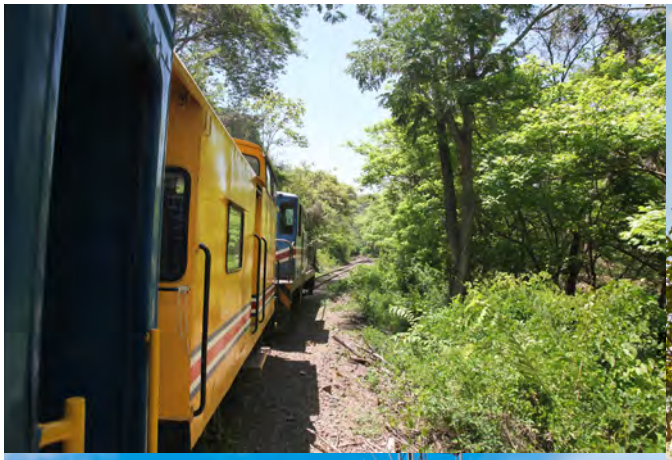
CABEI
Central American Bank for Economic Integration

OMFIF

CENTRAL AMERICA

Resilience, recovery and sustainability



About the Central American Bank for Economic Integration

The Central American Bank for Economic Integration (CABEI), is an international multilateral development financial institution. Its resources are continuously invested in projects that foster development to reduce poverty and inequality; strengthen regional integration and the competitive insertion of its member countries in the global economy; providing special attention to environmental sustainability.

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About OMFIF

With a presence in London, Singapore, Washington and New York, OMFIF is an independent forum for central banking, economic policy and public investment – a neutral platform for best practice in worldwide public-private sector exchanges.

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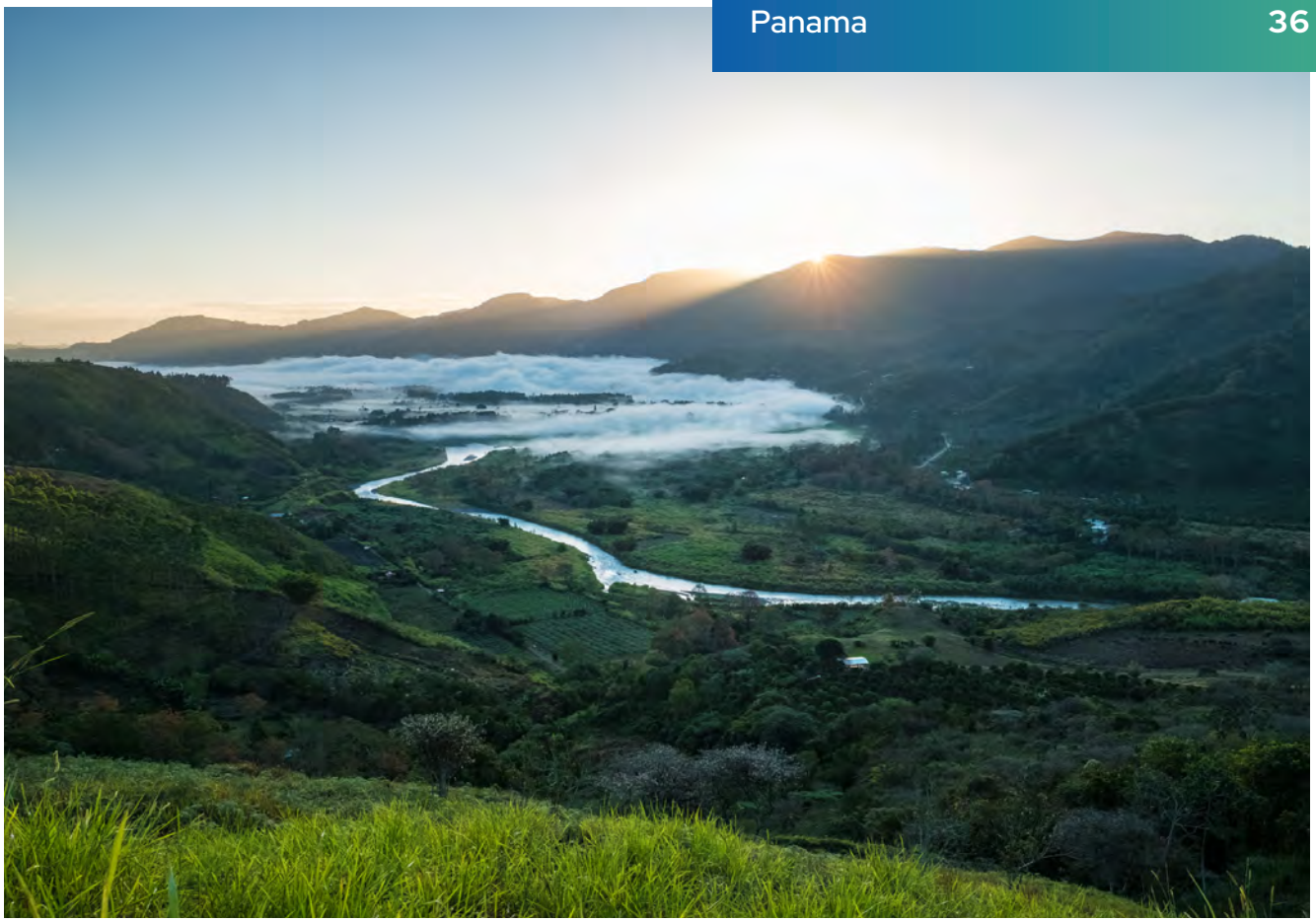


FOREWORD

OPEN FOR BUSINESS

As the region recovers from the Covid-19 pandemic, Central America is well-positioned for extra-regional trade, which will boost development in key areas such as climate mitigation and transport.

Dante Ariel Mossi Reyes, Executive President, Central American Bank for Economic Integration

THE Central American region has made significant progress in terms of economic and social integration in the past 60 years. Despite its high vulnerability to financial, economic, climate and health-related events, the region has moved closer to achieving its long-held goal of integration. This has led to higher economic growth over the past five years compared with other economic blocs. This has enabled the region address the Covid-19 pandemic and be better prepared for a stronger recovery.

The 'Central America: Integration, investment and trade opportunities' report presents relevant, updated information on the region structured in five pillars: a macroeconomic overview; commerce, external trade and foreign direct investment; integration; finance, tax and transparency; and sustainable investment.

This is the first of a series of reports that will share key insights on the region. It will provide valuable information for stakeholders, including government entities in the Central American region; governments with political, economic, and social interests in the region; the donor community; international financing institutions; and local, regional and international investors to make data-driven decisions. Thus, the report is meant to be a tool for anyone who is interested in doing business in Central America.

The Central American Bank for Economic Integration is proud to be part of this initiative. As the financial arm of the Central American region, CABEI will continue working and collaborating with its member countries, the private sector and the international community to fulfil its mission of a balanced economic and social development in the region.

After 60 years since its creation, CABEI is committed to its pivotal role in linking the opportunities of the Central American region with the world. Through its efforts, it continues to improve the region's competitiveness in global markets and create favourable, innovative investment climates in its member countries.

EXECUTIVE SUMMARY

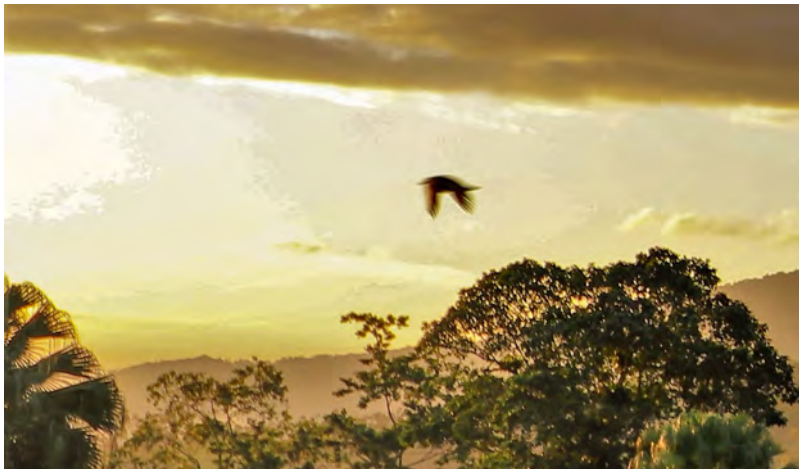
Central America set to recover faster than rest of Latin America and the Caribbean

WITH THE GLOBAL economic rebound from Covid-19 well under way, Central America is set to recover at a faster rate than most countries in Latin America and the Caribbean. The region is poised to take advantage of accelerated trends in the digital economy and the greater investor focus on sustainability projects that are highly valued by the markets as a result of the pandemic.

Integration is key to unlocking Central America's potential. New regional initiatives in financial markets, transport and energy look set to further cement close ties between the most integrated economic bloc in the Americas. Last year's report highlighted the potential for sustainable investment, and the development of several high-profile projects in the past 12 months has reiterated that Central America is a leader in this area.

This report covers the eight countries that make up the Central American Integration System: Belize, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua and Panama. It presents a detailed view of the region through six pillars: macroeconomic overview; sustainable investment; commerce, external trade and foreign direct investment; financial integration; digital economy; and integration. Each pillar examines where Central American nations stand in the respective areas, highlighting flagship projects and trends that demonstrate potential while identifying where improvement is required.

In its second edition, the report is expanding with the introduction of a new pillar that explores the digital economy in the region. The inclusion of this pillar is a reflection of the enormous opportunity that technological advancement represents for Central America.



MAIN FINDINGS

Impressive economic recovery

Central America is enjoying an above-average recovery in 2021, thanks to close links with the US economy, resilience in remittance flows and solid progress in vaccinations in much of the region. Economic output in the Dominican Republic, Guatemala and Nicaragua will return to pre-pandemic levels by the end of 2021. Central America is also likely to outperform expectations in the medium term, with regional growth predicted to average over 4% between 2022-26.

However, even faster growth is needed to improve prosperity and tackle vital social issues exposed by the pandemic. Governments' crisis exit plans and efforts to increase investment in the economy will be key to this. With the average external public debt to GDP increasing over 9 percentage points in 2020, Central American authorities will need to ensure they return to more sustainable debt ratios.

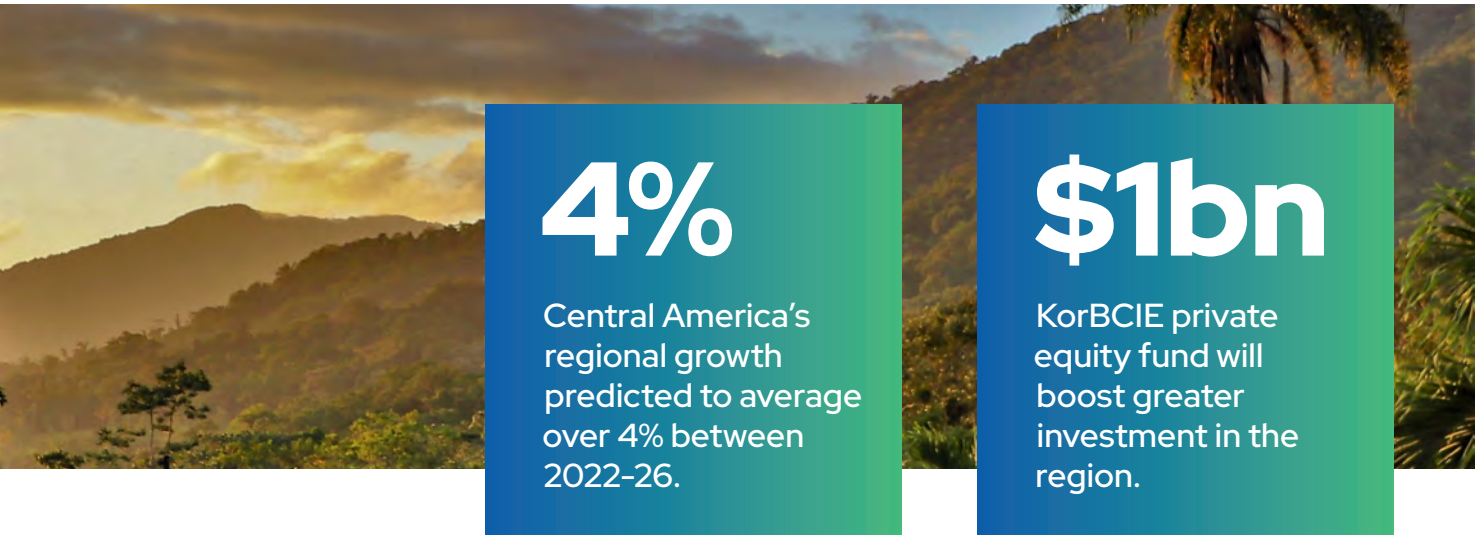
Sustainable projects attracting capital

Though Central America is not a significant contributor to climate change, its economies are vulnerable to extreme weather events. The region is therefore doubling its efforts on mitigation and adaptation policies to make its economies more resilient. The region has unique post-crisis potential with many opportunities for sustainable investment.

This year's approvals for funding from the Green Climate Fund include plans to combat deforestation in Nicaragua, increase adaptation efforts in the region, strengthen the resilience of the arid zones in the Dominican Republic and build the electric railway in Costa Rica. Belize's innovative blue bond restructuring, which reduces the country's debt burden and channels funding to marine conservation, was praised at November's COP26 conference, highlighting the region's ability to develop attractive projects for climate finance.

More foreign investment to diversify economies

Despite a worldwide slowdown in foreign direct investment in 2020, some economies in Central America continued to attract a healthy inflow of investment. Higher levels of FDI will be vital for Central America to increase productivity



levels and growth potential. The $1bn KorBCIE private equity fund is likely to be a catalyst for greater equity investment into the region, while the US has also made private sector investment in the Northern Triangle countries a priority.

While Central American export volumes were hit by the pandemic, the travel service sector accounted for almost all of the slump, given the collapse in international travel. However, the outlook looks bright for the region's exports, which are already posting significantly higher volumes in 2021.

The nearshoring phenomenon makes Central America a strategic destination for supply chains to the US. Costa Rica is already showing what is possible after a dedicated effort to diversify the economy and the country is – for its size – a leader in attracting FDI. Costa Rica also has the most complex export basket in the region.

Regional debt market will increase financial resilience

Liquidity in the region's banking sector was boosted by greater deposits and a decrease in the demand for credit, while the capital adequacy ratios deteriorated – albeit modestly and they remain well above international standards. The deterioration in the quality of banks' credit portfolios has been mild as a result of government policies to support borrowers.

To further improve financing options for both private and public sector entities, Central America is working to deepen its capital markets. CABEI's project to build a regional public debt market will offer governments attractive alternatives to the more expensive and volatile international bond markets. The Central American regional investment fund is a key part of the regional debt market initiative aimed at immersing international investors into Central American capital markets.

Digital sector offers unrealised potential

Investment in digital infrastructure and services can be transformative in Central America, where societies embraced the digital revolution during the pandemic. Continuing to build on recent progress in coverage will be the building block for increasing investment in telecommunications and the digital economy

Rapidly accelerating online transactions involving both the public and private sectors indicate that the region is stepping further into the digital arena. Digitalising administrative processes will make economies more efficient and reduce costs. Initiatives such as the Central American Digital Trade Platform, which enables interoperability between customs and other border entities, show how the region is using digital tools to facilitate trade.

Central America is also home to one of the most intriguing initiatives in cryptocurrencies. El Salvador has made bitcoin legal tender with the potential to drastically reduce the cost of sending remittances.

Gaining through greater integration

Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica and Panama would together form the sixth largest economy in Latin America. As Latin America's most integrated economic bloc, these nations have realised they have much to gain through greater regional integration.

Important infrastructure projects are in the pipeline and integration efforts in the energy sector are a priority. The focus is on increasing the supply of natural gas as part of the transition away from fossil fuel energy sources.

The reactivation and integration of national railway systems aims to benefit supply chains, improve trade efficiency, cut costs and reduce carbon emissions and road traffic, enhancing Central America's competitiveness in international trade. Feasibility or pre-feasibility studies are underway for potential railroad projects in Costa Rica, El Salvador, Guatemala, Honduras and the Dominican Republic.

The region is working on standardising regional regulatory frameworks to help foreign companies carry out cross-border investments in Central America.

Pillar 1
Macroeconomic overview

Central America set to outpace average global economic growth this year.

CENTRAL AMERICA'S recovery from the Covid-19 pandemic is well under way, with the region's economy expected to expand by 6.9% in 2021, slightly above the global average of 6%. The projected growth is supported by its close links to the US economy, resilience in remittance flows (see box on page 11) and rapidly improving vaccination numbers.

In 2022, economic growth in Central America is likely to be slightly below the global average in 2022, but it should outpace this the following year. Between 2022-26, the world's gross domestic product will grow by an average of 3.6%, while Central America's real economy is likely to expand by an average of 4.1%. It will also outpace the rest of Latin America and the Caribbean, where growth is forecast to be around 2.6% on average during the same period.

Central America is having a stronger recovery than initially estimated. Except for Panama, the International Monetary Fund significantly upgraded its real GDP growth forecasts across the region between the April and October 2021 editions of its World Economic Outlook. According to the latest estimates, GDP in all countries except for Belize, Honduras and Panama will have surpassed their pre-pandemic levels by the end of 2022.

The Dominican Republic has outperformed its peers in Central America with an average growth of 3.3% between 2016-20. It is set for the strongest recovery, after Panama, thanks to a quickly implemented vaccination programme and a rebound in tourism. The Dominican Republic's economy contracted by 6.7% in 2020, and the IMF is predicting a 9.5% growth this year – with room to expand even further – and 5.5% in 2022.

Panama, which was among the top three fastest growing economies in Central America before the pandemic, was hit hard. The densely populated Panama City experienced high Covid-19 fatalities, the country faced simultaneous slumps in tourism, trade and construction and GDP contracted by 17.9% in 2020, leaving the economy smaller than it was in 2015. Still, Panama is forecast to rebound the most in the region, with a 12% expansion in 2021 followed by a strong 5% in 2022.

Belize, which relies heavily on tourism, endured a 14% contraction in 2020. But as international tourism has rebounded, Belize's growth forecast saw the largest upgrades of any Central American economy in the IMF's October WEO, with the Fund upping its 2021 prediction for the Caribbean country to 8.5% from 1.9% in April.

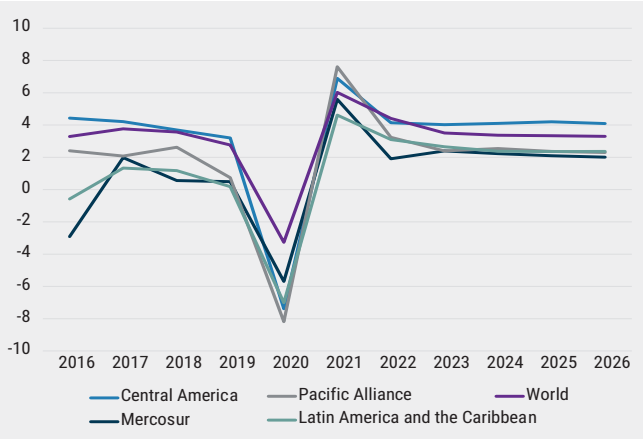
Guatemala's economy proved the most resilient to Covid-19, thanks to fiscal support and strong exports, shrinking by just 1.5% in 2020. This is forecast to expand by 5.5% in 2021 and 4.5% in 2022.

Greater economic activity means the region cannot escape the knock-on impact of inflationary pressures

1.1 Central America economic growth will outpace the region

Real GDP growth, %

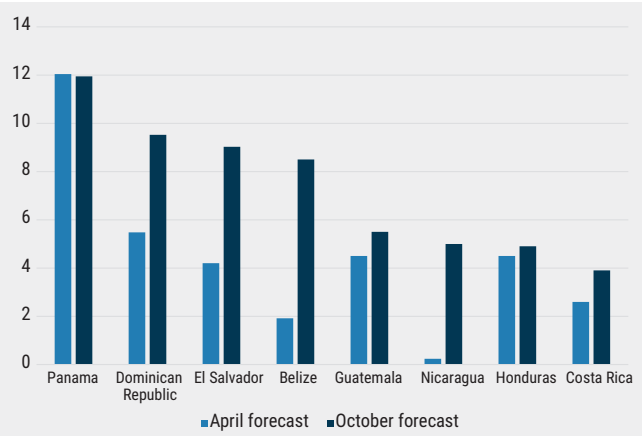
Source: Oxford Economics, OMFIF analysis



1.2 Economies will grow faster than initially expected

Real GDP growth forecast, %

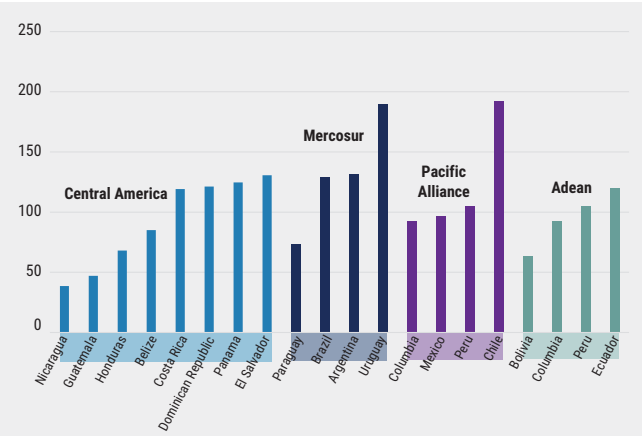
Source: IMF World Economic Outlook, OMFIF analysis



1.3 Vaccination rates in Latin America

Vaccine doses per 100 people

Source: Our World in Data, OMFIF analysis



occurring in the rest of the world. Higher energy prices tend to weigh on the outlook for Central American nations, which are net oil importers. But inflation across Central America was benign in the years up to the pandemic, and though forecasts have risen, the price spike looks set to be largely transitory for most countries.

The Dominican Republic is likely to see the highest increase in inflation, with the IMF forecasting annual price increases of 7.8% in 2021 and expecting inflation to remain above 4.5% in 2022. Guatemala and Honduras are all likely to experience inflation above 4.5% in 2021.

Challenges ahead

Though Central America has shown resilience to the Covid-19 shock, even faster growth is needed to improve prosperity and tackle vital social issues exposed by the pandemic. This year, no country in Central America had a GDP per capita above the global average ($13,722). Panama witnessed the sharpest decline in that metric – to $12,373 in 2020 from $15,831 in 2019. This trend is expected to rapidly reverse this year, with all countries except Costa Rica seeing an improvement in living standards compared to 2020. Costa Rica's GDP per capita is expected to revamp soon after in 2022.

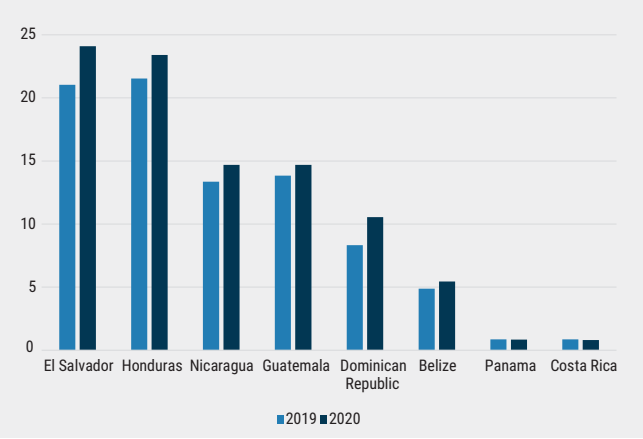
Most developing nations had a slow start to their vaccination programmes, but countries in Central America have been making steady progress in recent months. As of late October 2021, Costa Rica, Panama, the Dominican Republic and El Salvador are the outperformers in the region, with more than 70% of Costa Rica's population receiving at least one dose. In El Salvador, 67% of the population is fully vaccinated. These four Central American countries are among the top 10 nations in Latin America with the greatest percentage of their population having received at least one vaccine.

However, access to vaccines needs to be accelerated in Honduras and Guatemala where less than 40% of the population had received one dose by October, and especially in Nicaragua where this figure is just 14%. Slow vaccination programmes could not only weigh on private consumption, but also

1.4 Remittances contribute more to economic output

Remittances as a share of GDP, %

Source: World Bank



'Panama is forecast to rebound the most in the region, with a 12% expansion in 2021 followed by a strong 5% in 2022.'

increase social and political risks to the economic outlook.

Moreover, the sooner Central American governments can focus their efforts away from managing the crisis towards investment plans in the economy, the greater the long-term effect on growth. Growth trending higher would also enhance the efforts of regional governments to deal with the higher debt burdens left by the pandemic.

Panama, the Dominican Republic and Belize had the highest increases in external public debt to GDP. Panama and the Dominican Republic had a 55% and 48% year-on-year increase in this ratio, respectively. Belize's external public debt ended 2020 at 84.4% of GDP, but it is undergoing a bond restructuring that will lower its burden. El Salvador, the country with the fourth highest external public debt to GDP ratio in the region, is negotiating a programme with the IMF, which could act as a policy anchor, unlock further multilateral funding and put these countries on a smoother path to recovery.

Central American countries could take the opportunity to broaden government revenues, which remain low in comparative terms. A broader tax base would enable greater infrastructure investment and much-needed social spending. US brokerage Stifel notes that in 2020 El Salvador had the highest tax revenues to GDP ratio in the region, at just 18.5%, while all other Central American countries had tax revenues below 15% of GDP.

Furthermore, apart from Panama, which earns revenues from the Panama Canal, over 90% of government earnings in the region come from taxes, leaving budgets extremely vulnerable to economic cycles. On the spending side, apart from Honduras, Nicaragua and Panama, less than 20% of government expenditure is dedicated to capital outlay, making budgets hard to adjust and restricting public investment.

The need to increase the revenue base is particularly important to build buffers against climate events, as the region is particularly vulnerable to these shocks (see Pillar 2).

Capitalising on remittance resilience

Even before Covid-19, remittances had been gaining importance across large parts of Central America. But, after initially falling between March and May 2020, the resilience of remittances since the start of the pandemic has been remarkable and has proven to be a critical buffer to the economic shock by bolstering domestic demand and supporting international reserves and external accounts. Guatemala, Honduras and El Salvador all posted current account surpluses in 2020.

In Honduras, El Salvador, Nicaragua, Guatemala and the Dominican Republic – the five countries in the region where remittances represented over 10% of GDP last year – there was a significant increase in nominal remittances despite the global recession in 2020. As the region's economies contracted, the relative importance of remittances became even larger. Overall, remittances as a share of GDP in Central America and the Dominican Republic increased to 10.2% of GDP in 2020 from 8.8% in 2019, with the ratio improving everywhere except Costa Rica and Panama, where remittances represent less than 1% of GDP.

In El Salvador and Honduras, the two countries where the ratio of remittances to GDP is the highest, it reached 24.1% and 23.5% – increasing by three and two percentage points, respectively, between 2019-20. In El Salvador, Honduras, Nicaragua and Guatemala, remittances inflows are 10 times higher than what these countries receive in foreign direct investment, while across the whole region remittances surpass FDI by five times.

More recently, the IMF noted that remittances across Central America grew 46% year-on-year in the first half of 2021. When compared to pre-pandemic levels, remittance flows in May 2021 were up 47% in the Dominican Republic, 27% in El Salvador and 34% in Guatemala.

Undoubtedly, the US' fiscal stimulus package and rising wages were a major factor driving this remittances surge. But it is important to note that limited travel between the region and the US reduced the transport of remittances in cash, meaning greater flows were noted through formal channels. The question now is whether increased travel between the region and the US will lead to more cash being sent in person, and whether the phasing out of US fiscal stimulus could reduce volumes.

In this respect, CABEI has identified the need to continue to support its members in leveraging these flows, which still have relatively high costs. Possible avenues to work on could be diaspora bonds, improved access to financial services, facilitating mobile money transactions and improving remittance data collection to aid public policy design.

COUNTRY FOCUS:

BELIZE

Belize's outstanding natural beauty, boasting the world's second largest coral reef, has long been the motor of its economy, as tourism generally accounted for around 40% of GDP before the pandemic. But in 2021 the country astutely married its leadership position in conservation with innovative financial engineering.

In November, Belize issued a blue bond through non-governmental organisation The Nature Conservancy that enabled it to repurchase its $526.5m international bond at just 55 cents on the dollar, bringing a substantial reduction in debt. The country was able to do this thanks to a commitment to accelerate marine conservation (see Pillar 2).

The deal is a major boon for the country's outlook. Belize is a small nation with insufficient dollar revenues to justify exposure to international bond markets. Frequent restructurings over the previous 15 years have brought economic uncertainty. The debt that replaces the bond is highly rated (Aa2 by Moody's) as it enjoys a guarantee from the US government-owned Development Finance Corporation, which improves Belize's profile.

After a 14% economic contraction in 2020, Belize's economy is foreseen to grow by 8.5% and 5.4% year-on-year in 2021 and 2022, respectively. The country will exceed its pre-pandemic growth pace, according to the IMF's latest predictions. But challenges will remain.

Moody's believes Belize's debt could linger close to 100% of GDP by 2024, which it calls 'unsustainable'. Structurally the fiscal deficit will only be solved by a shift to primary surpluses – which is likely to require broadening the tax base, as per IMF recommendations – or achieving a higher trend growth.

In this respect, Belize's proactive engagement on sustainability issues is not accidental. It is exceptionally vulnerable to climate change and extreme weather shocks, and increasing its resilience and preparedness is a priority to support a positive growth outlook. To this end, Belize is one of six countries that have been involved in the IMF and World Bank's pilot Climate Change Policy Assessments since 2017.

There is room to strengthen non-tourism sectors, taking advantage of the country's proximity to the US and largely bilingual population (English and Spanish), which has made it a growing market for offshore outsourcing. The country could also attract investments in agriculture and agribusiness. Green energy is another sector with high potential, with Belize looking to increase its already high percentage of renewable energy to 85% by 2030.

Macroeconomic indicators

- GDP growth: -14.0%
- GDP per capita: $4,077
- Inflation: 0.1%
- Unemployment rate: 13.7%
- Public external debt to GDP: 84.4%
- Public deficit: 10.7%

Trade indicators

- FDI inflows: $76m
- Total exports in 2019: $639m
- Free trade agreements: 2

8.5%

Belize's economy is foreseen to grow by 8.5% in 2021 and 5.4% in 2022.

COUNTRY FOCUS:

COSTA RICA

Costa Rica leads in many aspects of economic development, with a more sophisticated export basket, a varied portfolio of growth drivers, the established presence of several multinationals, from Amazon to Microsoft, and GDP per capita several times higher than the Northern Triangle nations.

As a marker of this development, in May 2021 the OECD welcomed Costa Rica as its 38th member – the first from Central America and only the fourth from Latin America. This required significant reforms, including competition policy and a redesign of the national statistics system.

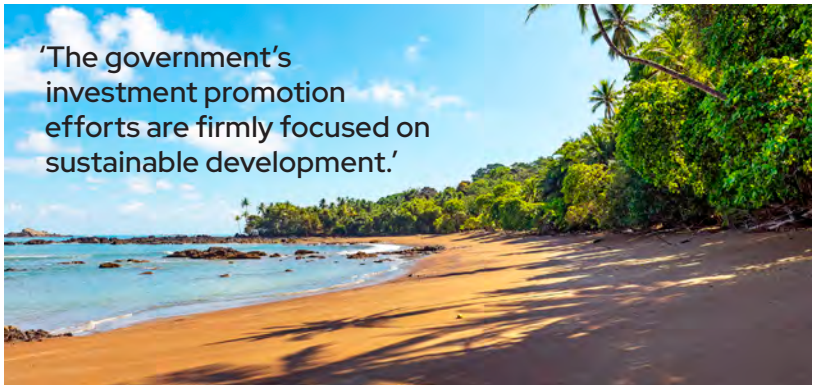
Despite Costa Rica's large tourism industry, the pandemic-induced contraction in GDP was relatively mild at 4.1%, thanks to the outperformance of sectors such as medical devices. However, it will undergo the meekest rebound of anywhere in Central America, with the IMF forecasting 3.9% growth in 2021 and 3.5% in 2022.

There is a risk that progress stalls, particularly because years of fiscal deficits and elevated financing costs have left Costa Rica with a high debt ratio, leading the government to turn to the IMF for help. Congress eventually approved a $1.8bn extended fund facility programme in July 2021. This should anchor policy and enable vital reforms to be made. However, the political gridlock that has complicated reform efforts over the past decade and contributed to lower growth continues to be a challenge.

For example, Congress is yet to pass the public employment law that would sustainably reduce spending pressures, and which forms one of the pillars of the IMF programme. For now, Costa Rica is meeting its fiscal targets, posting a primary surplus worth 0.3% of GDP in the first seven months of 2021, but any sign that the programme is going off track would be a severe blow.

Assuming the fiscal situation is brought under control, Costa Rica's economy is well positioned to capitalise. The government's investment promotion efforts are firmly focused on sustainable development, where Costa Rica is a global leader, with over 98% of energy coming from renewable sources. Costa Rica can also boast clusters in more high-tech sectors than its Central American neighbours, with renowned electronics and medical equipment sectors.

There is room to upgrade basic infrastructure, which has been somewhat neglected due to fiscal pressures. Among the key projects being supported by CABEI are San José's light passenger train and a potential electric cargo train (see Pillar 6).



Macroeconomic indicators

- GDP growth: -4.1%
- GDP per capita: $12,057
- Inflation: 0.7%
- Unemployment rate: 20%
- Public external debt to GDP: 22.1%
- Public deficit: 8%

Trade indicators

- FDI inflows: $1.8bn
- Total exports: $18.5bn
- Free trade agreements: 15

2021

Costa Rica became the first Central American OECD member.

Pillar 2
Sustainable investment

Central America is developing a greener and more sustainable investment environment, presenting new opportunities.

WHEN TROPICAL storms Eta and Lota caused devastation in Central America in November 2020, they severely interrupted the initial recovery from the Covid-19 pandemic, with several countries suffering damaged crops or slowdowns in manufacturing. It was a stark reminder that Central America, though not a significant contributor to climate change, is one of the regions most vulnerable to extreme weather events. While the world struggles to limit carbon emissions fast enough, Central America is working on adapting its economies to become more resilient.

The IMF estimates that investment in climate resilience could add more than 1% to GDP in the long term in Central America, and over 2% in the Dominican Republic. There would also be significant fiscal gains across the region, which represent nearly 2% of GDP in Honduras. The IMF recommends the region takes a 'comprehensive disaster resilience strategy' that includes insurance frameworks and scaling up government funding for transitioning away from carbon-intensive economic activities.

CABEI has been a leader in Central America's sustainability efforts with around 41% of the bank's loan portfolio dedicated to sustainability-related activities since 2015. This is forecast to increase to around 55% by the end of 2021.

The bank issued a $375m green bond in 2020 to fund sustainable land use, renewable energy, water management and clean transport projects. CABEI's rigorous approach – with each annual report being audited by an external party – cemented the bank's reputation as one of the leading environmental, social and governance bond issuers in Latin American bond markets. During 2021, CABEI issued a total of four ESG bonds – three social bonds and one green bond – for total of $1.2bn, the most recent green issuance taking place in the Swiss market.

The process of designing a green bond framework not only enabled CABEI to channel funding to eligible projects, but gave the bank greater

'CABEI has been a leader in Central America's sustainability efforts with around 41% of the bank's loan portfolio dedicated to sustainability-related activities since 2015.'

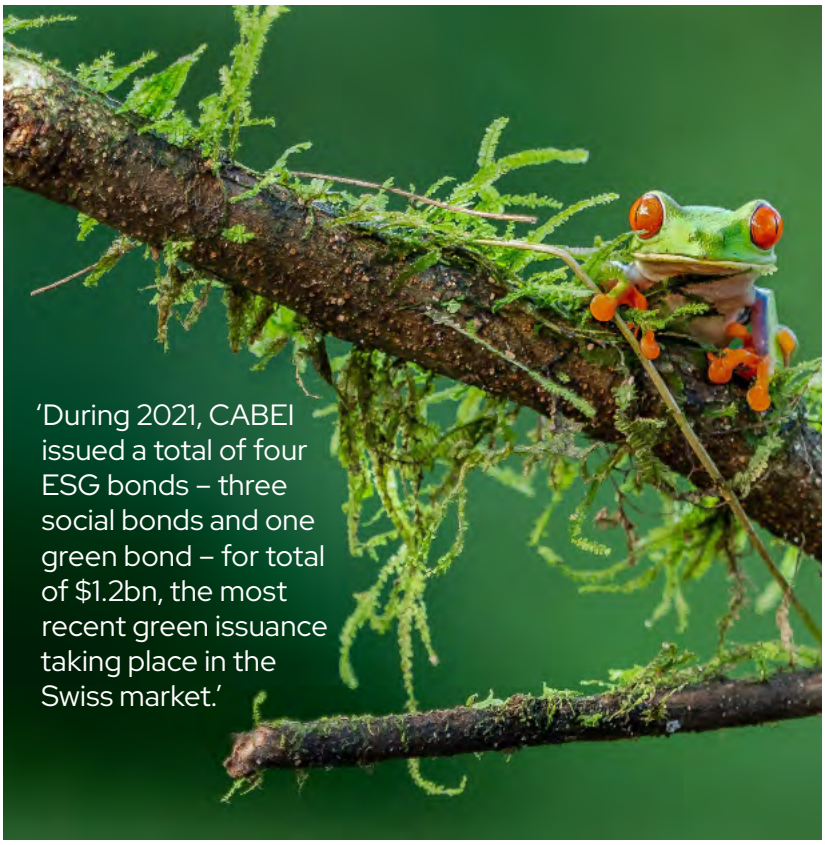
Belize's blue bond combines ocean protection with debt reduction

The Nature Conservancy has long seen Belize as a world leader in conservation, having been operating in the country for 30 years. But when the country was looking to restructure its $526.6m international bond – for the fifth time since 2007 – early in 2021, TNC came up with a proposal that showcases the potential for sustainable investment in Central America.

Instead of yet again renegotiating repayments with bondholders without gaining significant haircuts in principal, Belize offered to buy back the bonds in cash at 55 cents on the dollar using proceeds from a blue bond that was arranged by Credit Suisse, thus reducing the interest rate. The bond boasts a political risk guarantee from the US government's Development Finance Corporation. With over 87% of bondholders having agreed to participate, this transaction will significantly reduce Belize's overall debt stock.

The success of the deal is owed to Belize's commitment to accelerating marine conservation, including enhanced protection for its coastline, reef and ocean territory. Furthermore, the government is pre-funding an endowment account of $23.4m, to be administered by TNC, that will support future marine conservation projects.

This is by far the largest deal carried out under TNC's Blue Bonds for Conservation programme. It demonstrates the opportunity for innovation in the region as global leaders seek to channel sufficient climate finance into emerging markets without putting pressure on fiscal sustainability.



'During 2021, CABEI issued a total of four ESG bonds – three social bonds and one green bond – for total of $1.2bn, the most recent green issuance taking place in the Swiss market.'

understanding of the criteria that make projects eligible green investments. This is particularly crucial as Central American governments align policy with climate change targets and seek to attract investment for their own sustainable projects.

On the back of CABEI's green bond, there is growing interest in developing ESG-themed financing instruments in the region's domestic capital markets. The stock exchanges of Panama, Costa Rica, Honduras, the Dominican Republic, Guatemala and Nicaragua have all joined the United Nations' Sustainable Stock Exchanges Initiative since 2018. Under the framework of the agreement with the Agence Française de Développement, CABEI entered into an agreement with Costa Rica's national stock exchange to advise domestic issuers on the structuring of an ESG-themed bond in alignment with international standards. The plan is to extend this programme to other countries in the region.

CABEI is now in the process of designing a blue bond taxonomy that will help them decide which ocean projects to finance. This is an emerging part of sustainable finance that is only just starting to receive attention on a global scale, which is vital for Central America.

Investment potential

The UN Green Climate Fund's investments in Central America demonstrate the breadth of opportunities for sustainable investment in the region. In Nicaragua, the $116.6m Bio-CLIMA project, for which the GCF has provided over $64.1m in loans and grants, will reduce deforestation and strengthen the resilience of the Bosawás and Rio San Juan biospheres, the most biodiverse regions in the country. Resources will be channelled into restoring degraded forest landscapes and sustainable land and forest management.

The GCF's $28m Productive Investment Initiative for Adaptation to Climate Change (CAMBio II) offers concessional loans and technical assistance to encourage micro, small and medium-sized enterprises in all countries in the region except Belize to invest in adapting their practices to deal with climate change, offering financing rewards for doing so. This should improve the substantial obstacles to accessing credit faced by key industries – such as agriculture, livestock and forestry – that are highly sensitive to physical and transition risks related to climate change.

Most recently, in October 2021 the GCF board approved funding for a flagship programme for the Central American dry corridor and the arid zones of the Dominican Republic. These areas – home to an important part of Central America's population and productive activity – are among the most vulnerable in the world with extreme temperatures. The $268.4m programme, including $174.3m from the GCF, will strengthen the adaptive capacity and climate resilience of vulnerable rural communities.

Notably, the dry corridor initiative will look to encourage private sector participation through financing and technical assistance, seeking to enable investment in adaptation and in the implementation of water and energy-efficient technologies. There is a significant opportunity for Central America's private sector to fully comprehend how climate issues will affect economic sectors differently and reap the benefits of helping companies transition to net-zero emissions.

To properly tackle climate change, the region must be geared to take advantage of institutional investor appetite to support the sustainability agenda. The GCF's largest investment in Central America – Costa Rica's electric railway project – has received $571m of funding from CABEI and the GCF, but it will need funds from the private sector to meet its $1.3bn financing.

Given the potential for clean transport – with several feasibility studies for railways being undertaken across the region – and renewable energy developments across Central America, more bankable projects are in the pipeline.

COUNTRY FOCUS:

DOMINICAN REPUBLIC

THE DOMINICAN REPUBLIC outperformed the whole of Latin America in economic growth before the pandemic hit, thanks largely to a highly competitive tourism industry, consistent FDI inflows and robust construction and mining sectors. This has resulted in improvement in macroeconomic indicators over the years.

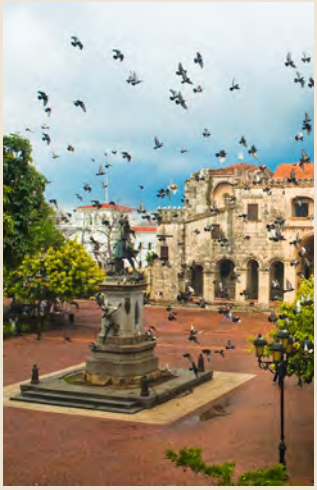
Though GDP contracted 6.7% in 2020, the economy is expected to bounce back as timely policy actions – including wage subsidies, monetary easing and early progress on vaccines – minimised the pandemic's adverse impact. As of October, the IMF is forecasting 9.5% growth in 2021 and 5.5% in 2022.

Crucially, the rebound has been accompanied by around 30% growth in government revenues, partly due to economic activity and partly down to the banks and some mining companies pre-paying an important share of their taxes in 2021. Important work has also been carried out to improve the efficiency of tax collection.

As growth returns to more normal levels, financial markets and rating agencies will keep a close eye on the Dominican Republic's debt ratio. In October, the government decided to postpone previous proposals to carry out a tax reform that would have structurally increased government revenues. Despite this, the government has managed to boost savings to around 0.5% of GDP and has revised its 2021 fiscal deficit forecast to just 3% of GDP in its latest budget amendment, which was presented to Congress on 15 November.

Tourism will remain an important part of the Dominican economy, but it is not the only driver of growth. The marine terminal and free zone at Punta Caucedo, on the south coast of the country, operated by DP World, is undergoing an expansion as it looks to become a logistics hub for the Americas.

Major investments are also being made in the energy sector, though more is needed as the country continues to experience power outages. The so-called Electric Pact, signed in February 2021 and part of the 2030 National Development Strategy, should facilitate investments into the sector as the country looks to diversify its energy sources into natural gas and renewables. The Dominican Republic is aiming for 25% of its electricity to come from renewable sources by 2025.



Macroeconomic indicators

- GDP growth: -6.7%
- GDP per capita: $7,554
- Inflation: 3.8%
- Unemployment rate: 5.8%
- Public external debt to GDP: 39.3%
- Public deficit: 7.9%

Trade indicators

- FDI inflows: $2.6bn
- Total exports: $14bn
- Free trade agreements: 4

'As growth returns to more normal levels, financial markets and rating agencies will keep a close eye on the Dominican Republic's debt ratio'.

5.5%

The IMF is forecasting 5.5% growth in 2022

Pillar 3 Commerce, external trade and foreign direct investment

Foreign investment and trade opportunities abound, as Central American economies diversify, improve productivity and increase complexity of output.

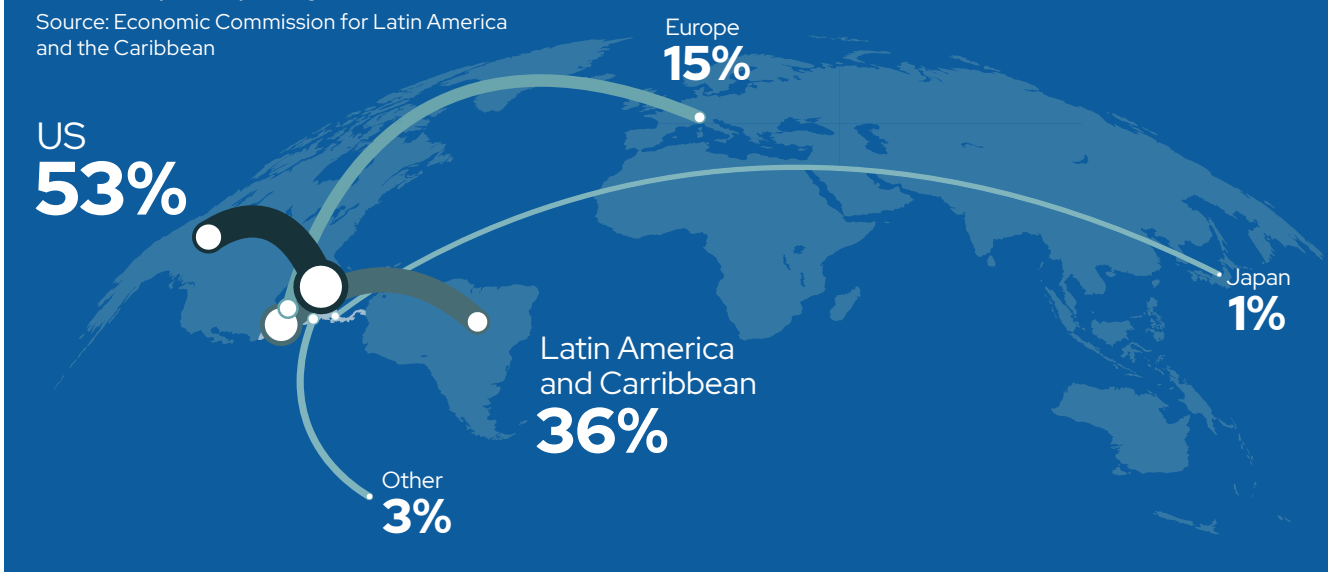
ATTRACTING MORE foreign direct investment is a clear priority for Central America as it looks to increase productivity and growth in the post-pandemic era. Despite a worldwide slowdown in FDI in 2020, some economies continued to attract a healthy inflow of investment.

Costa Rica topped a list of 84 countries globally for greenfield FDI, or investment in new projects, relative to size of the economy. fDi Intelligence, which produces the index, credited the country's strong performance to its effort over many years to diversify the economy away from agriculture. Instead, Costa Rica has managed to draw investment from foreign companies in the fields of medical equipment, IT and business services.

In 2020, at the height of the pandemic, Costa Rica attracted $1.8bn of foreign direct investment. Although this was 37% lower than in 2019, Costa Rica's diversification of its industrial capabilities is illustrative of the potential that exists in Central America, which has a strategic location close to the US. This opportunity is even more compelling amid expectations that nearshoring – whereby companies look to reduce their supply chain risk – will accelerate as a result of tensions in the US-

'US companies accounted for over half of FDI into Central America in 2020, while Latin America is the second largest source of investment flows to the region.'

3.1 Almost 90% of FDI came from US and Latin America and the Caribbean
FDI inflows by country of origin, %, 2020
Source: Economic Commission for Latin America and the Caribbean



China relationship. Covid-19 has also starkly demonstrated the challenge of relying on single suppliers.

Taking advantage of this opportunity will be key to attracting FDI in coming years. Panama, which had been the region's outperformer between 2016-19 with FDI averaging 7.3% of GDP, saw a slump to 1.1% last year. In Nicaragua, FDI fell to 1.4% of GDP in 2020 from a four-year average of 6.3%. Honduras, Guatemala and El Salvador all registered FDI below 2% of GDP in 2020, while the Dominican Republic was more resilient, having attracted FDI averaging 3.5% between 2016-19 and 3.2% in 2020.

US companies accounted for over half of FDI into Central America in 2020, while Latin America is the second largest source of investment flows to the region.

Potential for greater complexity

Exports from Central America's small, open, price-taking economies naturally took a hit from the global recession, as total exports of goods and services in the region fell 13.9% year-on-year in 2020. Apart from an impressive rise in Honduras, there were sharp falls in all countries across the region in the value of total exports, with Belize (30.7% year-on-year contraction), Panama (28.3%) and the Dominican Republic (27.8%) particularly badly hit. Honduras was the region's outlier, experiencing a 72.7% increase in its total exports value, driven by sharp surges in fabrics and clothes' export prices.

However, the bulk of the damage was felt in the tourism and travel-related services sector. Given travel restrictions and the closing of borders, the value of these exports fell by more than half in all countries in the region. In Guatemala and Panama, they reached less than a quarter of 2019 figures.

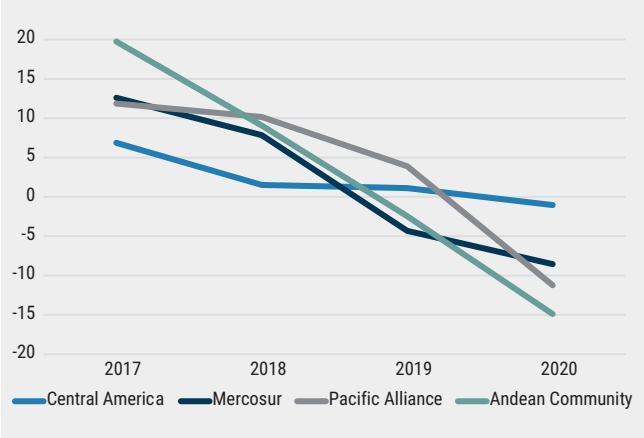
The impact on tourism and travel-related services appears temporary, as countries reopen their borders and international travel resumes. By July 2021, international tourist arrivals in the region had risen by 158% from the start of the year. The Dominican Republic is the close to pre-pandemic arrivals, having received just 5% fewer foreign visitors that month than two years before.

Excluding the tourism and travel-related services sector from the analysis reveals a far stronger picture of Central American exports during 2020. Applying this filter, the value of exports fell 5% year-on-year in the Dominican Republic and Nicaragua, 16% in El Salvador and 18% in Panama. The region experienced a contraction in export values of just

3.2 Exports steady despite international trade slowdown

Year-on-year total exports value growth, %

Source: International Trade Centre



'The bulk of the damage was felt in the tourism and travel-related services sector. Given travel restrictions and the closing of borders, the value of these exports fell by more than half in all countries in the region.'

1% – a far smaller drop than in other Latin American blocs. Commodities played an important role in this milder drop and will be crucial to Central America's post-pandemic recovery.

Figures from September 2021 show year-on-year increases in the prices of all of the region's main export commodities. Palm oil and Arabica coffee, two of the region's primary commodities sold abroad, saw the most significant rises, 104% and 75%, respectively. The economic recovery from Covid-19, along with the impact of heavy droughts on agricultural production in Brazil, made Central American products a cheaper alternative.

Beyond commodities, the value of total exported goods for the region has also recovered in 2021. The value of these goods sold abroad was 16% higher in June than they were two years prior. Costa Rica and Nicaragua lead the way with an increase of 26% and 23%, respectively, during this period.

'Figures from September 2021 show year-on-year increases in the prices of all of the region's main export commodities.'

Central America has room to increase the complexity of their exports and push these positive trends even higher. According to data from Harvard University's Atlas of Economic Complexity, Costa Rica's export basket in 2019 was the 44th most complex in the world – overtaking Panama, which had been the leading Central American country for over a decade up to 2017.

The Northern Triangle nations of Guatemala, El Salvador and Honduras are well located to take advantage of the nearshoring phenomenon by attracting investments that can diversify exports. To do so, there must be reassurances about security concerns, a focus on training to improve human capital indicators, increased research and development and better infrastructure.

With improved productivity levels, the Northern Triangle can become a far more attractive investment destination, and existing industries can maximise their potential in terms of employment creation and contribution to growth.

The US government has already recognised this opportunity. In May 2021, Vice President Kamala Harris launched the Partnership for Central America, a 'call to action' for private entities to make investments in these three countries, announcing at least $750m of commitments from 12 companies and organisations including Microsoft, Mastercard, Bancolombia and Nespresso. By October, the initiative had already borne fruit, as Nespresso produced its first capsule using coffee from Honduras.

Elsewhere, CABEI is supporting investments being implemented via public-private partnerships, which are largely used in Central America for transport projects, including the flagship electric train in Costa Rica. But PPPs could also be used to implement water, hospital and education infrastructure projects.

Mobilising South Korean investment in Central America

In response to the pressing need to attract greater equity investment into Central America, CABEI has provided $50m of seed capital to a new private equity fund – known as KorBCIE – that will mobilise private resources from abroad into the region's real economies. KorBCIE could be a game changer. It will amount to $1bn, but is expected to mobilise $3bn in total when taking into account third parties that will deploy resources as co-financiers in the fund's investments.

CABEI will be a limited partner in KorBCIE and is looking to tap into the huge South Korean pension funds. The development bank is set to select a general partner in November to manage the investment portfolio.

KorBCIE, which will have a life of 15 years, will invest in infrastructure, information and communication technologies, climate change, energy, health and education projects, giving special emphasis to PPP frameworks. The fund will look to use the philosophy of the Korean New Deal, an initiative launched by the Korean government in July 2020 to support the country's recovery from the pandemic. This comprises two main policies: a Digital New Deal and Green New Deal.

Pillar 4 Financial integration

Regional integration will propel Central America's growing sovereign debt market onto the global stage.

In 2020, CABEI – with the encouragement of the region's finance ministers – began working on building a regional market for local sovereign debt securities. Low savings rates in Central America equate to a relatively shallow domestic buyer base, which is particularly critical in economies where international bond market access is expensive for sovereigns, and where only a handful of private sector entities are large enough to issue.

A more integrated public debt market could ensure greater liquidity and depth in capital markets, increasing its attractiveness to foreign investors. With this in mind, CABEI is looking to develop a centralised trade repository that will keep an electronic record of transactions, enabling cross-border securities clearing and settlement and providing custody services for dollar-denominated sovereign bonds issued by Central American governments.

In May 2021, CABEI signed a memorandum of understanding with the executive secretary of the Central American, Panamanian and the Dominican Republic Council of Finance Ministers (Secosefin), the executive secretary of the Central American Monetary Council (Secma) and the Central American Stock Exchange Association (Bolcen) to support the project.

For now, the regional market will be focused on dollar-denominated bonds issued under local law by seven of CABEI's member countries: Honduras, Guatemala, Costa Rica, El Salvador, Nicaragua, Panama and the Dominican Republic. CABEI estimates that these countries have around $110bn-$120bn of sovereign bonds outstanding in total. Yet there is also an opportunity to look beyond Central America. CABEI has been in discussions about integrating Mexico – which neighbours Central America and is a non-regional member of the development bank – into the platform, potentially opening up a new, larger source of capital. Other foreign buyers could also participate.

By integrating Central American sovereign bond markets, the trade repository will deepen demand for this asset class and provide a viable alternative to the more expensive path of issuing in international bond markets. Most sovereigns in the region have only patchy access to international bond markets and are dependent on external conditions and investor sentiment towards domestic events. For example, as bond investors lose faith in El Salvador's ability to reach an agreement on an IMF programme, the government's global bonds have suffered a sharp sell-off. As of November 2021, El Salvador's 10-year dollar bonds yield around 12% – a prohibitively high level that would make it almost impossible to raise funding in international capital markets as of October 2021.

Several Central American governments face financing challenges as a result of the pandemic-induced recession, climate change and increasing interest rates in the US Treasury market, making this a particularly timely initiative.

The regional debt market could also benefit the Central American

'A more integrated public debt market could ensure greater liquidity and depth in capital markets, increasing its attractiveness to foreign investors.'

A debt fund for Central America

A key part of the regional debt market in Central America lies in a new investment vehicle, the Central American Regional Investment Fund (FIRCA-BCIE). This fund, which will be domiciled, listed and regulated in Panama, will initially deploy $150m of seed capital – provided by CABEI – into short-term US dollar-denominated bonds.

CABEI already runs an Undertakings Collective Investment in Transferable Securities fund that buys international debt issued by the region's sovereign and corporate issuers. But the thinking behind FIRCA-BCIE is to provide international investors with the chance to participate in the local markets more easily. Moreover, FIRCA-BCIE will allow specific investments in environmental, social and governance-themed bonds, complementing CABEI's efforts to support green, blue and other thematic bonds by other issuers in Central America (see Pillar 2). CABEI is in the process of selecting a manager for this new debt fund.

4.1 Central America's banking sector shows resilience

Financial soundness indicators, %

Source: IMF Note: Figures are as of year-end, except for the Dominican Republic where these figures are as of Q2 2019 and no data is available for 2020.

	2020			2019		
	Regulatory capital to risk-weighted assets	Non-performing loans to total gross loans	Liquid assets to total assets	Regulatory capital to risk-weighted assets	Non-performing loans to total gross loans	Liquid assets to total assets
Costa Rica	16.8	2.4	33.6	17.5	2.3	30.6
Dominican Republic	-	-	-	17.7	1.6	24.4
El Salvador	15.4	1.6	19.7	16.0	1.7	23.3
Guatemala	16.2	1.8	34.6	16.4	2.2	31.2
Honduras	14.5	3.1	29.3	14.1	2.3	22.7
Nicaragua	19.5	3.7	34.2	19.5	3.1	32.2
Panama	15.7	2.0	17.6	16.5	2.0	12.8

investor base, which is dominated by banks, co-operatives, pension funds and insurance companies. These institutions would be able to diversify their portfolios beyond central bank paper or Treasury bills issued in their own countries. Moreover, there is hope that the trade repository will soon enable the trading of quasi-sovereign and corporate bonds.

Final consultations to establish the integrated regional debt market in 2022 are underway. The next step will be to identify the country that will house the trade repository. The necessity of the market is clear, and this will be a big milestone for the region.

'Final consultations to establish the integrated regional debt market in 2022 are underway. The next step will be to identify the country that will house the trade repository.'

Financial resilience anchored on stable banking system

A resilient and well-structured financial market infrastructure is fundamental to domestic and foreign confidence. Central America's financial system has shown notable resilience throughout the pandemic. Broadly considered conservative in nature, the region's private sector lenders entered the crisis with robust capital buffers, although only half of the region's countries have implemented Basel III, at least partially. The capital adequacy ratio evaluates financial institutions' capital strength to withstand shocks and unexpected losses. This ratio deteriorated slightly during the first year of the pandemic in most countries of the region, but remains well above international standards.

Liquidity in the region's banking sector was boosted by greater deposits and a decrease in the demand for credit. The liquid asset ratio gauges the adequacy of these banks' assets to meet cash outflows. In El Salvador, this ratio dropped to 19.7% in 2020 from 23.3% in 2019. It remained stable in the Dominican Republic and improved in all other countries in the region. Panama, where the economic contraction was the sharpest, saw the most notable increase – to 17.6% from 12.8% last year – though this remains the lowest ratio in the region.

These ratios in part reflect the banking sector's largely cyclical policies during the pandemic, which avoided upsets that may have compounded the economic crisis. However, Secma notes that as banks changed the composition of their assets – preferring more liquid instruments to protect themselves against uncertainty – profitability levels at banks in all countries hit historic floors at the end of 2020 and early 2021. Furthermore, operating during lockdowns and restrictions also brought higher costs for banks.

The deterioration in the quality of banks' credit portfolios has been mild as a range of measures were taken to support businesses and households face the financial pressure of the pandemic. Non-performing loans as a percentage of the total loan portfolio only slightly increased across Central America, with the ratio decreasing in Guatemala and El Salvador. The greatest increases were in Honduras (to 3.1% from 2.3%) and Nicaragua (to 3.7% from 3.1%). Financial soundness indicators point to a banking sector that is in good stead as it faces up to the challenge of protecting asset quality as emergency support measures come to an end. Strong remittances from the US supporting household incomes in much of the region should also mitigate risks (see Pillar 1).

COUNTRY FOCUS:

EL SALVADOR

EL SALVADOR'S RAPID progress in Covid-19 vaccinations has fuelled a strong rebound in 2021. The economy is expected to recover from 2020's 7.9% contraction and experience average growth of 6.3% over the next two years.

External public debt increased 22% year-on-year, to 45% of GDP during the pandemic. Given a similar increase of 25% in total public debt, which reached 92% of GDP in 2020, an impressive recovery in government revenues has been vital. This is likely to be over 20% year-on-year for 2021. Part of this was an outperformance of VAT receipts, but the government has also yielded significant returns from anti-tax evasion and improved collection measures.

However, for El Salvador to regain debt sustainability it needs permanent measures, and liquidity pressures are rising as the government relies heavily on short-term debt. Much hinges on a potential agreement between the government and the IMF, which would ease severe financing constraints and send a strong message about El Salvador's desire to work with foreign investors.

An IMF programme would not only unlock further multilateral funding, but it would undoubtedly trigger a rally in El Salvador government bond prices. This would significantly reduce the government's financing costs.

Even before the pandemic, El Salvador showed slow economic growth, which averaged just 2.4% between 2015 and 2019. CABEI has identified two potential obstacles that could be tackled to unleash greater economic growth. First, though perception of security has improved under this government, according to CABEI, insecurity and crime have been estimated to have an economic annual cost of around 16% of GDP. Second, there is room to increase the productivity and competitiveness of the tradable sector, with improvements in human capital and infrastructure particularly pressing.

These are both hindrances to attracting investment, which has been historically very low, but the government is seeing some results. In November, a subsidiary of Honduran group Emco was awarded the contract to expand San Salvador's international airport, which serves as a regional hub, in the first PPP in the country's history. Similarly structured infrastructure projects are expected to follow.

Elsewhere, the National Energy Council is developing a long-term energy policy to continue developing El Salvador's potential in renewables, which should stimulate local industry and reduce electricity tariffs. In 2020, French firm Neoen rolled out the Capella Solar photovoltaic park, which generates around 4% of the country's wholesale electricity market. To fully harness this progress in attracting investment, the government should calm private sector concerns about governance, separation of powers and policy predictability.

> 'For El Salvador to regain debt sustainability it needs permanent measures, and liquidity pressures are rising as the government relies heavily on short-term debt. '

Macroeconomic indicators

- GDP growth: -7.9%
- GDP per capita: $3,799
- Inflation: -0.4%
- Unemployment rate: 8.7%
- Public external debt to GDP: 45.3%
- Public deficit: 9.2%

Trade indicators

- FDI inflows: $201m
- Total exports: $6.3bn
- Free trade agreements: 10

4%

Capella Solar photovoltaic park generates around 4% of the country's wholesale electricity market

Pillar 5
Digital economy

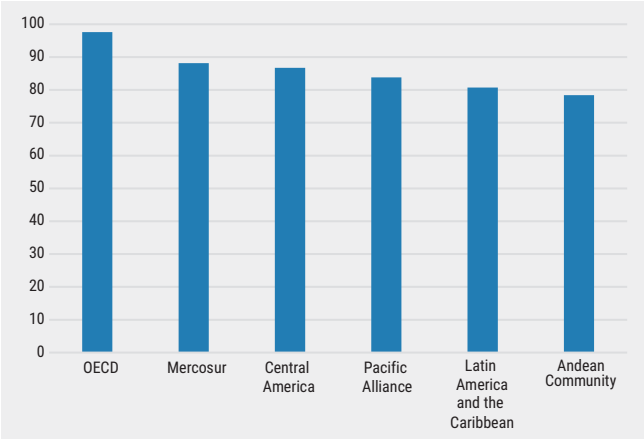
The digital challenge facing Central America has the potential to be transformative.

In recent years, there has been significant progress in improving telecommunications infrastructure and coverage in Central America. But there is plenty still to do – especially as the pandemic has accelerated the digital revolution across the world.

Central America has the second-highest 4G coverage among Latin American blocs, according to 2019 data from GMSA, a global industry organisation of mobile operators. On average, 87% of the population of Central American economies have access to 4G networks, only slightly below Mercosur's 88% but farther behind the OECD average of 98%.

Central America also lags in terms of mobile phone ownership, with the average level of ownership among countries in the region at 72% of the population, compared to 80% for the rest of Latin America. Mobile ownership is lowest in Honduras (60%), Guatemala (59%) and Nicaragua (54%).

More concerning is fixed-line internet connectivity. Levels of penetration are below mobile internet levels and there is little sign that the region is catching up with the developed world in this respect. The economic Commission for Latin America and the Caribbean shows that, Costa Rica is the leader in Central America, with almost 60% of the population having access to fixed line broadband.



5.1 Central America ranks second in the region for 4G network coverage

Percentage of population covered by 4G networks, %, 2019

Source: GSMA Intelligence

The digital gap represents an investment opportunity, especially in infrastructure. The pandemic acutely highlighted the need for the region's governments to increase investment in the digital arena, as school closures left unconnected students without access to virtual classrooms, and small businesses without an online presence struggled to keep up. ECLAC suggests that the region also needs to modernise outdated regulatory frameworks that add unnecessary costs to these projects.

While annual investment in telecommunications in OECD countries is on average over $140 per capita, in Central America only Costa Rica spends more than $80, and Panama over $60. Honduras spends only $20 per capita. Greater investment in this area is necessary for Central America to flourish in an increasingly digital global economy.

Guatemala is taking important steps to attract more investment to its telecommunications sector. In early November, Millicom, a Luxembourg-headquartered telecommunications company with businesses in Latin America and Africa, announced a $2.2bn investment in TigoGuatemala. Millicom will gain full control of the

'Costa Rica is the leader in Central America, with almost 60% of the population having access to fixed line broadband.'

El Salvador's bet on bitcoin

IN SEPTEMBER, El Salvador enacted a law making bitcoin legal tender. It was both a pioneering and controversial move that raised concerns over the potential risks to El Salvador's financial system.

Previously, the IMF had warned against the adoption of cryptocurrencies as legal tender. It is also unclear if Salvadorans are ready for this new development, and whether they have been sufficiently informed of the risks and benefits of using bitcoin to transact.

However, as discussed in Pillar 1, remittances play a vital role in Central American economies. The adoption of cryptocurrencies has the potential to drastically reduce the cost of cross-border transfers. El Salvador offered $30 in free bitcoin to citizens who download and register for the government's cryptocurrency application. Early usage of the country's Chivo bitcoin wallet was strong, though not without initial technical challenges.

CABEI is providing El Salvador with technical assistance on implementing the rollout of bitcoin as legal tender, ensuring that the country is carrying out appropriate risk assessments and developing adequate plans for regulation, financial education and investment.

Although it is too early to evaluate the impact of the bitcoin law on El Salvador's economy, it is certain that this development will be closely watched by the rest of the world.

Guatemalan company, the leading mobile and broadband internet services provider in the country. This capital inflow represents more than twice the country's total amount of foreign direct investment in 2020.

Obligatory acceleration

Latin America is very much at a preliminary stage of its digital journey. This is partly reflected in the scarcity of statistics on digital aspects of the economy, including e-commerce, according to the Inter-American Development Bank. Among Central American economies, Costa Rica is the only country where the percentage of internet users shopping online is above the Latin American and Caribbean average of 15.5%.

'Digital payment methods have been crucial in enabling governments to implement social programmes and provide financial aid to those most hit by the economic shock of the pandemic.'

The Covid-19 pandemic highlighted the need to bridge the infrastructure gap in telecommunications and forced digitalisation to accelerate across the world. Central America is catching up in this respect. Latin American e-commerce platform Mercado Libre reported that, between August 2019 and August 2020, new seller registrations multiplied by a factor of six in some Central American markets, including Costa Rica and the Dominican Republic. This was more than the rest of Latin America.

Public sector institutions are stepping into the digital arena and keeping pace with the private sector. Costa Rica's central bank said that its Sinpe Móvil online payments service saw an increase to 55m transactions in 2020 from 6.2m in 2019, after several financial institutions included the service in their online payment options.

Digital payment methods have been crucial in enabling governments to implement social programmes and provide financial aid to those most hit by the economic shock of the pandemic. As part of Panama's Vale Digital programme, eligible Panamanians receive $120 per month in a digital card. In return, people must either take a training course in human development and soft skills or perform community service.

Integration benefits

Greater digitalisation could bring significant benefits to commercial integration in Central America, broadening the customer base.

Digitalising administrative processes is an important step in reducing red tape and enhancing the efficiency of regional supply chains. Some digital platforms are already moving towards this. The Central American Digital Trade Platform – led by the IADB, European Union and Secretariat for Central American Economic Integration (SIECA) – and an application called CADENA, enable interoperability between customs and other border entities and use blockchain to facilitate data exchange from certified companies.

This is particularly important as

the IADB notes that Central America and the Caribbean underperforms against the rest of Latin America when it comes to cross-border paperless trade. It recommends working towards full implementation of single windows that would make processes more agile.

Also in partnership with SIECA and with funding from the EU as part of the Partnership for Central America agreement (see Pillar 3), the International Trade Centre has launched an initiative to connect female entrepreneurs in Central America. The programme aims to empower women to export their crafts through e-commerce platforms, develop their online business skills and improve access to foreign markets online.

Technology can be a vital tool to cost reductions, which is particularly relevant for remittances, an important contributor to most of the economies of Central America (see Pillar 1). Only 10% of remittances sent to Central America are via digital methods such as PayPal or Xoom, with a transaction cost of 2.8%. Meanwhile, 85% use financial institutions or open payment channels such as Western Union or MoneyGram, more expensive money transfer methods, with an average cost of 4.7%.

'Only 10% of remittances sent to Central America are via digital methods. Meanwhile, 85% use financial institutions or open payment channels such as Western Union or MoneyGram.'

A more prolific use of mobile money and fintech would reduce transaction and exchange rate fees. In late 2020, Guatemala's Banco Agromercantil launched the Cuenta Fácil Remesas (easy remittances account), which enables low-income Guatemalans living abroad to open an online bank account with minimum requirements. They can send remittances up to five times per month to a selected beneficiary without transaction fees.

Such is the importance of digital and financial inclusion initiatives that the Partnership for Central America made this one of its focus areas. Already, Mastercard has promised to digitise 1m micro and small businesses. Microsoft has pledged to expand internet access to 3m people in the region and initiate efforts to teach digital skills to women and young people.

COUNTRY FOCUS:

GUATEMALA

Guatemala stands out globally for its low debt levels, with external public debt to GDP below 12%. This, alongside resilience in remittances and a swift health policy response to Covid-19, enabled Guatemala to navigate the pandemic relatively smoothly. Using digital payments, it managed to increase cash transfers to 2.8m households in 2020 from 160,000 before the pandemic. The real economy contracted by 1.5%, the smallest decline in any Central American economy.

Guatemala has exceptional access to international capital markets at low rates for its rating. The country was the first sub-investment grade sovereign from emerging markets to issue internationally during the pandemic, launching a $1bn social bond in April 2020. In September 2021, the government issued $1bn of 12- and 20-year debt at 3.95% and 4.85%, respectively.

The challenge for Guatemala is to harness its macroeconomic stability to improve prosperity. Despite the unprecedented fiscal support during the pandemic, poverty and malnutrition increased. The same cautious spending policy that gives the country credibility in bond markets also leads to low investment in public services.

Tax collection as a share of the economy hardly moved between 2000-18, when it was 10.8% of GDP. Only Panama had a lower percentage in the region at 9.2%. Higher tax revenues could enable greater social spending, which is badly needed to enhance growth capacity.

Guatemala's commitment to free trade and welcoming approach to foreign investment is well established. A resilient agricultural sector takes advantage of several free trade agreements, most notably with the US. There has been a reasonable diversification of agricultural produce, with non-traditional agricultural products such as fruit and vegetables making up 6.6% of total exports.

Yet the government acknowledges Guatemala has lacked a rigorous economic development plan to take advantage of its stability. It has laid out a National Innovation and Development Plan, which takes a more aggressive approach to stimulating investment, trade, innovation, small and medium-sized enterprises, tourism, credit access, infrastructure, development hubs and participation strategies.

CABEI's studies identify two key areas to improve. First, there is a lack of convergence between labour supply and demand, making it hard to attract investments with high returns. Access to secondary education needs to be improved to breach gaps in gender, rural and urban areas and indigenous and non-indigenous populations.

Second, Guatemala needs to improve the quality and coordination of public institutions, governance levels, corruption indicators and business environment regulations. The past year has brought signs of increasing social unrest in the country, and this may continue unless the stable macroeconomic position is combined with progress.

'The challenge for Guatemala is to harness its macroeconomic stability to improve prosperity.'

Macroeconomic indicators

- GDP growth: -1.5%
- GDP per capita: $4,317
- Inflation: 3.2%
- Unemployment rate: 4.7%
- Public external debt to GDP: 13.5%
- Public deficit: 4.9%

Trade indicators

- FDI inflows: $906m
- Total exports: $14bn
- Free trade agreements: 9

$1bn

In September 2021, Guatamala issued $1bn of 12- and 20-year debt at 3.95% and 4.85%, respectively.

COUNTRY FOCUS:

HONDURAS

Honduras had the third-fastest growing economy in Central America during the pre-pandemic years, following Panama and Dominican Republic. The economy expanded on average 3.8% annually between 2015 and 2019 thanks to sound macroeconomic policy-making supported by two IMF programmes.

However, after a sharp pandemic-induced contraction of 9% in 2020 that was worsened by hurricanes Eta and Iota, the recovery has been relatively sluggish. GDP is expected to rebound just 4.9% in 2021 and 4.4% in 2022. This is partly down to a slow vaccination programme, with just 39% of the population fully vaccinated by the end of October.

Although the IMF has waived certain conditions of its programme due to the pandemic and storm-related emergencies, Honduras continues to pass its programme reviews, and is not at risk of debt distress.

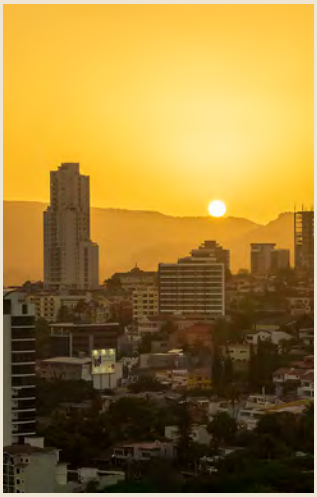
There are significant opportunities for investors given Honduras' strategic location, business-friendly framework and good port infrastructure on both Caribbean and Pacific coasts. The government's stated aim is to become a world-class logistics hub.

In October 2021, Honduras inaugurated the new Palmerola International Airport, some 70km north of the capital Tegucigalpa. The airport was built through a PPP agreement, and will become main point of departure for goods and passengers in Honduras, replacing the limited Toncontín airport.

Palmerola will be powered by solar panels. Solar energy is a sector of high potential in the country, with a boom in renewable energy having begun in 2015 thanks to concerted efforts to diversify the electricity matrix and new regulation. Honduras is a leader in the manufacturing industry, with textiles being the most important sector, and is the number one t-shirt manufacturer for the US.

Key to cementing the country's competitiveness is the electricity sector reform that seeks to make the sector more efficient, competitive and sustainable. Most importantly, this implies the restructuring of financially stressed national energy company Empresa Nacional de Energía Eléctrica, which has been slower than expected despite being a central part of the IMF programme. ENEE represents a high fiscal burden on Honduras, and implementing its loss reduction strategy and reducing arrears would improve the business environment.

Amid all this, there is an opportunity to rebuild after the 2020 storms with climate-resilient infrastructure as Honduras is – like others in the region – highly vulnerable to climate shocks.



Macroeconomic indicators

- GDP growth: -9.0%
- GDP per capita: $2,397
- Inflation: 3.5%
- Unemployment rate: 6.8%
- Public external debt to GDP: 38.2%
- Public deficit: 6.9%

Trade indicators

- FDI inflows: $419m
- Total exports: $10.5bn
- Free trade agreements: 12

'Key to cementing the country's competitiveness is the electricity sector reform that seeks to make the sector more efficient.'

3.8%

Average annual growth in Honduras was the third highest in the region over the past five years

Pillar 6
Integration

As countries with common borders, broadly similar economic dynamics and shared challenges, Central American nations have much to gain through greater regional integration.

ECONOMIC BLOCS proliferate in Latin America, but ECLAC notes that Central America is the most commercially integrated of the region's blocs. Central American exports grew at an average of 6.3% per annum between 1995-2019. In 2020, intraregional trade represented 26% of the region's exports, up from 23% the previous year. Only the US is a more important export destination for these countries, and the strength of intraregional trade provided a strong line of defence for Central American economies when the pandemic hit (see Pillar 3).

In 1960, landmark agreements that formed the base of Central America's economic integration were introduced, with the founding of the Central American Common Market and CABEI. A series of other agreements have followed since then and new initiatives are underway, such as the project aimed at creating a regional sovereign debt market (see Pillar 4).

Yet there is still room for Central American nations to work together more closely. This will be necessary if the region is to reach the higher levels of commercial integration seen in Europe or Asia. To this end, SIECA has made the realisation of the region's free trade zone one of its five biggest priorities.

Honduras and Guatemala have a customs union that came into force in 2017, which El Salvador joined a year later. SIECA has a 2015-24 roadmap to expand this union throughout the region. But until this happens, more can be done in the short term to reduce the time and cost of intraregional trade – whether simplifying bureaucratic processes or modernising customs infrastructure to speed up administrative procedures.

A more coordinated policy between national governments could enable the region to reach more export markets, attract new investors and avoid a race-to-the-bottom scenario under which commercial terms become less favourable. Joining forces and coordinating policies and procedures would enable the countries to earn greater returns from trade. Central America has great potential to develop distribution hubs for e-commerce platforms, generating greater value within the region's supply chain. Trade associations could take a leading role in these discussions.

'Central American exports grew at an average of 6.3% per annum between 1995-2019. In 2020, intraregional trade represented 26% of the region's exports, up from 23% the previous year.'

Countries are also facing challenges in increasing innovation, research and development in the region. This is another area where the economies of scale from a regional policy would be beneficial.

Building blocks

For Central American exports to remain competitive, infrastructure improvements are also required. This includes roads and railways, logistics, ports and airports, according to SIECA's 2035 master plan.

However, to attract the new capital required to carry out these projects, there needs to be robust regulation to help foreign operators navigate the Central American jurisdictions in which they invest. To this end, CABEI, in collaboration with SIECA, is working on developing and defining regional regulatory frameworks in areas such as public-private partnerships. Such standardisation should pave the way for cross-border PPPs, unleashing large scale investments and making such projects more accessible for potential investors who would only have to familiarise themselves with one set of rules.

Integration has also benefited the energy sector. The Central American

Electrical Interconnection System, which was completed in 2014 with support from CABEI and other financial institutions, connects the power grids of Panama, Costa Rica, Honduras, Nicaragua, El Salvador and Guatemala. To date, SIEPAC is the most advanced interconnection scheme in Latin America and the Caribbean and has intermediate levels of power exchanges, showcasing the region's potential when incentives are aligned. SIEPAC has also lowered electricity costs for Central American consumers, increased reliability of the power systems which has resulted in reduced outages and provided important returns for its investors.

The volume traded on Central America's Regional Electricity Market has already reversed the downward trend triggered by the pandemic, increasing by 1.8% year-on-year in the first half of 2021, according to Fitch Ratings. Timely execution of national transmission projects and an increase in the transmission rights in the regional electricity market would facilitate the implementation of projects and electricity tariff reductions.

Integration efforts in the energy sector are set to continue and one of the immediate priorities is to increase the participation of natural gas in the regional energy mix to support the transition away from diesel, fuel oil and – in some cases – coal. Flagship liquified natural gas projects have recently emerged in Panama and the Dominican Republic. New power plants operating on LNG are underway in Nicaragua and El Salvador.

CABEI is working with the region on defining alternatives to cope with electricity demand expansion across Central America and strengthening the natural gas regulatory environment to meet demand and create sufficient scale for regional gas projects. This will reduce fuel prices and electricity costs. In carrying out these studies and establishing and implementing strategic action plans, CABEI hopes to increase regional awareness and knowledge about demand and supply patterns that could facilitate increased participation of renewable energy in the region.

Central America on rails

CENTRAL AMERICA HAS 121km of existing railway lines. With the support of CABEI, it is in the process of strengthening its transportation infrastructure to emerge as a regional logistics hub, leveraging its geographical advantage of connecting the Atlantic and the Pacific oceans. To truly make the most of the potential for intraregional trade, it needs far more. The region must prioritise modes of transport that enable greater volumes of goods to be moved in shorter time periods, at lower costs and integrate different sectors more efficiently.

Key to this strategy is the development of a railway network designed around regional – not just national – needs. CABEI is at the forefront of this initiative. The modernisation of the transport sector and the consequent need for increased investments on railways to improve regional connectivity are part of the bank's 2020-24 strategic framework, aimed at promoting initiatives to improve the sustainable competitiveness of the region.

CABEI is leading the effort to transform and revitalise the Northern Triangle by exploring the feasibility of building a bi-oceanic railway connection that integrates the region.

Progress on railways is fastest in Costa Rica, where planning for the light railway in San José, the country's capital, is at an advanced stage having received funding from the GCF (see Pillar 2). Feasibility studies are ongoing for an electric cargo train that would connect Moín on the Caribbean coast with San Carlos in the interior of the country.

In partnership with South Korea, CABEI is supporting El Salvador in exploring the viability of the Pacific train and rail network for cargo and possibly passenger transport. With funding from the Korea Sharing Program, the results of a pre-feasibility study of the Guatemalan section of the Central American cargo and passenger train were released in October 2021. The first stages of this rail network will connect the southern Mexico border with Guatemalan ports in the Pacific Ocean.

To make the most of investments, these projects need to be designed with regional integration in mind. Part of SIECA's 2035 master plan is to reactivate national railway systems so that they can become part of a multimodal logistics system seamlessly linked to Central America's road, sea and air transport networks.

This is one of CABEI's priorities, too. It would bring benefits to supply chains and trade efficiency and reduce carbon emissions and road traffic. A train network from Mexico to Panama would enable Central America to make the most of existing logistical advantages, including the Panama Canal and the recently renegotiated trade deal between Mexico, the US and Canada. Such an endeavour would make Central America even more competitive on an international scale.

COUNTRY FOCUS:

NICARAGUA

Unlike the rest of Central America, Nicaragua's economy was already shrinking before the pandemic. The 2% contraction in 2020 was the third consecutive year of recession in the second poorest nation in the Americas. However, the pandemic-induced contraction was mild compared to most, and the recovery is accelerating, with the economy expected to grow 5% in 2021 and 3.5% in 2022.

Nicaragua's fiscal resilience led Fitch Ratings to improve outlook to stable from negative in June 2021. The public deficit expanded to just 1% of GDP in 2020, the smallest in the region. Multiple reforms have enabled Nicaragua to increase tax collection over the years where other countries have struggled. Revenues reached above 15.6% of GDP in 2018, below only Honduras and El Salvador in Central America.

Even before the pandemic, current account surpluses had radically improved the picture for Nicaragua's international reserves, which are vitally important to maintaining the crawling peg currency regime. The government did well to ease liquidity pressures by leaning on multilateral funding during the pandemic, obtaining $829m from CABEI, the IMF, the IADB and the World Bank in 2020. This was 52% higher than the 2017-19 average of multilateral funding and the IMF praised the government's efforts to increase transparency of its Covid-19 spending. The allocation of additional IMF special drawing rights approved in August 2021 bolstered international reserves by around $350m, taking them to record levels.

The SDRs were particularly significant as they represented an alternative to obtain liquidity despite economic sanctions from the US and the EU that complicate foreign currency funding. These sanctions, and the political turmoil that have triggered them, continue to weigh on Nicaragua's economic outlook.

Political polarisation has taken a severe toll on the economy and makes it hard to raise confidence in the business sector or in Nicaragua as an investment destination. Greater confidence in the country could generate significant opportunities in sectors such as tourism, agriculture and mining given the country's strategic location with easy access to both the Atlantic and Pacific oceans. Agricultural exports had already rebounded strongly in the first half of 2021.

There is opportunity for greater development geared towards climate change resilience, given the country is in the path of Atlantic hurricanes, and economic production that is highly reliant on natural resources.

Macroeconomic indicators

- GDP growth: -2.0%
- GDP per capita: $1,943
- Inflation: 3.7%
- Unemployment rate: 5%
- Public external debt to GDP: 55.1%
- Public deficit: 1%

Trade indicators

- FDI inflows: $182m
- Total exports : $6bn
- Free trade agreements: 9

1%

Public deficit expanded to just 1% of GDP in 2020, the smallest in the region

COUNTRY FOCUS:

PANAMA

AFTER BOASTING growth averaging 4.6% for the five years before the pandemic, Panama was hit by simultaneous slumps in international trade, tourism and construction in 2020, triggering the largest contraction in Central America by some distance, at 17.9%.

GDP is expected to rebound strongly, at 12% in 2021 and 5% in 2022, bolstered by a bounce-back in copper prices and production, private investment and external activity from the Panama Canal, logistics and Colón Free Zone. But GDP per capita may not return to its pre-pandemic level until 2023 or 2024, and Panama faces a delicate balance as it plans its medium-term outlook.

Panama's impressive growth had been built on large infrastructure spending, and CABEI highlights that capital expenditure consistently accounted for over 30% of public spending before the pandemic – far more than the rest of Central America. This had been financed by borrowing, but such strong growth meant that debt was hardly rising as a percentage of GDP.

The country's business-friendly environment means investment will likely continue to flow in. The government is betting on a robust recovery, increasing investment again after cutting back in 2020. However, there is a pressing need to address medium-term fiscal challenges. Debt levels have risen sharply in the wake of the pandemic, with the IMF expecting general government gross debt debt to surpass 62% of GDP in 2021, up 20 percentage point from its pre-pandemic levels in 2019.

Continuing to produce infrastructure projects with such an outsized impact on GDP will be a challenge, so some adjustments may be required to the growth model. In particular, the deteriorating financial situation of the social security system (Caja de Seguro Social) needs tackling. The government is aware of this and has launched a national dialogue, though it is likely to remain politically sensitive.

Despite the medium-term challenges, Panama remains Central America's only investment-grade economy, rated Baa2/BBB/BBB- by the three major agencies. It has a strong starting position thanks to a robust liquidity position, including an IMF Precautionary Liquidity Line approved in January 2021. The PLL is only available to countries with sound economic fundamentals.

Moreover, there are still key infrastructure projects under way, including a third metro line for Panama City, a tunnel below Panama Canal, energy transmission projects and road improvements. Momentum in investments should be maintained by the new PPP framework.

Macroeconomic indicators

- GDP growth: -17.9%
- GDP per capita: $12,373
- Inflation: -1.6%
- Unemployment rate: 18.6%
- Public external debt to GDP: 56.3%
- Public deficit: 9.3%

Trade indicators

- FDI inflows: $589m
- Total exports: $18.2bn
- Free trade agreements: 12

12%

Panama's GDP is expected to rebound strongly, at 12% in 2021

CONCLUSION

INTEGRATION PROVIDES CENTRAL AMERICA WITH RESILIENCE AND OPPORTUNITIES

Central America's rapid economic rebound in 2021 and the positive outlook for the coming years demonstrate the region's resilience to shocks and its development potential. As Central America emerges from the pandemic, the region will need to strike a delicate balance between ensuring sufficient support for economies and capping debt ratios that may squeeze governments' financing options if not stabilised.

This report aims to keep track of progress and encourage initiatives in the region that will drive economic growth and enhance investment. It follows the region's progress in six key areas of economic development and highlights paths to achieve sustainable growth and build investor confidence.

Sustainability and technology are at the forefront of policy-makers' and investors' agendas. Central America has an opportunity to harness these trends to drive growth amid the stable and promising macroeconomic environment in most countries in the region. The region can capitalise on appetite for sustainable investments – whether in green energy and transport, or for more climate-resilient infrastructure. And Central America's early stages in the adoption of digital technologies makes it fertile ground for investments in the sector.

The region is enriching its integration efforts, which date back more than 60 years, with infrastructure projects in the transport sector aimed at integrating the national railway system to enhance the region's competitiveness in international trade. Infrastructure projects in the energy sector are also tapping into greater efficiency and aiming to transition away from fossil fuel energy sources into natural gas.

The regional debt market is a timely initiative that will facilitate investor access and improve financing options for both private and public sector entities as the region continues down its path of economic expansion.

Opportunities abound in Central America, although the region still faces significant economic and social challenges. Continued integrated developments in the region aimed at strengthening institutions, supporting households and businesses, expanding vaccination efforts and enhancing security will enable economies to emerge from the Covid-19 crisis and compete in the post-pandemic world.

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