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Republic of El Salvador

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Republic of El Salvador

This report supplements our research update "El Salvador 'B+/B' Ratings Affirmed; Outlook Remains Stable," published on Dec. 22, 2015. To provide the most current information, we may cite more recent data than that stated in the previous publication. These differences have been determined not to be sufficiently significant to affect the rating and our main conclusions.

Rationale

Sovereign Credit Rating
B+/Stable/B

Standard & Poor's Ratings Services' ratings on El Salvador are mainly based on the sovereign's limited monetary and fiscal flexibility, which has led the country to significantly increase its general government and external debt burden over the past 10 years. At the same time, the rating incorporates the country's slow-growing economy and our assessment of political institutions' capacity to raise the country's growth prospects over the next two to five years.

We find governability difficult in El Salvador. The ruling party, Frente Farabundo Martí para la Liberación Nacional (FMLN), has little common ground with El Salvador's other major party, the Alianza Republicana Nacionalista (ARENA). The legislature has 84 seats. ARENA holds 35 seats, while FMLN has 31, so ARENA has enough votes to block any legislation that requires the two-thirds majority (external debt authorization, for example). Nevertheless, FMLN has been able to draw on the support of smaller parties for structural reforms that require only 43 votes. For example, in November 2015, FMLN was able to impose surtax on corporate profits above US$500,000 and to hike excise taxes on telecommunications by 5%. The government will earmark these extra revenues for law enforcement to address the country's high crime rate. Continued political antagonism could result in prolonged low growth, putting pressure on financial sustainability and employment.

Political differences could halt reform of El Salvador's pension system. The country implemented a three-pillar private pension system in 1998. However, the coverage of the system is narrow, and the transition costs have significantly increased since 1998. In addition, administrative costs are high. As a consequence, nearly two decades after the initial reform, financial obligations stemming from the current pension system that the state needs to fund still represent about 2% of GDP. The government is looking to convert the system into a still-undefined framework that would combine both public and private participation. Since we currently do not expect the reform proposal to include modifications in the benefits, we do not believe the pension scheme will change the current solvency of the state, although this reform could narrow the government's cash deficits. Because any change would affect the constituencies of the FMLN and ARENA differently, we do not expect reform to take effect for at least the next three years.

We project that net general government debt will be slightly below 60% of GDP for 2015-2018. This forecast is based on our assumptions that primary fiscal deficits will narrow to near balance, the economy will grow, on average, 2.5%-3% in real terms, and real interest rates on government debt will not increase. The tightening of the primary fiscal balance, in turn, will come from expenditure control, notwithstanding shortfalls in basic services and infrastructure. Our debt stock metric is net of liquid government fiscal assets. As of year-end 2015, we project that these assets will be less than 2% of GDP, which we find low for a fully dollarized economy.

In our view, external factors should play a big role in the sovereign's economic growth in 2016-2018. Lower oil prices and expected continued strong remittances from the U.S. should help household consumption. Over time, we think the government's anti-crime plan ("El Salvador Seguro") could be a boon to the economy because crime depresses investment, raises business operating costs, and hurts tourism receipts. Given El Salvador's demographics, we expect the country's per capita GDP to remain above $4,000 and per capita growth to average just under 2%.

We expect that positive growth in remittances and merchandise exports, in combination with a lower oil import bill, will help moderate the current account deficit (CAD) to 3.3% of GDP in 2018 from about 3.5% of GDP for 2015. As a result, we project that the country's external debt net of public- and financial-sector external assets will remain less than the sum of its current account receipts (CARs) through 2018. We also expect the country's gross external financing needs will remain less than its CARs plus usable reserves.

On the monetary side, complete dollarization has contributed to lower inflation and stabilized the financial system in El Salvador. This means, however, that the country has ceded monetary policy to the U.S. Federal Reserve Bank and has foregone having a lender of last resort for its banking system.

The banking system is well capitalized, with reported capital slightly below 17% of risk-weighted assets as of September 2015. More than 90% of the banking system, as measured by assets, is foreign-owned--about half Colombian. Nonperforming loans (NPLs) are still about 2.4% of total loans in 2015, similar to the previous year, and they are fully covered by loan loss provisions. The banking system also remains highly liquid, with liquid assets about 21% of total assets. Deposits equal slightly below 100% of loans. About 35% of the loan portfolio is for consumer lending, followed by housing at 22%. In our Banking Industry Country Risk Assessment, we assess El Salvador in group '7' (with '1' being the best ranking and '10' the weakest).

Outlook

The stable outlook indicates that we see a less than one-in-three probability that we will change our rating on El Salvador in the next 12 months. The outlook is premised on El Salvador's key fiscal and external metrics remaining at current levels. We could lower the ratings if El Salvador's debt dynamics deteriorate such that net general government debt surpasses 60% of GDP, or if rising CADs weaken its external liquidity or international investment position.

On the other hand, we could raise the ratings if--either through reform of the economy, the pension scheme, or public safety--the government permanently improves El Salvador's growth potential and, with it, public finances and external resilience.

Table 1

El Salvador--Selected Indicators										
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015f**	**2016f**	**2017f**	**2018f**
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	20.7	21.4	23.1	23.8	24.4	25.2	25.9	27.1	28.4	29.9
Nominal GDP (bil. $)	20.7	21.4	23.1	23.8	24.4	25.2	25.9	27.1	28.4	29.9
GDP per capita (000s $)	3.3	3.4	3.7	3.8	3.8	3.9	4.0	4.2	4.4	4.6
Real GDP growth	(3.1)	1.4	2.2	1.9	1.8	2.0	2.3	2.5	2.6	2.8

Table 1

El Salvador--Selected Indicators (cont.)

Real GDP per capita growth	(3.9)	0.7	1.6	1.2	1.2	1.3	1.7	1.9	2.0	2.2
Real investment growth	(19.2)	2.4	13.8	(1.4)	9.3	(6.4)	2.3	2.5	2.6	2.8
Investment/GDP	13.4	13.3	14.4	14.1	15.0	13.6	13.6	13.6	13.6	13.6
Savings/GDP	11.9	10.8	9.6	9.0	8.5	8.8	10.1	10.2	10.3	10.3
Exports/GDP	23.2	25.9	28.0	25.6	26.4	25.8	25.8	25.8	25.8	25.8
Real exports growth	(16)	11.6	9.3	(7.3)	4.8	(0.9)	2.3	2.5	2.6	2.8
Unemployment rate	7.3	7.1	8.0	6.1	6.3	6.2	6.2	6.0	6.0	6.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(1.5)	(2.5)	(4.8)	(5.2)	(6.5)	(4.8)	(3.5)	(3.4)	(3.3)	(3.3)
Current account balance/CARs	(4)	(6.1)	(11.3)	(12)	(14.8)	(10.9)	(7.9)	(7.6)	(7.2)	(7.2)
Trade balance/GDP	(17)	(18.8)	(20.6)	(20.7)	(21.7)	(20.7)	(19)	(18.9)	(18.8)	(19.1)
Net FDI/GDP	1.8	(1.1)	0.9	2.0	0.7	1.1	1.1	1.0	0.9	0.9
Net portfolio equity inflow/GDP	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross external financing needs/CARs plus usable reserves	93.6	94.7	100.8	99.0	99.3	102.1	102.2	99.0	98.9	97.8
Narrow net external debt/CARs	66.6	75.4	80.1	86.2	89.7	96.7	96.9	96.6	96.2	95.9
Net external liabilities/CARs	128.7	125.2	122.2	133.2	137.7	141.8	142.1	141.6	140.8	140.2
Short-term external debt by remaining maturity/CARs	21.2	22.5	19.2	11.2	14.3	16.9	18.1	17.6	16.7	15.8
Reserves/CAPs (months)	3.9	4.0	3.2	2.6	3.1	2.7	2.6	2.9	2.8	2.9
FISCAL INDICATORS (%, general government)										
Balance/GDP	(5.7)	(4.3)	(3.9)	(3.4)	(4)	(3.6)	(3.3)	(3.1)	(2.9)	(2.8)
Change in debt/GDP	7.0	2.9	4.1	6.9	1.5	3.4	3.3	3.1	2.9	2.8
Primary balance/GDP	(3.2)	(2)	(1.7)	(1.2)	(1.6)	(1.2)	(0.6)	(0.4)	(0.2)	(0.1)
Revenue/GDP	17.3	18.5	19.1	19.8	20.1	19.7	19.9	20.0	20.0	20.0
Expenditures/GDP	23.0	22.8	23.0	23.2	24.1	23.3	23.2	23.1	22.9	22.8
Interest /revenues	14.5	12.5	11.5	11.2	11.9	12.0	13.4	13.5	13.5	13.5
Debt/GDP	48.8	50.0	50.4	55.9	56.2	57.8	59.4	59.9	60.1	59.9
Net debt/GDP	44.3	47.6	48.9	51.5	54.5	56.2	57.6	58.3	58.5	58.4
Liquid assets/GDP	4.5	2.4	1.5	4.4	1.7	1.6	1.8	1.6	1.5	1.5
MONETARY INDICATORS (%)										
CPI growth	0.6	0.8	5.1	0.8	0.8	2.1	0.8	2.0	2.3	2.3
GDP deflator growth	(0.5)	2.3	5.7	1.0	0.4	1.4	0.8	2.0	2.2	2.2
Banks' claims on resident private sector growth	(4)	(0.8)	5.1	3.4	9.8	6.2	7.8	8.8	8.9	8.9
Banks' claims on resident private sector/GDP	44.7	42.8	41.6	41.8	44.9	46.1	48.2	50.3	52.1	54.0

Table 1

El Salvador--Selected Indicators (cont.)
Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local Currency. CARs--Current account receipts. FDI--Foreign Direct Investment. CAPs--Current account payments. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Institutional And Governance Effectiveness: Political Polarization Hinders Fiscal Reforms And Discourages Private Investment

- A divided Congress hampers policy implementation and efforts to reduce the fiscal deficit.
- The Sanchez Ceren Administration will continue to have good ties with the U.S.
- Crime and corruption continue to afflict El Salvador.

A divided legislature continues to hamper policy implementation. Neither of the two main political parties, the conservative ARENA nor the governing leftist FMLN, has a majority in the 84-seat Congress. ARENA holds 35 seats, while FMLN holds 31. ARENA has enough votes to block any legislation that requires a two-thirds majority (external debt authorization, for example).

The FMLN administration of President Sanchez Ceren has followed a moderate economic stance and sought the support of smaller parties for passing its legislative program. It has shown broad continuity in economic policies and has sought to work closely with the business community but continues to face disagreements from the private sector on proposals to raise tax revenues. Such disputes continue to block structural reforms that would set the stage for more private investments and higher economic growth.

However, FMLN and small parties in Congress have cooperated to approve laws on public safety. Congress has also passed laws raising taxes on telecommunications and income, which have been coming into effect since November 2015. These taxes will raise money to fund the national security plan ("El Salvador Seguro"), which also has the support of the Inter-American Development Bank.

Political polarization has delayed approval of the proposed fiscal responsibility law by the Ceren Administration, which is intended to reduce the country's fiscal deficit and control the recent rise in the debt burden. The Sanchez Ceren Administration will maintain good ties with the U.S. The El Salvadorian and U.S. governments entered into a second compact of an aid program called "Fomilenio II" in September 2015, allowing El Salvador to get funding from the U.S.' Millennium Challenge Corp. The agreement complements existing U.S. support through the Partnership for Growth program. The second compact commits the El Salvadorian government to working with the private sector to encourage investment and implement reforms to strengthen key regulations and institutions. El Salvador has committed to contribute $88.2 million on top of the Millennium Challenge Corp. investment, which results in a combined total of $365.2 million. The compact aims to strengthen human capital by investing in school infrastructure, as well as in technical and vocational education and training for the demands of the private labor market. The agreement also enhances regulations that improve the investment climate (for example, through El Salvador's public-private partnership law, which currently has been struggling with administrative processes) and develops a logistical infrastructure project to improve transportation and cut logistical costs of regional trade. Continued U.S. aid in coming years should provide a modest impetus for GDP growth.

The bitter legacy of El Salvador's civil war (which ended in 1992) is gradually diminishing as a new generation enters the political process. ARENA has taken steps to introduce new members and rejuvenate the party after consecutive losses in presidential elections, while FMLN has undergone less change. Continued political antagonism could cause prolonged low growth, which contributes to growing public-sector debt, as well as high unemployment.

Crime, typically related to drug-trafficking gangs, and insecurity, including from extortions, also hurts growth.Lack of public safety is also reflected in an increasing rate of emigration, especially to the U.S., where more than 2.3 million Salvadorians live (compared with 6 million in El Salvador). Over time, the government's anti-crime plan ("El Salvador Seguro") could stimulate investment, business operating costs, and tourism.

Economic Analysis: Improved International Context Should Boost GDP Growth Mildly

- Real GDP growth is likely to pick up very modestly to 2.6% on average during 2015-2018.
- Low investment, partly as a result of high crime rates, continues to constrain GDP growth.
- El Salvador's growth rate depends heavily on U.S. demand.

Our economic growth forecast for 2016-2018 is based primarily on external factors.Current international economic conditions, primarily increasing U.S. demand and lower oil prices, have provided support for El Salvador's growth prospects. GDP growth is likely to pick up to 2.6% on average during 2016-2018, compared with our estimated 2.3% in 2015. Quarterly GDP, as of September 2015, posted the highest growth, 2.6%, of the last four years, showing positive increases in all sectors of production.

Better economic performance is closely linked to the economic dynamism of the U.S., with which El Salvador has close commercial relations. Increasing U.S. demand benefits exports of El Salvadoran coffee, sugar, and maquila. Strong remittances, resulting from the expansion in the U.S. labor market, are helping household consumption. Overall demand--internal and external as of November 2015--posted a real increase of 3.4%, compared with the same period last year. Additionally, a sharp decrease in oil prices has significantly reduced the import bill for oil-related products, which, as of November 2015, posted a 20.8% reduction.

We estimate that per capita GDP for 2015 will slightly exceed $4,000. El Salvador ranks poorly at 116 (out of 188 countries, with 1 being the best and 188 being the worst) in the U.N.'s Human Development Index, reflecting significant shortfalls in basic services and infrastructure. According to the most recent data, government spending as a percentage of GDP has been consistently around 20%, and the public spending on education has been between 3.0% and 3.5%--less than most countries.

We expect that economic growth will remain low for the next three years, unless the government makes progress in building consensus on key economic policies that promote private investment and strengthen public finances. The consequences of many years of poor GDP growth appear in weak fiscal performance, which has contributed to a rising government debt burden; poor physical infrastructure, resulting from low public-sector investment; and poor job creation, also because of low private-sector investment. Job creation is essential to balance the large informal sector, which employs about 65% of the workforce.

El Salvador has created a framework for economic integration with the external world (through dollarization, free trade agreements, and privatization) but has been unable to develop a strong export sector that could boost industry and create jobs. The nontradable sector of the economy, which has lower productivity and salaries than the tradable sector, has grown as a share of the total economy in recent decades. Successive governments have failed to boost public or private investment, which have shown moderate increases over the last year, and relied mainly on fiscal measures because the country lacks a currency and monetary policy.

Slow implementation of public-private partnership projects, because of bureaucratic constraints, has resulted in construction delays in key investment projects, such as the $1 billion natural gas power plant and the modernization and expansion of the airport.

On the other hand, according to the Corruption Perceptions Index from Transparency International, the rank and the grade for El Salvador has been constant since 2012 in the middle but with an average grade of 38.5 over 100. In order to improve its World Bank Ease of Doing Business ranking, the sovereign presented minimal reforms to reduce complexity and cost of regulatory processes and strengthen legal institutions from 2006 to 2014. Since 2015, the government has initiated additional reforms to further boost its position on the ranking.

External Analysis: Current Account Deficits Could Moderate Thanks To Better External Conditions

- We estimate that growth in remittances and merchandise exports, in combination with a lower oil import bill, helped to reduce the CAD to 3.5% of GDP in 2015 from more than 4.8% in 2014 and should reduce it slightly further in the next two years.
- El Salvador will continue to depend highly on remittances, which represent about 40% of all CARs, sustaining external liquidity.
- We estimate gross external financing needs to remain slightly below 100% of CARs plus usable reserves for 2015-2018, on average.

We analyze El Salvador's external indicators in the context of the country's full dollarization. Similar to the experience of some countries on the periphery of Europe, the adoption of a foreign currency (in 2001) created monetary stability but so far has not led to more investment and growth. Political factors caused risk aversion, while lack of microeconomic reforms kept productivity low, limiting the country's global competitiveness

For 2015, we estimate that the CAD likely fell moderately to 3.5% of GDP from over 4.8% in the previous year, and we expect it to continue to decrease over 2016-2018. We expect reduction in 2015 mainly because we anticipate an increase in U.S. demand and remittances, which we expect will pick up and remain over 18% of GDP for 2015-2018, and, for 2018, we expect remittances to reach 19% of GDP.

We also estimate that the trade deficit fell slightly last year toward 19% of GDP from 21% on 2014. The trade deficit is likely to be 19% of GDP during 2016-2018, supported by more exports (thanks to an increased U.S. demand) and a slower pace of growth in imports (mainly because of lower oil prices). El Salvador is vulnerable to sudden changes in international commodity prices. Manufactured exports picked up as of the second half of 2015. Despite the expected reduction in the CAD, we expect that foreign direct investment will fund only about 30% of this deficit, and external debt will cover the majority of the remaining portion. We estimate that total capital inflows slightly exceed the CAD, likely boosting the level of foreign exchange reserves in 2015, which we expect to add up to about $3 billion.

The U.S. accounts for about half of Salvadorian exports, followed by Central America (mainly Guatemala and Honduras) at just below 40%. Exports to the U.S. consist mainly of maquila products (about 80% of which are textiles), coffee, and agricultural products. Maquila exports, as of October 2015, posted an annual increase of 9.1%, boosting total exports to grow about 5.8%, while coffee exports were growing at a 46% annual rate. Imports of capital goods rose in 2015, mainly as a result of more investments in the manufacturing, construction, commerce, and energy sectors.

The government has not received congressional approval for incurring additional external debt.As a result, the fiscal deficit is expected to be funded largely through short-term borrowings (Letras del Tesoro "LETES") up to $800 million in the domestic market, which, as of August 2015, added up to $433.95 million, and through disbursements from existing loans from international financial institutions.

We project that El Salvador's gross external financing requirements will remain slightly below 100% of CARs plus usable reserves, and its narrow net external debt for 2015 will be about 97% of its CARs. We are expecting both indicators to remain below 100% and keep decreasing in 2016-2018.

Fiscal Analysis: Pension Contributions Continue To Burden Fiscal Results

- Pension system obligations continue to burden El Salvador's fiscal performance and raise its debt burden.
- Absent monetary flexibility, fiscal policy remains the main tool for economic policy.
- We project that the increase in general government debt will average close to 3% for 2015-2018 annually.
- Shortfalls in basic services and infrastructure limit fiscal flexibility.

Fiscal performance and flexibility

El Salvador's fiscal weaknesses reflect slow economic growth, a large, informal economy, and shortfalls in basic services and infrastructure. Despite rising tax collections, government revenues have not kept pace with spending needs, especially in the pension system. The funding needs of pension system obligations have contributed to a steadily rising level of general government debt. The pension system shortfall accounts for about 2% of GDP, or more than half the government's fiscal deficit.

We estimate that the nonfinancial public-sector deficit was about 3.3% of GDP in 2015 and, absent pension reform, will be around 3% in 2016 and 2017. The government financed the 2015 fiscal deficit largely through short-term debt (a LETES issuance of about $800 million) because Congress failed to approve the issuance of additional debt in 2015.

For 2015, we are expecting the fiscal deficit to reach about 3.3% of GDP, moderating from the 3.6% posted in the previous year. This is supported mainly by a significant increase, as of November 2015, in central government revenues, which grew about 4.2%, compared with 0.3% the previous year. On the expenditure side, as of November 2015, the growth pace continues to be low and reached about a 1.4% annual growth rate, but it was still unable to compensate for financial obligations of the pension system. These are trends that we expect to continue in 2016-2018. We estimate the fiscal deficit, absent pension reform, will continue to decrease moderately and reach around 2.8% of GDP in 2018., The fiscal deficit should receive a boost from the surtax on corporate profits above $500,000 and the hike in excise taxes on telecom by 5%, which went into effect in November 2015, compensating for costs of the "El Salvador Seguro" plan. We expect the government to continue reducing capital expenditures and maintain spending cuts that it implemented in 2015.

We are not assuming that Congress will approve a fiscal responsibility law, which members discussed in 2015. The parties did not reach a consensus.

El Salvador privatized its public-sector managed pension system in 1998 by implementing a three-pillared private approach. Since then, the government has had to pay the transition costs of the reform, contributing to a fiscal deficit. The initial reform was accompanied by certificates that compensated workers who passed from the public system to the private one (about 130,000 contributors). In the following years, the government issued several decrees that boosted the value of its obligations. The move to dollarization in 2001 reduced interest rates and therefore lowered the rate of return on pension fund investments. Congress unified benefits available under both systems in 2003 and increased them in 2006. In addition, that year the government created Certificates for Pension Investments (CIPs)--debt issued by the sovereign and placed with the private pension funds (AFPs) to fund its pension liabilities. As a result, the government owes more than half of the pension debt for benefits that it did not envisage in the original reform. Additionally, El Salvador has only two AFPs, which reduces competition. The funds charge fees that make up about 17% of the total contributions.

Nearly two decades after the initial reform, the annual shortfall of the pension system is about 2% of GDP. Only 23% of people of working age are incorporated in the pension system, and the rest belong to the informal sector. Of those who do contribute to the pension system, only 40% will be entitled to receive a pension (after meeting the requirements of length of contributions). Contributors retiring earlier from the system are entitled to receive their full contributions and therefore drain the system's liquidity. Plus, about 88% of those who receive a pension will receive a minimum pension amount and therefore have less incentive to support higher contributions. All of these shortcomings add to the political controversy surrounding both pension and tax reform (as the latter is needed to boost resources for the former).

The Sanchez Ceren Administration plans to present pension reform to Congress in early 2016, in January or the first few days of February at the latest, to convert the current system into a mix that includes both the government and the AFPs. As we currently do not expect this reform to alter the existing parameters of the system, we do not believe any modifications to the pension scheme will change the present solvency of the state, although this reform could narrow the government's cash deficits. Depending on the details, a successful reform could reduce the government's fiscal deficit by 60%-70%. Nevertheless, the reform is controversial and may not pass. ARENA does not want to assume the political risk of amending the pension reform that it introduced in 1998.

Debt burden

The general government debt burden has steadily increased in recent years, largely because of the problems in the pension system. We estimate that general government debt will reach about 59.4% of GDP in 2015, while we estimate net general government debt to be around 57.6% of GDP. We expect total public-sector debt to be slightly below 60% of GDP for 2015 and will likely exceed that threshold in the following years, reaching about 62% of GDP in 2017. In our projections, we expect interest expenses to be about 13.5% of general government revenues on average for 2015-2018. Our debt stock metric is net of liquid government fiscal assets. As of year-end 2015, we project that these assets will be less than 2% of GDP, which we find low for a fully dollarized economy

Internal debt consists largely of short-term LETES, as well as long-term special bonds (CIPs) the government issued for recognizing future pension obligations (amounting to 14% of GDP in 2015).

In our assessment, we considered that, as of October 2015, 84% of commercial loans are held by nonresidents. We estimate that the banking sector poses a limited contingent liability to the sovereign, according to our criteria. Public-sector enterprises pose a limited contingent liability to the sovereign. El Salvador has a relatively small state-owned enterprise sector, thanks to privatization the sovereign implemented in previous years.

Monetary Policy: Limited Flexibility Because Of The 2001 Adoption Of Dollarization

- We expect that El Salvador will maintain the U.S. dollar as its currency for the foreseeable future.
- The banking sector remains highly liquid and well capitalized.
- We believe that El Salvador's contingent liabilities from the financial sector will remain limited.

El Salvador has a long history of monetary stability. The country moved from a de facto pegged exchange rate with the U.S. dollar into full dollarization in 2001. We believe that the government is committed to this arrangement despite the economic costs of an inflexible monetary regime. Dollarization has lowered inflation and facilitated international trade, especially with the U.S., but it has failed, in the eyes of its critics, to sufficiently lower local interest rates and promote investment and growth. Nevertheless, critics of dollarization, including those in government, believe that the costs of abandoning the current monetary regime exceed potential benefits. Hence, much of the focus of government policy is on boosting productivity and reducing crime to promote investment.

Inflation is dropping and reached 1% in 2015. Inflation may pick up in 2016 and reach 2%-2.3% over 2016-2018, reflecting sluggish domestic demand, but subject to fluctuations in the price of food and natural resources (like oil). El Salvador's central bank has few tools available for managing liquidity in the financial system, relying largely on reserve requirements.

The banking system is well capitalized, with reported capital slightly below 17% of risk-weighted assets as of September 2015. More than 90% of the banking system, as measured by assets, is foreign-owned, about half Colombian. The top five banks account for about 80% of total assets in the system. Nonperforming loans are still about 2.4% of total loans in 2015, similar to the previous year, and they are fully covered by loan loss provisions.

The banking system remains highly liquid, with liquid assets about 21% of total assets. Deposits equal slightly below 100% of the level of loans. About 35% of the loan portfolio is for consumer lending, followed by housing at 22%.

El Salvador's financial markets are relatively undeveloped, given their small size. Pension funds (and banks) are the main domestic creditors. The funds typically buy LETES (short-term government debt) and some long-term sovereign debt as well. Sovereign debt accounts for less than 20% of total bank assets. On average, the banks have purchased about half the outstanding stock of LETES.

Total domestic claims on the private sector and on the nonfinancial public sector are about 45% of GDP as of November 2015 and are likely to be at that level as of year-end--high by regional standards. Bank lending, as of November 2015, has been growing about 3.7% in 2015, while deposits have grown only 5.2% (increasing significantly from negative 1% at year-end 2014 and from 1.4% in November 2014).

Chart 1

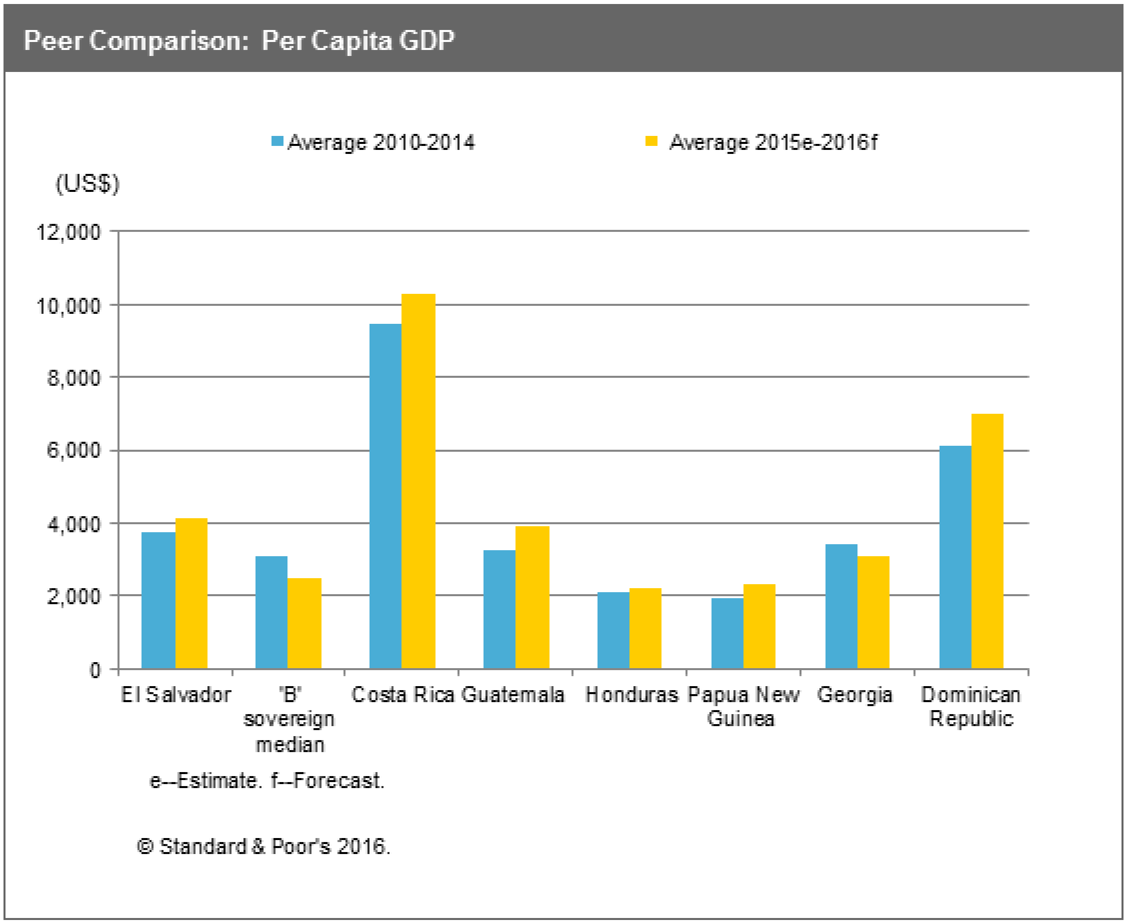
Peer Comparison: Per Capita GDP
Average 2010-2014
Average 2015e-2016f
(US$)
12,000
10,000
8,000
6,000
4,000
2,000
0
El Salvador
"B" sovereign median
Costa Rica
Guatemala
Honduras
Papua New Guinea
Georgia
Dominican Republic
e--Estimate. f--Forecast.
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Chart 2

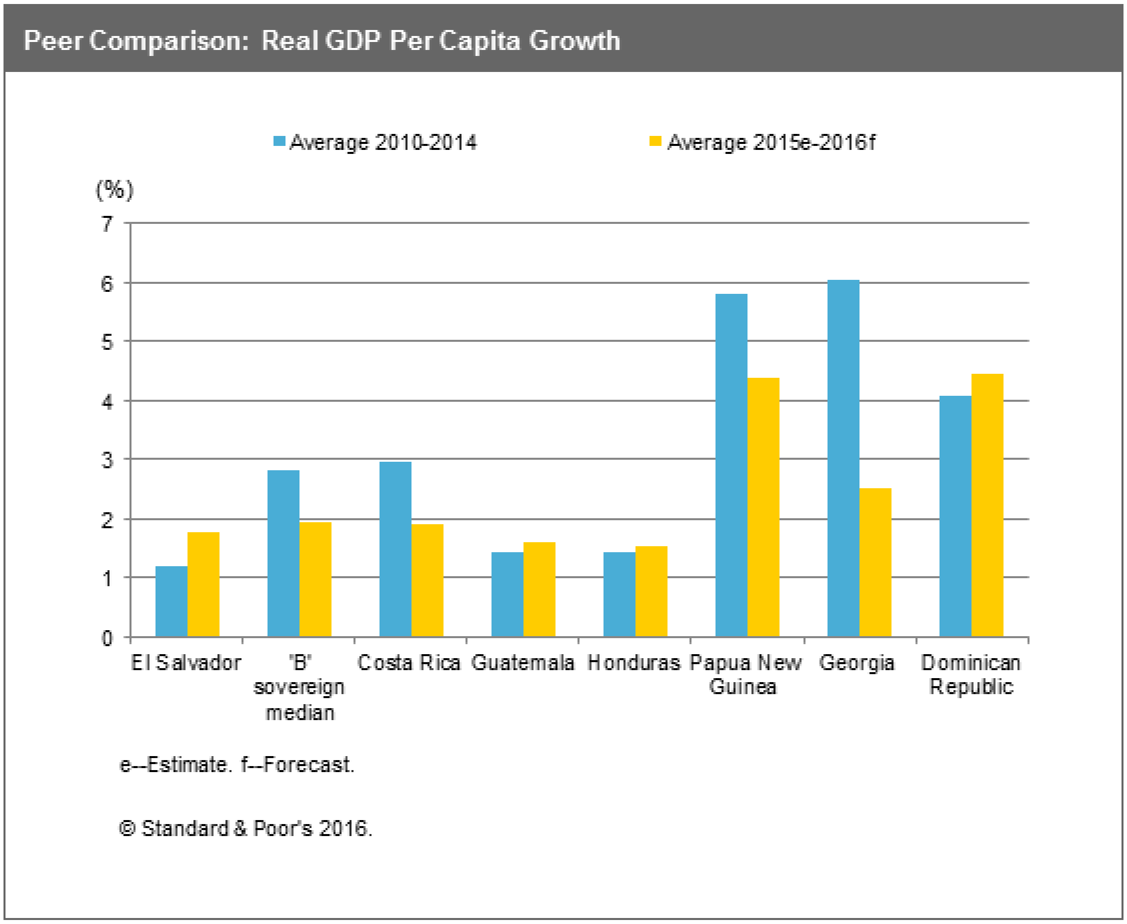
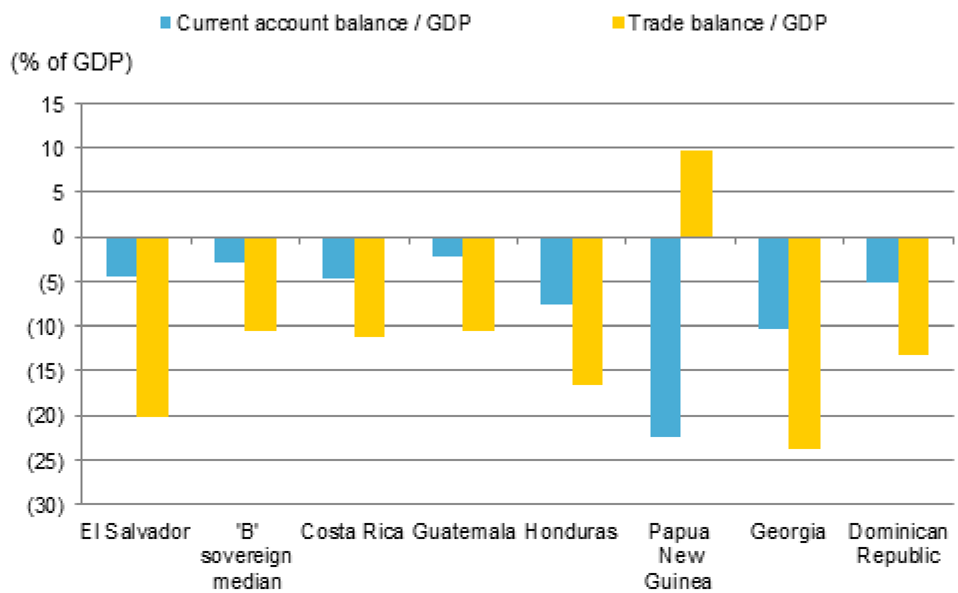

Peer Comparison: Real GDP Per Capita Growth
Average 2010-2014
Average 2015e-2016f
(%)
7
6
5
4
3
2
1
0
El Salvador
'B' sovereign median
Costa Rica
Guatemala
Honduras
Papua New Guinea
Georgia
Dominican Republic
e--Estimate. f--Forecast.
© Standard & Poor's 2016.

Chart 3

Peer Comparison: Current Account Balance And Goods And Services Exports (Average 2010-2015e)



e--Estimate. f--Forecast.

Chart 4

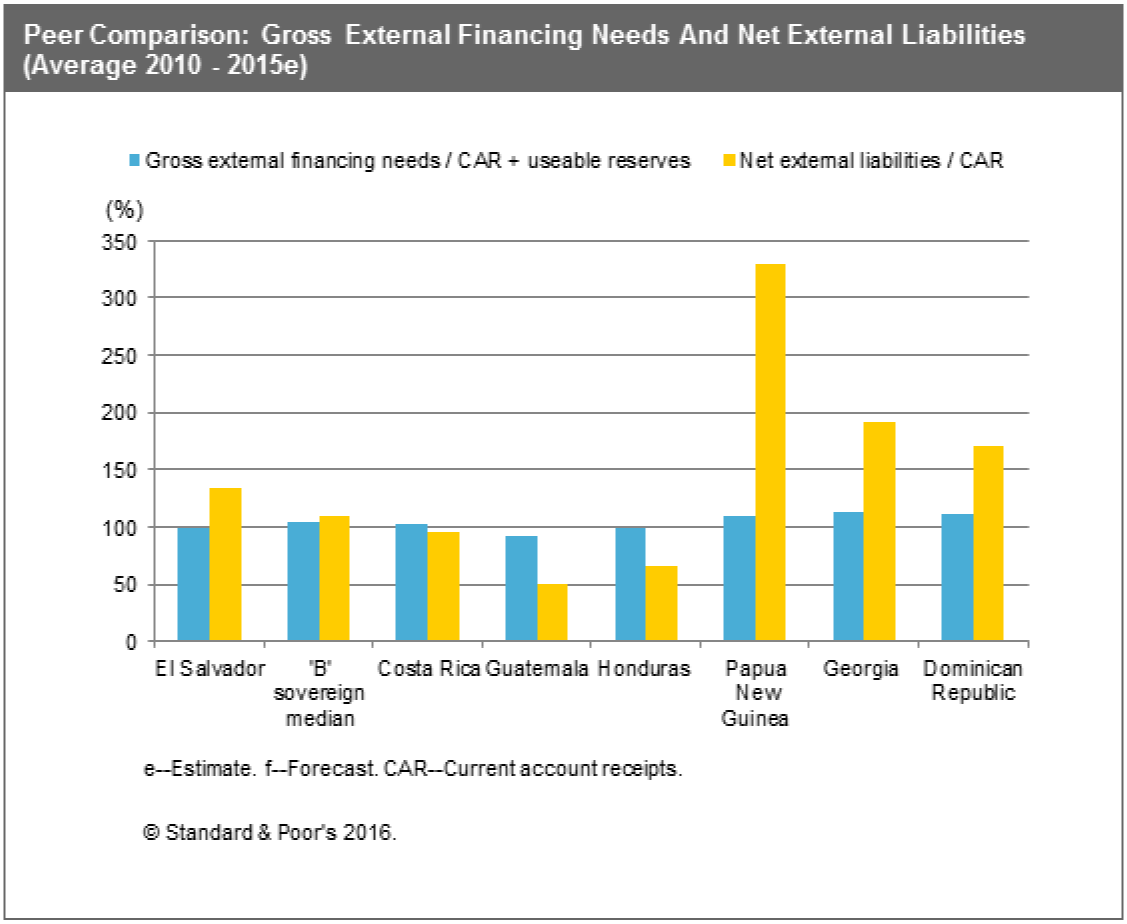
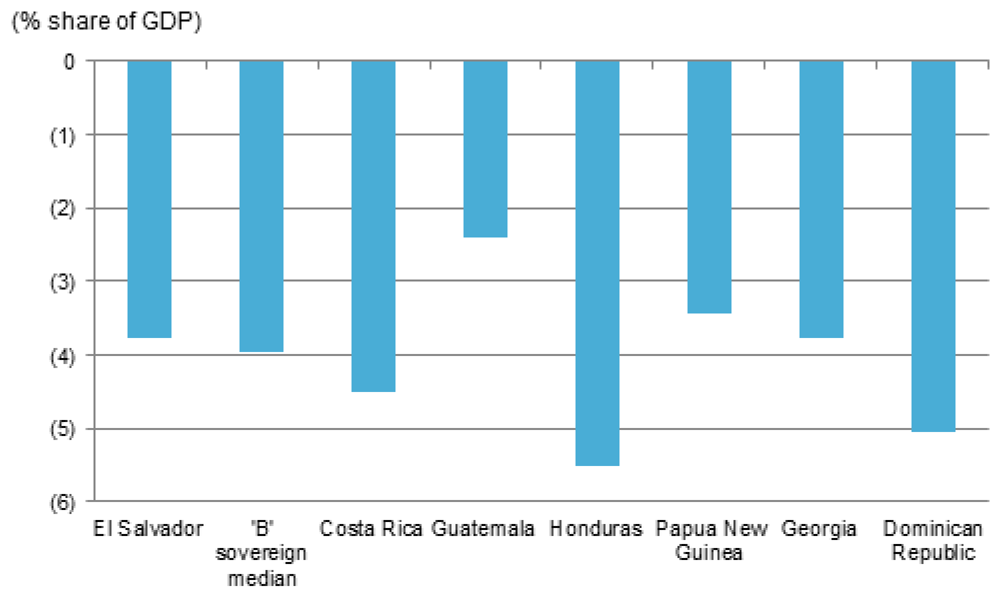

Peer Comparison: Gross External Financing Needs And Net External Liabilities (Average 2010 - 2015e)
Gross external financing needs / CAR + useable reserves
Net external liabilities / CAR
(%)
350
300
250
200
150
100
50
0
El Salvador
'B' sovereign median
Costa Rica
Guatemala
Honduras
Papua New Guinea
Georgia
Dominican Republic
e--Estimate. f--Forecast. CAR--Current account receipts.
© Standard & Poor's 2016.

Chart 5

Peer Comparison: General Government Balance (2010-2015e)



e--Estimate. Negative (positive) indicates an overall general government fiscal deficit (surplus).

Chart 6

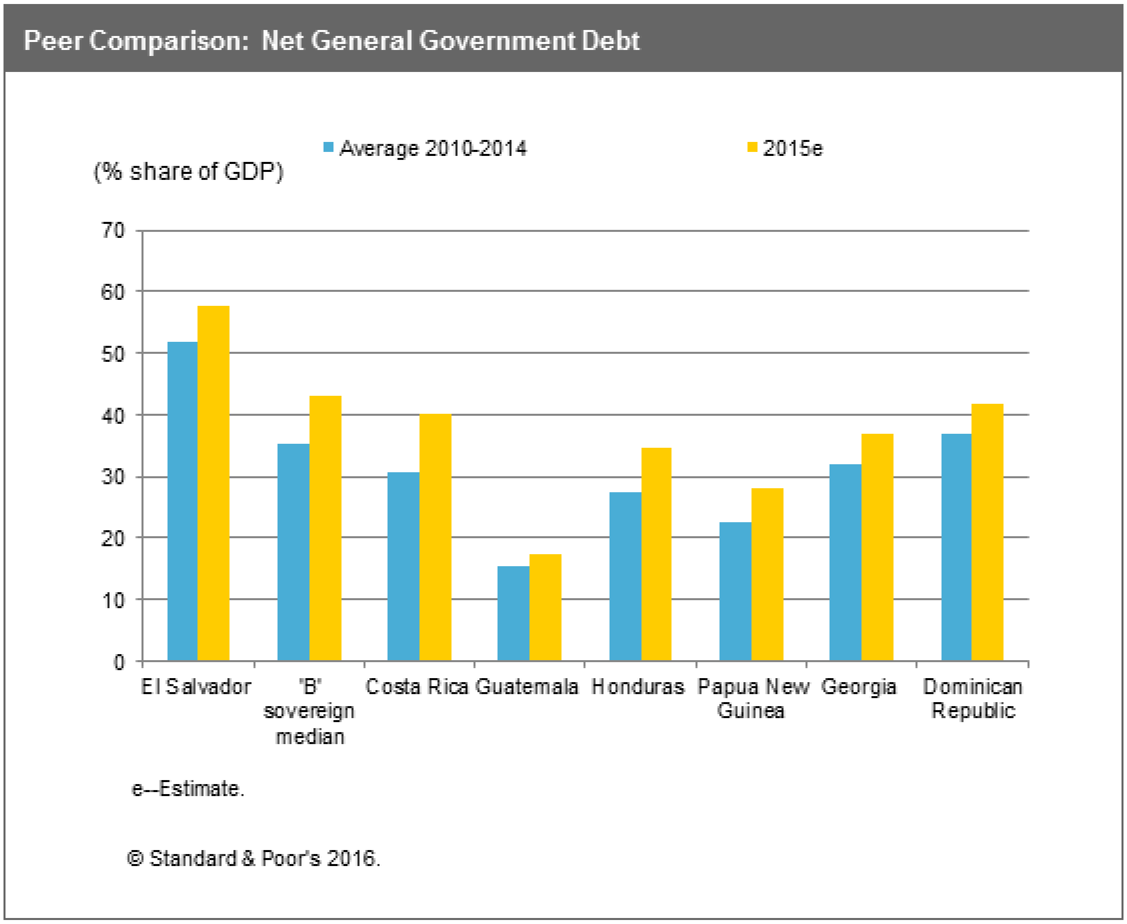
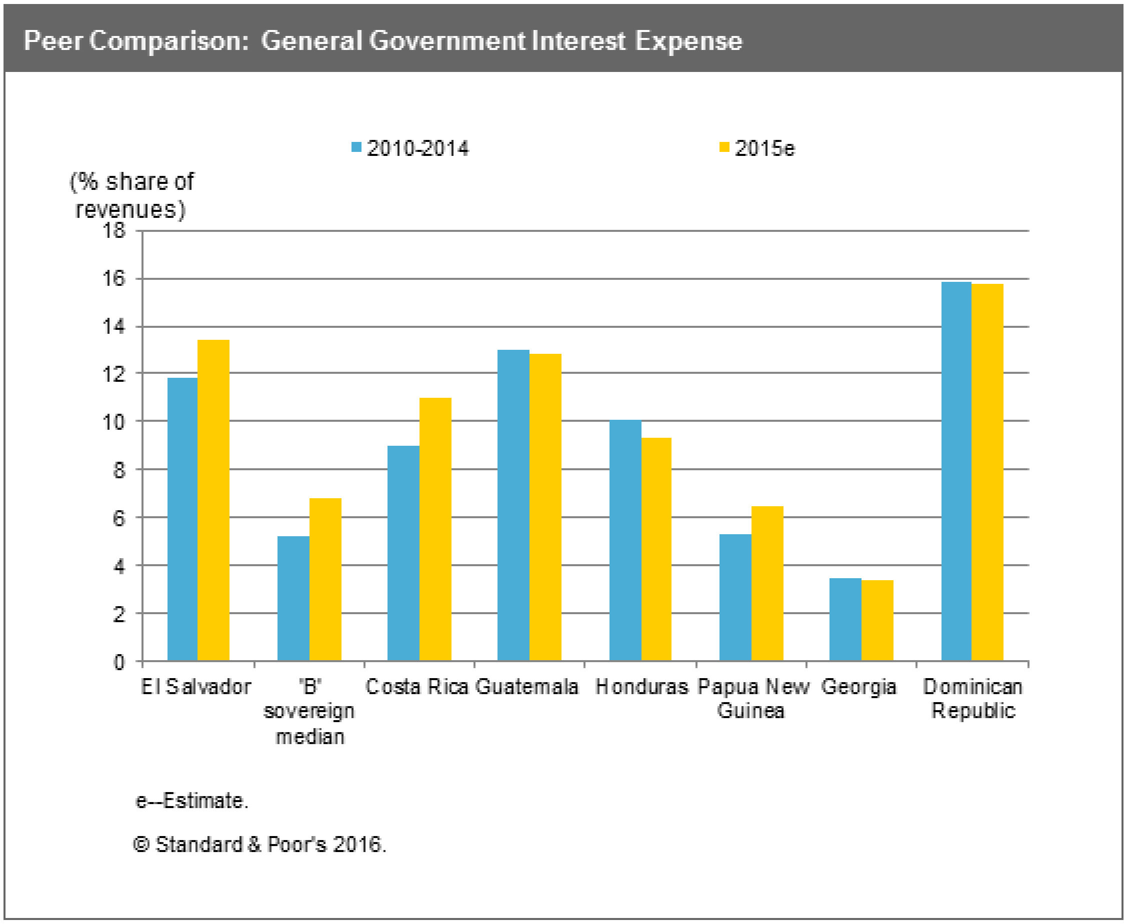

Peer Comparison: Net General Government Debt
Average 2010-2014
2015e
(% share of GDP)
70
60
50
40
30
20
10
0
El Salvador
'B' sovereign median
Costa Rica
Guatemala
Honduras
Papua New Guinea
Georgia
Dominican Republic
e--Estimate.
© Standard & Poor's 2016.

Chart 7



Local Currency Rating And T&C Assessment

The local currency rating on El Salvador is 'B+', and the transfer and convertibility (T&C) assessment is 'AAA'. These reflect the country's adoption of full dollarization in 2001. El Salvador is unlikely to de-dollarize because it considers the costs of doing so to be much greater than the disadvantages of limited monetary flexibility.

Related Criteria And Research

Related Criteria

- Sovereign Rating Methodology, Dec. 23, 2014
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Ratings Detail (As Of January 26, 2016)	
El Salvador (Republic of)	
Sovereign Credit Rating	B+/Stable/B

Ratings Detail (As Of January 26, 2016) (cont.)		
Transfer & Convertibility Assessment		AAA
Senior Unsecured		B+
Sovereign Credit Ratings History		
22-Dec-2014	*Foreign Currency*	B+/Stable/B
21-Dec-2012		BB-/Negative/B
14-Jan-2011		BB-/Stable/B
22-Dec-2014	*Local Currency*	B+/Stable/B
21-Dec-2012		BB-/Negative/B
14-Jan-2011		BB-/Stable/B

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.