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EL SALVADOR

EMERGENCY PROGRAM FOR MACROECONOMIC AND FISCAL SUSTAINABILITY

(ES-L1142)

LOAN PROPOSAL

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ABBREVIATIONS

AML	Anti-money laundering
BCR	Banco Central de Reserva de El Salvador [Central Reserve Bank of El Salvador]
CCC	Centros de contención de cuarentena [quarantine containment centers]
CFT	Combating the financing of terrorism
FERRE	Fondo de Emergencia, Recuperación, y Reconstrucción Económica [Emergency, Recovery, and Economic Reconstruction Fund]
IDB	Inter-American Development Bank
IMF	International Monetary Fund
MLTFF	Medium- and Long-term Fiscal Framework
MTFF	Medium-term Fiscal Framework
NFPS	Nonfinancial public sector
PBP	Programmatic policy-based loan
RFI	Rapid Financing Instrument
SARS-CoV-2	Severe acute respiratory syndrome coronavirus 2
SDL	Special Development Lending
SDR	Special drawing rights
TC	Technical cooperation
WHO	World Health Organization

PROJECT SUMMARY

EL SALVADOR
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Financial Terms and Conditions				
Borrower:			**Special Development Lending**[(a)]	
Republic of El Salvador			**Amortization period:**	7 years
Executing agency:			**Disbursement period:**	1 year
Ministry of Finance			**Grace period:**	3 years
Source	**Amount (US$)**	**%**	**Interest rate:**	3-month LIBOR in U.S. dollars, plus/minus the IDB lending spread, plus the variable interest spread for Ordinary Capital resources, plus the fixed premium on the lending spread of 115 basis points[(a)]
IDB (Ordinary Capital):	250 million	100%	**Front-end fee:**	1% of the loan principal, payable within 30 days of the entry into effect of the contract
			Credit fee:	0.75%
Total:	250 million	100%	**Weighted average life (WAL):**	5 years
			Currency of approval:	U.S. dollars

Project at a Glance

Project objective/description: The general objective of the program is to support the government's efforts and actions to contain the COVID-19 health crisis with a view to restoring macroeconomic stability and fiscal sustainability. The specific objectives in the medium term are to: (i) reduce the fiscal deficit to achieve public debt sustainability; and (ii) maintain a competitive and transparent economy

The program is aligned with the Rapid Financing Instrument (RFI) of the International Monetary Fund (IMF), approved on 14 April 2020. The budgetary support provided through this loan under the Special Development Lending (SDL) category will contribute to finance efforts to contain the health crisis, mitigate its impact on vulnerable households, and promote countercyclical policies to reduce its effect on the economy and mitigate the decline in fiscal revenues in the short term. The program is structured as a single operation to be disbursed in a single tranche.

Commitments and disbursement of the loan proceeds: The sole disbursement of the loan proceeds will be made in accordance with the terms established in the Loan Contract to be signed between the borrower and the Bank, including the provision requiring that proceeds under the RFI financing arrangement approved by the IMF are being or have been disbursed. The Commitments Matrix (Annex II) identifies the commitments made by the Government of El Salvador and contained in its Letter of Intent to the IMF, dated 4 April 2020, which forms an integral part of the IMF report, Request for Purchase Under the Rapid Financing Instrument, approved by the IMF Executive Board. These commitments are also stated in the Policy Letter, dated 20 April 2020, and will be reflected in the abovementioned Loan Contract (see paragraph 4.2).

Exceptions to Bank policies: None

Strategic Alignment

Challenges:[(b)]	SI ☐	PI ☐	EI ☐
Crosscutting themes:[(c)]	GD ☐	CC ☐	IC ☒

(a) Under the Special Development Lending category (document AB-3134) and its Operational Guidelines (document GN-2031-17), this operation will be documented under the Flexible Financing Facility (FFF) with limited debt management options. The borrower has the option of requesting currency and interest rate conversions. The Bank will take operational and risk management considerations into account when reviewing such requests. The applicable amortization schedule for this loan will consist of equal, six-monthly installments that begin to accrue at the end of the grace period.

(b) SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

(c) GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. Description and Results Monitoring

A. Background, problem to be addressed, and rationale

1.1 **Macroeconomic background.** El Salvador is the fourth largest economy in Central America with a GDP of US$27 billion (2019(e)). From 2000 to 2008, the economy grew at an annual average of 2%. In 2009, it contracted -2.1% as a result of the international crisis, and from that point through 2019 economic growth has averaged 2.5% (Central Reserve Bank of El Salvador (BCR), 2018). For 2020, projected growth in economic activity was 2.5%, but given current global conditions due to the COVID-19 pandemic, growth expectations for this year have fallen sharply. The International Monetary Fund (IMF) projects (April 2020) that GDP will contract -5.4% in 2020.

1.2 The current account deficit averaged 4% of GDP in the last decade, driven by the trade deficit (average 19% of GDP) and high payment outflows abroad, moderated by remittance inflows (average 18.9% of GDP) and other net transfers from abroad. In 2019, the current account deficit was cut in half (-2.1% of GDP) from 2018 (-4.7% of GDP), largely due to the oil price drop, as the country is a net importer. The Salvadoran economy has also been characterized by low inflation, which stood 0% at year-end 2019. Inflation is directly impacted by commodity price fluctuations; the country is a net importer of these products and has a dollarized monetary system, so the external environment transfers almost instantaneously to domestic prices.

1.3 El Salvador has been gradually improving its primary fiscal balance for nearly 10 years, posting consecutive primary surpluses in the last 3 years. This was achieved through efforts to raise tax revenue intake while containing expenditure in line with the Fiscal Responsibility Law passed in 2016. Nonetheless, the country still has a high level of public indebtedness (70.2% of GDP in 2019), and finance costs are increasing (3.7% of GDP in 2019), reflecting debt dynamics that tend to reduce fiscal headroom. This, combined with poor economic growth dynamics, limits the ability to respond to external shocks. Moreover, since the economy is dollarized, the only macroeconomic policy tool for dealing with such shocks is fiscal policy. In terms of quality of expenditure, the country exhibits high technical inefficiency levels of around 6.5%[1] of GDP. Ensuring better expenditure quality, along with greater efforts in tax administration (including electronic invoicing and cross-auditing) and improvements in tax policy (such as establishing a property tax), are still outstanding items on the fiscal agenda.

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[1] Izquierdo, Pessino, and Vulentin, eds. Better Spending for Better Lives: How Latin America and the Caribbean Can Do More with Less. IDB, 2018.

Table 1. Selected economic indicators, 2015-2019
(NFPS fiscal data)

	2015	2016	2017	2018	2019
Real GDP growth (% variation)	2.4	2.5	2.2	2.4	2.4
Unemployment (% of economically active population)	7.0	7.1	7.0	6.3	6.7
Inflation (%, end of period)	1.0	-0.9	2.0	0.4	0.0
Total revenue (% of GDP)	21.9	22.1	22.8	23.0	22.8
Tax revenue (% of GDP)	17.6	17.5	18.0	18.3	18.2
Total expenditure (% of GDP)*	25.5	25.2	25.3	25.6	25.8
Primary expenditure (% of GDP)*	22.87	22.32	22.1	22.1	22.1
Public sector fiscal balance (% of GDP)*	-3.6	-3.1	-2.5	-2.7	-3.1
Public sector debt (% of GDP)*	66.2	67.5	69.2	69.2	70.2
Remittances received (US$ millions)	4,256	4,543	4,985	5,391	5,649

Sources: BCR (March 2020), Ministry of Finance, World Economic Outlook (April 2020), and IMF.
* Includes the cost of social security

1.4 **The COVID-19 pandemic and the health crisis.** The severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2), which causes the disease COVID-19, was first detected in China in late 2019 and spread rapidly to the rest of the world. On 11 March 2020, the World Health Organization (WHO) declared it a pandemic, and as of 18 April 2020 there were more than 2.1 million confirmed cases and over 146,000 deaths related to COVID-19 worldwide.[2] Although the spread of SARS-CoV-2 in the Americas began later than in Asia and Europe, the number of cases in the region has also been increasing rapidly. By 1 May 2020, the number of confirmed infections in North, Central, and South America had reached 1.3 million, and the number of deaths exceeded 69,000,[3] although these figures will soon be out-of-date.

1.5 COVID-19 is highly contagious disease.[4] This has meant that, on average, recorded cases in a country rise daily by 33%.[5] These high infection rates of contagion lead to spikes that can overwhelm the capacity of health systems, since sick patients require specialized medical care. To keep this from happening, social distancing and isolation have become essential measures in the public health response, since they slow the transmission of COVID-19[6] and delay demand for medical services.[7] Implementing this type of measure is particularly important in

2 World Health Organization (2020). Situation Report.

3 Idem footnote 2.

4 COVID-19 can be spread from person to person through respiratory secretions and direct contact.

5 This means that the number of new infections more than doubles approximately every three days, if public health measures are not taken to contain the spread. Financial Times (2020).

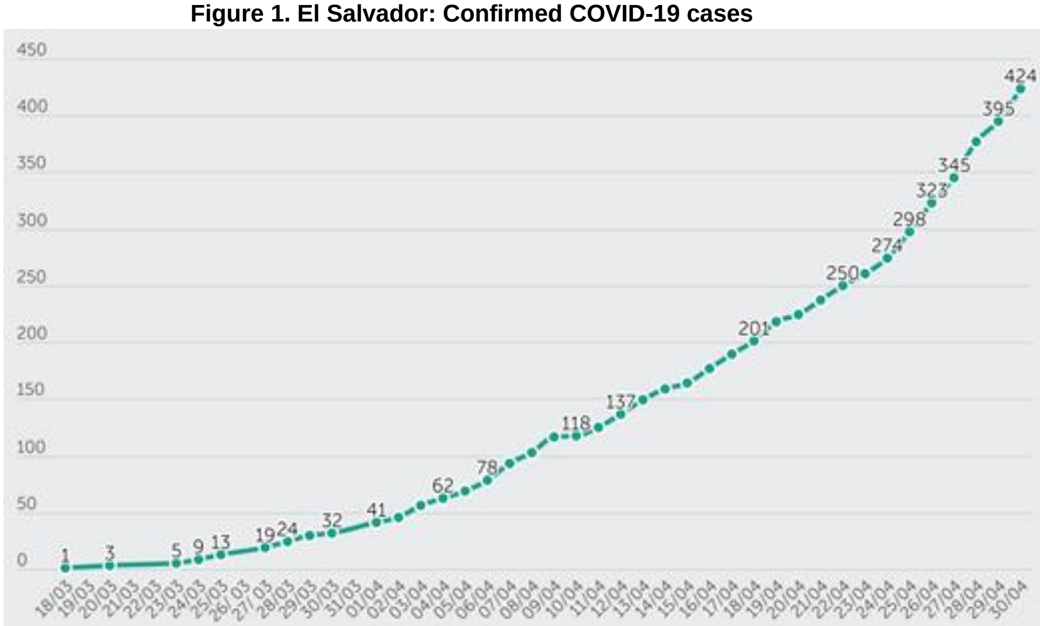
6 Eichenbaum M. S., Rebelo S., and Trabandt M. (2020). The Macroeconomics of Epidemics (No. w26882). National Bureau of Economic Research.

7 Hellewell J., Abbott S., Gimma A., Bosse N. I., Jarvis C.I., Russell T. W., et al. Feasibility of Controlling COVID-19 Outbreaks by Isolation of Cases and Contacts. Lancet 2020; 8(4):488-496.

Latin America and the Caribbean, considering that a recent WHO analysis shows that most countries of the region are unprepared to manage pandemics.[8]

1.6 In El Salvador, the total number of confirmed cases as of 1 May was 424, 289 of which were active, 125 recovered, and 10 deaths.[9] Of these 424 cases, 117 were people held at quarantine containment centers upon entering the country, so they have a relatively low risk of spreading the disease to the general population.[10] The vast majority of the remaining cases were detected through contact tracing and are spread across practically all of the country's departments.

Figure 1. El Salvador: Confirmed COVID-19 cases



Source: Government of El Salvador.

1.7 **Pandemic response actions.** Although social distancing and stay-at-home restrictions may slow the transmission of COVID-19, they have not fully stopped the spread of the disease worldwide. For that reason, countries have had to implement additional health measures. First, to replicate relatively successful experiences like South Korea's, early health sector interventions are needed for mass testing of the population to detect the presence of the virus and trace possible cases of contagion, so they can be isolated. Interventions of this kind have proven effective in ending health crises more swiftly.[11,12] Additionally, the

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8 Operational capacity was assessed according to the percentage of fulfillment of the 13 core capacity requirements to manage public health events established in the International Health Regulations (2005), an agreement among 196 countries to develop their capacities to respond to such events.

9 Government of El Salvador.

10 As of 1 May 2020, there were 3,780 people at 93 quarantine containment centers throughout the country.

11 A recent study on the impacts of the 1918 flu pandemic found that cities that acted earlier and more aggressively grew faster once the pandemic was over. S. Correia, S. Luck, and E. Verner. Pandemics Depress the Economy, Public Health Interventions Do Not: Evidence from the 1918 Flu.

supply of health services must be increased, to treat infected people with serious symptoms. Both types of interventions require physical and financial resources delivered in an urgent and timely manner. Many countries, including several in Latin America and the Caribbean, have been rapidly scaling up public health spending. Paraguay, for example, announced a package of health measures that entails expenditure equivalent to 2.7% of its GDP. Chile, El Salvador, and Peru also announced similar packages with approximate costs of 0.65%, 0.27%, and 0.25% of their respective GDP.[13]

1.8 Consistent with this international experience, El Salvador adopted prompt and urgent measures to address the pandemic, including the following:

a. **Declaration of a state of emergency (Legislative Decree 593).** The Legislative Assembly unanimously declared a national state of emergency on 14 March for an initial period of 30 days,[14] which: (i) limits the circulation of people; (ii) prohibits performances of all kinds; (iii) allows the Consumer Protection Office to set price ceilings for items and services related to the pandemic; (iv) permits the Legislative Assembly to conduct an urgent review of budget allocations; (v) suspends classes and academic work; and (vi) suspends work nonessential to the emergency for public sector workers, among other measures.

b. **Temporary restrictions on certain guarantees related to personal movement (Legislative Decree 611).** At a special session on 29 March, the Legislative Assembly passed a new law restricting constitutional guarantees related to freedom of movement, the right to unarmed peaceful assembly for any lawful purpose, and the right not to be forced to change residence, with the objective of keeping the pandemic from spreading. The law does not limit freedom of expression or dissemination of thought. It protects privacy in telecommunications and puts no limits on Salvadorans entering the country, provided that they comply with the mandatory quarantine.

c. **Response and economic relief plan.** Given the impending economic impact of the pandemic, the government is executing 30 measures contained in its COVID-19 economic crisis prevention plan. These measures were sent to the Legislative Assembly on 19 March 2020 and approved a few days later. They seek to assist individuals and legal entities directly affected by the pandemic. The primary measures are: (i) waiving import tariffs on certain categories of goods; (ii) temporarily suspending payment for services like water, electricity, and telecommunications; (iii) transferring US$300 to low-income families that have lost their source of income;[15] (iv) paying essential public employees a US$150 bonus; and (v) extending the 2019 income tax payment deadline for several types of taxpayers.

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[12] Prem K., Liu Y., Russell T.W. et al. The Effect of Control Strategies to Reduce Social Mixing on Outcomes of the COVID-19 Epidemic in Wuhan, China: A Modelling Study. Lancet Public Health 2020 (published online on 25 March).

[13] IDB Fiscal Management Division (FMM) (2020). FMM Technical Note: Fiscal Measures to Reduce the Impact of COVID-19.

[14] Legislative Decree 631 extended Legislative Decree 593 until 1 May 2020.

[15] This transfer will cost the treasury an estimated total of US$450 million.

1.9 From a regional perspective, efforts to control the spread of the disease have achieved positive outcomes, especially considering that El Salvador is the most densely populated country in Central America, highly urban, and a regional air transportation hub. The successful initial containment of the virus has given authorities the opportunity to prepare and get ready with sufficient tests, beds, and ventilators. As a result of these measures, El Salvador is one of the Central American countries where the virus has spread the slowest.[16]

1.10 **Financing of the emergency response.** Although the Government of El Salvador has increased the health budget in recent years (from 2.4% of GDP in 2018 to a budgeted 2.7% of GDP in 2020), the pandemic emergency response measures will cost far more than the budgeted amount. However, limited fiscal headroom and the magnitude of the required funds mean that the country must resort to external borrowing. Thus, on 26 March the Legislative Assembly authorized the establishment of an Emergency, Recovery, and Economic Reconstruction Fund (FERRE) of up to US$2 billion (8% of GDP),[17] to be financed by issuing securities or securing loans. The legislative decree also calls for a public-private steering committee to be created with a supervision role. To date, the government has identified the following sources of financing for the FERRE.

Table 2. Financing identified for the FERRE (US$ millions)

Source	Amount	Status
Bond issues on the international market	841	Pending
World Bank	220	Partially approved
IMF Rapid Financing Instrument (RFI)	389	Approved
Central American Bank for Economic Integration (CABEI)	50	Pending approval
IDB Special Development Lending (SDL) loan	250	In preparation*
IDB Programmatic policy-based loan (PBP) requested on 8 April 2020	250	In preparation
Total	**2,000**	

* This operation is being processed separately from other supplemental programs in preparation.

1.11 The FERRE will implement the following pandemic response actions:

a. **Health crisis containment:** Purchase of medications, hospital equipment and supplies, and medical supplies, as well as building a new hospital devoted to COVID-19 in San Salvador and improving hospital infrastructure throughout the country.

[16] World Health Organization (2020). Situation Report.

[17] Approximately 50% of this amount will be used for the emergency response, and 50% for economic recovery.

b. **Mitigation of impact on vulnerable households:** Cash transfers of US$300 to nearly 1.5 million vulnerable households, as well as measures to suspend the payment of utility bills.[18]

c. **Promotion of policies to safeguard the economy:** Municipal projects, prioritization of food security, repair of the productive fabric, and tax measures to extend payment deadlines and accelerate income tax refunds for various categories of taxpayers.

1.12 **Macroeconomic repercussions.** A number of investment banks are projecting a global economic contraction of between -1% and -3% for 2020, although these estimates are still highly speculative.[19] In El Salvador, the impact on economic growth will be determined primarily by two factors: the performance of the U.S. economy and the cost of the government response. The BCR estimates that, for every percentage point the U.S. economy contracts, the Salvadoran economy contracts 0.8%, an elasticity similar to other Central American countries.[20] Considering estimates that the U.S. economy will contract by around 6% in 2020 due to the pandemic,[21] the IMF has projected that the transfer to the Salvadoran economy will cause it to shrink by around 5.4%.

1.13 The fall in international oil prices is, on its own, net positive for the balance of payments. The price of crude oil has fallen more than 60% since the beginning of the outbreak in China, and oil and derivatives account for approximately 15% of total imports of goods in El Salvador. Depending on how long COVID-19 affects international prices, the oil bill could go down by US$400 million to US$900 million (1.5% and 3.4% of GDP). In the balance of goods, the disruption of value and supply chains could hurt local production and some key export sectors like the textile industry.

1.14 The combined impact of stay-at-home measures and the recession will have significant repercussions for households. Microestimates simulating the shock suggest that the impact at the household level is considerable, and 600,000 people could join the ranks of the poor. The consolidated middle class would shrink from 22% to 17% of the population, and the vulnerable middle class, from 47% to 43%, and poverty would increase from 29% to 40%[22] of households. The shock would also cause income inequality to rise, as the measures taken domestically to reduce infections will lead to a sharp drop in incomes in the informal sector, which accounts for almost 70% of the workforce.[23] Significantly, by providing US$300 in assistance to 75% of households, the impact on poverty could be reduced by almost three percentage points, assuming that the cash transfers are perfectly targeted.

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[18] In accordance with Legislative Decree 601, "Transitory Law to Defer Payment of Water, Electric Power, and Telecommunications Bills (Telephone, Cable, and Internet)," payments for March, April, and May 2020 will be deferred.

[19] IDB: Research Department (RES), Macroeconomic Report (forthcoming).

[20] Source: BCR research document (Aquino).

[21] IMF World Economic Outlook, April 2020.

[22] Staff calculations based on the 2019 Multipurpose Household Survey.

[23] Staff calculations based on the 2019 Multipurpose Household Survey.

1.15 El Salvador faces adverse financial market conditions. On 19 March, the government issued US$440 million in treasury bills and certificates on the domestic market with a yield of around 11% and a maturity of one year. This amount is part of the US$645 million approved by the government to finance the 2020 national budget. It is important to remember that the last bonds issued on the international market had a much lower yield of 7.12% and a 30-year maturity, illustrating the sudden deterioration in terms for access to finance. The government is now in talks with international markets to explore the possibility of securing funds on less onerous terms, while at the same time seeking financing from bilateral and multilateral sources.

1.16 **Fiscal impact.** After almost seven years of steady improvement and three consecutive years of primary surplus, falling tax revenue and rising expenditure due to the pandemic will tilt the balance towards a substantial deficit in 2020.[24] Since 2016, the country has run a positive primary balance equivalent, on average, to 0.7% of GDP. Under the current scenario, tax revenue is projected to fall by at least 1% of GDP, due to the preventive slowdown in economic activity.[25] Moreover, health needs will require additional budget reinforcement in that sector, as well as cash transfers to the most vulnerable homes and multiple forms of assistance for affected productive sectors and municipalities, to mitigate the economic impact and lower the risks of a social crisis. This will lead to an increase in public expenditure, estimated by the IMF at around 3.5% of GDP, that, taking the tax revenue shortfall into account, will result in deterioration of the primary balance of 4.5% of GDP.[26]

1.17 Given the tight fiscal conditions, more public debt must be taken on, to deal with the crisis. Total public debt had held steady at around 70% of GDP since 2017 and is required to reach 60% by 2030 under the Fiscal Responsibility Law. Given the limited fiscal leeway, the authorities have also announced that the government will assume or issue US$2 billion in indebtedness above the amount stated in the 2020 Budget Act to address the pandemic. This, combined with the expected economic contraction, could cause public debt to surpass 80% of GDP by year-end 2020.

B. Program for Macroeconomic and Fiscal Sustainability

1.18 On 14 April 2020, the IMF approved the use of the Rapid Financing Instrument (RFI) for El Salvador in the amount of US$389 million, equivalent to 100% of its quota of special drawing rights (SDR). The RFI provides rapid, low-access financial assistance to member countries facing an urgent balance of payments need, without the need to have a full-fledged program in place. A member country requesting RFI assistance is required cooperate with the IMF to make efforts to solve its balance of payment difficulties and to describe the general economic policies it proposes to follow. The instrument provides financial support for a broad range of urgent needs, including those arising from commodity price shocks, natural disasters, conflict and postconflict situations, and emergencies resulting from fragility. Unlike other IMF instruments, the RFI does not require structural

[24] Staff estimates based on the Debt Sustainability Analysis framework.

[25] Source: Ministry of Finance.

[26] Data in the IMF Staff Report (required link 2).

measures to be adopted in order to trigger the disbursement of funds. Instead, to gain access, and as part of part of the eligibility criteria, a member country assumes a series of commitments to address the crisis and restore fiscal and financial sustainability. These commitments are recorded in a Letter of Intent, which is appended to the report submitted for the approval of the IMF Executive Board. The Board's approval includes a technical report that provides a rationale for the decision based on an analysis of urgent balance of payment needs resulting from different types of emergencies, as well as a public debt sustainability analysis. If the debt is deemed to be unsustainable, the borrower should also undertake a commitment to adopt subsequent measures to return the country to a path of fiscal sustainability.[27] The following IMF estimates support the approval of the RFI in El Salvador:[28]

a. **Economic contraction.** The expected total economic cost of the pandemic, calculated as the accumulated drop in production through 2025, is around US$2.5 billion, equivalent to about 10% of GDP. This estimate considers an expected contraction of 5.4% in 2020, followed by a 4.5% recovery in 2021.

b. **Impact on the balance of payments.** Due to lower economic growth, exports, and remittances, the balance of payments will suffer an impact of US$855 million in 2020.

c. **Fiscal impact.** The fiscal impact of measures to prevent, detect, control, treat, and contain the virus is projected to reach US$900 million in 2020, approximately 3.5% of GDP. This would lead to a primary fiscal deficit of -4.5% of 2020 GDP.

1.19 **Measures to restore fiscal sustainability.** The government's commitment to introduce medium-term measures to restore debt sustainability is contained in the Letter of Intent of 4 April 2020. It consists primarily of a commitment to carry out a gradual fiscal adjustment of 3% of GDP in the period 2021-2024. This adjustment would reestablish a path of fiscal sustainability and signal a strong commitment to the Fiscal Responsibility Law public debt anchor (including pensions) of 60% of GDP by 2030. The IMF prepared its medium-term macroeconomic framework on the basis of this commitment. The planned government measures and others recommended by the IMF to attain this fiscal adjustment through 2023 are as follows:

[27] For further details on the IMF instrument, see the following link: RFI.

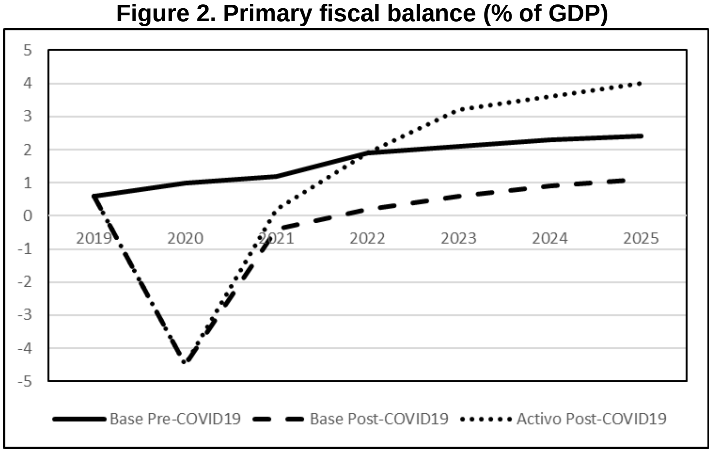
[28] All estimates in this section are based on the macroeconomic framework found in the IMF Staff Report, available under required link 2.

Table 3. Fiscal adjustment measures (% of GDP)[29]

Measure	2021	2022	2023	Total
Planned government measures				
Electronic invoicing (+)	0.1	0.2	0.2	0.5
Other tax administration (+)	0.1	0.1	0.1	0.3
Additional measures proposed by the IMF				
Property tax (+)		0.3	0.3	0.6
Fuel taxes (+)		0.1	0.1	0.2
Goods and services expenditure (-)	0.2	0.2		0.4
Wage bill adjustments (-)	0.2	0.2	0.1	0.5
Total	**0.6**	**1.1**	**0.8**	**2.5**

1.20 The Medium- and Long-term Fiscal Framework (MLTFF)[30] issued by the Ministry of Finance in September 2019 envisaged a gradual primary fiscal balance increase of 0.25% per year, on average, over 2019-2025, reaching 2.45% of GDP by the end of that period. IMF projections on the pandemic, however, point to a primary deficit of -4.5% of GDP in 2020, followed by a deficit of -0.4% in 2021, and a gradual recovery to 1.1% by 2025. With the gradual fiscal adjustment agreed to by the government, estimates point to a primary surplus of 0.2% of GDP in 2021, which would climb to 4% by 2025. Figure 2 compares the pre-COVID-19 base scenario projected in the Medium-term Fiscal Framework (MTFF), the post-COVID-19 base scenario (in the absence of adjustment measures agreed to by the government), and the active post-COVID-19 scenario (with the agreed measures).

Figure 2. Primary fiscal balance (% of GDP)



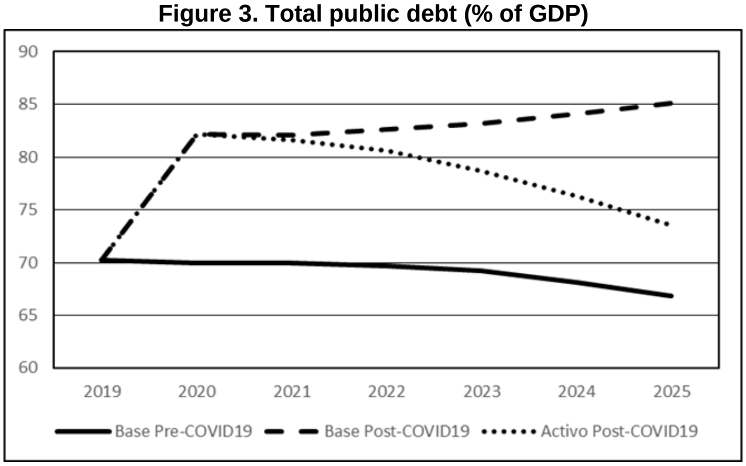
Source: MTFF and IMF.

[29] The IMF recommends additional measures equivalent to 0.5% of GDP for 2024 but does not specify what they are. Source: IMF Staff Report (required link 2).

[30] Government of El Salvador (Ministry of Finance).

1.21 To comply with the Fiscal Responsibility Law passed in 2016 and amended in 2018, public debt needs to be put on a declining path from around 70% of GDP at year-end 2019 to 60% by 2030. MTFF forecasts called for a gradual drop to 66.8% of GDP by 2025. But the impacts of the pandemic have altered that course, and the IMF's RFI projections are for a total public debt of 82.2% of GDP at year-end 2020, increasing gradually to 85.1% by 2025. Through the agreed adjustment measures, that path may be inverted to an 8.7% drop in GDP from 2020 to 2025, with public debt reaching 73.5% of GDP at the end of that period. Figure 3 compares the total public debt scenarios.

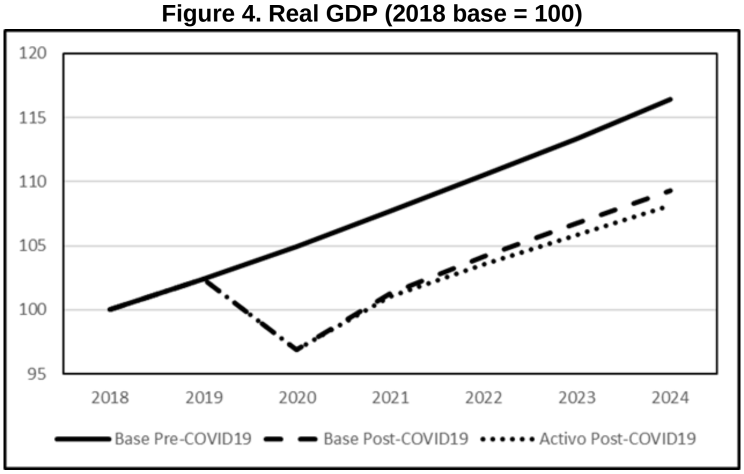
Figure 3. Total public debt (% of GDP)



Source: MTFF and IMF.

1.22 The agreed fiscal adjustment will entail a significant reduction in public sector demand, which will inevitably slow down economic growth over its implementation period. MTFF projections point to average growth of 2.6% during the period 2019-2025, while the IMF, considering the impact of the pandemic, lowers this figure to 1.7% without a fiscal adjustment and 1.5% with the agreed adjustment. Figure 4 compares real GDP growth scenarios.

Figure 4. Real GDP (2018 base = 100)



Source: MTFF and IMF.

1.23 **Conclusions of the IMF Staff Report.** The IMF evaluation in response to El Salvador's request for RFI financing reaches the following conclusions: (i) The COVID-19 pandemic is severely hurting El Salvador and creating significant external financing and fiscal needs; (ii) the authorities have taken appropriate measures to temporarily increase the fiscal deficit to accommodate greater spending on health and other mitigation measures, and are committed to preserving fiscal sustainability; (iii) there is a need to monitor the stability of the financial system while adopting relief and recovery measures; and (iv) the government's request for an RFI repurchase of SDR278.2 million, equivalent to approximately US$389 million (100% of the quota), should be approved.

II. ELIGIBILITY CRITERIA

2.1 **Eligibility criteria for SDL loan.** The Special Development Lending (SDL) category, established in the Proposal to Create a Special Development Lending Category (document AB-3134), approved by the Board of Governors on 30 June 2017 pursuant to Resolution AG-9/16, and its Special Development Lending Category Operational Guidelines (document GN-2031-17), is a budgetary support lending instrument for dealing with macroeconomic crises[31] and preserving social gains and economic growth in countries of the region facing a macroeconomic crisis. The Government of El Salvador meets the eligibility criteria for this loan (document AB-3134), inasmuch as El Salvador: (i) is experiencing a macroeconomic crisis (see paragraphs 1.12 to 1.17); and (ii) has a lending arrangement approved by the IMF. The RFI arrangement was approved by the IMF on 14 April 2020 in the amount of US$389 million, equivalent to 100% of the country's SDR quota. The SDL operation amount (US$250 million) falls within the limit set by IDB policies: 2% of the country's GDP or a maximum of US$500 million.[32]

2.2 The IMF's Rapid Financing Instrument (RFI) is one of the eligible IMF instruments that can be accompanied by an SDL from the Bank[33] but does not include a policy matrix with actions to be completed prior to disbursement. In addition to the IMF analysis certifying the need for urgent balance of payments support, the RFI requires a letter of intent from the country describing the steps it commits to take in order re-establish macroeconomic and fiscal stability. To ensure consistency with the IMF instrument, this program incorporates a Commitments Matrix that reflects the country commitments contained in the abovementioned RFI Letter of Intent.

2.3 This operation also contributes to the objective of the SDL instrument to protect social gains and economic growth. The operation's proceeds, despite being for budgetary support, and thus untied, will directly finance measures to protect family incomes in the most vulnerable populations. The proceeds will also help finance

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[31] Defined as a situation in which the country lacks or potentially lacks sufficient financing on affordable terms to meet its net international obligations, such as paying imports or external debt redemptions, while maintaining prudential reserve buffers (document GN-2031-17).

[32] Whichever amount is less. This limit applies to new country funds (see paragraph 4.6 of document AB-3134).

[33] See document GN-2031-17, paragraph 3.1.

economic relief measures for businesses and municipal projects, mitigating the impact on the business economy and job losses at the local level.

2.4 **The Bank's operational work and technical support in the country.** For several years, the Bank has supported and promoted the process of strengthening public finances in El Salvador. It provided technical assistance to establish a legal framework for fiscal responsibility and prepare a preliminary draft bill, and then facilitated dialogue and discussion among major political stakeholders to promote the legislation, which passed in November 2016. It also supported improvements in public debt management and the adoption of El Salvador's first Medium-term Fiscal Framework (MTFF).[34] Based on this work, in 2018-2019 the Bank financed a programmatic series, "Fiscal Strengthening for Inclusive Growth," for a total amount of US$550 million with two operations (4542/OC-ES and 4807/OC-ES) that laid the groundwork for efficient and sustainable management of public finances.

2.5 Execution of the US$30 million investment loan 3852/OC-ES, "Tax Administration Strengthening Program," began in 2019 with the objective of comprehensive transformation of the Deputy Ministry of Revenue (VMI) by implementing electronic invoicing, modernizing information systems, and significantly improving customs management. The Bank has also provided technical assistance to El Salvador to improve the efficiency of public expenditure on payroll, public procurement processes and systems, and results-based management with a focus on the budget system.

2.6 **The Bank's experience in the region and lessons learned.** The Bank has experience assisting the countries of the region in overcoming macroeconomic crises and fiscal imbalances similar to those faced by El Salvador. For example, the SDL approved for the Government of Barbados (loan 4656/OC-BA) supported: (i) the restoration of macroeconomic stability; (ii) fiscal adjustments to promote sustainable fiscal balance in the short and medium term; and (iii) protection of social spending to preserve social gains. The SDL approved for Ecuador (loan 4771/OC-EC) supported: (i) macroeconomic stability; (ii) the restoration of fiscal sustainability; (iii) strengthening of the central bank's institutional structure; and (iv) safeguarding of social spending to support the most vulnerable population. Both operations were approved in conjunction with IMF macrofiscal support. In 2014, moreover, the Bank approved the Development Sustainability Contingent Credit Line in Ecuador (loan 3415/OC-EC), which offered liquidity to withstand the external shock caused by the oil price drop.

2.7 The many lessons learned from this experience include the following: (i) the Bank's SDL instrument is an effective vehicle for channeling budgetary support resources swiftly in crisis situations; (ii) its main value-added, other than financial, is that it leverages and strengthens the IMF program and adds a layer of technical support to help the government carry out the agreed measures; and (iii) the technical cooperation (TC) assistance and ongoing dialogue with the authorities to support fulfillment of the commitments with the IMF play an important role.

[34] Technical cooperation operations ATN/OC-16234-ES, ATN/FI-12988-ES, ATN/FI-15360, ATN/FI-12417-ES, ATN/KM-10650-ES, and ATN/SF-9888-ES, and loan 2269/OC-ES.

2.8 **Coordination with other donors.** Since the SDL instrument requires that an IMF program be approved and disbursing funds, ongoing coordination with the IMF Mission Chief for El Salvador was necessary to prepare this operation. The Bank is also coordinating actively with other donors to the Emergency, Recovery, and Economic Reconstruction Fund (FERRE), including the World Bank and the Central American Bank for Economic Integration (CABEI).[35]

2.9 **Complementarity with other Bank operations.** In addition to this SDL financing, on 8 April 2020 the Government of El Salvador requested the first of two programmatic policy-based loan (PBP) operations to assist with the COVID-19 emergency response and economic recovery measures. The first operation in the programmatic series, now in preparation, would contribute an additional US$250 million to finance short-term economic relief and health efforts. The second operation would support the implementation of a set of medium-term measures to strengthen fiscal management and debt sustainability, consistent with both the RFI Letter of Intent and the “Fiscal Strengthening for Inclusive Growth” programmatic series (see paragraph 2.3).

2.10 The Bank is also preparing a set of regional TC operations to assist countries in the post-pandemic economic and fiscal recovery. These TCs, each with a subregional focus, will help member countries leverage each other’s solutions, and will offer specific technical assistance to strengthen fiscal and institutional management. TC operation ATN/OC-17732-ES, now in execution, will support El Salvador’s Ministry of Finance in preparing an operational and legal proposal for a new property tax, in line with one of the IMF recommendations to restore fiscal sustainability (see Table 3). Additionally, a TC is planned to directly support efforts by El Salvador’s Ministry of Finance to establish institutional mechanisms aimed at enhancing the quality of public expenditure. All these TCs will contribute to the implementation of the commitments underlying this operation and fulfillment of the medium-term measures included in the policy matrix of the PBP in preparation (see paragraph 2.9).

2.11 **Strategic alignment.** The program is consistent with the Update to the Institutional Strategy (document AB-3190-2) and aligned with the crosscutting area of institutional capacity and rule of law through reduction of the fiscal deficit to achieve public debt sustainability. The program will also contribute to the Corporate Results Framework 2020-2023 (document GN-2727-12) by increasing tax revenue as a percentage of GDP. It is aligned with the public sector management and financing and macrofiscal management areas of the Sector Strategy: Institutions for Growth and Social Welfare (document GN-2587-2), and is consistent with the Fiscal Policy and Management Sector Framework Document (document GN-2831-9), which emphasizes the importance of institution-strengthening to improve the quality of public expenditure, as well as fiscal equity and social inclusion. As this program will help improve the primary fiscal balance, it is aligned with the IDB Country Strategy with El Salvador 2015-2019 (document GN-2828) through the priority area of strengthening public finance and the strategic objective of strengthening fiscal sustainability.

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[35] The primary forum for coordination is weekly meetings of representatives of the organizations involved, to monitor the emergency support, the Latin America approvals agenda, and portfolio programming.

A. Objectives, components, and cost

2.12 **Program objectives.** The general objective of the program is to support the government's efforts and actions to contain the COVID-19 health crisis with a view to restoring macroeconomic stability and fiscal sustainability. The specific objectives in the medium term are to: (i) reduce the fiscal deficit to achieve public debt sustainability; and (ii) maintain a competitive and transparent economy.

2.13 The program is aligned with the Rapid Financing Instrument (RFI) of the International Monetary Fund (IMF), approved on 14 April 2020. The SDL budgetary support will contribute to finance efforts to contain the health crisis, mitigate its impact on vulnerable households, and promote countercyclical policies to reduce its effect on the economy and mitigate the decline in fiscal revenues in the short term. The program is structured as a single operation to be disbursed in a single tranche.

2.14 In line with the IMF's RFI, the paragraphs below describe the specific commitments assumed by the Government of El Salvador under the components of the proposed program, as reflected in Policy Letter for this operation and the Letter of Intent to the IMF.

2.15 **Component 1: Reduce the fiscal deficit to achieve public debt sustainability.** (i) Implement a gradual fiscal adjustment of at least 3% of GDP over 2021-2024, to achieve a primary fiscal surplus of 3.5% by 2024 and put the debt-to-GDP ratio on a declining path to reach the target of 60% by 2030, complying with the Fiscal Responsibility Law; and (ii) abstain from adopting measures or policies that would deteriorate the public debt sustainability position.

2.16 **Component 2: Maintain a competitive and transparent economy.** (i) Analyze the public investment program and, if necessary, postpone lower-priority projects that to not address the post-pandemic recovery; (ii) strengthen competitiveness by improving the business environment, reduce public debt, combat corruption, and strengthen the financial supervision regulatory framework, as well as governance of frameworks for anti-money laundering and combating the financing of terrorism (AML/CFT); and (iii) comply with the provisions of the IMF Articles of Agreement that prohibit imposing restrictions on international payments, entering into multiple currency practices, or putting trade restrictions in place for balance of payments purposes.

B. Key results indicators and program beneficiaries

2.17 The expected impact is to contribute to incremental reduction of El Salvador's public debt until it reaches 60% of GDP by 2030. The main expected outcomes between 2020 and 2024 are: (i) an 8.1% of GDP improvement in the primary fiscal balance; (ii) a 7.4% of GDP reduction in the overall fiscal deficit; (iii) the 2019 Basel AML Index[36] score for money laundering risk remaining at 5.46 points; and (iv) a 0.3% of GDP increase in public investment.

[36] Measures the risk of money laundering taking place in a country.

2.18 The program will benefit:

a. The Government of El Salvador in two ways: (i) fast-disbursing resources to finance pandemic response and economic recovery actions through the FERRE; and (ii) a medium-term fiscal policy strategic framework for restoring fiscal sustainability.

b. The population at large, by financing programs to protect family and business incomes, improving the national health system's response to the pandemic, and, in the medium-term, promoting actions to preserve macroeconomic stability.

c. The private sector, by promoting measures to keep the economy competitive, open, and transparent, as well as generating the medium- and long-term benefits that come with macroeconomic stability for business planning and operation.

III. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

3.1 This Sustainable Development Lending (SDL) loan will be financed with the Bank's Ordinary Capital resources. However, it is not part of the Bank's regular lending program approved in the Long-term Financial Plan, so use of the Bank's enhanced lending capacity is proposed for financing this SDL. The operation has been prepared in coordination with the Rapid Financing Instrument (RFI) approved by the International Monetary Fund (IMF). The single-tranche structure and complementary financing arrangements with the IMF provide a flexible and effective mechanism for supporting the government's emergency measures to mitigate the health and economic impacts of the pandemic. The SDL resources will be disbursed to the government in a single tranche into the bank account designated for such purpose by the Ministry of Finance.

3.2 The amount of this program is US$250 million, in addition to the US$389 million from the RFI to be disbursed in 2020, which brings the total amount to US$639 million. The following were taken into account to determine the loan amount: (i) the size of the package of macroeconomic adjustment measures required to address the macroeconomic crisis; (ii) the US$389 million available from the IMF; and (iii) the fiscal and balance of payment shortfalls, the country's debt sustainability, and risk factors (see paragraph 3.3 of the SDL guidelines (document GN-2031-17). The program will help cover the additional financing needed by the country as a result of the pandemic, estimated at US$2 billion for the remainder of 2020, US$250 million of which will be provided by the Bank with the SDL loan.[37]

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[37] Additionally, as seen in Table 2, the World Bank has committed approximately US$220 million and the Central American Bank for Economic Integration (CABEI), US$50 million; plus, bonds will be issued on the international market.

B. Environmental and social safeguard risks

3.3 Under Directive B.13 of the IDB's Environment and Safeguards Compliance Policy (Operational Policy OP-703), no environmental impact classification is required because this is a budgetary support loan. No direct or significant adverse social or environmental impacts are foreseen.

C. Fiduciary risks

3.4 No fiduciary risks have been identified for this program. The proceeds will be disbursed directly into the account designated by the Ministry of Finance, which it will access to cover financing needs. The executing agency has the necessary financial management instruments and control systems for such purpose.

D. Other key risks and issues

3.5 **Macroeconomic and fiscal sustainability (high).** This operation is being prepared before the COVID-19 pandemic begins to abate, and there is no certainty as to how long the state of emergency will last. The projected costs of the pandemic used for the fiscal analysis are estimates that may vary significantly, if the pandemic lingers and it becomes necessary to continue providing direct subsidies to households, in addition to the impacts on the productive infrastructure and the resulting delay in the start of the economic recovery. If this scenario materializes, the Bank will offer technical assistance through its regional pandemic response TC operations (see paragraph 2.10), to identify additional measures for restoring fiscal sustainability while protecting the most vulnerable populations. This new Bank operation under the PBP modality will also complement and follow up on the implementation of the measures described in the RFI Letter of Intent.

3.6 **Public management and governance (high).** The IMF program calls for considerable fiscal adjustment measures equivalent to 3% of GDP over two years. Although the authorities have made a commitment via the RFI Letter of Intent, there are governance risks associated with the 2021 legislative elections and post-pandemic social demands that could jeopardize the reduction of expenditures, including rollback of the bonuses granted during the emergency for essential government employees. This risk will be partially mitigated with technical assistance from the Bank through its regional pandemic response TC operations (see paragraph 2.10) in priority areas for the fiscal adjustment and improvement of public expenditure. Moreover, regular social expenditure (not the additional spending generated by the pandemic response) is shielded by the government's decision to retain the clause protecting social spending from cutbacks in future budget laws.

IV. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

4.1 **Borrower and executing agency.** The borrower will be the Republic of El Salvador. The executing agency will be the Ministry of Finance, which will be responsible for: (i) providing evidence that the loan disbursement conditions agreed upon by the government and the Bank have been met; (ii) promoting measures to achieve the policy objectives set in the program; and (iii) compiling, maintaining, and providing to the Bank the necessary information, indicators, and parameters for monitoring and evaluation of the program outcomes.

4.2 **Commitments and disbursement of the loan proceeds. The sole disbursement of the loan proceeds will be made in accordance with the terms established in the Loan Contract to be signed between the borrower and the Bank, including the provision requiring that proceeds under the RFI financing arrangement approved by the IMF are being or have been disbursed. The Commitments Matrix (Annex II) identifies the commitments made by the Government of El Salvador and contained in its Letter of Intent to the IMF, dated 4 April 2020, which forms an integral part of the IMF report, Request for Purchase Under the Rapid Financing Instrument, approved by the IMF Executive Board. These commitments are also stated in the Policy Letter, dated 20 April 2020, and will be reflected in the abovementioned Loan Contract.**

4.3 The Bank financing will be disbursed to, and executed by, the Ministry of Finance, which will channel the proceeds through the Emergency, Recovery, and Economic Reconstruction Fund (FERRE), as appropriate for budget records. As described in paragraph 0 above, the expected expenditures from this fund are aligned with the areas of support envisaged for Sustainable Development Lending (SDL) operations in the respective operational guidelines (document GN-2031-17), particularly supporting new efforts to mitigate the impact of the crisis on poor and vulnerable segments of the population and facilitating access to credit for small and medium-sized enterprises.

B. Summary of arrangements for monitoring results

4.4 **Monitoring.** The borrower and the Bank will meet regularly to monitor the commitments described in the Commitments Matrix. The Bank will also maintain regular contact with the El Salvador IMF mission and take note of any IMF decision related to the RFI and any potential new arrangement with the country. The executing agency will compile and process all data necessary for program monitoring and evaluation. Consulting engagements to verify Results Matrix indicators and Commitments Matrix activities will be financed with IDB administrative funds.

4.5 **Evaluation.** After the close of fiscal year 2024, when the medium-term commitments reflected in the Results Matrix have concluded, the Bank will prepare an evaluation of the agreed indicators and respective targets for this operation, as input for an assessment of the SDL instrument's overall effectiveness.

4.6 **Policy Letter.** The Policy Letter of the Government of El Salvador, reaffirming its commitment to the macroeconomic framework policies agreed upon with the Bank, is aligned with the program's Commitments Matrix and Results Matrix.

RESULTS MATRIX

Objective: The general objective of the program is to support the government's efforts and actions to contain the COVID-19 health crisis with a view to restoring macroeconomic stability and fiscal sustainability. The specific objectives in the medium term are to: (i) reduce the fiscal deficit to achieve public debt sustainability; and (ii) maintain a competitive and transparent economy.

EXPECTED IMPACT

Indicators	Unit	Baseline 2020[1]	2022	2024	Target 2030	Means of verification
General objective: Restore macroeconomic and fiscal sustainability						
Total public debt does not exceed 60% of GDP by 2030	%	82.2	80.6	76.3	60.0	Ministry of Finance fiscal year-end reports for 2020 and 2022

EXPECTED OUTCOMES

Indicators	Unit	Baseline 2020[1]	2021	2022	2023	Target 2024	Means of verification
Specific objective 1: Reduce the fiscal deficit to achieve public debt sustainability							
Primary fiscal balance as a percentage of GDP	%	-4.5	0.2	1.9	3.2	3.6	Ministry of Finance fiscal year-end reports
Overall fiscal deficit as a percentage of GDP	%	-8.7	-4.1	-2.7	-1.5	-1.3	Ministry of Finance fiscal year-end reports
Specific objective 2: Maintain a competitive and transparent economy							
Basel AML Index score (anti-money laundering)	Score	5.46[2]	5.46	5.46	5.46	5.46	Basel Institute of Governance publication[3]
Total public investment as a percentage of GDP	%	3.3	3.5	3.5	3.5	3.6	Ministry of Finance fiscal year-end reports

1 The baseline is the year-end 2020 estimated outcome found in the IMF's RFI macroeconomic framework. For evaluation purposes, this value will be updated once final official figures are available.

2 The baseline for this indicator is the 2019 AML Index score. It will be updated with the 2020 score, when available, for evaluation purposes. In any event, the objective is to maintain a stable risk level over the review period.

3 Available at Basel Institute on Governance.

COMMITMENTS MATRIX[1]

Objective: The general objective of the program is to support the government's efforts and actions to contain the COVID-19 health crisis with a view to restoring macroeconomic stability and fiscal sustainability. The specific objectives in the medium term are to: (i) reduce the fiscal deficit to achieve public debt sustainability; and (ii) maintain a competitive and transparent economy.

Objective of the areas of action	Commitments
Reduce the fiscal deficit to achieve public debt sustainability	I. Implement a gradual fiscal adjustment of at least 3% of GDP over 2021-2024, to achieve a primary fiscal balance of 3.5% by 2024 and put the debt to GDP ratio on a declining path to reach the target of 60% by 2030, complying with the Fiscal Responsibility Law.
	II. Abstain from adopting measures or policies that would deteriorate the public debt sustainability position.
Maintain a competitive and transparent economy	I. Analyze the public investment program and, if necessary, postpone lower priority projects that to not address the post-pandemic recovery.
	II. Strengthen competitiveness by improving the business environment, reduce public debt, combat corruption, and strengthen the financial supervision regulatory framework, as well as governance of frameworks for anti-money laundering and combating the financing of terrorism.
	III. Comply with the provisions of the IMF Articles of Agreement that prohibit imposing restrictions on international payments, entering into multiple currency practices, or putting trade restrictions in place for balance of payments purposes.

[1] The commitments identified in this matrix are those adopted by the Government of El Salvador and contained in its Letter of Intent to the IMF, dated 4 April 2020. That letter is appended to the IMF report, Request for Purchase Under the Rapid Financing Instrument, approved by the IMF Executive Board on 14 April 2020.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/20

El Salvador. Loan _____/OC-ES to the Republic of El Salvador
Emergency Program for Macroeconomic
and Fiscal Sustainability

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of El Salvador, as Borrower, for the purpose of granting it a financing to cooperate in the execution of the "Emergency Program for Macroeconomic and Fiscal Sustainability". Such financing will be for the amount of up to US$250,000,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on _________2020)

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