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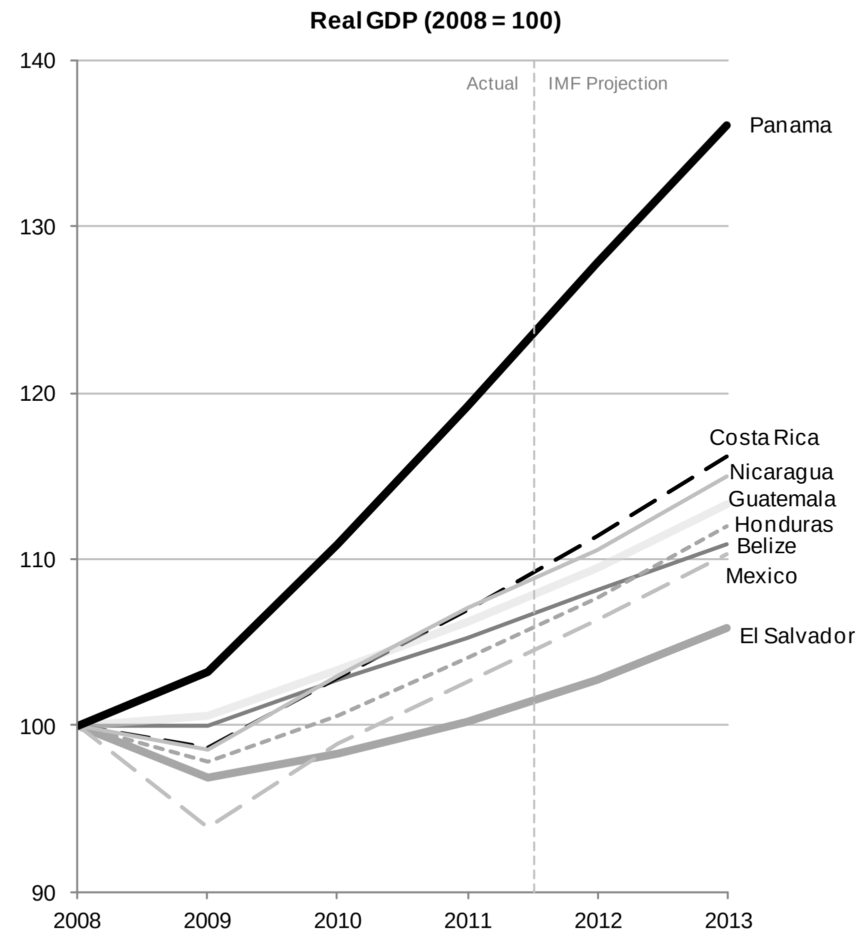
EADS Economic Trends Report

Central America and Mexico

September 2011

Economic Overview



SOURCE: IMF, *World Economic Outlook*, September 2011.

Economic growth in the Central American region bounced back in 2010 after a contraction in 2009. Compared with the rest of Latin America, Central America and Mexico were the hardest hit by the global slump due to relatively deeper ties to the sluggish U.S. economy. Most countries are growing modestly, but Costa Rica and Panama are achieving strong annual growth rates of 4–6 percent.

For the region as a whole, real GDP is projected to rise at or slightly above four percent in both 2011 and 2012. The IMF credits the growth rebound to strong external demand, enabling countries to narrow their output gaps.

With an estimated real GDP growth rate of four percent in 2011, Mexico is below the median growth rate in the region. However, the Mexican manufacturing sector is expanding rapidly and the unemployment rate dropped in 2010.

Panama's robust growth rates are boosted this year and next by several "mega-projects" in infrastructure. Compared with 2001 levels, Panama has had the strongest economic growth in the region. Costa Rica leads the rest of the countries and El Salvador has been the laggard.

Remittances flows to Central American countries have risen in the last two years, but remain restrained. In Costa Rica, where the role of remittances in the GDP is relatively minor, the growth forecast is brighter than in countries such as Guatemala and El Salvador, where the economy is more reliant on worker remittances.

Related to the stronger economic growth are projections for an uptick in inflation during 2011–2012, from around four percent to just over five percent, as well as a mild widening of the current account deficit.

Countries covered in this report include Belize, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, and Panama. Due to data limits, not all countries are represented in every graph or analytical section.

Nicaragua and Panama have the widest current account deficits, with both exceeding ten percent of GDP this year. At the other end of the spectrum, Guatemala and El Salvador have the smallest deficits at less than five percent of GDP. Rising incomes in Central America are prompting new demand for imported goods and services. In addition, increased investment spending in Central America tends to boost imports. In Central America, as well as the rest of Latin America, investment goods have relatively higher import content than in other regions. A partial offset to the trends widening current account deficits is the rebound in tourism to the region, an increasingly important sector for economic growth.

The World Bank has identified more credible monetary policies, better fiscal management, and improved financial regulation in Central America and the rest of Latin America as key reasons for the ability of the region to limit the economic damage from the recent world financial crisis. However, there is no room for complacency. Corruption and infrastructure shortages remain problems in the region. (Global Economic Prospects, Annex, January 2011.)

World Bank Income Groups

All seven Central American countries are in the World Bank's Middle Income group. Two of them (Costa Rica and Panama) are in the Upper Middle Income category. Mexico is an Upper Middle Income country.

The CAFTA-DR Free Trade Agreement has boosted economic growth in the Central American countries overall since 2004, but it has also increased their trade links with the United States. As the U.S. economy struggles to regain its footing, short-term growth in Central America is restrained.

Fiscal Policy

Despite relatively strong growth in the Central American region and in Mexico, the fiscal position has weakened. Revenue growth has been weak in most countries. In El Salvador, Honduras, and Nicaragua, the fiscal balance improved in 2010 after spending cuts more than offset the revenue weakness. In most other countries, the fiscal deficit of the central government widened.

In Nicaragua, the fiscal deficit is modest but is likely to increase somewhat as expenditures increase in advance of national elections in November 2011. In Guatemala, tax revenues during the first half of 2011 were stronger than expected, enabling the country to narrow its budget gap this year.

After a fiscal stimulus in 2009, Mexico has been tightening its policy stance and restraining spending. The government has set a goal of reducing public sector borrowing requirement to 2.5 percent of GDP in 2012. As the OECD and other institutions have noted, Mexico needs to diversify its revenue sources away from a reliance on oil revenues. In periods of economic upturn, the country should also consider building up a stabilization fund to cushion the inevitable downturns.

Monetary Policy

Countries in the region are generally pursuing accommodating monetary policies, with recent stability in international food and oil prices facilitating the goal of lowering inflation in some of the countries. The central bank in Guatemala raised its policy rate in July 2011, but at five percent it remains at an accommodating level. Guatemala had brought its benchmark interest rates down sharply in the first part of 2009 in order to foster an economic rebound.

Nicaragua's central bank is using relative currency stability and targets for monetary aggregate growth to keep inflation in check. Credit growth is being constrained by the regulatory uncertainty facing commercial banks, reflected in wide interest rate spreads.

El Salvador's economy has been fully dollarized for several years, leaving the central bank with regulation of the banking system as its main policy focus. Interest rates at commercial banks should be flat or lower this year and next, according to the Economist Intelligence Unit (September 2011), before rising in 2013 as the economy picks up speed.

Real GDP Growth Rates, 2010	South America 6.2%	**Mexico 5.5%**	**Central America 3.7%**	Caribbean 3.4%

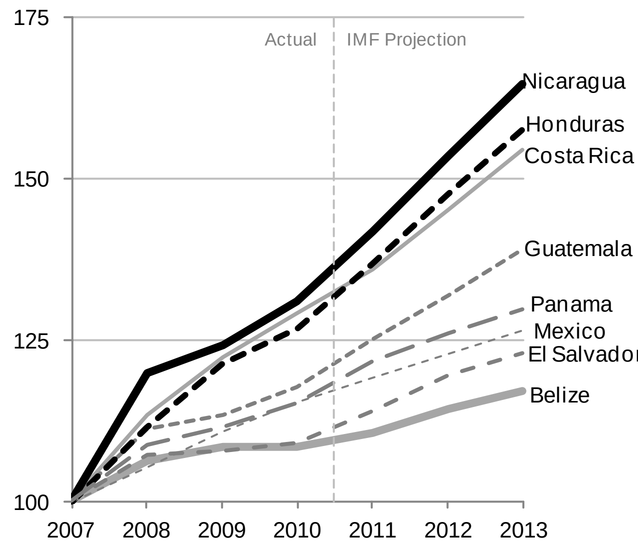
Inflation

Overheated economies and rising inflation are increasingly seen as risks to the region. Stronger exports and capital inflows have boosted exchange rates throughout the Latin American region. In those Central American countries where the currency has faced relatively less upward pressure, and where monetary policies remain expansionary, the IMF (April 2011) recommends a policy shift to stay ahead of the curve and thwart overheating.

The three Central American countries currently facing the least inflationary pressures—El Salvador, Panama, and Belize—are also the countries with the least inflation over the past decade. El Salvador's dollarization program has helped it to achieve an inflation lower than the regional average.

The other four Central American countries, as a group, have been less able to tame inflation, either now or in the recent past. In Guatemala, the central bank's target band of 4–6 percent inflation will be exceeded by a modest amount both this year and next. Heavy rainfall so far in 2011 has caused shortages of domestic supply in Guatemala and exerted upward pressure on prices. Nicaragua is having even less success at lowering inflation, with the rate expected to exceed eight percent in 2011 despite a moderation in price pressures in the first half of the year.

Consumer Prices (2007 = 100)



SOURCE: IMF, *World Economic Outlook*, September 2011.

Generally Low Inflation

Recently low inflation: Mexico and five of the Central American countries had inflationary periods during the 1990s, with at least one year with an inflation rate exceeding 20 percent. In contrast, the past decade for those six countries has been much less inflationary.

Consistently low inflation: Two Central American countries (Belize and Panama) always kept inflation below 9 percent during the past two decades.

In contrast to most other countries in Latin America, the economic slowdown in 2008–2009 had only a very mild impact on Mexican inflation. Had inflation been tamed more effectively, the resultant gains to real wages and to export competitiveness would have accelerated the current economic expansion.

Consumer Price Inflation, 2011 (projected)	South America 8.8%	Caribbean 7.7%	**Central America 5.4%**	**Mexico 3.6%**

Banking and Financial Sector

Over the past decade, Nicaragua has achieved the largest expansion of domestic credit (relative to GDP) in the region. But its domestic credit ratio was the lowest in the region in 2001 and remains close to the lowest in the region despite approximately doubling during the period.

Although Panama's index shows a decline over the period, it remains the Central American country with the highest level of domestic credit. El Salvador, by contrast, shows a flat index over the period and the level of domestic credit is about average for the sub-region.

Like many countries in Latin America, the Central American countries have relatively low levels of domestic saving and underdeveloped private capital markets. Those factors increase the economy's reliance on credit from the international financial system. (OECD Latin American Economic Outlook 2011.)

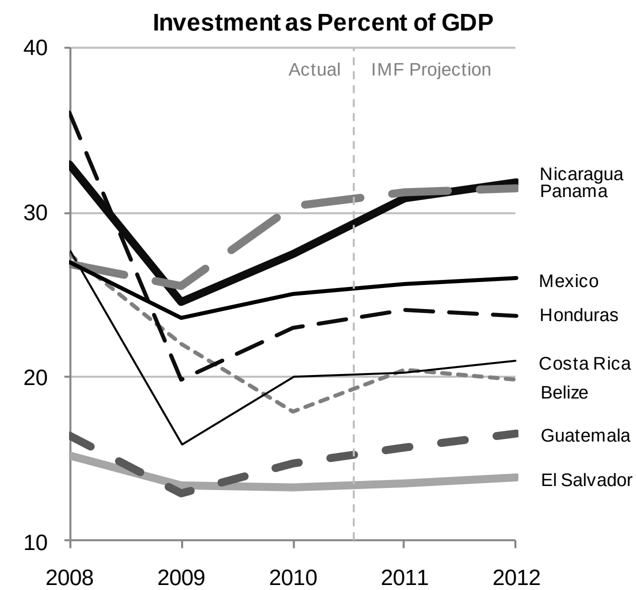
In Mexico, loan loss provisioning requirements helped to spark a consumer credit boom in the first part of the last decade. Commercial banks were tamping down credit growth even before the world financial crisis hit. Mexico has changed its provisioning requirements to make them more counter-cyclical and has established a Financial System Stability Council to reform the diverse segments of its financial system.

Investment

As was the case in other sub-regions in LAC, the Central American countries generally posted lower rates of capital spending for 2009, as the world economy slowed. The decline in investment was sharpest in Honduras, Costa Rica, and Nicaragua. All three countries have bounced back during the past two years, but only Nicaragua is estimated to have raised investment spending close to its pre-slump level.

Mexico, with one of the highest investment ratios in the LAC region, had only a modest decline in 2009. Overall, the share of investment in GDP has been relatively steady in recent years.

Over the past decade, Panama has posted the best record on increasing its investment spending. Guatemala, El Salvador, and Belize have lagged the other Central American countries.



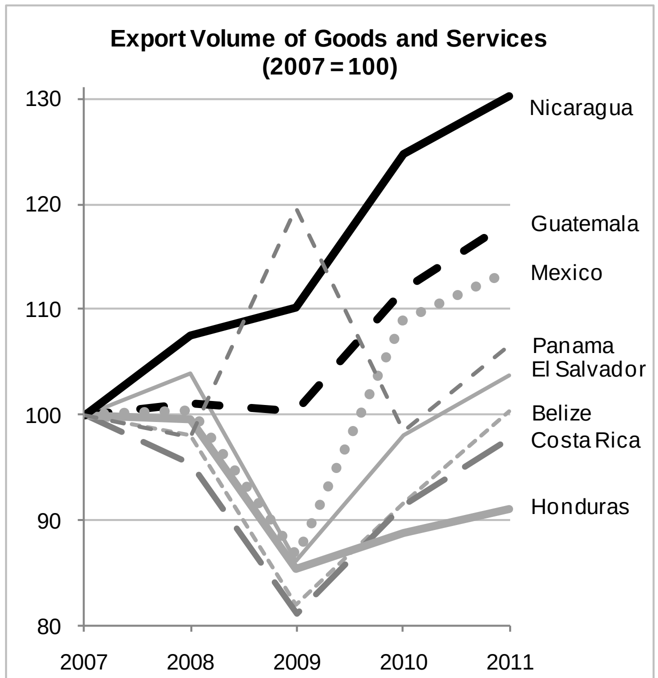
SOURCE: IMF, *World Economic Outlook*, September 2011.

Over the next few years, Central America should continue to attract private capital flows from foreign investors, according to World Bank projections. The investment trends are expected to improve in the medium term.

Investment as a Percent of GDP, 2010	**Mexico 25.7%**	South America 21.0%	**Central America 19.8%**	Caribbean 17.7%

Trade

Most of the countries in the region experienced a drop in export volumes in 2008 and 2009. The impact of the slowdown in world economic growth did not spare Mexico and Central America. However, most countries have benefited from a sharp rebound in trade over the past two years.



SOURCE: IMF, *World Economic Outlook*, September 2011.
NOTE: 2011 values are projections.

Nicaragua and Guatemala were able to buck the general trend (see graph), with exports either steady or sharply rising each year. Panama's trade has also not been in sync with the region, but not always in a positive way. Panama's exports dropped slightly once the world recession hit, spiked upward in 2009 and then plunged in 2010.

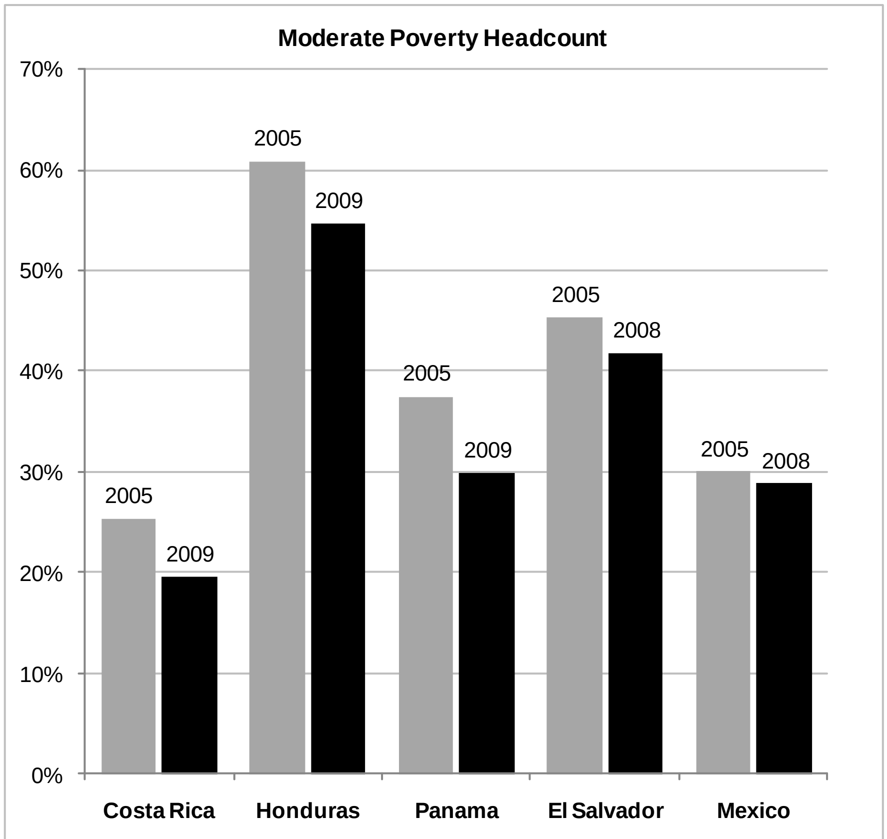
For all the Central American countries, the share of intra-regional trade continues to rise over time. The IMF (April 2011) reported that the Central America and Dominican Republic region trades more within itself than do the other LAC subregions. However, the region also has significant ties to high-income countries, particularly the United States, where continued sluggish growth is constraining Central America exports, remittances, and tourism.

Mexican exports are mostly driven by demand from the United States, its largest trading partner. The volume of exports of goods and services in Mexico is projected to expand by an average of about eight percent this year and next, but being associated with sluggish U.S. economic growth means downside risks.

Percentage Change in Export Volume of Goods and Services, 2010	**Mexico 14.2%**	South America 8.5%	**Central America 7.4%**	Caribbean 5.5%

Poverty Reduction

The recent world financial crisis and economic slowdown raised the number of poor in Central America, but on a notably smaller scale than in previous economic slumps. Country experience varied. The World Bank (October 2010) reported that in Panama, where per capita GDP continued to grow during the period and the unemployment rate dropped, the income distribution became less unequal. The lowest income groups increased their incomes faster than other groups. In Honduras, per capita income fell, but the income distribution also became less unequal. Honduran low income households had a smaller drop in income than other groups. In Costa Rica, per capita income declined and unemployment rose sharply. Income distribution got more unequal, but poverty did not increase. In Mexico, the poverty rate increased in 2008 and 2009 as economic growth was hit hard, diminishing its progress against poverty.



SOURCE: World Bank, October 2010.

Progress on Human Development

Three of the Central American countries, along with Mexico, are rated as achieving "High Human Development" in the latest Human Development Index (UNDP): Costa Rica, Belize, and Panama. The other four are rated as "Medium Human Development:" El Salvador, Guatemala, Honduras, and Nicaragua.

Despite the short-term reversals in some countries, the general pattern since 2005 has been lower poverty rates (see graph). The World Bank estimates that poverty rates in Central America generally declined in 2010, but that the regional average remained above the pre-crisis level.

Additional Information

For country-specific data and additional information about the countries covered in this report, please visit the EADS Country Portal at http://esdb.eads.usaidallnet.gov/query/do?_program=/eads/esdb/countryPortal.

Sources used in compiling this report include the semi-annual *World Economic Outlook* from the International Monetary Fund (http://www.imf.org/) and the *Global Economic Prospects* from the World Bank (http://www.worldbank.org/).