



British Embassy Panama City

British Embassy
Panama City, Panama

Tel (507) 297-6577
ben.myers@fco.gov.uk

CENTRAL AMERICA QUARTERLY ECONOMIC REPORT JULY 2012

From Ben Myers, Regional Prosperity Officer

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Central America Highlights

- Central American trade ministers sign the Association Agreement with the EU.
- Panama starts sovereign wealth fund; but reveals \$400 million hole in the budget.
- Costa Rica makes formal application to the OECD.

Regional:

1. **The governments of Central America formally signed off on the Association Agreement with the European Union in June.** The ceremony took place during the 35th SICA Conference in Tegucigalpa, Honduras. The Agreement covers three pillars: political, cooperation and trade, comprising Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica and Panama. The Trade Pillar will automatically come into force in each of those countries once its assembly has ratified the Agreement.
2. **For Central American countries the deal is a chance to increase exports of agricultural products, diversify trade away from the US and attract more investment to support development.** It is heavily weighted in their favour. Bananas, sugar, tuna, rum, rice and textiles will have better access to EU markets than under the Generalised System of Preferences. Currently around 75% of regional exports to the EU come from Costa Rica.
3. **The Agreement also commits Central American governments to push forward regional economic integration.** This includes the harmonisation of tariffs and customs procedures. Goods entering circulation in one country will have free access across the region. Central American countries hope to promote the region as a single market of over 40 million people and combined GDP of \$167 billion, encouraging greater foreign direct investment. On the same day Panama officially entered SIECA, the region's economic grouping, as part of this process.

4. **Central America is one of the happiest places on earth, according to the New Economics Foundation.** The Happy Planet Index, which takes into account environmental concerns as well as traditional measures of happiness, revealed that Costa Ricans are the happiest people on earth. Other Central American countries fared well, with El Salvador (5th), Panama (7th), Nicaragua (8th), Guatemala (10th) and Honduras (13th) all ranking highly.

Panama

5. **Panama has joined the list of countries possessing a Sovereign Wealth Fund.** The Fund will manage the additional income generated by the Panama Canal expansion, which is expected to raise an extra \$1 billion per annum in profit. A further \$1.3 billion raised in earlier privatisations of telecoms and utilities will act as seed capital. The "*Panama Savings Fund*" will be called on in the event of an economic slowdown or natural disaster, and is expected to reach a value of \$11.5 billion by 2025. An international tender to manage its assets is expected before the end of the year.
6. **Economy and Finance Minister, Frank de Lima, has revealed a \$400 million hole in the annual budget.** The government had been counting on the sale of public shares in its joint venture with Cable and Wireless to fund its spending targets. But large-scale opposition forced a shelving of that plan, meaning that either new revenue must be found or that spending will be cut. Megaprojects such as the canal expansion and metro are unlikely to be affected. De Lima reaffirmed the (revised) 2.9% deficit target for this year. But a report by UBS questioned the government's commitment to fiscal responsibility, stating that "*risks may be rising compared to other high-grade credits in the region*". Several commentators have queried the potential impact on Panama's investment grade, vital to the country's borrowing and growth plans. Standard and Poor's disagreed, raising Panama's credit rating up one notch to BBB.
7. **Panama expects economic growth of 10% this year following faster-than-expected activity in the first three months of the year.** The Economist Intelligence Unit now expects an expansion of 8.9%, up from the 6.0% previously forecast.

Costa Rica

8. **Costa Rica has formally submitted an application to join the OECD.** President Chincilla stated Costa Rica's interest at the OECD Forum in April, and has now written formally to OECD Secretary-General to confirm. Costa Rica hopes membership will help it modernise its public sector – the latest World Bank *Doing Business* survey showed how excessive bureaucratic procedures hinder competitiveness. Commentators noted, however, that Costa Rica remains some way off a welcome into the club.
9. **Costa Rica's fiscal plan failed in the Constitutional Court in April after significant opposition.** The country has the largest fiscal deficit in Latin America at around 4.4%. The reforms had aimed to reduce the deficit by 1.5 percentage points by increasing the tax base. But the opposition and private sector demanded greater reductions in government spending as part of the bargain. The Government has now acknowledged this. New minister of finance, Eduardo Ayala, announced a strategy to tackle the precarious fiscal situation which includes spending caps, as well as swapping domestic

for foreign debt. Whilst agreeing with the policy, the Central Bank warned that international borrowing prices might be higher than expected so long as the deficit issue remains unresolved.

Guatemala

10. **Guatemala has launched a National Competitiveness Strategy aimed at attracting investment and boosting exports.** This follows an early success for the then new government in implementing a fiscal reform – Guatemala’s first in 15 years – that will reduce the deficit to 2.4% of GDP in 2013, from 2.8% last year. The competitiveness plan includes reforms to the business environment, such as improvements in regulation and the development of export-oriented infrastructure, as well as increasing opportunities in the mining and energy sectors. Each ministry has its own set of specific targets, with a vice-minister for competitiveness charged with overseeing delivery. Some measures are likely to encounter opposition, particularly from militant peasant groups.
11. **Elsewhere the Pérez Molina administration has been frustrated in its efforts to advance its legislative programme.** Bills that have been delayed in Congress include measures to improve transparency in public administration and reduce pervasive corruption at all levels of government.
12. **After a gap of eight years, Guatemala returned to global bond markets in May with a successful issuance of \$700 million of ten-year bonds.** Demand was unexpectedly strong. The interest rate of 5.75% was well below the 8-10% rates on previous Guatemalan bond issues, and lower the rates faced by Spain and Italy at that time.

El Salvador

13. **The IMF has temporarily suspended the availability of emergency funds worth \$785 million because it has not met agreed targets.** A reported budget deficit of \$906 million in 2011 was £200 million higher than the terms stipulated in the agreement. An IMF statement said the government recognised “the importance of further strengthening El Salvador’s fiscal position through expenditure restraint and higher fiscal revenues.” It is widely expected that the country will seek to renegotiate the terms of the deal in order to maintain the IMF relationship until at least 2014. El Salvador has struggled to reduce spending due to high subsidies and an inefficient pension system, something the government will find difficult to change as the pre-election period draws nearer, despite a commitment to reduce the deficit to 2.7% of GDP. Instead, more borrowing is expected. Thirty years of budget deficits mean that public debt has risen to 50% of GDP, while interest payments are worth 2% of GDP.

Dominican Republic

14. **Danilo Medina of the ruling PRD party won presidential elections in May, securing a third consecutive term for his party.** Little change in economic policy is expected. Chief priorities will be to promote economic growth and job creation whilst tightening fiscal policy. The government is expected to seek a new agreement with the IMF to prevent erosion in investor confidence and increase access to external financing. The previous stand-by-arrangement expired in February with \$500 million left undisbursed.

15. **Medina's immediate challenge is to tackle the fiscal deficit.** A spree of pre-election spending has resulted in a deficit worth some 2.8% of GDP. This year's budget is already exhausted, and debt repayments account for around two fifths of government income. An unrealistic deficit target of 0.9% was set late last year based on expected cuts to electricity subsidies, as stipulated by the IMF deal. However, the superintendent of electricity disclosed in May that subsidies had already reached 69% of the total allotted in the annual budget in its first five months.
16. **The Central Bank decided to reduce the policy rate by three quarters of a point to 6% in May.** It had previously been at 6.75% since May 2011. The annual inflation rate was just 4% in April, compared with 8.2% a year earlier and well below the central inflation target of 5.5% for end-2012. Analysts noted that with the election out of the way and external environment uncertain, the authorities are trying to support growth.

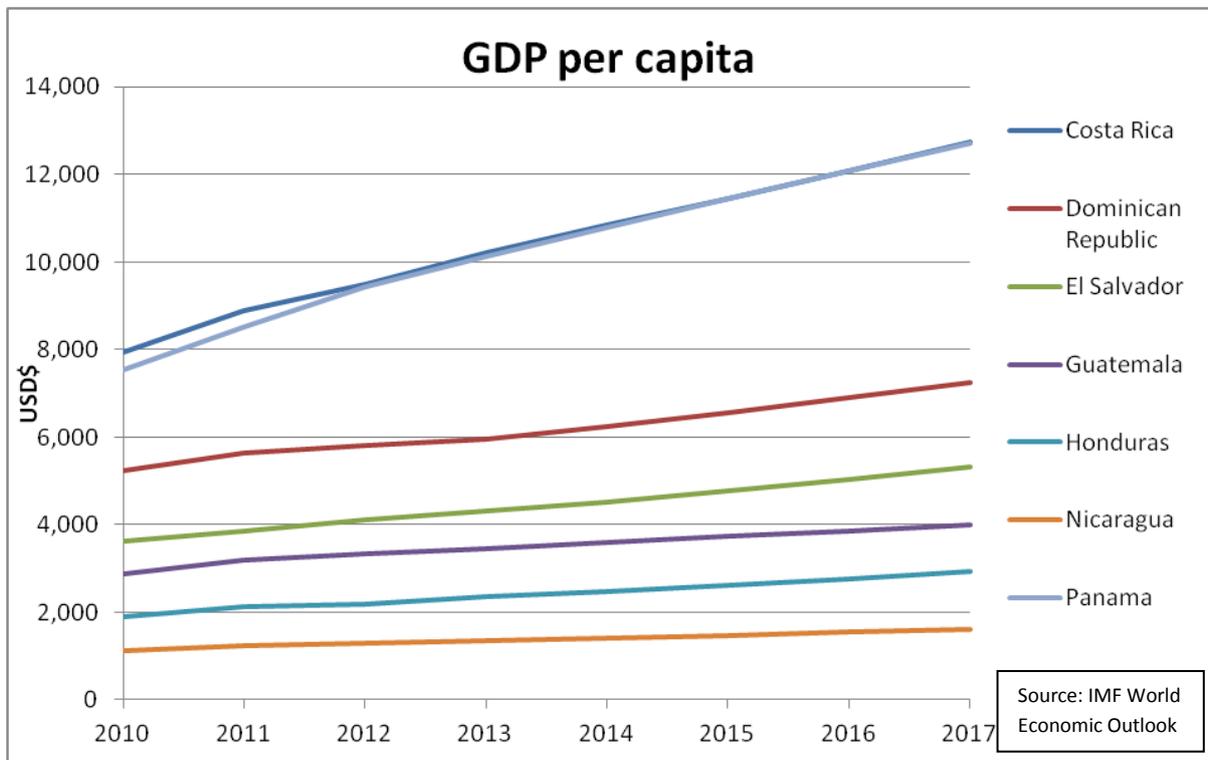
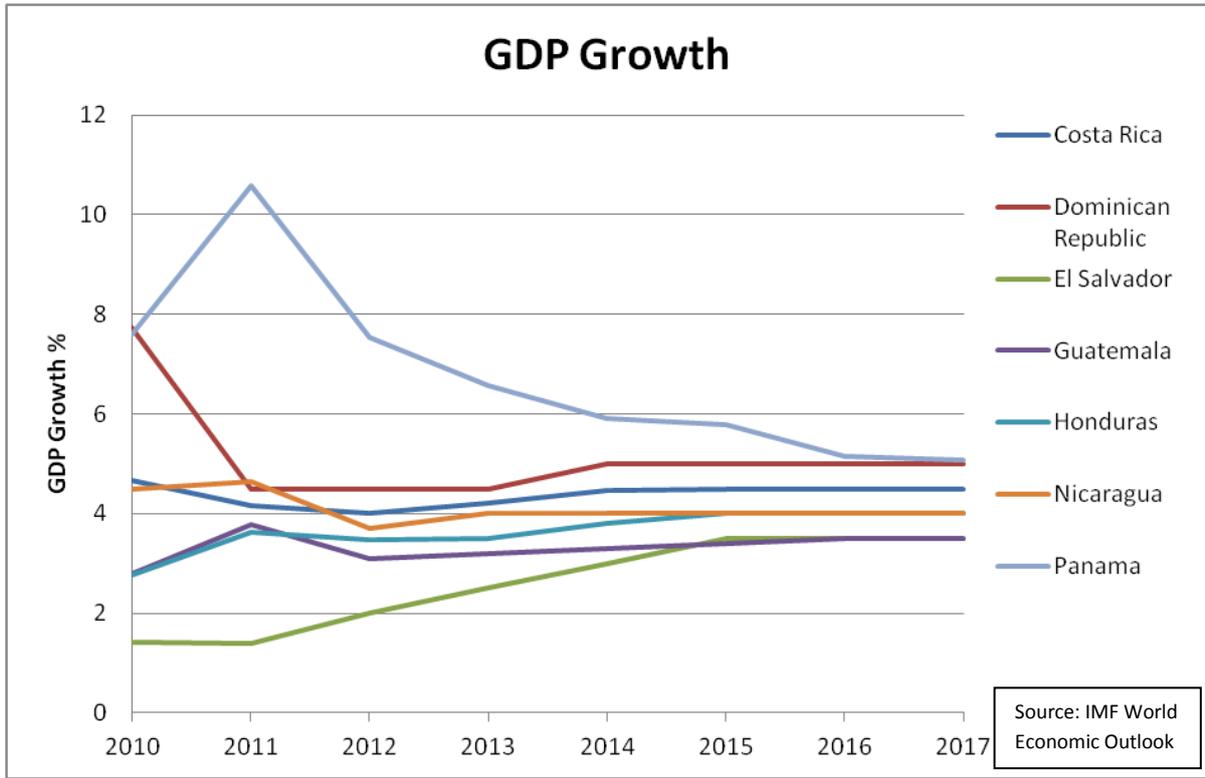
Nicaragua

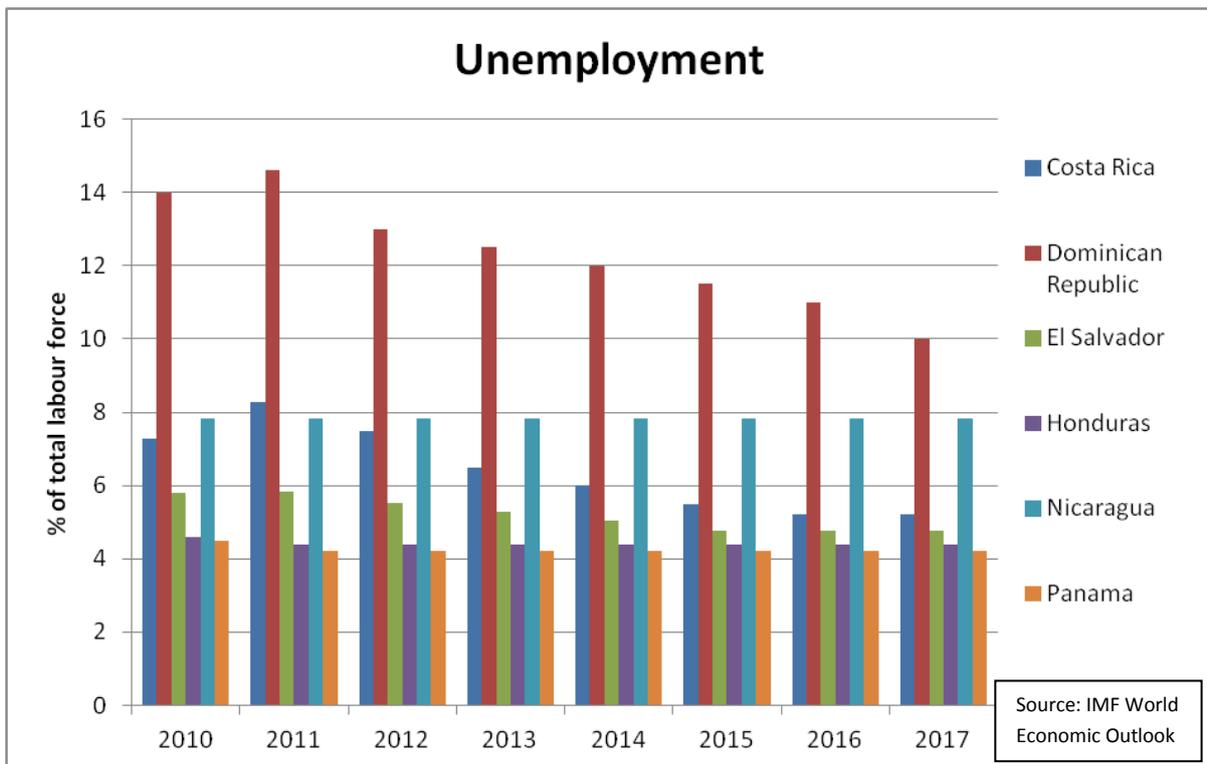
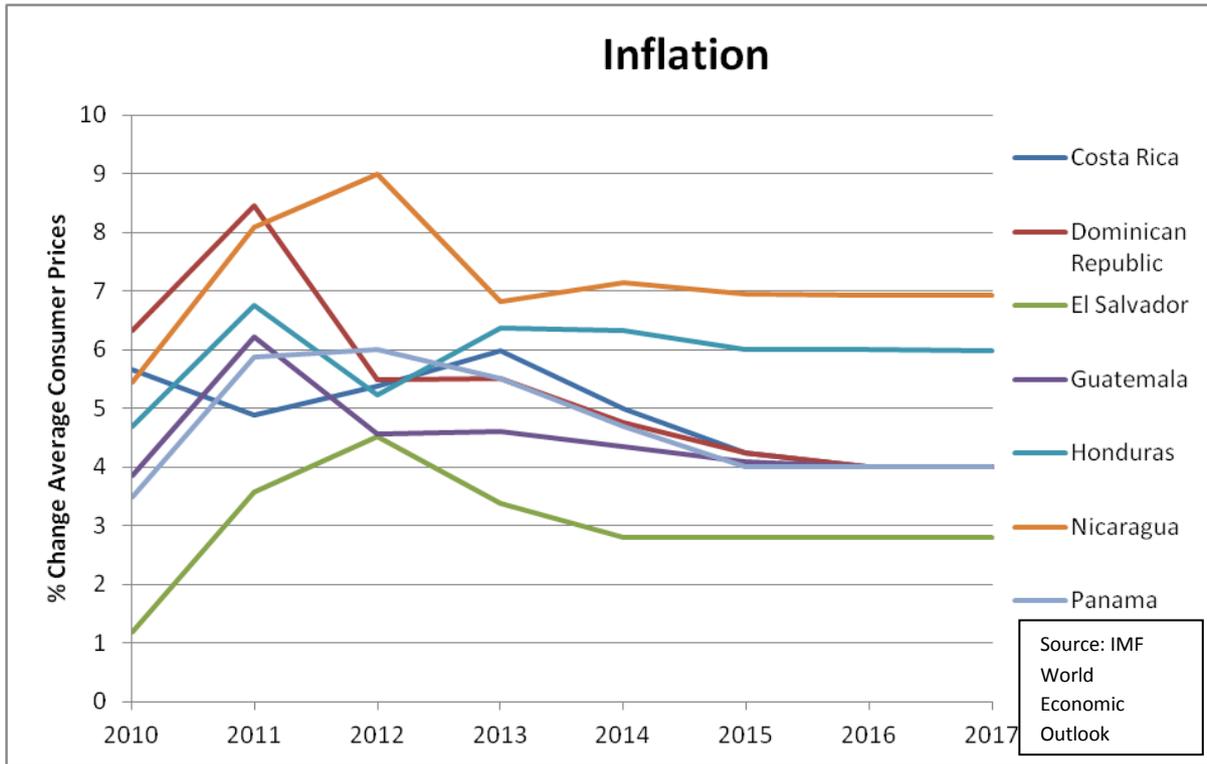
17. **The IMF stated that the macroeconomic outlook for Nicaragua was generally positive, despite slowing growth on the back of weaker global activity.** Following Article IV consultations, the Fund praised Nicaragua's commitment to sustainable public finances – Nicaragua secured a surplus of 0.6% of GDP last year. Nevertheless, Directors underscored that important macroeconomic and structural challenges remain to be addressed, including widespread poverty and large external imbalances. It stressed the need for institutional strengthening, tackling of energy sector weaknesses, a reduction in labour market informality and improved effectiveness of public spending. A four year Extended Credit Facility expired in 2011 and the government hopes to sign a new agreement by the end the year.
18. **Venezuelan aid and trade flows to Nicaragua add a percentage point annually to Nicaragua's GDP growth rate, according to a local study.** The report estimated that under a scenario where all Venezuelan assistance (\$565 million in 2011) was abruptly eliminated, the negative impact upon GDP growth could be as much as 3.2%.

Honduras

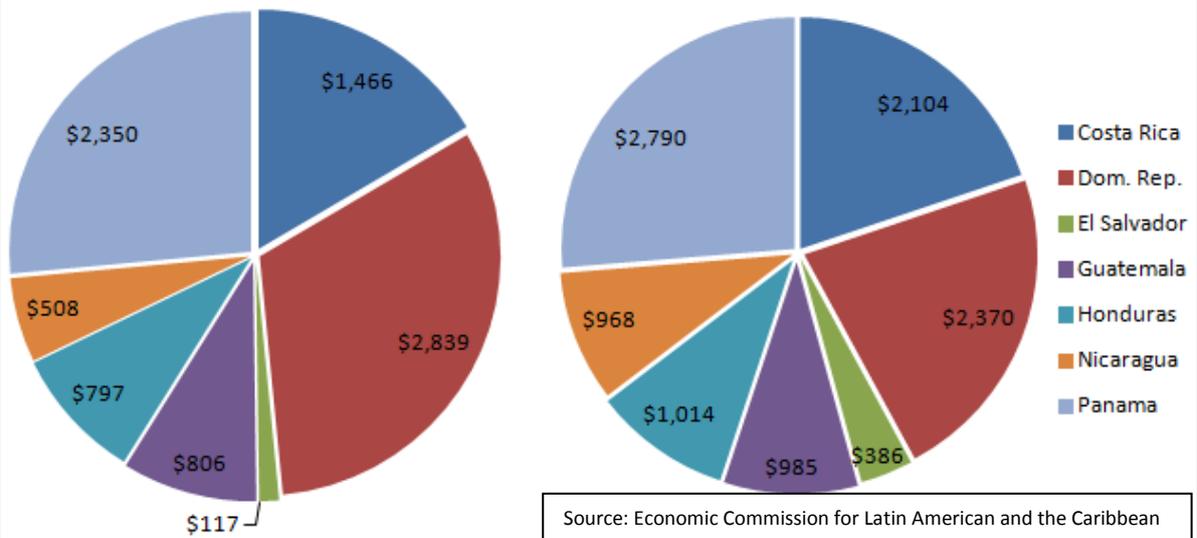
19. **Honduras remains in negotiations with the IMF over a new stand-by arrangement, after the last one expired in March.** The new deal is expected to broadly follow the targets set in the previous agreement, which helped restore Honduras' international standing after the 2009 coup d'état. The IMF has however requested a series of new measures focused on: more transparent public debt; better planning around risks associated with new PPP projects; more controlled spending in response to natural disasters and on security reforms; and a reduction in public spending on wages and salaries, especially teachers.
20. **New mining laws under discussion will establish a legal framework that would jump-start mining activity.** Honduras has seen its mining sector stagnate as a result of legal uncertainty and weak institutions. The industry is estimated to have missed out on exporting \$3 billion in metallic minerals in 2011 alone.

Major Economic Indicators





Proportion of FDI Attracted 2011 (millions)



Goods Trade with the UK in 2011 (millions)

