the difficulties encountered in obtaining approval of foreign borrowing in the Assembly, the Bank remained fully engaged in each of the areas identified in the CAS and contributed via AAA services and grants to strategy/program development and outcomes in each of the CAS's three pillars, including the focused strategy now being supported through this DPL.* As noted in the CAS and the CAS progress report the three main pillars of the government's strategy supported by the Bank include: (i) accelerating broad-based growth (including promoting macro stability and fiscal consolidation), (ii) improving equity and human capital, and (iii) enhancing security and reducing vulnerability. Government mobilized alternative sources of funding that did not require approval by a qualified majority in Congress (local bonds, external grants) to implement the programs originally supported by the cancelled Bank loans, making strong progress in each of the pillars. Some key sources included the EU, Luxembourg and the US Millennium Challenge Account.

32. *Preparation of this DPL operation was initiated following a specific request from Government to help support its program (paragraphs 17-29) -- developed in consultation with the political opposition and civil society -- to address fiscal issues and strengthen/maintain the gains achieved in strengthening governance and the social sectors.* On November 6, 2008, Congress granted the government the authority to negotiate the operation with a two-thirds majority, reflecting the agreement reached between the two main political parties, ARENA and the FMLN. Agreement on borrowing from the Bank for this program is partly associated with the seriousness of the fiscal issues to which the DPL would respond and partly due to the difficulty of predicting the outcome of the next Presidential election to be held in March 2009. So far, both ARENA and the FMLN feel confident that they can win the electoral battle, thus creating an incentive for each party to reach an agreement on borrowing that would ease the fiscal situation for the next administration. The uncertainty over the outcome of the presidential election therefore creates a window of opportunity within which both parties are disposed to support the DPL. Indeed, both parties recognize that it may be difficult to extend the present agreement on new sovereign borrowing beyond the presidential elections, once a winner emerges.

33. *The Salvadoran authorities have requested that the DPL be designed as a two-tranche operation so as to minimize the number of times that congressional approval would need to be*

sought. Loan effectiveness in El Salvador requires two Congressional approvals. The first of these approvals – already achieved for the proposed DPL -- grants the government the authority to negotiate. The second approval would be sought following approval by the Bank's Board of the proposed DPL and would be the only additional approval needed for the loan to move ahead. The alternative of moving forward with a series of two single-tranche DPLs – while allowing more flexibility with respect to benchmarks -- would involve two additional approaches to Congress following the presidential election, thereby making approval of the second DPL much more uncertain. In this context, and following discussions with all interested parties, the Bank agreed to the two-tranche approach: the first tranche of \$200 million would be disbursed immediately after Board approval; the second tranche for \$250 million is designed as a floating tranche, but is expected to disburse in 2011 in view of the time needed to accomplish the benchmarks defined for that tranche. It should be noted here that with approval of this DPL the CAS envelope for El Salvador will have been entirely committed, implying no further lending to the country until a new CAS has been developed.

34. ***The main objectives of the Public Finance and Social Sector DPL are to: (i) help El Salvador strengthen medium-term fiscal sustainability; (ii) support good governance and transparency in the use of public resources; and (iii) maintain steady improvements in social protection and education.*** More specifically, the supported program is structured around seven priority areas: (i) expanding fiscal space through the implementation of tax administration measures to fight tax evasion and the implementation of new tax measures; (ii) improving the targeting of existing public subsidies through the elimination of the non-residential electricity subsidy; (iii) modernizing public finance management through the expansion of the integrated financial system and improvements in budget management; (iv) enhancing public sector transparency through the promotion of access to information; (v) expanding the coverage of the social protection program *Red Solidaria*; (vi) improving the quality of primary education through the implementation of a strategy to address the performance in the lowest ranking schools; and (vii) expanding access opportunities to secondary education through the implementation of the EDUCAME program.

35. ***The conditions included to trigger disbursement of each tranche of the DPL are fully aligned with, and drawn from, the Government strategy and program*** described in Section IV above, and as already mentioned (paragraph 29), address the core challenges identified in Bank analytical reports including the PER, the Country Fiduciary Assessment and the Poverty Assessment and recent Update (in progress). The DPL matrix (Annex 1) describes each of the prior actions for the first tranche, conditions for the second tranche as well as the expected outcomes of the DPL-supported program. Table 3 below shows the links between the conditions included in the DPL program (first and second tranche) and the recommendations included in recent Bank analytical work.

36. ***The matrix has been discussed with the government and with the presidential candidates of both main parties.*** Since Salvadoran legislation prevents the President from running for office in two consecutive terms, the Administration negotiating this DPL will not be the Administration responsible for the conditions that lead to disbursement of the second tranche. Thus, in order to both gain support from Congress and minimize the risks of the program derailing in the months ahead, the Bank has consulted the matrix with all interested parties and

found a large degree of consensus. It is worth mentioning that the actions agreed to by the political parties and key civil society and private sector actors are critical to the future development of El Salvador – including enhancing the macro stability of the economy, further strengthening public sector efficiency and maintaining poverty reduction and human development efforts.

37. ***The DPL complements, and is complemented by, a similar policy-based operation prepared by the IDB.*** The authority granted by the Salvadoran Congress to the government to negotiate the DPL was part of a package that also included authority to negotiate a US\$500 million operation with the IDB. The IDB’s operation was considered by the IDB Board on November 25th and is expected to be approved by the Salvadoran Congress soon thereafter. The IDB operation supports a set of policies and measures that are aimed at improving targeting mechanisms for social programs and improving the information system of the country’s main safety net program, *Red Solidaria*. In addition to IDB, the strategy for this operation and analysis of the country’s fiscal situation was undertaken in close collaboration with the IMF, which recently completed its Article IV consultations in El Salvador. Indeed, one of the main policy recommendations of the recent Article IV consultations is that Government seeks the necessary political consensus to gain access to long-term financing from the multi-lateral development banks (MDBs).

Table 3. Links between the DPL and Prior Analytical Work

	Analytical Reports – Findings and Recommendations	Links to DPL Actions (see Matrix of Policy Actions and Expected Outcomes)
Public Expenditure Review (FY05)	<i>Annual increases in tax revenue are needed to return to a non-financial public debt level that allows for the required fiscal flexibility to respond to shocks, contingencies, cyclical economic management and to address the country’s needs in the social sectors.</i>	<p>I.1 The government has implemented tax administration measures to fight tax evasion and raise tax revenues, through: (a) the creation of a functional criminal investigation unit within the tax administration office (DGII); (b) the establishment of a cooperation agreement between DGII and Customs (DGA) to cross-check tax collection information, and (c) the creation of a functional internal affairs unit, organized within DGII.</p> <p>I.1 (Second tranche) The government has made progress towards raising tax revenues and continuing to fight evasion as evidenced by: (a) the implementation of a new tax on vehicles; (b) the introduction of an ad-valorem tax on alcoholic beverages; and (c) the installation and operation of x-ray machines and weight controllers in the customs posts of Acajutla, San Bartolo and Comalapa Airport.</p>
	<i>Overall repetition and drop out rates remain high, and programs directed at addressing these problems should continue to be supported.</i>	<p>III.2 The Ministry of Education has (a) developed and implemented an education quality monitoring system using a standardized learning assessment for primary education students, and (b) developed a strategy to address deficiencies of non performing schools, including: (i) a monitoring system for teachers; (ii) a peer collaboration program to</p>

		<p>replicate successful experiences among public schools; (iii) enhanced distribution of education material; and (iv) a training program for teachers.</p> <p>III.2 (Second tranche) The Ministry of Education has: (a) implemented a strategy to address non-performing schools deficiencies in all schools with average grades of 5 point or less in the PAESITA Test; and (b) undertaken a special mid-term test for targeted non-performing schools to assess progress and improvements.</p> <p>III.3 The government has: (a) eliminated tuition and graduation fees for secondary education in regular public schools; and (b) created 20,000 education grants (“cupos”) under the EDUCAME program.</p> <p>III.3 (Second tranche) The government has increased the number “cupos” under the EDUCAME program by 10,000 and has increased by 200 the number of “secciones” (operating classrooms of up to 40 students) for secondary education in public schools.</p>
	<p><i>The education budget should be increased in order to reach the necessary coverage rates in the primary, basic and secondary cycles.</i></p>	
<p>Country Financing Accountability Assessment Report (FY06)</p>	<p><i>The Government should expand the SAFI software to those decentralized entities and extra-budgetary funds that are currently operating outside the system.</i></p>	<p>II.1 Public financial management has been strengthened by the expansion of the integrated financial management system (SAFI) to at least 24 entities of the central government, 59 decentralized public institutions and 2 public enterprises.</p>
<p>Update on the Country Financing Accountability Assessment Report (FY07)</p>	<p><i>In order to continue advancing in the areas of strategic allocation of resources, consideration could be given to the development of a medium-term budget framework, with particular emphasis on the “bottom-up” preparation of costed strategic plans and ensuing investment programs, consistent with the “top-down” fiscal framework</i></p> <p><i>The Ministry of Finance could broaden the dissemination of interim reporting on public finances and investment programs, and in the medium term it could make better use of information technology to enable customized queries from citizens.</i></p>	<p>II.1 (Second tranche) Budget management has been improved through: (a) the introduction of a medium-term budget framework; and (b) the piloting of a result-based budgeting methodology, including the use of performance indicators linked to budget allocations, in at least 2 central government agencies.</p> <p>II.2 (Second tranche) The government has: (a) issued regulations to enable and promote public access to fiscal information; (b) redesigned and launched an effective Fiscal Transparency Portal.</p>
<p>Country Procurement Assessment Report (FY06)</p>	<p><i>The Government should develop and maintain an e-procurement system as part of the e-Government strategy starting with an e-disclosure module and gradually moving to a comprehensive electronic bidding system.</i></p>	<p>II.2 Increasing the transparency and efficiency of the public procurement system by implementing the public procurement dissemination module MODIV of COMPRASAL in at least 172 Government agencies and municipalities.</p>

VI. OPERATION IMPLEMENTATION

A. Poverty and Social Impacts

38. *Although none of the specific actions supported by this DPL is likely to have negative social consequences, some of the actions could have significant distributional effects.* For example, even though the action plan to remove the electricity subsidy to firms supported by this DPL has been broadly consulted by the government with the private sector, in principle the elimination of the subsidy could have a negative impact on the productivity of country's largest firms (as the removal of the subsidy does not affect small firms) and this in turn affect the firms' labor decisions. Similarly, even though tax policy changes supported by this DPL are basically aimed at offsetting (at least partly) other tax interventions (e.g. decline of taxes associated to CAFTA) or target goods such as alcoholic beverages, they could have distributional implications. On the social front, actions aimed at expanding the coverage of *Red Solidaria* to additional municipalities would increase transfers to the country's lowest income households, and over the longer-run, expansions of secondary education access to vulnerable groups would also likely have distributional effects, as closing education gaps will likely contribute to closing income gaps in the future. Thus although this operation is likely to promote poverty reduction, its implementation will require monitoring of the distributional aspects.

39. *The Bank will support government efforts to monitor the distributional impact of actions supported by this DPL with two AAA activities.* The Bank has started preparation of two pieces of analytical work that would be especially useful in measuring and analyzing the distributional impacts associated to measures supported by this DPL: (i) a *Public Expenditure Review* which would analyze the impact of changes in subsidies and taxation, with particular attention to incidence concerns; and (ii) a set of policy notes and ongoing technical assistance under the *Human Development for Poverty Reduction* program which would monitor the impact of the expansion of *Red Solidaria* as well as developments with respect to education and health services. Perhaps more importantly, both studies (together with ongoing information systems) will be integral to the monitoring of the impact and outcomes of the Government program supported by the DPL by complementing operational monitoring of the program (see below) with more rigorous analysis of available data.

B. Consultations

40. *As highlighted in the description of the socio-political context for this operation, the preparation of this DPL has been based on extensive consultations with political and civil society actors.* Taking into account the political context, the background for Bank involvement, and the risks associated with the design of this operation, the Government and the Bank have invested in a substantial consultation process with political actors, including the policy teams of the ARENA and FMLN presidential candidates as well as the representatives of the various parties in represented in Congress. In addition, discussions have been held with a wide range of civil society organizations including think tanks, private sector representatives, and more activist groups. Finally, the proposed Bank and IDB loans, and their implications for El Salvador's macro-economic stability and continued socio-economic growth have been widely discussed in

the local press and are, therefore, relatively well understood – and supported -- by the public at large.

C. Monitoring and Evaluation

41. *The Ministry of Finance is responsible for the implementation of the DPL series as well as for coordinating actions among the concerned line agencies*, including, in particular, the Central Bank, the Technical Secretariat of the Presidency (for aspects concerning *Red Solidaria*), and the Ministry of Education (for aspects concerning the education sector). Together with the Ministry of Finance, these institutions will collect the necessary data to assess implementation progress and report it to the Bank, taking into account both process advances and service statistics, survey and other data that might be used to assess the achievement of the program's end outcomes.

42. *The Government, through the concerned agencies, will prepare progress reports on the implementation of agreed action plans linked to the second-tranche release*. These reports will be particularly important for second-tranche condition III.2 that involves implementation of a strategy to address non-performing schools deficiencies. In this case, progress reports will include specific milestones to help monitoring adequate and timely implementation of agreed actions as well as detailed follow up of the strategy components.

43. *The Ministry of Finance and the Bank have also agreed to conduct joint reviews of program progress on a semi-annual basis*. These reviews will aim at identifying areas of strengths and weaknesses, and possible assistance needed to maintain momentum toward the planned medium-term outcomes. They will also assess possible downside risks and agree on measures to address these to the extent feasible. A mid-term review will be undertaken in the context of preparation of the next CPS, when the Government and the Bank will jointly evaluate progress towards achieving the outcomes laid out for the DPL program and, if necessary, agree on course corrections.

D. Environmental Aspects

44. *The Specific actions supported by this DPL are not likely to have significant effects on the environment, forests or other natural resources*. Actions aimed at improving public expenditure management and fiscal transparency, or at expanding social protection and education are not likely to have a significant effect on the environment either directly or indirectly. This is also likely to be the case for the actions aimed at improving the targeting of existing subsidies and more specifically the action aimed at eliminating the electricity subsidy for firms. In fact, the elimination of this subsidy may contribute to the adoption of energy efficient technology with likely positive effects on the environment. Moreover, taking into account that the subsidy being eliminated focuses on large firms, it is unlikely that this action will contribute to a change in the source of energy used by firms (i.e. from publicly provide electricity to the used of private electricity generation capacity).

45. *Moreover, since the late 1990s El Salvador has made significant progress in establishing a solid legal and institutional infrastructure for environmental protection*. As

discussed in the FY06 Country Environmental Analysis, El Salvador has a sound –albeit still incomplete- framework for developing effective environmental policies. This framework comprises a general environmental law and complementary laws that address specific environmental concerns, particularly in forestry, protected areas, and mining, including associated regulations and technical standards. The Country Environmental Analysis provided recommendations to improve the country’s environmental management capacities which are being considered, and implemented as feasible, by the Government.

E. Fiduciary Aspects

46. ***El Salvador’s fiduciary environment for DPLs is adequate.*** As part of the Government’s overall long-term focus on public sector modernization, significant improvements in the performance of budget and procurement management institutions have been made over the past one and a half decade. To document the current state of public financial management in the country and propose priorities for action, the World Bank and the IDB carried out in 2004 a Country Financial Accountability Assessment (CFAA) and a Country Procurement Assessment (CPAR). While overall findings indicated that the environment is solid, the Government has been moving ahead to further strengthen its public fiduciary control framework. In connection to this, and as part of the DPL program, the Bank is engaged in public financial management dialogue with the Government to follow up on recommendations made through the CFAA and CPAR.

F. Loan Administration

47. ***Borrower and Credit Amount.*** The borrower is the Republic of El Salvador and this operation is a two-tranche loan of US\$ 450 million equivalent. The first tranche of US\$ 200 million would be made available upon loan effectiveness with the second, floating, tranche to be disbursed in about 2011 when the Government has met the conditions for its release laid out in the policy matrix. The Bank will disburse the loan proceeds into an account of the Central Reserve Bank (BCR) denominated in US dollars, which is legal tender in the country. The BCR will immediately credit the disbursed amounts to the Ministry of Finance’s Treasury Single Account (“Fondo General”), thus becoming available to finance budgeted expenditures. Within a week of the disbursement, the Ministry will provide the Bank with a written confirmation of the receipt of funds. If, after deposit in the BCR, the proceeds of the Loan are not used as determined above (including use for ineligible purposes as defined in the Loan Agreement), the Bank will require the Government to promptly refund the disallowed amount.

48. ***The latest IMF review of central bank safeguards and of the country’s public financial management systems indicates that the Government has built a strong foundation for a well-functioning budget management system and that controls in the banking environment into which the loan proceeds will flow are adequate.*** In this context, additional fiduciary arrangements (such as the use of a dedicated deposit account) are not deemed necessary in this case. Moreover, the DPL program itself supports Government’s efforts to continue to strengthen public financial management and increase public access to fiscal information.

G. Risks

49. *The program supported by the Public Finance and Social Sector DPL is subject to four main risks as follows: (i) political risks, given the political context in which the DPL has been developed; (ii) macroeconomic risks, in the event of a deeper-than-anticipated global deceleration; (iii) natural disaster risks, as the country is highly vulnerable to natural disasters; and (iv) risks associated with the two-tranche design of the operation.* These risks, and some factors which tend to mitigate them, are described below.

- *The principal risk to the proposed DPL derives from the highly polarized political climate in El Salvador which could affect program implementation following the Congressional and Presidential elections in January and March 2009.* The current uncertainty with respect to the outcome of these elections has given both dominant political parties an incentive to cooperate on key national issues and work out a focused, common program to address the looming fiscal crunch, and, hence, a window of opportunity to move forward with this DPL. However, once the elections are conducted, there is a significant risk that one of the parties could cease to cooperate, thus complicating the implementation of actions included in the second tranche of the operation. In particular, failure by the party of the new President to gain at least a simple majority in Congress could jeopardize the approval of new legislation (e.g., in the area of tax policy) that would allow for the second tranche release. This risk is mitigated to a large extent by the consultation process followed in the preparation of this DPL. While the current Administration has been the main counterpart in the preparation process, the program matrix and the structure of the operation have been discussed with the teams of the two main presidential candidates, so that the proposed operation reflects only areas in which there is significant consensus.
- *On the macroeconomic front, the main risks derive from the global financial crisis and more specifically from a deep and prolonged global deceleration.* As discussed previously, the current global situation is expected to negatively impact El Salvador as credit to the private sector becomes tighter, remittances and foreign direct investment growth decelerate, and the US demand for Salvadoran products declines. These factors have already been taken into account in the design of the program and in the projections developed for the medium-term. However, to the extent that the global slowdown lasts longer or is deeper than anticipated, and hence affects El Salvador more than projected, the government may find some difficulties implementing its program. Similarly, the outcomes of the program can be derailed. These risks are somewhat mitigated by the design of the program and by recent steps taken by the authorities to enhance crisis preparedness. A critical component of the effort to mitigate macroeconomic risks is related to the need for fiscal restraint, so the expansion in the fiscal envelope and the reduction of untargeted subsidies which are supported by this DPL will be steps in the right direction. Similarly, the expansion of *Red Solidaria* will mitigate some of the risks by improving income prospects for the poorest. The authorities have also taken efforts to minimize stress in the banking sector, including through the temporary increase of liquid assets requirements on banks.

- ***The operation is also susceptible to risks deriving from natural disasters, to which El Salvador is subject by virtue of its geographic location.*** As with other Central American countries, El Salvador is highly vulnerable to multiple natural disasters risks –floods, hurricanes and earthquakes. A major climatic or seismic disaster would, of course, pose a significant threat to economic growth and fiscal stability and can also delay the government’s program. Government focus on building a strong safety net is intended in part to help the population’s most vulnerable segments better withstand this recurring shocks. Nonetheless, occurrence of a major natural disaster during the implementation of the DPL program would likely imply a reassessment of the country’s development priorities (at least temporarily). Should such an event occur, the ongoing engagement through the DPL would enable the Bank to support the Government in revising its strategy as needed to harmonize between short-term imperatives and medium- to longer-term socio-economic development goals.
- Finally, as suggested by the discussion of political risks above, ***the design of the DPL as a 2-tranche operation carries some inherent risk that second tranche benchmarks may not be met as currently agreed*** due to changing circumstances in El Salvador or exogenous shocks (including natural disasters). Nonetheless, the two tranche operation remains the instrument most suited to El Salvador at this time, given its national requirements for approval of public foreign borrowing. The team will maintain a close engagement with the government to minimize the risks to disbursement of the second tranche and ensure the satisfactory completion of the program.

Annex 1. Government of El Salvador Policy Actions to be Supported by the DPL			
Government Priorities/	Prior actions for first tranche (by December 2008)	Expected outcomes	Conditions for second tranche release
I. Expand fiscal space for priority spending and improve targeting of existing public spending			Expected DPL medium-term outcomes (end-FY2011)
I.1 Expand Fiscal Space	The government has implemented tax administration measures to fight tax evasion and raise tax revenues, through: (a) the creation of a functional criminal investigation unit within the tax administration office (DGII); (b) the establishment of a cooperation agreement between DGII and Customs (DGA) to cross-check tax collection information, and (c) the creation of a functional internal affairs unit, organized within DGII.	The number of tax payers has increased by 6.1 percent (IVA) and 14 percent (income tax). Tax collection has increased to 14.1 percent of GDP from 12 percent of GDP in 2003.	The government has made progress towards raising tax revenues and continuing to fight evasion as evidenced by: (a) the implementation of a new tax on vehicles; (b) the introduction of an ad-valorem tax on alcoholic beverages; and (c) the installation and operation of x-ray machines and weight controllers in the customs posts of Acajutla, San Bartolo and Comalapa Airport.
I.2 Improve the targeting of existing public spending	An action plan to gradually eliminate the electricity subsidy for firms has been approved and its implementation has been initiated by cutting the electricity subsidy for firms by 40 percent.	The amount of untargeted public subsidies has been reduced by \$28 million with respect to July 2008 (\$325 million).	The amount of untargeted public subsidies has been reduced by 40 percent with respect to July 2008.
II Improve Public Expenditure Management and Fiscal Transparency			
II.1 Modernizing public finance management	Public financial management has been strengthened by the expansion of the integrated financial management system (SAFI) to at least 24 entities of the central government, 59 decentralized public institutions and 2 public enterprises.	95% of the total central government expenditure is being recorded, accounted and controlled according to international PFM standards.	Budget management has been improved through: (a) the introduction of a medium-term budget framework; and (b) the piloting of a result-based budgeting methodology, including the use of performance indicators linked to budget allocations, in at least 2 central government agencies.
			The Multi-Year Budget preparation and review process and the results based framework have increased the government's ability to plan strategically the use of public resources.

Annex 1. Government of El Salvador Policy Actions to be Supported by the DPL				
Government Priorities/	Prior actions for first tranche (by December 2008)	Expected outcomes	Conditions for second tranche release	Expected DPL medium-term outcomes (end-FY2011)
II.2 Enhance Public Sector Transparency	The government has increased the transparency and efficiency of the public procurement system by implementing the public procurement dissemination module MODIV of COMPRASAL in at least 172 Government agencies and municipalities.	44% of actual public sector procurement is recorded and published in COMPRASAL.	The government has: (a) issued regulations to enable and promote public access to fiscal information; (b) redesigned and launched an effective Fiscal Transparency Portal.	Population and specialized interested groups are accessing and analyzing the information in the Fiscal Transparency Portal, about public finances and budgetary execution. 80% of actual public sector procurement is recorded and published in COMPRASAL.
III. Expanding Opportunities for Vulnerable Groups				
III.1 Expanding the coverage of social protection programs	The social protection program <i>Red Solidaria</i> is operative in 77 of the poorest municipalities targeted.	85,000 households are being covered by the program and receive \$12.6 million in transfers.	The government has: (a) further expanded <i>Red Solidaria</i> to fully cover the 100 poorest municipalities.	120,000 households are being covered by the program and receive \$27 million in transfers.
III.2 Improve quality of primary education	The Ministry of Education has (a) developed and implemented an education quality monitoring system using a standardized learning assessment for primary education students, and (b) developed a strategy to address deficiencies of non performing schools, including: (i) a monitoring system for teachers; (ii) a peer collaboration program to replicate successful experiences among public schools; (iii) enhanced distribution of education material; and (iv) a training program for teachers.		The Ministry of Education has: (a) implemented a strategy to address non-performing schools deficiencies in all schools with average grades of 5 point or less in the PAESITA Test; and (b) undertaken a special mid-term test for targeted non-performing schools to assess progress and improvements.	The number of non-performing schools (as measured by the scores of the tests) has been reduced from 8% in 2007 to 5% percent points by 2011.

Annex 1. Government of El Salvador Policy Actions to be Supported by the DPL				
Government Priorities/	Prior actions for first tranche (by December 2008)	Expected outcomes	Conditions for second tranche release	Expected DPL medium-term outcomes (end-FY2011)
III.3 Expand access opportunities to secondary school	The government has: (a) eliminated tuition and graduation fees for secondary education in regular public schools; and (b) created 20,000 education grants (“ <i>cupos</i> ”) under the EDUCAME program.		The government has increased the number of “ <i>cupos</i> ” under the EDUCAME program by 10,000 and has increased by 200 the number of “ <i>secciones</i> ” (operating classrooms of up to 40 students) for secondary education in public schools.	Secondary education enrollment to be increased by about 38,000 students.

Annex 2. Debt Sustainability Analysis

50. The outlook on El Salvador's medium-term macroeconomic prospects has deteriorated as a result of the global financial turbulence experienced over the second half of 2008. The debt sustainability analysis in this Programs Document is based on the macroeconomic framework developed for the IMF 2008 Art. IV Staff Report, which already incorporates the expected negative impact that the global financial turbulence experienced during the second half of 2008 will have on the Salvadoran economy.

51. Before the crisis, growth was expected to moderate to about 4 percent per year over 2008-2009 and recover to 4.5 percent over 2010-2013. The new medium term macroeconomic framework projects growth in the range of 2.6 to 3.5 percent from 2009 to 2011. After 2011 growth would be expected to reach 4.5 percent. This growth rate would be underpinned by structural reforms adopted during the last decade, further integration of the Salvadoran economy into the global economy, continued output diversification, and an increase in public spending in infrastructure. Inflation is expected to fall to 3 percent as the inflationary impact of commodity prices abates and domestic demand adjusts to restore the external equilibrium.

Table A2.1. Composition of long-term public debt (NFPS) as of December 2007

	US\$ (million)	% of total debt
Total	7,081	100
By residence		
Internal	863	12
External	6,218	88
By creditor		
Multilateral	2,334	33
Bilateral	644	9
Private	4,103	58
Currency composition		
US\$	5,948	84
Euro	212	3
Yen	283	4
Other	708	9
Average terms		
Debt with interest rates lower than 3%	1,841	26
Debt with interest rates between 3% and 6%	3,186	45
Debt with interest rates between 6% and 8%	1,133	16
Debt with interest rates between 8% and 9%	921	13
Maturity		
Between 1 and 5 years	1,062	15
Between 6 and 10 years	708	10
Between 11 and 20 years	2,549	36
More than 20 years	2,762	39

Source: Central Bank of El Salvador

52. Table A2.1 present the stock of long-term debt of the Non Financial Public Sector as of December 2007. It indicates that El Salvador's long-term NFPS debt is mainly (i) external debt (88 percent of total debt); (ii) with private creditors (58 percent of total debt); (iii) US\$ denominated (84 percent of total debt); (iv) with interest rates between 3 and 6 percent (45 percent of total debt); and (v) with maturities above 10 years (75 percent of total debt).

53. The debt sustainability analysis (Table A2.2) indicates that an average primary surplus of 1.3 percent of GDP would be needed between 2009 and 2013 to obtain a public debt-to-GDP ratio that would gradually fall to 32.7 percent of GDP. This primary surplus would be consistent with an overall public sector deficit of 1.1 to 2.2 percent of GDP between 2009-2011 and of .5 percent of GDP over 2012-2013.

Table A2.2. Debt Sustainability Analysis

	Projection					
	2008	2009	2010	2011	2012	2013
Total External Debt (%of GDP) 1/	46.6	46	44.9	43.9	42.4	40.6
Public Debt (% of GDP)	40.5	40.4	38.8	37.1	34.9	32.7
Key Assumptions						
Real GDP growth (%)	3.0	2.6	3.0	3.5	4.0	4.5
Inflation (% , e-o-p)	9.0	6.0	4.0	3.0	3.0	3.0
Growth of real primary spending (% of GDP)	8.5	2.8	3.2	1.7	2.2	3.9
Primary balance (% of GDP)	0.0	0.2	1.1	1.4	1.9	1.9
Nominal interest rate on public debt (%)	6.4	6.5	6.5	6.7	7.0	7.3
Growth of exports (US dollar, %)	12.5	4.1	7.5	8.4	7.7	7.2
Growth of imports (US dollar, %)	11.7	2.0	5.1	5.6	6.0	6.4
Non-interest current account balance (% of GDP)	-3.5	-2.7	-2.0	-1.4	-0.9	-0.8

1/ Includes both Public and Private Debt.

54. In the absence of a crisis scenario, the medium term external position of El Salvador remains sustainable. Higher public and private savings would lead to a gradual decline in the external current account deficit to about 4 percent of GDP by 2013. This level, which appears to be broadly in line with the structural current account determinates, would allow total external debt to fall to 41 percent by 2013.

55. The main risks to the medium-term outlook are associated with the global financial turmoil as well as with the ability of the new administration to maintain macro stability and push

structural reforms in a very volatile environment. Table A2.3 presents projected debt dynamics under more pessimistic alternative scenarios:

- Under less optimistic growth scenarios (3 percent over 2008-2013) than the one in the baseline (3.5 percent over 2008-2013) –scenarios A1 and B1- the total external debt to GDP ratio would be about 1 percentage point of GDP higher than under the baseline scenario, whereas the public debt would be 2.4 percentage points of GDP higher than under the baseline scenario.
- Under tighter financial market conditions resulting in higher interest rates both for the external and the public debt of around .5 percentage points over 2008-2013 –scenarios A2 and B2-, projected debt indicators for 2013 would be 1.2-1.3 higher than under the baseline scenarios for both external and public debt.
- Under a more difficult external environment –scenario A3- resulting in a higher current account deficit (.5 percentage points of GDP), the total external debt to GDP ratio would reach about 43 percent in 2013.
- Under a looser fiscal policy -scenario B3- with an average primary balance surplus of .8 percent of GDP over 2008-2013 rather than the assumed 1.3 percent of GDP under the baseline scenario, the public debt to GDP ratio would be in 2013 about 2 percentage points of GDP higher than under the baseline scenario.
- Scenarios projecting the impact of contemporaneous shocks (albeit more moderate than those in A1-A3 and B1-B3) -scenarios A4 and B4- would result in indicators for 2013 of 42.9 percent of GDP and 35 percent of GDP for the external and public debt respectively.
- Scenarios based on key variables fixed at historical levels differ dramatically depending on whether historical averages are based on the last 5 or 10 years. For example, using average data for the last 5 years –scenarios A5 and B5- would result in an external debt to GDP ratio 2013 projection that is about 2 percentage points lower than under the baseline and in a public debt to GDP ratio that is basically unchanged with respect to the 2008 level. Instead, using 10 years average –scenarios A6 and B6- would result in an external debt to GDP ratio 2013 projection that is almost 5 percentage points lower than under the baseline and in a public debt to GDP ratio that is 4.4 percentage points higher than the level in 2008. This last figure is motivated by the significant differences between the baseline scenario and the historical data based on the past 5 and more dramatically 10 years, when the country had to face not only the reconstruction associated to an earthquake, but perhaps more importantly from the debt sustainability analysis perspective the fiscal pressures associated to the pension reform.
- The final scenario in Table A2.2 simulates the impact of a shock to the exchange rate in 2009 (which would require de-dollarizing the economy) equivalent to a 30 percent nominal depreciation. It indicates that such a shock would increase the stock of external debt to 58 percent of GDP in 2013, and the stock of public debt to about 61 percent of GDP in 2013.

Table A2.3. Debt Sustainability Analysis: Alternative Scenarios

	2008	2009	2010	2011	2012	2013
External Debt Sustainability Analysis						
A1. Real GDP growth is baseline minus 1/2 s.d.	46.6	46.2	45.4	44.5	43.2	41.6
A2. Interest rate on external debt is baseline plus 1/2 s.d.	46.6	46.2	45.4	44.6	43.3	41.8
A3. Non-interest CAB is baseline minus 1/2 s.d.	46.6	46.4	45.9	45.4	44.3	43.0
A4. Combination of A1-A3 using 1/4 s.d. shocks	46.6	46.4	45.9	45.3	44.2	42.9
A5. Key variables are at their 5 year historical averages	46.6	44.9	43.0	41.4	40.0	38.7
A6. Key variables are at their 10 year historical averages	46.6	44.3	41.8	39.6	37.7	35.8
A7. One time 30 percent real depreciation in 2009	46.6	68.6	65.9	63.7	60.8	57.7
Public Debt Sustainability Analysis						
B1. Real GDP growth is baseline minus 1/2 s.d.	40.6	40.8	39.5	38.3	36.6	35.1
B2. Interest rate on public debt is baseline plus 1 s.d.	40.6	40.7	39.3	37.9	35.9	34.0
B3. Primary balance is baseline minus 1/2 s.d.	40.6	40.9	39.8	38.6	36.9	35.2
B4. Combination of B1-B3 using 1/4 s.d. shocks	40.6	40.9	39.8	38.5	36.8	35.0
B5. Key variables are at their 5 year historical averages	40.6	41.0	40.9	40.8	40.8	40.8
B6. Key variables are at their 10 year historical averages	40.6	41.9	42.6	43.3	44.1	45.0
B7. One time 30 percent real depreciation in 2009	40.6	69.8	67.9	66.1	63.8	61.4

Annex 3. El Salvador Broad Based Growth DPL series

The FY04 – 08 Country Assistance Strategy for El Salvador proposed to channel most of the financial assistance through a series of three DPL operations for a total amount of US\$300 million (US\$100 million each). The DPL series was designed to support the Government's medium term development strategy to accelerate broad based and equitable economic growth and to contribute to the Government's objectives of: (i) reigniting growth, particularly through increased private investment and trade; (ii) reinforcing macroeconomic stability and strengthening fiscal sustainability; and (iii) increasing the efficiency and transparency of public sector management.

Although only the first operation was actually approved and implemented, the Government actually completed implementation of the entire program. Specific actions supported by the DPL series included:

DPLI (prior actions completed and loan disbursed)

DR-CAFTA treaty signed and dissemination programs launched.

Implementation of Competition Law.

Creation of the *Centro de Trámites Empresariales*.

Implementation of the fiscal reform package approved in 2004.

Elimination of early retirement provisions to improve sustainability of the public pensions system.

Launch of an e-Government strategy.

Issuance of operational directives for procurement unit UNAC.

Ministry of Finance adopted public sector internal control norms consistent with international standards.

DPLII (prior actions completed but loan cancelled)

Ratification of DR-CAFTA and launch of programs to ensure broad participation in its benefits.

Securitization Law approved by the National Assembly.

Consumer Protection Law approved by the National Assembly.

Increase of excise taxes approved by the Assembly and later successfully implemented.

Issue budget formulation policy for 2006 consistent with a NFPS deficit target of 2.3% of GDP.

Issuance of new rules on loan classification, provisioning and credit risk administration consistent with international best practices.

Progress in implementing the e-Government strategy. Launch and implementation of the payments portal and module for publication and dissemination of public bids (MODDIV).

Issuance of implementing regulations for Procurement Law.

Ministry of Finance finalized its project for internal control system regulation.

DPLIII (prior actions completed but loan not prepared)

Creation of Superintendence of Competition.

Expansion of the *Centro de Trámites Empresariales* outside of San Salvador.

Creation of the Consumer Protection Agency.

Banks began implementation of new rules on loan classification, provisioning and credit risk administration.

NFPS deficit at 3% of GDP for 2005.

201 public institutions including all central Government ministries use the Dissemination Module (MODDIV).

Expansion and implementation of SAFI in all Central Government institutions and ISSS.



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San Salvador, November 10, 2008

Mr. Robert Zoellick
President
World Bank
Washington, D.C.

Dear Mr. Zoellick:

The Government of President Elias Antonio Saca is requesting from the World Bank a "Public Finance and Social Sector Development Policy Loan" (DPL), for \$450 million. These resources along with \$500 million in loans in the process of approval from the Inter-American Development Bank will be used to improve the country's debt profile by pre-funding the Eurobond that matures in 2011 as well as to expand the financing of priority social programs.

El Salvador has solid macroeconomic fundamentals. These are the results of years of continuous and well oriented reforms. However, challenges remain and the external shocks such as volatile oil markets, high food prices, the slowdown of the US Economy, and more recently the international financial crisis, are increasing the financing needs to implement the necessary actions to protect poor families, preserve the progress achieved in the social area, and sustain economic growth momentum. In this context, these resources will help meet the new challenges.

The Government Plan 2004-2009, "Safe Country," three lines of strategic actions: Economic and Employment Growth, Equity Promotion, and Security Improvement, have been crucial in meeting successfully ambitious goals set in the Government Plan. First of all, the Administration has worked to establish the conditions to accelerate economic growth and decrease poverty levels. Second, it has taken a deep fiscal reform to strengthen public finances increasing the tax intake, reducing the deficit, lowering debt levels, and raising the budget allocated to investment and social programs. And third, the Government had continued its efforts to modernize the public sector, in order to achieve greater efficiency and accountability in the use of public funds.

The set of policies that will guide this \$450 million program are aimed at continuing expanding the fiscal space to tackle poverty. In this instance, the program will focus on measures to further increase tax collections, streamlining expenditures while at the same time further increasing the allocations to priority social programs with greater levels of transparency and responsibility.

This letter is intended to inform the Board of Directors of the World Bank on the most recent economic and social developments, the progress in the consolidation of public finances, the modernization of the public sector as well as to point out the great importance of this operation for medium term fiscal sustainability and the set of policies that will be part of the Program.

1. Financing need justification

The present world economic environment characterized by high and volatile oil prices, the food crises, the slowdown of the world economy, and the recent financial crisis turmoil, are imposing enormous challenges to all economies and especially to emerging economies such as El Salvador. The Administration has taken several actions to lessen the negative impacts from these different international shocks both to macroeconomic level as well as to protect families from falling into poverty as a result of higher cost of living, especially the most vulnerable.

This \$450 million operation along with the \$500 million from the Inter-American Development Bank to be executed starting with the approval of the loan and ending in May 2011 is part of the efforts that President Saca's Administration is undertaking to expand fiscal space for the present and next Administration. Its importance lies down on the need to continue and to strengthen the path toward higher economic growth and the creation of new and better opportunities for Salvadoran families by fortifying priority socially inclusive programs, including the strengthening of the social safety net oriented to protect the poor, especially the most vulnerable population.

The combined \$950 million program will allow the Government to increase by \$300 million the allocation for social spending in the next three years, providing \$100 million for health programs, \$60 million for agriculture, \$50 million for education, \$40 million for rural roads, \$30 million for water projects, \$20 for risk mitigation projects, and to pre-fund the \$650 million in Eurobonds that matures in 2011, improving further El Salvador's debt profile. It is important to mention that if there is a window of opportunity to redeem the eurobonds outstanding prior to maturity, the Republic will take such opportunities to repurchase them.

2. Recent Economic and Social Developments

As a result of several years of sound policies, well-oriented structural reforms, El Salvador has solid macroeconomic fundamentals and is one of a few countries in Latin America with investment grade. Beginning in the 1990's, and as a result of structural reforms and a disciplined fiscal policy combined with the increase in spending for education and health, the creation of the social investment fund, El Salvador grew at a strong annual rate, with macroeconomic stability characterized by low inflation and low interest rates, reducing successfully high poverty levels.

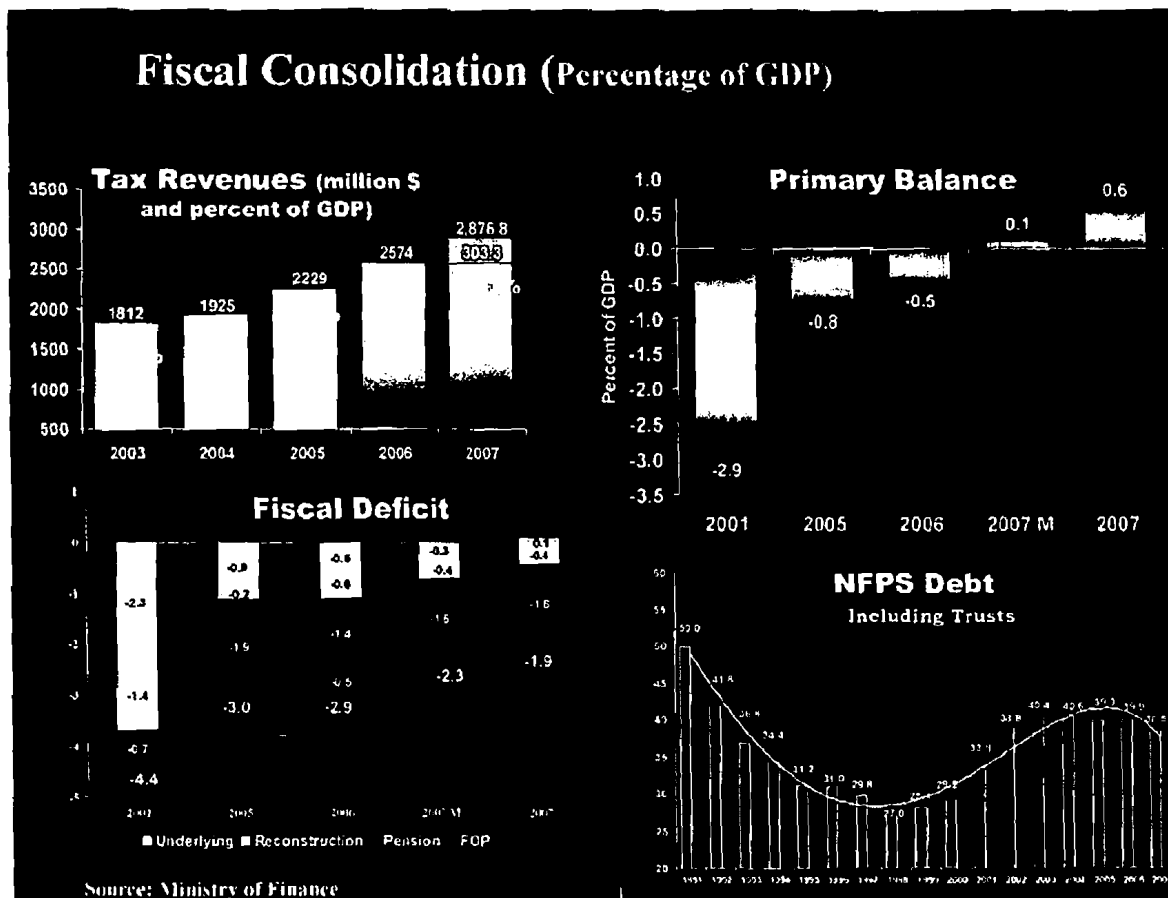
El Salvador's economy has gone through three phases of growth since the 1990's: a) The 1991-1999 period characterized by a high and fast growing economy with a 4.9% annual average; b) an intermedium phase during the 2000-2004 period, when the economy slowed down to an annual growth rate that averaged 2.2%; and c) a recovery phase toward a high grow rate beginning in 2005 reaching a 3.9% average for the 2005 – 2007 period. Over these three periods, total poverty was reduced from 61% in 1991 to 34.6% in 2007.

Since taking office in June 2004, the present Administration has continually worked for a robust broad-based grow strategy to accelerate economic growth, strengthen public finances, modernize public sector management and increase social spending in order to reach the Millennium Development Goals.

As a result of carefully and efficient designed sectorial polices to boost agriculture sector output, expand tourist activities into a high level industry, foster private sector productivity and new

investments by cutting red tape, increase higher public investment, and the positive impact of the Central American-Dominican Republic Free Trade Agreement signed with the United States of America, economic growth picked up in the last two years, reaching 4.7% in 2007, the highest grow rate in the last twelve years.

A deep fiscal reform was introduced at the end of 2004 and early 2005. As a result of such reforms, the tax to GDP ratio increase by more than two percentage points from 12.0% of GDP in 2003 to 14.1% of GDP in 2007, the primary balance switched from a deficit of 2.9% of GDP in 2001 to 0.6% of GDP surplus in 2007 -for the first time in more than a decade, the overall deficit was cut from 4.4% of GDP in 2002 to 1.9% of GDP in 2007, and the total debt for the non financial public sector was cut from 40.6% of GDP in 2004 to 38.5% of GDP in 2007.



At the same time, capital and social expenditures were the priority in the budget. Public investment rose from \$335 million in 2004 to an estimated \$575 million for 2008 and the education and health budget were increased by 53% and 68%, respectively during President Saca's Administration.

Strong Economic growth and the consolidation of public finance were accompanied with notable reduction in poverty levels as well as improvements in access and quality of public services. These are the results of prioritizing capital over current expenditures and the introduction of innovative social programs such as the "Fondo Solidario para la Salud" (FOSALUD) to expand health coverage, the "Plan Nacional de Educación 2021", and "Red Solidaria" one of the five components of the umbrella program "Oportunidades". It is important to mention that El

Salvador is exposed to natural disasters that cause high economic losses and pressures on public finances. To lessen such negative impacts, the Government created a Fund to mitigate and prevent natural disasters, especially in vulnerable areas of the country.

All these achievements are recognized by international institutions: a) according to the Heritage Foundation Index of Economic Freedom, El Salvador moved from the fourth position in 2006 to the second most free economy in Latin America in 2008; b) the country also improved its position in the Index of Corruption published by International Transparency moving to the second place in the Central America region and fourth in Latin America; and c) ranked fifth in the World Economic Forum's Global Competitive Index.

Looking forward, the economic outlook remains solid and positive. Notwithstanding the external shocks arising from volatile oil prices, the food crisis that pressured consume price index (after reaching 9.9% year to year in August 2008, inflation slowed down to 7.4% year to year in October), the slowdown of the US Economy – El Salvador's main trading partner, and the recent financial crisis, El Salvador will still grow around 3.5% in 2008 and remain around that level for 2009. Such grow will be the result of the internal economic drivers such records levels of agriculture output, a 20% increase in public investment, an 16% rise in exports. It is important to mention that GDP for the first semester grew 3.8% in real terms compared to the first semester of 2007; over the same period, employment rose 4.4% on an annual base. Consequently, these indicators support the 3.5% estimate for the year as a whole.

Sustained economic growth ... despite severe external shocks

Year	GDP Growth (%)
1997	4.2
1998	3.7
1999	3.1
2000	2.2
2001	1.7
2002	2.3
2003	2.3
2004	1.8
2005	2.8
2006	4.2
2007	4.7
2008 Est.	3.5
2009 Est.	3.5

Source: Central Reserve Bank

Year	Investment (US\$ millions)
2004	334.5
2005	429.6
2006 Estimate	500.0
2008	570.0
2009 Budget	709.9

Source: Ministry of Finance

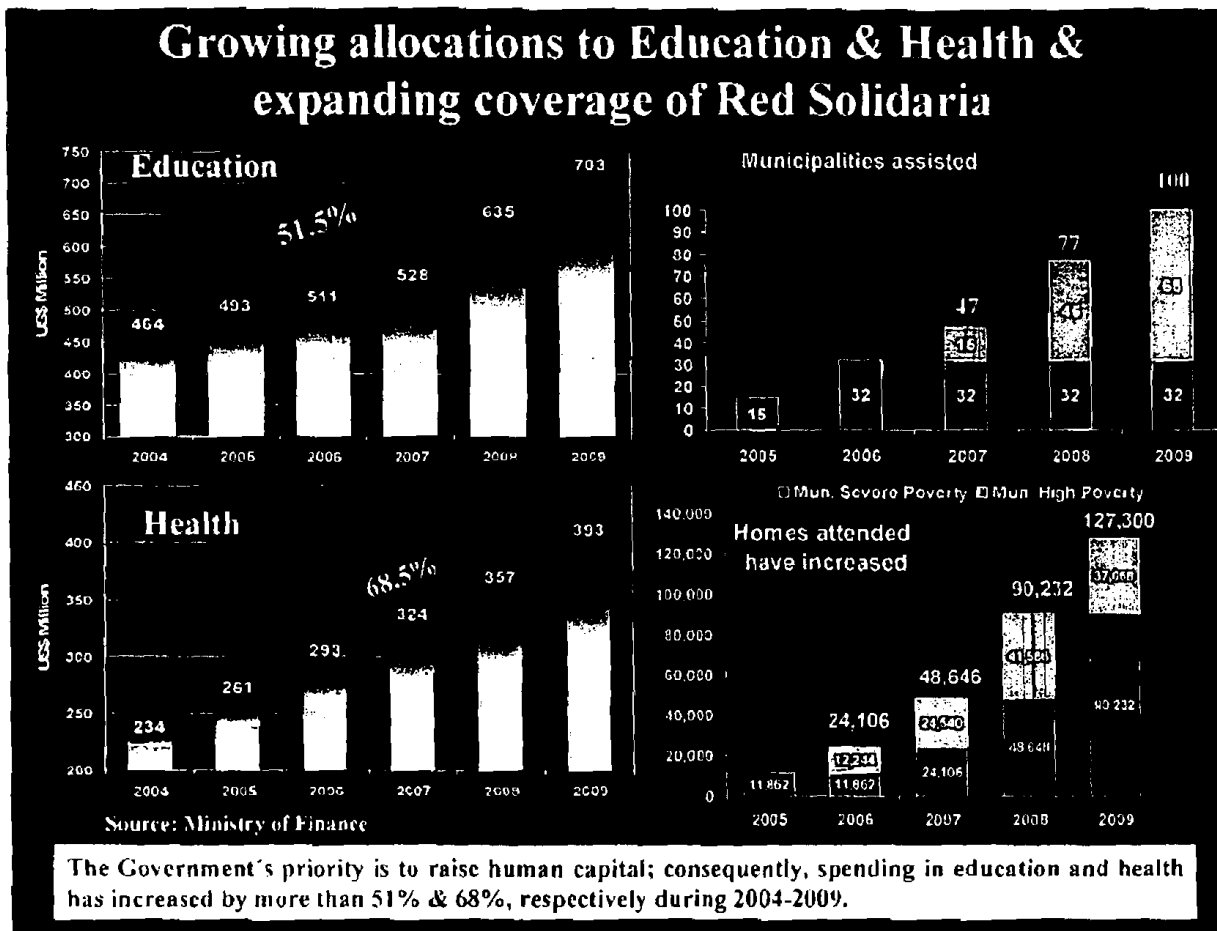
The Salvadoran economy has weathered relatively well the volatile and high oil price shock, the international food crisis, the slowdown of the U.S economy, and the recent global financial turmoil.

Supported by record level in agriculture output, the continued expansion of the tourism sector as well as the industrial production, higher public investment levels, fast growing exports and sustained remittances levels, the economy will grow between 3.5% and 4.0% in 2008 and will remain around 3.5% in 2009.

Public investment rose on the back of internal efforts to increase tax revenues and despite the lack of new loans

3. Social Programs to tackle poverty

The Government's priority has been the capital over current expenditure and social sector spending to improve social inclusion, reduce poverty, and improve social indicators.



Given the external shocks than began last year with record oil prices set last July, the food crisis, the subprime problem, the slowdown of the U.S. economy, and most recently the financial crisis turmoil, El Salvador's Government launched the so called "Alianza por la Familia" Program, a 19 measure strategy to lessen the negative impact of such shocks on population consumption - specially the most vulnerable, maintain economic momentum, and maintain social and political stability.

Among the main measures the Government has undertaken is the increase in the budget for the Food School Program, extending gratuity to secondary education, expanding the coverage of the technologically improved corn and beans seed program toward improving national self supplying in basic grains, lowering the tariffs for the imports of oil and its derivatives as well as for the imports of fertilizers and wheat flour, and raising income tax deductions for education and health expenditure, among others.

4. The Program

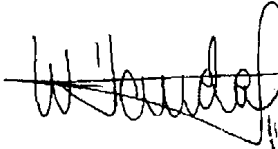
El Salvador has strong fundamentals as a result of a record of structural reforms, total and extreme poverty levels had been already reduced by half, thus reaching well in advance the Millennium Development Goals (MDG) set for 2015. But challenges remain especially given the unfavorable international conditions imposed by high and volatile oil markets and other commodities, the food crisis, and the recent financial turmoil. Consequently, the Government of El Salvador requests the World Bank for technical and financial support to implement this Program, which focuses on three main objectives:

- a. Expand fiscal space for priority spending and improve targeting of existing public spending. In this area the Government, through the Ministry of Finance, is committed to continue increasing the tax to GDP ratio and streamline expenditures. Targets in this component include:
 - i. Increase tax collection from 14.1 percent of GDP in 2007 to 15 percent of GDP in 2011. To reach such a goal the Ministry of Finance will work on three complementary areas: a) tackle tax evasion and smuggling through continuous improvements in both the tax administration and the customs authority; b) expand the tax base; and c) tax reforms that will require Legislative Assembly approval.
 - ii. Reduce the amount of untargeted public subsidies by 40 percent, including the phase out of electricity subsidy for non residential consumers.
- b. Improve public expenditure management and fiscal transparency. To achieve such objective, the Government will:
 - i. Prepare by 2010, a Multi-Year Budget to be included as a technical annex in the Budget for fiscal year 2011 and review results based framework thus increasing the government's ability to plan strategically the use of public resources.
 - ii. Launch a Fiscal Transparency Portal enabling population and specialized interest groups access to public finance information, including budgetary execution.
- c. Expand opportunities for vulnerable groups. Given the additional fiscal space generated by raising tax revenues and streamlining current expenditures, the Government will expand the coverage and quality of social program. Specific targets in this area include:
 - i. The Social Safety Net Program "Red Solidaria" will be expanded to the 100 poorest municipalities of the country with 120,000 households being covered by the CCT program Red Solidaria by 2010 and a strategy to expand the social protection activities to urban areas will be adopted.
 - ii. The performance (as measured by the scores of the tests) of the 411 lowest ranking schools will be improved by 3 % by 2011.
 - iii. Secondary education enrollment will be increased by about 28,000 students, of which about half will be enrolled in programs aimed at students outside the formal system.

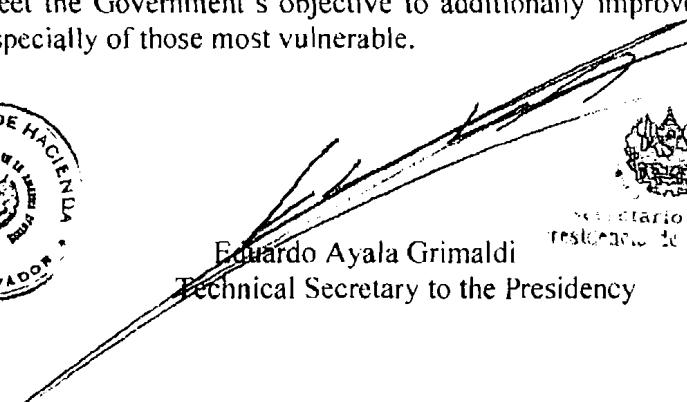
5. Request to support the Program

This letter-report summarizes the main policies and expected outcomes that El Salvador will implement in the following two years. Their purpose is to continue promoting broad-based economic growth, expand fiscal space to increase further budget allocations for capital and priority social spending to improve social indicators towards meeting all the remaining Millennium Development Goals with macroeconomic stability and medium and long term fiscal sustainability.

Given the present international adverse conditions, the technical and financial support from the World Bank is important to help meet the Government's objective to additionally improve its debt profile and attend social needs, specially of those most vulnerable.


William J. Handal
Minister of Finance




Eduardo Ayala Grimaldi
Technical Secretary to the Presidency



Annex 5. El Salvador—Assessment Letter to the World Bank
Statement by the IMF Staff
December 1, 2008

The latest assessment by the Executive Board is presented in the Public Information Notice of March 14, 2008 (<http://www.imf.org/external/np/sec/pn/2008/pn0836.htm>). The last Article IV Consultation discussion took place on November 12, 2008.

Economic growth is decelerating and inflation has started to come down against the backdrop of a slowing U.S. economy and the reversal of high commodity prices. Growth in economic activity slowed to 3.5 percent in the year to August, while inflation fell to 7.4 percent y/y in October, driven mainly by the fall in oil and food prices. FDI flows are expected to halve in 2008 after their unusually high level in 2007 related to the foreign purchase of banks. The banking system—now mainly foreign-owned—is highly liquid and has so far been resilient to the global financial turmoil. However, financial conditions have tightened, reflected in higher sovereign spreads and domestic interest rates, and are expected to get tighter as elections draw closer. The real exchange rate is in line with fundamentals and several indicators suggest that exports remain competitive. The external and public debt stocks were at 46 and 41 percent of GDP, respectively, by end-2007.

The near-term outlook is clouded by the global financial crisis, political uncertainty, and the U.S. slowdown. Growth is expected to fall to 3 percent in 2008 and 2 percent in 2009, with risks on the downside. Inflation will rise to 7.5 percent in 2008 and then moderate to 4.5 percent in 2009, aided by easing commodity prices and the strong nominal anchor provided by official dollarization. The current account deficit is projected to stay at 5.5 percent of GDP in 2008, while moderating in 2009, in part due to lower oil imports, though lower remittances and a higher non-oil import bill would partly offset the improvement. The main risk is that external financial conditions and electoral uncertainties lead to significant deposit withdrawals and undermine the government's ability to raise funds.

Fiscal and financial policies will be crucial to support macro stability and contain potential risks in the run-up to the January 2009 congressional and municipal, as well as the March 2009 presidential elections. The authorities are committed to maintaining fiscal restraint by proposing a 2009 budget consistent with a fiscal deficit of about 2.4 percent of GDP (a primary surplus of 0.1 percent of GDP), compared to an estimated deficit of 2.4 percent of GDP in 2008, while expanding well-targeted social programs to address the impact of commodity price increases on the poor. To address any financing shortfalls, the government has secured a credit line with a regional development bank (CABEI). To further strengthen banks' liquidity, they introduced an additional 3 percent liquidity requirement, and are developing an action plan to deal with situations of stress in banks.

Over the medium term, further structural reforms will be needed to enhance the economy's resilience and create conditions for higher growth and faster poverty reduction. These include increasing public spending on infrastructure investment (particularly transport) and social programs, reducing and better targeting energy subsidies, passing structural financial sector reforms (including the financial supervision bill), strengthening the central bank's lender-of-last-resort functions, and bolstering the deposit insurance fund.

Annex 6. El Salvador
Addendum to the Proposed
Public Finance and Social Sector Development Policy Loan

The purpose of this addendum is to update Executive Directors on a number of developments that have taken place since distribution to the Board of the report “El Salvador -Public Finance and Social Sector Development Policy Loan” (P114910) which is scheduled for Board consideration on January 22, 2009.

As noted in paragraph 14 of the Program Document, at the time of distribution of the report the authorities were exploring the possibility of a Stand-by Arrangement with the IMF. Indeed, an IMF mission team traveled to San Salvador in the second half of December and reached agreement at the technical level for a SDR 513.9 million (US\$800 million) 15-month Stand-by Arrangement. The Salvadoran authorities intend to treat the arrangement as precautionary and do not intend to draw on it unless required by currently unforeseen events. An IMF Board has scheduled discussion of the Arrangement for January 16, 2009. Bank staff stands ready to update Executive Directors following that IMF Board date.

In this context, the IMF team has updated the medium term macroeconomic framework (table 1) which differs slightly from the one in the distributed report, particularly as regards: (i) growth projections which have been revised downwards by 0.1 percent in 2009 and 0.5 percent point in both 2010 and 2011; (ii) end of year inflation projections which are now expected to decline faster than anticipated as a result of lower commodity price projections; (iii) the public sector deficit which is now expected to be about 0.5 percentage points higher than before; and (iv) debt to GDP ratios which are now slightly higher as a result of the revised projections for the deficit and a lower nominal GDP. These changes do not affect the overall conclusion in paragraph 16 of the report regarding the adequacy of the country’s economic fundamentals for Bank development policy lending.

A second development that has taken place since distribution of the report relates to the US\$500 million IDB operation referred to in paragraphs 14, 21 and 37 of the Program Document. As noted in the report, the authority granted by the Salvadoran Congress to the government to negotiate this proposed DPL was part of a package that also included authority to negotiate another loan with the IDB. In this regard, the IDB’s operation, which was considered by the IDB Board on November 25, 2008 received final approval by the Salvadoran Congress on December 18, 2008.

A third development regards the approval by the Board of the IDB of a US\$400 million loan under the IDB’s Liquidity Program for Growth Sustainability window on December 17, 2008. The goal of this operation is to facilitate access by the private productive sector to financial resources to help sustain the country’s economic growth. Its purpose is to provide the Central Bank with funding to acquire short-term loan portfolio receivables for working capital and trade financing, and to provide financial institutions with liquidity to grant new short-term loans for working capital and trade financing in accordance with program requirements.

Table 1 Medium Term Macroeconomic Scenario: Base Case
(percentage of GDP, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013
Income and prices						
GDP growth (% change)	3.2	2.5	2.5	3.0	4.0	4.5
Inflation (cpi end of period % change)	5.5	3.8	3.5	3.0	3.0	3.0
Investment and savings						
Gross domestic investment	15.4	15.3	15.9	15.9	15.7	16.6
Gross domestic savings	9.4	12.5	12.5	12.5	12.5	13.5
Consolidated Public Sector						
Total revenues and grants	17.0	17.2	18.6	18.4	18.5	18.5
Total tax revenue	13.2	13.6	14.3	14.6	14.7	14.7
Total expenditures	19.8	20.1	20.2	20.0	19.8	19.5
Current expenditure	16.9	16.7	16.5	16.4	16.2	16.0
Capital expenditures	2.9	3.4	3.8	3.6	3.6	3.5
Primary balance	-0.5	-0.5	0.7	0.8	1.1	1.1
Overall balance	-2.9	-2.8	-1.7	-1.6	-1.3	-1.0
Public Debt						
Total debt	40.0	41.5	40.7	39.7	38.5	36.5
O/w external	23.9	24.0	22.8	21.5	19.7	17.5
External public debt servicing (% of exports)	8.7	12.5	10.2	11.5	9.1	8.0
Balance of Payments						
Current account balance	-6.0	-2.7	-3.4	-3.3	-3.2	-3.1
Trade balance	-19.9	-16.5	-16.8	-16.6	-16.6	-16.7
Exports of goods (f.o.b)	21.3	21.1	20.8	21.2	21.3	21.2
Imports of goods (f.o.b.)	41.2	37.6	37.6	37.8	37.9	37.9
Foreign direct investment	1.9	1.4	1.9	2.4	2.9	2.9
Remittances	17.2	16.6	16.1	16.1	16.1	16.2
Memorandum Item						
Nominal GDP (billions of US dollars)	22.2	23.6	24.9	26.4	28.3	30.5

Source: Ministry of Finance, Central Bank and staff estimates.

