Central America and the Global Context: Mitigating Vulnerabilities and Raising Growth

November 2016

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Global perspectives

- Weak global growth is a concern, but external environment is still broadly favorable.
- US growth pickup expected in 2017.
- Persistent favorable shock to regional TOT, with commodity prices stabilizing at low levels.
- Global and regional financial conditions have eased.

Regional outlook, risks, and vulnerabilities

- Moderate growth expected in most CAPDR countries.
- External positions were boosted by low oil prices, but not likely to persist.
- Fiscal deficits have declined in some cases, but debt is high and rising in several CAPDR countries.
- Financial sector buffers are sound, but risks from dollarization and de-risking.

Policies

- Fiscal consolidation where needed. Pension and health system reforms to counter aging.
- Monetary policy: greater exchange rate flexibility consistent with move to inflation targeting.
- Financial Sector: Strengthen supervision, minimize risks from dollarization, boost AML/CFT.
- Structural reforms to boost inclusive growth.

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Global growth remains subdued, with substantial uncertainties…

Global Growth

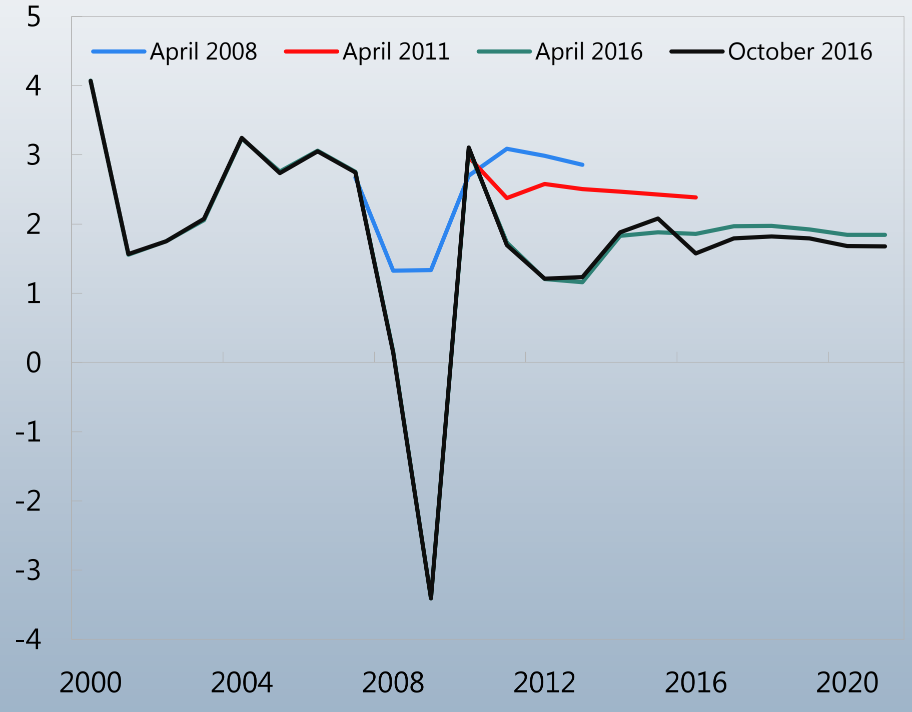
(In percent change from previous year)

	World	United States	China	Latin America and the Caribbean	CAPDR
2003-07	**5.1**	**2.9**	**11.7**	**4.9**	**5.0**
2010	**5.4**	**2.5**	**10.6**	**6.1**	**4.1**
2015	**3.2**	**2.6**	**6.9**	**0.0**	**4.3**
2016	**3.1**	**1.6**	**6.6**	**-0.6**	**4.0**
2017	**3.4**	**2.2**	**6.2**	**1.6**	**3.8**
2018	**3.6**	**2.1**	**6.0**	**2.1**	**3.8**

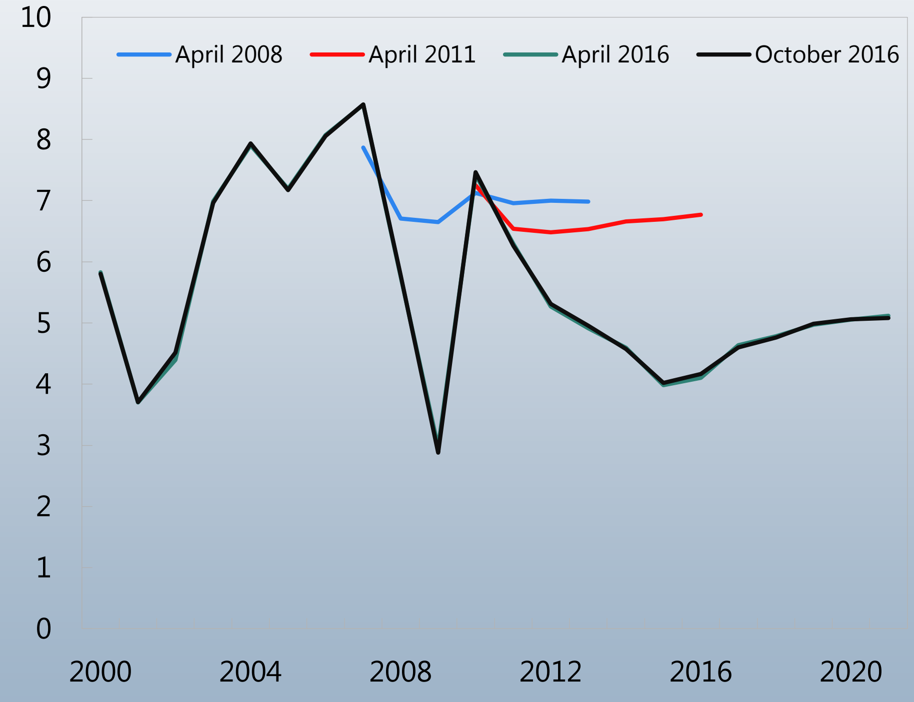
Sources: WEO; and IMF staff calculations.

…and, since the global financial crisis, revisions have generally been downward

AEs: Real GDP Growth
(Percent; various WEO forecast vintages)



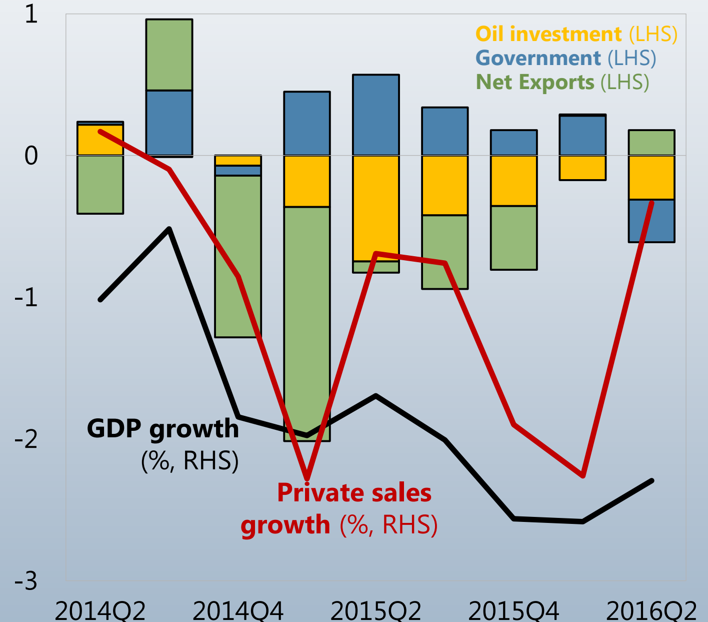
EMs: Real GDP Growth
(Percent; various WEO forecast vintages)



Sources: WEO; and IMF staff calculations.

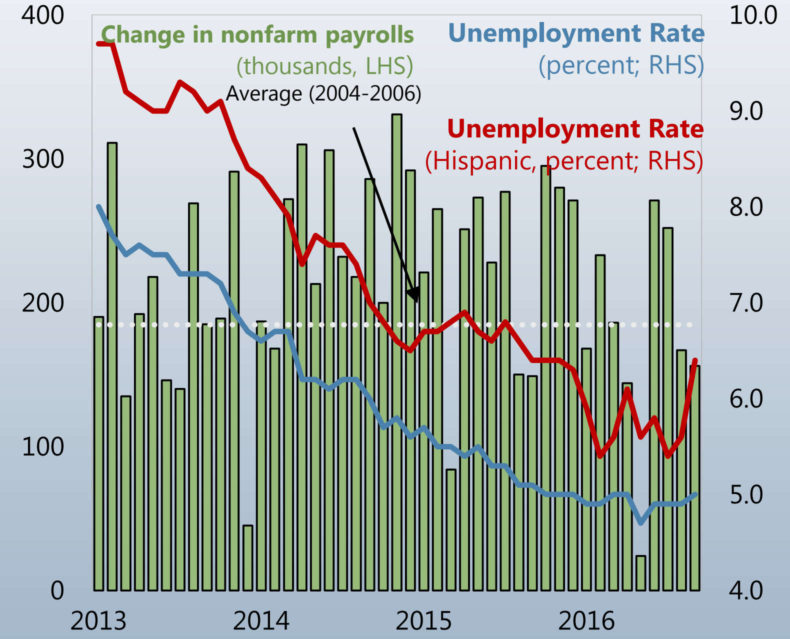
US growth has been weaker than expected despite solid consumption growth, but unemployment has been steadily decreasing

United States: Contribution to Growth
(Percentage points)



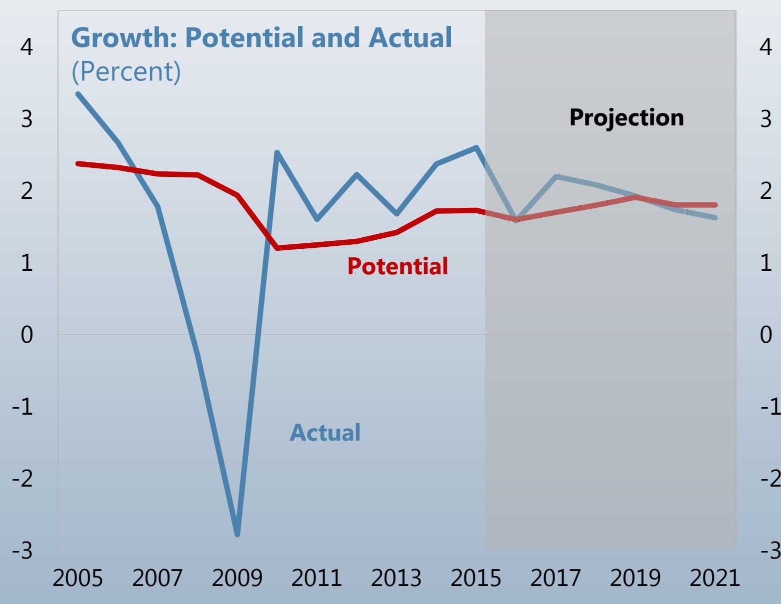
Sources: Bureau of Economic Analysis; and IMF staff calculations.

Payrolls and Unemployment Rate

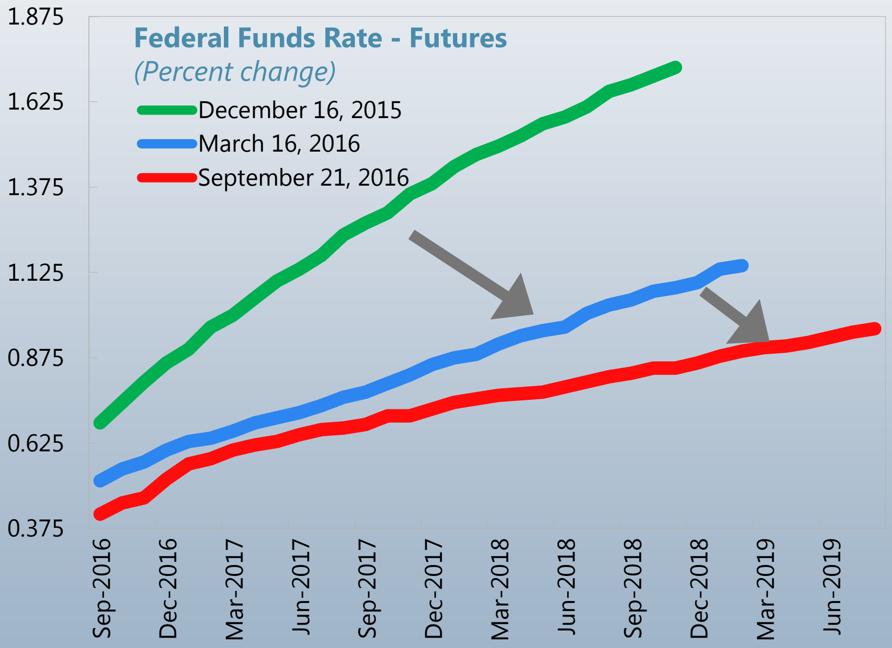


Sources: Bureau of Labor Statistics; and IMF staff calculations.

Following a pick up in 2017, US growth will hover around its potential of about 2 percent. The expected pace of federal funds rate normalization is slower



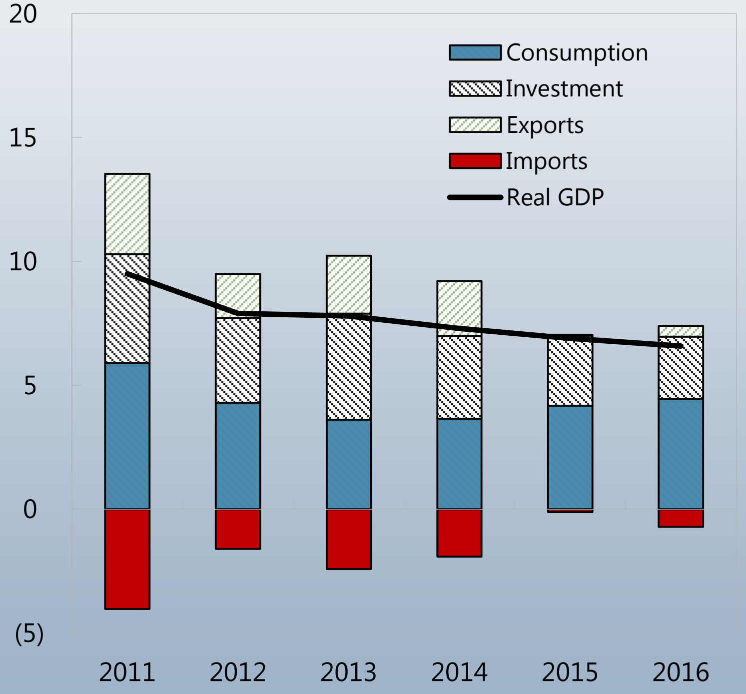
Sources: WEO, BEA, and IMF staff calculations.



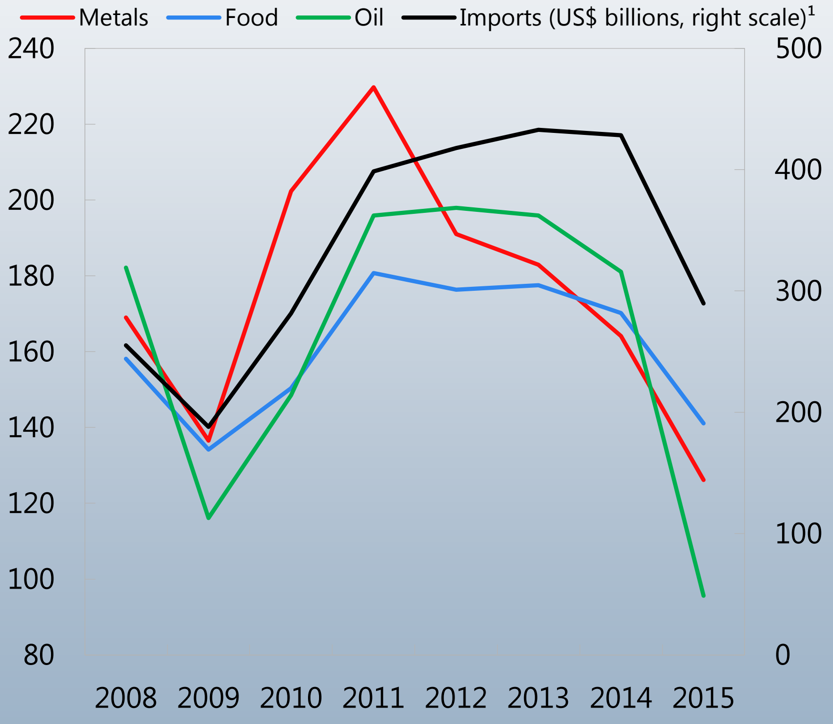
Sources: Bloomberg L.P.

China: Improved short-term outlook due to stimulus, but rebalancing continues and imports are weakening

China: Real GDP Growth, Contribution of Demand Components
(Percent)



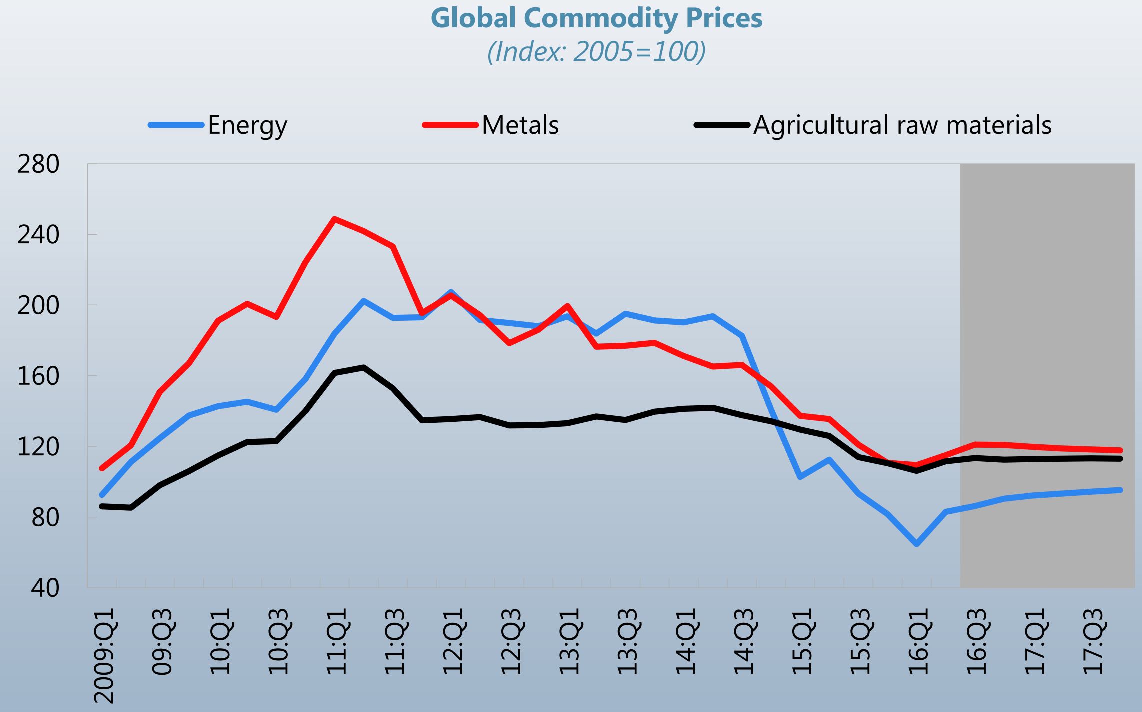
China's Commodity Imports versus Commodity Prices
(Index: 2005 = 100, unless otherwise indicated)



[1] Include metals, food, and oil.

Sources: : WEO; Haver Analytics; and IMF staff calculations.

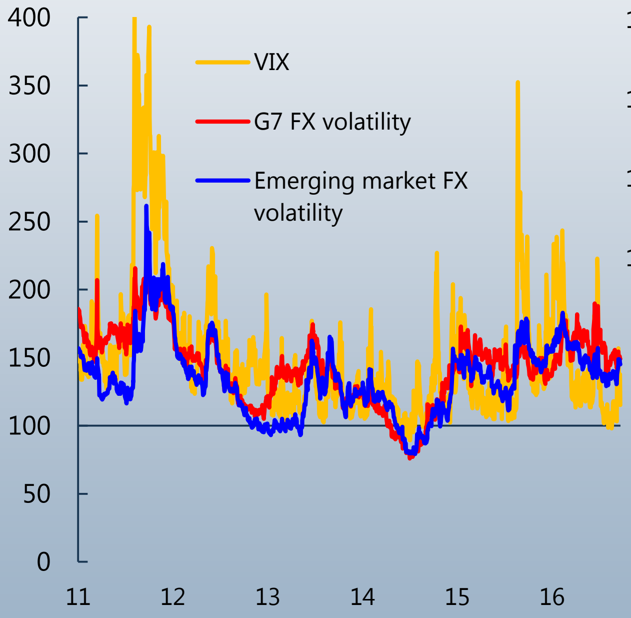
Commodity prices are stabilizing at low levels



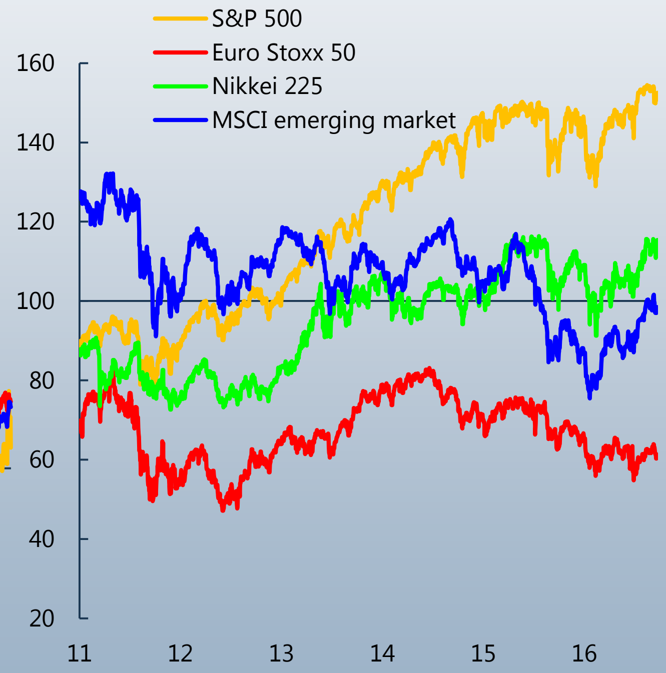
Source: WEO, and IMF staff calculations.

Global financial conditions have eased

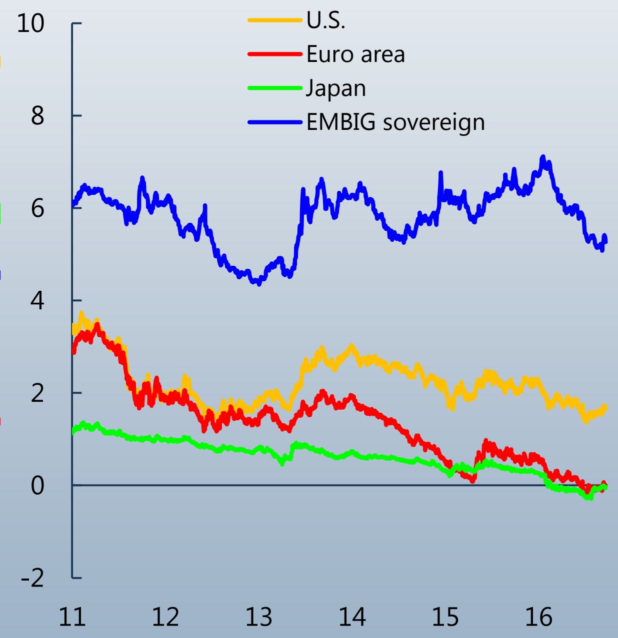
Financial Market Volatility[1]
(Index; Jan. 1, 2007=100)



Equity Prices[1]
(Index; Jan. 1, 2007=100)

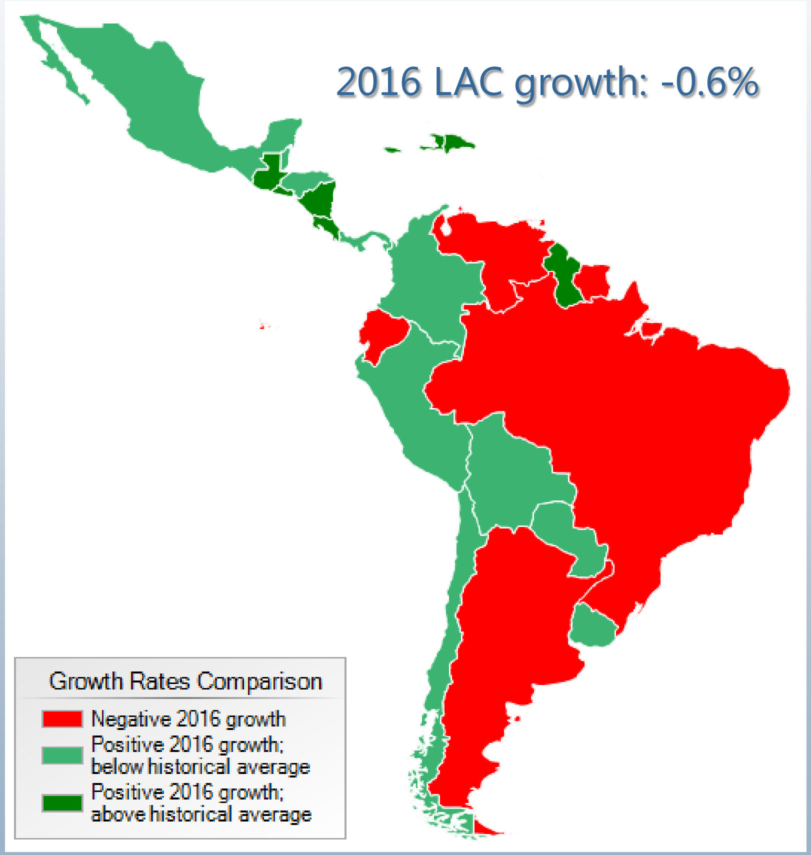


Government Bond Yields[1]
(Percent)



Sources: Bloomberg, L.P.; Haver Analytics; and IMF staff calculations. [1]Latest available data are for September 21, 2016.

LAC: major commodity exporters in recession, but moderate growth in commodity importers



Source: WEO.
Note: Historical average refers to the average growth from 2000–13.

LAC: Real GDP Growth
(Percent)

			Projections	
	2010	2014	2015	2016	2017
LAC	**6.1**	**1.0**	**0.0**	**-0.6**	**1.6**
South America	6.7	0.3	-1.3	-2.0	1.1
Excluding ARG, BRA, ECU, SUR, VEN	5.9	3.3	2.9	2.5	2.9
CAPDR	4.9	4.8	4.9	4.5	4.2
Caribbean					
Tourism-dependent	-1.0	0.9	0.8	1.4	1.9
Commodity exporters	3.7	0.1	-1.2	-2.5	2.2
Memorandum items:					
LA6	6.4	1.4	-0.3	-0.2	1.6
Brazil	7.5	0.1	-3.8	-3.3	0.5
Mexico	5.1	2.2	2.5	2.1	2.3

Source: WEO.
Note: Purchasing-power-parity GDP-weighted averages.

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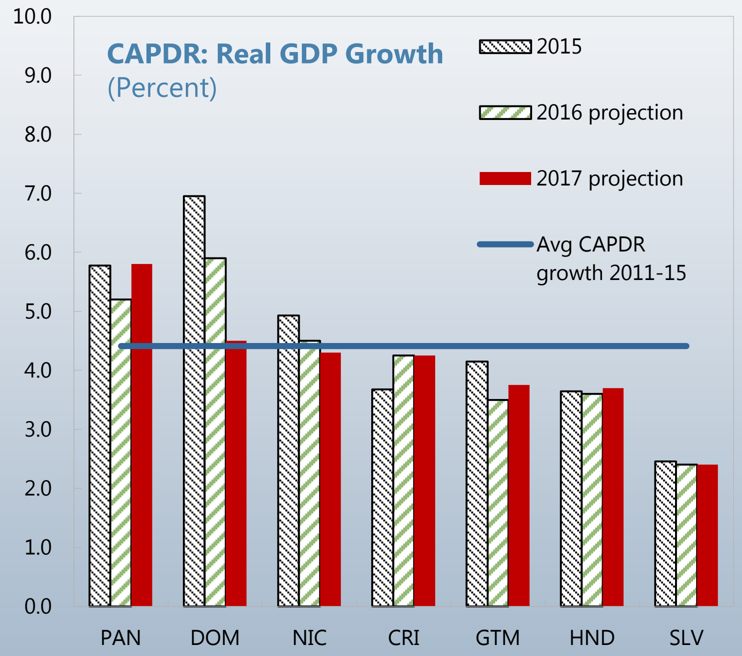
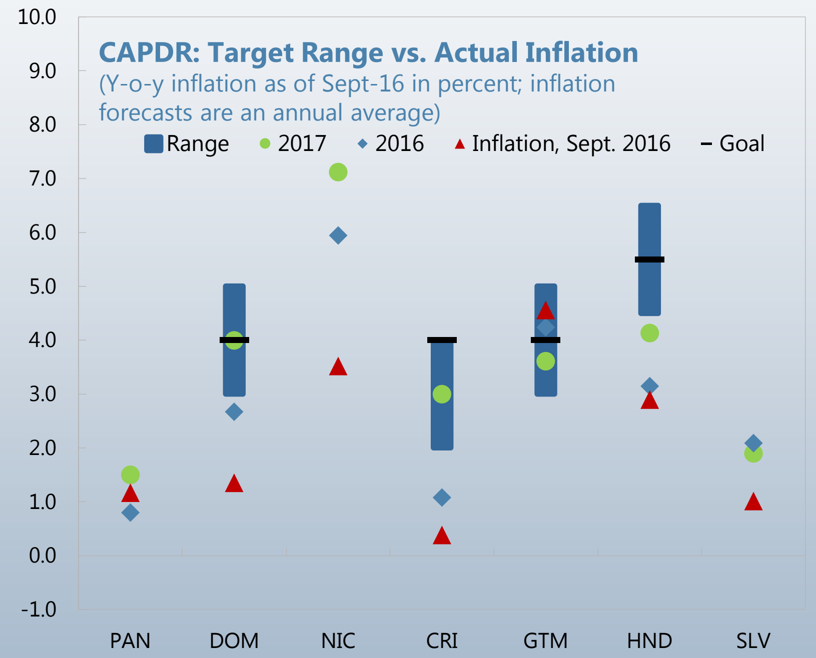
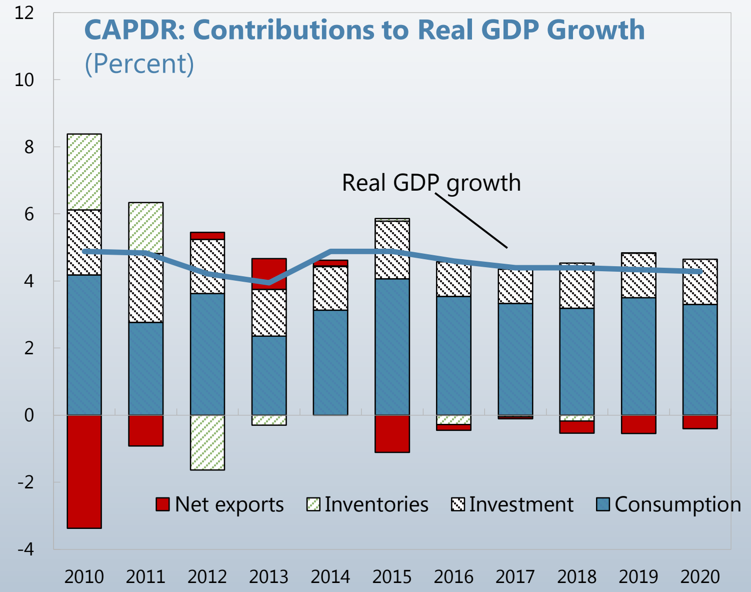
Growth will remain moderate and inflation low for most CAPDR countries



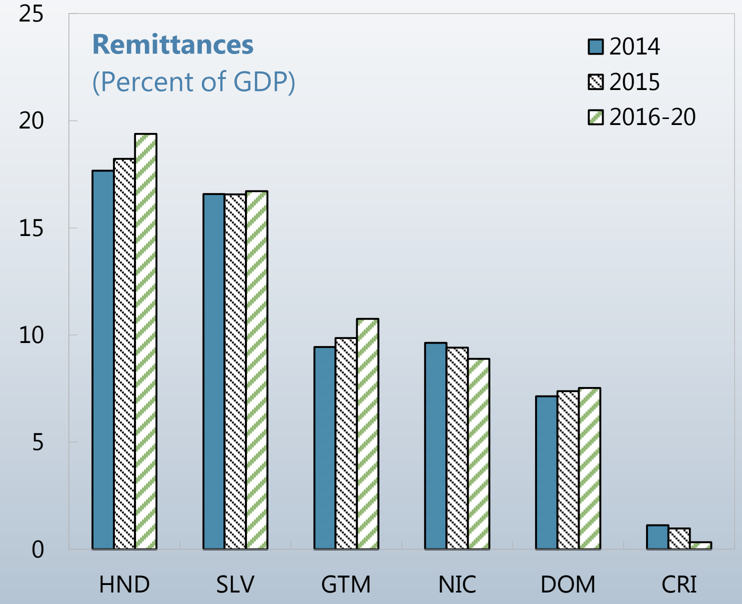


Sources: WEO; national authorities; and IMF staff calculations.

Domestic consumption will be the main driver of growth, supported by remittances and low oil prices

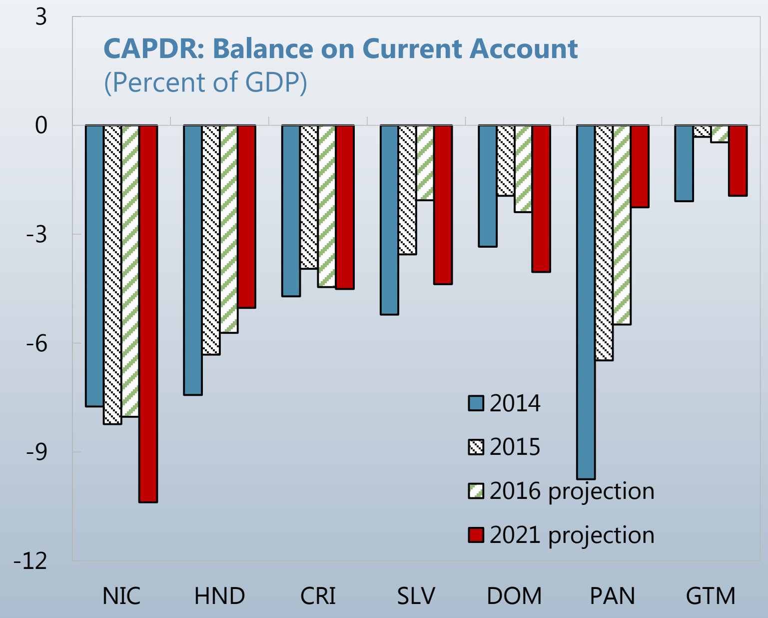


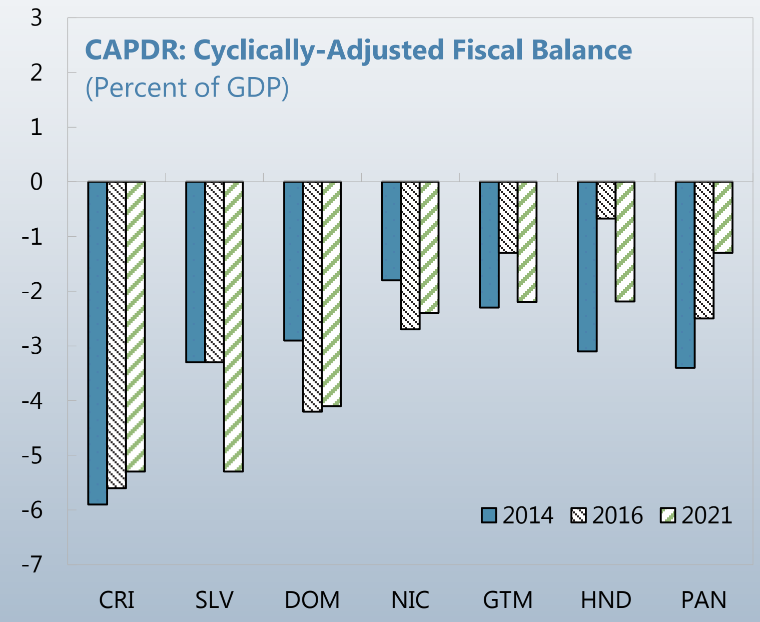
Note: Seasonally adjusted. Purchasing power parity GDP-weighted averages of Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, and Panama. Inventories include statistical discrepancies.



Sources: WEO; national authorities; and IMF staff calculations.

External positions improved following the drop in oil prices, but the improvement is not expected to persist in most countries. Durable fiscal consolidation is also not expected in most countries





Sources: WEO; national authorities; and IMF staff calculations.

Balance of risks for CAPDR is tilted to the downside

Global Risks

- Persistently lower energy prices

- Tighter and more volatile global financial conditions
- Continuing dollar strength
- Weaker-than-expected global growth
- Economic fallout from political fragmentation (i.e. Brexit)

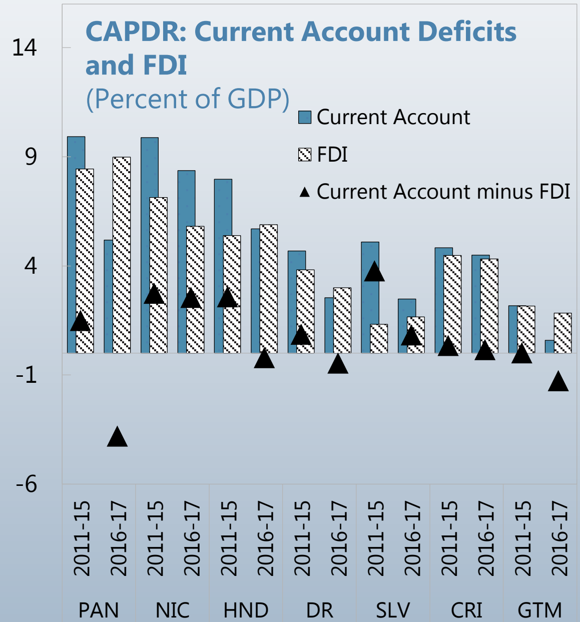
Regional Risks

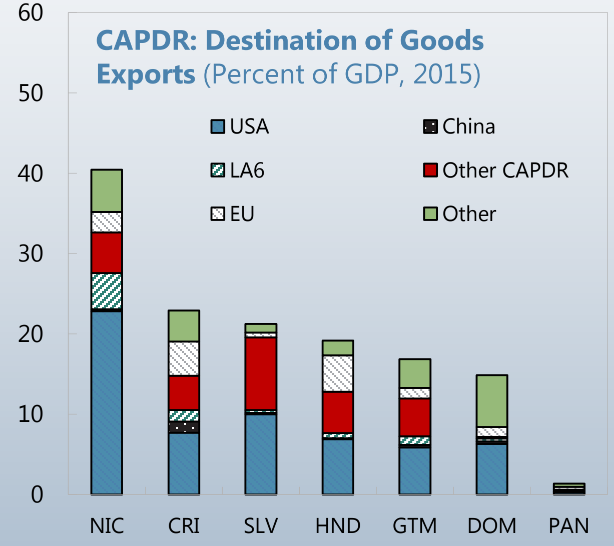
- Political gridlock
- Lack of action in addressing fiscal imbalances
- Withdrawal of CBRs, possibly related to delays in strengthening the AML/CFT framework
- Lack of action in removing constraints to long-term growth and addressing social tensions
- Natural disasters
- Stronger-than-expected spillovers from a sharper slowdown in the LA6

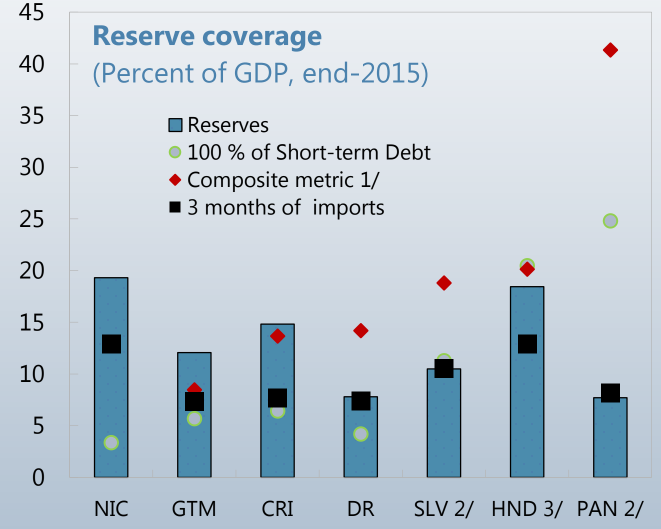
Vulnerabilities remain significant in several CAPDR countries

Sources: IMF staff calculations.

FDI covers a significant portion of CA deficits, and spillovers from LA6 are low, but risk-based reserve adequacy measures suggest possible external vulnerabilities in some countries



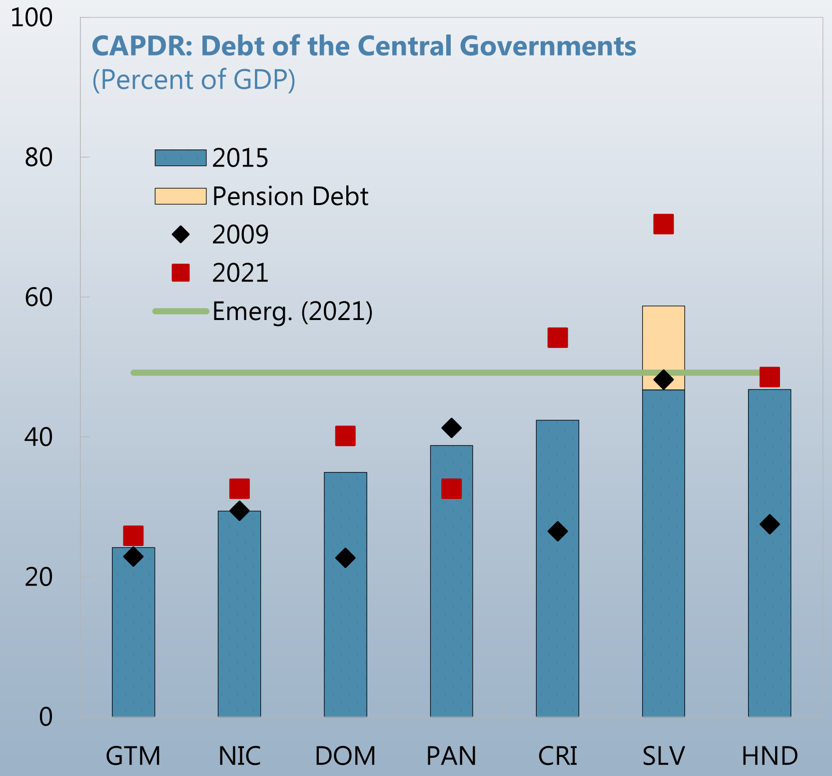


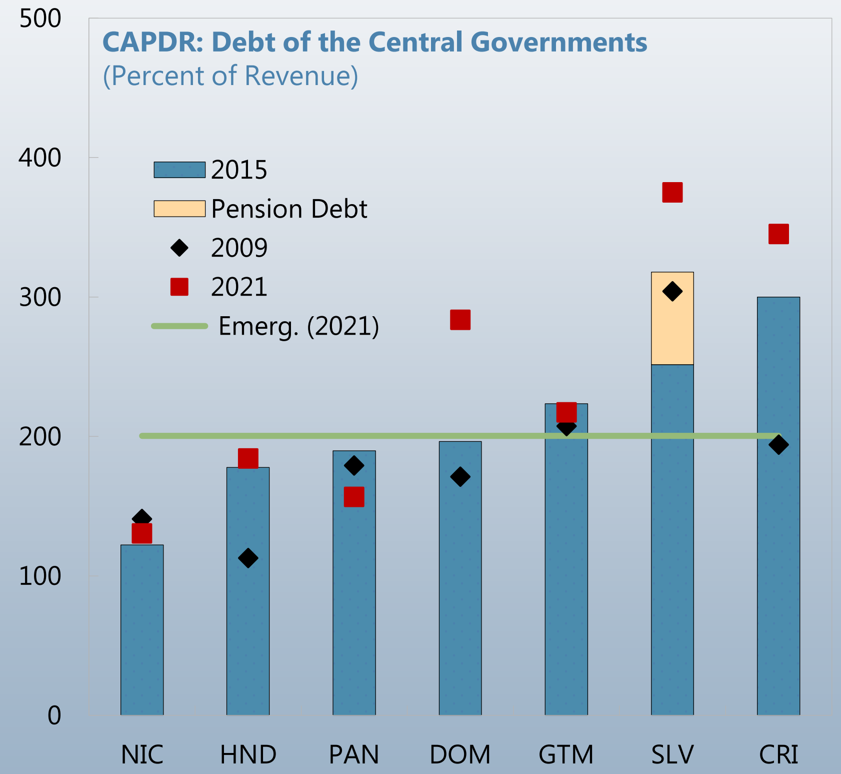


1/ Composite Metric (floating exchange rate) = 5% × Exports + 5% × Broad Money + 30% × Short-term Debt + 10% × Other Liabilities
Composite Metric (fixed exchange rate) = 10% × Exports + 10% × Broad Money + 30% × Short-term Debt + 15% × Other Liabilities
2/ El Salvador and Panama are dollarized economies. Also, Panama does not have a Central Bank. Hence the interpretation of reserve adequacy might be different for these countries.
3/ 3 months of imports refers to the following year's imports of non-maquila goods.

Sources: WEO; national authorities; and IMF staff calculations.

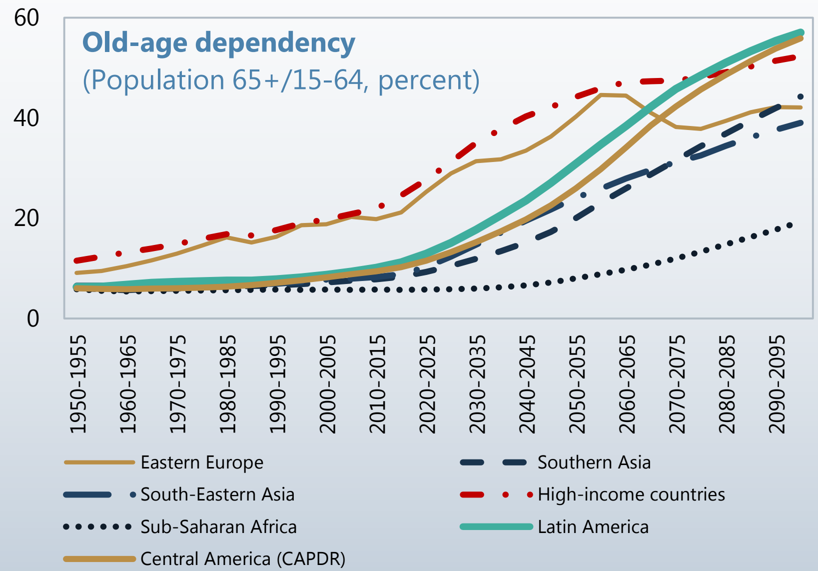
Fiscal vulnerabilities are expected to intensify in many countries in the absence of the required adjustment…

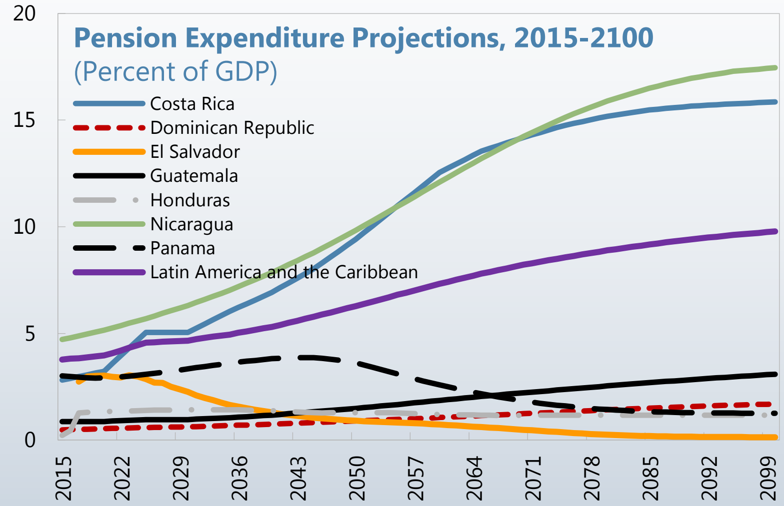


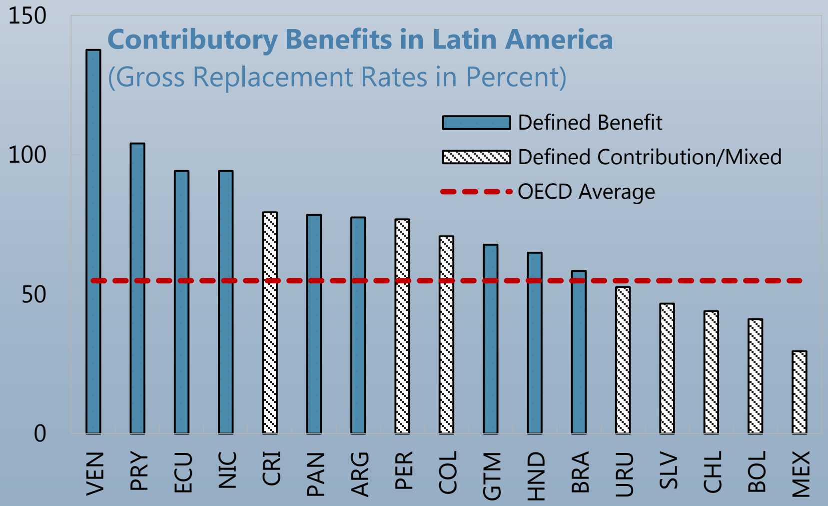


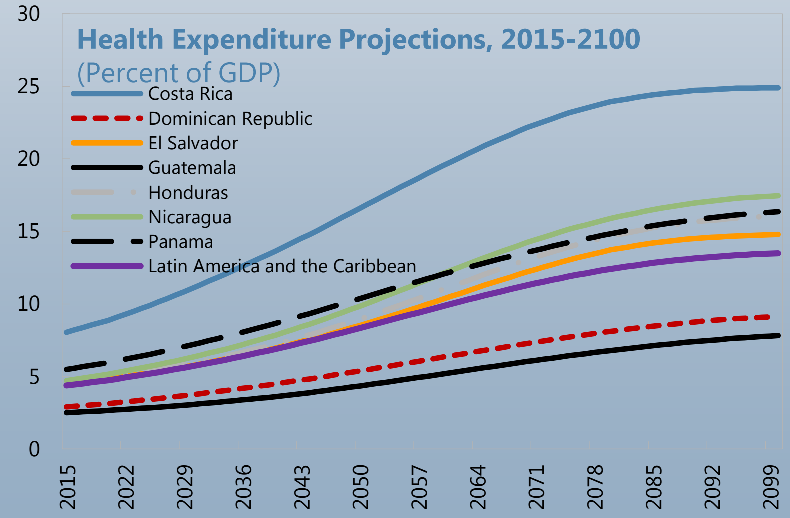
Sources: WEO; national authorities; and IMF staff calculations.

Aging will add to fiscal pressures through higher pensions and healthcare spending



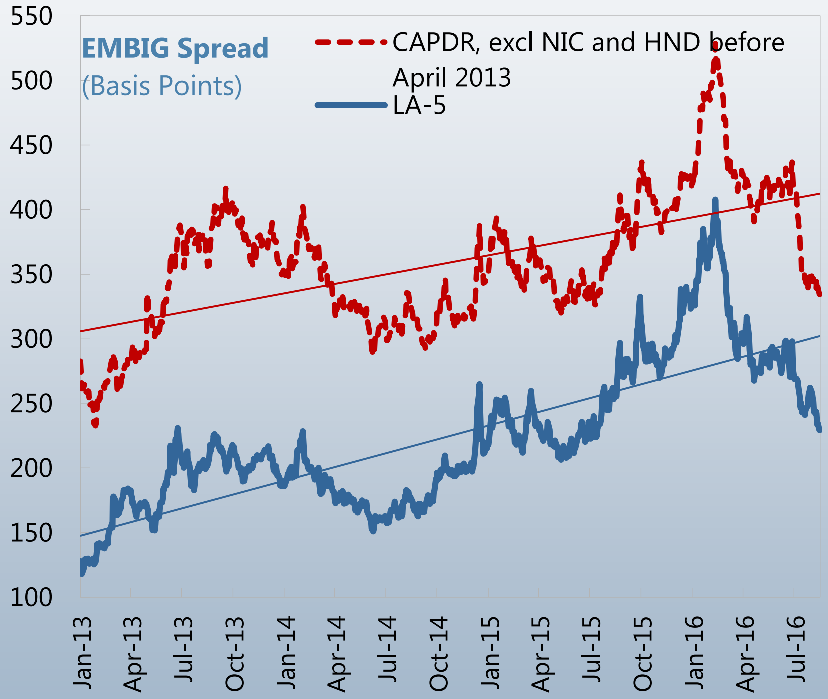


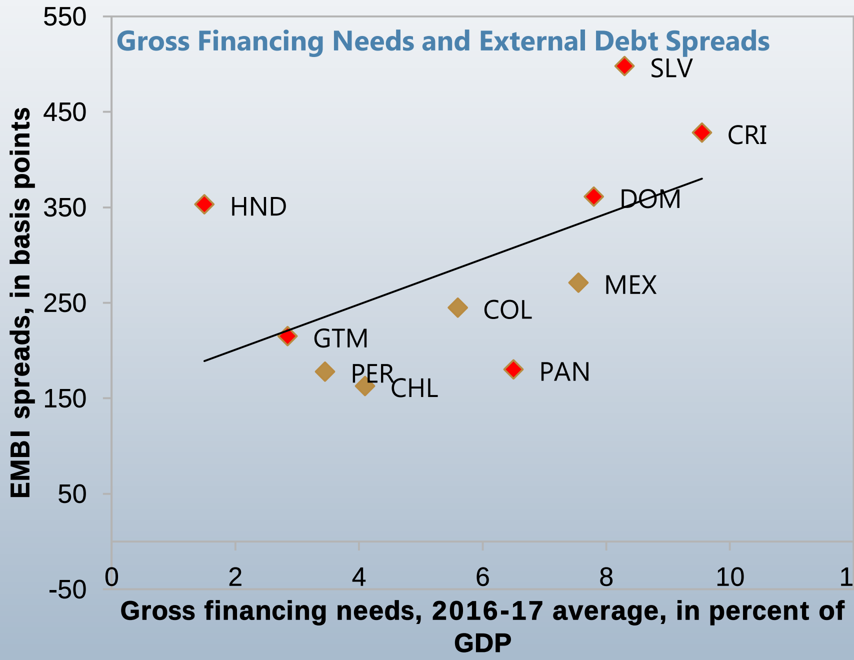




Sources: UN; IDB, OECD; national authorities; and IMF staff calculations.

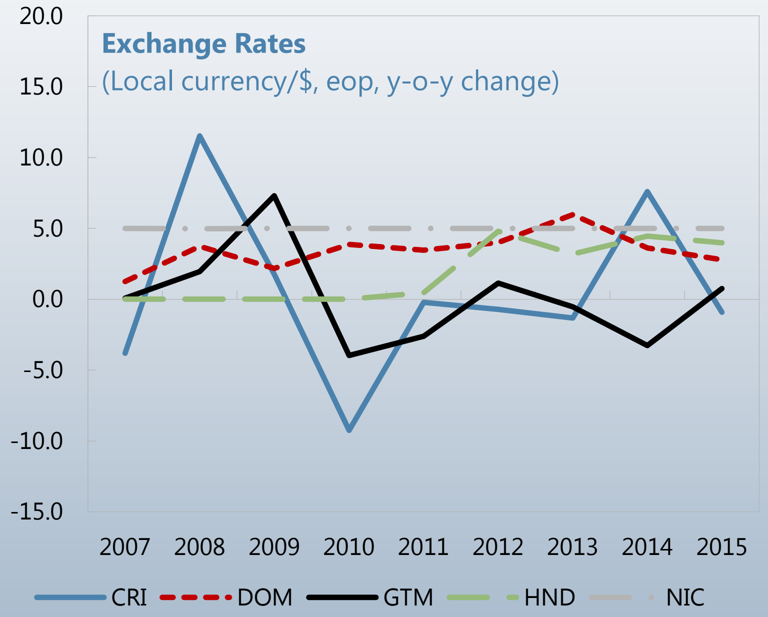
As in other EMs, external financial conditions for CAPDR have improved, but countries with high public debt and financing needs remain vulnerable to a change in sentiment

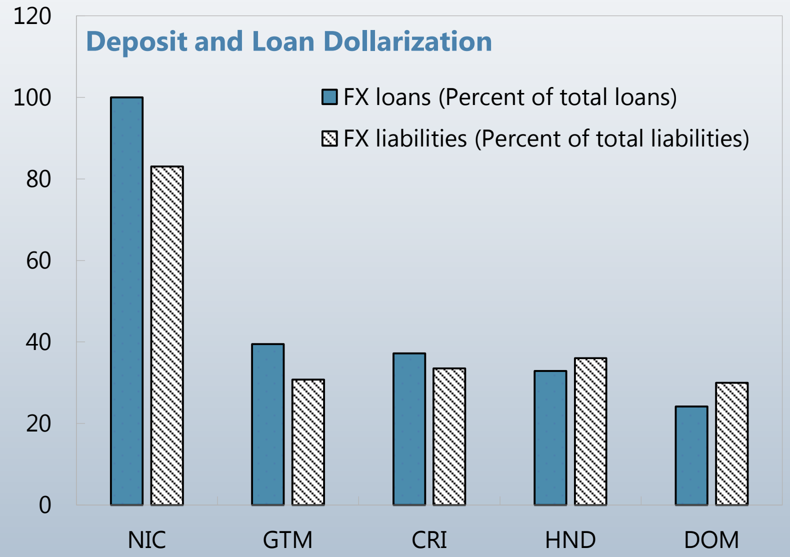




Sources: WEO; national authorities; and IMF staff calculations.

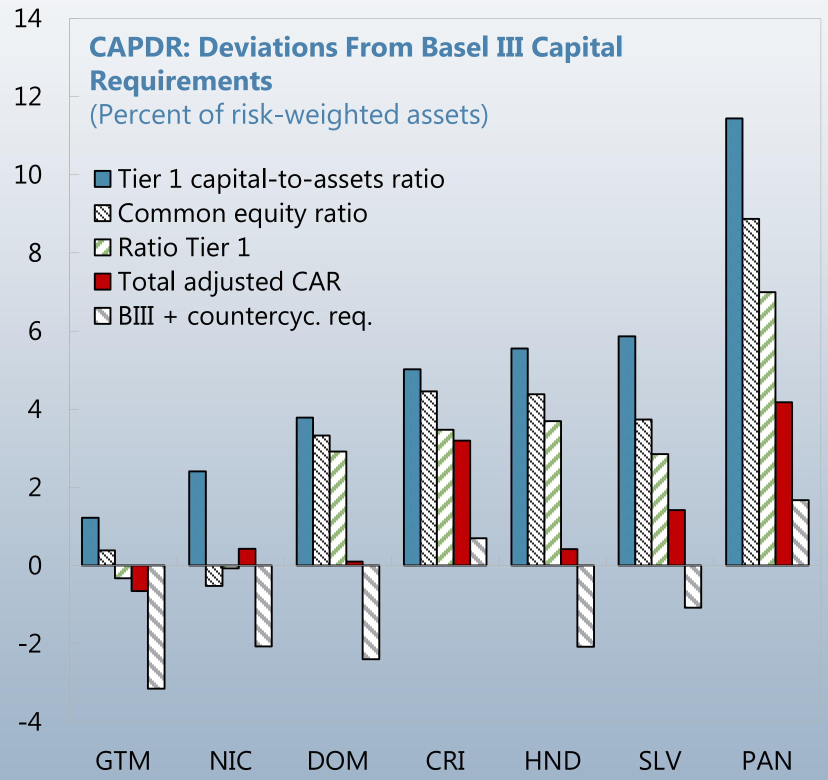
Dollarization has hampered monetary policy transmission and exchange rate flexibility

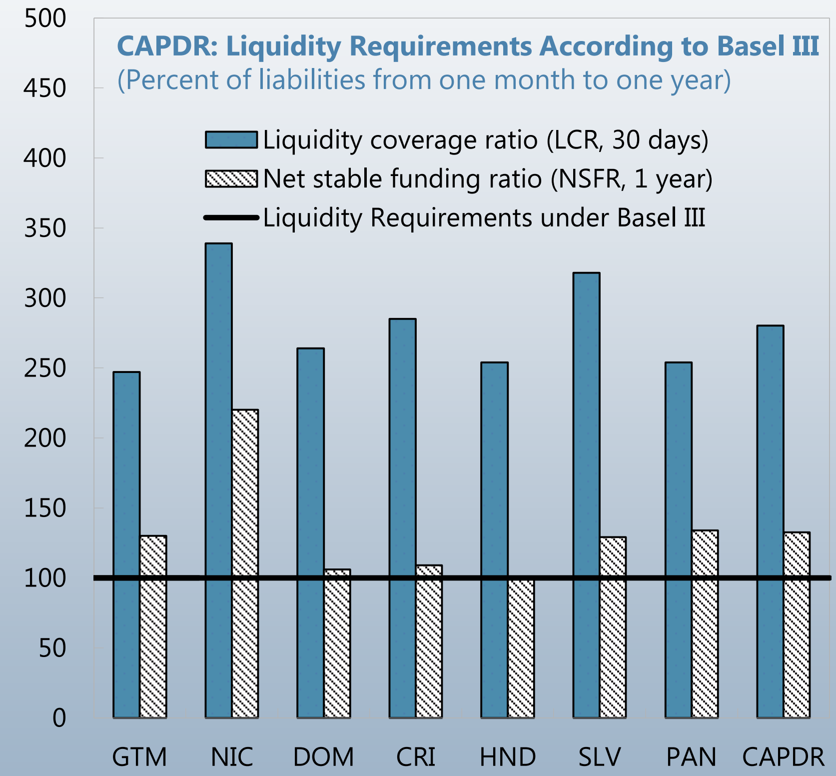




Sources: IMF FSIs; national authorities; and IMF staff calculations.

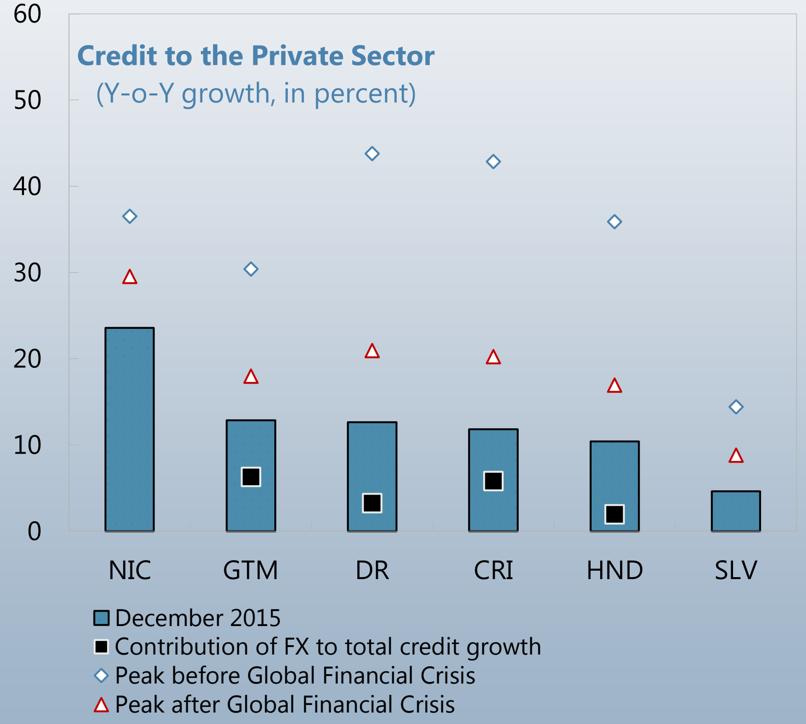
Banks appear to be in broad compliance even with Basel III requirements

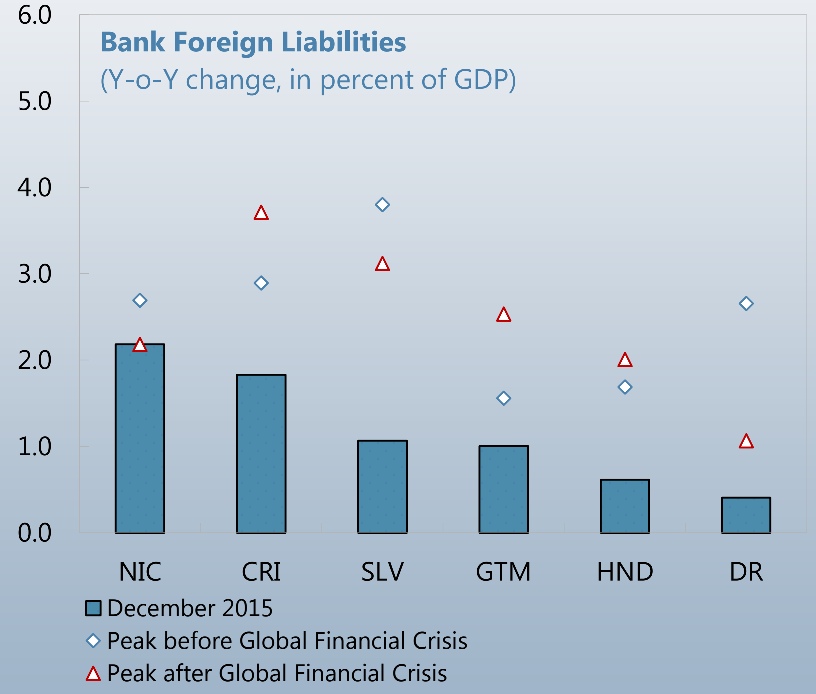




Sources: National authorities; and IMF staff calculations.

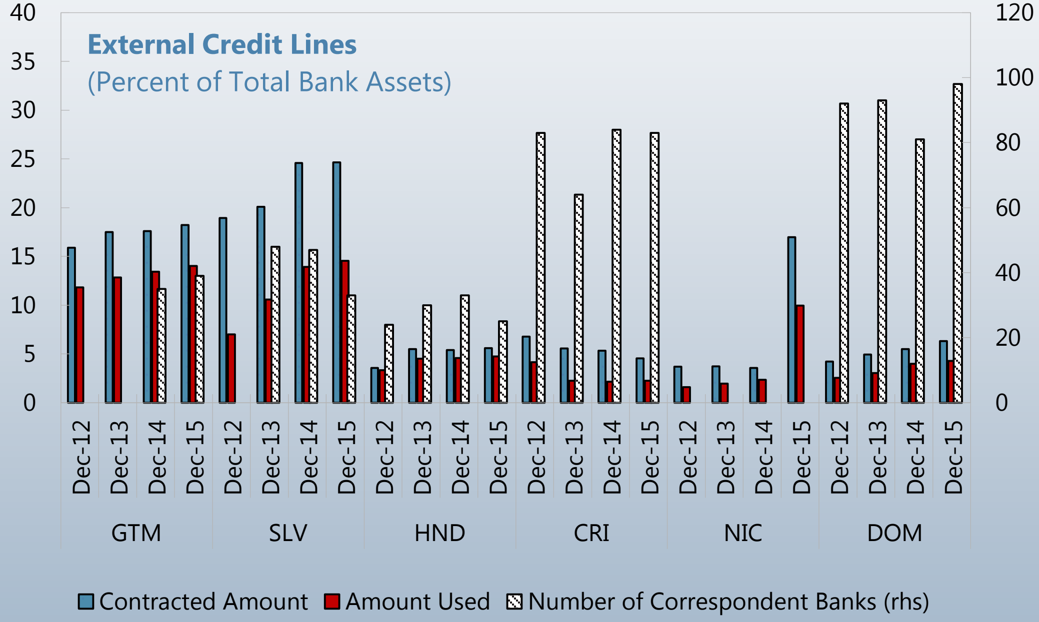
Credit growth is mostly moderate, but lending to unhedged borrowers creates credit risk, while increased reliance on foreign funding creates liquidity risk





Sources: WEO; national authorities; and IMF staff calculations.

Banks in some countries could face risks from withdrawal of foreign credit lines and equity spillovers from Colombian banks



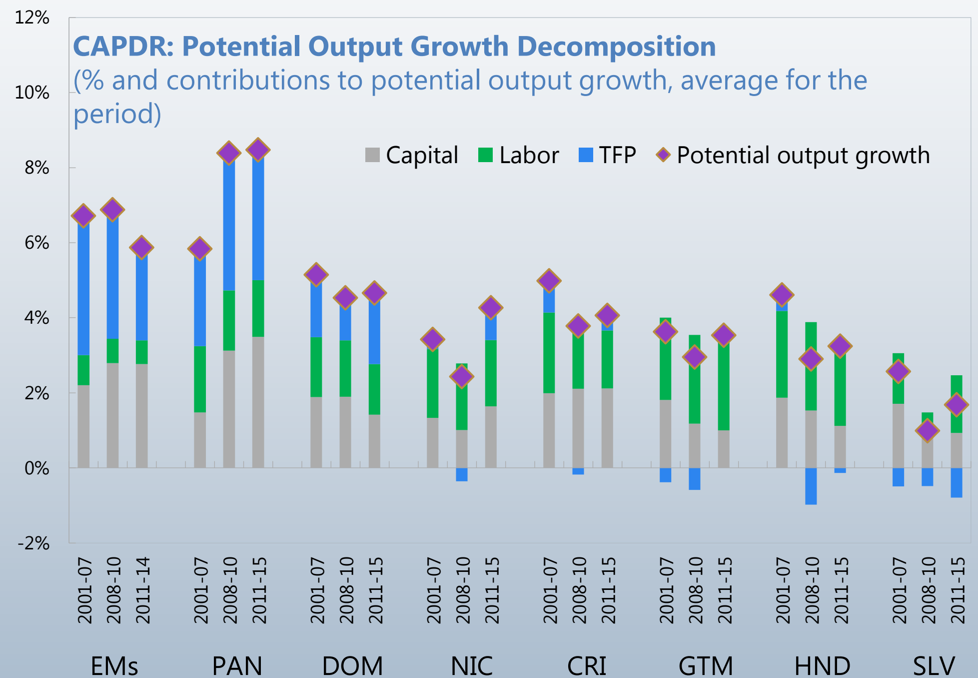
Sources: National Superintendencies of Banks; and IMF staff calculations.

Assets of Colombian Banks in CAPDR
(Share of Parent Banks' Assets)

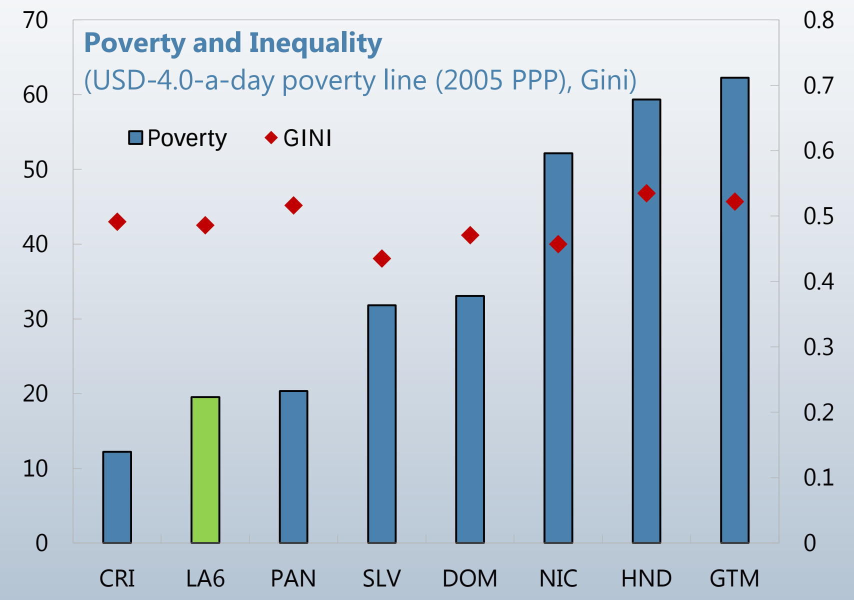
Bancolombia	29.1%
in El Salvador	6.6%
in Panama	21.6%
in the Caribbean	0.9%
Banco de Bogota	43.0%
in Costa Rica	9.0%
in El Salvador	3.6%
in Guatemala	4.6%
in Honduras	3.9%
in Nicaragua	2.9%
in Panama	16.3%
in the Caribbean	2.9%
Davidienda	21.6%
in Costa Rica	6.2%
in El Salvador	7.4%
in Honduras	3.4%
in Panama	4.5%
Occidente	9.3%
in Panama	7.4%
in the Caribbean	1.9%

Source: Colombian Superintendency of Banks.

Structural constraints to capital, labor and TFP growth limit potential growth and poverty reduction

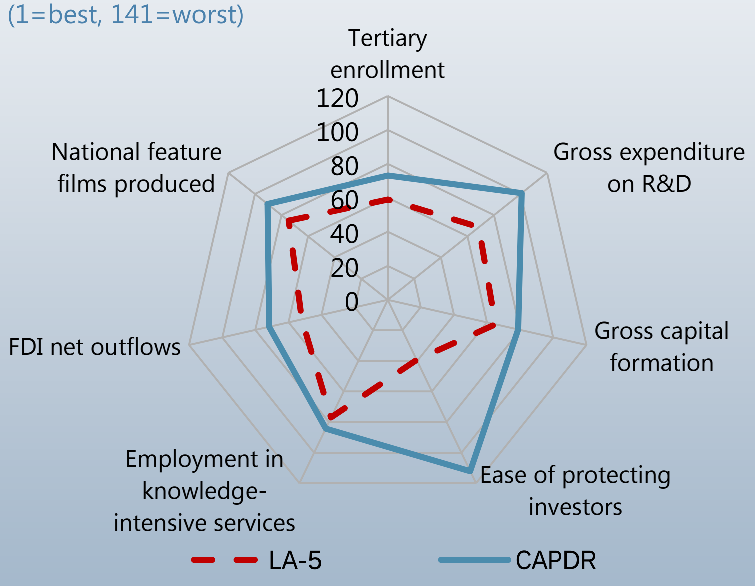


Source: IMF staff estimates.

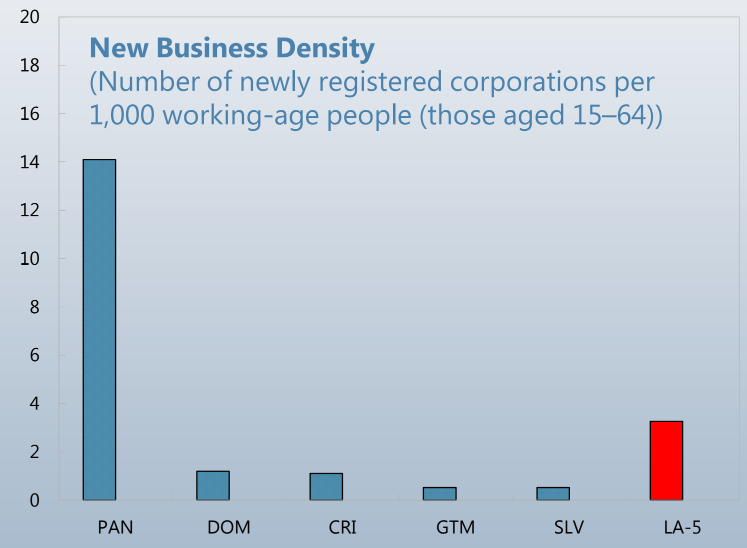


These constraints reflect low human and physical capital, high entry barriers together with limited innovation, which hamper creation of new businesses…

Global Innovation Index Ranking
(1=best, 141=worst)

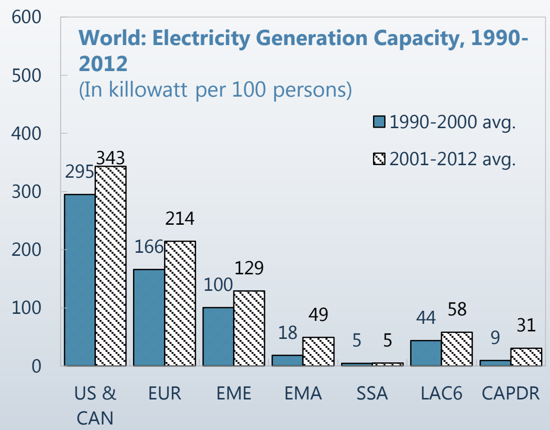


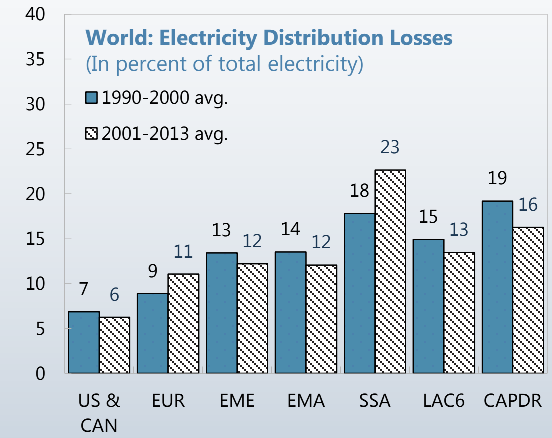
Source: Global Innovation Index.

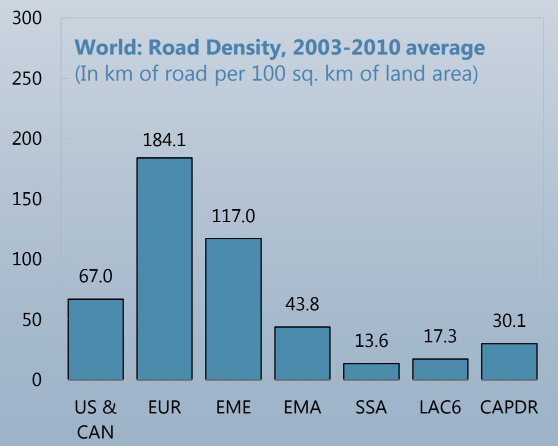


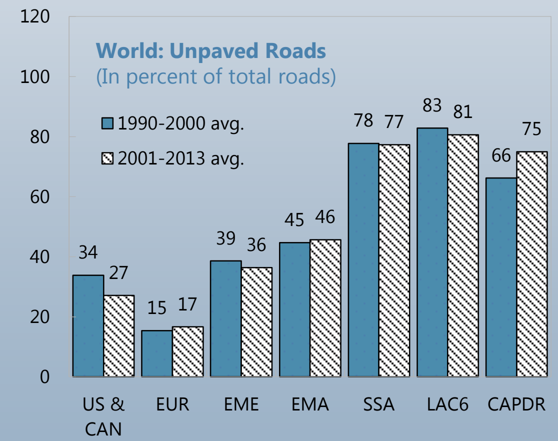
Source: Doing Business, 2016.

...as well as insufficient quantity and quality of infrastructure



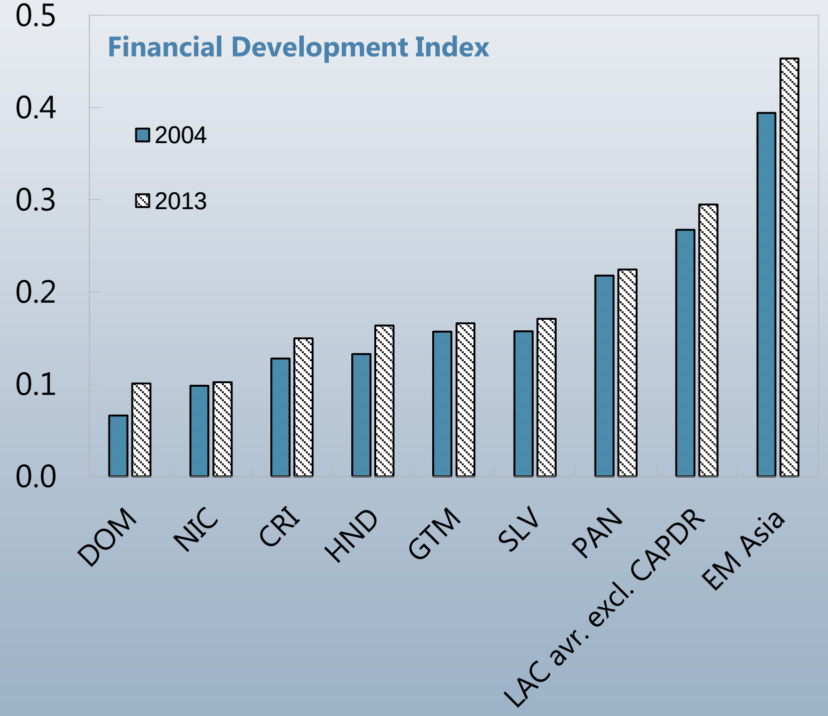




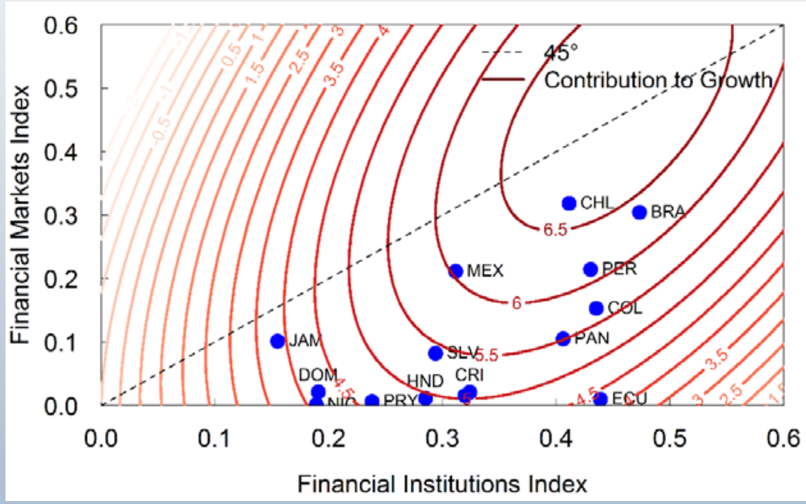


Sources: WB; and IMF staff calculations.

CAPDR lags LAC countries on financial development, and substantial benefits could be reaped from further financial deepening in the long run



Financial Institutions and Market Development, and Economic Growth



Source: IMF staff estimates.

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Fiscal Policy

Goals

- Implement fiscal consolidation when appropriate and institutionalize fiscal discipline
- Strengthen the fiscal policy framework

Measures

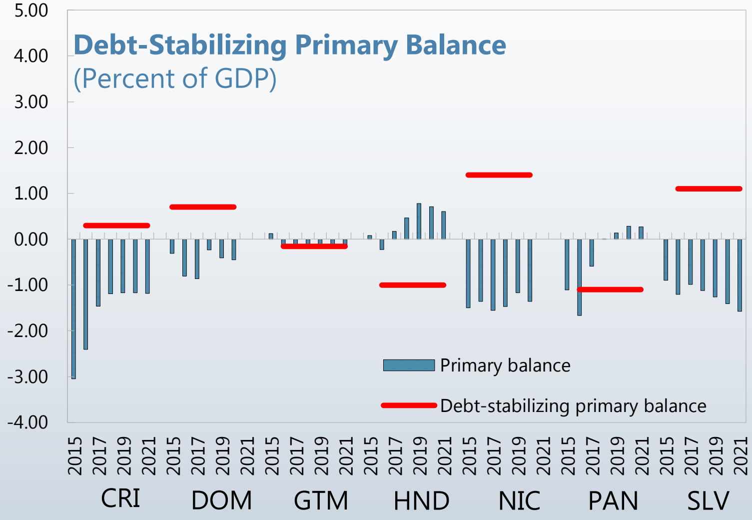
- Establish medium term fiscal targets consistent with public debt sustainability while minimizing the negative impact on growth
- Raise revenue through tax policy and administration reforms
- Improve the efficiency of current expenditures, and boost the social safety net
- Prioritize public investment expenditure and improve public investment management
- Increase fiscal transparency in line with recommendations of fiscal TA & ROSCs
- Develop a strong framework to implement PPPs and minimize fiscal risks
- Introduce fiscal rules

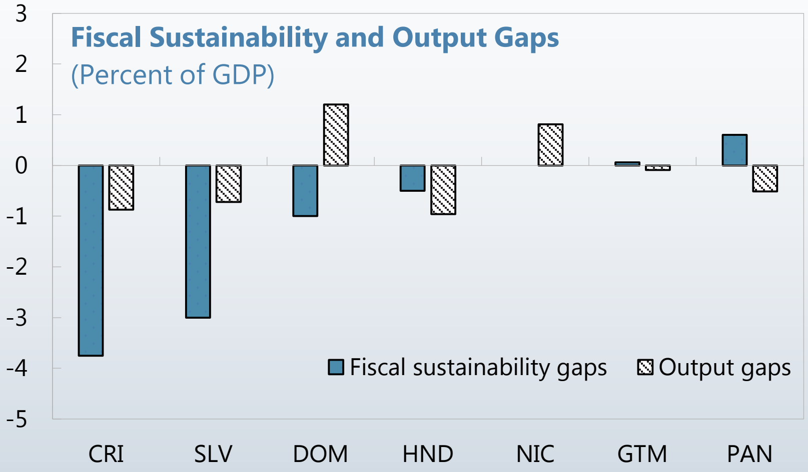
Fiscal Policy

Measures

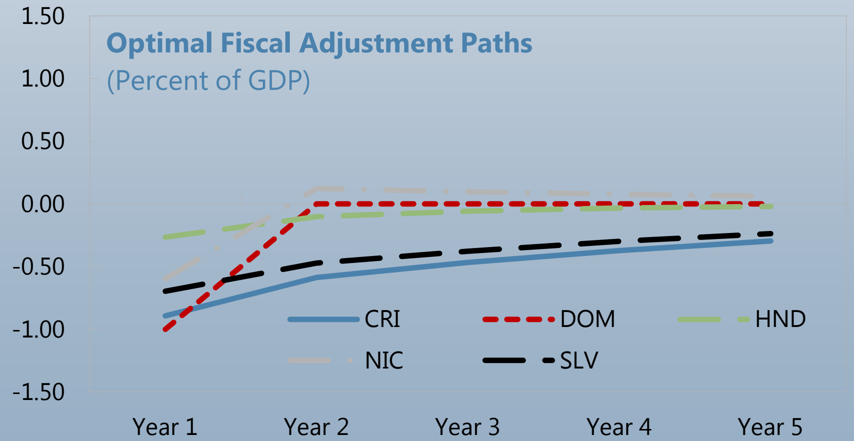
- Parametric reforms to pension systems
  - Raise contribution rates (i.e. Costa Rica, Guatemala, Honduras, Nicaragua, El Salvador) or lower benefits (Costa Rica), but balance such reforms with concerns about informality
  - Raise retirement age in line with life expectancy
- Broaden the contribution base
- Boost pension system coverage
- Policies aimed at increasing female and old-age labor force participation
- Improve efficiency and control costs in health care systems

Moderately frontloaded fiscal consolidation would strike appropriate balance between adjustment and support for growth in some countries





Note: Fiscal sustainability gap defined as the difference between the 2015 primary deficit and the primary deficit that would stabilize debt by 2021, except for CRI, HND, and SLV where lower debt levels are targeted; aging pressures are not included in the estimates, which would significantly increase fiscal sustainability gaps. Output gap as of 2016.



Note: According to model of quadratic preferences (Kanda, 2011), assuming 90 percent weight placed on closing output gap and 10 percent on closing fiscal sustainability gap. For HND, the weight placed on closing the output gap vs. the fiscal sustainability gap is 50-50 percent.

Monetary Policy

Goals

- Strengthen monetary policy transmission mechanism
- Improve credibility of monetary policy and anchor inflation expectations

Measures

- Continue transition towards full-fledged inflation targeting
  - Strengthen inflation forecasting methodologies
  - Improve central bank communication strategy
  - Develop derivatives and complementary markets
  - Increase exchange rate flexibility
  - Strengthen capacity to monitor and contain exchange rate risk
- Strengthen monetary policy transmission by reducing dollarization and deepening financial systems

Financial Policy

Goals

- Ensure and protect financial stability
- Minimize risks from currency mismatches
- Minimize risks from withdrawal of correspondent banking relationships

Measures

- Step up consolidated supervision frameworks, implement risk-based supervision, and strengthen supervision of non-banks
- Ensure full integration of systemic risk in the regulatory and supervisory frameworks and enhance macro-prudential instruments
- Perform regional-level stress-testing and spillover analysis
- Continue the transition towards Basel III
- Strengthen AML/CFT frameworks
- Strengthen bank resolution frameworks
- Boost liquidity buffers for dollarized economies

Structural Policies

Goals

- Strengthen long-term growth
- Reduce poverty and inequality

Measures

- Improve business climate and remove barriers to business entry
- Streamline business regulation and promote competition across sectors
- Increase less-distortionary revenue to support education, health, infrastructure and security spending
- Continue fostering integration of regional markets
- Continue advances in the use and integration of SIEPAC to lower energy costs
- Foster financial market development and financial inclusion