

Foreword

Central America has come a long way since it emerged from the so-called lost decade of the 1980s. Peace and democracy have been firmly reestablished; governments have implemented important economic and social reforms; and, as a result, the region enjoyed relatively strong growth and improved macroeconomic stability in the 1990s.

Nevertheless, Central America still faces important economic, social, and political challenges. Poverty remains high in most countries, as institutional weaknesses have tended to undermine growth and governments' ability to deliver on the high expectations associated with the peace process; and weak fiscal positions and financial sectors have left economies vulnerable to shocks and natural disasters to which the region is particularly exposed.

In the face of these challenges, recent years have seen a renewed effort at adjustment and reform across the region, geared toward boosting growth and reducing poverty in a lasting way. Central America is also becoming increasingly integrated, as a region and globally, and there is growing recognition, at home and abroad, that increased regional cooperation is key to each country's success as it tries to compete in the global economy.

This study looks at these challenges and how Central America is attempting to meet them, with particular emphasis on issues and challenges arising from the growing integration under way in the region. By focusing on the policy implications of increased trade and financial integration, the study should help policymakers make the best of Central America's considerable potential and set the region on a path of sustainable rapid growth. The IMF stands ready to continue to assist the region in its efforts to meet these challenges.

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Issues raised by Central America's growing economic integration are at the center of this study coordinated by our team in the Western Hemisphere Department. A core theme is the need to intensify regional collaboration in a number of areas to maximize the benefits offered by globalization in terms of sustained growth, poverty reduction, and broader social progress. In particular, the study provides a framework for deepening cooperation in banking supervision and regulation, tax policy and administration, and economic statistics. It also notes that integration must be anchored in strong domestic economic policies, especially fiscal reforms to ensure sustainable public debt levels and structural reforms to raise productivity and competitiveness. The study is especially timely as the Free Trade Agreement with the United States (CAFTA-DR) will provide a new impetus for economic integration in the region and its ability to compete successfully in the global economy.

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Preface

This Occasional Paper is the product of a team effort led by Markus Rodlauer and Alfred Schipke, both staff members of the IMF's Western Hemisphere Department. The team includes authors from a number of other departments in the IMF, as well as an outside co-author from the region.

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The opinions expressed in this paper are solely those of its authors and do not necessarily reflect the views of the International Monetary Fund, its Executive Directors, or the authorities in the respective Central American countries and the Dominican Republic.

Abbreviations and Acronyms

ASCM	Agreement on Subsidies and Countervailing Measures
BIS	Bank for International Settlements
CABEI	Central American Bank for Economic Integration
CACM	Central American Common Market
CACS	Central American Council of Superintendents of Banks, Insurance, and Other Financial Institutions
CAFTA	Central American Free Trade Agreement
CAFTA-DR	Central American–Dominican Republic Free Trade Agreement
CAMC	Central American Monetary Council
CBERA	Caribbean Basin Economic Recovery Act
CBTPA	Caribbean Basin Trade Partnership Act
CBI	Caribbean Basin Initiative
CET	Common external tariff
CGE	Computable general equilibrium
CPI	Consumer price index
DQAF	Data Quality Assessment Framework
DSGE	Dynamic stochastic general equilibrium [model]
EMU	European Monetary Union
FDI	Foreign direct investment
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
GDDS	General Data Dissemination System
GFS	Government Finance Statistics
GSP	Generalized System of Preferences
GTAP	Global Trade Analysis Project
HIPC	Heavily indebted poor countries
IDB	Inter-American Development Bank
IIP	International Investment Position
MFN	Most favored nation
MOU	Memorandum of understanding
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Cooperation and Development
PPI	Producer price index
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
ROSC	Report on the Observance of Standards and Codes
SIECA	Secretariat for Central American Economic Integration
SDDS	Special Data Dissemination System
SNA	System of National Accounts
UN	United Nations
VaR	Value-at-Risk
VAR	Vector autoregressive system
VAT	Value-added tax
WTO	World Trade Organization