Central America's Macroeconomic Environment and the Role of the Investment Climate under Free Trade

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Local Gains from Global Opportunities: Improving Central America's Investment Climate

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Chapter 1. CENTRAL AMERICA'S MACROECONOMIC ENVIRONMENT AND THE ROLE OF THE INVESTMENT CLIMATE UNDER FREE TRADE[1]

INTRODUCTION

1.1 Central America's economic performance in recent years has benefited from improved macroeconomic management, a favorable external environment, as well as rising investor confidence since the region has pursued greater access to global markets, particularly with the signing DR- CAFTA in 2004. Nonetheless, while important reforms have been made, much remains to be done, and the context of a less favorable global environment underlines the urgent need to improve competitiveness and enhance productivity. An improving investment climate would contribute to both.

1.2 This chapter discusses the broad economic factors that shape the investment climate in Central America. Section 1 describes the overall strategic context, highlighted by the opportunities and challenges emerging from the new trade deal. Section 2 discusses the region's macroeconomic environment—economic growth, sectoral changes, the business cycles with the US, and overall stability. Section 3 covers trade, financial and remittances flows, which are particularly important to the region. Section 4 summarizes and takes a look ahead.

1. STRATEGIC CONTEXT

1.3 In recent years, the Central American countries—individually or as a region—have negotiated, or are in the process of negotiating, free trade agreements with the United States, the European Union, Chile, Taiwan, as well as other countries. Dominating this agenda has been the free trade agreement signed with its largest trading partner, the United States. DR-CAFTA has been in the forefront because it has constituted a significant turning point for the region and its integration with the global economy. A comprehensive agreement, DR-CAFTA solidifies the framework of trade relations between the US and Central America and within Central America itself. It provides a context for regional integration and greater access to the Central America's largest export market and has shown promise in increasing the region's foreign direct investment (FDI) inflows. DR-CAFTA has been approved and implemented in El Salvador, Guatemala, Honduras and Nicaragua. Costa Rica has passed the accord and anticipates legislative approval of several laws necessary for implementation in 2008. Panama, which was not part of DR-CAFTA, is seeking its own bilateral FTA with the US.

1.4 Free trade implies significant advantages for economic performance. Growth will likely speed up for participating countries in the medium to long run, mainly because of expected gains from greater trade and domestic and foreign direct investment.[2] How much growth freer trade delivers will largely depend on Central America's ability to pursue complementary policies, particularly those expanding economic opportunities.

[1] This chapter was prepared by David Gould and Josef Loening. The authors thank María Ivanova Reyes for research assistance and comments.
[2] Gould and Gruben (2005).

Box 1.1: What does DR-CAFTA do and has there been an impact

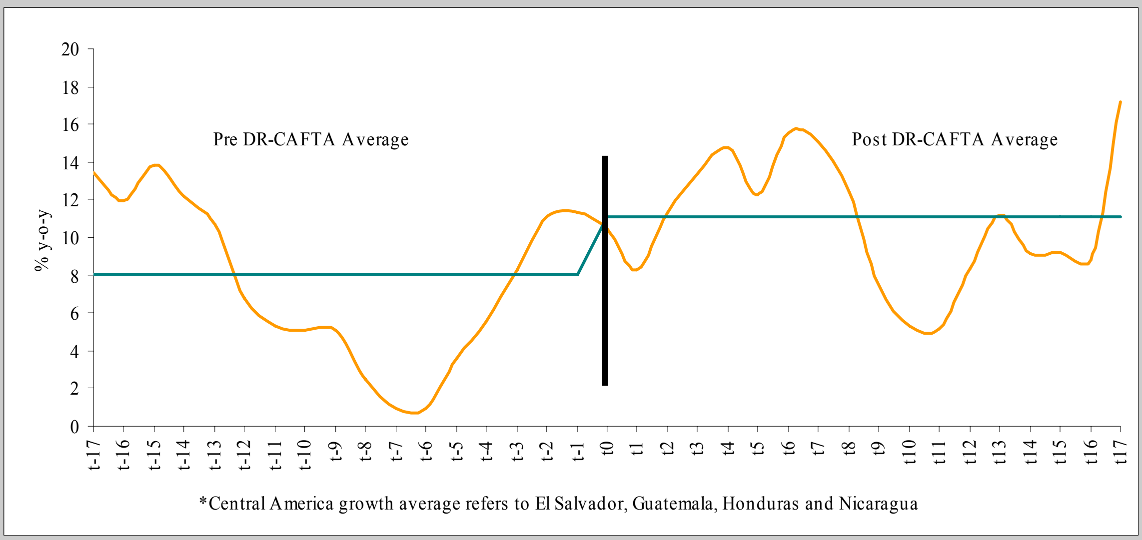
The Dominican Republic–Central America Free Trade Agreement (DR-CAFTA) reduces barriers to imports, exports and financial flows, giving the region the same kind of benefits the US, Canada, and Mexico enjoy under the North American Free Trade Agreement (NAFTA).

After the US Senate approved the DR-CAFTA in 2005, El Salvador became the first country to approve and implement the agreement on March 2006. Honduras and Nicaragua implemented it a month later, followed by Guatemala in July. The Dominican Republic came on board in March 2007, while Costa Rica is awaiting passage of several laws necessary for implementation after approving the agreement in a national referendum in October 2007.

Under DR-CAFTA, tariffs on about 80 percent of US exports to the participating countries will be eliminated immediately, and the rest will be phased out over the next decade. US trade barriers also fall, but because the vast majority of goods produced in the participating countries already entered the US duty-free under the Caribbean Basin Initiative (CBI) of 1983, US barriers had less to decline. The CBI is a unilateral trade preference granted by the US and, as such, its continuation was subject to periodic review and approval by the U.S. Congress. The DR-CAFTA solidifies trade liberalization efforts and should help facilitate long-term investments in the region.

DR-CAFTA should not be regarded as a dramatic shift in trade policy, but rather as a step in a gradual process of trade liberalization that began in the region over a decade ago. The agreement addresses the following areas: Cross-border trade in services, financial services, investment, government procurement, market access, agriculture, intellectual property rights, antidumping, and dispute resolution. It also includes environmental protections, labor standards, and transparency rules.

Figure 1.1: Trade between the US and Central America before and after DR-CAFTA implementation (three-month moving average)



Note: Central America growth average refers to El Salvador, Guatemala, Honduras and NicaraguaThe figure shows monthly data that has not been seasonally adjusted. Source: Moller 2008

Because DR-CAFTA became effective in Central America only in the last 1-2 years, statistically significant evidence that it has increased trade flows is not yet available (taking into consideration other factors that would influence trade, such as income growth, exchange rates, and other variables). Nonetheless, as the figure above indicates, average trade growth in the year and a half after implementing DR-CAFTA is higher than it was over the same period before its implementation.

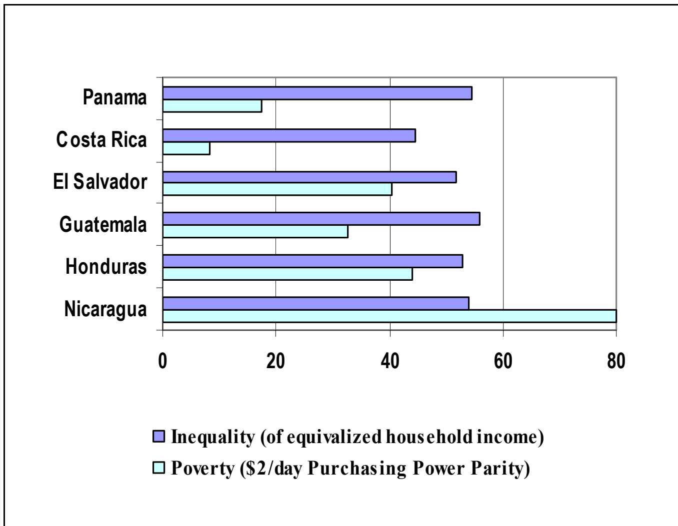
While it may be too early to precisely measure DR-CAFTA's economic impact to date, early signs have been encouraging, although not all of them are necessarily due to the FTA. They include:

- Increased inflows of foreign direct investment;
- Increased investment plans from multinational companies in Central America—for example, Nicaragua ICT-Cone Demin and HBSC acquiring the Banisto Group, which has operations in the entire region;
- Job creation in some sectors, such as in the textile exporting sector;
- Improvement in Country Risk Classification—for example, Standard and Poor's has reclassified Guatemala's country risk from BB- to BB;
- Improvements and harmonization in customs and trade regulations.

1.5 Many of these policies affect the investment climate, which shapes international competitiveness and the ability to diversify into non-traditional exports. A stable macroeconomic environment and sectoral factors are also key factors in domestic growth. Such topics as governance challenges, infrastructure needs, and technological and skill deficiencies will be discussed in later chapters.

1.6 Better economic fundamentals not only improve the business climate but also allow the poor to take better advantage of freer trade's opportunities. About half of Central America's population lives in poverty; some 20 percent endures extreme poverty, and inequality remains high, particularly in the poorest countries (Figure 1.2).[3] In part, poverty and inequality reflect low-wage employment in the informal sector, and it is concentrated in rural areas where access to public services remains limited. A lesson from Mexico's experience with the North American Free Trade Agreement (NAFTA) is that lower commercial barriers, while important, are not a sufficient condition for growth, development, and poverty reduction. The states in Mexico that had better infrastructure and public services prior to NAFTA enjoyed higher growth after NAFTA. This suggests the importance of complementary polices to boost the impact of market openness.

Figure 1.2: Poverty (%) and Inequality (Gini %)



Notes: Poverty: average 1999-2003, except Honduras (1999 only); Inequality: latest available year (1998-2000).

Source: World Bank,Inequality in Latin America & Poverty at a Glance Tables

1.7 Trading opportunities are likely make a significant contribution to growth, but so far the impact has not been sufficient to raise aggregate growth rates, transform economies or significantly reduce poverty rates. Evidence suggests that Central America's competitiveness has remained flat over the past year. Agricultural products still dominate exports, leaving countries vulnerable to terms-of-trade

[3] The numbers reported in Figure 1.2 are based on a poverty line of 1 dollar a day at 2000 purchasing power parity (PPP). Recently, Ravaillion et al. (2008) proposed to use 1.25,dollars a day as the new international poverty line.

shocks that can derail economic growth and fledging attempts toward policy reforms. Regional and national analyses typically reveal that increases in output per worker almost exclusively reflect capital deepening, rather than the productivity increases usually associated with greater efficiency and technological advances (Loayza et al. 2002; Desruelle and Schipke, 2007).

2. REGIONAL MACROECONOMIC ENVIRONMENT

Economic growth returns

1.8 Central American countries have relatively small domestic markets, but together they form a significant regional market. With about 40 million people, the region accounts for about 7 percent of Latin America's population and 5 percent of its total output. Dependence on traditional exports and close economic ties to the US still characterize the region's economies. Central America faces challenges from increased global competition in some key export products, such as agricultural commodities and textiles, while its economies are exposed to common shocks, such as natural disasters and terms-of-trade changes.

Table 1.1: Per capita GDP Growth in Central America, 2000-2007 (in percent)

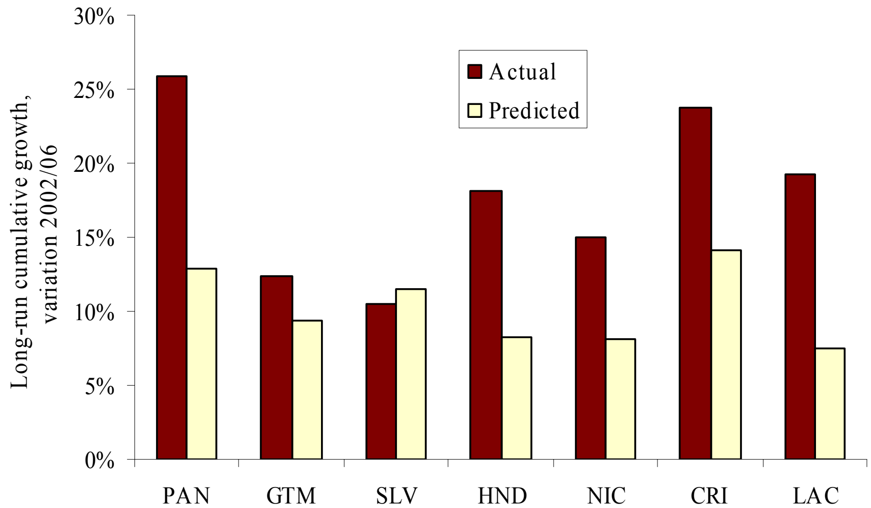
	2000	2001	2002	2003	2004	2005	2006	2007
Costa Rica	-0.5	-1.1	0.8	4.4	2.4	4.1	6.4	5.3
El Salvador	0.4	0.1	0.8	0.8	0.4	1.7	2.7	2.8
Guatemala	1.2	-0.1	-0.2	-0.4	0.1	0.7	1.9	2.2
Honduras	3.6	0.6	0.7	1.5	3.0	2.1	4.0	4.2
Nicaragua	2.5	1.5	-0.6	1.2	4.0	3.0	2.4	2.5
Panama	0.7	-1.3	0.3	2.3	5.6	5.1	6.3	7.8

Note: per capita GDP growth based on per capita GDP in constant dollars of 2000.
Source: 2000-2006 from WDI, 2007 estimated by CEPAL based on WDI data.

1.9 Economic growth accelerated in Central America since 2003 (Table 1.1), benefiting from the global economic expansion and, in particular, the US economy's dynamism, which spurred demand for exports and increased remittances. Driven initially by a pickup in exports and rising commodity prices, the recovery spilled over to domestic demand. Figure 1.3 shows the difference between actual and predicted GDP growth for the six CA countries and the LAC average during 2002 and 2006. The predicted GDP growth is estimated as a function of internal factors, assuming that external factors had remained constant at 2002 levels. In all cases, the actual growth is higher than the predicted growth, revealing that a considerable proportion of recent growth is due to favorable external factors.

1.10 Overall, the region's per capita GDP growth increased to about 3 percent (Figure 1.4, Panel A). Between 2004 and 2007, Panama achieved per capita growth rates of around 6 percent, while Costa Rica 5 percent, and Honduras and Nicaragua 3 percent. El Salvador and Guatemala had growth rates of 1 percent from 2004 to 2006, but both improved to more than 2 percent in 2007.

Figure 1.3: Per capita growth in Central America



Note: Panel Regression: dlog(gdp)=f(dlog(ToT), dlog(Ind.Prod.G7), dlog(US5Y), dlog(HighYield)); 1991-2002.
Predicted: setting external factors to zero.

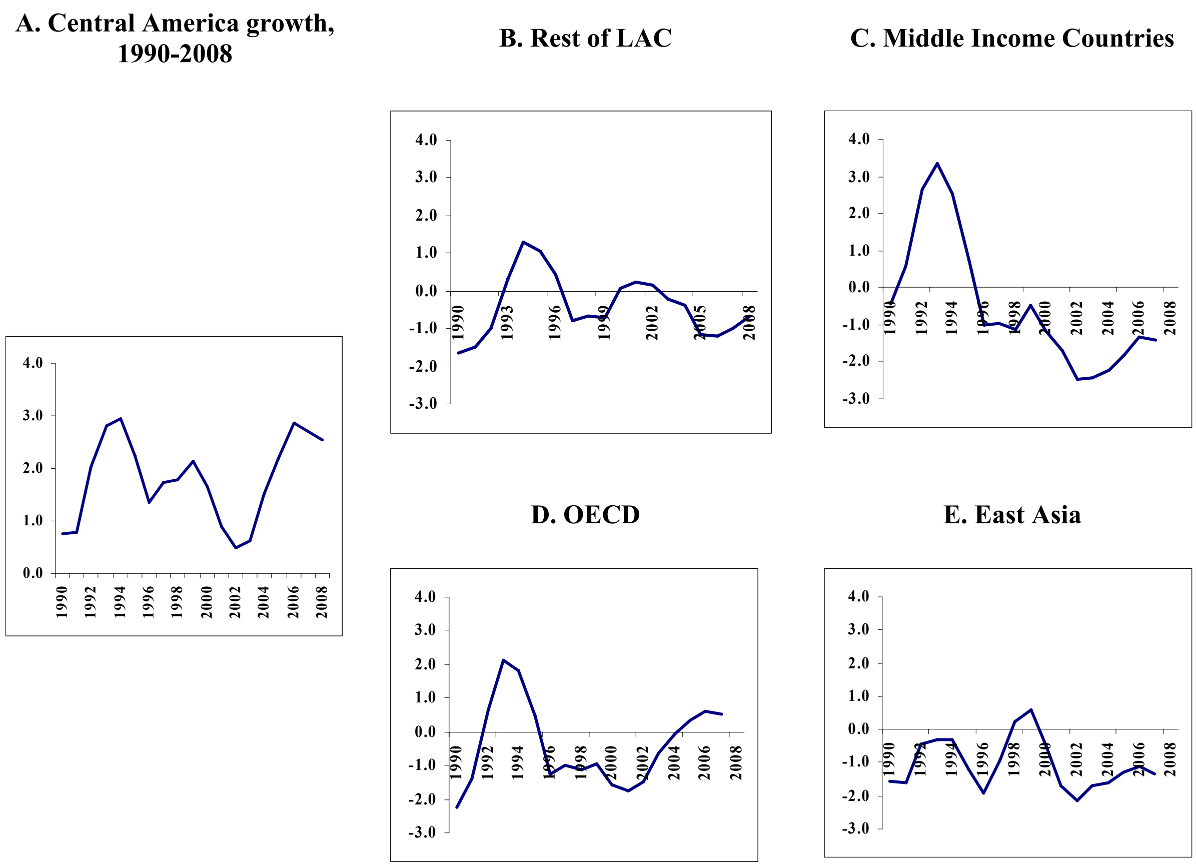
Source: World Bank LCRCE staff calculations

1.11 Nonetheless, Central America still lags behind the rest of Latin America, East Asia, and middle-income countries in growth (Figure 1.4, Panels B-E). The underperformance may be explained by the rise in global raw materials prices, including oil. In addition, Central American light manufacturing exports may have lost some dynamism in the face of competition from China and other Asian countries (SIECA, 2007). Growth also remains volatile, continuing the pattern of previous decades and reflecting the region's vulnerability to external economic shocks (commodity price increases), natural disasters (El Niño, hurricanes, and earthquakes) and domestic policy reversals (pre-election spending). Over the near-term, regional growth remains vulnerable to the expected slowdown in US growth.

1.12 Structural change is important to growth in the region. Advancements in technology and export performance imply shifts from one sector to another. Central America's economy is highly diverse and shows some changes over time, suggesting that technological and/or terms of trade changes have influenced the structures of the economies (Montobbio and Rampa, 2005; Yuki, 2007). The manufacturing industry has grown in all countries except Panama (Figure 1.5). In Guatemala, Honduras, and Nicaragua, economic activity is highest in agricultural sectors, but has declined in most countries with the exception of Nicaragua. Panama derives a large fraction of its GDPs from financial services, with the share increasing slightly over the past decade. The trade, restaurants, and hotels sector has been volatile in all countries. The sector with the strongest growth performance has been transport and communication services.

Figure 1.4: Per capita growth in Central America

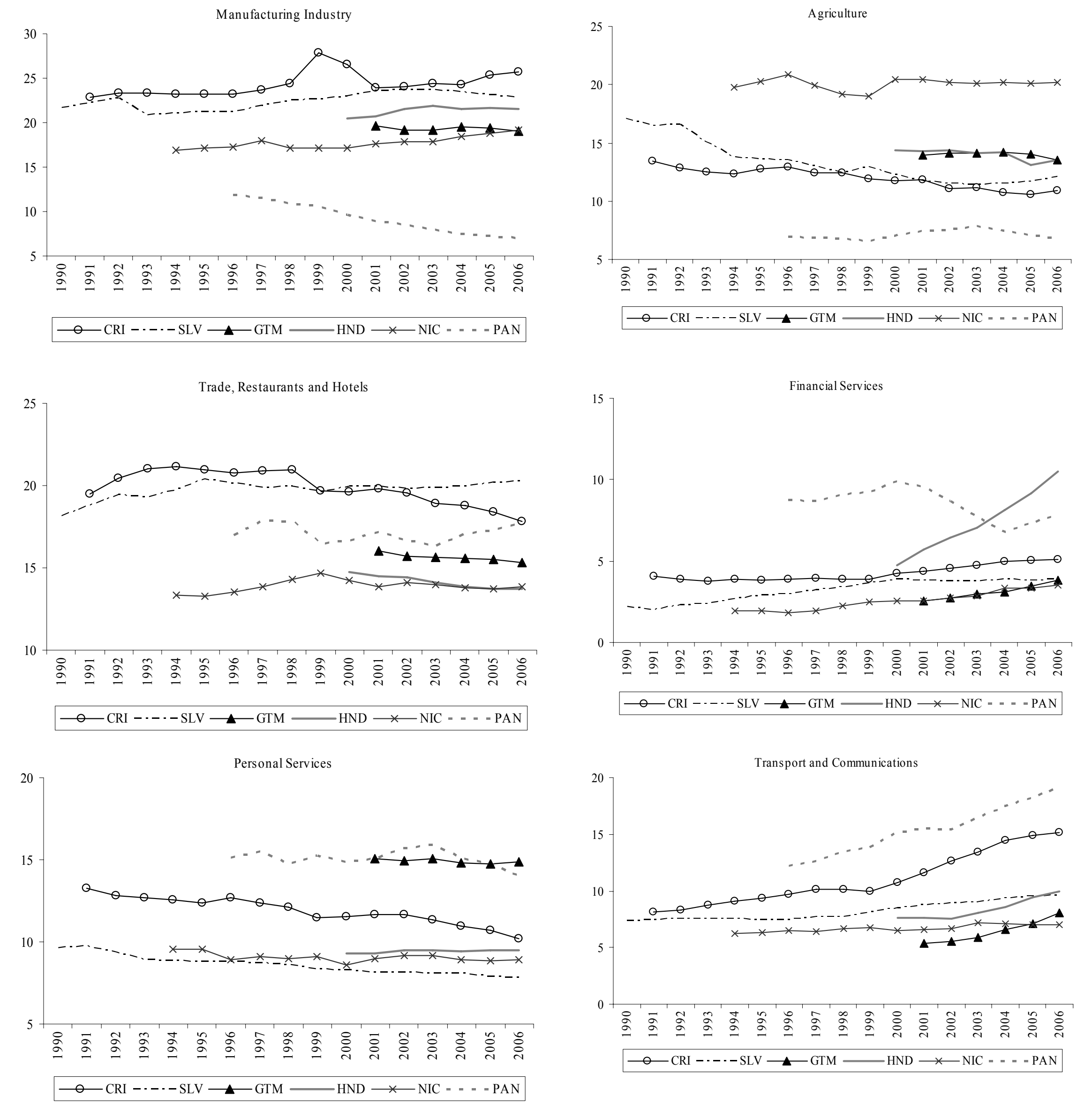
Deviations with respect to selected country groups, 1990-2008



Note: Deviations with respect to selected country groups are computed as Central America's annual median growth rate minus the reference group's annual median growth rate. All series have been smoothed with a backward looking three-year moving average.

Source: Authors' calculations based on data from WDI.

Figure 1.5: Sectoral GDP Shares in Central America, 1990-2006



Source: National authorities

Box 1.2: Country Specific Challenges

Central America faces many common challenges. At the same time, a number of issues characterize each country's domestic business environment and macroeconomic context. Among the most important are:

Costa Rica is a middle-income country of about 4.4 million people with a per capita income of about US$4,900. It boasts one of Latin America's most stable democracies, with uninterrupted elected governments since 1949. Since the mid-l980s, Costa Rica has followed a successful strategy of export-led growth, openness to foreign investment, and gradual trade liberalization. As a result, the structure of exports and the economy itself have been transformed from dependence on agriculture and agro-industry to greater diversity, featuring computer and electronic industries, services, non-traditional agriculture, and eco-tourism. Costa Rica attracts significant FDI, including high-tech investors such as Intel.

El Salvador has been a regional leader in economic reforms. Starting in the early 1990s, successive governments have tackled trade liberalization, tax reform, strengthening of the financial sector, and promotion of private participation in telecoms, energy, and pensions. A decision to dollarize the economy in 2001 has resulted in lower inflation and interest rates and reduced business uncertainty. Despite the country's impressive reforms and prudent macroeconomic policies, growth has been volatile. Instability largely reflects external shocks—earthquakes, terms of trade deterioration, and swings in coffee exports and the large maquila sector. Poverty has declined, but about one-third of the 7.7 million Salvadoreños remain poor. Per capita income is US$2,500.

Guatemala has a record of sound macroeconomic management, with small fiscal deficits. Tax collections are low, which creates a challenge in meeting infrastructure needs. As with the other Central American countries, Guatemala is vulnerable to natural disasters and commodity price shocks. After 35 years of civil war, ending with the 1996 peace accords, Guatemala faces a post-conflict situation with a very large share of the population remaining poor, particular among the indigenous population suffering from social exclusion. With 13.4 million people, Guatemala has the largest population and biggest economy in Central America, a regional share of 33 percent. Per capita income is US$ 2,600.

Honduras, with a population of 7.2 million, is a lower middle-income country, with an open economy and sluggish growth. Honduras transitioned from an authoritarian military regime to a pluralistic democracy. State institutions are considered fragile, and the governance framework is weak. The economy remains highly vulnerable to shocks from natural disasters or commodity price shifts. Recent years have seen a gradual shift away from traditional exports, which have been superseded by the rapid growth in maquila sales. Little progress has been made in reducing poverty in recent years, with volatile growth putting achievements at risk. About half of the population is considered poor. The per capita income is US$1,200.

Nicaragua remains the second poorest country in Latin America after Haiti, with a per capita income of only US$1,000. Although economic gains have reduced poverty, 46 percent of the population still lives below the poverty line. Growth has been modest, averaging around 3 percent per year, even though exports have doubled. Nicaragua remains highly aid dependent. More than 30 percent of its budget comes from official development assistance. The country's 5.4 million people are also vulnerable to natural shocks, evidenced by the devastation of Hurricane Mitch in October 1998. Maintaining fiscal discipline and improving governance remain key policy challenges.

Panama, a country with a population of about 3.5 million, offers an international transport corridor, a modern financial center, a dollarized economy, and a per capita GDP of about US$ 4,900 that ranks among the upper-middle income nations. Despite its small population, Panama produces 15 percent of the region's GDP, making it the second largest economy in Central America. The country has experienced spectacular economic growth in recent years. The government's decisions to expand the Panama Canal over the next six to seven years and an expected bilateral free trade agreement with the US are likely to boost the economy for some time. Even so, Panama is still a country of stark contrasts. Perpetuated by educational disparities, more than one-third of Panama's 3.3 million people were living in poverty in 2003, and 16 percent faced extreme poverty

Source: Country Assistance Strategies; various documents and unofficial reports

Volatility and Business Cycles

1.13 GDP volatility has declined in most Central American economies during the past decade.[4] In particular, significant decreases occurred in El Salvador, Honduras, and Nicaragua (Table 1.2). Trade and financial flows may have helped to reduce volatility by accelerating diversification of the export base (Kose and Rebucci 2005). Another reason for decreasing volatility may have been the US economy's relative stability and increased integration with U.S. markets.

Table 1.2: Volatility of per Capita GDP Growth, 2000-2006 (standard deviations)

	1991-1999	2000-2006
Costa Rica	2.8	2.3
El Salvador	1.9	0.6
Guatemala	0.7	0.6
Honduras	2.7	1.4
Nicaragua	3.0	1.5
Panama	2.6	2.8

Source: WDI

1.14 Shocks originating in the US tend to play a prominent role in the region. Increasing trade, investment, and remittances suggest that the Central America has become more attuned to US economic developments. With an economic slowdown expected in the US, additional domestic policies may be needed to address regional growth, including policies that stimulate the investment climate and diversify business for exporting firms.

1.15 How dependent are Central America's economies on the US? Roache (2008) finds strong GDP growth co-movement between the US and most countries in the region. Distinguishing between the contributions of cyclical and trend GDP growth, Roache finds that the cycle contributes most to GDP changes for the majority of Central American countries. Growth elasticities are generally high, ranging from about 1.07 to 0.41, implying that a 1 percent increase (or decrease) in US growth would increase (or reduce) regional growth by about 1.07 to 0.41 percent, depending on the country. The study does not identify the direct sources of cyclical fluctuations, but the most likely transmission mechanisms are trade, financial flows, and remittances.

1.16 Likewise, Fiess (2007) measures business cycle synchronization for Central America and finds evidence of close relationships between Costa Rica, El Salvador, Guatemala, and Honduras and between these countries as a group and the U.S., suggesting that a significant portion of Central American variability is driven by external factors. The US is by far the region's most important trading partner; the financial linkages via remittances are weak. Overall, Central America has become more sensitive to developments in the US economy.

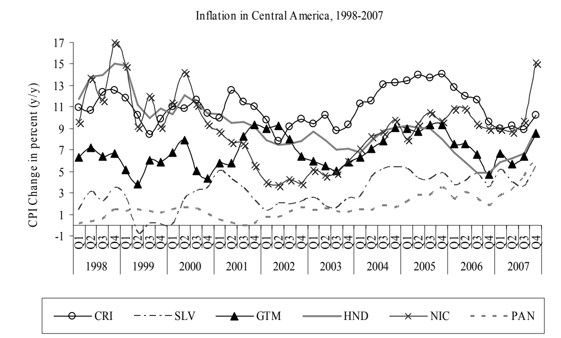
Macroeconomic stability

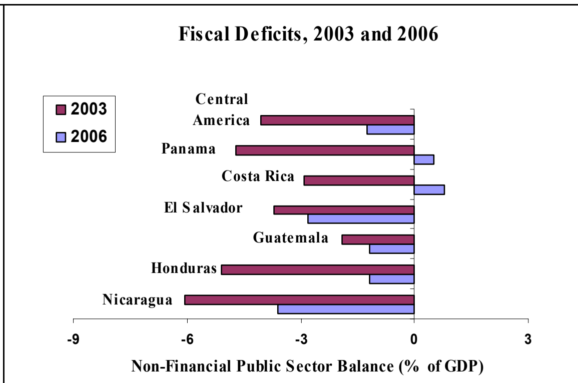
1.17 Central America has made substantial progress in regaining macroeconomic stability. It has also continued to further integrate at both the global and regional levels. Inflation peaked in 2005, but recent increases in oil and food prices, along with stronger demand, have caused inflation to rise throughout the region (Figure 1.6). Nevertheless, inflation still remains modest in all countries. Although still relatively modest by historical standards, in the region inflation is

[4] Growth volatility is measured as the standard deviation of GDP growth.

highest in Costa Rica and Nicaragua. As might be expected, it is lowest in the two dollarized economies—El Salvador and Panama.

Figure 1.6: Inflation and Fiscal Deficits





Source: WDI and national authorities

1.18 The region made progress in reducing fiscal deficits. While most countries saw debt-to-GDP ratios rise over the past decade, the current cyclical upturn has allowed them to strengthen policies and improve fiscal accounts. Deficits declined from an average of nearly 3 percent of GDP in 2000 to about 1 percent in 2006, helped by buoyant revenue collections that reflected a growth dividend and ongoing reforms in tax policy and administration. Nevertheless, public debt remains a concern in most countries, with little room to expand public borrowing.

1.19 In terms of current account balances, Central American countries external positions have continued to improve. Current account deficits remained largely unchanged at about 6 percent of GDP in 2007, reflecting in part the higher oil import bill. Capital inflows have boosted international reserves.

Integration and coordination

1.20 Movements toward regional integration have been modest, although momentum toward greater coordination is improving. The past decade has witnessed growing trade and financial linkages among the region's economies and with their largest trading partner, the United States. Central America has a relatively open trade regime, with a tariff structure largely determined by the common external duties of the Central American Common Market. Although the region had already preferential access to the US market under the Caribbean Basin Initiative, the DR-CAFTA should make access more permanent and extend it further in some areas, leading to continued deepening of trade integration. Countries have seen a significant increase of intra-regional financial sector ties.

1.21 Economic policy coordination is at an early stage. Countries continue to pursue their own fiscal policies; while central banks consult regularly, monetary and exchange rate policies evolve largely independently. The region is working toward better coordination and has a set of regional institutions—for example, the Central American Monetary Council, Central American

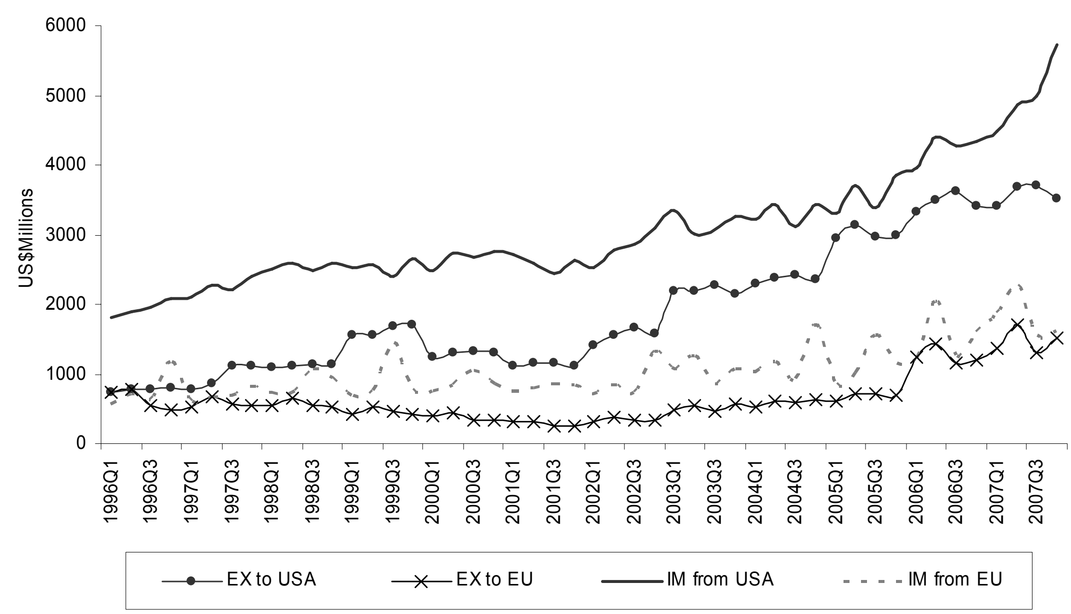
Bank for Economic Integration, and the Secretariat for Central American Economic Integration. They are increasingly involved in information sharing, regulatory harmonization, and policy coordination, particularly in areas such as banking supervision, central banking, and trade.

1.22 El Salvador, Guatemala, and Honduras have made some progress toward a customs union. Other areas that could be strengthened include the standardization of norms and regulations, the flow of information among government agencies (such as financial sector supervisors), and policy coordination in certain areas (such as 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.

3. TRADE AND FINANCIAL FLOWS

Trade and tariffs

Figure 1.7: Central American Trade Flows with the US and EU, 1996-2007



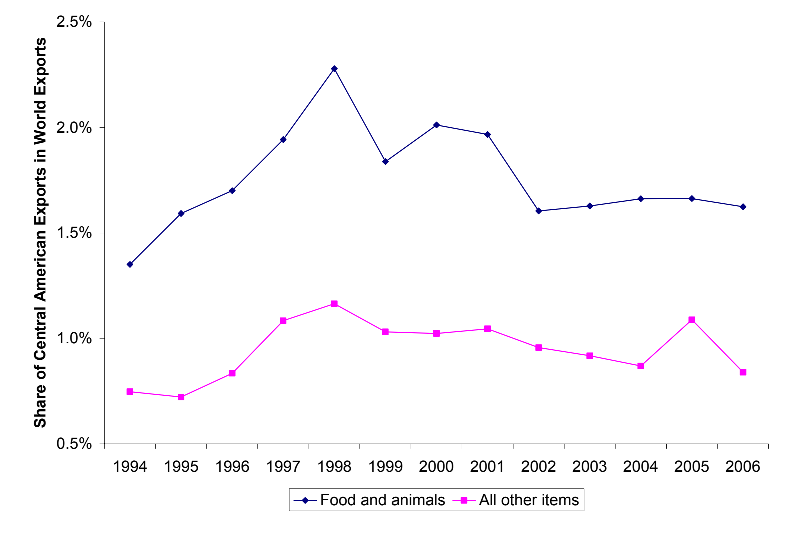
Source: IMF Direction of Trade Statistics

1.23 Since the 1990s, Central American economies have been very open, leading to a surge in international trade. The region's average openness ratio (exports plus imports of goods and services divided by GDP) was roughly 76 percent during 1980–2007, but it showed some variation across countries. From 1980 to 2007, for example, the average openness ratio was less than 60 percent in El Salvador and Guatemala, about 80 percent in Costa Rica and Honduras, and above 150 percent in Panama.

1.24 Trade linkages between the US and Central America have grown rapidly over the past decade, in absolute terms as well as relative terms compared to other large trading blocks, such as the European Union (Figure 1.7). The region's trade with the US increased fivefold in dollar terms from 1996 to 2006. While it is too early to attribute substantial gains to the impact of DR-CAFTA, non-traditional exports started to pick up at the end of 2006 in most countries. Exports from Central America to the US grew over 13 percent in dollar terms in 2006 and continued to show significant gains in 2007. The main increases in DR-CAFTA's exports are in textiles, clothing, and processed crops.

1.25 Central American countries are similar in the general categories of exports and imports they send to and receive from the US (Appendix Table A.1.1.). Differences are greater in dependence on the US market for exports. In 2007, Honduras sent more than 70 percent of its exports to the US, while Guatemala shipped about 44 percent. Costa Rica's export share was the smallest at less than 30 percent. As a whole, Central America's share of the world's export market has declined as other countries have increased their share, particularly China and other East Asian countries (Figure 1.8).

Figure 1.8: Share of Central American Exports in World Exports, 1994-2006



Source: COMTRADE

1.26 Over the past decade, the Central American countries substantially diversified their trade (Table 1.3). For the region as a whole, manufacturing's share of total exports rose from 24 percent to 34 percent from 1996 to 2006. Costa Rica, El Salvador, and Guatemala posted the largest gains in manufacturing exports. Agricultural and food exports' dominance has declined. However, these goods still account for the majority of total exports.

1.27 The extent of export diversification is somewhat lower than expected. Countries continue to focus on agricultural commodities and textiles. In the long run, however, DR-CAFTA can lead to a substantial increase in trade flows through its impact on productivity and specialization. These gains could be substantial since DR-CAFTA includes various provisions about the flows of investment, financial services, and intellectual property. Countries have already begun expanding the scope trade with the US (Kose and Rebucci, 2005). For example, most US electrical machinery and apparel imports are being used as intermediate inputs for other goods that are then exported back to the US.

Table 1.3: Structure of Merchandise Exports, 1996-2007 (Percentage)

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Manufacturing						
1996-2000	50.94	45.00	31.97	22.84	16.55	17.52
2001-2005	63.95	57.62	41.53	30.36	13.23	12.92
Agriculture and food						
1996-2000	47.51	48.44	63.32	70.81	81.65	75.02
2001-2005	34.53	34.01	50.65	64.46	84.03	81.60
Fuel and metals						
1996-2000	1.40	6.26	4.71	6.29	1.57	7.46
2001-2005	1.51	8.22	7.82	5.14	2.53	5.47

Source: WDI

Box 1.3: Export Diversification and Growth

Export diversification may contribute to growth through a number of channels. First, it may reduce the reliance on a limited number of export commodities that may be subject to extreme price or volume fluctuations—such as coffee, natural resources, or textiles. Swings in foreign exchange revenues may hamper efforts at policy planning, reduce import capacity, and contribute to an undersupply of investment by risk-adverse producers. Therefore, decreasing economic vulnerabilities through export diversification may provide significant benefits.

Second, export diversification may affect long-run growth through its role in increasing returns to scale and dynamic spillovers. Some analysts have argued that the quality of the export basket matters for growth--that is, specializing in some products may bring higher growth than specializing in others. This implies an important role for policy in encouraging a broad-based production structure (Hausmann et al. 2005).

Relatively few detailed empirical investigations have looked into the links between export diversification and growth. Based on panel data, de Ferranti et al. (2003) find positive linkages for Latin America. To spur growth, the authors point to the importance of combining diversification with complementary factors associated with improving the investment climate, such as technology and skills. Further research is needed to distinguish between the role of a diversified export base and the overall investment climate in determining growth

1.28 Central American tariffs have decreased (Appendix Table A.1.2.).[5] Countries began to reduce import duties in the early 1990s, making rates among the lowest in Latin America. Average tariffs fell from about 10 percent in 1995 to 7 percent in 2000 and 5 percent in 2006. Costa Rica has the lowest rates; Nicaragua the highest. Evidence suggests that Central America has also reduced non-tariff barriers, largely sanitary and phytosanitary standards that had been used as trade barriers prior to reforms (Jaramillo and Lederman, 2006). Most of the remaining restrictions are limited to sanitary and technical standards.

Foreign direct investment and remittances

1.29 Central American countries were able to increase FDI flows significantly in recent years. Panama, for example, has the highest gross FDI flows as percentage of GDP at about 15 percent

[5] Tariffs reported in Table A.1.2 refer to Trade-weighted MFN averages.

in 2006. For the region, these flows were sizeable, averaging about 14 percent of domestic investment or 5 percent of GDP. The US is the largest source of FDI flows. Provided a favorable investment climate, DR-CAFTA may therefore serve as a “commitment device” to prevent further increases in trade barriers and encourage greater FDI inflows, including from outside the United States, while inducing a change in the nature of trade flows in favor of vertically integrated trade. DR-CAFTA could also help attract foreign multinational corporations to the Central American countries.

1.30 Remittances sent from the US are an important source of revenue in Central America, with some analysts suggesting they might surpass FDI flows. Estimates of these transfers range from about 2 percent of GDP in Costa Rica to 25 percent in Honduras (Table 1.4). Remittances may have grown rapidly over in recent years, reflecting the positive economic environment in the US. Unlike FDI and trade, remittances seem to be less cyclical, suggesting that migrant workers smooth their remittance flows by sending relatively steady US dollar amounts each month or quarter (Roache, 2008). Nonetheless, the recent US slowdown has reduced remittance flows to Central America. Migrant workers typically transfer monthly amounts of about US$250-300 on a frequent basis (Cheikhrouhou et al., 2006; World Bank 2006 and 2007b).

Table 1.4: Estimated Size of Remittances, 2005-2006

	US$ in billions	Shares in percent		
		GDP	FDI Inflows	Exports
Costa Rica	0.5	2%	74%	4%
El Salvador	3.3	18%	667%	69%
Guatemala	3.6	10%	1111%	66%
Honduras	2.2	25%	774%	60%
Nicaragua	0.7	12%	235%	28%

Source: Cheikhrouhou et al. (2006); World Bank (2006); World Bank (2007b); Roache (2008)

4. LOOKING AHEAD

1.31 The international economic environment over the past few years has been favorable to Central American countries. The region was able to make important gains in improving fiscal balances, reducing external debt exposure, and accelerating economic growth. Despite these gains, the region did not grow as fast it did in prior decades, or as fast as the rest of Latin America or other regions of the world. This suggests the need to improve the investment climate and accelerate growth.

1.32 The region’s governments continue to embrace macroeconomic and political stability. A series of presidential and congressional elections have demonstrated that democracies are functioning well, transferring power smoothly. Moving economic reforms forward will depend critically on the ability to build alliances because many governments lack majority support in their legislatures.

1.33 The outlook for the near future suggests that the world economy will be less favorable for Central America. Slowing global growth—most importantly, in the United States—could stall the momentum of Central American exports, FDI inflows, and remittances. With oil prices at record highs and Central America facing increased competition from Asia, the region needs to improve on policies that foster productive development and innovation. Economic integration within the region and with the US can be beneficial, but it needs to be backed with complementary policies improving the investment climate.

1.34 Achieving higher growth rates and improving the investment climate will rest largely on implementing institutional and governance reforms. The Doing Business Reports show the region improved over the past year, albeit from a low base. Central American countries have been particularly focusing on trade facilitation, registration of property procedures, and credit access. A continued effort to improve the investment climate is of central importance to ensure that the DR-CAFTA will lead to the expected productivity improvements and more tangible benefits for Central America.

1.35 By looking in detail at the microeconomic and sectoral determinants of domestic growth, and the determinants of growth of exporting firms, this report can help to identify important policy priorities to achieve this goal.