1 Overview

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Central America has made substantial progress in regaining macroeconomic stability and has continued to integrate further both globally and at the regional level.[2] The challenge now is how to entrench these gains, improve growth performance to significantly reduce poverty, and reduce vulnerabilities, including those that are associated with increased integration. This paper addresses some of these important issues. After reviewing recent developments, this chapter provides an overview of key policy issues facing Central America: economic growth, fiscal issues related to pension reform and sovereign debt structures, the development of capital markets, and monetary policy. It also briefly discusses the progress that has been made with integration and regional policy coordination.[3] The subsequent chapters analyze these key issues in more depth.

Recent Developments

Over the past two years, a series of presidential and congressional elections in Central America have demonstrated that democracies are functioning well and that transfers of power occur smoothly. While the governments in the region continue to embrace macroeconomic stability, the ability of the countries in the region to move economic reforms forward will depend critically on their ability to build alliances, since many governments lack majority support in congress.

Benefiting from a continued favorable global environment, the region has recently improved its growth performance, reaching on average 5 percent in 2005 and around 6 percent in 2006. Growth in Costa Rica, the Dominican Republic, and Panama has been particularly impressive in recent years (Table 1.1). Exports from countries in the region grew by 11 percent in dollar value terms in 2005 and 2006.

Despite the uptick in inflation that followed the oil price shock, external positions remained strong. As a result of the oil price hike, inflation in the region rose to 8 percent in 2005, but fell to around 6 percent in 2006. At the same time, the regional current account deficit did not deteriorate notably and remained stable at about 5 percent of GDP in both 2005 and 2006, aided by strong export growth and rising remittances. In addition, strong capital flows to the region have led to further accumulation of foreign exchange reserves.

Authorities in the region have maintained robust fiscal policies, but public finances remain vulnerable, and more is to be done to reduce debt levels and finance priority spending (Figure 1.1). With Guatemala the notable exception, public debt levels in the rest of region remain high (an average of about 53 percent of GDP at end-2005), despite debt relief delivered to Nicaragua and Honduras under the Heavily Indebted Poor Countries (HIPC) Initiative. The need for urgent increases in priority spending in many of the countries in the region will require raising revenue, reducing exemptions, and reorienting spending.

Financial sector intermediation is increasing, but financial dollarization, weaknesses in supervision, and rapid credit growth remain sources of vulnerability. With the exception of Panama, financial systems in the region are still shallow. In that light, the rise in credit growth is a welcome development, but, with increases in credit of 3½ percentage points of GDP or higher in Costa Rica, Nicaragua, and Panama during 2006, risks need to be closely monitored.[4] The proliferation of foreign currency lending is a potential source of currency-induced credit risk for banks, even in countries where

[1]This chapter has benefited from comments by Ivanna Vladkova Hollar.

[2]Unless otherwise stated, Central America refers to Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua, as well as Panama and the Dominican Republic. The inclusion of the latter two countries reflects their membership in a number of regional institutions such as the Central American Integration System.

[3]This paper complements Occasional Paper 243 (Rodlauer and Schipke, 2005), which covered the macroeconomic implications of the Central America-Dominican Republic Free Trade Agreement with the United States, trade liberalization and tax coordination, fiscal sustainability, regional integration and exchange rate arrangements, financial system issues, and issues related to the political economy of reforms and macroeconomic statistics.

[4]Rapid rises in credit raise questions about the capacity of the banking system to assess risk and to allocate credit efficiently. However, the current credit expansion does not so far appear to qualify as a "lending boom" (Gourinchas, Valdes, and Landerretche, 2001; Borio and Lowe, 2002). Furthermore, fiscal consolidation has likely played a role in "crowding in" the private sector.

Table 1.1. Central America: Real GDP Growth

	2004	2005	2006
Central America	**4.0**	**5.1**	**6.0**
Costa Rica	4.1	5.9	7.5
Dominican Republic	2.0	9.3	10.1
El Salvador	1.8	2.8	4.2
Guatemala	2.7	3.2	4.6
Honduras	4.6	4.2	5.5
Nicaragua	5.1	4.0	3.7
Panama	7.5	6.4	6.5

Source: IMF, *World Economic Outlook*.
Note: 2006 numbers are preliminary.

net foreign currency positions of banks are roughly balanced. Weaknesses in supervision, particularly of the offshore banking sector and nonsupervised deposit-taking institutions, pose significant additional risks. Recent banking failures in Guatemala, including the failure of the fourth largest bank (Banco del Café) as a result of problems in an affiliate offshore and of Banco del Comercio related to lending to an unregistered deposit-taking institution, have brought to the fore the need to improve supervision and bank resolution frameworks at both the national and regional levels.

Key Policy Issues

Economic Growth

Central America's biggest challenge is how to reduce still widespread poverty and narrow the income gap with more developed countries. Despite Central America's improved record of macroeconomic stability and recent recovery in economic activity, average growth rates over the past decade have fallen short of the records achieved in the 1960s and 1970s. Furthermore, the region scores less favorably when compared against the growth performance of the more dynamic emerging market economies in the world, especially emerging Asia. Given that poverty levels remain extremely high (except in Costa Rica) and are well above the Latin American average, addressing issues of economic growth will be paramount to lift people out of poverty and significantly raise living standards. Only three countries (Costa Rica, Panama, and the Dominican Republic) have succeeded in raising GDP-per-capita levels above their levels in the late 1970s. A growth accounting exercise at the regional and country level reveals that, from 1960–2005, increases in output per worker almost exclusively reflected capital deepening as opposed to productivity growth, and that variations in growth within subperiods and across countries were closely associated with differences in productivity growth.

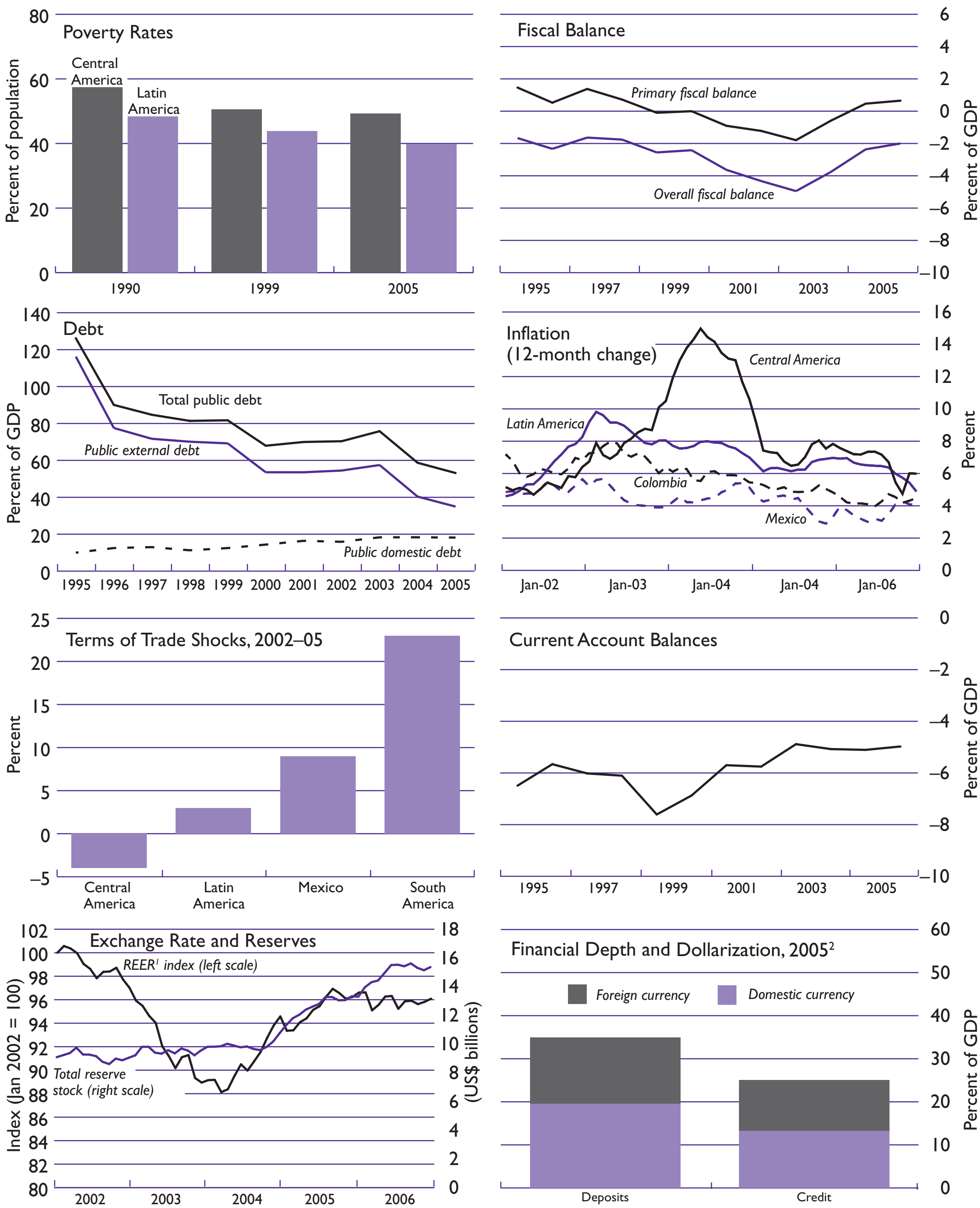
Improving growth performance in Central America will depend to a large degree on the countries' abilities to implement productivity-enhancing reforms. Both the recent growth literature and the empirical evidence for Central America presented in Chapter II suggest that the region would benefit substantially by improving the quality of institutions, including those related to business activity and governance. Bringing institutional quality up to Chile's level, for example, could raise growth by 0.5 percentage points per year in countries with relatively strong institutions (Costa Rica) and by 3 percentage points or more per year in countries with relatively weak institutions (Honduras and Nicaragua). A concerted effort to improve institutions and the business environment in Central America is also paramount to ensuring that implementation of the Central America-Dominican Republic Free Trade Agreement with the United States (CAFTA-DR) and potential trade agreements with the European Union will lead to the expected productivity improvements and tangible benefits for all.

Fiscal Issues: Pension Reform and Sovereign Debt Structures

Creating sustainable debt dynamics is another key policy challenge for countries in the region. As shown in Chapter III, a key element in a strategy to reduce fiscal vulnerabilities is putting Central America's pension systems on a sound footing. Although Central America has more favorable demographics than countries with low or even declining birth rates, its population will age substantially in the coming decades. The ratio of the working age population to the elderly will fall from about eight today to less than three in 2050. In addition, by international standards, the countries in the region have very generous benefits relative to contributions and low retirement ages, even when taking into account differences in life expectancy. As a result, the real internal rate of return of the defined-benefit systems in the region is about 10 percent on average, that is, more than twice the growth rate of the real wage bill or the average growth performance over the past decades.

While some countries have started to introduce pension reforms, more needs to be done. Pension reform is warranted both in countries with pay-as-you-go, defined-benefit systems and those that have shifted to defined-contribution systems through privatization. Although there is no one-size-fits-all solution, sustainability requires some combination of increased contribution rates, higher retirement ages, and lower

Figure 1.1. Central America: Selected Macroeconomic Indicators



Sources: IMF, *World Economic Outlook*; IMF, *International Financial Statistics*; IMF, Information Notification System; and Economic Commission for Latin America and the Caribbean.

[1]REER = Real effective exchange rate.

[2]Excludes Panama.

benefits in most countries. Also, the link between contributions and benefits should be strengthened. Countries that have privatized their pension system still need to make additional parametric reforms to their old defined-benefit system to reduce transition costs. Success in implementing pension reforms in Central America will depend not only on the design of the reforms themselves, but also on the authorities' ability to mobilize the necessary political support. As experience both in the region and in other countries has shown, successful pension reform requires broad-based consensus in society.

Another key element in reducing vulnerability is moving toward "safer" debt structures. Sustainable debt dynamics are a function not only of the level of debt, but also of its structure. Currency denomination, maturity composition, capital structure, and solvency play an important role in the likelihood of a crisis. The public sector balance sheets often exhibit significant mismatches along those dimensions. The analysis in Chapter IV of Central America's sovereign debt structures reveals that the region not only has relatively high public debt levels (except Guatemala), but also a higher share of foreign currency debt in total debt (except Costa Rica) than the rest of Latin America. At the same time, Central America compares favorably to other Latin American countries in terms of its share of short-term debt, with the exception of Costa Rica and the Dominican Republic. In line with broader developments in emerging markets, Central America more recently has been able to reduce its foreign currency exposure and modestly lengthen its maturity structure.

While Central America's debt structure is endogenous to past policies and institutions, economic policies can help further improve structures and therefore reduce vulnerabilities. As the empirical evidence in Chapter IV shows, stronger institutions, for example, go hand-in-hand with the ability of Central American countries to issue debt domestically. The chapter also reveals that the more financially developed a country, the lower the share of foreign currency and short-term debt. Strengthening institutions will therefore be important to reducing vulnerabilities.

Financial Sector Issue: Development of Public Debt Markets

Central America's financial system is largely bank-based. With the exception of Panama, which has a bank-asset-to-GDP ratio of 250 percent, there is substantial scope for further development in the region.[5] Guatemala and the Dominican Republic, in particular, have relatively low levels of financial sector penetration, with bank-asset-to-GDP ratios of around 35 and 40 percent, respectively. Capital markets in turn are underdeveloped and dominated by public debt markets. The number of equity and corporate bond listings are generally in the single digits (except in Panama). Institutional investors (pension funds, mutual funds, and insurance companies) intermediate only a small share of national savings.

The development of capital markets would not only be important to reduce vulnerabilities stemming from limited diversification and improve access to financing, but would also allow the authorities to conduct monetary policy more effectively. Chapter V shows that there is substantial scope for institutional and operational improvements. To aid the establishment of liquid public debt markets and a unified sovereign yield curve, the quasi-fiscal debts of central banks need to be transferred to the government, thus dealing directly with the problem of dual sovereign debt issuers.[6] Central America has a large stock of nonstandard and nontradable debt that should be restructured. In most countries, it will also be important to develop and implement a medium-term debt management strategy and improve the technical capacity of debt management units. In that respect, Costa Rica, El Salvador, and Panama have made some improvements over the past few years.

A regional public debt market may help overcome the size and scale limitations of the individual Central American countries. This can, however, only be accomplished in the medium to long term, after improvements in local markets provide the foundation on which such an integrated regional market could be built. The Central American Monetary Council, in collaboration with the Central American Committee of Finance Ministers, is working to harmonize the technical standards of public debt issuance.

Monetary Policy Issues

Bringing inflation down to the level of trading partners generally remains a challenge for the region. The conduct of monetary policy in the non-dollarized economies in Central America is further tested by regional integration with the United States, record levels of remittance flows, and in some cases increasing integration into global capital markets. Given theses challenges for monetary policy, some countries (for example, Costa Rica and Guatemala) are reviewing their policy regimes to make them more effective.

Chapter VI shows that all the countries in the region have made substantial progress in strengthen-

[5]For a discussion of financial sector issues, see Morales and Schipke (2005) and Brenner (2006).

[6]These quasi-fiscal debt stocks are substantial: 11 percent of GDP in Costa Rica and 18 percent in the Dominican Republic.

ing the institutional underpinnings for formulating and executing monetary policy. New central bank legislation has given the monetary authorities enhanced autonomy. As a result, the mandate of central banks is more clearly focused on preserving price stability, even though some attention is still given to the competitiveness of the tradable sector. Central banks have also benefited from increased de jure political autonomy.

Despite these advances, substantial shortcomings remain. Trying to maintain price stability while, at the same time, preserving the external value of the domestic currency raises concerns about objectives, causes policy conflicts (for example, in the case of strong capital inflows), and undermines the credibility of central banks. Also, while direct political intervention and the financing of fiscal deficits has been curtailed, there is still, in practice, a potentially strong link between the political business cycle and monetary policy decisions. Indeed, since the executive branch continues to have substantial leeway to remove central bank governors and other members of central bank boards of directors. Furthermore, central banks still generally lack financial autonomy, as there are often no legal provisions to protect the integrity of central bank capital.

Integration and Policy Coordination

Trade Liberalization and Bilateral Trade Agreements

The region continues to move toward greater trade liberalization and is negotiating additional regional and bilateral trade agreements. Of course, these should be intermediate steps toward greater multilateral opening and the completion of the Doha trade round, which are still the most important vehicles for promoting strong global growth and sustained poverty reduction. In 2006, CAFTA-DR became effective in El Salvador, Guatemala, Honduras, and Nicaragua. The Dominican Republic followed in 2007. Ratification in Costa Rica is pending; the new government of Oscar Arias in Costa Rica, however, has made ratification of the agreement a priority. Panama, which was not part of CAFTA-DR, has concluded, on a technical level, negotiations on a separate agreement with the United States (Table 1.2.). In addition, Central America is set to begin negotiations for an Association Agreement with the European Union in early 2007, which would create a free trade area between the two regions.

Increased Regional Coordination

With the private sector and financial institutions increasingly operating regionally, the challenge will be to maximize the benefits that integration will bring and to reduce integration-related vulnerabilities. This implies that government policies, regulation, and supervision follow suit. In particular, more needs to be done to standardize norms and regulations (e.g., customs), improve the flow of information among government agencies (e.g., financial sector supervisors), and improve policy coordination in certain areas (e.g., tax policies). At the center of this coordination effort is the Central American System of Integration, which brings together heads of state as well as regional councils and committees of ministers, central bank presidents, and superintendents.

Association Agreement Negotiations with the European Union

The framework of negotiations for an Association Agreement between Central America (including Panama) and the European Union could further accelerate policy coordination and integration among the Central American economies. Based on the Declaration of Vienna (May 2006), the respective countries committed themselves to implementing the decisions adopted at the presidential summit in Panama, ratifying the Central American Treaty on Investments and Services, and developing a legal framework to ensure that commercial and economic regulation is applied uniformly within the region. Furthermore, the format of negotiations with the European Union, employing a single regional spokesperson,[7] would go substantially beyond the setup of CAFTA-DR negotiations, where country-specific schedules and exemptions were negotiated bilaterally.

Tax Coordination

Implementation of CAFTA-DR and the establishment of the planned customs union will provide additional benefits to the region. At the same time, increased economic integration will be associated, at least in the short-term, with custom revenue losses. It could also lead to further tax competition at a time when the countries in the region need to raise tax revenue to address social needs, fight poverty, and reduce vulnerabilities by bringing down relatively high debt-to-GDP ratios.

Initial steps have been taken over the past year to overcome these risks. In addition to efforts aimed at improving tax administration and raising taxes in some countries (notably in Guatemala, Costa Rica, Nicaragua, and the Dominican Republic), the ministers of

[7]It is expected that while each country will have its own negotiation team, discussions with the European Union will be headed by a single spokesperson, with that position being held on a rotating basis by a representative of each of the Central American countries.

Table 1.2. Central America: Regional and Bilateral Free Trade Agreements

Country	Agreement and Date
Guatemala	Regional, CAFTA-DR (2006)[1] Regional, Central America–Dominican Republic (1999) Taiwan, Province of China (2006) Regional, Northern Triangle, Mexico (2001)[2] Regional, Central America–Chile (negotiating) Regional, Central America–Panama (negotiating)
El Salvador	Regional, CAFTA-DR (2006)[1] Regional, Central America–Dominican Republic (1999) Regional, Northern Triangle, Mexico (2001)[2] Regional, Central America–Chile (negotiating) Regional, Central America–Panama (negotiating)
Honduras	Regional, CAFTA-DR (2006)[1] Regional, Central America–Dominican Republic (1999) Regional, Northern Triangle, Mexico (2001)[2] Regional, Central America–Chile (negotiating) Regional, Central America–Panama (negotiating) Colombia and Taiwan (negotiating)
Nicaragua	Regional, CAFTA-DR (2006)[1] Regional, Central America–Dominican Republic (1999) Mexico (1998) Regional, Central America–Chile (negotiating) Regional, Central America–Panama (negotiating)
Costa Rica	Regional, CAFTA-DR (2006),[1] not ratified Regional, Central America–Dominican Republic (1999) Canada (2002) Mexico (1995) Caribbean Community (2004)[3] Regional, Central America–Chile (negotiating) Regional, Central America–Panama (negotiating)
Dominican Republic	Regional, CAFTA-DR (2007)[1] Regional, Central America–Dominican Republic (1999)

Source: http://www.sieca.org.gt.
[1]Free trade agreement between Central America, the Dominican Republic, and the United States.
[2]Free trade agreement between Mexico, Guatemala, and Honduras.
[3]Free trade agreement with the Caribbean Community.

finance of the region have identified a number of areas to achieve greater coordination of their tax policies. Key measures in that respect are: (1) increasing transparency by compiling a matrix of current tax incentives in the respective countries and making the information available to the seven countries; (2) reducing the risk of a "race to the bottom" and further proliferation of tax incentives by seeking an agreement on a code of conduct on good practices for fiscal incentives for investments; (3) protecting the corporate tax base by defining clear rules on transfer pricing and thin capitalization; (4) increasing cooperation between tax and customs administrations through a systematic exchange of information, which will be even more necessary given the stated goal of creating a customs union; and (5) improving international taxation by establishing treaties to avoid the double taxation of income and capital.

Furthermore, institutionally, countries in the region strengthened their coordination efforts through the establishment of a regional Committee of Finance Ministers and a supporting technical secretariat. Creation of this committee closes an important gap in the regional institutional structure, which already has regional coordination mechanisms such as the Central American Monetary Council and the Council of Ministers of Economy and Trade.

Coordination of Financial Sector Regulation and Supervision

The regionalization of financial services is accelerating, with more and more banks establishing offices and subsidiaries in different countries. While Central America's financial sector integration allows for a reduction in funding costs and risk diversification for companies and households alike, it requires the adoption of appropriate regulation and supervision arrangements to minimize regulatory gaps, arbitrage, and cross-border contagion. Given these challenges, the Central American Council of Financial Sector Superintendents is strengthening its efforts to improve the coordination of financial sector regulation and supervision. It has initiated a regional project that aims to (1) strengthen understanding of the current operations of regional financial groups and the regulatory system governing their activities; (2) devise an adequate regulatory framework for cross-border consolidated supervision by improving the flow of information and enhancing collaboration between the supervisory authorities of the region; (3) adopt minimum regulatory standards and harmonize them at a regional level; and (4) create mechanisms to monitor progress.

In 2006, Panama, Costa Rica, and El Salvador signed an agreement to establish a regional exchange for equity and corporate bonds with the objective of creating a regional capital market. Superintendents of security exchanges also initiated efforts to increase coordination. At their first regional meeting in the Dominican Republic in 2006, the security superintendents started the process of creating a Central American Council of Security Regulators.

Harmonization of Macroeconomic Statistics

Deepening economic integration and increasing policy coordination require reliable and comparable data across countries. While Central America has made significant progress in improving data quality and provision, the quality of data remains heterogeneous and the region lacks a coordinated, consolidated, and harmonized statistical system.

As a first step, the authorities in the region have embarked on a project to improve and harmonize monetary and finance statistics, which at a later stage could be followed by the harmonization of fiscal statistics. The aim is to facilitate cross-country comparison and regional analysis and provide reliable and comprehensive data to the private sector and policymakers. The project will (1) improve existing monetary and financial statistics compilation systems; (2) expand coverage by gathering data from all the major financial institutions in the region, including offshore banks and other financial intermediaries such as pension funds, insurance companies, and investment funds; and (3) define common classification and valuation criteria for financial instruments and economic sectors. The project is expected to be completed in 2008.

Moving Forward

Reflecting both sound economic policies and a benign global environment, Central America has experienced an improved economic performance over the past few years. It is in a good position to build on progress that has been made. Its political and economic institutions are maturing and there is a broad-based consensus on maintaining macroeconomic stability, taking advantage of the benefits that globalization brings, and strengthening regional cooperation. In this context, the challenge is how to reduce poverty, improve the living standards of all citizens, and increase the region's resilience against adverse shocks. The following chapters address these issues in more depth.

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