CHAPTER 1

Building a Foundation for Sustained Growth

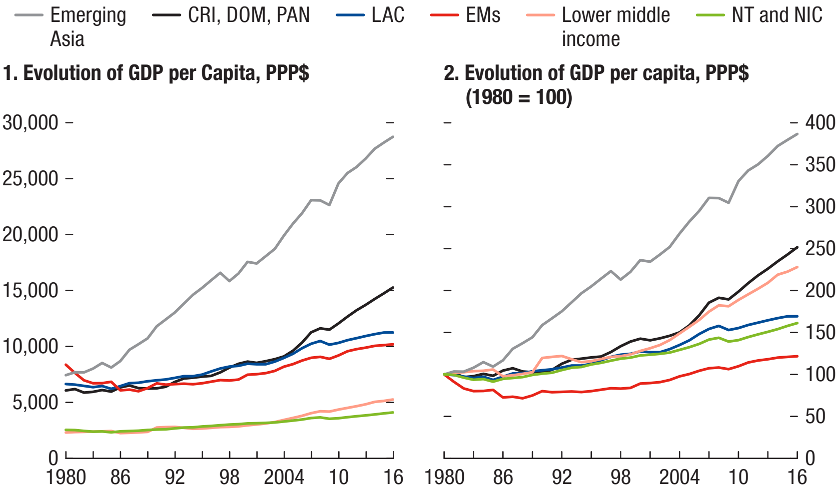
Kimberly Beaton, Lorenzo Figliuoli, Roberto Garcia-Saltos, and Iulia Teodoru

Over the past three decades, the countries of Central America along with Panama and the Dominican Republic—collectively referred to as CAPDR—have undergone a sustained economic transformation. These countries have moved away from the rural and agricultural economic base of the past toward a modern and urban economic structure characterized by significant regional and global integration. Overall growth in CAPDR has been subpar (Figure 1.1): since 2000, annual real GDP growth has averaged 4.1 percent, compared with 4.5 percent in other emerging market and developing economies. The gap between income per capita in CAPDR and in the United States has been quite large and only recently diminished to levels that prevailed during the 1960s and 1970s (Figure 1.2). Weak growth has been concentrated in Nicaragua and the so-called Northern Triangle countries—El Salvador, Guatemala, Honduras—where income per capita has been stagnant over the past 35 years and has yet to recover to 1960s and 1970s levels. These countries experienced civil wars during the 1980s, the Latin American financial crisis during the 1990s, and, in some, natural disasters during the late 1990s and early 2000s. During this same period, Costa Rica, the Dominican Republic, and Panama outperformed their CAPDR peers, even though they experienced lower growth during the 1980s than Nicaragua and the Northern Triangle countries. Starting in the 1990s and particularly during the 2000s, they narrowed the gap in income per capita with the United States and surpassed the progress of other emerging market and developing economies on this measure.

The divergent growth paths of these countries reflect differences in their economic structures and in their ability to innovate and adapt. For example, Costa Rica, Panama, and the Dominican Republic have been able to diversify from agriculture to manufacturing and high-value-added services. Costa Rica shifted resources to higher-productivity sectors such as circuitry, mechanical parts, accounting and financial services, and medical equipment; Panama shifted to logistics and transportation services, financial intermediation, communications, and trade; and the Dominican Republic shifted to electrical equipment and

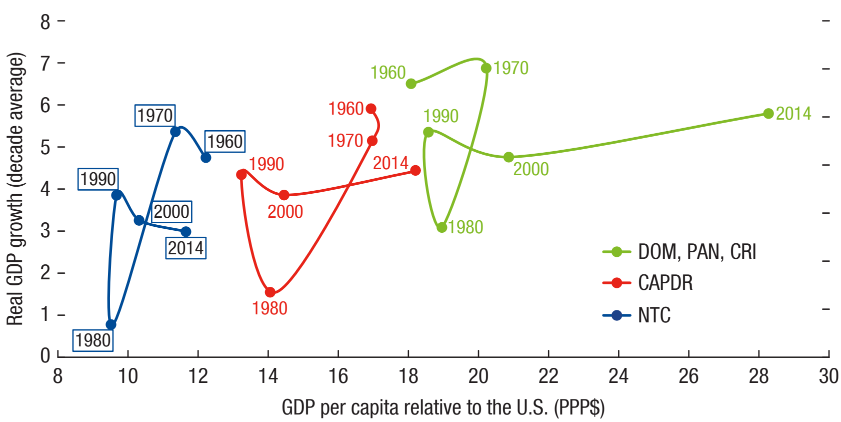
Cristhian Vera provided superb research assistance.

Figure 1.1. Evolution of GDP



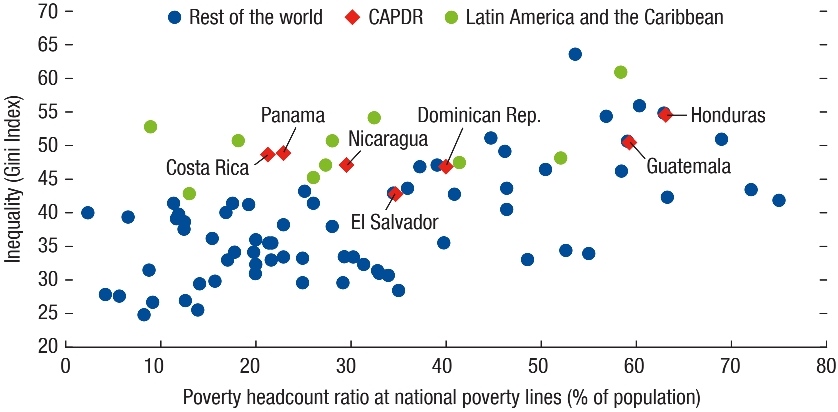
Sources: World Bank, World Development Indicators; and IMF staff estimates.
Notes: NT = Northern Triangle refers to El Salvador, Guatemala, and Honduras; Emerging Asia = China, Hong Kong SAR, Indonesia, India, South Korea, Malaysia, Philippines, Singapore, Thailand. Figure reports country-group averages. Data labels in figure use International Organization for Standardization (ISO) country codes.

Figure 1.2. Convergence



Sources: Penn World Tables 9.0; World bank; and IMF staff calculations.

Figure 1.3. Poverty and Inequality

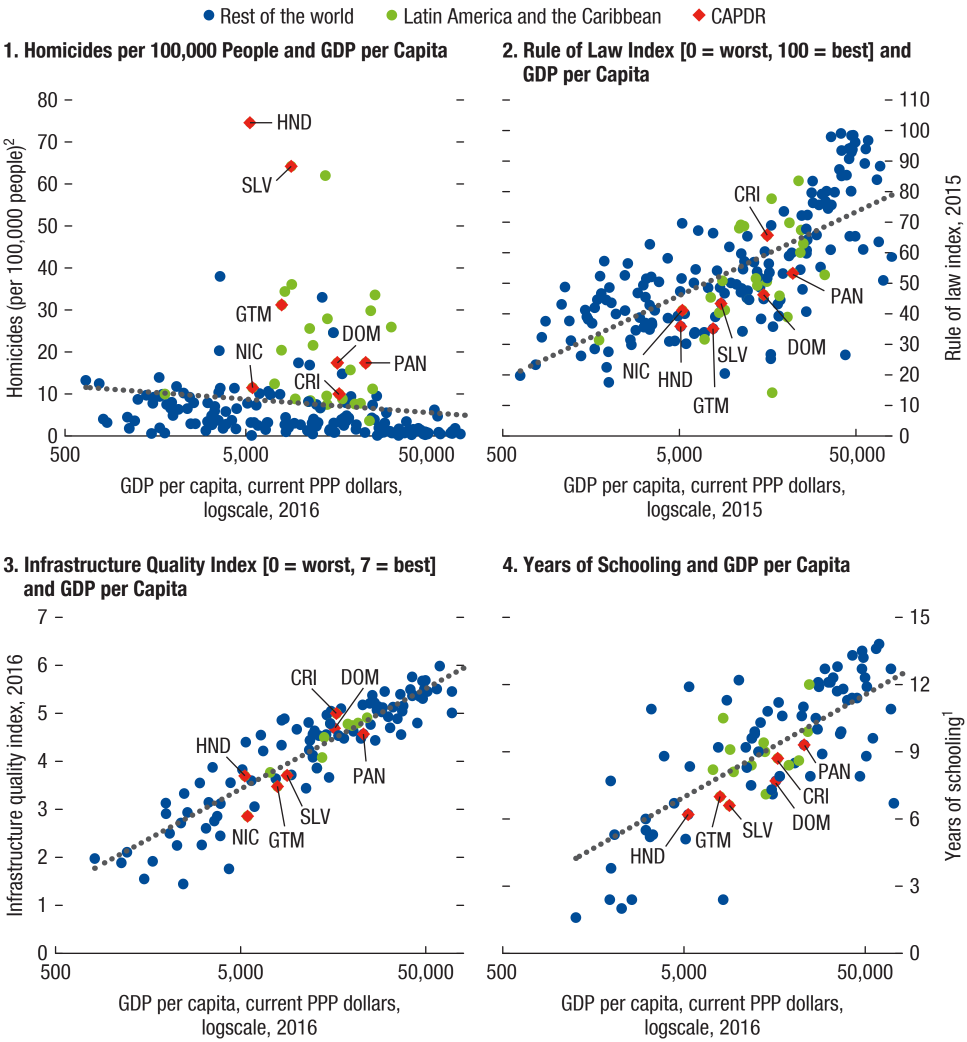


Sources: World Bank Development Indicators; and IMF staff calculations.
Note: The numbers for poverty and inequality represent the average from 2010 to 2015, with the available data for country and year.

medical instruments. Panama and the Dominican Republic rank highest in Latin America and the Caribbean in economic complexity—the amount of productive knowledge embodied in their export content. That complexity, along with higher human and physical capital and greater export diversity, have likely contributed to rapid growth in their total factor productivity and, in turn, to greater economic growth in the longer term. In contrast, in the Northern Triangle countries the process of diversifying away from agriculture and into higher-value-added and more complex products and sectors is still underway.

Differences in growth performance have contributed to differences in social development—that is, the overall well-being of individuals that allows them to reach their potential. Social development can be gauged by rates of poverty and inequality and by human opportunity indicators such as life expectancy, maternal mortality, access to water and/or electricity, and education. Poverty in Guatemala and Honduras is very high—60 percent of the population—and has not fallen during the past decade. It is lower in the Dominican Republic and El Salvador at 40 percent, but because of the large size of the informal sector in these economies, much of this poverty is structural. Inequality is high in all the CAPDR countries. Human opportunity indicators point to scant access to basic services (education, running water, electricity), especially in El Salvador, Guatemala, Honduras, and Nicaragua. Malnutrition rates are among the highest in the world, and in Nicaragua, Honduras, El Salvador, and Panama it is double the level in South America. Life expectancy in the region is about 75 years, but maternal mortality is above the overall rate in Latin America. Entrenched poverty and inequality in the Northern Triangle, coupled with a lack of job opportunities, pushes many people to emigrate.

Figure 1.4. Structural Factors Affecting Growth



Sources: IMF, World Economic Outlook database; World Bank, Worldwide Governance Indicators; World Economic Forum; Transparency International, Global Corruption Barometer database; UNESCO Institute for Statistics (UIS) database; and IMF staff calculations.
[1]Mean years of schooling; Percentage of population (age 25+).

Structural and macroeconomic impediments underlie these countries' uneven economic performance (Figure 1.4). The structural impediments include infrastructure and education gaps, a large informal sector, high crime, aging populations, and weaknesses in the rule of law. Large infrastructure gaps in most countries, though to a lesser extent in Costa Rica and Panama, constrain potential growth and living standards and have a particularly outsized effect on the poorest households. Access to education, as measured by average years of schooling and net enrollment, especially in secondary education, is low, particularly in the Northern Triangle; this limits the contribution of human capital to growth. Disproportionately high crime and extortion in the Northern Triangle and widespread gang violence drive outward migration and constrain small business operations. Weak institutions also pose significant constraints to doing business. Anti-corruption measures in the region fall short of those in place in other emerging market and developing economies, although there has been good progress and some high-profile cases in some CAPDR countries.

Macroeconomic weaknesses compound these structural weaknesses. There is limited fiscal space, with the exception of Panama, and as a result, pro-growth spending has been insufficient to ensure support for infrastructure development, education, and security. Tax revenues have been low in many of these countries, which also limits social spending because they cannot afford large deficits given low growth and high borrowing costs. At the same time, low financial intermediation and inclusion constrain investment and growth.

This book explores how CAPDR countries can overcome these obstacles and achieve higher and more inclusive growth. The book aims to foster policy dialogue and contribute to the efforts to address the region's unique challenges. The first part examines the region's growth with a view to understanding how structural determinants—capital formation, employment, demographic factors, including immigration, productivity, and violence—contribute to the region's uneven gains and how best to strengthen the pillars of growth. The second part of the book highlights the importance of addressing the region's fiscal challenges to create the fiscal space required to support growth and improve social outcomes. Fine-tuning public spending can help ease emerging spending pressures, including from an aging population. At the same time, fiscal consolidation can include more progressive taxation and enhanced redistributive policies to lower income inequality, along with strengthened fiscal anchors to support the adjustment through enhanced accountability. Finally, the third part of the book emphasizes the importance to growth of a supportive financial sector, including through broader access to financial services and further development and deepening of the financial sector.

THE PILLARS OF GROWTH

Economic growth in Central America, Panama, and the Dominican Republic has been robust, as noted, albeit with substantial country-specific differences that are expected to persist. Growth dynamics are projected to remain positive in the near term, reflecting strong US and global growth. However, there are important downside risks to growth. These include tighter US immigration policy, which could mean more deportations and lower remittances, particularly for the Northern Triangle countries. Tighter global financial conditions could limit access or raise the cost of external financing given weak budgetary situations (for example, in Costa Rica, Dominican Republic, El Salvador), and slower global growth could lead to a retreat from cross-border integration in the region.

The first part of the book identifies the structural factors that shape the region's recent economic performance and contribute to its potential growth, specifically by addressing the following questions:

- What is the region's potential growth, and which reforms will help overcome its structural challenges and boost its medium-term prospects?
- How will demographics and the role of women in the workforce shape the future of the region's labor force?
- To what extent do migration and remittances contribute to the region's economic performance, and what risks are posed by the region's reliance on remittances?
- How is the region integrated into global markets, and what role does trade play in shaping its economic prospects?
- How do crime and corruption affect the region's economic development?

Chapter 2, Roberto Garcia-Saltos, Iulia Teodoru, and Fan Zhang explore the factors that contribute to movements in potential output. In the aftermath of the global financial crisis, potential output growth declined in most of these economies, a decline the authors largely attribute to lower capital accumulation and stagnant productivity growth. However, these factors were offset in Costa Rica, the Dominican Republic, and Panama by a demographic dividend and in other countries (for example, Costa Rica) by improvements in education, which contributed to faster growth than in the Northern Triangle and in Nicaragua. On average, the potential growth rate for the region overall is expected to remain above 4 percent during the medium term but to be lower in the Northern Triangle and in Nicaragua, at 3.5 percent, and to be higher (at 5 percent) in faster-growing Costa Rica, the Dominican Republic, and Panama. The challenge throughout the region will be to address structural constraints to capital and employment growth to improve medium-term growth prospects.

Chapter 3 explores how, despite favorable demographic conditions, the contribution of human capital to potential growth has remained elusive given the low participation of women in the labor force. Authors Anna Ivanova, Jaume Puig-Forne, Victoria Valente, and Joyce Wong explore why CAPDR has some of the world's largest gaps between male and female labor force participation (exceeding 25 percent) and highlight the importance of tapping women to boost potential growth. In fact, at close to 40 percent, the gender gaps in two of the Northern Triangle countries (Guatemala, Honduras) are the largest in the world. Their analysis suggests that low female labor force participation is driven not only by the region's middle-income status (given the U-shaped relationship between the level of economic development and female labor force participation), but also by gender gaps in education, high fertility, infrastructure gaps, and other factors that affect access to the job market. To enhance the role of women and improve their economic and social well-being, countries in the region will need to broaden access to education, increase investment in infrastructure and information technology, and undertake measures to support working mothers with children. Enhanced female labor force participation can also boost the region's growth potential, especially in countries where the population is aging more rapidly.

In Chapter 4, Kimberly Beaton, Metodij Hadzi-Vaskov, and Bogdan Lissovolik explore outward migration, a very important CAPDR demographic phenomenon, particularly for the Northern Triangle countries. There has been a wave of emigration from the region since the 1980s, driven by civil wars, political instability, and natural disasters, as well as family reunification and the search for better economic opportunities abroad. Emigrants account for nearly 10 percent of the region's population, compared with about 2 percent for emerging market and developing economies as a whole. Emigrant remittances account for about 8 percent of the region's GDP. Northern Triangle countries, with the largest numbers of migrants abroad, receive considerably more remittances than other countries in the region. Do the population losses associated with emigration hurt economic growth? Do remittances compensate for this loss? Do remittances spur growth? The analysis in Chapter 4 suggests that the negative effects of emigration on economic growth stemming from the reduction in labor supply are largely offset by the positive effects from remittances on investment, education, and trade links. Nevertheless, the authors caution that the region's extensive reliance on remittances, especially when most migrants from the region reside in a single country, can be risky and can amplify negative spillovers from changes in US economic conditions and policies. The authors advocate policies that can tilt the effects of emigration and remittances in a favorable direction. For example, the effects of remittances can be made more stable by reducing the transaction costs, facilitating their formal intermediation, and enacting measures to enhance the financial sector's resilience to the volatility of remittance flows, including potential sudden stops. Improving the overall business environment and strengthening institutions can help raise productivity and limit incentives for outward migration. For the Northern Triangle, effective policies to improve security will be critical.

Chapter 5 examines how enhancing trade can promote and sustain higher growth. The region liberalized trade in the 1990s and is well integrated into global markets: trade openness represented about 74 percent of regional GDP in 2016. Honduras, Nicaragua, and Panama are the most integrated economies; Costa Rica, the Dominican Republic, El Salvador, and Guatemala are relatively less integrated. Given this considerable heterogeneity, Kimberly Beaton, Xiaodan Ding, Metodij Hadzi-Vaskov, and Rosalind Mowatt conclude that there is ample scope for further trade integration in the region, primarily by tackling its structural challenges. Strengthening the region's infrastructure and human capital development would be useful not only as part of a broad growth strategy, doing so will also enhance trade integration, by opening new opportunities for technology transfer and allowing the region's exports to become more diverse and complex. With the region's exports largely targeted toward the United States, diversification could also promote external stability and improve productivity and economic growth. Opportunities for regional cooperation on trade should also be exploited. There may be limited scope to expand intraregional trade given the similarity of the region's production structures and export bases, but countries in the region should continue their efforts to negotiate joint trade agreements and seek to expand regional cooperation on regulatory issues, trade facilitation, and connectivity, including infrastructure, to promote economies of scale and lower administrative and compliance costs.

Crime and corruption have emerged as key obstacles to increasing investment, building physical capital, and as a result promoting growth. In Chapter 6, Ana Lariau, Dmitry Plotnikov, and Joyce Wong argue that persistent crime is one of the biggest challenges to economic development for the Northern Triangle countries, which account for 4½ percent of the world's nonwar homicides but only ½ percent of the world's population. Violent crime rates in the remainder of the region are broadly comparable with those in other emerging market countries and in Latin America as a whole. Persistent crime in the Northern Triangle is closely intertwined with these countries' relatively poor growth rates. In the face of high poverty (especially in the Northern Triangle), the authors advocate that CAPDR countries tackle crime through a combination of policies to spur growth, promote labor market activity, increase the expected benefits from legal and nonviolent activities, strengthen policies to curb gang activity, and improve the criminal justice system.

FISCAL POLICY CHALLENGES TO GROWTH

Promoting inclusive growth will require many CAPDR countries to maintain or bring public finances to sustainable levels. High fiscal deficits and rising debt levels are serious concerns for Costa Rica and El Salvador. Public debt is also expected to rise in the Dominican Republic and Nicaragua, though to a lesser extent. Honduras has relatively high debt but has recently regained fiscal discipline. Guatemala and Panama are projected to experience sustainable debt dynamics. Setting a clear, consistent, and disciplined fiscal path could reduce the cost of capital and open up fiscal space to support social development programs and to foster private investment, including for infrastructure. There are a number of fiscal policy measures that can influence the region's growth prospects, including by improving the quality of spending, creating fiscal space to deal with population aging, reducing income inequality, and institutionalizing fiscal discipline by introducing fiscal responsibility frameworks. The second section of the book explores these issues by tackling the following questions:

- How can countries in the region maintain or restore fiscal buffers while simultaneously increasing social spending?
- What are the fiscal policy challenges related to population aging?
- How can fiscal instruments reduce income inequality?
- What has been the result of recent measures to institutionalize fiscal discipline through fiscal responsibility frameworks and fiscal rules?

In Chapter 7, Javier Kapsoli and Iulia Teodoru advocate more efficient public expenditure as a means to rebuild fiscal buffers while increasing public spending to close social gaps and develop human capital. The potential long-term savings could be significant—in the range of 0.25 to 3 percent of GDP. More efficient public spending, however, must rest on a foundation of deep structural reforms. The authors discuss policy options for each country and find that reducing the wage bill is the main challenge across the region, except in Guatemala, where social spending lags regional averages. The specific reforms most appropriate for each country differ, but the broad basket of reforms includes reducing large public-private wage premiums, tackling the disconnection between compensation rules and productivity, and reallocating teacher resources to match enrollment trends.

In Chapter 8, Jaume Puig-Forne highlights the major fiscal challenges presented by population aging for the CAPDR region. Although the region continues to benefit from a demographic dividend, the old-age dependency ratio (the ratio of the retirement population to the working-age population)—as in the rest of the world—is projected to rise. Most of these countries have pay-as-you-go defined-benefit pension systems (except Dominican Republic, El Salvador, Panama) and high public health expenditures (except Dominican Republic and Guatemala). Puig-Forne advocates supporting fiscal sustainability through carefully designed pension and health care reforms. For defined-benefit pension systems, parametric pension reforms—including increasing contribution rates and raising retirement ages to reflect longer life expectancies—can help slow the growth of age-related public spending and enhance the scope for extended coverage, which is particularly low in the Northern Triangle and Nicaragua. For defined-contribution systems, gradually raising the retirement age and increasing early contribution rates can help contain contingent fiscal risks from inadequate projected benefits (especially Dominican Republic and Panama). Gradual adjustments can help mitigate the potentially negative social effects of reforms. To help people adjust, reforms should be introduced while countries still have the fiscal space for such gradual change. Health care reform should aim to manage the growth of spending while preserving health outcomes and ensuring equitable access to basic services. A combination of tight budget controls and efficiency-enhancing measures will be key to reforming health care in all countries.

Another challenge is how best to design fiscal consolidation to enhance the redistributive power of fiscal policy and help reduce income inequality. While there is no one-size-fits-all strategy, in Chapter 9, Aliona Cebotari, Valentina Flamini, Roberto Garcia-Saltos, and Adrian Peralta offer some suggestions. First, well-designed social programs are essential to consider at the outset of any consolidation strategy. Second, focusing revenue mobilization efforts on greater tax *progressivity*—by scaling back exemptions, removing preferential treatment, and combating tax evasion and avoidance, especially by higher-income households—can enhance the redistributive power of fiscal policies. Third, greater reliance on direct taxes, which are progressive—in some cases through lower thresholds to capture more high-income households in the tax net—would help broaden the tax base with few distributional costs. Fourth, a successful consolidation that reduces (or stabilizes) the debt and lowers the risk premium could generate savings in terms of lower interest payments not only to the public sector but also to the private sector. Using these savings to reduce social and infrastructure gaps could offset the demand drag from fiscal consolidation and reduce inequality.

CAPDR countries are increasingly seeking to institutionalize fiscal discipline through fiscal responsibility frameworks and fiscal rules. In Chapter 10, Hadzi-Vaskov, Kapsoli, and Lissovolik explore the initial experience with fiscal responsibility frameworks, which have been adopted by three countries in the region. Panama originally enacted its fiscal rule in 2002, and El Salvador and Honduras adopted theirs in 2016. Other countries in the region are in earlier stages of exploring the applicability of such frameworks. The authors conclude that the design of the region's existing fiscal rules, particularly those focused on expenditures, is appropriately geared toward local conditions and in line with best practice. The region's track record on compliance with existing fiscal rules has been positive, albeit limited: two of the existing frameworks were adopted only recently. To support compliance, the authors recommend accelerating institutional reforms to strengthen public financial management, introducing medium-term fiscal frameworks consistent with fiscal responsibility frameworks, and strengthening fiscal institutions. To raise public accountability for fiscal responsibility frameworks, the authors also advocate enhanced transparency and communication with the public, to promote greater public scrutiny and support achievement of the frameworks' main objectives.

MONETARY AND FINANCIAL SECTOR POLICIES TO SUPPORT GROWTH

Although the region's financial systems were left mostly unscathed by the global financial crisis, that episode underscores that a weak financial sector can quickly undermine economic growth. Such weakness can translate into financial instability, itself inflicting considerable harm on an economy, and can hamper inclusive growth by failing to allocate resources efficiently. Deciding which activities to finance—that is, which yield the best risk-adjusted return—can have a crucial long-term impact on economic prospects, both on the overall level and on the distribution of outcomes. The central role of the financial sector in fostering inclusive growth and maintaining financial stability argues for proper and effective regulation and for a strong and credible monetary policy framework. The third section of the book addresses these questions:

- How do monetary policy frameworks contribute to financial stability?
- What is the state of financial development and financial inclusion in the CAPDR region?
- What is the experience with macroprudential regulation in the region?

CAPDR countries—except El Salvador and Panama, whose economies are officially dollarized—have been enhancing the effectiveness of monetary policy to control inflation and blunt the impact of short-term fluctuations. In Chapter 11, Cristhian Vera, Prachi Mishra, and Rogelio Morales discuss priorities to further strengthen monetary policy frameworks and deepen financial systems. They track how the nondollarized economies have strengthened their monetary policy transmission channels, but point out how additional measures to discourage financial dollarization and foster the development of secondary securities markets can facilitate further improvement. These countries can also benefit from boosting the flexibility of their exchange rates to enhance adjustment to changing external conditions, making foreign exchange interventions more transparent, and clarifying central bank communication on the primacy of inflation objectives. Concerted efforts to discourage financial dollarization and foster the development of secondary securities markets are needed to further improve monetary policy transmission. Promoting bank competition and strengthening the monetary and financial market infrastructure would expand the credit and capital base.

The region has made significant strides in financial deepening and inclusion, but in Chapter 12 Joyce Wong identifies areas for further improvement. She finds that the region's financial development is generally on par with that of other emerging markets, with financial institutions more developed than financial markets. However, in general financial inclusion of households and small and medium enterprises lags that in other emerging markets. Advances have not been uniform. For example, Panama stands out in terms of financial development and Costa Rica in terms of household inclusion. At the same time, there is low financial inclusion of households in Panama and high spreads and collateral requirements in Costa Rica. To promote financial development, the author proposes stronger institutional and legal frameworks related to property rights and collateral. She also advocates policies to support credit to small and medium enterprises—for example, reducing information costs by strengthening credit bureaus and lowering operational costs through the expansion of mobile networks. To safeguard the benefits of expanded financial inclusion without jeopardizing financial stability, the author advocates strong financial regulation and consumer protection.

In Chapter 13, Kimberly Beaton, Mario Dehesa, Fernando Delgado, and Xiaodan Ding assess the region's uneven progress in safeguarding financial stability by exploring institutional frameworks for macroprudential policy, documenting the use of macroprudential policy, and evaluating its effectiveness. Although there have been important inroads in strengthening microprudential regulation and supervision, macroprudential oversight over systemic risks and related policies is still at a nascent stage. To better prepare the region for systemic risks to financial stability, they advocate reinforcing institutional frameworks for macroprudential policy by clarifying the policy mandates and enhancing coordination between central banks and financial sector supervisors. Macroprudential policies have yet to be used extensively by the region to address systemic risk, but the authors find that tools to reduce the buildup of credit risk, particularly related to foreign currency credit, have helped. The authors conclude that the region should continue to develop its macroprudential policy toolkit to prepare for emerging risks to financial stability.

To enhance the resilience of the banking system the region could consider adopting a countercyclical capital buffer, a time-varying broad-based capital instrument. In Chapter 14, Valentina Flamini, Pierluigi Bologna, Fabio Di Vittorio, and Rasool Zandvakil study the credit cycle in the region and find the credit-to-GDP gap to be a powerful early warning of future financial stress. They recommend that countries consider introducing such a buffer to protect the banking sector from excessive aggregate credit growth by limiting the procyclicality of lending. The decision to activate the buffer should be anchored in movements in the credit-to-GDP gap complemented by more granular analysis on credit developments. The authors echo the recommendations in Chapter 13 for strong coordination between central banks and financial sector supervisors in assessing systemic risks to financial stability and the mobilization of the countercyclical capital buffer.

CONCLUSION

The experiences of economic transformation during the past three decades in Central America, Panama, and the Dominican Republic present bright opportunities, but significant challenges remain. All CAPDR countries have made significant progress toward integrating their economies regionally and globally. The payoffs in terms of higher economic growth from reducing gaps in infrastructure and education in Costa Rica, the Dominican Republic, and Panama are self-evident. The toll of emigration on economic growth in the Northern Triangle countries, the Dominican Republic, and Nicaragua through the reduction in labor supply has been offset by gains from remittances through investment, education, and other trade links.

Region-wide, it is essential to address structural constraints to capital and employment growth to support medium-term growth. Improvements in the business environment and strong institutions can help raise productivity and limit incentives for outward migration. For the Northern Triangle countries, effective policies to improve security are critical. Better access to education and investment in infrastructure and information technology—and support for working mothers—will enhance the role of women and their economic and social well-being.

With respect to fiscal policy, mobilizing additional resources to provide an adequate level of public goods such as security, education, and infrastructure will require action in all CAPDR countries. These include (1) raise revenue, including through tax reform, revamping tax and customs administrations, and reducing tax exemptions and (2) boosting the benefit of public spending by prioritizing pro-growth and pro-social expenditures, enhance budget transparency, and accountability reforms to pension and health care systems to support fiscal sustainability while improving pension coverage.

Although the financial systems in the region remained largely unscathed by the global financial crisis, that episode underscored the potential danger of a weak financial sector for sustained economic growth. The region has made significant strides in financial deepening and inclusion, but there is scope for further improvement. An important challenge is to integrate the analysis of systemic risk into supervisory and regulatory frameworks, including through the development of macroprudential policy frameworks to support financial stability and provide more flexibility to manage macro-financial risks.