1 Introduction and Overview

Markus Rodlauer and Alfred Schipke

Central America has received growing attention in recent years as a region that is integrating successfully into the global economy. A decade and a half after the end of civil conflicts and serious economic dislocation in parts of the region, Central America has seen great progress on many fronts: peace and democracy have been firmly established, economies have stabilized and important market-oriented reforms have been implemented, and trade and financial openness have increased notably. As a result, growth has returned and social indicators have improved. At the same time, the glass can also be seen as half empty: poverty is still widespread in most countries; economic and social progress remains constrained by weak institutions and political difficulties; and the institutional framework of regional cooperation and integration is still at an early stage. There is concern that these problems, if unaddressed, could inhibit sustained growth and therefore undermine domestic consensus on the stability and market-oriented policy frameworks now being followed throughout the region. The key task facing policymakers in Central America is thus how to entrench and strengthen the virtuous cycle of good policies and strong institutions, solid growth that is more widely shared across societies, and domestic consensus on the policy framework. The vigorous embrace by the Central American countries and the Dominican Republic of the Free Trade Agreement with the United States (CAFTA-DR) is clear testimony of their commitment to a strategy of outward-looking and market-oriented integration to meet these challenges. This paper looks at the progress that has been made, the challenges ahead, and the region's efforts to meet them.

Background

Although the Central American countries are relatively small, they are quite large as a group and face many common policy challenges. With about 40 million people, Central America accounts for about 7 percent of the population in Latin America and the Caribbean and 4½ percent of total output.[1] In addition to a shared history and a common language, the Central American economies are characterized by small domestic markets, significant—albeit diminishing—dependence on traditional exports, and close economic ties to the United States. In addition, they face a major challenge from increased global competition in some of their key export products—such as from the recent expiry of quotas in world textiles trade—and are exposed to shocks such as natural disasters and terms-of-trade changes.

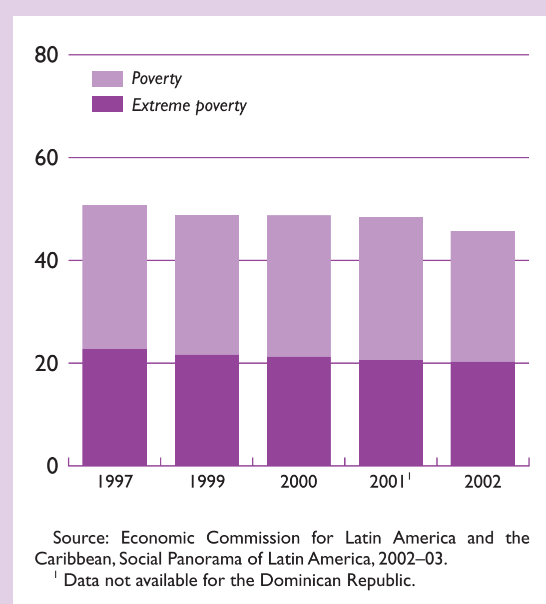
After the so-called lost decade of the 1980s, economic growth returned in the 1990s, reflecting improved domestic and external conditions. Economic progress was severely constrained in the 1980s by adverse external conditions and, in some of the countries, by civil conflicts and misguided economic policies. Following the resolution of the conflicts, in the 1990s the region enjoyed a significant peace dividend, and policymakers sharpened their focus on economic growth, macroeconomic stabilization, and structural reforms such as privatization, trade liberalization, and financial sector deregulation. As a result, the region grew by 4.5 percent a year during the 1990s (1.8 percent in per capita terms), spurred by increased foreign investment and greater export diversification. Substantial progress was also made on inflation, which has been reduced to single digits. However, despite the recovery in output, the benefits of growth often were not widely shared and the gains in per capita income were not sufficient to make significant inroads against poverty (Figure 1.1). Furthermore,

[1]In this paper, Central America is generally defined to include Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama; certain sections also include the Dominican Republic. This broader definition mirrors the membership of the Dominican Republic in the Central American Monetary Council and the Central American Council of Bank Superintendents, as well as the Dominican Republic's participation in CAFTA-DR. Including the Dominican Republic, the total population of Central America makes up about 9 percent of the population in Latin America and the Caribbean and about 6 percent of total output.

Figure 1.1. Central America: Real GDP per Capita Growth
(In percent)

Source: IMF, *World Economic Outlook.*

Figure 1.2. Poverty in Central America
(In percent)



Source: Economic Commission for Latin America and the Caribbean, Social Panorama of Latin America, 2002–03.
[1] Data not available for the Dominican Republic.

growth slowed in many countries in 2001, partly reflecting deteriorating external conditions but also because of difficulties in some countries in sustaining the reform momentum. Weak institutions and political uncertainty in some countries continue to undermine confidence and depress the investment climate.

Recent Developments

Political and Social Environment

Notwithstanding the great improvement in Central America's political conditions during the 1990s, economic policymaking remains hampered by weaknesses in the political process. To be sure, several rounds of peaceful elections over the past decade show that democracy has taken firm root in the region, supported by an active civil society and a free press. Nevertheless, the political landscape in many countries remains highly fragmented, and many governments (such as those in El Salvador, Guatemala, Honduras, and Nicaragua) are facing parliaments with an opposition party majority. Short election cycles also complicate sustained implementation of economic reform programs, and after just having gone through a series of elections in recent years, most countries in the region are about to enter another round of elections (presidential, legislative, or municipal) in 2005–06. In addition, vested interest groups pursuing their own agendas often wield disproportionate influence, complicating macroeconomic and structural policy implementation. At the same time, however, there appears to be a groundswell of support throughout the region for the basic overall principles of macroeconomic discipline, low inflation, market orientation, and openness—evidenced, for example, in the fairly broad support in Honduras for maintaining the economic programs supported by the Poverty Reduction and Growth Facility (PRGF), notwithstanding the difficult political situation and various pressure groups' desire for a bigger share of the budget. It remains to be seen whether the political process can deliver a critical mass of reforms, stability, and investor confidence over the next few years—which in turn will produce the kind of growth and social progress necessary to maintain broad domestic support for the policy framework.

Recent economic progress has not been mirrored by a similar improvement of social conditions, and much of the region continues to face widespread poverty (except in Costa Rica and Panama). About half the population lives in poverty, while some 20 percent faces extreme poverty (Figure 1.2). In part, poverty is associated with low-wage employment in the informal sector and is concentrated in rural areas where access to public services remains limited. Similar to inequalities elsewhere in Latin America, Central America's income distribution remains very uneven.

Recent years have seen renewed efforts across the region to address corruption and governance problems. New governments in Costa Rica, El Salvador, Guatemala, and Nicaragua have made fighting corruption a centerpiece of their policy platforms, and governance issues also figure prominently in Honduras' reform program supported by the IMF and other international financial institutions. Sustained progress in strengthening governance and reducing corruption will require continued focus on building institutions such as an independent and strong judiciary, transparency and accountability in public resource management, and reliable supervisory and regulatory bodies in the financial systems.

Recent Economic Developments

In 2003–04, Central America emerged from a period of sluggish growth to face a more favorable short-term outlook. Driven initially by a pickup in exports due to firming external demand conditions and commodity prices, the recovery in 2004 spilled over to domestic demand—despite the dampening effect of the oil price shock. Real GDP growth increased from 2¼ percent in 2002 to 3½ percent in 2004. The near-term outlook is also favorable, with regional growth in 2005 projected at 3¼ percent, although longer-term growth faces several challenges, including increased competition from China, especially in textiles, and rising world interest rates.

After a decline in inflation through 2003, recent increases in oil prices and stronger demand conditions caused inflation to rise throughout the region in 2004 to an average of 8½ percent. Assuming oil prices stabilize, inflation is expected to return to a downward path, supported by prudent fiscal and monetary policies.

External positions have continued to improve. Export growth in 2004 averaged over 14 percent in 2004, driven by strong U.S. demand and a recovery in commodity prices, especially that of coffee. While current account deficits remained largely unchanged (near 6 percent of GDP in 2004), in part reflecting the higher oil import bill, strong capital inflows have boosted international reserves.

Progress was made in reducing fiscal deficits. While most countries in Central America saw debt-to-GDP ratios rise over the past decade, the current cyclical upturn has allowed countries to strengthen policies and improve fiscal accounts: fiscal deficits declined from an average of near 6 percent of GDP in 2002 to 3 percent in 2004, helped by buoyant revenue collections that reflected both a growth dividend and ongoing reforms of tax policy and administration. Nevertheless, in several countries (Costa Rica, El Salvador, and Nicaragua), public debt remains high or has been on an upward trend. In Guatemala, while public debt and fiscal deficits remained well contained, government efforts to strengthen the tax effort—and thus achieve the Peace Accord target of a tax-to-GDP ratio of 12 percent—were stalled by court decisions and opposition in congress. The 12 percent target was included as a key element in the 1996 Peace Accords to provide more resources for social programs and spending.

Regional Integration

Regional integration in Central America is gaining momentum. The past decade has witnessed growing linkages among the Central American economies as well as with their largest trading partner, the United States. While trade among the Central American countries has risen relatively slowly, trade with the United States increased fivefold in dollar terms during 1994–2003. On the other hand, the region has seen a significant increase of intraregional financial sector linkages. Central America has an open trade regime, with a tariff structure that is largely determined by the common external tariff of the Central American Common Market.[2] Although Central America has already preferential access to the U.S. market in the context of the Caribbean Basin Initiative,[3] the Central American Free Trade Agreement (CAFTA-DR), signed in 2004, should make this access permanent and extend it further in some areas leading to continued deepening of trade integration with the United States.

Economic policy coordination, however, is still at an early stage. The Central American countries continue to pursue independent fiscal policies, and while there is a regular consultation process among central banks, monetary and exchange rate policies evolve largely independently of each other.[4] Nevertheless, the region has a set of regional institutions that are increasingly involved in information sharing, harmonization of regulation, and policy coordination, particularly in areas such as banking supervision, central banking, and trade (Box 1.1).

Looking Ahead

What are the economic policy priorities for Central America to support a virtuous cycle of growth, strong policies and institutions, and domestic support?

[2]See Box 1.1 for the CET rates. The origins of economic integration efforts date back to the 1961 General Treaty of Economic Integration, which initiated the creation of a Central American Common Market.

[3]The Caribbean Basin Initiative would expire in 2008.

[4]The monetary policy stance in the officially dollarized economies (Panama and El Salvador) reflects, of course, that in the United States.

Box 1.1. Regional Economic Institutions

Central American Monetary Council (CAMC). The council was created in 1964 to coordinate the development of a Central American monetary union. The goal of setting up a monetary union has been abandoned, and the focus is now on policy coordination and technical assistance in monetary and credit policy and financial sector issues. The council meets every three months and has four standing committees: monetary policy, exchange and clearing policies, financial operations, and capital market and legal issues. The council comprises the central bank presidents of Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic (which joined the council as a full member in 2002); Panama participates in meetings as an observer.

Central American Council of Superintendents of Banks, Insurance, and Other Financial Institutions (CACS). The principal objective of the council is to foster cooperation and the exchange of information among the superintendencies. One of its main projects is to facilitate consolidated supervision and standardization. The council was established in 1974 and includes the superintendents from Costa Rica, Guatemala, Honduras, El Salvador, Nicaragua, the Dominican Republic, and Panama. The council meets 2–3 times a year.

Central American Bank for Economic Integration (CABEI). The bank supports regional economic integration and development. Lending operations are directed mainly to infrastructure, industry, agriculture and livestock, social development, and the environment. The bank began operations in 1961 and was opened to non-regional members in 1992. The bank's capital is currently subscribed by the regional members (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua) and non-regional members (Argentina, China, Colombia, Mexico, and Spain). Under a special agreement, El Salvador, which is officially dollarized, could borrow funds for liquidity purposes.

Secretariat for Central American Economic Integration (SIECA). The general treaty for economic integration, signed in 1959, envisaged the creation of the Central American common market (CACM), which became effective in December 1960. The establishment of the CACM initially suffered a series of setbacks, but important progress has been made since 1985 with the adoption of (1) the Brussels tariff nomenclature (September 1985); (2) a tariff system based on the international harmonization system (January 1993);[1] (3) regional free trade (March 1993); and (4) a common external tariff (February 2001). The CACM comprises Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua (Panama is an observer). The common external tariff has four rates: zero (capital and intermediate goods, and raw materials not produced in the region); 5 percent (raw materials regionally produced); 10 percent (capital and intermediate goods regionally produced); and 15 percent (final goods).

[1]The Central American external tariff (CET) currently covers more than 90 percent of the region's trade and has an average tariff of 4.9 percent.

There is no single blueprint of reform for the region, as what is most needed and works best depends on the specific circumstances of each country. Nevertheless, the common history, similar features, and growing integration of the Central American countries suggest some key priorities that need to be addressed for sustained growth and social progress in the region.

- *Completion and implementation of CAFTA-DR.* The region has rightly set high expectations for this important trade agreement; the task is now to complete the agreement through ratification by members' parliaments and to implement the range of supporting reforms and institutional arrangements foreseen in it.[5]
- *Fiscal reforms.* The recent improvement in fiscal balances needs to continue, to ensure sustainable debt dynamics. Experience has shown that fiscal consolidation will endure only if it is based on a broad agenda to raise growth and implement structural reforms, especially institutional reforms to strengthen fiscal systems and make them more resilient against shocks and political pressures. Thus, efforts need to continue to strengthen countries' tax efforts, reduce budget rigidities, and improve budgets so that they better reflect the priorities in infrastructure, human capital, and support for the poor. Broader reforms to the overall fiscal framework may also be helpful in entrenching fiscal discipline, such as legislation to improve the budget process and/or impose sustainable debt limits.
- *Sound new credit flows.* Banking reforms in each country have already strengthened systems and made them more resilient against shocks. These reforms must continue to ensure new credit flows in an environment of sound prudential and supervisory standards. As part of this effort, regional coordination of regulations and supervision needs to be stepped up to keep pace with the

[5]El Salvador was the first country to ratify the agreement, at the end of 2004, followed by Honduras and Guatemala.

accelerating financial integration among Central American countries.

- *Investment climate.* The region is keenly aware of the need to improve the investment climate to increase its attractiveness for foreign direct investment. This may require further work to identify specific impediments in individual countries; typically, it will involve continuing improvements in infrastructure, including through private sector participation, strengthening the rule of law, and lowering the cost of doing business.
- *Transparency and governance.* Governments in the region recognize that fostering transparency in government and fighting corruption are top priorities if they are to effectively improve the investment climate and sustain domestic support for their policies. These goals must continue to pervade the full range of economic reforms being implemented, and governments should press ahead with establishing a preventive strategy and, in a given case, punishing wrongdoing wherever it occurs.
- *Regional collaboration.* Competing successfully in the global economy calls for further collaboration among countries in the region to maximize the benefits offered by economic integration, while minimizing its risks, such as those from cross-border financial transactions. In particular, increased coordination is needed in the areas of banking supervision and regulation, tax policy and administration, economic statistics, and large public investment projects.

Overview

The sections that follow bring together recent analysis by IMF staff, which focuses on six broad areas: the implications of CAFTA-DR, fiscal sustainability and related policy issues, exchange rate regimes, financial sector issues, macroeconomic statistics, and the political economy of reforms in Central America. In addressing these topics, the paper highlights the regional perspective and the need to match increasing economic integration with efforts to step up policy coordination and institution-building at the regional level.

- Section II analyzes the *macroeconomic implications of CAFTA-DR*, both for growth and the dynamics of macroeconomic fluctuations. Although Central America is already highly integrated with the United States, the section finds that CAFTA-DR will likely provide a further boost to trade, foreign direct investment, and growth in the region—a boost that will help meet the growing competition the region is facing in some of its key export items, notably textiles. CAFTA-DR should also reduce macroeconomic volatility in the region as its economies integrate further with the U.S. economy. For the growth and stability benefits of CAFTA-DR to materialize, however, the agreement needs to be supported by reforms to strengthen key institutions such as regulatory bodies, dispute resolution and property rights, and labor market flexibility.
- In reviewing the *fiscal implications of trade liberalization*, Section III expects a near-term (direct) loss of customs revenues due to tariff reductions in the range of 0.1 to 0.3 percent of GDP. However, this impact should be mitigated over time by the (indirect) positive effect on revenue through higher growth and import volumes. Looking forward, the section argues that the growing regional trade integration heightens the need for greater cooperation on tax policy and administration—in particular, to avoid a “race to the bottom” among countries trying to compete for foreign direct investment through additional tax incentives.
- Section IV, on *fiscal sustainability*, uses a value-at-risk (VaR) approach to complement traditional assessments of sustainability. The analysis underscores the need for fiscal adjustment in most of the Central American countries—except Guatemala—to ensure sustainable debt dynamics. The section also shows the usefulness of the VaR approach in designing a country’s debt management strategies.
- Section V looks at the implications of *exchange rate systems and the ongoing regional integration process*—as affected further by CAFTA-DR—on the kind of exchange rate regime that countries might consider in the long run. (The section notes that, in the short run, other important considerations may condition the choice of regime.) The empirical analysis suggests that Central America is still less suitable for a common currency (an independent Central American currency or the U.S. dollar) than Western Europe was in the 1970s, even after taking into account the predicted integration effects of CAFTA-DR. The analysis shows that during 1993–2003, the Central American countries have become relatively more suitable to dollarization, reflecting increased synchronization of business cycles, reduced inflation differentials, and rising trade flows with the United States. Similarly, looking ahead, the section posits that dollarization would probably bring more relative benefits for the region than a common currency that floats

independently—although, again, neither of these two options is advisable in the near future. For countries that are already officially dollarized, the priority is to implement policies that ensure the sustainability of the regime, including prudent fiscal and wage policies and structural reforms to strengthen competitiveness and growth.

- Section VI, on *regional integration and financial systems*, notes the substantial progress made in recent years in strengthening financial systems. However, it also points to remaining weaknesses such as limited access to credit, high informal dollarization, portfolio problems, gaps in supervision and regulation, and underdeveloped capital markets. By addressing the accelerating regional financial integration and cross-border activities, the section underscores the need for stepped-up regional coordination in financial regulation and supervision; in particular, it highlights the significance of implementing effective consolidated supervision at both the domestic and regional level.
- Section VII, which discusses *macroeconomic statistics from a regional perspective*, calls for improvements and greater convergence of statistical systems in Central America, to support better economic analysis and policy design as well as deeper economic integration and policy coordination. It finds that the region has a fairly solid base of economic statistics, with most countries either already subscribing or preparing to subscribe to the IMF's Special Data Dissemination System (SDDS) or the General Data Dissemination System (GDDS). Moves toward greater comparability of data and methodological convergence should be anchored on an advanced level, guided by those countries that already subscribe to the SDDS.
- Finally, Section VIII looks at the *political economy of reforms in Central America*. It summarizes the substantial progress made by the region over the past decade and a half in building stable democracies, implementing significant economic and social reforms, and entrenching a shared vision of the overall goals of economic growth, stability, and poverty reduction. At the same time, it highlights the challenges still being faced by the region in building the institutional framework for sustained sound economic policymaking and structural reforms. It concludes by noting the risks and constraints imposed by current institutional weaknesses for the implementation of ambitious economic reform programs, while also emphasizing the imperative of broadly engaging the political process in efforts to build domestic consensus on reforms. The section also notes the important contribution that economic policy and reforms can make in advancing the goals and principles that characterize successful political systems.