DAC WORKSHOP: TOWARDS GOOD PRACTICES FOR DONORS ON CAPACITY DEVELOPMENT FOR TRADE

EL SALVADOR CASE STUDY

This document is submitted as background material for discussion at the Workshop, to be held in Paris on 29-30 May 2000 and should be considered together with the background paper [DCD(2000)10].

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EL SALVADOR CASE STUDY

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I. El Salvador’s Trade Policy and Institutions

A. Background

1. The relevant background for El Salvador’s trade policy and institutions goes back to the establishment of the Central American Common Market (CACM) in 1961. At that time El Salvador was a very poor, agriculturally-based country. The country was the most technically advanced in coffee production in Central America, but this was based on production by large estates. These estates were the historical legacy of the Spanish conquest. Population growth over time had produced the most densely-populated country in Latin America, many working as an agricultural proletariat on the large estates. Government social programmes were limited, and a large fraction of the rural population was illiterate. The country’s infant mortality rate, about 130 per thousand births, was one of the highest in Latin America. Coffee was the primary export crop, accounting for about 70% of all merchandise exports.

2. The creation of the CACM in 1961 was thought at the time to provide an opportunity for the country to outgrow its historical dependence on agriculture. Establishment of a high tariff wall around the five Central American members did produce substantial investment in industry during the 1960s, of which El Salvador was one of the principal beneficiaries. Its export base diversified substantially, and exports of manufactures – almost entirely to Central America – became important.

3. The Economic Commission for Latin America of the United Nations, led by Raul Prebisch, had believed that an initial period of import-substitution behind high tariff walls could be followed by exports of manufactures. The tariff walls would be gradually reduced to spur competitiveness of the manufacturing sector, which would gradually emerge from its “infant-industry” status. The tariff reductions sought by regional economic theorists in the late 1960s did not materialise, however, for two reasons. First, the leaders of the newly-emerged manufacturing sector, now politically influential, saw them as threatening to the continued existence, or the profitability, of local manufacturing. Second, a brief war between El Salvador and Honduras in 1969 effectively ended the shift toward closer regional integration among the CACM members.

4. Slow economic growth during the 1970s, with a narrowing of opportunities for political expression under successive military governments, produced societal polarisation. This broke out into civil war in 1979. A reformist coup later that year led Jose Napoleon Duarte, one of the earlier reformers, to power, first as a member of a ruling junta, later as sole leader, and subsequently in 1984 as elected president. Duarte undertook a land reform programme that seized and redistributed the largest estates in the country, nationalised banks, and established government agencies to control exports of coffee and cotton. He also instituted a variety of measures to broaden popular participation in government and to promote democracy. But Duarte’s policies did not end the polarisation, and the civil war continued past the end of his term of office.
5. A reformist conservative government, led by Alfredo Cristiani, was elected in 1989. The Cristiani government quickly reversed most of the economic policy changes instituted by Duarte. The banking system was re-privatised, the multiple exchange-rate system was abandoned for a market-based rate free of capital controls, and foreign trade institutions were returned to the private sector. The Duarte land reform programme and many of the Duarte initiatives in health and education were maintained.

6. Like his predecessor, Cristiani sought to negotiate an end to the civil war. Though the ideological gulf with the left was far wider for Cristiani than for Duarte, a final peace agreement between the Cristiani government and the FMLN leadership was signed in Mexico in January 1992. The former guerrillas began to participate in the political process, which has continued to be democratic. Subsequent victories in presidential elections in 1994 and 1999 consolidated the conservative control over national economic policies, though the left became a major force in the congress after the legislative elections of 1996. The left won 29 out of 84 seats in the March 2000 national elections, becoming the largest party in the legislative assembly.

B. Economic Policies

Evolution and Current State

7. Historically, El Salvador followed economic policies that were largely laissez-faire. The government was small, providing only limited government services to rural areas. The country’s central bank was private until 1961, and maintained a passive monetary policy that kept inflation at the level of the country’s major trading partner, the United States.

8. Although subsequent governments during the 1960s and 1970s began to take a more activist stance, the Duarte period was still a sharp departure from the past. As mentioned above, the government took a central role in the economy, nationalising banks and foreign trade in the main commodities. Government spending rose sharply, both because of increased defense spending due to the insurgency and because of expanded government programmes in health, education and other social sectors. Monetary policy became active, supporting government spending, and controls were imposed on foreign exchange transactions to prevent depreciation of the currency.

9. The Cristiani government that took power in 1989 moved to restore the basic free-market orientation of productive activity. Commercial banks were privatised, foreign trade transactions were returned to private hands, and the exchange rate was allowed to depreciate to a market level. The government’s social policies, however, continued the orientation of the previous government, seeking to expand access to education and health, maintain the agrarian reform, and generally to promote broad-based development. The World Bank is effusive in its praise of these efforts (World Bank 1996, p.1):

"Since 1989, El Salvador’s policymakers have accomplished three remarkable achievements: end the civil war; implement a coherent economic strategy leading to the stabilisation of the economy and the reactivation of growth; and initiate a systematic attack on poverty…The country’s economic performance during the last six years is a remarkable success story. During the 1990s, El Salvador has registered among the highest growth rates in the hemisphere and this has occurred despite the migration of the best of its labour force to the United States."

10. The principal goals for macroeconomic policy had been achieved by the mid-1990s, and the government turned to some sectoral problems. Government enterprises in electricity and telephones were privatised. The privatisation of telephone service in particular had dramatic results. In the last year, the total number of telephones in the country has doubled to about 900,000, due to expansion of the cellular...
network and the use of pre-paid cards for cellular users. Telephone rates have fallen dramatically, with calls to the U.S. now below 20 cents per minute. The country’s overall economic growth rate fell in 1996, and averaged only 3% during the 1996-99 period, compared to 6% during 1991-95. Inflation was brought under control during the first half of the 1990s, and inflation since 1997 has averaged less than 2%, with a slight price decline in 1999.

11. The major macroeconomic problem at present is evident in very high levels of real interest rates. Lending rates are on the order 15% for borrowers in local currency, and 10% in dollars. The tight monetary policy is required by the conjunction of two economic circumstances: the tendency for government to run fiscal deficits; and the massive inflows of remittances from Salvadorans living abroad.

Assessment

12. Overall, Salvadoran economic policy is very favourable for economic growth and for trade development. There are no obvious policy gaps. While the exchange rate (as discussed below) is seen by many as overvalued, this is a product of market forces and not of government policy action. There are obstacles to faster economic growth in the country, but these are less due to policy than to environmental conditions. The two most obvious ones are poor infrastructure and lack of education of the labour force.

13. The road infrastructure, particularly in rural areas, suffered during the civil war, both from lack of maintenance and the failure to make the new investments that would have occurred in peacetime. Ports are inadequate. The low average level of education of the labour force limits the opportunities for skills development and the upgrading required by higher-skill export industries. These problems are only susceptible to long-term solution through appropriate investments. Donors can support such activities, but their payoff will be gradual.

C. Trade Policy

Evolution and Current Situation

14. Since 1990, successive Salvadoran governments have striven to establish and maintain a very open and transparent trade policy, viewing liberal trade as important for the long-term economic growth of a small country like El Salvador. A related feature is a very liberal policy towards inward foreign investment, particularly investment intended for export. There seems to be very broad support for these views in the country. The main features of policy relevant to trade are given below.

15. Tariff structure. El Salvador undertook a major reform of its import tariff system in the early 1990s, sharply reducing maximum tariffs. The government had proposed moving to a uniform tariff of 6% on all imports in order to eliminate distortions that would result from variation in effective rates of protection for different commodities. Faced with resistance from industrialists and from other members of the CACM, a new tariff structure with rates ranging from zero to 15% was approved, which went into effect in January 2000, and all Central American countries have adopted the same rates. There is tariff escalation, with capital goods and raw materials not produced in Central America with zero or low rates, and consumer goods at the 15% rate. Nevertheless, this is a dramatic reduction from the very protectionist common tariff of the CACM, under which consumer goods were subject to 40-80% tariffs.

16. Exchange rate policy. The Salvadoran colon has been informally pegged at 8.75 colones per dollar since 1993. Inflation averaged 10% per year during 1993-96, so the real exchange rate appreciated considerably vis-à-vis the U.S. dollar. Because inflation since 1997 has approximated the U.S. rate, no further appreciation of the real exchange rate has occurred since then. Nevertheless, exporters have argued
that the rise in the real exchange rate has damaged their competitiveness abroad. The major notable factor behind the rising real exchange rate has been the steady inflow of remittances – estimated at $1.5 billion in 1999, or an amount equivalent to more than 12% of El Salvador’s GDP – from Salvadorans living in the United States. Banks lend and borrow in both dollars and colones, the national currency. The substantial “dollarization” of the economy has led some, including leading figures in the banking community, to propose complete elimination of the national currency and its replacement by the U.S. dollar.

17. The one step that the government has taken in this area is that of providing a “drawback” for non-traditional exports of 6% of the value exported. It is not available for coffee, sugar, shrimp, or export processing zone (EPZ) exports, but is provided automatically for all other products. While the drawback is marketed as reimbursement for taxes paid, it is a simple direct subsidy to exports: the exporter receives a check from the government for 6% of the value exported. As a consequence, exporters receiving it are vulnerable to countervailing duty actions in foreign markets.

18. Foreign investment. El Salvador enacted a liberal foreign investment law in 1990, and has actively sought foreign investment as a major part of its export promotion programme. Although some domestic firms operate in the country’s EPZs, most firms there are foreign. The policymakers believe that foreign firms bring important technology and marketing advantages that can increase export dynamism. The country has been able to attract substantial amounts of investment in the last several years for both exports and domestic infrastructure. Both the national power system and the telephone company were sold to foreign firms, leading to a net foreign investment inflow of more than $1 billion in 1998-99. Nevertheless, any potential foreign investor visiting the country is sure to note the presence of armed guards in front of most businesses. The high level of crime and personal insecurity is likely to be an important obstacle to foreign investment.

19. Position on trade negotiations. Many developing countries see multilateral trade negotiations (MTN) as arcane and beyond their capacity for influence. This has not been the case with El Salvador or the other Central American countries. All have participated actively in MTN. Both Salvadoran officials and private-sector leaders were unambiguous in their support for closer ties with the world economy – and particularly with the major export partner, the United States. There was general agreement that free trade with the United States was the major goal for trade policy. This might be achieved through the Free Trade Agreement of the Americas (FTAA), which the United States and 34 other Western Hemisphere governments established as a goal to be achieved by 2005. The general perception in El Salvador was that achievement of an FTAA had become less certain because of changes in U.S. views on trade, evident in recent U.S. trade policy and manifested in the Seattle WTO conference.

20. As a near-term alternative to the FTAA, Salvadoran policymakers and private groups have pressed for approval by the U.S. Congress of “NAFTA parity” for countries of the Caribbean basin – extension of the same access to the U.S. market enjoyed by Mexico and Canada, but without either a U.S. commitment to permanence or reciprocal obligations to market liberalisation by the recipient countries.

21. Within Central America, El Salvador has sought closer economic integration as a tool for reducing costs, increasing competitiveness, and promoting exports. It has pressed for liberalisation of intra-regional trade in services, for improvements in regional road and port infrastructure, and for simplification of border crossing procedures. Recently, El Salvador and Guatemala agreed to seek a customs union. Under the proposal, for which a target date of 2002 has been established, the two countries would first replace their border customs posts by a single jointly-managed post, later to be eliminated

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Central American regional trade was dealt a setback in November 1999, when Nicaragua unilaterally (and in violation of treaty obligations) imposed a 35% tariff on imports from Honduras. The action followed Honduran ratification of a maritime territorial rights treaty with Colombia, which the Nicaraguan government viewed as impinging on Nicaraguan sovereignty.
entirely. This process has moved quickly at the technical level, with agreements reached on procedures for sharing customs revenues on imports from outside the union, but much remains to be done to complete the planned integration. One attraction of the customs union for El Salvador is the fact that its access to Guatemala’s Caribbean ports would be eased.

22. El Salvador appears to be moving to meet most of its commitments to the WTO. Its investment regulations appear to provide for national treatment of foreign investment, including in insurance and management of the new Salvadoran pension funds. The country has modernised customs procedures, permitting electronic filing of customs forms and self-declaration of duties. Salvadoran law still reserves large government procurement projects for national firms, but the government has introduced legislation to conform to WTO obligations. El Salvador’s WTO commitments regarding intellectual property appear to be uncontroversial. The leading San Salvador newspaper reported recently that the government of El Salvador had missed a January 1 deadline for enforcing copyright procedures for musical performances and recordings, but expected to be in compliance by June 1. New trademark legislation was to go to the legislature in February, along with a treaty of co-operation on patented materials. An accompanying article identified a new association of Salvadoran composers who intended to see that the new law protected their work. They identified a song by a Salvadoran composer that had been widely distributed in Central America and the United States, but the composer never received any royalties.

Assessment

23. Like the overall policy environment, trade policy is generally favourable for trade development. The Salvadoran government has a clear sense of policy direction, and has worked to put it into practice.

24. The technical capacity of the government appears to be satisfactory, and the country has entered into its WTO commitments with a clear idea of their implications. As discussed below, donors have done an effective job of making specialised technical assistance and training available to strengthen the capacity of the Salvadoran institutions. Nevertheless, it seems to be the seriousness of purpose of the Salvadoran government that makes effective technical assistance easy to provide.

25. Exchange rate policy is the most problematic factor in trade policy. It clearly has a “Dutch Disease” element, with the profitability to the economy of the remittances from “exported” workers so large that the exchange rate may be unfavourable for other export activities. Successive governments have predicted that this inflow would gradually begin to decline, but there has so far been no abatement. Macro policy has prevented further deterioration of the real exchange rate for the last three years, but El Salvador needs to find ways to increase productivity or to develop other ways to compensate for its relatively high costs compared to the past.

26. There has been some backsliding on trade policy, as with the retreat from a government commitment to a uniform tariff to acceptance of one with escalation. More recently, negotiations with Mexico for a free trade agreement have included Salvadoran requests for exceptions for five specific sectors in which major Salvadoran firms had obvious interests in limiting competition.

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2 The U.S. government concluded (U.S. Department of Commerce 1999) that present law does not constitute a significant barrier, because most large projects are financed by multilateral banks, which require international competitive bidding.


4 The term comes from the experience of the Netherlands after the discovery of oil in its sector of the North Sea. The subsequent oil exports caused the Dutch guilder to appreciate, making many traditional Dutch products no longer competitive in foreign markets.
D. Trade Institutions

Evolution and Current Situation

27. El Salvador has a developed set of institutions – public, private, and non-profit – providing information and other services for the export sector. A few organisations have long histories of support for technology development and export promotion for particular products (e.g., coffee, cotton, and sugar). For non-traditional exports, however, most of the institutions that support exports have been established during the last fifteen years.

28. Salvadoran Association of Clothing Industries (ASIC). This association includes producers of clothing, notably including the EPZ clothing firms. Among other activities, ASIC has promoted the substitution of Salvadoran cloth for imported material in garment exports, apparently with some success. ASIC has also worked with human rights groups to establish a code of conduct for the apparel industry and to monitor compliance with commitments on child labour and working conditions.

29. Coexport. This institution, the Corporacion de Exportadores de El Salvador, was originally set up during the early 1980s as a Committee of the Association of Salvadoran Industrialists (ASI). During the mid-1980s, USAID provided financing to help Coexport establish itself as a separate entity to give an institutional voice for non-traditional exporters. It provides a range of services for exporters and for foreign buyers, including a web page, a directory of exporters and a variety of specialised services. It receives funding for basic operations from its 299 member firms, and uses donor funding for a variety of projects to promote exports. It has received funding from USAID, the IDB, and the European Union, among others.

30. FUSADES. Fusades, the Foundation for Economic and Social Development, was established in 1983 as a private non-profit organisation to provide progressive leadership on national problems. It quickly became the vehicle for USAID to channel much of its assistance to El Salvador. The diverse activities of FUSADES include:

- An economic studies department. A central focus of FUSADES at the outset was research on the country’s economic problems and strategies for solving them. This unit provided most of the “brain trust” for the Cristiani government’s economic reform programme, and the institution has continued to be a major factor in economic debates in the country.

- An investment promotion unit (Pridex). This unit was established in the mid-1980s to promote foreign investment in El Salvador, receiving substantial amounts of USAID funding to operate offices abroad and to bring potential investors to El Salvador.

- Export financing and support. One department (Fidex) provides export financing to medium-sized and large businesses, while another (Propemi) provides financing and technical assistance to small firms and micro-enterprises.

- Agricultural technology and export promotion. Another unit previously provided technical assistance for non-traditional agricultural exports, and now operates a large farm that both exports and does research on agricultural technology. A separate quality control laboratory provides soil testing and other agricultural and environmental-related services to Salvadoran firms.

31. Ministry of Economy. The Ministry of Economy has primary responsibility within the government both for trade negotiations and for export and investment promotion. The Ministry re-
acquired this responsibility after the abolition of a separate Ministry of Foreign Trade during the 1990s. One vice-minister is responsible for trade negotiations and Central American regional integration and another is responsible for export and foreign investment promotion. This appears to provide greater coherence in trade policy than when responsibility was divided between two ministries.

- **Trade negotiations.** The government maintains an active trade negotiating agenda. Within Central America, there is an ongoing process aimed at reducing barriers to trade within the region. The country has also actively negotiated free-trade agreements with Mexico and with several other Latin American countries. The Mexico agreement is expected to be concluded during 2000. Salvadoran trade negotiators appear to have had access to significant amounts of technical assistance from a variety of donors.

- **Export-Investment promotion.** The ministry has a limited programme for export promotion, and also works to co-ordinate with the various private associations and other government agencies working in this area. The ministry also works with a number of sectoral groups, or clusters, aimed at improving the competitive conditions for the sector. These groups resulted from a series of studies, financed by the World Bank, along lines suggested by Michael Porter of Harvard. The ministry’s investment promotion activities are to be moved to a new organisation that is expected to begin operations in March 2000. The new institution, the Investment Center, is to operate as a quasi-private institution, overseen by a board of directors representing both the private and public sectors. The Center is seen as a vehicle for substantially increasing the level of government spending on investment promotion.

32. **Ministry of Foreign Relations.** Salvadoran Embassies abroad also participate in both export and investment promotion, and provide broad policy guidance for trade negotiations. Collaboration between key Salvadoran embassies abroad and associations of exporters appears to be relatively good, with e-mail providing rapid communication on important issues.

**Assessment**

33. Over the past fifteen years, El Salvador has developed a set of useful institutions supporting trade development. They provide a means for the views of various actors in the export sector to communicate and interact. Private sector groups can identify obstacles to exporting and have vehicles to seek action by government. The main private groups have shown a capacity for sustainability, and a hard-headed focus on delivering services at minimum cost.

34. The largest gap at present in the country’s arsenal of institutions and programmes appears to be in the area of foreign investment promotion. Investment promotion is inherently more of a “public good” than export promotion. In export promotion, the sharing by potential exporters of the costs of technical assistance, trips to trade fairs, or other market development services helps ensure that assistance is properly targeted. If the right firms are targeted for such assistance, they will benefit directly from increased exports and profits, and they should be willing to share the costs.

35. Investment promotion is different. Foreign investors in a particular sector typically exhibit a considerable amount of herd behaviour. Once the ability of foreign investors to operate successfully in a sector (e.g., in apparel in El Salvador) has been demonstrated, new foreign investors will explore the country on their own. But apparel investment will not attract investors to new and more technologically-advanced areas. Such potential investors typically view the country as risky: if the country has the right conditions, why have others not invested in that sector? Such investors need to be lured to the country in order to discover that conditions are more attractive than they expected. They will not be willing to pay to explore the country on their own. Such attraction efforts thus require funding from governments or donors.
36. Fusades provides a modest level of assistance for this activity at present, but has very limited funding. The government has recognised the problem and is moving to establish an Investment Promotion Center to attract foreign investment. International experience with government-managed investment promotion is quite mixed. Such institutions have typically been less flexible than private-sector counterparts, at least partly because of procedural requirements, and they have typically become more attuned to intra-government policy debates than to the needs of potential investors.

II. Salvadoran Trade Performance

A. Overall Trends

37. El Salvador’s exports have grown rapidly over the past decade. Chart 1 and Table 1 show the trend since 1980 in current dollars. There was a steady decline during the 1980s, reaching a nadir in 1989, followed by a steady rise during the following decade.

![Chart 1](image)

38. The categories shown in the chart require some explanation. The base grouping, traditional products, includes coffee, sugar, cotton, and shrimp. Coffee dominates this group, and is responsible for its steady decline. The second category, labelled CACM, represents exports to the Central American Common Market. These are almost entirely manufactured exports. Central American trade declined during the 1980s when the intra-regional payments system collapsed, but regional trade first recovered to previous levels and subsequently reached new highs. The third category, EPZ, represents exports from export processing zones in El Salvador. This is mostly apparel exported to the United States. Apparel exports to the United States rose from $11 million in 1986 to $1.2 billion in 1999\(^5\) -- a spectacular rise that

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5 Until recently, exports from EPZs were excluded from export statistics, but current practice is to include them. This obviously creates a comparability problem, as the level of domestic value added – typically 20-25% for apparel – is far lower than for most exports. Because manufactured exports to the CACM have often been produced largely from imported components, this problem is not new for Central America.
paralleled export gains by El Salvador’s Central American neighbours. The final category is non-traditional exports to countries outside the CACM.

Table 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Traditional</th>
<th>CACM</th>
<th>EPZ</th>
<th>Other</th>
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<tr>
<td>1980</td>
<td>1,170</td>
<td>730</td>
<td>296</td>
<td>95</td>
<td>49</td>
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<tr>
<td>1981</td>
<td>878</td>
<td>544</td>
<td>206</td>
<td>80</td>
<td>48</td>
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<tr>
<td>1982</td>
<td>785</td>
<td>479</td>
<td>174</td>
<td>85</td>
<td>47</td>
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<tr>
<td>1983</td>
<td>848</td>
<td>550</td>
<td>165</td>
<td>90</td>
<td>43</td>
</tr>
<tr>
<td>1984</td>
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<td>817</td>
<td>586</td>
<td>109</td>
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<td>1987</td>
<td>660</td>
<td>387</td>
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<td>1997</td>
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<td>1999</td>
<td>2,500</td>
<td>318</td>
<td>627</td>
<td>1,333</td>
<td>222</td>
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</tbody>
</table>

Source: Adapted from Banco Central de Reserva and IMF

B. Trends in Specific Sectors

39. Coffee. Throughout the 1960s and 1970s, El Salvador was the largest coffee exporter in Central America, and Salvadoran coffee typically sold at the highest prices in the region. This changed during the 1980s. Coffee production in El Salvador first stabilised and then gradually fell. In contrast, Guatemala, Costa Rica, and Honduras all increased their production. El Salvador gradually lost its lead in coffee technology, as yields in other countries rose while they fell in El Salvador.
40. During the 1980s and 1990s, other countries were replanting with higher-yielding varieties while little such investment was taking place in El Salvador. Both the agrarian reform and the civil war, which was primarily fought in rural areas, likely contributed to the loss of Salvadoran competitiveness. It is noteworthy, however, that this loss of competitiveness continued through the 1990s, even though the civil war had ended, the land tenure situation stabilised, and government policies made exporting more profitable. This experience suggests – at least for a long-lived tree crop like coffee – that serious disruptions in production that lead to deferred investment and loss of skilled workers may have long-term consequences. Once the technological edge is lost, it may take a long time to regain it. It is unfortunate that, again perhaps mainly as a consequence of the civil war, the redistribution of wealth to farm workers resulting from the agrarian reform was accompanied by a reduction in the productivity of the land, and thus in the amount of rural wealth. Recent trends in world coffee prices exacerbate these problems. The sharp fall in coffee exports over the past two years is due mostly to a fall in world prices.

41. **Other traditional products.** Besides coffee, three other products – cotton, shrimp and sugar – are classified as “traditional” exports. Cotton exports are of little consequence, having virtually disappeared during the 1980s from the combined effects of low world prices, land reform, and civil war. Sugar is an export industry only because of El Salvador’s preferential access to the protected U.S. market, and exports are determined by the level of U.S. quotas. Shrimp ($25 million in 1999) has shown moderate growth.

42. **Central American Common Market (CACM).** El Salvador exports a wide range of manufactured goods to Central America, with food products, textiles, and light consumer goods the main articles exported. Exports to Central America have been a dynamic element of Salvadoran trade. Policymakers argue that the expansion of trade within Central America during the 1990s differs importantly from the growth during the 1960s. Because all of the Central American countries have adopted maximum external tariffs of 15% or less, they argue, there is far less likelihood of trade diversion and of production using highly inefficient methods. There has also been a shift in El Salvador’s regional exports away from final consumer goods towards intermediate goods. The Salvadoran private sector notes another major difference between the 1960s and the 1990s in Central America – the presence of substantial Central American foreign investment. During the 1960s, most of the foreign investment in Central America came from outside, mostly the United States. These foreign companies were the major actors at the regional level. In recent years, in contrast, Central American-owned firms have begun to operate beyond their home country. This is particularly the case with retailing, supermarkets, and banking. Salvadoran entrepreneurs are particularly active. The Salvadoran airline, TACA, has also swallowed most of the national airlines from the other countries, and substantially improved regional travel schedules, using San Salvador as a hub.

43. **Export processing zone products.** The El Salvador EPZ exports are nearly entirely of apparel. Of all manufactured imports by the United States (the primary market for EPZ exports), 95% consists of apparel and other textile products. This has continued to be the case since the first private free zones were established around 1990. The growth in these exports has been spectacular, resulting from a combination of several factors: improved access to the U.S. market due to the Caribbean Basin Initiative; Salvadoran government policy changes that eliminated obstacles to the development of EPZs; and a change in competitive strategies by U.S. firms, leading them to compete with apparel imports from Asia by a shifting labour-intensive operations from the United States to Central America.

44. Other countries that made EPZs a major part of their export strategy, such as Costa Rica and the Dominican Republic, have been able gradually to diversify production in their EPZs. This typically involved movement from apparel into a variety of other assembly sectors, including electrical appliances, medical supplies, and other products. In the case of Costa Rica, it eventually led to the construction of a computer chip manufacturing facility by Intel. This diversification has brought several advantages. First, a more diversified production structure reduces vulnerability to demand trends in a particular sector. Second, these new assembly sectors typically require a more skilled labour force. They thus provide a mechanism for upward mobility for workers who acquire basic skills in apparel. In El Salvador, this
mechanism cannot operate, because firms in other sectors have not come to El Salvador. At the same time, El Salvador’s EPZs appear to be using steadily more domestic value-added. The ratio of imports of the EPZ sector to exports has steadily fallen, from 81% in 1991 to 71% in 1998.

45. The reasons for El Salvador’s inability so far to attract foreign investors in other sectors are unclear. NAFTA may be a factor, leading companies to look no farther than Mexico. Costa Rica and the Dominican Republic had started to shift away from apparel when El Salvador was still being viewed as a risky investment target. If this is correct, it is another cost of the prolonged civil war: it made El Salvador unattractive when the opportunities for attracting foreign investment were most propitious.

46. EPZ firms, particularly those in the apparel sector, have become controversial in recent years because of concerns about the use of child labour, lack of worker rights (including the rights to organise and bargain collectively), and the quality of working conditions. “Sweatshops” has become the catch-all term for this combination of abusive practices. In El Salvador, human-rights groups have long been active in raising questions about working conditions in the EPZs and in pressing for governmental action to prevent abuses. U.S. apparel importers have also become concerned about this issue.

47. Perhaps because of the considerable attention to these issues, the Salvadoran EPZs seem to be models of good practice in all respects but one, the exception being unionisation. The U.S. Embassy makes regular visits to the plants and reports on working conditions. It reports (1998a) that “working conditions and worker benefits meet legal standards under Salvadoran law and are higher than the private sector average for comparable work.” Legal standards require retirement and medical care benefits, and two weeks of paid vacation. In cases of individual firms that violate legal requirements, human rights organisations have been empowered by ASIC, the apparel industry association, to monitor the company’s subsequent performance.

48. Other non-traditional products. Donors and the Salvadoran government have promoted a number of other potential export sectors, including winter fruits and vegetables for the U.S. market, artisan products, and ethnic foods for Salvadorans living abroad. None of these sectors has yet shown substantial results. In the case of winter fruits and vegetables, El Salvador had some initial success with melons, sesame and okra. After several years of growing exports, however, exports of individual products have begun to fall off or disappear entirely. Since exports of these products from its Central American neighbours have continued to grow rapidly, El Salvador appears to be at a competitive disadvantage. Its lack of a Caribbean port for exporting to the U.S. east coast may be a contributing factor.

49. Services. No quantitative data is available on Salvadoran exports of services, but the country has sought to establish itself as a leader in this area. The country is promoting tourism, though it lags behind most of its neighbours in this sector. Moreover, the high incidence of crime and large number of armed guards probably limits the country’s tourist appeal in the near term. El Salvador has the most robust banking sector in Central America, and Salvadoran banks have established affiliates in several other countries. The Salvadoran airline is now dominant in the region. Salvadoran investment promotion efforts are now being aimed at establishing the country as a “call center” for services by telephone. Several companies have begun operating in the country in this sector. The Salvadoran government has also been promoting the country as a center for software development. The government training institution financed a year of study in computer software training centres in India for 120 Salvadoran students in the hope that this might create a critical mass of trained technicians for the sector.

C. Trends in Geographical Distribution

50. The change in geographical destination of exports for the 1994-98 period, disaggregated into primary products and manufactures, is shown in Table 2. Trade with the Western Hemisphere has risen sharply, while trade with Europe has grown only modestly. The United State is not shown separately, but
it accounted for 96% of the exports to NAFTA shown in the table, and for all of the growth between 1994 and 1998 in exports to NAFTA. The great bulk of this growth was from the EPZs.

51. Most exports to OECD countries other than USA and Canada are primary products, mainly coffee, and – at least according to Salvadoran statistics – exports of manufactures to other OECD countries are insignificant. OECD import statistics (available only through 1997) give a somewhat different picture. That source reports that imports of manufactures from El Salvador increased from $23 million in 1994 to $34 million in 1997. Discrepancies between Salvadoran and OECD sources also exist for primary products. The fact that shipments to Europe usually move via a port in Guatemala may be one source of error.

52. Trade with Latin America, particularly in manufactured goods, did rise sharply between 1994 and 1998. Trade with Panama and the Dominican Republic, in particular, showed rapid growth
Table 2
El Salvador Exports, 1994-98
By Trading Partner and Type of Product
(Million Dollars)

A. 1994 Exports

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Primary Products</th>
<th>Manufactures</th>
<th>EPZ</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAFTA</td>
<td>638</td>
<td>139</td>
<td>75</td>
<td>425</td>
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<tr>
<td>CACM</td>
<td>343</td>
<td>72</td>
<td>272</td>
<td>0</td>
</tr>
<tr>
<td>OTHER LATIN AMERICA</td>
<td>54</td>
<td>25</td>
<td>29</td>
<td>0</td>
</tr>
<tr>
<td>OTHER OECD</td>
<td>212</td>
<td>203</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>OTHER COUNTRIES</td>
<td>2</td>
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<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>1,249</td>
<td>440</td>
<td>379</td>
<td>430</td>
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</tbody>
</table>

B. 1998 Exports

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Primary Products</th>
<th>Manufactures</th>
<th>EPZ</th>
</tr>
</thead>
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<tr>
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<td>1,454</td>
<td>182</td>
<td>102</td>
<td>1170</td>
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<tr>
<td>CACM</td>
<td>618</td>
<td>175</td>
<td>443</td>
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<tr>
<td>OTHER LATIN AMERICA</td>
<td>84</td>
<td>26</td>
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<td>OTHER OECD</td>
<td>249</td>
<td>226</td>
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<td>19</td>
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<tr>
<td>OTHER COUNTRIES</td>
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<td>35</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2,443</td>
<td>644</td>
<td>609</td>
<td>1,189</td>
</tr>
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</table>

C. Change in Exports from 1994 to 1998

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Primary Products</th>
<th>Manufactures</th>
<th>EPZ</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAFTA</td>
<td>816</td>
<td>44</td>
<td>27</td>
<td>745</td>
</tr>
<tr>
<td>CACM</td>
<td>274</td>
<td>103</td>
<td>171</td>
<td>-</td>
</tr>
<tr>
<td>OTHER LATIN AMERICA</td>
<td>30</td>
<td>1</td>
<td>29</td>
<td>-</td>
</tr>
<tr>
<td>OTHER OECD</td>
<td>37</td>
<td>23</td>
<td>0</td>
<td>14</td>
</tr>
<tr>
<td>OTHER COUNTRIES</td>
<td>36</td>
<td>34</td>
<td>2</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>1,193</td>
<td>205</td>
<td>230</td>
<td>759</td>
</tr>
</tbody>
</table>

D. Geographical Distribution of Exports, 1998

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Primary Products</th>
<th>Manufactures</th>
<th>EPZ</th>
</tr>
</thead>
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<tr>
<td>NAFTA</td>
<td>60%</td>
<td>28%</td>
<td>17%</td>
<td>98%</td>
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<tr>
<td>CACM</td>
<td>25%</td>
<td>27%</td>
<td>73%</td>
<td>0%</td>
</tr>
<tr>
<td>OTHER LATIN AMERICA</td>
<td>3%</td>
<td>4%</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>OTHER OECD</td>
<td>10%</td>
<td>35%</td>
<td>1%</td>
<td>2%</td>
</tr>
<tr>
<td>OTHER COUNTRIES</td>
<td>2%</td>
<td>5%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Source: Adapted from El Salvador export statistics; EPZ exports are estimates.
D. Impacts of Trade Growth

53. Poverty and wages: After 1991, the Salvadoran economy recovered quickly, and the country had four consecutive years of growth exceeding 6% per year. This was also a period of rising real wages. Based on household survey data, the Ministry of Economy reports that the average wage rose from 99% of the cost of the basic consumer budget (“canasta basica”) to 144% by 1998. The most recent UNDP national development report (Rivera Campos, 1999, p. 118), reports that the percentage of the population in poverty fell from 59% in 1992 to 48% in 1997. Wage growth seems to have been particularly rapid at the lower end of the wage structure, and the share of the population in extreme poverty fell by more than one-third over the same period, from 28% to 18%. Two factors probably contributed to this encouraging trend. First, the continued departure of relatively unskilled workers for the United States would have reduced competition for jobs at the lower end. Second, the rapid growth of employment in the EPZs during the 1990s probably helped tighten the labour market. The official unemployment rate, about 7.3% in 1999, appears to have fallen only slightly over the past five years, though it is significantly lower than during the 1980s.

54. Exports vs. production for the domestic market. During the import-substitution period, when barriers to imports were quite high, the distinction between production for export and production for the domestic market was quite clear. The quality of products for export had to be relatively high and predictable, while production for the domestic market was typically lower. Exporters had to pay attention to trends in technology and closely monitor cost, delivery schedules, and quality.

55. Production for the domestic market, on the other hand, was typically more comfortable. Cost-consciousness was lower, because price competition was less intense. Styles were often dated because consumers had little choice, and the materials used in production were of a lower quality, but the goods were sellable because of the lack of import competition. Today, with a maximum tariff of 15% on finished goods, shops are filled with imported products. Producers for the domestic market have been forced to behave like exporters. There is no longer a place for products with low quality in relation to price.

56. In effect, the trade liberalisation should blur some of the distinctions that have existed in the past between the export and the import-substituting sectors. Both now face the same challenges – to improve productivity, quality, and reliability of production.

E. Assessment of Trade Performance and Challenges

57. Salvadoran trade performance during the past decade has been good, reflecting the improvement in the enabling environment. The end of the civil war, the elimination of a large number of procedural obstacles to exporting, and the establishment of a stable macroeconomic environment were all important. The steady deterioration of exports during the 1980s was reversed, and a major new export sector – apparel assembly in EPZs – was developed. Some progress has been made in finding new markets for Salvadoran goods, particularly in the rest of Latin America. Salvadoran policy helped reactivate the CACM, this time on a basis much closer to world prices.

58. Despite this progress, the sources of future export growth are not obvious. The apparel sector is likely to slow down because of various factors, including competition from lower-wage neighbours in Central America and the end of the Multi-Fibre Agreement, scheduled for 2005. El Salvador is too dependent on apparel, and has not yet developed a wider range of manufacturing sectors that can compete on global markets. Finding such sectors is important.
59. Four challenges seem to suggest themselves from the recent Salvadoran experience.
   - Addressing the exchange-rate issue so that Salvadoran products will be more competitive;
   - Finding means to restore El Salvador’s technological capability in the coffee sector;
   - Attracting new investment in other sectors into the EPZs, so that the labour-intensive, export manufacturing sector is not so narrowly-based; and
   - Finding products or means to access European markets, so that the dependence on the U.S. market is not so extreme.

III. Donor Activities and their Relevance

60. This section discusses donor programmes of assistance for trade development. It is divided into two sections. The first describes and assesses donor activities. The second looks at donor support for the sector with respect to co-ordination and host country ownership.

A. Donor Assistance Programmes

61. There are two distinct phases of donor support for Salvadoran trade development. In the first phase, running from the early 1980s to 1992, USAID was the dominant player. For that period, USAID provided about 85% of all ODA disbursements. The situation changed abruptly in 1993, with USAID assistance beginning a steady decline, and other OECD donors and the World Bank sharply increasing their disbursements. The European Union and its members gradually became the dominant source of foreign aid.

USAID Dominance, 1984-93

62. The magnitude and pervasiveness of USAID assistance during the pre-1992 period needs to be emphasised. It totalled more than $3 billion, not including substantial military aid given to the Salvadoran government. The Salvadoran government had limited capacity to collect taxes while the war was going on, and the economy failed to produce enough foreign exchange earnings to meet the country’s needs. USAID assistance played a dominant role in keeping imports flowing and permitting the government to carry out basic social and economic functions.

63. USAID was particularly active in trade development, which it saw as a central part of its strategy. It took the view that El Salvador’s long-run growth would depend heavily upon the development of new products for export on world markets. In particular, the elimination of permanent dependence on continued flows of U.S. assistance required that alternative sources of foreign exchange needed to be found.

64. The USAID strategy was to work both at the national policy level and at the institutional level. The former involved two main elements: dialogue with the Duarte government over economic policy; and promotion of research and debate on economic issues – particularly through funding of studies and seminars at Fusades. The institutional-level activities involved creation or strengthening of a series of organisations and associations thought important for expanding export capacity.

65. The USAID work on policy produced little in direct results. Despite the heavy dependence on U.S. funding, the Duarte government took little heed of U.S. economic policy prescriptions. USAID saw devaluation of the currency, and elimination of the complex system of exchange controls and multiple exchange rates, as critical to export development, yet the Duarte government successfully resisted such
pressure. The Salvadoran government’s main priorities were domestic – implementing the land reform, carrying out social programmes, and fighting the civil war. Since support for the Duarte government was the overriding political objective of U.S. policy, U.S. assistance could not be made contingent on export policy reforms.

66. The basic approach pursued by USAID at the institutional level was the creation of a set of private organisations or associations that could act as intermediaries between USAID assistance and individual exporters. The approach was based on the experience that government export promotion agencies had seldom been effective. (Keesing and Singer (1990) provide a good summary of this experience.) Private associations were thought to more accurately understand the problems of exporters, and joint efforts by the private sector could identify for government the most critical problems that needed resolution. The USAID approach included substantial financing in four areas: Fusades, export processing zones, Coexport, and non-traditional agricultural exports.

67. Fusades. The variety of activities pursued by Fusades has already been mentioned. These roles were developed largely through the interaction between the Fusades leadership and USAID during the 1980s. Altogether, USAID provided more than $120 million in assistance to El Salvador through this institution.

68. Export processing zones. USAID support was important to the initial establishment of the EPZ sector. USAID promoted legislation, passed in 1991, permitting the creation of private free zones, and provided a $26 million loan for development of such zones. This stimulated rapid growth of labour-intensive exports, particularly of clothing.

69. El Salvador had established a government-owned export-processing zone in the early 1970s. The zone had only limited success. A large electronics firm exporting capacitors and a few small firms exporting apparel were attracted to the zone, and their experience did not encourage others to invest. Exports from the zone stagnated at $95 million between 1980 and 1990. (This has been typical for government-owned zones in other countries. Foreign investors have tended to be sceptical of the quality of services in such zones, whose sites are frequently chosen more for political than for economic reasons.) The creation of the private zones, together with the investment promotion effort carried out by FUSADES, quickly brought new investors to El Salvador. Free zone exports rose from $95 million in 1990 to $1,335 million in 1999, and free-zone employment rose from several thousand to 65,000.

70. USAID initiated no new activities in either EPZs or investment promotion after October 1992, when the U.S. Congress passed legislation effectively prohibiting use of USAID funds for such purposes. The EPZs in El Salvador had been the subject of a U.S. television programme, which suggested that American workers were losing jobs because American companies were moving to El Salvador. This became a political issue during the 1992 presidential campaign. Nevertheless, the rapid growth of the sector even after USAID assistance ended suggests that further aid was not necessary. Six private free zones, along with the original government-owned zone (which is in the process of being privatised) are now operating in El Salvador, employing an estimated 65,000 workers.

71. Non-traditional agricultural exports. A third area in which USAID sought to promote export growth was in new agricultural products. As in other Central American countries, USAID sought to increase rural incomes in El Salvador by helping small farmers switch from low-value crops, like corn and beans, to high-value ones, like melons and winter vegetables, that required substantially higher amounts of labour per hectare, and that could be exported to the United States.

72. USAID used several vehicles for promoting such exports. Fusades established a division to provide technology to small farmers wanting to export. Clusa, the international affiliate of the U.S. National Cooperative Business Association, was a second conduit. Another set of activities was carried
out through the National Reconstruction Project, which provided land and other assistance to ex-
combatants and others affected by the warfare in the countryside.

**Impact of USAID Trade Development Programmes**

73. In retrospect, the USAID activities of a decade ago appear to have stood the test of time relatively
well. At the policy level, the directions that USAID had promoted through support for research at Fusades
and through financing of external technical assistance during the 1980s were incorporated into policy
during the 1990s. It is, of course, impossible to say with certainty what caused a particular policy outcome
in the real world, but the evidence shows that USAID was a major participant, pushing in the direction that
policy moved.

74. At the institutional level, permanent results also seem to have been achieved. Despite the heavy
dependence of Fusades on USAID support in the early 1990s, and the abrupt reduction of that support,
Fusades survived, and has continued to play an important role. Its economic studies department continues
to exert a major, and positive, influence on the national policy debate. Its investment promotion
programme, though very modestly funded, appears to be quite effective. Other Fusades programmes have
succeeded in obtaining support from other sources, and continue to play a catalytic role in Salvadoran
economic and social development. Coexport has also continued to grow and to improve the quality of the
services it offers to exporters. Both organisations have had to live under austere budgets, drawing most of
their core resources from members and receiving money from various donors for specific programmes.

75. Export-processing zones grew rapidly after the initial USAID support, and have continued to be
at least a significant contributor to El Salvador’s integration into the global economy. The non-traditional
agricultural export programmes have fared much less well. This may be due to a lack of comparative
advantage in such products for El Salvador, or to the land ownership and property issues that have been a
feature of Salvadoran agriculture for the last several decades. Whatever the cause, USAID’s substantial
investment (perhaps $30 million) in funding for non-traditional agricultural exports has yielded very
modest results, and surely a low return on the investment.

**Other Donor Programmes, 1993-99**

76. The level of donor support for trade development in recent years pales in comparison with the
USAID activities during the late 1980s and early 1990s. In part, this must be due to an obvious reason:
USAID had done such a wide variety of policy and institution-building activities for export promotion that
there were no obvious gaps that later donors could identify that would justify large-scale programmes.

77. Table 3 provides a summary of donor activities since 1993. It is organised into three categories:
trade policy, implementation, and competitiveness. These categories are notional. The table also includes
assistance to El Salvador from regional projects. Data for expenditures in El Salvador for these regional
projects are not available (the region in question is either Central America or all of Latin America,
depending on the donor.) In addition, the line between projects that promote trade and those that do not is
often unclear. Projects for small and medium enterprises, for economic policy, or for economic
infrastructure will have significant consequences for the trade sector in a small, open economy like El
Salvador.

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6 This is not to say that the USAID programs were cost-effective. More analysis would be required to
answer that question, given the massive sums provided by USAID.
Overall, donors have devoted very little attention to trade development in their programming for El Salvador in recent years. Donors have been providing about $400 million per year to El Salvador, so the amount linked to trade development – less than $40 million over six years – represents less than 2% of total donor activity. The principal focus of donor assistance in recent years has been post-conflict and social-sector issues. Providing land and services to ex-combatants in the civil war has been one preoccupation. Promoting improvements in health care, education, and economic infrastructure in rural areas – where the conflict halted investment for a decade – is another major use of donor funds.

Briefly, the activities for which information could be obtained include the following: World Bank--Competitiveness. This was the largest project aimed at improving trade policy and private-sector competitiveness. The biggest activity under this project was a national competitiveness study by Fairbanks Associates, a firm associated with the ideas of Michael Porter of Harvard. The basic concept is that export competitiveness comes not from comparative advantage but from the existence of “clusters” of firms, including competitors and ancillary firms like suppliers, buyers and providers of services, linked
Table 3

Trade and Development: Donor Activities Since 1993

<table>
<thead>
<tr>
<th>Country</th>
<th>Activity</th>
<th>Funding ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1. Trade Policy Formation and Negotiations</td>
<td></td>
</tr>
<tr>
<td>World Bank</td>
<td>Competitiveness</td>
<td>$16,000,000</td>
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<tr>
<td>IDB</td>
<td>Preparations for FTAA, WTO</td>
<td>Regional</td>
</tr>
<tr>
<td>OAS</td>
<td>Preparations for FTAA, WTO</td>
<td>Regional</td>
</tr>
<tr>
<td>USAID</td>
<td>Preparations for FTAA, WTO</td>
<td>Regional</td>
</tr>
<tr>
<td></td>
<td>2. Policy Implementation and Agreement Implementation</td>
<td></td>
</tr>
<tr>
<td>UNDP</td>
<td>SIDUNEA – Customs computerisation</td>
<td>$710,000</td>
</tr>
<tr>
<td>IDB</td>
<td>Modernisation of commercial legislation:</td>
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<tr>
<td>UNDP</td>
<td>Automated customs system</td>
<td>$70,000</td>
</tr>
<tr>
<td>Canada</td>
<td>Web based trade information system</td>
<td>Regional</td>
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<tr>
<td></td>
<td>3. Export Competitiveness</td>
<td></td>
</tr>
<tr>
<td>USAID</td>
<td>Non-Traditional exports via Cooperatives</td>
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<tr>
<td>IDB</td>
<td>Agricultural Cooperatives – Proexsal</td>
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<tr>
<td>IDB</td>
<td>Small enterprise competitiveness</td>
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<tr>
<td>EU</td>
<td>Gourmet coffee</td>
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<tr>
<td>Canada</td>
<td>Productivity-diversity-markets</td>
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<tr>
<td></td>
<td>For small producers</td>
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<td>EU</td>
<td>Promotion of non-traditional exports</td>
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<td>Strengthening Exports to the EC</td>
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<td>National Commercial Information Center</td>
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<td>EU</td>
<td>European importers visit Central America</td>
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<td>EU</td>
<td>Foreign Investment Promotion</td>
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<td>Spain</td>
<td>(NGO) Marketing for Shrimp co-operative</td>
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</tr>
<tr>
<td>Spain</td>
<td>Hotel management training</td>
<td>$107,000</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>$36,329,000</td>
</tr>
</tbody>
</table>

Source: UNDP and individual donors
to educational institutions and government. Only when this entire cluster of actors is able to operate in a mutually-supporting way, the theory goes, will the country have a sector that is really competitive. The Fairbanks effort sought to identify a half-dozen potential clusters for future concentration by El Salvador. The government then built upon this analysis to establish a set of committees for the chosen sectors – coffee, apparel, tourism, software, ornamental plants, plus several others – that would provide the public-private co-operation needed to establish long-term competitive advantage.

80. There were mixed reviews of this project’s impact on competitiveness. A number of private sector interlocutors believed that most of the clusters had achieved little, both because the government participants sought to control the process, and because clusters represented interests that were too diverse to have common agendas. Government interviewees took a more positive view of this activity.

81. **IDB/OAS/USAID—trade negotiation preparations.** This was a series of activities in training and technical assistance to help El Salvador with WTO accession and later with preparations for the FTAA. The three donors operated separately, but in close co-ordination. There was some division of labour in technical areas.

82. **UNDP—customs modernisation.** This activity included installing modern computer software for customs management and an automated customs system. Firms report that the customs-clearance process has improved considerably in recent years, with computerisation and automated clearance procedures. USAID also contributed to this effort.

83. **Canada—web-based trade information system.** Under this regional project, Canada provided support to SIECA, the Secretariat for Regional Economic Integration of the CACM, to build an internet-based information system for the five member countries. It is being used by both the Salvadoran government and private sector. The information system is of very high quality, and provides documentation on Central American economic integration, as well detailed trade statistics for the Central American countries. This system has apparently been of significant value in trade negotiations, and is said to be a model for the FTAA information system being financed by the IDB for use at the hemispheric level.

84. **USAID—non-traditional agricultural exports.** This project was intended to develop export markets for non-traditional agricultural exports, primarily for the U.S. market, through agricultural co-operatives. It is a follow-on to an earlier co-operatives export project, and was expected to produce co-operatives with sustainable export markets in the United States, primarily for winter fruits and vegetables. Altogether, USAID spent about $20 million attempting to promote exports of melons and other perishables to the United States. Melon exports reached several million dollars per year, but then fell back to zero because the Salvadoran producers could not establish a marketing chain that permitted profitable operation. Export of perishable products is a difficult business, particularly when channels are not well-established. The co-operatives proved unable to master these complexities and lacked the flexibility necessary to adapt to rapidly-changing markets. Exports, initially successful with substantial subsidies, were uncompetitive without donor support.

85. **IDB—agricultural co-operatives marketing.** This new project uses the institutions strengthened in the USAID project mentioned above, but with a change in market focus away from exports to production of organic fruits and vegetables for the Salvadoran market. It has just begun operating, and it remains to be seen whether the shift to the domestic market will provide a better base for sustainability.

86. **IDB—small enterprise competitiveness.** This IDB project seems to have begun a useful process of transferring technology to smaller enterprises with export potential.
87. EU—promotion of non-traditional exports. This project, with Coexport, funded a variety of activities, including a directory of Salvadoran exporters and handbooks for exporters.

88. EU--European importers visit to Central America. This EU project was thought by Coexport to have been extremely successful. About $20 million in firm export sales were said to have resulted from the project. The success of the project was attributed to very careful preparation prior to the visit. Identification of the appropriate firms on both the European and Salvadoran sides was the major element of this.

89. EU--investment promotion. This new project, which is not yet underway, will support the work of Fusades to promote export-related foreign investment in new sectors, in order to diversify away from apparel.

B. Donor Effectiveness Issues

Donor Co-ordination

90. A shared vision on the part of donors is the easiest form of donor co-ordination. When donors agree on a country’s development problems and what should be done about them, the “donor co-ordination” problem is very manageable. No such shared vision exists within the donor community in El Salvador. Rather, there is a dichotomy between those donors (the World Bank, the IMF, and sometimes the IDB and USAID) that have a basic concern about macroeconomic policy and private sector development, and most other donors, whose focus is mainly on post-conflict issues and on expanding social programmes to address the wide gaps in education and health. Both sets of problems are important for El Salvador’s future, and there is no reason that donors need to work on the same issues. But complaints that other donors are ignoring the country’s “real” problems are more frequent, when, as in El Salvador today, donors have different emphases.

91. Donors reported that a modest amount of co-ordination took place in El Salvador during the last few years. (In the 1980s, the requirements for co-ordination were more clear cut: other donors needed to know what USAID intended to do, and adjust their activities accordingly.) At present, UNDP prepares an annual compilation of donor projects, which serves as an information source of some value in identifying the activities of other donors. For the most part, donor co-ordination consists of information exchange. Donors do not attempt to co-ordinate programmes: rather, they use the knowledge of what another donor is doing to make appropriate adaptations in their own plans.

92. As mentioned earlier, trade development is only a small part of donor activity in El Salvador, and most donors are doing little in this area. Among those that are active in trade development, there has been a limited amount of explicit division of labour. In trade, USAID has provided technical assistance in the area of intellectual property rights, while Canada and other donors have provided technical assistance and training in other aspects of WTO undertakings. The regional information system managed by SIECA, which was mentioned earlier, provided another case of division of labour. Canada provided the software system, while the IDB and USAID provided some hardware to make the system work.

93. The most effective locus for co-ordination of donor projects is the implementing institution. Where these institutions are strong and have a clear vision of their goals, they can fit donor programmes into their overall conception. In El Salvador, the main institutions responsible for export promotion have usually had a fairly clear idea of their goals, so fitting donors into their strategy has been reasonably straightforward.
Host Country Ownership

94. It is clear that Salvadoran political leaders have exerted primary control over policy relating to trade. During the 1980s, USAID – then the principal donor – continually pressed the Duarte government to devalue the currency, without success. When the Cristiani government did devalue in 1989, this reflected the commitment of the government to market-based economic policies and not primarily donor encouragement. The decision to reduce import duties unilaterally was similarly a national decision.

95. The first World Bank Structural Adjustment Loan in 1991 also illustrates this pattern. Nearly all the conditions established for disbursement under the loan had been completed by the time that the World Bank board approved the loan. The Bank essentially accepted the programme that the Salvadoran government had designed and implemented for its own reasons.

96. El Salvador has carried out a series of strategic exercises relevant to the export sector over the past decade. The first of these was a national export strategy, developed with the help of USAID consultants at the outset of the Cristiani government. This strategy identified exports as the basic pillar of economic reactivation in the country. The export plan was an effort to provide concrete steps to implement the government’s overall approach, and was developed by a joint government/private-sector working group. It identified five sectors for near-term export emphasis: apparel assembly, coffee, the Central American common market, textiles and apparel, and non-traditional agriculture.

97. A second effort at national consensus took place at the beginning of the Calderon Sol government, when a wide-ranging series of roundtables and public discussions – reportedly including about 35,000 people covering the whole spectrum of Salvadoran economics and society – sought to promote debate and consensus on national problems. This exercise seems to have been successful in promoting debate, but it produced no consensus. Perhaps some of the perspectives uncovered in the effort helped the Calderon Sol government in its policymaking, but the contribution seems to have been modest.

98. The third effort has been the “clusters” exercise funded by the World Bank, which was intended to bring the various actors in export development together and to create a consensus on the key issues. This effort at sectoral collaboration still continues, though it has come to be viewed with considerable scepticism by many in the business community. Some have come to believe that efficient clusters cannot be produced by collaboration; rather they emerge from fierce competition, combined with flexible institutions and entrepreneurial behaviour.

99. Of these three efforts at strategy, only the first can be considered an unqualified success. Most of the actions in this case were concrete and fairly immediate, and the locus of responsibility for them was also clear: government action.

100. The second consensus-building effort seems to have produced agreement mainly on issues of a very general nature. At bottom, there may be a basic inconsistency between the idea of national consensus and the fact of political governance by political parties. The party in power will usually seek to vest its actions with the mantle of national purpose, but the role of opposition parties is precisely to prevent this from happening.

101. Finally, the “cluster” effort seems to have had mixed results, though the reasons for this are not totally clear. Since this effort has now been underway for several years, a careful analysis of what this approach has and has not done would be useful at this point.

102. The above discussion of host-country ownership deals with general policy issues. One could also view it from the perspective of individual donor-supported projects. In general, the situation is largely similar. Salvadoran implementing institutions were committed to the projects they were implementing, and appeared to have participated in the design process. The only instance observed where this was not the
case related to research on trade issues conducted by one of the multilateral donors, in which the research topics were not considered important, nor the researchers particularly able. The funding involved appears to have been small.

Sustainability

103. There appears to be no serious sustainability issue in the donor activities in the trade development sector. Most activities are small, and they do not create institutions or bureaucracies that will have difficulty continuing beyond the donor project.

Private-Public Sector Consultation

104. There is a fair degree of co-ordination between the public and private sectors in El Salvador. At the level of general principles, government leaders see their role as overseeing a market economy, where the important economic decisions are made in the private sector. In practice, the tendency of government to want to direct and manage everything happening in the country sometimes wins out. Several businessmen complained that the “clusters” effort was less a joint private-public effort than an opportunity for the government to try to control the agenda.

105. The World Bank project that developed the clusters was only recently completed. No evaluation of this has yet been conducted. An evaluation could be of considerable value in determining the extent to which such collaborative approaches can improve the policy environment by strengthening the dialogue between government and business. The trade statistics themselves do not offer cause for much optimism, since export growth has been slower during the last several years, when the clusters have been operating.

IV. Conclusions and Lessons Learned

106. The Salvadoran case is an interesting one. The country has had considerable success in exporting, particularly in apparel, but future sources of export growth are not obvious. Economic policy has provided a stable and favourable environment for economic growth, but the exchange rate is an obstacle for exporters. The main findings of the study are:

107. **Salvadoran producers still have much to do to meet the requirements of export markets.** El Salvador and its Central American neighbours have had good access to the U.S. market, even in the quota-restricted apparel sector. Exports of two of El Salvador’s neighbours, Guatemala and Costa Rica, have grown faster both in value and diversity than those of El Salvador. Many Salvadoran firms wanting to export are unable to meet the quality and timeliness requirements of the international market.

108. **The biggest gap in current donor programmes is in investment promotion.** As discussed earlier, investment promotion is inherently a “public good.” If found to be important in a national context, it deserves to be subsidised. The government of El Salvador recognises this problem, and has been moving to establish a government-managed investment promotion office. International experience suggests that such agencies are usually less effective than private institutions. Donor funding for investment promotion through private institutions like Fusades is one answer.
Donor assistance to help diversify El Salvador’s export markets is also useful. El Salvador depends too much on the U.S. market for its manufactured exports. Exports to Europe and Japan have grown little in recent years. Donors from these regions might look for ways to support greater market access for Salvadoran products.

Institution-building played a key role in Salvadoran trade development. The creation of Fusades, in particular, has been of substantial benefit to Salvadoran trade development efforts.

Exporting through co-operatives is risky. USAID and other donors have sought to promote exports of non-traditional agriculture through co-operatives. The basic idea is that co-operatives provide low-income farmers with the means for substantial increases in income. Substantial funding for such efforts has been provided both in El Salvador and in neighbouring countries, but with only modest – and sometimes negative – results. The main reason for failure seems to be the enormous complexity of managing an export business for perishable products. Great flexibility, speed, and entrepreneurial skill are required, particularly before organised channels of export and of export services have developed. To expect co-operatives, with their need for consensus among members, to do well in such circumstances is unrealistic.

Export Processing Zones have made a significant contribution to Salvadoran export development. EPZs can provide an opportunity for rapid growth in employment of relatively low-skill workers, helping to reduce poverty and to overcome a variety of obstacles to exports of other types. But they are no panacea, and governments need to be pro-active by continually pushing for higher-skill products and towards integration of the EPZs with the domestic economy.

Multilateral trade obligations have not placed an excessive burden on El Salvador. The Salvadoran government has made a basic commitment to an open trade regime, and technical assistance from donors has helped provide specialised expertise when required. Senior government officials have taken the position that they know enough to be able to decide what trade policy is appropriate for El Salvador, and that El Salvador intends to be a full participant in the world trading system, accepting the obligations that this involves.

Donor support for trade negotiating capacity has been effective and co-ordinated. There has been some division of labour among donors with respect to technical areas. Nevertheless, the principal reason for the effectiveness of donor support in this area seems to have been the strength of the Salvadoran (and Central American) side. Adequate capacity and seriousness of purpose on the part of the recipient government are the best prescription for effective donor technical assistance.

Neo-liberal economic policies provide no panacea for the country’s foreign trade situation. The shift in Salvadoran economic policies and institutions toward domination by free markets during the 1990s has been dramatic. In view of the magnitude of the policy changes, the performance during the last several years in both economic growth and export growth seems disappointing. It may be that the primary source of these slowdowns is the country’s “Dutch disease.” Even if this is the case, it demonstrates that developing country governments cannot assume that free markets will always produce the right outcome. The Salvadoran government must find some means to prevent the large capital inflows from being a drag on the export sector.
**Bibliography**


Appendix 1: Chronology of Major Events in El Salvador

1961 Central American Common Market is established
1969 War with Honduras; massive repatriation of Salvadorans living there
1979 Civil war begins
1980 Jose Napoleon Duarte joins the ruling junta
March 1984 Duarte is elected president
June 1989 Inauguration of President Cristiani
January 1992 Peace Accords signed
June 1994 Inauguration of President Calderon Sol
June 1999 Inauguration of President Flores
March 2000 Mayoral and Legislative Elections
Appendix 2: Persons Interviewed

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