

# Contents

|                                                                                                   |            |
|---------------------------------------------------------------------------------------------------|------------|
| <b>Foreword</b>                                                                                   | <b>vii</b> |
| <b>Preface</b>                                                                                    | <b>ix</b>  |
| <b>Abbreviations and Acronyms</b>                                                                 | <b>x</b>   |
| <b>I. Introduction and Overview</b>                                                               | <b>I</b>   |
| <i>Markus Rodlauer and Alfred Schipke</i>                                                         |            |
| Background                                                                                        | 1          |
| Recent Developments                                                                               | 2          |
| Overview                                                                                          | 5          |
| <b>II. Macroeconomic Implications of CAFTA-DR</b>                                                 | <b>7</b>   |
| <i>M. Ayhan Kose, Alessandro Rebucci, and Alfred Schipke</i>                                      |            |
| Implications for Trade and Investment Flows                                                       | 9          |
| Implications for Economic Growth and Welfare                                                      | 17         |
| Could CAFTA-DR Help Reduce Poverty in the Region?                                                 | 22         |
| CAFTA-DR's Potential Impact on Macroeconomic Volatility and the<br>Co-Movement of Business Cycles | 24         |
| Conclusions                                                                                       | 31         |
| Appendix I. The Model                                                                             | 33         |
| Appendix II. Volatility and Co-Movement of Macroeconomic Variables                                | 35         |
| References                                                                                        | 37         |
| <b>III. Trade Liberalization and Tax Coordination</b>                                             | <b>41</b>  |
| <i>Chiara Bronchi and Dale Chua</i>                                                               |            |
| Structure and Trend of Tax Revenues in Central America                                            | 41         |
| Estimating the Loss of Tax Revenue from CAFTA-DR                                                  | 46         |
| Dealing with the Revenue Impact of CAFTA-DR                                                       | 50         |
| CAFTA-DR and Issues of Tax Coordination                                                           | 53         |
| Conclusions                                                                                       | 56         |
| Appendix. Data and Methodology for the Calculation of Revenue<br>Losses                           | 57         |
| References                                                                                        | 58         |
| <b>IV. Fiscal Sustainability: A Value-at-Risk Approach</b>                                        | <b>59</b>  |
| <i>Ricardo Adrogué</i>                                                                            |            |
| Analytical Issues and the Traditional Sustainability Approach                                     | 59         |
| Modeling the Debt-to-GDP Ratio Using VaR                                                          | 62         |
| Assessment of Policy Options                                                                      | 66         |
| Conclusions                                                                                       | 66         |
| Appendix. Value-at-Risk Methodology                                                               | 67         |
| References                                                                                        | 68         |

|              |                                                                                                                   |            |
|--------------|-------------------------------------------------------------------------------------------------------------------|------------|
| <b>V.</b>    | <b>Regional Integration and Exchange Rate Arrangements</b>                                                        | <b>69</b>  |
|              | <i>Jun Il Kim and Laura Papi</i>                                                                                  |            |
|              | Issues Concerning Exchange Rate Regimes in Developing Countries                                                   | 69         |
|              | Current Exchange Rate Arrangements                                                                                | 71         |
|              | Long-Run Options for Exchange Rate Regimes in Central America                                                     | 72         |
|              | Choosing Among the Long-Run Options: Key Factors                                                                  | 74         |
|              | Choosing Among the Long-Run Options: An Index Approach                                                            | 81         |
|              | Conclusions                                                                                                       | 85         |
|              | Appendix. Technical Appendix                                                                                      | 87         |
|              | References                                                                                                        | 97         |
| <b>VI.</b>   | <b>Regional Integration and Financial System Issues</b>                                                           | <b>99</b>  |
|              | <i>R. Armando Morales and Alfred Schipke</i>                                                                      |            |
|              | Financial Sector Development and Structure                                                                        | 99         |
|              | Challenges for Financial Regulation and Monitoring                                                                | 104        |
|              | Recent Progress and Looking Forward                                                                               | 110        |
|              | Conclusions                                                                                                       | 111        |
| <b>VII.</b>  | <b>Regional Issues in Macroeconomic Statistics</b>                                                                | <b>112</b> |
|              | <i>Lorraine Ocampos</i>                                                                                           |            |
|              | Data Suitability for Analytical Purposes                                                                          | 113        |
|              | Moving Toward a Harmonized Statistical Framework                                                                  | 115        |
|              | Technical Assistance to the Region                                                                                | 115        |
|              | Conclusions                                                                                                       | 116        |
|              | Appendix. Statistical Issues, Suitability of Data for Analytical<br>Purposes, and Technical Assistance Missions   | 116        |
| <b>VIII.</b> | <b>The Political Economy of Implementing Pro-Growth and<br/>Anti-Poverty Policy Strategies in Central America</b> | <b>125</b> |
|              | <i>Luis Breuer and Arturo Cruz</i>                                                                                |            |
|              | Setting                                                                                                           | 125        |
|              | Political Support for Pro-Growth and Anti-Poverty Strategies                                                      | 127        |
|              | Generating Consensus on a Long-Term Reform Strategy                                                               | 131        |
|              | Implications for the IMF                                                                                          | 132        |
|              | References                                                                                                        | 133        |
|              | <b>Boxes</b>                                                                                                      |            |
|              | 1.1. Regional Economic Institutions                                                                               | 4          |
|              | 3.1. Revenue Effects of Growth Enhancement from CAFTA-DR                                                          | 50         |
|              | 3.2. Current Status of Customs Administration in Central America                                                  | 56         |
|              | 5.1. History of Exchange Rate Regimes in Central America                                                          | 72         |
|              | 5.2. Regression Results                                                                                           | 82         |
|              | 5.3. Projections for Indices of Central American Countries                                                        | 85         |
|              | 6.1. Institutions Conducting Cross-Border Financial Transactions in<br>Central America                            | 103        |
|              | 6.2. Panama's Financial System and Regional Offshore Center                                                       | 107        |
|              | 6.3. Dominican Republic: Banking Crisis and Financial Reform                                                      | 108        |
|              | 7.1. Main Data Issues in Central America                                                                          | 113        |
|              | 7.2. Dominican Republic: Data Issues                                                                              | 114        |
|              | 8.1. Institutional Aspects of Strategies to Boost Growth and<br>Reduce Poverty                                    | 129        |
|              | 8.2. Consolidated Supervision of the Financial Sector                                                             | 130        |

## Tables

|                                                                                                          |     |
|----------------------------------------------------------------------------------------------------------|-----|
| 2.1. Tariffs in Central America, 1980–99                                                                 | 8   |
| 2.2. Selected Economic Indicators: Central America and Mexico, 2004                                      | 10  |
| 2.3. Growth of Exports and Imports                                                                       | 13  |
| 2.4. Top Eight U.S. Merchandise Imports from Central America, 2003                                       | 14  |
| 2.5. Top Eight U.S. Merchandise Exports to Central America, 2003                                         | 15  |
| 2.6. Diversification of Exports                                                                          | 15  |
| 2.7. Gross Foreign Direct Investment Flows                                                               | 16  |
| 2.8. Foreign Direct Investment Inflows from the United States                                            | 17  |
| 2.9. Dynamics of Economic Growth                                                                         | 20  |
| 2.10. Contributions to GDP Growth                                                                        | 20  |
| 2.11. Potential Welfare Gains from International Risk Sharing                                            | 25  |
| 2.12. Forecast Variance Decomposition of GDP Growth                                                      | 26  |
| 2.13. Forecast Variance Decomposition of GDP Growth (Regional Shocks)                                    | 28  |
| 2.A1. Volatility of Macroeconomic Aggregates                                                             | 35  |
| 2.A2. Co-Movement of Macroeconomic Aggregates with U.S. Aggregates                                       | 36  |
| 3.1. Consolidated Central Government: Tax Structure for Selected<br>Central American Countries, 2000–03  | 44  |
| 3.2. Central America: Average Collected Import Duty Rates                                                | 45  |
| 3.3. Customs Revenue on Imports from the United States, 2003                                             | 46  |
| 3.4. Schedule A Imports, 2003                                                                            | 48  |
| 3.5. Revenue Impact of CAFTA-DR, First Year                                                              | 48  |
| 3.6. Honduras and Nicaragua: Revenue Impact of CAFTA-DR, First Year                                      | 49  |
| 3.7. Summary Table: Revenue Loss of CAFTA-DR                                                             | 49  |
| 3.8. VAT Productivities                                                                                  | 52  |
| 3.9. Excise Tax Summary                                                                                  | 55  |
| 4.1. Results from Traditional Debt Sustainability Analysis                                               | 61  |
| 4.2. Main Vulnerability Measures                                                                         | 64  |
| 4.3. Projected Change in Primary Balance                                                                 | 65  |
| 4.4. Relative Contribution by Risk Factor                                                                | 66  |
| 4.5. Effect of Increased Reliance on Domestic Currency Debt                                              | 67  |
| 5.1. Exchange Rate Regimes                                                                               | 71  |
| 5.2. Exchange Rate Regimes, Natural Classification                                                       | 73  |
| 5.3. Trade Structure and Openness                                                                        | 76  |
| 5.4. Consolidated Claims of BIS Reporting Banks on Central<br>American Countries                         | 77  |
| 5.A1. Co-Movements in Output                                                                             | 88  |
| 5.A2. Source of Output Co-Movements                                                                      | 89  |
| 5.A3. Terms of Trade                                                                                     | 89  |
| 5.A4. Co-Movements in the Terms of Trade                                                                 | 90  |
| 5.A5. Correlations of Terms of Trade                                                                     | 91  |
| 5.A6. Inflation Performance                                                                              | 92  |
| 5.A7. Co-Movements in Prices                                                                             | 93  |
| 5.A8. Optimum Currency Area Index: Regression Results                                                    | 94  |
| 5.A9. Optimum Currency Area Indices for Central America and<br>Europe vis-à-vis Anchor Country           | 95  |
| 5.A10. Central America: Projections for the Optimum Currency Area<br>Indices vis-à-vis the United States | 96  |
| 6.1. Central America: Structure and Performance of the Financial<br>Sector, 1996–2003                    | 102 |
| 6.2. Regional Banks, 2003                                                                                | 104 |
| 6.3. Prudential Requirements                                                                             | 106 |
| 6.4. Financial Sector Assessment Programs                                                                | 108 |
| 7.A1. Statistical Issues                                                                                 | 117 |
| 7.A2. Suitability of Data for Analytical Purposes                                                        | 121 |

|                                                                       |     |
|-----------------------------------------------------------------------|-----|
| 7.A3. Statistics Technical Assistance Missions, 1995–end-January 2005 | 124 |
| 8.1. Comparative Social Indicators                                    | 126 |
| 8.2. Comparative Governance Indicators                                | 128 |

**Figures**

|                                                                                                          |     |
|----------------------------------------------------------------------------------------------------------|-----|
| 1.1. Central America: Real GDP Per Capita Growth                                                         | 2   |
| 1.2. Poverty in Central America                                                                          | 2   |
| 2.1. Trade Openness                                                                                      | 11  |
| 2.2. Trade with the United States                                                                        | 11  |
| 2.3. Exports to the United States                                                                        | 12  |
| 2.4. Imports from the United States                                                                      | 12  |
| 2.5. Growth Rate and Volatility of Macroeconomic Aggregates in Mexico and Central America                | 18  |
| 2.6. Impulse Responses of GDP                                                                            | 27  |
| 2.7. Co-Movement of Economic Variables in Mexico and the United States                                   | 29  |
| 2.8. Co-Movement of Economic Variables in CAFTA-DR Countries and the United States (Average Correlation) | 30  |
| 2.9. Impulse Responses                                                                                   | 32  |
| 2.A1. Production Structure of the CAFTA-DR Model                                                         | 36  |
| 3.1. Tax Revenue, 1990–2003                                                                              | 42  |
| 3.2. Central America: Composition of Tax Revenue, 1990–2003                                              | 43  |
| 3.3. Composition of Tax Revenue, 1990–2003                                                               | 45  |
| 3.4. Estimated Minimum VAT Rate to Compensate for Tariff Loss, 2003                                      | 52  |
| 4.1. Distribution of the Public Ratio of Debt to GDP in 2008                                             | 64  |
| 5.1. Nominal Exchange Rate Variability, 1984–2003                                                        | 80  |
| 5.2. Optimum Currency Area Indices, 1984–2003                                                            | 83  |
| 5.3. Comparison of OCA Indices vis-à-vis the United States, 1994–2003                                    | 84  |
| 5.4. Central America and Europe: Optimum Currency Area Indices                                           | 86  |
| 6.1. Central America: Public Debt, 1990–2003                                                             | 100 |
| 6.2. Central America: Financial Sector Development                                                       | 100 |
| 6.3. Banking Sector Dollarization, 2003                                                                  | 101 |
| 6.4. Organizational Structure of Cuscatlán                                                               | 105 |

The following symbols have been used throughout this paper:

- . . . to indicate that data are not available;
- to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;
- between years or months (e.g., 2003–04 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
- / between years (e.g., 2003/04) to indicate a fiscal (financial) year.

“n.a.” means not applicable.

“Billion” means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term “country,” as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.