DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

EL SALVADOR

COMPETITIVENESS SUPPORT LOAN

(ES-0151)

LOAN PROPOSAL

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ANNEXES

BASIC SOCIOECONOMIC DATA

The basic socioeconomic data for El Salvador available on the Internet at the following address:

www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata

Information available in the files of RE2/FI2

Preparation:

GAMA: Misión de Apoyo en Políticas de Formación para el Empleo, Innovación y Desarrollo Tecnológico, Junio, 2003

Larrain, Felipe: El Salvador: ¿Cómo Volver a Crecer?, 2003

World Economic Forum: various documents

Execution:

ABBREVIATIONS

FDI	Foreign Direct Investments
ACSA	*Agencia Centroamericana para la Seguridad Aérea*
AMP	Maritime and Ports Authority
ANEP	National Association of Private Enterprises
CAA	Civil Aviation Authority
CEPA	Autonomous Executive Ports Commission
CESI	Committee on Environmental and Social Impact
CONACYT	*Consejo Nacional de Ciencia y Tecnología*
DGTM	*Dirección General de Transporte Marítimo*
ENADE	*Encuentro Nacional de la Empresa Privada*
FEPADE	*Fundación Empresarial para el Desarrollo Educativo*
FOMEX	Export Promotion Program
FTA	Free Trade Agreements
FTAA	Free Trade Area of the Americas
FUSADES	Salvadoran Foundation for Economic and Social Development
GDP	Gross Domestic Product
GOES	Government of El Salvador
INSAFORP	The Salvadoran Institute for Profession Formation
ITCA	Central American Technological Institute
LIM	Monetary Integration Law
LOAC	Statutory Civil Aviation Lay
MARN	Environment and Natural Resources
MOPTVDU	Ministry of Public Works, Transport, Housing and Urban Development
ONI	National Investment Office
PROEXPORT	Export Promotion Agency
SIC	Competitiveness Information System
SPNF	Non financial public sector
STP	Technical Secretariat of the Presidency
WEF	The World Economic Forum
WTO	World Trade Organization

Inter-American Development Bank
Regional Operations Support Office
Operational Information Unit

El Salvador

Tentative Lending Program

2003

Project Number	Project Name	IDB US$ Millions	Status
ES0151	Sector Program for Competitiveness Reforms	100.0	
*ES0163	Banco de Comercio Backed Security	20.0	
	Total - A : 2 Projects	**120.0**	
*ES0161	Oceanic Digital Communications of El Salvador	24.5	
	Total - B : 1 Projects	**24.5**	
	TOTAL 2003 : 3 Projects	**144.5**	

2004

Project Number	Project Name	IDB US$ Millions	Status
ES0154	Urban Transport Integrated System	10.0	
ES0125	Modernization of Financial Sector Program	100.0	
	Total - A : 2 Projects	**110.0**	
ES0133	Lower Lempa River Integral Solution Mngt	8.0	
	Total - B : 1 Projects	**8.0**	
	TOTAL - 2004 : 3 Projects	**118.0**	
	Total Private Sector 2003 - 2004	**44.5**	
	Total Regular Program 2003 - 2004	**218.0**	

*** Private Sector Project**

EL SALVADOR

IDB LOANS

APPROVED AS OF AUGUST 31, 2003

	US$Thousand	Percent
TOTAL APPROVED	**2,915,660**	
DISBURSED	2,431,222	83.38 %
UNDISBURSED BALANCE	484,438	16.61 %
CANCELATIONS	199,237	6.83 %
PRINCIPAL COLLECTED	825,849	28.32 %
APPROVED BY FUND		
ORDINARY CAPITAL	2,020,122	69.28 %
FUND FOR SPECIAL OPERATIONS	748,606	25.67 %
OTHER FUNDS	146,933	5.03 %
OUSTANDING DEBT BALANCE	**1,605,373**	
ORDINARY CAPITAL	1,083,254	67.47 %
FUND FOR SPECIAL OPERATIONS	514,668	32.05 %
OTHER FUNDS	7,451	0.46 %
APPROVED BY SECTOR		
AGRICULTURE AND FISHERY	200,839	6.88 %
INDUSTRY, TOURISM, SCIENCE AND TECHNOLOGY	136,882	4.69 %
ENERGY	504,466	17.30 %
TRANSPORTATION AND COMMUNICATIONS	488,911	16.76 %
EDUCATION	207,064	7.10 %
HEALTH AND SANITATION	354,234	12.14 %
ENVIRONMENT	73,792	2.53 %
URBAN DEVELOPMENT	101,208	3.47 %
SOCIAL INVESTMENT AND MICROENTERPRISE	341,786	11.72 %
REFORM AND PUBLIC SECTOR MODERNIZATION	266,574	9.14 %
EXPORT FINANCING	79,823	2.73 %
PREINVESTMENT AND OTHER	160,081	5.49 %

* Net of cancellations with monetary adjustments and export financing loan collections.

EL SALVADOR

STATUS OF LOANS IN EXECUTION

AS OF AUGUST 31, 2003

(Amount in US$ thousands)

APPROVAL PERIOD	NUMBER OF PROYECTS	AMOUNT APPROVED*	AMOUNT DISBURSED	% DISBURSED
<u>REGULAR PROGRAM</u>				
Before 1997	8	508,733	490,924	96.50 %
1997 - 1998	6	242,157	126,829	52.37 %
1999 - 2000	3	37,110	2,303	6.21 %
2001 - 2002	9	349,273	39,026	11.17 %
TOTAL	26	$1,137,273	$659,082	57.95 %

* Net of cancellations. Excludes export financing loans.

COMPETITIVENESS SUPPORT LOAN

(ES-0151)

EXECUTIVE SUMMARY

Borrower and guarantor:	Republic of El Salvador		
Executing agency:	Technical Secretariat of the Presidency of the Republic		
Amount and source:	IDB: (OC)	US$	100.0 million
	OC/FFI	US$	77.9 million
	OC	US$	22.1 million
	Total:	US$	100.0 million
Financial terms and conditions:	Amortization Period:		25 years
	Grace Period:		5 years
	Disbursement Period:	minimum	18 months
		maximum	24 months
	Interest Rate:	variable	
	Supervision and Inspection:	1	%
	Credit Fee:	0.75	%
	Currency:	US-Dollar, Single Currency Facility	

Objectives: The objective of the proposed operation is to support the Government of El Salvador to implement measures aimed at facilitating increased competitiveness of the country's businesses through enhanced factor productivity and access to markets, within a framework of maintain economic stability and sustainable growth. To achieve its objective the operation has established specific policy and reform conditions in defined sectors, against which implementation fast disbursing resources for fiscal and balance of payment application would be disbursed.

Description: The operation has been structured as a Policy Based Loan (the Loan) of US$100 million, with four disbursements: the first in form of a "fixed" tranche disbursement of up to US$40 million, followed by three "floating" tranche disbursements of US$20 million each. *First tranche disbursement would become effective upon approval of the operation by the Bank's Board*, pursuant to compliance with established conditions. The proposed front-loading of the disbursements would recognize the substantial efforts already undertaken by GOES in economic reform and in improving the competitiveness environment of the country, as well as specific advances achieved in the outlined reform areas.

Floating tranche disbursements would become effective pursuant to compliance with established specific disbursement conditions. However, disbursement of final resources of the proposed operation, i.e. the last tranche, will not take place prior to eighteen (18) months following loan effectiveness according to established Bank policy.

Bank's country and sector strategy:

The proposed operation would plainly be centered within the Bank's Country Strategy with El Salvador for 2000 - 2003, as approved in January, 2001[1] and up-dated in May, 2002. The strategy outlines ten key components, including (i) fiscal consolidation, (ii) greater productivity and competitiveness of strategic sectors, (iii) increased private sector participation, (iv) strengthening of human capital, and (v) modernization of the State, which it groups within three interrelated lines of action: (i) reactivation of economic growth, stability and competitiveness, (ii) poverty reduction and strengthening of human capital, and (iii) modernization of the state and enhancement of governance. The proposed operation would make a contribution in the first line of action and would be expected to have to a various degree long term beneficial effects on the second and third.

Coordination with other Multilateral Development Institutions:

Based on substantial analytical work carried out in the mid 1990s[2], the World Bank, in September, 1995, approved a technical cooperation loan of US$16 million, aimed at improving competitiveness. The operation's principal objectives was to support GOES in facilitating accelerated the development and productivity of the private sector, specifically export oriented companies, and encouraging increased foreign direct investments. Project activities were developed in ten distinct thematic areas, such as: investment promotion, export promotion, cluster development, private – public sector cooperation and dialogue, property registries and company registration (par. 1.33).

Environmental/ social review:

The proposed operation has no direct negative environmental or social impact, given its nature as a Policy Based loan in support of Government reform and policy initiatives to enhance the country's competitiveness. Moreover, the indirect impacts of the measures to be implemented under the operation are judged to be environmentally and socially neutral or positive. International competitiveness in general and an increasing number of trade agreements in particular do increasingly factor in environmental and social aspects and exert positive pressure to prevent or remedy sub standard situations. Moreover, economic evidence and thinking increasingly points to the fact that degrading environmental and

[1] GN-2121-3

[2] El Salvador Meeting the Challenge of Globalization, Report No. 14109-ES, October 13, 1995

social conditions is only of very limited use in reaching sustainable improvement in competitiveness. The positive impact of external pressure is further aided by current legislation and regulation for example in the area of environmental protection, which is deemed appropriate to contain and reduce negative environmental impacts of business activities. The Committee on Environmental and Social Impact (CESI) approved the operation September 18, 2003, without objections.

Benefits: The proposed operation would support the Government of El Salvador in further enhancing and deepening the process of reforms and policy actions initiated in the early 1990's and aimed at creating and strengthening conditions for competitiveness of the country's businesses. The measures contemplated in the proposed operation would complement those earlier reforms and enhance their effectiveness and sustainability by addressing specific micro economic competitiveness constraints, which affect, inter alia, production, resources and market access costs, factor productivity and equality in participation in domestic markets. Diversification of exports, reduction of external imbalances and strengthening of the economies aggregate liquidity would further enhance the economy's capacity to withstand external shocks. Furthermore, sustainable increased competitiveness of businesses in El Salvador could lead to the generation of higher value employment and income, thereby contributing to a potential reduction in the country's social inequalities and poverty indicators.

Risks: The proposed operation does not face significant operational risks, in light of the proven capacity of the designated Executing Agency and its position within GOES organizational structure. However, the operation and successful implementation of agreed measures could face macro economic and political risks. Regarding the former, the principal risks would derive from a potential increase in domestic and external imbalances. Specifically, different projections point to the need to further strengthen the fiscal position, in order to alleviate increasing pressure on debt sustainability, which could weaken competitiveness. Deteriorating internal and external balances could not only affect the short term competitiveness of the country, but ultimately jeopardize the sustainability of the monetary regime and therefore long term competitiveness and growth prospects. Macro economic risks are mitigated by the current and prior administration's track record of policy and management, specifically with regard to fiscal prudence shown since the early 1990's and recent action taken by the Government to contain spending pressures. Moreover, the resources from the proposed operation would also contribute to cushion fiscal pressure in the short term.

	The second risk is derived from and associated with the democratic processes and the need to achieve consensus regarding the approval of the operation and implementation of the reform initiatives and policy measures contemplated. Those processes, needed for the successful implementation of measures and their sustainability in the longer term, could contribute to "politicize" the technical debate and result in delays in the implementation of proposed measures. All the more so, given that the disbursement period of the proposed operation transcends the electoral cycle of the executive branch. However, the shown commitment of all Governments and society since the early 1990's to advance needed reforms, despite equally challenging political circumstances, provide a measure of comfort regarding the operation's potential political risks.
Special contractual clauses:	Disbursements under each tranche of the program will be conditioned on the fulfillment of the policy action outlined in Chapter III, paragraphs 3.5 through 3.18 and summarized in the Policy Matrix (Annex I)
Poverty-targeting and social sector classification:	The operation does not qualify as a social-equity enhancing project, as described on the indicative targets mandated by the Bank's Eights Replenishment (document AB-1704), in light that it does not directly benefit any of the indicated target groups or economic sectors (par. 4.21).
Exceptions to Bank policy:	None
Procurement:	Not applicable

I. BACKGROUND

A. Introduction

1.1 The Government of El Salvador (GOES) has requested the Bank's support to strengthen macro economic stability and to implement additional macro and micro economic reforms in support of attaining higher sustained growth rates over the medium term. The proposed operation would provide resources toward short term fiscal strengthening, while at the same time supporting policy measures to enhance the country's productive sectors competitiveness through a reduction in businesses' costs and an increase in factor productivity.[3]

1.2 The operation acknowledges current academic and pragmatic debate over the degree of causality between specific policy interventions and increased competitiveness. Nevertheless, the program's guiding premise is that in an open – globalized – economy firms' competitiveness are closely related to their costs of placing goods and services in any given market. Therefore, reducing the costs to access current and new markets and enhancing factor productivity, through policy interventions and corresponding changes in the incentives structures for economic agents, would constitutes a valid approach to achieving the desired goal of increased competitiveness. This relative-costs based approach is all the more important, in light of likely diminishing traditional trade preferences, such as those associated with special trade regimes or the establishment of tax exempted production zones, in the framework of additional Free Trade Agreements (FTA).

B. Context and rational of the Program

1.3 Since 1989, following the conclusion of the civil war[4], El Salvador initiated a process of economic stabilization, structural adjustment and liberalization, aimed at reversing the negative growth trends of the prior decade and establishing conditions for sustained per capita growth going forward. Policy reforms focused on the reduction of domestic and external disequilibria, divestment of state assets and diminishing the role of the public sector in directly supplying goods and services, as well as the removal of domestic and external market access constraints and trade barriers. Whereas the macro initiatives and reforms followed a fairly traditional approach, beginning in the early 1990's, Government of El Salvador (GOES) incorporated "competitiveness", as a central, overarching theme of economic policy. Consequently, over time "macro" reforms have increasingly been embedded in a conceptual vision of enhancing competitiveness and have

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[3] The concept of "competitiveness" can be broadly defined as "a set of institutions and economic policies supportive of sustainable high rates of growth, through enhanced factor productivity", yet recognizing a wide variety of interpretation and definitions of the very idea. For a discussion of the theoretical background and measuring methodology see: The World Economic Forum – Global Competitiveness Report. Furthermore, see IDB, Competitiveness: The Business of Growth – Economic and Social Progress in Latin America, 2001 Report; and a host of other authors on the subject, including Michael Porter.

[4] The peace agreements were formally signed in 1992.

been complemented by specific "micro" policies and interventions to improve markets' functioning, facilitate investments and enhance the business climate. Policy initiatives were accompanied by an emphasis to strengthen regional integration and access to markets, through customs accords and FTA with all major trading partner*s.*

1.4 ***Recent economic performance.*** Policies adopted have allowed for positive results over the last decade, with resumption of growth, improvement in the fiscal situation, increased price stability and expansion of foreign trade.[5] This strong economic track record and positive comparable performance during that period was recognized by the international capital markets and rating agencies, as evidenced by the sovereign bond rating, as well as the development of the yield curve and spread differential. In April of 1997 El Salvador received a "BB+" long-term and "B" short-term sovereign rating, which was confirmed in subsequent revisions.[6]

1.5 However, significant challenges remain in consolidating the macro economic achievements of the 1990's, especially in light of potentially growing domestic and external imbalances, as well as the slow growth perspectives. Those challenges and concerns were equally recognized by the international capital markets through the rating outlook adjustment at the end of the first quarter of 2003 to a "negative" view. More recently Moody's Investors Service announced a rating review opening the possibility for an official downgrading of the countries rating.

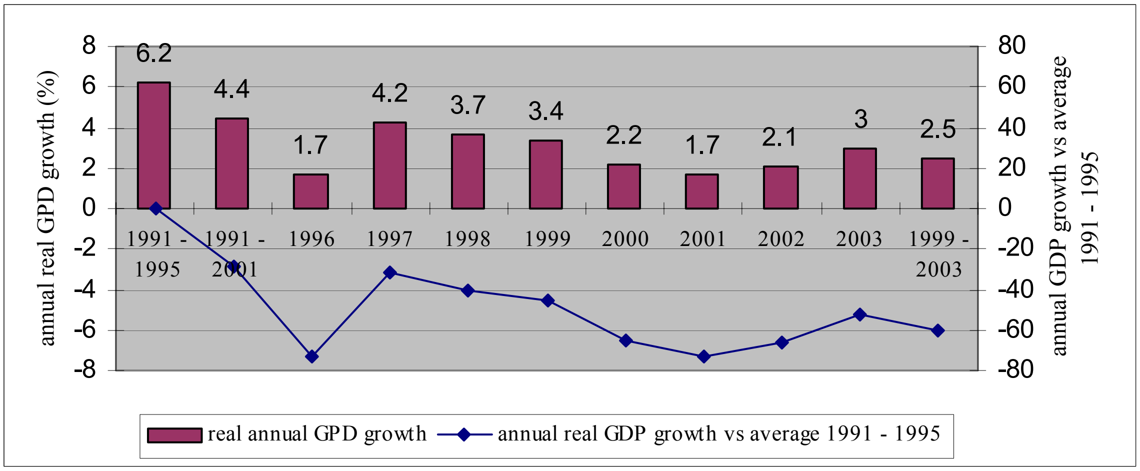
1.6 Whereas during the 1980's the rate of real Gross Domestic Product (GDP) growth was negative, during the following decade GDP growth averaged 5.1% annually; although beginning at mid decade growth rates decelerated and have remained comparatively depressed ever since. GDP performance over the observed period could indicate that early growth rates rather reflected gains from an initial "peace dividend", i.e. the positive effect of the end of the war on aggregate consumption and investment, as well as the positive impact from stabilization and economic reform efforts, then be all the result of structural improvements in El Salvador's underlying growth potential. Correspondingly, the deceleration of growth during the second part of the decade could be indicative to some extend of a return to a more moderate trend rate. The later, however, is assumed to be determined to a substantial degree by the competitiveness of the country's firms, notwithstanding the potential transitory impact of external events.

[5] Inflation rates diminished from 14% early in the decade to low single digits at the end and during the following years. Foreign trade expanded significantly, with export volume increasing more than threefold to US$2,992 million in 2002. However, imports saw equal strong growth and the trade balance remained substantially negative over the period reaching US$2,198 million in 2002. Remittances of close to US$2,000 million partially off-set the trade deficit

For a more comprehensive discussion of past, current and expected economic trends see, for example, El Salvador - Economic Situation and Perspectives (SEP) Report, last up-dated October, 2002 (at: http://re2.iadb.org/nfp/seps.htm), and Economic Situation and Prospects: The World Economy and the Countries of Region II, May, 2003 (at: http://re2.iadb.org/documents/overview_sep_eng.pdf).

[6] Standard & Poor's; BB+ represents the highest rating below investment grade. Only four countries in the region had an equal or better rating at this time: Chile, Barbados, A-; Mexico, Trinidad & Tobago, BBB-

Graphic 1.1: **El Salvador – Annual GDP Growth 1996 – 2003**
(average 1991 – 1995 = 100)



1.7 As can be observed in Graphic 1.1 after already experiencing slowing growth in the years until 2000, El Salvador's economy recently further decelerated. During 2001 GDP growth fell short of 2% and in 2002 it reached 2.3%, contributing in both years to continued stagnation of GDP per capita growth. With regard to 2003, early GOES estimates point to a GDP growth of 3%. The economic performance reflects continued adversity in external trade, specifically marked divergence in the price of major export (coffee) and import (oil and derivates) commodities and decreased demand in its major trading partner the United States, as well as the effects of the earthquakes during the first quarter of 2001. The direct damage of the latter was estimated at 12% of GDP and additional fiscal costs for reconstruction are projected at about 1.5% of GDP over the five year period beginning in 2001.

1.8 In addition to the growth challenge, GOES will need to address the potential risk of growing domestic and external imbalances, without been able to resort to monetary or exchange rate policy instruments in the wake of the implementation of the Monetary Integration Law (see below). With regard to the fiscal deficit the macroeconomic stability course pursued by successive governments over the last decade allowed for its reduction from about 5% of GDP early in the last decade to around 3% by its end. Following the earthquakes and in light of unfavourable external conditions, deficits rebounded in 2001 and 2002, reaching 4.4% of GDP, in both years, with the primary deficit more than doubling from 1.4% of GDP in 2000 to 2.9% of GDP the following two years. Excluding earthquake related reconstruction costs and pension liabilities the overall deficit was contained at 2.3% and 1.4%, respectively, principally as a result of a significant reduction in current expenditures and stagnating economic and social investments[7], as well as efforts to expand the tax revenues by expanding the tax base and increasing

[7] Current expenditures were reduced from 16.3% of GDP in 2000 to 14.6% in 2001 and 2002, whereas economic and social investments equaled around 3% of GDP in 2000 and 2001 and 2.3% in 2002.

collection efficiency. Tax revenues as percentage of GDP increased from approximately 11% in 2000 to 11.9% in 2002.

1.9 For 2003 the overall deficit, including pension costs and reconstruction, is anticipated at 3.9%[8], largely accounted for by continued contraction of current expenditures and a low level of non reconstruction investments, as well as additional efforts to increase tax revenues. The primary deficit is estimated ar close to 2% of GDP. However, the improvement in the fiscal position is predicated on economic growth of 3% and, considering the tenuous tax base[9], any deterioration in private demand – and lower growth - could derail the projected deficit reduction. Baring additional adjustment measures or external shocks current projections beyond 2003 anticipate comparable deficit levels. Benefits from declining reconstruction spending and increased tax collection will likely be off-set by growing pension costs and the fiscal effects of some recently enacted stimulus measures. In consequence, Government financing needs will remain substantial and show an increasing tendency (see below). To revert this situation, the required fiscal adjustment is estimated at between 2% and 3% of GDP.

1.10 To address the challenge of fiscal sustainability GOES has reiterated its commitment to fiscal restrain, containing as needed current expenditures and investment outlays. Furthermore, the declining need for reconstruction spending should provide some relieve of fiscal pressure. With regard to revenue enhancing measures, GOES anticipates further improvements in the effective tax burden of the economy through strengthened tax collection and the broadening of the tax base through accelerated growth in the wake of the Free Trade Agreements, especially with the United States of America. However, whether those measures would be sufficient to achieve the targeted fiscal adjustment is a matter of debate.

1.11 The fiscal deficit is financed principally through debt financing, especially external funding, which contribution doubled from US$638.6 million in 2001 to US$1,235.5 million in 2002. As a result, non financial public sector (SPNF) debt has seen an increase in 2002, after having been held fairly stable in 2001. At the end of 2001 total SPNF debt equalled roughly 34% of GDP, with 68% of it - equivalent to about 23% of GDP - corresponding to external obligations. By the end of 2002, external public debt had risen to 33% of GDP, and total SPNF debt reached US$5,582.0 million, equivalent to 38.8% of GDP. By the end of December 2002, total debt services exceeded US$1,562 million, with interest payments in that year amounting to about US$245 million, or approximately 13% of SPNF revenues, excluding capital gains, donations and social security contributions. For 2003 a further increase in public debt, mainly external, is expected in light of the continued reconstruction requirements, with total SPNF debt reaching 39.5% of GDP.

[8] Recent revision point to an increase in the NFPS deficit from 1.6% of GDP to 2.5% of GDP. Baring further contraction on the spending side this would result in a larger than anticipated overall deficit.

[9] As noted tax recipes as percentage of GDP have increased over the last three years to close to 12%, but still compare to 14% on average for Latin America and 37% on average for OECD countries.

1.12 Although at present the level of interest payment obligations still allows for a very limited primary fiscal deficit, debt services capacity could become a cause for concern: Total debt service in 2002 equalled 85% of normalized SPNF revenue, indicating the constraints faced by GOES for debt reduction. It is in this context that during 2002 Government began a process of addressing the debt sustainability issue through a proactive restructuring process, which aims at reducing interest costs and extending tenors. On various occasions GOES tapped into the international bond markets, with issuances of combined US$1,251 million. Maturities and yields varied between 9 years and 7.442% and 30 years and 8.374%.[10] Bank financing, as proposed in the present operation, would constitute an important element in further pursuing this strategy, complementing access to private sector capital and supporting to maintain a favourable credit rating.

1.13 However, under most growth scenarios debt restructuring efforts will need to be accompanied by fiscal adjustments of a substantial magnitude to revert the trend for growing public debt. If no adjustments are implemented and assuming growth will recover to about 3.5%, SPNF debt to GDP could increase to well in excess of 50% by decade's end, with a persistent primary deficit of close to 1% of GDP during the whole period. Annual gross financing needs would be in the order of US$1.8 billion or 8% of GDP by 2010. Alternatively, with an estimated fiscal adjustment equivalent to 3% of GDP growth trends in SPNF debt could be reversed and total debt to GDP ratio would decline to around 34% at decade's end and a primary surplus of approximately 1.5% of GDP could be achieved.

Table 1.1: **Macro economic data and indicators 1999 – 2003**

	1999	**2000**	**2001**	**2002**	**2003***
GDP (% growth rate	3.4	2.2	1.7	2.1	3.0
GDP/per capita (US$)	2,025	2,094	2,148	2,186	2,225
Inflation (IPC, var. %)	- 1.0	4.3	1.4	2.8	2.5
Non financial public sector Deficit (% PIB) 1/	- 2.8	- 3.0	- 3.7	- 3.3	- 2.5
Current Account Deficit (%PIB)	- 2.2	- 3.2	- 2.0	- 3.0	- 3.0
External Public Debt (% GDP)	22.4	21.5	22.9	28.1	30.4
Interest payments / Revenues (%)	10.9	12.2	11.5	13.1	n.a.

* Projected
1/ does not include costs of pension obligations, estimated between 0.7% and 1.4% of GDP for 2001, 2002 and 2003

1.14 ***Competitiveness – a decade of initiatives.*** As noted above, since the end of the 1980's, El Salvador's successive Governments[11] have defined "*competitiveness*" as an objective of economic policy, specifically in the design of sector and

[10] In December 2001, the National Assembly approved new foreign borrowing of US$1,250 million; US$800 million for debt management by substituting favorable external borrowing for domestic obligations, and US$450 million for budget financing. In April 2002, GOES placed US$500 million of 30 year eurobonds with an 8.25% coupon, exceeding the original scheduled allocation of US$350 million in light of substantial over subscription of the emission.
[11] A. Cristiani 06/1989 – 05/1994; A. Calderon Sol 06/1994 – 05/1999; F. Flores 06/1999 – 05/2004

liberalization policies. Over the decade, efforts on the structural – macro – level were increasingly accompanied by specific policy interventions in the markets' function and institutions to foster competitiveness; the first of which were adopted during the Government of A. Cristiani. Measures focused on export promotion, facilitating Foreign Direct Investments (FDI) and the development of Free Trade Zones, improving the investment and business climate, as well as reduction of "red tape" in the economy. Moreover, in the context of efforts to modernize the state, reduce fiscal deficits and improve service delivery Government moved to re-privatize the banking system and privatize a number of state owned companies which did not provide strictly public services. Also the groundwork was developed for the later privatization of public infrastructure services, with the development of proposals for the legal framework and the design of implementation mechanism.

1.15 The subsequent administration of A. Calderon Sol pursued the policy of structural reforms and liberalization, further opening the economy to foreign investments and expanding trade integration efforts, as well as the promotion of export activities through the Export Promotion Program (*Program de Fomento de Exportaciones* - FOMEX). Moreover, during that administration, GOES develops and launches the country's National Modernization of the State Program, as an integrated effort of specific policy actions and measures aimed at fostering efficiency of public sector functions and enhancing the economy's competitiveness. Issues to be addressed include: (i) quality and efficiency of public services and Government, (ii) quality of infrastructure services, (iii) public safety and (iv) access to capital. In the framework of the Program, GOES advances the privatization of services in the telecommunication and energy sector, as well as pension provision. Furthermore, specific initiatives are implanted to (i) deregulate investments and create transparent regulation, (ii) provide new business services, including "one-stop-shop" investment services, (iii) set-up a promotion and investment agency, and (iv) foster development initiatives based around "sector cluster" of businesses.[12]

1.16 El Salvador's current Government of President F. Flores, which assumed office in June 1999, has deepened and expanded the reform and modernization efforts of its predecessors, moving competitiveness even more to the center of attention of economic policy. Access to and communication with markets became the *Leitmotiv* for GOES policy, determining "competitiveness decisions" in a broad array of sector interventions, as well as specific policy and support initiatives. Trade policy[13], infrastructure development as well as business services and export promotion initiatives are examples of the implementation of this focus. Moreover,

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[12] Various of the initiatives undertaken by GOES were supported by the Bank, as well as the World Bank, through lending and technical cooperation operations. In the area of fostering competitiveness, a number of the "micro" initiatives were supported by the World Bank in the framework of a "competitiveness" technical cooperation loan approved in 1995. This loan is currently completing execution (see Chapter II.E)

[13] Trade initiatives include the Caribbean Basin Initiative, the Treaty for Latin American Integration and Customs Harmonization, Free Trade Agreements (FTA) with Chile, Dominican Republic, Mexico and Panama, and the framework agreement for a Customs Union with Guatemala, Panama and Honduras. Moreover, FTA negotiations with Canada are advanced and with the US are initiated.

efforts were stepped-up to consolidate and expand competitiveness and modernization initiatives embarked during the two previous administrations, some of which have been accompanied by Bank operations and further action would be supported by the proposed operation (see Chapter III). Initiatives include (i) pursuance of the privatization process in public utilities sectors, (ii) advances in the modernization of the seaport administration (Acajutla), and (iii) establishment of an innovative financing and administration scheme for the roads infrastructure. Moreover, (iv) legislation has been drafted to provide for additional private provision of infrastructure services and enhanced market regulation of the various infrastructure services sectors, and GOES has (v) progressed in the modernization of the state, particularly the Ministry of Public Works, as well as (vi) embarked on the modernization of the legal environment for investments and business. Some planned and proposed measures, however, did not receive required legislative approval, including for example labour market reforms and further private participation in infrastructure provision.

1.17 As during prior administrations, GOES complemented the "macro" reforms geared toward competitiveness with the implementation of specific "micro" interventions to foster the supply of business support services, enhance the investment climate and facilitate the creation and registration of businesses, with an emphasis on supporting small and medium size enterprises. Specific initiatives are: creation of the National Investment Office (*Oficina Nacional de Inversiones* – ONI), and the Export Promotion Agency (*Agencia de Promoción de Exportaciones* – PROEXPORT), both of which provide "one-stop windows" services for investors and businesses; strengthening of investors' and business' market information services through the Trade Points and InfoCentros programs, as well as the Competitiveness Information System (*Sistema de Inteligencia Competitiva* – SIC); and special small and medium enterprise promotion, linkages and market information services in the framework of the CENTROMYPE program.

1.18 ***Monetary Integration Law – a boost to stability and competitiveness.*** Arguably, the introduction of the Monetary Integration Law (*Ley de Integración Monetaria* – LIM), in January of 2001, constitutes a central and most visible element of GOES economic policy implementation and provides an opportunity for a major step forward in long term stability and increased competitiveness. The LIM establishes the US-Dollar (US$) as legal tender in parallel to the domestic *Colón*, at a fixed exchange rate of US$1 : 8.75 Colones. With the implementation of the law, the US$ became the mandatory Unit of Account for the financial sector, its introduction as currency in circulation, however, will be subject to the replacement rate of the *Colón* currency stock by the Central Bank. At the end of 2001 approximately 50% of the initial *Colón* currency stock was replaced by US$ currency stock. Moreover, 85% of all companies surveyed by FUSADES reported a significant majority of transactions in US$ at the end of 2001. By the end of 2002 the process of full dollarization was essentially completed with almost 90% of currency in circulation denominated in US-Dollar.

1.19 The introduction of the LIM, which caps a decade of economic stability, structural adjustment and liberalization efforts, not only represents a significant shift of the economic model, with substantial opportunities and challenges, but also markedly changes the competitive environment of the Salvadoran economy. By constraining domestic independent monetary policy - and thereby implicitly reducing the discretion of fiscal policy - the introduction of the LIM would signal to the markets a willingness to pursue a sustained stable economic policy in the future. Combined with the elimination of the US-Dollar currency risk, the "signaling" could facilitate domestic investments and Foreign Direct Investments (FDI) through increased access to capital, as well as investment of domestic assets abroad, while also eliminating exchange rate induced trade advantages and disincentives. Even as those benefits will materialize only over time, already in the short term, the elimination of exchange rate risks has contributed to a substantial reduction of domestic interest rates: between January 2000 and end of 2001 the average borrowing rate was almost halved from 15.2% to 7.8%, falling further, albeit much slower, to around 6.7% by the end of 2002.[14] In addition, longer term financing has become more readily available.[15]

1.20 However, while the introduction of the LIM would provide important disciplining incentives for future economic policy and has already in the short term generated some substantial benefits, its ultimate success and sustainability will depend in large measure on further reducing and preempting structural economic imbalances and increasing the economy's capacity to absorb external shocks. In fact, "dollarization", by eliminating the potential for monetary or exchange rate policies, places the *onus* for adjustments and macro economic stability squarely on fiscal policy and the competitive capacity of El Salvadoran firms engaged in a global market.

1.21 ***Economic stability and competitiveness – challenges.*** While the achievements of successive Governments in reforming and stabilizing the economy are undeniably, as pointed out substantial challenges to insure and maintain macro economic sustainability, as well as the resumption of growth remain. The key vulnerability for the economy lies in the prospect of continued substantial fiscal deficits and a corresponding high public sector financing requirements and increasing public debt. Concerns about fiscal and public debt sustainability could translate into an erosion of confidence in the investment climate and affect business competitiveness, thus undermine future growth.[16]

1.22 It is in this context, that increasing the country's competitiveness, i.e. the aggregate competitiveness of firms established in El Salvador, will be an essential

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[14] Depressed domestic private sector credit demand, which showed significant contraction in real terms in most of 2001 and 2002, aided that process.

[15] Not surprisingly "ease of access to credit" indicators have improved and are generally better than in comparable countries; see World Economic Forum. However, as noted earlier financial sector conditions still could affect El Salvador's competitiveness and are expected to be addressed in a separate operation.

[16] A further deteriorating domestic and external balance could also set the stage for a crisis of confidence in the financial sector, with additional potential repercussions for GOES fiscal position and the competitive environment of the country. Financial Sector reform and stabilization issues are anticipated to be addressed in a separate Policy Based Lending operation scheduled for 2004.

element to facilitate sustainability of the economic model, in addition to required fiscal adjustments. Albeit efforts have been made over the last decade to create conditions to strengthen the country's competitive potential, deteriorating Terms of Trade and ever increasing trade balance deficits indicate stagnating or even declining competitiveness. This line of reasoning is supported by different recent theoretical and empirical works on the development of productivity and costs in El Salvador and their comparison to other countries.[17] For example, one recent study concludes that labor productivity has essentially stagnated since the middle of the 1990's, whereas another argues that the deterioration of El Salvador's Terms of Trade and the increasing external deficit is partially explained by cost disadvantages vis a vis its trading partners. Moreover, those theoretical analytical works point out relevant areas of reform and government policy which could impact positively in El Salvador's competitiveness and growth rates.

1.23 Concerns over a declining competitiveness of the El Salvadoran economy are also voiced in different analysis and assessments published over the last years by the Salvadoran Foundation for Economic and Social Development *(Fundación Salvadoreña para el Desarrollo Económico y Social* – FUSADES), as well as other domestic interests. For example, the National Association of Private Enterprises (*Asociación Nacional de la Empresa Privada* – ANEP) in the context of its three annual private enterprise "encounters" (*Encuentro Nacional de la Empresa Privada* – ENADE) has consistently indicated concerns over the competitiveness of the country's enterprises, indicating the constraints and challenges the private sector perceives in the general macro economic management and specific sector conditions. Sectors and areas which the private sector considers to affect its competitive capacity include, inter alia, transport infrastructure, vocational education and training, science and technology development, and legal and citizens security.[18]

1.24 The most commonly used, purely empirical, international competitiveness comparators clearly eco the above outlined theoretical assessments and considerations of El Salvador's private sector: El Salvador's overall competitiveness and specific indexes rank comparatively low, even within the Latin America region; with the notably exception of the "Freedom of Economy" indicator[19], where the country has ranked consistently first or second over the last years within the region. The World Economic Forum (WEF) "Global Competitiveness Report 2001 – 2002" ranks El Salvador 64 in the *Current Competitiveness Index* and 58 in the *Growth Competitiveness Index*, both out of 75 surveyed countries, placing it at the top of the lower half of the twenty IDB borrowing member countries surveyed.[20]

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[17] See: Larraín, Felipe: Crecimiento Económico en El Salvador, January, 2003, mimo; as web as recent work published by FUSADES, Sebastián Edwards, Ricardo Hausmann and others.

[18] See reports for ENADE I, II, III, held in 2000, 2001 and 2002, respectively.

[19] Heritage Foundation Economic Freedom Index

[20] The compilation process, relevance and use of the WEF indicators and others is subject to some methodological and conceptual criticism, as some indicators are based on *perceptions* rather than *data*.

1.25 An assessment of relevant sub-indices sheds additional light on some of competitive challenges facing El Salvador (see Table 1.2 for a summary of selected indicators). The WEF report and other assessments indicate the persistence of – comparative - competitive disadvantages in (i) different areas of infrastructure services, including see and air transport infrastructure, and utility services;[21] (ii) technical proficiency of the labour force, as well as technological and innovative competence of the business sector, including the sophistication of company operations and strategy in management; and (iii) the Rule of Law, including contract enforcement, as well as the culture of competition and competition policy that would improves the way markets function and prevent and sanction anticompetitive practices. As such, the sub indicators coincide with the concerns voiced by El Salvador's private sector.

Nevertheless, given the importance of perception for investment decisions and the ease of understanding of the indicators they will be used in the following as reference.

[21] The variation between different sub-indices is significant, with telecommunication services ranked fairly high, while transportation services are generally lower rated, with the exception of air transport facilities.

Table 1.2: El Salvador – Selected Competitiveness Indicators - 2001

Concept	Value	Rank[1)]
GDP		
Real GDP growth/per capita 1999 – 2000, %, (mean value = 3.2)	1	65
GDP per capita, US$	4,477	56
Change in GDP per capita relative to US 1992/2000, average annual %	- 0.09	38
Aggregate Competitiveness		
Growth Competitiveness Indicator		58
Current Competitiveness Indicator		64
Technology/Know-how development/application		
Technological sophistication vs. world, 1 = lags behind world, 7 = world's leader, mean value = 4.2	2.7	64
Importance of innovation for firm, 1= not important for business, 7 = important, mean value = 5.3	4.7	68
Interest in technology by firms, 1 = none, 7 = aggressive absorbing new technologies, mean value = 5.0	4.4	63
FDI and technology transfer, 1 = little new technology, 7 = important source, mean value = 5.1	5.5	18
Company spending on R&D, 1 = none, 7 = heavy relative to intern. Peers, mean value = 3.9	2.8	65
Subsidies for firm level R&D, 1 = never occur, 7 = widespread and large, mean value = 3.3	2.2	65
Tax credits for firm level R&D, 1 = never occur, 7 = widespread and large, mean value = 3.2	1.9	71
Scientists/Engineers availability, 1 = scarce, 7 = widely available, mean value 5.1	3.5	72
Patents (US) granted per million population, year 2000, ***65 countries***/values, 0 = none, max. value = 308	0.0	65
Extend of staff training, 1 = little investment, 7 = heavy, mean value = 4.2	3.6	55
Local specialized research and training services, 1 = not available, 7 = world class, mean value = 4.5	3.8	58
Average years schooling population 15 years +, 1999, ***63 countries***	5.5	63
Skill based exports, % GDP, 1997 – 1999, ***72 countries***	2.6	53
General Infrastructure		
Overall assessment, 1 = bad, 7 = among world best, mean value 4.3	3.0	60
- roads		59
- sea ports		61
- air transport facilities, mean value = 5.0	5.0	41
Quality of competition transport sector, 1 = poor, 7 = high, mean value = 4.4	3.4	63
Electricity Prices relative to world, 1 = much higher, 7 = lowest, mean value 4.1	3.5	54
Domestic competition environment		
Intensity of local competition., 1 = low, 7 = high/changing market leaders, mean value = 5.1	5.0	51
Origin of domestic/local competition, 1 = imports, 7 = local competitors, mean value = 4.4	4.0	54
Informal sector % of businesses, 1 = lowest % bracket, 7 = highest, mean value 3.2	6.0	74
Anti-Trust policy, 1 = not effective, 7 = effective, mean value = 4.2	3.1	65
Administrative burden for start-up company, 1 = difficult, 7 = easy, mean value = 4.5	4.5	34
Days required to start a firm, mean value 40.2 days	30	19
Regulatory standards (production etc.), 1 = lax, 7 = among most stringent, mean value = 4.6	3.2	67
State of cluster development, 1 = limited/shallow, 7 = common, mean value = 3.5	2.4	70
Product/process collaboration, 1 = within firm/foreign supplier, 7 = with local non firm resources, mean value = 4.0	3.6	54
Corruption - exports/imports, 1 = common, 7 = never, mean value 4.8	4.0	51
Corruption – public contracts, 1 = common, 7 = never, mean value = 4.4	3.7	51
Corruption – business costs of corrupt behavior by competitor, 1 = high, mean value = 4.7	4.1	53

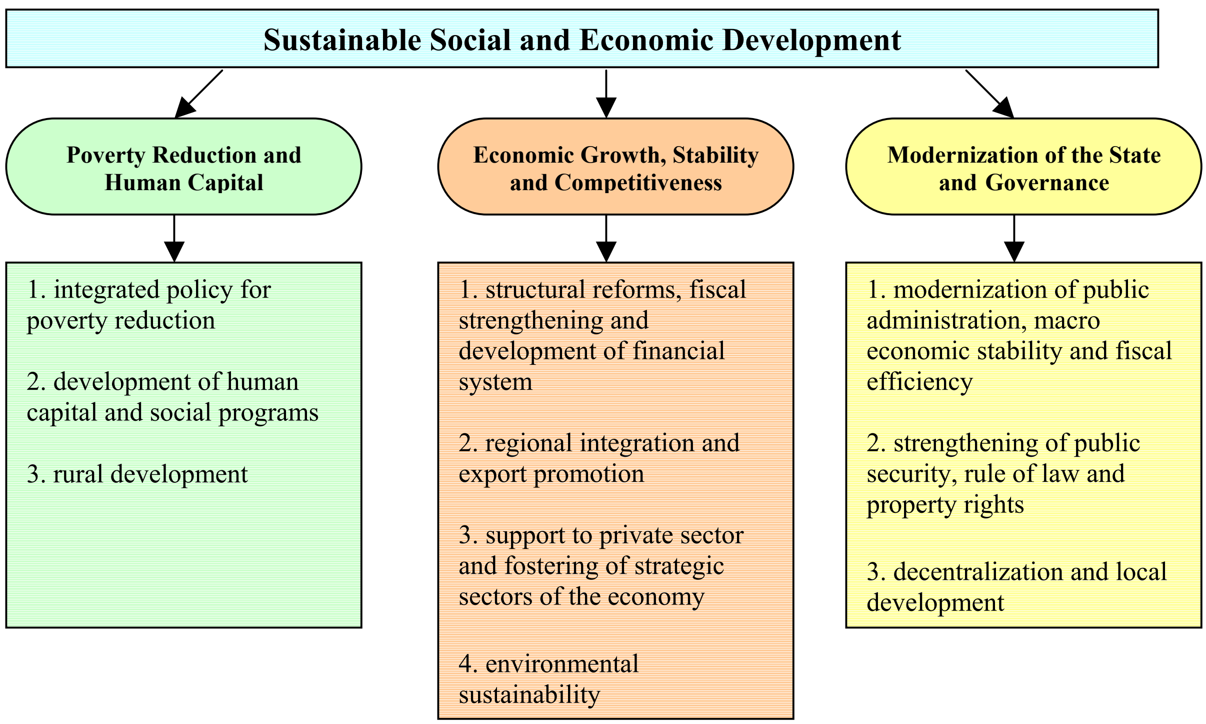
[1)] over 75 countries, if not stated different

Source: World Economic Forum the Global Competitiveness Report 2001 - 2002

C. Bank strategy

1.26 The proposed operation would plainly be centered within the Bank's Country Strategy with El Salvador for 2000 - 2003, as approved in January, 2001[22] and updated in May, 2002. The strategy outlines ten key components, including (i) fiscal consolidation, (ii) greater productivity and competitiveness of strategic sectors, (iii) increased private sector participation, (iv) strengthening of human capital, and (v) modernization of the State, which it groups within three interrelated lines of action: (i) reactivation of economic growth, stability and competitiveness, (ii) poverty reduction and strengthening of human capital, and (iii) modernization of the state and enhancement of governance. The proposed operation would make a contribution in the first line of action and would be expected to have to a various degree long term beneficial effects on the second and third.

Graph 2.1: Bank Country's Strategy – El Salvador 2000 - 2003



1.27 The proposed operation is also fully consistent with the Bank's Competitiveness Strategy, approved in June 2003.[23] As outlined in that document, strengthening humans resources and labour productivity, improving infrastructure and enhancing technological capacity, inter alia, are areas of intervention which could impact positively in a country's competitiveness. Moreover, the proposed operation is consistent with the lessons learned outlined in the strategy document. As recognized, macroeconomic stability and adequate economic and institutional signaling are important conditions to successfully implement competitiveness improvements, and the operation would contribute to both aspects. Furthermore,

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[22] GN-2121-3
[23] GN-2243-1

the strategy document emphasizes the importance of broad institutional consensus and private – public collaboration in the identification of necessary reform areas and measures. The proposed operation has strive to achieve this within the constraints of a Policy Based lending operation through close consultation with all potential sector agencies involved in the anticipated reform efforts and consultation with the private sector, as well as consideration of the private sector's views in the identification of the specific reform areas/sectors.

D. Bank experience and lessons learned

1.28 The Bank's operational program with El Salvador during the last decade has emphasized support for the structural reform processes and macro economic stabilization, laying the groundwork for a propitious business and investment climate and strengthened competitiveness of the country. Although none of the operations specifically targeted "competitiveness" as an operational objective, an important number of them did impact it directly. Examples are operations aimed at modernizing and expanding transport infrastructure and energy services, operations in support of the deepening and strengthening of the financial sector, as well as operations aiding the modernization of the public sector and public/citizens' security. From a broader perspective, educational reform and modernization of the judiciary could also be considered as contributing over the long term towards fostering the economy's competitiveness. In addition, the Bank has financed a substantial number of Small Projects and technical assistance operations, aimed at supporting the implementation of macro reform programs, as well as the institutional strengthening of public sector entities and private sector service suppliers. The emphasis of the latter was generally the support of small and medium size enterprises and their enhanced access to financial and non financial services in support of increase productivity and competitiveness.

1.29 Although in a general sense, the above outline operational program of the Bank in El Salvador over the last years coincides with and echoes some of the lessons learned as reflected in the Competitiveness Strategy document GN-2243-1, from a focus and instrument standpoint the present operation represents a novelty: it is one of the first of its kind for the Bank that aims explicitly at supporting competitiveness in the framework of a Policy Reform loan.[24] The Bank's experience with specific competitiveness operations is rather recent and so far limited to technical cooperation arrangements, e.g. the recently approved innovation loan "Panama Program to Foster Competitiveness (1410/OC-PN)" and similar operations in preparation in Honduras and Dominican Republic, or "competitiveness" constituted – at best - an implicit goal of projects in support of specific sectors or services providers; e.g. El Salvador energy sector and transport sector loans (731/OC-ES, 653/OC-ES), TC for agro-business competitiveness (TC-9903041), Panama MIF-TC for enhanced business climate (TC-0006035), Nicaragua MIF-TC for improved quality of Small Medium Enterprise in tourist businesses (TC-9909008).

[24] Peru – Competitiveness Reform Program, PE-0239, is also conceived as a policy reform loan to enhance competitiveness, but as of time of writing has not been approved yet.

1.30 Irrespective of the novelty of the proposed operation, some lessons can be gleaned from those first operations cited above, as well as those carried out by others donors, mainly with regard to (i) the importance of consulting the private sector view in the definition of interventions, (ii) the necessity for institutional ownership of the program, and (iii) the likely cross-sector nature of addressing competitiveness constraints. The program design tries to incorporate those lessons, specifically (i) and (ii). The intervention areas and sectors have been defined taking into consideration the views of the private sector as expressed for example in the WEF indicators or ENADE conclusions. Moreover, with the Technical Secretariat of the Presidency of the Republic (*Secretaría Técnica de la Presidencia de la República* - STP) an execution agency has been designated with a substantial track record in designing and implementing modernization of the state and competitiveness programs, as well as the institutional capacity to assume ownership.

1.31 Nevertheless, the innovative character of the proposed operation and the substantial advances of GOES in enhancing the framework for competitiveness also pose a substantial challenge for identifying adequate policy actions which, moreover, exhibit a clear and measurable linkage between the input and expected outputs, outcome and impact. Moreover, the proposed operation needs to acknowledge the lack of a clear theoretical model of what drives competitiveness. The body of available literature on the topic seems to indicate that – improvement in - competitiveness constitutes a continuous process of revising the efficient allocation of resources. Moreover, once a reasonable stable macro-economic and political framework is in place, academic research and discussion does not appear to indicate a defined "best practice" catalogue or "road map" for further action. What it does indicate is a likely diminishing scope for and impact of macro policy reforms, but rather a growing need to implement appropriate "micro" and "mezzanine" reforms[25] and design adequate incentive systems, as well as adaptable institutional arrangements. These, nevertheless, need not only be country and sector specific and adjustable to a constantly changing environment, but also tend to result from "trial & error".[26]

1.32 A different set of Lessons Learned can be derived from prior Bank experience in the execution of Policy Based Loans in El Salvador and the hemisphere. To a large extend they refer to the adequate design of the operation, specifically in the definition of disbursement conditions, and the choice of executing agency, as important prerequisites for a successful implementation of the policy measures and disbursement of the operation. Accordingly, in incorporating those Lessons Learned the project team developed the operation in close coordination with

[25] The distinction between macro, mezzanine and micro reform is somewhat arbitrary. However, in this text "micro" reforms principally refers to aspects affecting the microeconomic business environment in which a nation's firms compete, whereas "mezzanine" reforms relate to the implantation of conducive institutional arrangements, including specific legislation, regulation and policy, and "macro" reform to the removal of major distortions, imbalances and structural disincentives.

[26] E.g. see the widely different designs of "cluster" initiatives in different countries and equally different results of the instrument within any given country, as illustrated in a recent Bank study of experiences in El Salvador and Colombia.

GOES and defined all disbursement conditions, as well as compliance verification indicators in consensus with authorities. Moreover, STP by virtue of its positioning within GOES organizational structure is the best suited agency to coordinate and enforce implementation of the policy measures and administer the operation.

E. World Bank support and coordination

1.33 Based on substantial analytical work carried out in the mid 1990s[27], the World Bank, in September, 1995, approved a technical cooperation loan of US$16 million, aimed at improving competitiveness. The operation's principal objectives was to support GOES in facilitating accelerated the development and productivity of the private sector, specifically export oriented companies, and encouraging increased foreign direct investments. Project activities were developed in ten distinct thematic areas, such as: investment promotion, export promotion, cluster development, private – public sector cooperation and dialogue, property registries and company registration. Their main focus was on establishing institutional support infrastructure and policy dialogue mechanism, as well as reducing business transaction costs and improving know-how and innovations capacity of business. As such, the interventions were aimed at the micro level, mirroring the Bank's recently approved technical cooperation programs for competitiveness. However, the operation did not encompass or address specifically the underlying structural constraints, including some of those identified in the cited assessment.

1.34 Project results seem to be mixed. Whereas most of the institutional innovations, such "one-stop" facilities etc. have been implemented, their impact remains unclear. Likewise, the cluster development appears of only limited success. On the whole the operation has encountered substantial implementation delays and currently is in its final stage of disbursements. More noteworthy is, however, the fact, that substantial challenges remain, as evidenced in the international comparators, as well as in the views of the private sector.

F. Donor Coordination

1.35 During preparation of the proposed operation the project team has made substantial efforts for Donor Coordination and consultation. Inter alia, the project conceptions were communicated and shared with technical staff in the World Bank, as well as other multilateral and bilateral donors. For specific topics consultation with relevant international institutions was sought, such as the United Nations Conference on Trade and Development (UNCTAD). In addition, in specific cases relevant excerpts of approved project documents were shared and discussed with multilateral and bilateral donors' staff working in the field of competitiveness and business development for their comments. Such is the case, for example, with the German Technical Cooperation (GTZ). Moreover, project documents were placed with the Public Information Center of the Bank, following standard procedures, and the project was subject to extensive domestic press

[27] El Salvador Meeting the Challenge of Globalization, Report No. 14109-ES, October 13, 1995

coverage and repeated request for information by international Non Governmental Organizations representing specific Salvadoran constituencies.

II. COMPETITIVENESS CHALLENGES AND CONSTRAINTS

2.1 As outlined in the previous chapter, El Salvador's private sector has identified potential areas for reform and policy action, which could provide a positive impulse for increased productivity and reduction in costs of Salvadoran businesses. The areas identified coincide to a large extend with those which show comparable weakness in international indicators, such as the WEF indicators. Moreover, their importance is echoed in the Bank's own research[28] and the lessons learned form its operational experience. The following provides a description of the competitiveness challenges and constraints faced in particular sectors/areas, which have been jointly identified with GOES, and which would form part of the operation's reforms.

2.2 **Maritime and air transport.** Relative to other countries in the Central America, El Salvador has one of the most advanced and developed infrastructure networks in the region, especially with regards to the road network and air transport facilities. However, pronounced deficiencies can be observed in the area of maritime transport, and the rail transport system has ceased to function. The challenges and constraints facing the transport sector are echoed in the earlier cited comparable competitiveness indicators. As can be observed in Table 1.2, in the overall assessment of infrastructure services El Salvador is ranked 60 out of the 75 countries surveyed, with a value substantially below the mean value for the indicator. The comparative rankings and values for the specific transport infrastructure services reflect their distinct degree of development, with air transport attaining the highest ranking. However, the lack of competition in the transport sector seems of a substantial concern, as indicated by the comparative ranking.

2.3 Over the years, infrastructure development has been placed increasingly within the framework of facilitating access to domestic and overseas markets and reducing transport costs. Another guiding principle of policies has been the liberalization of the sectors and the increased participation of private services providers, to increase competition and efficiency in the sectors, as well as higher degrees of cost recovery and sustainability of services and investments. Advances have been achieved, although substantial constraints remain: measured against relevant global comparators, service levels are low and costs elevated, with negative effects on the country's competitiveness. To further increase the supply and efficiency of services will require additional modernization of the legal and regulatory framework of services provision, as well as innovations in services delivery and administration arrangements.

2.4 The maritime transport and ports sector is a prime example of the above outlined strategy. Traditionally, El Salvador's access to international maritime freight transport was limited to the port of Acajutla on the western Pacific coast, which

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[28] During project preparation specialized consulting services were contracted to review sector performance. Moreover, Bank staff undertook reviews of a number of specific areas.

proved efficient for access to Asia and the US West coast, but not for other major markets on the US East coast or Europe. To reach those markets, Salvadoran firms depend on access to Atlantic ports in Guatemala and Honduras. In an effort to increase efficiency of access to those ports and markets, GOES embarked on initiatives to improve the connecting road infrastructure as well as to reduce logistics barriers and costs through trade and customs agreements with its neighboring countries.

2.5 In the case of access to the Pacific, El Salvador pursues a two prong strategy of modernizing existing port facilities and services in Acajutla, and advancing the development of entirely new port infrastructure in Cutuco in the eastern part of the country. Acajutla, first developed in 1952, was built, and is owned and operated by public sector through the Autonomous Executive Ports Commission (*Comisión Ejecutiva Portuaria Autónoma* – CEPA)[29], which was established for this purpose the same year. The port traditionally experienced a host of operational difficulties, substantial overstaffing and labour unrest, and increasing infrastructure investment needs. In consequence, port operations suffered from comparable high costs and low efficiencies, increasingly driving business to other more competitive ports in the region and producing recurrent negative operational results.

2.6 To remedy the inefficiencies in Acajutla and facilitate the development of future maritime and port services, such as Cutuco, GOES embarked on a process to reform and modernize this port and the sector in general. With regard to the sector's legal and regulatory framework, GOES has passed a new General Maritime and Ports Law (LGMP)[30], which reforms the governance structure for the sector, including the creation of a new regulatory body, the Maritime and Ports Authority (AMP) and establishes the framework for private sector participation in maritime transport and the provision of port services. With regard to Acajutla, GOES proceeded to increase private sector participation in service delivery and to renegotiate labour contracts, allowing for a substantial increase in cargo handling efficiency at the port. On October 2002, the Legislative Assembly also approved the Basic Conditions for a master concession to the private sector of Acajutla[31]. CEPA contracted out and presented an Environmental Impact Assessment to Ministry of Environment and Natural Resources (MARN), and subsequently MARN issued the Environment Permit to go ahead with the Acajutla's concession program. CEPA with the advice of experienced investment bank and legal firms is conducting the concession process.

[29] From an institutional perspective, CEPA had assumed leadership in virtual all aspects of the sector, including the definition of sector policies, regulation, planning and – as mentioned – provision of all port services. In addition to CEPA the second public sector agency related to maritime transport and ports until 2002 was the General Directorate for Maritime Transport (*Dirección General de Transporte Marítimo* – DGTM) of the Ministry of Public Works, Transport, Housing and Urban Development (*Ministerio de Obras Públicas, Transporte, Vivienda y Desarrollo Urbano* – MOPTVDU), with responsibility for maritime security and the adoption of international maritime agreements/conventions. However, in spite of its mandate, DGTM for all purposes did not intervene in the sector.

[30] Legislative Decree N. 994 September 19, 2002.

[31] Legislative Decree N. 1014 October 3, 2002.

2.7 Future activities will focus on developing the appropriate normative and regulatory framework in accordance with the LGMP, as well as strengthened AMP to execute its regulatory functions. Furthermore, MOPTVDU and CEPA will need to be restructured to conform to the new legal and institutional arrangements for the maritime and port sector. The reform and policy initiatives would address the sector's shortcomings identified in the WEF report and others, and allow to further increase El Salvador's relative competitiveness and rankings. Their development and implementation would be supported by the proposed operation, in the framework of specific conditions.

2.8 The air transport sector displays some similar governance structure and regulation characteristics as the maritime transport and ports sector, with CEPA being the owner and operator of the only commercial (international) airport of El Salvador. Effective sector governance also rests with CEPA and the dominant domestic carrier.[32] Although the institutional arrangements have allowed for some degree of effectiveness, they are perceived to have resulted in losses in efficiency and competitiveness in the sector and imbalances in the development of different sub-components; e.g. passenger traffic vs. freight handling. Moreover, sector legislation, dating back to the 1960's has proved inadequate to address the challenges of a modern air traffic industry.

2.9 To strengthen the sector and increase its competitiveness, GOES has initiated a broad reform process which includes: (i) reform of the legislation governing the sector; (ii) reform of the regulatory framework, to increase capacity and independence; and (iii) promotion of private sector services provision for airport operations. Within this context, in 2001 GOES reformed civil aviation legislation, passing a new Statutory Civil Aviation Lay (LOAC)[33]. Inter alia, LOAC established a new governance structure for the sector with the creation of the Civil Aviation Authority (AAC) and paved the way for increased private sector services provision. During 2002, GOES enacted implementing regulations for LOAC and initiated a strengthening plan for AAC.[34] Future activities will focus on further strengthening AAC, especially with a view to regional cooperation, restructuring MOPTVDU and CEPA to conform to the new legal and institutional arrangements for the civil aviation and airport sector and improve efficiencies in selected services areas.

2.10 Although the corresponding WEF indicators for the air transport sector reflect its comparable modern and advanced development and the positive contribution toward the country's competitiveness, the envisaged reform steps and policy measures will permit to further strengthen the sector's performance. Development

[32] As within the maritime and ports sector, the governance structure in the air transport sector also contemplated the participation of a specialized public sector agency, the General Directorate of Air Transport (DGTA) in the MOPTVDU. However, lack of financial, staff and technical resources had left DGTA increasingly unable to comply with its mandate.

[33] Legislative Decree N. 582 October 19, 2001.

[34] The Bank provided technical assistance through a project with the regional aviation body, *Agencia Centroamericana para la Seguridad Aérea* – ACSA.

and implementation of different reform measures would form part of specific disbursement conditions required under the proposed operation.

2.11 **Vocational education and training; innovation and technological development.**[35] Low labour productivity resulting – among other aspects - from limited labour qualification and lack of technological innovations in the production processes constitute an important constraint for El Salvador to meet increased global competition for its products and move-up the ladder of value added production. As pointed out earlier (see Table 2.1) El Salvador is ranked consistently comparatively low in average schooling of its population, the extend of labour force training and the availability of technically skilled labour. For its part, technology development, adaptation and implementation on the firm level is not existing or severely limited compared to competitor nations. This is reflected in spending levels on science and technology and Research & Development equivalent to less than 0.9% of GDP in the late 1990's[36], as well as one of the lowest proportion of researchers to labour population in the continent.

2.12 Historically, structured vocational education and technical training of the workforce have been scant in the country's public and private sector, fostered by and compounding the effects of already low average schooling of the population. The Salvadoran Institute for Profession Formation (*Instituto Salvadoreño de Formación Profesional* (INSAFORP) is the principal public sector agency in charge of vocational training, and is generally well regarded compared to its counterpart institutions within the region. INSAFORP an ample mandate to regulate and supervise the sector, i.e. assume "third tier" functions, the institution in effect has converted into being the dominant provider of second tier vocational education and training services, i.e. providing financing for direct services provider of a wide variety of products and instruments. While INSAFORP's size and resources generally stifles competition, other public and private initiatives do exist, some of them in parallel to INSAFORP offerings and other complementing those programs. Those competing institutions include, from the public sector, for example the Central American Technological Institute (*Instituto Tecnológico Centroamericano* – ITCA), financed by the Ministry of Education and managed by a private sector foundation (Fundación Empresarial para el Desarrollo Educativo – FEPADE), which offers tertiary technical education in four regional specialized centers.

2.13 However, the effectiveness of INSAFORP's programs and all other public and private initiatives is seriously diminished by the lack of integration of activities within a comprehensive policy framework that would address the issue in an organized conceptual approach. A recent assessment undertaken on behalf of the Bank comes to the conclusion that policy and institutional arrangements for the

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[35] For an extensive assessment of the sector see: Grupo de Asesoría Multidisciplinaria (GAMA), Informe Final Misión de Apoyo en Políticas de Formación para el Empleo, Innovación y Desarrollo Tecnológico, June, 2003 mimo.

[36] See, IDB - Economic and Social Progress in Latin America, 2001 Report. It should be noted, however, that the data for 1994 – 1997 indicate substantial lower aggregate spending than the one reported for 1998 at 0.3% of GDP.

sector: (i) lack a clear vision that would guide public intervention and could set the incentives for private participation; (ii) are characterized by duplication of some functions and lack of others, and the predominance of direct management of programs and service provision; (iii) present contradictory mandates and instruments even within public sector interventions; and (iv) do not facilitate adequate coordination between public interests and private initiatives. Moreover, seemingly, over time a substantial number of initiatives have been developed and implemented, but scant attention seems to have been devoted to assure coherence in objectives and use of instruments and the evaluation of results. The innovative capacity for developing new instruments, products and institutional arrangements is not matched by equal strength in evaluating results and extracting lessons learned. This partly reflects the lack of vision, but also the fact that (vi) neither INSAFORP nor any other public sector institution (or private sector entity for this matter) currently assumes regulatory or supervisory functions for the sector, i.e. the required "third tier" role. In addition, current conceptual and institutional weaknesses (vii) impede the desired coordination and integration of vocational training efforts within the wider framework of education policy and strategy in the country.

2.14 In the area of innovation and technological development a recent Bank assessment arrives at similar conclusions as those cited above for vocational education and training. The sector is marked by a lack of clear policy, the duplication of functions, initiatives and instruments, as well as a lack of cooperation and coordination between public sector and private sector initiatives. The preeminent public sector institution in the sector, the National Council for Science and Technology (*Consejo Nacional de Ciencia y Tecnología* – CONACYT), does not appear to assume governing functions, partially due to its own institutional weakness and partially because of an insufficient explicit mandate. To increase the efficient usage of the existing "innovation and technology infrastructure" in the country will require the definition of a coherent policy, which would establish clear roles for the public and private sector, providing incentives for the latter to exclusively assume all the provision of first tier services. The development and implementation of the policy would need to be accompanied by the strengthening of the policy and regulatory capacity of the designated public sector institution, a review of current interventions and instruments, as well as the consideration of additional measures and incentives in support of private sector technological innovations, adoptions and dissemination.

2.13 **Competition Policy.** Competition policy is another area where reform could contribute to strengthen the country's competitiveness by improving the way markets function, providing adequate and equal incentives and conditions for present and future private as well as public suppliers of goods and services. Little research is available on the structure and functioning of different markets in the country, the degree, origin and impact of any distortions, and the requirements and ways to improve regulations, with a view to increase market effectiveness and consumer welfare. There is a substantial degree of concentration in several markets, and concerns about anticompetitive business conduct by private and public sector participants, as well as of public interventions that create disincentives for competition are raised regularly.

2.14 Competitive concerns apply both to recently privatized, which have still substantial public regulation, as well as predominantly private sector markets. Markets where public ownership has been replaced by private ownership and public regulation, such as energy, telecommunications, water, fuel and banking are characterized by highly concentrated structures with few exposure to national or international competition; deficient enforcement of regulation, weakness and capture of their sectors' regulatory body or superintendence, lack of transparency in the definition of costs and prices for the final user (energy), *inter alia,* contribute to the wanting competition. On the other hand, firms in traditionally private sector markets tend to have higher competitive constraints from national and international competitors. However, even in these markets it is possible to identify restrictions and distortions due to trade measures (sugar, jute, cement), discriminatory subsidies (private universities), and highly concentrated market structures (beer, supermarkets, meat distribution, pharmacies), as well as restrictive business practices.

2.15 In spite of many economic policies and regulations with impact in the competitive environment, Salvadorian authorities have yet to formulate a coherent and encompassing competition policy, as well as competition rules and an enforcement authority to foster competition and safeguard the proper functioning of local markets. In the past decade several draft competition rules have been prepared and a project was submitted to the Legislative Assembly on 2003. There are no regional competition rules in the Central American economic integration system, in spite of an enabling rule in the Protocol of Guatemala (Art. 25). Likewise, both the Free Trade Area of the Americas (FTAA) and World Trade Organization (WTO) will eventually include rules on competition. There is a scope for national action to improve the domestic competitive environment and pave the way for later regional or multilateral rules.

2.16 The introduction of specific competition legislation would aim, inter alia, to promote and advocate a culture of competition; safeguard against abusive or distorting market behavior by private and public sector agents; facilitate equal entrance and access to markets for all suppliers; and establish adequate sanctions mechanisms, as well as the basis for cooperation in international cases. Legislation would have to establish linkage mechanisms with existing sector regulations, in order to provide for a homogenous approach across different sectors, as well as safeguard its congruity with other laws and regulations governing firms and the business environment. The latter might require a more extensive review of the legal and regulatory framework, as well as selective adjustments. Effective implantation of legislation would require the establishment of a corresponding institutional arrangement, including a definition of institutional responsibility for enforcing the legislation's aims, as well as the strengthening of public institutional capacity to analyze and monitor market structures in El Salvador. The operation would support those efforts through specific conditions.

III. OBJECTIVES AND DESCRIPTION

A. Objectives

3.1 The objective of the proposed operation is to support the Government of El Salvador to implement measures aimed at facilitating increased competitiveness of the country's businesses through enhanced factor productivity and access to markets, within a framework of maintain economic stability and sustainable growth. To achieve its objective the operation has established specific policy and reform conditions in defined sectors, against which implementation fast disbursing resources for fiscal and balance of payment application would be disbursed.

3.2 The proposed operation would require the adoption of policy measures in three distinct sectors, i.e. transport infrastructure, innovation and vocational training, and competition legislation. As pointed out earlier, those sectors are characterized by comparative competitive disadvantages or challenges. Moreover, the sectors and specific policy measures proposed have been selected with a view that improvements will either reduce the costs to access or operate in current and new markets and/or enhance factor productivity. Theoretical research and empirical evidence suggest that the former would support measures in the area of transport infrastructure and competition legislation, whereas the latter would justify policy actions in the areas of innovation and vocational training. A second consideration for selecting the areas of intervention was the degree to which GOES policy action could effectively induce change. Thirdly, as noted earlier, all of the areas/sectors to be addressed have been identified as impacting the competitive potential of business both by the private and the public sector, representing something of a consensus vision for action.

B. Program description and structure

3.3 The operation has been structured as a Policy Based Loan (the Loan) of US$100 million, with four disbursements: the first in form of a "fixed" tranche disbursement of up to US$40 million, followed by three "floating" tranche disbursements of US$20 million each. *First tranche disbursement would become effective upon approval of the operation by the Bank's Board*, pursuant to compliance with established conditions. The proposed front-loading of the disbursements would recognize the substantial efforts undertaken by GOES in economic reform and in improving the competitiveness environment of the country over the course of time, as well as specific advances achieved in the outlined reform areas. Floating tranche disbursements would become effective pursuant to compliance with established specific disbursement conditions. However, disbursement of final resources of the proposed operation, i.e. the last tranche, will not take place prior to eighteen (18) months following loan effectiveness according to established Bank policy.

3.4 The proposed operation recognizes El Salvador's track record of prudent economic policy and reform and the fact that the country has been at the forefront within the hemisphere of defining competitiveness as an explicit policy goal. It also recognizes, that GOES current and future competitiveness efforts are a continuum of initiatives and policies initiated over the last decade and are embedded in a consistent pattern of structural adjustment, liberalization and market opening, as well as sector and state reform begun in the early 1990's. The implantation of the LIM in early 2001 would have not been feasible without the track record of macro economic stability and enhanced competitiveness. Likewise the market opening and privatization of infrastructure services in the telecommunication and energy sectors, fully implemented under the current administration, capped efforts initiated during the prior two administrations; and equally recent advances in most other areas affecting competitiveness are build upon initial initiatives designed and implemented during previous periods. The aforementioned is reflected in the proposed disbursement structure and conditionality of the operation.

C. First Disbursement condition

1. Macro Economic Framework

3.5 Government will maintain a macro economic policy framework consistent with program objectives. Compliance will be assessed by the Bank, based on the information generated in the context of the semi-annual consultations of the IMF (Article IV). Performance benchmarks to be assessed would emphasize elements indicative of growing domestic and external imbalances.

2. Maritime and air transport

3.6 In the area of maritime transport, disbursement conditions will support the Government efforts to increase efficiency and enhance service quality of maritime transport, as well as to improve the competitiveness of port infrastructure by means of: (i) establishment of a new institutional and regulatory model for the maritime and port sector; and (ii) introducing specialized operators to deliver port services. Prior to disbursement of resources from the first disbursement the Government will present evidence that:

- modernized maritime and ports legislation has been enacted;
- the regulatory agency for the maritime transport sector has been legally and functionally established;
- port services in the seaport of Acajutla have been outsourced to private providers;
- legislation has been approved establishing the rules and conditions for granting a Master Concession for the operation of the seaport of Acajutla.

3.7 In the area of air transport, disbursement conditions will support the Government efforts to increase efficiency and enhance service quality of air transport, as well as to improve the competitiveness of airport infrastructure services by means of:

(i) establishment of a new institutional and regulatory model for civil aviation and airport sector; and (ii) introducing specialized operators to freight handling operations in the international airport. Prior to disbursement of resources from the first disbursement the Government will present evidence that:

- modernized civil aviation legislation has been enacted;
- a regulatory agency for the civil aviation sector has been legally and functionally established;
- freight handling, infrastructure maintenance and operational security services at the international airport have been outsourced to private service providers.

3.8 GOES has advanced substantially in the fulfillment of all disbursement conditions for this tranche, enacting the required legislation for the maritime and port and air transport sector and establishing the corresponding regulatory agencies. Moreover, port services in the seaport of Acajutla have been outsourced to private providers and legislation for the granting of a Master Concession for the port's operation has been approved. Freight handling services at the international airport are expected to be outsourced to private service providers prior to Board presentation. In light of the advanced compliance with tranche conditions it is anticipated that the tranche will disbursed upon effectiveness of the loan.

D. First floating tranche disbursement condition

1. Macro Economic Framework

3.9 Government will maintain a macro economic policy framework consistent with program objectives. Compliance will be assessed by the Bank, based on the information generated in the context of the semi-annual consultations of the IMF (Article IV). Performance benchmarks to be assessed would emphasize elements indicative of growing domestic and external imbalances.

2. Vocational Education and training and Innovation

3.10 In the areas of vocational education and training, Government will

- formulate and formalize a national strategy, which will guide policies and public intervention in the sectors. The strategy will:
    - establish an institutional framework in which public intervention would focus on policy definition and governance of the sector, i.e. "third tier" functions, delegating "second tier" functions and service provision – first tier functions - to private suppliers;
    - define the linkages with and requirements for the formal education sector and interventions to support innovation and technological development;
- review the role and institutional characteristics of INSAFORP;

- strengthen INSAFORP according to its revised mandate, as defined in the national strategy.
- assess all current public sector interventions in the sector and redefine its approach with a view to create stronger incentives for private sector provision of services. Within the framework of this review, all current programs and instruments will be assessed to determine their congruity and cohesiveness with the objectives of the national strategy.

3.11 In the area of innovation and technological development, Government will:

- formulate and formalize a national strategy, which will guide policies and public intervention in the sector. The strategy will:
    - establish an institutional framework in which public intervention would focus on policy definition and governance of the sector, as well as resources allocation, i.e. "third tier" functions, delegating "second tier" functions and service provision – first tier functions - to private suppliers;
    - define the guiding policy, scope and implementation arrangement for public financing of private sector innovation and technology development initiatives;
    - establish the institutional mechanism to facilitate the wide dissemination of information regarding innovation and technology development services;
    - define the linkages with and requirements for the formal education and vocational education sector.
- review the role and institutional characteristics of CONACYT according to the new national strategy;
- strengthen the entity responsible for implementation of the national strategy, so it can assume third tier functions in the sector.
- assess current public sector interventions in the sector and redefine its approach with a view to create stronger incentives for private sector provision of services. Within the framework of this review, all current programs and instruments will be assessed to determine their congruity and cohesiveness with the objectives of the national strategy.

3.12 During project preparation initial assessment work on the overall conditions of the sector was undertaken, which could aid in compliance with conditions. Furthermore, substantial prior work on specific issues affecting the sector, for example the operations of INSAFORP, have been undertaken over time and could provide some basis for definition and implementation of policy actions. Nevertheless, additional background and assessment work will be required before tranche conditions can be completed.

E. Second floating tranche disbursement condition

1. Macro Economic Framework

3.13 Government will maintain a macro economic policy framework consistent with program objectives. Compliance will be assessed by the Bank, based on the information generated in the context of the semi-annual consultations of the IMF (Article IV). Performance benchmarks to be assessed would emphasize elements indicative of growing domestic and external imbalances.

2. Competition Policy and Legislation

3.14 With respect to competition policy and legislation efforts would address the three distinct areas of concern elaborated in Chapter II. Government would be required prior to disbursement of resources to present evidence of having:

- Identified competition constraints and adequate competition levels in relevant markets, taking remedial action in those markets were anti competitive behaviour or structures are found, based on existing legislation;
- drafted and presented to the Legislative competition legislation for public debate and parliament consideration;
- designed and implemented the institutional structure to facilitate competition advocacy, enforcement of rules and strengthen effective market regulation.

3.15 As to the first requirement, the Government shall undertake a thorough review of the functioning of key markets, as defined by their importance for the domestic economy, such as energy, telecommunication, transport, or their potential linkage effects on other markets, such as the case of supermarkets, cement and goods distribution. The purpose of this review is to generate awareness and a better knowledge of the competitive playing field faced by undertakings willing to make business in El Salvador, and their impacts in terms of competitiveness and consumer welfare. Aside from specific reforms and improvements of public policies and regulations currently in place, which distort the conditions of competitions in these markets, the expected result of this activity are guidelines that introduce competition policy principles to public activity in areas such as regulatory reform, trade and industrial policy, privatization and modernization of the state, supervision of public services, etc., in such a way as to foster that future public interventions in the economic arena will not compromise the existence and functioning of dynamic and contestable markets.

3.16 The Government shall put in place a permanent instrument to monitor and follow up the structure and performance of key markets, that allows it to detect economic trends, the evolution of business and industrial indicators (concentration, product innovation, entrance and exit of rival firms, price trends, etc.) and serve as an early warning of competitive concerns and restrictive business practices. The Government shall approve rules that promote and advocate a culture of competition, as well as to prevent and sanction restrictive business practices of public and private undertakings, addressing at least anticompetitive practices among competitors and abuse of market dominance. The legislation shall be horizontal in scope, covering both markets subject to public intervention and markets with predominantly private participation; any possible exemption shall be clearly and narrowly defined, transparent and subject to periodic review. The legislation shall include an institutional arrangement to effectively enforce the competition rules. The competition authority shall have technical and political independence to fulfill its duties, including at least guarantees such as i) fixed term for its Director, not coincident with the President's term in office, and a qualified process for designation and removal of its Director; and ii) legal immunity to the authority and its officials. The Competition Authority shall have strong competition advocacy powers, even towards public entities, and be able to enforce the competition rules against private and public undertakings.

3.17 As a last requirement, the Government shall put in place the institutional arrangements defined in the legislation. This includes creation of the competition authority, designation of its Director and key personnel, hiring or designation of a team of professionals to attend the core activities of competition advocacy and control of restrictive business practices. The Government will also formulate a plan to train administrative and judicial in the competition policy guidelines and the competition rules.

3.18 GOES has initiated work on compliance with tranche conditions. Specifically, competition legislation is being drafted. However, work on the remaining two conditions has not commenced.

F. Third floating tranche disbursement condition

1. Macro Economic Framework

3.19 Government will maintain a macro economic policy framework consistent with program objectives. Compliance will be assessed by the Bank, based on the information generated in the context of the semi-annual consultations of the IMF (Article IV). Performance benchmarks to be assessed would emphasize elements indicative of growing domestic and external imbalances.

2. Maritime and air transport

3.20 In the area of maritime transport, conditions will address remaining reform issues and consolidation of the process. Government will present evidence that the following conditions have been met:

- Restructure the Ministry of Public Works, Transport, Housing and Urban Development (*Ministerio de Obras Públicas, Transporte, Vivienda y Desarrollo Urbano* – MOPTVDU) and the Autonomous Executive Ports Commission (*Comisión Ejecutiva Portuaria Autónoma* – CEPA) so as to enable those entities to assume their respective roles of policy definition, regulation and control for the sector, following the approval of reformed maritime and port legislation;

- Enactment of relevant technical and economical implementing legislation for the revised maritime and port legislation;
- Strengthening of the technical capacity of the sector's regulator to effectively supervise and regulated the sector;
- Granting and implementation of the Master Concession for the port operation in Acajutla, through signature and entry in force of the concession agreement.

3.21 In the area of air transport, disbursement conditions will conditions will address remaining reform issues and consolidation of the process. Government will present evidence that the following conditions have been met:

- Restructure the MOPTVDU CEPA so as to enable those entities to assume their respective roles of policy definition, regulation and control for the sector, following the approval of reformed civil aviation legislation;
- Enactment of relevant technical and economical implementing legislation for the revised civil aviation legislation;
- Strengthening of the technical capacity of the sector's regulator to effectively supervise and regulated the sector;

3.22 GOES has initiated work on compliance with the disbursement conditions and substantial advances have been achieved in the restructuring of the MOPTVDU and the drafting of the implementing legislation for the revised maritime and port and aviation legislation.

IV. FINANCING AND EXECUTION

A. Financing

4.1 The total amount of the program will be US$100 million of fast-disbursing resources from the Ordinary Capital (OC) reserves, to be disbursed according to the normal conditions of OC resources. Furthermore, with communication dated September 04, 2003, GOES through the El Salvador Governor to the Bank requested that all available FFI resources for fiscal year 2003, in the amount of US$77.9 million, be assigned to the proposed operation. The terms and conditions of the loan are provided below:

Table 4.1

Terms and Conditions	
Amount	IDB: US$100 million OC/FFI US$77.9 million OC US$22.1 million Total Program: US$100 million
Amortization period	25 years
Grace period	5.0 Years
Disbursement period	Minimum 18 months, maximum 24 months
Interest rate	Variable
Inspection and Supervision	1.0%
Credit fee	0.75%
Currency	U.S.-dollar Single Currency Facility

B. Disbursement schedule, conditions and dimensioning, of the program

4.2 The proposed operation will be disbursed in four disbursements, subject to compliance with the conditions presented in Section III C above and in the Policy Matrix (Annex I), which will be included in the operation's loan contract. Confirmation of compliance of contractual conditions will be based on the Bank's assessment and agreed-upon means of verification, as established in the Means of Verification Matrix (Annex II). The first disbursement will be up to US$40 million and all three following disbursements will be up to US$20 million. Final disbursement of resources is expected within no less than eighteen (18) months and no more than twenty four (24) months following loan effectiveness.

4.3 The disbursement structure and tranche values reflect the consistency and success of GOES in addressing competitiveness constraints over the last decade and the substantial progress in implementing specific policies in the recent past, as well as the level of additional reform efforts implied by the disbursement conditions. Specifically the first disbursement takes account of that long term track record and efforts undertaken by GOES in the infrastructure area prior to loan approval, whereas the following disbursements address additional policy areas and further reform measures.

C. Borrower and executing agency

4.4 The Borrower of the resources of the proposed operation would be the Republic of El Salvador.

4.5 The Executing Agency of the program will be the Technical Secretariat of the Presidency of the Republic (*Secretaria Técnica de la Presidencia de la República* - STP), which is the designated coordinating entity within GOES, and has been the GOES counterpart for the design of the proposed operation. Within the organizational structure of the Government of El Salvador STP is the agency charged with promoting the modernization process of the state and it derives its mandate and authority from the fact that it reports to the president of the republic.

4.6 STP would be responsible for coordinating and supervising the efforts of the different GOES agencies in the various sectors with regard to compliance with all relevant technical and administrative aspects of the disbursements' requirements. Nevertheless, STP would be the sole GOES agency responsible for presentation of all evidence of compliance with disbursement conditions and requests for disbursements, as well as maintain all relevant records related to disbursement process.

4.7 Moreover, STP will provide or coordinate the provision of all human, technical and financial resources required for adequate technical and administrative compliance of disbursement conditions. However, it is anticipated that compliance with the proposed disbursement conditions will not require substantial budgetary efforts on the part of STP or the sector agencies involved, and STP has confirmed the availability of those resources. Specifically, in the infrastructure area, as noted above, compliance with disbursement conditions has advanced significantly in all areas and the remaining technical aspects can be addressed satisfactory within the context of current human, technical and financial resources available to STP and the sector agencies.

4.8 In the area of vocational education and training and innovation, STP can draw upon a number of background and sector assessments carried out over the last years. Those works will need to be supplemented by some additional analysis and design efforts, some of which can be carried out within the framework of current resources and some of which will require additional resources, mostly specialized technical know how. The later will likely need to be contracted international, however, costs are estimated to not surpass US$250,000, including the costs of the assessment of all public programs. The anticipated restructuring efforts of the sector are anticipated to be undertaken within the framework of applying the existing human, technical and financial resources of the sector.

4.9 With regard to the implementation of the Competition policy and legislation conditions, it is anticipated that to a large extent requirements can be fulfilled making use of available resources in STP and the Ministry of Economics, where a special advisory group to the ministry has been addressing those issues. Some limited additional resources will be required in the assessment of competition conditions in relevant markets, but it is assumed that those can be financed with in the normal budget allocations of STP or the sector agency. In addition, the establishment and sustainability of an institutional structure to facilitate competition advocacy and market regulation will require additional human, technical and budgetary resources. Some of the latter might be garnished through user fees, however the bulk will need to be allocated in the context of GOES budget allocation. Human and technical resources will likely need to be contracted, although it is anticipated that present expertise could be reassigned. Nevertheless, initial resources requirements for compliance with disbursement conditions are moderate.

4.10 Nevertheless STP's central role in the definition, negotiation and implementation of the proposed operation, during project preparation efforts were made to coordinate and communicate with the relevant sector agencies involved in or potentially impacted by the implementation of the reform and policy measures. All specific disbursement conditions where consulted extensively with the line entities and agencies, and the possibility to implement the proposed initiatives and reforms was confirmed. However, enforcement responsibility and competence will ultimately rest with STP as the designated executing agency of GOES.

D. Policy Letter

4.11 The country and the Bank have agreed upon a Policy Letter, which presents the program in the broader context of the Government's economic strategy (see Annex III).

E. Disbursement procedure

4.12 Fast-disbursing resources from the program will be used to finance - inter alia - the costs of eligible imports from the Bank's member countries. Funds shall be disbursed for Borrower's use upon request through presentation of evidence of compliance with all contractual conditions.

4.13 Ministry of Finance, in coordination with the STP, is responsible for maintaining appropriate accounting records. Loan resources shall be deposited in segregated accounts. The Bank will require the Borrower to maintain appropriate records of funds disbursed from the loan and reserves the right to require the borrower to furnish an audited report of disbursed funds.

F. Monitoring and Evaluation

4.14 Monitoring and evaluation of attainment of project objectives and impact of project activities/components will be based on a defined set of outcome and impact indicators of the operation. The principal set of indicators will be the aggregated competitiveness indicators, i.e. Current and Growth Competitiveness Indexes, as well as sector specific competitiveness indicators provided by the WEF (see Table 1.2). In addition, specific quantitative and qualitative technical performance indicators have been defined for each area. Outcome and impact indicators would be evaluated twelve (12) months and thirty-six (36) following the final disbursement of funds, respectively, by the Bank to derive lessons learned and assess the operation's development impact.

Policy Area	Output	Outcome[1)]	Impact[1)]
Project Objective	Increased Competitiveness	Improvement in the Current and Growth Competitiveness Index of the WEF	Improvement in the Current and Growth Competitiveness Index of the WEF
Macro economic framework	Stable, conducive	Improvement in fiscal deficit indicators Improvement in SPNF total debt and debt service/revenues indicators	Sustainable fiscal deficit Sustainable SPNF total debt and debt service/revenues
Maritime Transport	Legal and regulatory framework Creation of regulatory body Restructuring of MOPTVDU and CEPA Master concession Acajutla	Tariff reduction by 25% vs 2002 Increased maritime traffic (# service providers and service frequency) Cargo handling efficiency (handling volume and average lay-over for ships)	Improvement in relevant WEF competitiveness indicators Legal Security Increased cargo volume handled by maritime transport Reduced average costs for maritime import/export shipments
Air Transport	Legal and regulatory framework Creation of regulatory body Restructuring of MOPTVDU and CEPA Outsourcing of operations of freight handling facilities to private sector	Increased freight traffic Increased freight handling quality measured by * reduction in complaints * reduced average storage time for goods Cost coverage of services	Improvement in relevant WEF competitiveness indicators Legal Security Increased cargo volume handled by air freight Reduced average costs for air shipments Increase of service frequency and destinations
Vocational education and training	National strategy Reposition INSAFORP Assessment of effectiveness of public intervention	Improvement in coverage ratio Reduced average costs for services Increased number of private suppliers and instruments/products offered	Improvement in relevant WEF competitiveness indicators Productivity growth Increase in El Salvador's ranking in international indicators/benchmarks measuring technical capability of labour force
Technology development and innovation	National technology policy Reposition	Improvement in coverage and access ratios Financing system	Improvement in relevant WEF competitiveness indicators

	CONACYT Establish "third tier" responsibilities within the public sector Assessment of effectiveness of public intervention	established and sustainable funded (R&D spending/GDP) Increased number of private suppliers and instruments/products offered	Productivity growth Increase in El Salvador's ranking in international indicators/benchmarks of technology development, adaptation and innovation
Competition Legislation	Legal and institutional framework	Identification and addressing of anti competitive and abusive market behaviour (# of reported, investigated and addressed cases)	Improvement in relevant WEF competitiveness indicators Tradable goods and services are priced in El Salvador at comparable levels to global markets

[1)] Proposed indicators

G. Inspection, supervision and External audits

4.15 The Bank shall establish such inspection procedures as it deems necessary to ensure satisfactory execution of the program. The Borrower shall cooperate fully in providing all assistance and information required for this purpose.

4.16 Furthermore, the Bank reserves the right to request the Borrower to provide financial reports on the use of the resources from the loan, audited by independent auditors acceptable to the Bank and in accordance with Terms of Reference approved prior by the Bank.

H. Ex-post evaluation

4.17 The Borrower through its Executing Agency advised the Bank that she has elected to not undertake an ex-post evaluation of the operation, in accordance with Bank operational policy (OP-305). Nevertheless, the Borrower has agreed to generate, maintain and provide to the Bank all the information required to enable an assessment of achievement of project objectives. Specifically, the Borrower through the Executing Agency will provide the Bank with the data required for assessing the development impact of the operation through the criteria outlined above (see IV.F). Equally, the Borrower has agreed to cooperate with and assist the Bank with any additional evaluation or assessment to be carried out eventually.

I. Environmental and social aspects

4.18 The proposed operation has no direct negative environmental or social impact, given its nature as a Policy Based loan in support of Government reform and policy initiatives to enhance the country's competitiveness. Moreover, the indirect impacts of the measures to be implemented under the operation are judged to be environmentally and socially neutral or even positive. Positive impacts could be derived from the fact that the increasing openness of El Salvador's economy has amplified international scrutiny and awareness of environmental and social imbalances in the wake of economic activities. For example, an increasing number of trade agreements consider social and environmental aspects and exert positive pressure to prevent or remedy sub standard situations. In addition, economic evidence and thinking increasingly points to the fact that degrading environmental and social conditions is only of very limited use in reaching sustainable improvement in competitiveness. Lastly, current legislation and regulation for example in the area of environmental protection, is deemed appropriate to contain and reduce negative environmental impacts of business activities.

4.19 Nevertheless, where applicable, specific policy action will be implemented taking into account relevant environment and social protection provisions, as established in Bank policy. This is specifically the case with regard to the outsourcing of port services in Acajutla sea port and freight handling services at the international airport, expected as part of the first disbursement conditions, as well as the granting ting of a master concession for the Acajutla sea port, expected as part of the third floating tranche.

4.20 The Bank Committee on Environmental and Social Impact (CESI) approved the operation September 18, 2003, without objections.

4.21 The operation does not qualify as a social equity enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (Document AB-1704). The rational is that the operation does not directly benefit any of the indicated target groups and will have only a very indirect, long term effect on improving the income for vulnerable and poor strata of society or fostering a more equal income distribution.

V. JUSTIFICATION AND RISKS

A. Justification

5.1 The proposed operation would support the Government of El Salvador in further enhancing and deepening the process of reforms and policy actions initiated in the early 1990's and aimed at creating and strengthening conditions for competitiveness of the country's businesses. With the latter established as a specific policy goal, initial reforms and measures to establish macro economic stabilization were accompanied and followed by the implementation of next generation structural reforms which focused on "macro" and "mezzanine" adjustments. The measures contemplated in the proposed operation would complement those earlier reforms and enhance their effectiveness and sustainability by addressing specific micro economic competitiveness constraints, which effect, inter alia, production, resources and market access costs, factor productivity and equality in participation in domestic markets.

5.2 Within the context of fiscal prudence, enhanced competitiveness of the country's businesses constituted an essential element to support macro economic stability and the sustainability of the country's current economic and social model, including the success of the implementation of the Monetary Integration Law. Diversification of exports, reduction of external imbalances and strengthening of the economies aggregate liquidity would further enhance the economy's capacity to withstand external shocks. Furthermore, sustainable increased competitiveness of businesses in El Salvador could lead to the generation of higher value employment and income, thereby contributing to a potential reduction in the country's social inequalities and poverty indicators.

5.3 Although the resources provided under the proposed operation are small compared to the overall size of El Salvador's economy, it is considered that the measures to be taken in its framework would provide for important multiplier effects over the longer term. Moreover, the resources would allow the economic authorities to further strengthen the country's macro economic position, thereby enhancing the necessary conditions for the business' sector competitiveness. This would include supporting recent government initiatives to restructure its external debt, with an aim to extend average terms and reduce debt service requirements.

B. Risks

5.4 The proposed operation does not face significant operational risks, in light of the proven capacity of the designated Executing Agency and its position within GOES organizational structure. However, the operation and successful implementation of agreed measures could face macro economic and political risks. Regarding the former, the principal risks would derive from a potential increase in domestic and external imbalances. Specifically, different projections point to the need to further strengthen the fiscal position, in order to alleviate increasing pressure on debt sustainability, which could weaken competitiveness.

Deteriorating internal and external balances could not only affect the short term competitiveness of the country, but ultimately jeopardize the sustainability of the monetary regime and therefore long term competitiveness and growth prospects. However, it is considered that the macro economic risks are mitigated by El Salvador's track record of economic policy and management, specifically with regard to fiscal prudence shown since the early 1990's. This confidence is underscored by GOES recent decisions to withstand political pressure for spending increases and veto corresponding legislation passed by parliament. Moreover, the resources from the proposed operation would also contribute to cushion fiscal pressure in the short term.

5.5 The second risk is derived from and associated with the democratic processes and the need to achieve consensus regarding the implementation of the reform initiatives and policy measures contemplated in the proposed operation. Those processes needed and wanted for the successful implementation of measures and their sustainability in the longer term, could contribute to "politicize" the technical debate and result in delays in the implementation of proposed measures. All the more so, given that the disbursement period of the proposed operation transcends the electoral cycle of the executive branch. However, the shown commitment of all Government and society since the early 1990's to advance needed reforms, despite equally challenging political circumstances, provide a measure of comfort regarding the operation's potential political risks.

MATRIX OF DISBURSEMENT CONDITIONS
COMPETITIVENESS SUPPORT PROGRAM (ES-0151)

	FIRST DISBURSEMENT *FIXED TRANCHE*[1]	SUBSEQUENT DISBURSEMENTS *FLOATING TRANCHES*[2]		
	Conducive Macroeconomic Framework			
Issues/ *Actions*	**Maritime Transport Sector** ** *Enactment of new maritime and ports legislation* ** *Creation of the new regulatory agency, the Autoridad Marítima Portuaria (AMP)* ** *Outsourcing of port services in the seaport of Acajutla* ** *Legislative approval of Basic Conditions for the Master Concession to operate the Port of Acajutla*	**Technical education/ Vocational training** ** *Adopt a national strategy for technical education and continuing vocational training* ** *Define the role and management of INSAFORP and strengthen it to perform its mandate* ** *Evaluation of all government programs in support of technical education and vocational training*	**Competition legislation** ** *Examine the functioning of the major markets for goods and services, and prepare and adopt competition policy guidelines or other regulatory measures for markets where competition is deficient, based on the current legal framework* ** *Submit competition legislation for public debate and consideration by the legislature* ** *Design, establish, and begin operation of a regulatory institution (competition authority).*	**Maritime Transport Sector** ** *Restructure the MOPTVDU and the head office of CEPA, to prepare them for their new policy-setting, regulatory and supervisory tasks under the LGMP.* ** *Prepare technical and economic regulations to the LGMP* ** *Strengthen the AMP for supervising and regulating the sector.* ** *Master Concession for the Port of Acajutla awarded and in effect*
	Air Transport Sector ** *Enactment of new civil aviation legislation* ** *Creation of the new regulatory entity, the Autoridad de Aviación Civil (AAC)* ** *Outsourcing of freight services at the international airport(AIES) in the areas of cargo handling and warehousing, maintenance and preservation of infrastructure, and operational security*	**Technological Innovation** ** *Adopt a national strategy to promote innovation* ** *Define the role and management of CONACYT* ** *Strengthen the entity responsible for implementing the national strategy to promote technological innovation, so it can assume the functions of a third-tier entity for the sector* ** *Evaluation of all government programs in support of technological innovation*		**Air Transport Sector** ** *Restructure the MOPTVDU and the head office of CEPA, to prepare them for their new policy-setting, regulatory and supervisory tasks under the LOAC.* ** *Prepare technical and economic regulations to the LOAC* ** *Strengthen the AAC for supervising and regulating the sector.*
Value *US$ millions*	**40**	**20**	**20**	**20**

[1] First tranche disbursement would become effective upon approval of the operation by the Bank's Board, subject to prior compliance with established conditions.

[2] The last disbursement will be made no earlier that 18 months after signature of the loan contract.

Matrix of Disbursement Conditions–Verification of Disbursement Conditions
Competitiveness Support Program (ES-0151)

AREAS	TRANCHE	CONDICIONALITY	MEANS OF VERIFICATION
Maritime transport and ports	**FIXED**	*** Enactment of new maritime and ports legislation*	Certified copy of the General Maritime and Ports Law (LGMP), enacted through Legislative Decree 994 of 19 September 2002.
		*** Creation of the new regulatory agency, the Autoridad Marítima Portuaria (AMP)*	Autoridad Marítima Portuaria (AMP), created through the LGMP and implemented through the Executive Agreement of 3 July 2003, which appoints the Executive Board. Certified copy of the Executive Agreement and evidence that the Board has been appointed.
		*** Outsourcing of port services in the seaport of Acajutla*	Certified copy of the signed management contracts for cargo handling and warehousing, infrastructure and suprastructure maintenance and preservation, and operational security operations in the seaport of Acajutla.
		*** Legislative approval of Basic Conditions for the Master Concession to operate the Port of Acajutla*	Basic Conditions for the Master Concession to operate the Port of Acajutla approved through Legislative Decree 1014 of 3 October 2002. Certified copy of the Legislative Decree and Bidding Conditions.
Air transport and airports		*** Enactment of new civil aviation legislation*	Certified copy of the Statutory Civil Aviation Law (LOAC), enacted through Legislative Decree 582 of 19 October 2001.
		*** Creation of the new regulatory entity, the Autoridad de Aviación Civil (AAC)*	Autoridad de Aviación Civil (AAC) of El Salvador created through the LOAC and implemented through Executive Agreement 124 of 22 January 2002, which appoints the Executive Board. Certified copy of the Executive Agreement and evidence that the Board has been appointed.
		*** Outsourcing of freight services at the international airport (AIES) in the areas of cargo handling and warehousing, maintenance of preservation of infrastructure, and operational security*	Certified copy of the signed management contracts for the operations.
Technical education/ vocational training	**FLOATING** **I**	*** Adoption of a national strategy for technical education and continuing vocational training*	Strategy paper and action plan for its implementation approved by the Committee of Ministers, composed of at least the Technical Secretary of the Office of the President of the Republic, the Minister of Education, and the Minister of Labor.
		*** Definition of the role and management of INSAFORP and strengthening it to perform its mandate*	Certified copy of the INSAFORP board agreement and action plan to implement the national technical education and continuing vocational training strategy in its areas of competence, including allocation of financial, technical, and human resources.
		*** Independent evaluation of all government programs in support of technical education and vocational training*	Terms of reference for commissioning the evaluation; evaluation report.

AREAS	TRANCHE	CONDICIONALITY	MEANS OF VERIFICATION
Technological innovation		*** Adoption of a national strategy to promote innovation*	Strategy paper and action plan for its implementation approved by the Committee of Ministers, composed of at least the Technical Secretary of the Office of the President of the Republic, the Minister of Education, and the Minister of Labor.
		*** Definition of the role and management of CONACYT*	CONACYT board agreement; certification of amendments to the statutes/charter.
		*** Strengthening of the entity responsible for implementing the national strategy to promote technological innovation, so it can assume the functions of a third-tier entity for the sector*	Institutional strengthening plan with a program for implementation and allocation of financial, technical, and human resources.
		*** Evaluation of all government programs in support of technological innovation*	Terms of reference for commissioning the evaluation; evaluation report.
Competition legislation	**II**	*** Examination of the functioning of the major markets for goods and services, and preparation and adoption of competition policy guidelines or other regulatory measures for markets where competition is deficient, based on the current legal framework*	Curriculum; report from the studies; certified copies of supporting documents for the actions taken.
		*** Submittal of competition legislation for public debate and consideration by the legislature*	Certified copy of the document remitting the bill to the Legislative Assembly; copy of publication of the preliminary bill; plan for public circulation of the preliminary bill, establishing the timeline, goals, and resources needed.
		*** Design, establishment, and operation of a regulatory institution (competition authority)*	Documentation showing evidence of its legal establishment, budget allocation, and implementation of operating structures, such as staffing and by-laws.
Maritime transport and ports	**III**	*** Restructuring the MOPTVDU and the head office of CEPA, to prepare them for their new policy-setting, regulatory, and supervisory tasks under the LGMP*	Study commissioned and performed Supporting documents for implementation of the study's recommendations.
		*** Preparation of the technical and economic regulations to the LGMP.*	Certified copy of the technical and economic regulations issued.
		***Strengthening of the AMP for supervising and regulating the sector*	Strategic plan approved, including the establishment of its mission and objectives; organizational/operating structure, and technical, financial, and human resource needs; institutional strengthening work plan approved, with an implementation schedule.
		*** Master Concession for the Port of Acajutla awarded and operating*	Certified copy of the signed concession contract for the Port of Acajutla and record of the awarding of the concession.

AREAS	TRANCHE	CONDICIONALITY	MEANS OF VERIFICATION
Air transport and airports		*** Restructuring of the MOPTVDU and the head office of CEPA, to prepare them for their new policy-setting, regulatory, and supervisory tasks under the LOAC*	Study commissioned and performed Supporting documents for implementation of the study's recommendations.
		*** Preparation of technical and economic regulations to the LOAC.*	Certified copy of the technical and economic regulations issued.
		*** Strengthening of the AAC for supervising and regulating the sector*	Strategic plan approved, including the establishment of its mission and objectives; organizational/operating structure, and technical, financial, and human resource needs; institutional strengthening work plan approved, with intertemp oral targets.
Macro-economic	**All**	*** Conducive macroeconomic framework*	Bank verification, based on official data from the Article IV consultations with the International Monetary Fund.