Following a weak performance in the 1980s, the Central American economies experienced a turnaround in the 1990s as they adopted improved policies within a more stable political environment. Now, how can they best maintain macroeconomic stability, continue structural reforms, and strengthen social policies to maximize rates of economic growth and reduce the incidence of poverty?

Central America

Adjustment and Reforms in the 1990s

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IN MANY WAYS, the 1980s were a lost decade for the economies of Central America (for the purposes of this article, the region comprises the five members of the Central American Common Market: Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua) that featured large external imbalances, high inflation, output stagnation, and a deterioration of social conditions in most countries. Contributing factors included the armed conflicts in El Salvador, Guatemala, and Nicaragua (which also had adverse effects on the economies of Costa Rica and Honduras), weak macroeconomic and structural policies, and the impact of external shocks, including the Latin American debt crisis and a worsening in the region's terms of trade.

In the early 1990s, most countries implemented comprehensive macroeconomic adjustment and structural reforms, which were often supported by financial and technical assistance from the IMF, the World Bank, and the Inter-American Development Bank. Macroeconomic adjustment continued during the second half of the 1990s, although at a slower pace, while structural policies were strengthened on several fronts, including privatization, financial sector reform, and trade liberalization. As a result of these efforts, economic performance improved considerably: growth increased; inflation declined; the external position strengthened; and the incidence of poverty decreased.

Average annual regional real GDP growth rose to almost 4 percent during the 1990s, with per capita output increasing at an average annual rate of 1.2 percent (compared with a decline of 2.1 percent during the previous decade) and most countries recording increases in saving and investment rates (see table). There were significant differences among countries, however, with the more advanced economies (Costa Rica, El Salvador, and Guatemala) growing almost twice as fast as the poorer ones (Honduras and Nicaragua). Nicaragua began to recover only in 1994, after a period of hyperinflation and implementation of bold reforms that transformed its highly regulated economy into a market-based one (real GDP growth averaged 4½ percent a year during the second

half of the 1990s), while Honduras's weak performance could be traced to low factor productivity and the serious effects of Hurricane Mitch on the economy during 1998–99 (see box).

Inflation was significantly reduced in all Central American countries. In particular, Nicaragua conquered the hyperinflation it had experienced during the late 1980s and early 1990s, while El Salvador and Guatemala achieved single-digit inflation. Excluding Nicaragua, regional inflation declined to 6 percent in 1999 from 27 percent in 1991.

Central America's international trade expanded substantially during the early 1990s, with the initiation of trade and exchange liberalization, and accelerated further in the second half of the decade. Total regional exports increased by 8 percent a year (in U.S. dollar terms) over the decade (compared with an average annual decline of 1½ percent in the 1980s), with nontraditional exports expanding very rapidly. The region's current account deficit remained relatively large (6.1 percent of GDP) during the first half of the 1990s, owing to a significant recovery in investment financed by a large increase in official and private capital inflows. This deficit fell to 4.4 percent of GDP in the second half of the decade owing to the strong expansion of exports (including nontraditional products), tourism, and remittances from abroad. The reduction in external imbalances and the substantial debt relief provided by official and private creditors strengthened the external positions of all countries in the region during the 1990s. Central America's gross international reserves rose to 3.6 months of merchandise imports in 1999 from 2 months in 1990, while the ratio of total external debt to GDP fell to less than 40 percent from 90 percent.

Macro policies and structural reforms

Central American countries' improved economic performance has resulted from their adoption of more disciplined fiscal and monetary policies, consistent exchange rate policies, and important structural reforms, and was facilitated by the expansion of the world economy and trade since the mid-1990s.

Public sector deficits were more than halved during the decade, falling to a regional average of about 3½ percent of GDP during 1990–94 and less than 3 percent during 1995–99, with all countries strengthening their fiscal positions, mainly by restraining expenditures. Tax reforms included simplifying tax systems, reducing exemptions, increasing the rates of value-added or sales taxes, and improving tax-collection procedures. Because of the significant reductions in trade taxes, regional tax revenue remained at about 12 percent of GDP during most of the 1990s. Government expenditure declined considerably in most countries owing to substantial reductions in military outlays (particularly in El Salvador and Nicaragua, following the resolution of armed conflicts), the curtailment of distortionary subsidies, and the implementation of civil service reforms. These efforts were not sufficient to achieve fiscal

Central America: Selected economic and financial indicators

	Central American Common Market				Costa Rica		El Salvador		Guatemala		Honduras		Nicaragua	
	1980–89	1990–94	1995–99	1990–99	1980–89	1990–99	1980–89	1990–99	1980–89	1990–99	1980–89	1990–99	1980–89	1990–99
	(percentage change)													
Real GDP	0.7	3.9	3.9	3.9	2.2	4.4	–1.6	4.7	1.0	4.0	2.0	2.7	–0.8	2.7
Real GDP per capita	–2.1	1.2	1.2	1.2	–0.8	2.2	–3.1	2.3	–1.9	1.1	–1.3	–0.2	–4.2	–0.4
Total exports [1]	–1.5	7.6	8.6	8.1	3.7	8.7	–7.4	9.6	–2.7	9.6	0.7	4.9	–2.4	8.2
Nontraditional exports [1]	1.6	13.3	12.2	12.7	7.0	11.0	–2.5	13.8	–1.1	13.7	–2.7	17.1	...	18.5
Total imports [1]	0.9	11.1	9.8	10.5	2.8	10.4	2.4	11.1	2.2	11.2	0.3	10.4	–3.3	10.3
	(percent of GDP)													
Overall fiscal balance	–7.2	–3.6	–2.7	–3.1	–6.3	–3.5	–5.6	–2.0	–4.5	–1.7	–8.8	–4.5	–20.5	–13.7
Central government tax revenue	12.1	11.4	12.6	12.0	14.2	15.6	11.4	10.6	7.3	8.1	13.2	16.0	24.6	20.8
Central government current expenditure	15.2	12.8	12.5	12.7	15.6	17.8	13.9	11.6	8.8	7.6	16.8	14.8	36.2	24.7
External current account balance	–7.5	–6.1	–4.4	–5.2	–7.2	–4.7	–1.9	–1.4	–4.6	–4.6	–8.8	–5.7	–26.5	–27.4
Gross domestic investment	16.9	19.5	18.6	19.1	23.3	23 9	13.3	16.9	13.3	15.2	19.1	24.1	21.0	25.4
National savings	8.5	13.3	14.2	13.8	16.1	19.2	8.1	15.1	8.7	10.5	9.2	18.7	–8.3	–1.9
Memorandum items:	**1990**	**1994**	**1998**		**1990**	**1998**	**1990**	**1998**	**1990**	**1998**	**1990**	**1998**	**1990**	**1998**
Consumer price inflation (average, in percent)	378.5	13.1	8.7		19.0	11.7	24.0	2.5	41.6	6.5	23.3	15.7	3,127.0	13.0
Public external debt (percent of GDP)	90.2	67.3	37.6		61.3	27.9	38.8	22.2	30.1	15.3	88.4	74.0	686.9	280.3
Gross international reserves (months of merchandise imports)	2.0	2.9	3.6		1.1	2.0	5.0	6.8	2.1	3.3	0.0	4.2	1.6	1.7

Sources: IMF, Western Hemisphere Department and World Economic Outlook databases.
[1] In U.S. dollar terms.
... indicates no data available.

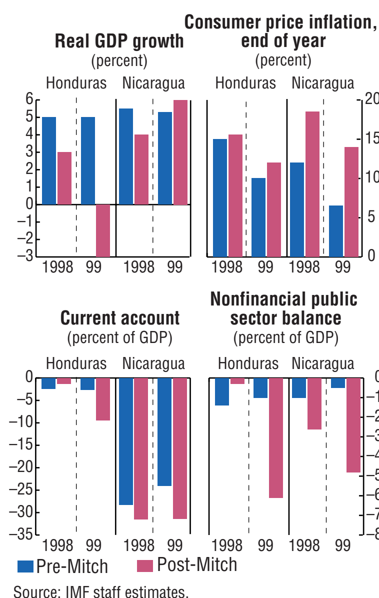
Effects of Hurricane Mitch

In late 1998, Hurricane Mitch and the subsequent flooding and landslides inflicted significant damage on Central America, resulting in a large loss of human life and severe infrastructure destruction. The human and economic toll was heaviest in Honduras and Nicaragua and lighter, though still significant, in El Salvador and Guatemala.

In Honduras, where Mitch is considered the worst natural disaster to have affected the country in recent years, more than 13,500 people died and about 2.5 million (out of a total population of 6 million) were displaced or left homeless. Damage to crops (including bananas) and infrastructure was extensive, and a large proportion of the country's roads, bridges, and water systems was destroyed or seriously impaired. Overall direct and indirect damages are estimated at $5 billion (95 percent of Honduras's 1998 GDP).

In Nicaragua, about 3,000 people died and about 870,000 (out of a total population of 4.8 million) were displaced. The impact on agriculture (basic grains, bananas, and sugar) and infrastructure was substantial, with total direct and indirect damages estimated at $1.2 billion (57 percent of Nicaragua's 1998 GDP).

The accompanying charts present pre-Mitch projections and post-Mitch estimates of real GDP growth, inflation, the external current account, and fiscal balances for Honduras and Nicaragua in 1998 and 1999. Because of the less extensive damage that Mitch inflicted on Nicaragua, its economic recovery started in 1999, sooner than in Honduras, where a return to positive real GDP growth is expected in 2000.



consolidation, however, and some countries had to curtail much-needed investment in infrastructure to reduce their fiscal imbalances. Moreover, the region's fiscal position weakened in 1999 owing to the high costs of reconstruction in Honduras and Nicaragua after Hurricane Mitch and to increased expenditure pressures in the other countries. Reconstruction expenditures are being financed largely with increased concessional assistance from multilateral and bilateral sources.

Fiscal adjustment was accompanied by far-reaching reforms to reduce state involvement in the economy by privatizing public enterprises and reducing public employment. Substantial advances were made in privatization in El Salvador and Nicaragua in the early 1990s. Efforts continued in El Salvador and were intensified in Guatemala during the second half of the decade, leading to privatization or increased private sector participation in the electricity and telecommunications sectors. In Costa Rica and Honduras, where progress has been slower, initiatives to increase the private sector's role in key areas of the economy are under way.

In the early 1990s, most countries liberalized their financial systems by eliminating controls on interest rates and quantitative credit allocation by sector, and began strengthening bank supervision and prudential regulations. Other reforms have included the privatization of inefficient state banks (except in Costa Rica, where state banking continues to play a dominant role in financial intermediation) and legislation to provide greater autonomy to central banks while restricting their financing of government budgets.

Following frequent shifts in their exchange rate arrangements, which were characterized by multiple exchange rates and restrictions, all countries in the region moved, during the 1990s, toward unified exchange rate systems and the removal of restrictions on both current and capital account transactions. El Salvador has pegged its currency to the U.S. dollar since 1993, while all the other Central American countries have exchange systems that allow for some degree of exchange flexibility—either a crawling peg (Costa Rica, Honduras, and Nicaragua) or a managed float (Guatemala). These arrangements reflect, to a large extent, the differences still remaining in their macroeconomic fundamentals, including the depth of their domestic capital markets and the progress they have made toward fiscal consolidation.

Substantial progress was also made in trade liberalization. In particular, there was a fundamental shift in the process of regional integration within the Central American Common Market, as the previous emphasis on import substitution was replaced by one on export-led growth. Following reductions in tariff rates, tariff rate dispersion, and export taxes, and the elimination of most nontariff restrictions in the late 1980s and early 1990s, in 1995 the governments agreed on a schedule for convergence on lower common external tariffs ranging between zero and 15 percent by the end of 2000; El Salvador, Guatemala, and Nicaragua have implemented this agreement ahead of schedule. There are, however, important exceptions to the maximum common tariff policy, with a slower schedule of tariff reductions applying to poultry, cold meat, dairy products, cigarettes, and textiles.

The incidence of poverty declined during the 1990s in all countries in the region, with health and education indicators improving noticeably, owing partly to the increased availability of external funds for social expenditure associated with postwar reconstruction in El Salvador, Guatemala, and Nicaragua, and to the high priority Costa Rica continued to

attach to basic social services. Also, some countries improved targeting and regional decentralization in the delivery of social services. A large proportion of the population (ranging from 20 percent in Costa Rica to more than 50 percent in the region's poorer countries) still lives below the poverty line, however, and for all countries except Costa Rica, most social indicators remain below the average for Latin America.

Challenges ahead

Looking ahead, the region faces the difficult challenges of consolidating macroeconomic adjustment and structural change while strengthening social policies to achieve higher economic growth, improve external competitiveness, and reduce poverty levels.

Although public finances have strengthened over the past decade, most countries' fiscal positions remain fragile. In particular, more needs to be done to achieve sustainable fiscal positions in Honduras and Nicaragua while reducing these countries' dependence on foreign assistance, and in Costa Rica to reduce its domestic public indebtedness. Moreover, El Salvador and Guatemala's tax efforts remain insufficient to meet these countries' large social and public investment needs. Thus, all countries need to strengthen public sector saving to ease pressures on domestic interest rates, modernize their social and physical infrastructures, improve security conditions, and increase investment in human capital to improve labor productivity and stimulate private investment. A well-trained workforce provides a powerful incentive to investors, as has been demonstrated by Costa Rica's successful experience in the 1990s in attracting high-technology enterprises.

Additional efforts to strengthen tax revenue, including by eliminating remaining exemptions and making further improvements in tax and customs administration to reduce evasion, will be essential in the period ahead. At the same time, most countries need to improve the structure of government expenditures by linking wage remuneration to productivity, streamlining subsidies, and reducing revenue earmarking to help eliminate unproductive outlays and free up resources to address social needs. Moreover, further steps are needed to strengthen targeting and decentralization in the provision of social services, particularly in health and education.

Financial liberalization has advanced more rapidly than supervision and prudential regulation over the last decade, and further steps need to be taken to deal with remaining vulnerabilities in banking systems. Thus far, weaknesses in the region's banking systems have generally led to isolated problems without systemic implications, and these were contained by the authorities' prompt actions, including intervention or liquidation of bankrupt institutions. Looking ahead, there is a need to move forward with plans to further increase capital-adequacy requirements, strengthen loan-loss provisions, and implement an effective consolidated supervision of financial intermediaries, including offshore activities. Further steps also are necessary to improve monetary management by strengthening indirect monetary instruments, improving central bank auction mechanisms for placements of securities, and deepening securities markets.

Regarding structural reforms, some countries need to move ahead with divesting public enterprises or increasing private sector participation in sectors of the economy still controlled by state monopolies. In addition, most countries will need to carry out current plans to reform public pension systems, which cover a relatively small portion of the population and are not financially sound. In 1998, El Salvador replaced the state-run, pay-as-you-go system with privately managed individual capitalization funds; in the near future, it will need to make plans to cover the transitional costs of the reform. Costa Rica, Guatemala, and Nicaragua plan to introduce private pension funds to supplement their pay-as-you-go systems, while Honduras is evaluating various options for comprehensive pension reform.

Improving countries' governance is also essential if efforts to attract private sector investment are to succeed. In particular, transparency and accountability in the management of public funds should be enhanced, and judicial systems should be strengthened to ensure the enforcement of contracts and combat corruption.

Finally, the large public external debts of Nicaragua and Honduras impose a serious burden that needs to be eased by providing these countries with substantial debt relief. Such debt relief, which is expected to be available under the Initiative for Highly Indebted Poor Countries (HIPC Initiative), would help them achieve a sustainable external position and significantly increase their capacity to meet essential social needs and reduce the incidence of poverty. F&D

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