

**Economic Trends & Outlook**  
**Central America and Dominican Republic**  
**April 2010**

**Office of the Chief Economist**



## Table of Contents

<b>I. International Context</b>	2
<b>II. Regional Performance</b>	6
Economic Growth	6
Foreign Trade and Financial Flows	7
Inflationary Trend	8
Public Finance	8
Banking Sector	9
<b>III. Performance by Country</b>	11
Guatemala	11
El Salvador	13
Honduras	14
Nicaragua	15
Costa Rica	17
Panama	19
Dominican Republic	20

**I. International Context**

Due to the most profound recession registered in recent history since the Great Depression, the world economy reflected a significant deceleration in 2009. The crisis, which developed in the financial markets of the developed economies, expanded to the rest of the countries through commercial and financial channels as a result of the liquidity restriction, credit tightness, and a lower aggregate demand.

In this scenario, monetary authorities and governments<sup>1</sup> concentrated their efforts in implementing monetary and fiscal stimuli, which contributed to lessen and surpass the impact of the crisis. In addition, the contingency measures displayed by international agencies contributed in the reduction of uncertainty and strengthened confidence worldwide. However, signs of stabilization were not observed until the second half of 2009. Currently, questions still prevail on the dynamics of the recovery process.

First quarter data of 2010 has consolidated evidence of the stabilization process and eventual recovery, however recovery dynamics have expanded at different rates throughout the regions. On one hand, the extraordinary magnitude of stimulus measures helped rebound global activity to better than expected rates. This was possible by means of monetary policies that kept benchmark interest rates to minimum levels, fiscal policies that expanded spending and played a countercyclical role, and public sector support to the financial systems that helped lessen negative flows between the banking and real sector.

On the other hand, growth dynamics are evolving unevenly across regions and countries. Thus, developed economies will grow at a slower pace than emerging and developing economies since financial channels takes longer to recover. Even so, both groups will not reach the growth rates observed before the recession, and the expected results for 2010 will be below potential output. These results not only depend directly on the stability of the macroeconomic fundamentals for

each country, but also on the speed of authorities implementing and maintaining stimulus measures.

March 2010 data indicates that the global economic recovery has clearly been led by the Asian emerging economies, largely by China and India. The recent developments in worldwide output and credit growth reflect a change from the trend observed in 2009, demonstrating a vigorous push of aggregate demand and industrial activity levels. Furthermore, as months pass by, it will be clearer how the structural weakening of private consumption in the United States will be offset by the high dynamics of Asian and European countries.

World Economies Outlook (percentage)				
Region	2007	2008	2009	2010 p/
United States	2.1	0.4	-2.4	3.1
Euro Zone	2.7	0.6	-4.1	1.0
Japan	2.3	-1.2	-5.2	1.9
Industrialized countries	2.7	0.5	-3.2	2.3
Latin America	5.7	4.3	-1.8	4.0
Developing Asia	10.6	7.9	6.6	8.7
Emerging countries	8.3	6.1	2.4	6.3
World	5.2	3.0	-0.6	4.2

Source: International Monetary Fund (IMF). World Economic Outlook, April 2010. p/ : Projected.

The momentum shown by global activities has led to positive revisions of expected figures, generating a more optimistic outlook. The latest figures from the International Monetary Fund (IMF)<sup>2</sup> indicate that the global recovery and improvement of financial conditions have begun with greater strength than expected. The projections of output growth in developed economies, as well as emerging and developing countries, were adjusted upwards by 0.3 percentage point.<sup>3</sup> According to the report, the developed economies should pay particular attention to the limitation mainly related to high unemployment levels, high debt levels, and weaknesses in the financial systems. Meanwhile, emerging economies and developing countries must overcome possible fluctuations in international demand and prices of raw materials and commodities.

<sup>1</sup> The actions of governments and central banks were aimed at the obtainment of stability in local markets.

<sup>2</sup> World Economic Outlook Update, April 2010.

<sup>3</sup> Adjusted in relation to the projections of the World Economic Outlook Update, January 2010.

Throughout the year, inflationary pressures progressively fell given the economic downturn mainly because of the decline in aggregate demand and relative stability of oil prices. In many cases, inflationary pressures eased the general price index to historical lows. Additionally, the gaps were quantitatively significant because the reference levels of 2007 and 2008 were influenced by the food and oil price crisis.

Conversely, as in the rates of economic activity, inflation rates have been heterogeneous during the first quarter of 2010. Although the rates remain relative low, projections expect a moderate rise. Inflationary pressures would be contained by the low levels of capacity utilization and inflation expectations anchoring in the developed economies. Meanwhile, emerging economies should remain alert to the limited scope of its installed capacity utilization, capital flows, and raw material and commodity prices.

In the case of the United States, the region's principal trading partner, reported a contraction of -2.4% in 2009 due to high unemployment levels and a sharp deceleration in economic activity during the first semester. To date, industrial activity levels have rebounded significantly and unemployment has begun to decrease. Yet, the total adjustment of the unemployment rate is not expected in the short term. Under the current conditions, the consolidation of the growth trend observed during the fourth quarter of last year is expected throughout 2010.<sup>4</sup> Last year's fourth quarter reflected the contribution from investments in private inventory and residential fixed capital, the rebound of exports, and private consumption expenditures.

In this context, the IMF forecasts that the United States economic recovery will be gradual during 2010, reaching a GDP growth of 3.1%; a result influenced by the balance of power between fiscal and monetary stimuli, the gradual recovery of personal consumption (representing approximately 70.0% of GDP), and the slow recovery of employment levels.

<sup>4</sup> According to data in the second revision of the Bureau of Economic Analysis (BEA), GDP growth during IV quarter 2009 increased to 5.9%.

Consistent with the global economic conditions, United States' foreign trade reflected the damages from the crisis. According to figures from the Bureau of Economic Analysis (BEA), at the end of 2009, the contraction in imports outpaced the decline in exports, resulting in shrinkage of -45.6% in the trade balance deficit. In January 2010, imports recorded an annual increase of 11.9%, resulting from a boost in purchases of industry supplies and materials, capital goods, and consumer products. Similarly, exports reported an increase (15.1%), largely due to higher sales of industrial inputs, capital goods, and automotive parts.

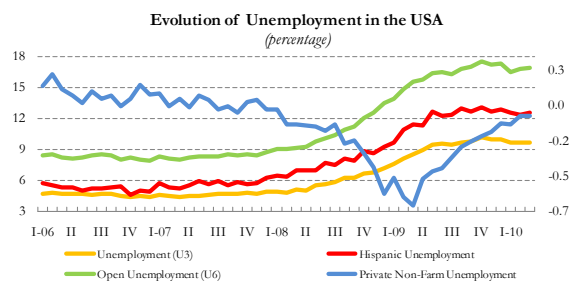
United States Foreign Trade		
Year	Exports	Imports
	<i>(million of dollars)</i>	
2006	1451,683	2212,043
2007	1643,169	2344,591
2008	1826,597	2522,532
2009	1554,718	1933,347
2010*	142,664	179,952

Source: Bureau of Economic Analysis (BEA).

\* As of January 2010.

Moreover, unemployment levels have been adjusted downwards. However, there is no evidence indicating that unemployment will reach traditional levels in the short term. During 2009, rates soared to historic levels not seen since 1983. According to reports from the Bureau of Labor Statistics (BLS), at the end of 2009, the unemployment rate rose to 10.0%, exceeding by 2.6 percentage points the previous year recorded rate. Thus, meaning that the unemployed climbed approximately to 15.2 million. In March 2010, the rate was adjusted to 9.7% promoted by new hires to temporary jobs and health services, as well as federal government hiring in view of developing the 2010 Census. This adjustment reduced the number of unemployed to 15.0 million.

Within the main labor groups, Hispanic unemployment stands out at 12.6%, exceeded only by African American unemployment (16.5%). The economic sectors that are still reporting employment loss have been those related to financial activities and information.



Source: ADP National Employment Report and Bureau of Labor Statistics.

In relation to the Euro Zone and Japan, both managed to register growth since the second half of 2009, being Germany and France the main contributors to the improvement of the region's economic performance. Economic growth in the Euro Zone was revived after being negative for six consecutive quarters; nonetheless, it registered a year on year fall of -4.1%. At March 2010, the economic recovery has taken place at a slow pace. Thus, the expected growth for this year is close to 1.0%.

Japan, the second largest world economy, recorded a cumulative growth contraction of -5.2%. Economic activity began tracking improvements since the second quarter of the year explained mainly, among other reasons, by economic incentives. Despite the data, at March 2010 doubt still precedes about the sustainability of the recovery, mainly due to a strong deflationary trend and a weak domestic demand. The government will continue to provide fiscal, monetary, and financial support as a palliative measure towards the effects of the continuing deflation and falling wages.

In regards to China and India, both economies were also affected by the global crisis. However, due to the appropriate policies and measures implemented by the authorities, their recovery continues to strengthen. The economic upturn of these economies not only represent strength for the Asian region but also for the global economy. According to the National Bureau of Statistics, China's GDP stood around 8.7% in 2009, due to both heavy infrastructure investments associated with the government's stimulus package, and the rebound in spending on residential development. According to authorities, by 2010, growth will be underpinned by means of a strategy that aims to refocus the economic model of private consumption and reduce the country's reliance on

exports. Although India registered one of the world's highest expansions (5.7%), the year represented a significant drop compared to the 7.3% in 2008. To date, economic activity appears to be well established. Thus, sustained GDP growth is expected by means of private growth consumption prospects and domestic and foreign investment.

In general, developed economies managed to recover from the severe recession during the second half of 2009. First quarter data of 2010 indicates that the recovery continues to strengthen, but authorities must remain vigilant to dangers that may affect growth.

The turmoil unleashed in the financial markets coupled with the global economic slowdown progressively affected the flow of foreign direct investment (FDI) in 2008 and 2009.<sup>5</sup> After five years of continuous growth (2003-2007), FDI declined from a record high reported in 2007 (US\$1,978.8 million). At the end of 2009, global investment flows contracted by around 39.0%, since resources began to dwindle to the extent of how their economies were being affected by the crisis and their sharp rise in sovereign debt premiums.

Despite the crisis, it should be noted that emerging and transition economies continue to represent the major recipients of financial flows. Furthermore, given the slow signs of recovery in 2010, a worldwide FDI acceleration is not expected until 2011. Thus, the medium-term outlook remains positive.

Region	Foreign Direct Investment Flows (billion of dollars)				
	FDI Inflows				
	2005	2006	2007	2008	2009 a/
World	973.3	1,461.1	1,978.8	1,697.4	1,040.3
Developed countries	613.1	972.8	1,358.6	962.3	565.6
Developing countries	329.3	433.8	529.3	620.7	405.5
Transition economies	30.9	54.5	90.9	114.4	69.3

Source: UNCTAD - Global Investment Trends Monitor, January 2010.  
a/ Estimated.

Presently, there is evidence of a world economic recovery, but it is difficult to indicate precisely the path it will take. Thus, the analysis will focus on contributing to the difficult task of identifying

<sup>5</sup> United Nations Conference on Trade and Development (UNCTAD), Global Investment Trends Monitor, January 2010.

trends and behavior that will distinguish the global economic recovery process. In terms of GDP growth, modest and unequal growth rates are expected in 2010. It is foreseen that the advanced economies will experience sustained growth during the second semester of 2010, contributing to a cumulative world growth of 4.2%.

In the case of the United States, some analysts suggest that recovery will be slow and gradual yet sustainable, adopting the V form. While others estimate that there are still risks of new falls (W) i.e. a moderate recovery, a new fall and a later on recovery. Those who embrace the former theory argue that economic activity will recover gradually in a sustained manner because of the monetary and fiscal measures and the better perspectives of world growth. The pessimistic indicate that the recovery will be problematic considering the high household debt that will fail to maintain the demand momentum in the medium term, the reduction of stimuli directed plans, the risks associated with the huge U.S. government deficit, and inflationary pressures that will force central banks to raise interest rates in coming months.

## II. Regional Performance

During 2009, the region's economic performance was affected by the recession resulting from the global crisis. Overall, the crisis affected the region due to a liquidity restriction, a lower aggregate demand, and a fall in international commodity prices. The cumulative effects were higher than those projected by central banks. However, economic activity has recorded a change in trend since the third quarter of 2009.

To date, most countries have recorded positive monthly activity indices. Within an international context with buoyant macroeconomic conditions and positive prospects for medium term growth, the shape and strength of the recovery trajectory will be closely linked to the dynamics of the industrialized countries, especially the United States.

### *Economic Growth*

The slowdown in international demand from the major regional trading partners had a strong impact on the dynamics of the product in 2009. In this context, the regional GDP performance was lower than estimated by the monetary authorities of each country. Thus, the range of product growth was defined by the economies of El Salvador and the Dominican Republic (-3.5% and 3.5%, respectively).

At January 2010, the trend cycle of the region's Monthly Economic Activity Index (MEAI)<sup>6</sup> registered an annual variation of 1.5%, contrasting the -2.2% recorded in January 2009. This slight rise reflects the superlative domestic macroeconomic conditions associated with the worldwide gradual recovery process.

Although the slowdown was widespread throughout the region, a discrepancy exists between countries. Costa Rica being the country with best performance, recorded a change in its product trend since February 2009. In contrast, the Salvadorian economy was greatly affected and continues to record negative indicators. According

to the latest available figures, Costa Rica's MEAI trend cycle reported an annual growth of 6.3% in January 2010, reflecting a solid performance contrasting that reported by El Salvador (-3.0%).

Panama, the region's country with the most pronounced economic slowdown (pre-crisis growth of 10.0%), recorded a 3.0% annual MAEI at January 2010. Nevertheless, Panama achieved to be one of the few Latin American countries presenting growth in 2009 and emerging with better prospects for 2010.

Although the governments and central banks efforts were aimed at mitigating the impact of the crisis and reviving economic activity, their initial forecasts were not met and continually modified growth forecasts for 2009.

GDP growth 2009 (percentage)	
Country	Central Banks *
Guatemala	0.6
El Salvador	-3.5
Honduras	-2.1
Nicaragua	-1.5
Costa Rica	-1.3
Panama	2.4
Dominican Rep.	3.5

\*Observed.

Source: Central Banks.

It is important to note the constant discrepancies between year-end estimates made by central banks and those published by international and private agencies over the past year. For example, according to estimates published in the WEO October 2009, El Salvador was expected to experience the greatest regional contraction (-2.5%), Panama's growth outlook was anticipated to be at 1.8%, and Dominican Republic's growth at only 0.5%; figures that differed from the observed behavior .

In view of the strong commercial and financial links between the region and the United States, the authorities are waiting for the American economy to rebound in order to notice further significant changes in their economies. In addition, for the formulation of expectations it is necessary to consider the lag effect in the transmission mechanisms from developed economies to emerging countries. Meanwhile, economic activity during 2010 will continue to

<sup>6</sup> Includes only countries in Central America. Calculated weighted average according to size of economies. Source: SIMAFIR-SECMCA.

depend closely on the changing economic conditions of their main trading partners and domestic macroeconomic adjustments.

Regarding growth expectations in the region for 2010, despite the relative differences between the projections published by international and private agencies, they all agree that the dynamics of growth will be modest and gradual. CABEI agrees with the latter and believes that further growth will be uneven not only among countries, but also that the rates will fail to recover to levels observed in the period before the crisis.

Country	ECLAC	World Bank	International Monetary Fund	CABEI
Guatemala	2.0	1.6	2.5	1.3 - 2.3
El Salvador	2.0	0.8	1.0	1.3 - 2.3
Honduras	1.5	1.8	2.0	2.3 - 3.3
Nicaragua	2.0	1.7	1.8	1.0 - 2.0
Costa Rica	3.5	2.1	3.5	3.7 - 4.7
Panama	4.5	2.7	5.0	3.5 - 4.5
Dominican Rep.	3.5	2.4	3.5	4.2 - 5.2

\*Projected.  
Source: ECLAC Statistical Yearbook 2009, World Bank, IMF - WEO April 2010, CABEI

At March 2010, the monthly information received from critical variables such as the MEAI, exports, imports, remittances, tourism, foreign investment, etc., still do not support prospects for an accelerated growth. Additionally, critical variables such as Hispanic unemployment (very relevant to remittances) and imports in the United States (as this is where our exports fit in) do not envision significant improvements in the short term.

In other words, at this stage of the recovery it would be inadequate to make optimistic statements about the prospects of recovery. For CABEI, therefore, the country with the lowest growth will be Nicaragua (1.0% - 2.0%) and the country with highest growth will be the Dominican Republic (4.2% - 5.2%).

*Foreign Trade and Financial Flows*

Consistent with the decline in global demand, regional trade was severely diminished. Central America (including Panama and Dominican Republic) recorded a sharp drop of exports in 2009 (-12.3%), which was succeeded by the contraction of imports (-23.5%).

As mentioned before, the magnitude of the effects varied from one economy to another. On the export side, Panama and the Dominican Republic

were the most affected economies, while Guatemala and Nicaragua suffered the least reduction in abroad sales.

Furthermore, the regions' imports marked a sharper contraction. The Honduran and Dominican economies restricted foreign purchases the most, about -30.0% for both. In almost all the regional economies, the slowing spread between purchases and abroad sales led to a relative improvement of the trade balance.

Country	Exports			Imports		
	2007	2008	2009*	2007	2008	2009*
Guatemala	14.7	12.2	-6.5	13.9	7.2	-20.8
El Salvador	9.2	6.6	-16.5	13.7	12.0	-25.6
Honduras	21.0	13.7	-20.1	20.2	29.6	-30.6
Nicaragua	14.7	8.3	-6.6	17.6	15.8	-21.9
Costa Rica	13.9	1.8	-7.5	12.2	18.7	-25.9
Panama	10.1	10.4	-28.3	22.9	14.8	-13.4
Dominican Rep.	8.3	-3.0	-27.0	11.7	18.4	-30.3
Regional variation	12.1	6.2	-12.3	14.9	15.4	-23.5

Source: SECMCA, Central Banks and INEC Panama.  
\*Latest available data.

In January 2010, the relative improvement in demand from the region's major trading partners have generated a modest upturn in the number of regional exports, which is expected to continue depending on the improvement of external macroeconomic conditions. In addition, the value of imports has consistently increased with the normalization of domestic production and commodity prices.

The prevailing liquidity pressures in the financial markets and the deteriorating labor markets have restricted cash flows worldwide, primarily those associated with FDI and capital transfers. UNCTAD's Global Investment Trends Monitor report (January 2010), showed a drop of -40.7% in cumulative FDI flows to Latin America and the Caribbean, at the end of 2009. This figure amounted to a reduction of approximately US\$86.0 billion.

The data indicates that FDI noticeably decelerated compared to flows from the previous year. In the case of Honduras, the fall reached -46.2%, mainly because of the political crisis. Nicaragua registered a contraction of approximately -33.8%, while El Salvador registered a fall of -45.1%.

Financial Flows (million of dollars)						
Country	Foreign Direct Investment			Remittances		
	2007	2008	2009*	2007	2008	2009*
Guatemala	745.0	838.0	775.2	4,128.4	4,314.7	3,912.3
El Salvador	1,509.0	784.0	430.6	3,695.3	3,787.7	3,465.7
Honduras	926.1	901.2	485.0	2,591.8	2,689.8	2,388.5
Nicaragua	382.0	626.1	414.6	739.6	818.1	768.4
Costa Rica	1,896.0	2,021.0	989.4	338.1	329.6	376.6
Panama	1,907.0	2,402.0	1,849.5	320.0	325.0	292.5
Dominican Rep.	1,578.9	2,884.7	1,158.7	3,032.7	3,110.7	2,279.9
Regional accumulated	8,944.0	10,457.0	6,103.0	14,845.9	15,375.6	13,484.0

Source: UNCTAD and Central Banks.

\*Latest available data.

Capital transfers to the region in the form of remittances reported a decreasing trend. In the case of the Central America, this phenomenon was associated with the increasing Hispanic unemployment rates in the United States (12.9% at December 2009). Remittances represent an important flow to the region since they make up a significant percentage of the countries' GDP being Honduras, El Salvador, and Guatemala the highest. March 2010 data indicates that El Salvador reported an accumulative annual increase of 0.6%, while Guatemala registered a contraction of -2.8%.

The importance of remittances is evident, as in most cases they are a source of income that is used for consumption. Capital flows for 2010 will be linked to the recovery of Hispanic employment levels in the United States, which was 12.6% in March 2010. Finally, capital flows in the form of loans and FDI will remain restricted as long as the liquidity pressures proceed in international markets and the country risk premiums fail to stabilize.

### *Inflationary Trend*

Inflationary pressures eased sharply because of the world aggregate demand downturn and low commodity prices. Therefore, the region experienced significantly lower inflation rates. In some cases deflation occurred which contrasted the double-digit rates reported by several countries during previous years, as was the case of Honduras, Nicaragua and Costa Rica.

The sharp drop in the rates, compared to those recorded in previous years, was not only due to the effects of the global economic slowdown, but also because the inflation rates in 2007-2008 showed the effects of the food and oil crisis. Thus, for some countries like Guatemala and El

Salvador, a year-end negative figure had not occurred in 30 years.

Consumer Price Index (percentage)					
Country	2007	2008	2009	2010*	2010**
Guatemala	8.8	9.4	-0.3	3.3	3.6
El Salvador	4.9	5.5	-0.2	0.5	2.6
Honduras	8.9	10.8	3.0	5.1	4.6
Nicaragua	16.9	13.8	0.9	5.1	6.0
Costa Rica	10.8	13.9	4.1	4.9	5.3
Panama	4.2	6.8	2.4	3.3	2.6
Dominican Rep.	8.9	4.5	5.8	6.5	4.0
Simple average	9.0	9.2	2.2	4.1	4.1

Source: Central Banks, IMF and CABEI.

\* IMF - World Economic Outlook, April 2010.

\*\* CABEI estimated ( $\pm$  1 percent).

Despite the significant reduction seen in inflationary pressures during the previous year, at March 2010 they have increased because of the reactivation of regional and global economic growth, as well as the rebound in prices of oil and raw materials that are now moderate but could increase throughout the year. At March, the regional inflation (including the Dominican Republic) amounted to 5.3%, with Costa Rica and the Dominican Republic countries experiencing the highest rates (5.8% and 7.4% respectively), and El Salvador with the lowest rate (0.9%).

The IMF forecasts that the country with the lowest inflation for 2010 will be El Salvador (0.5%), while higher pressures would be held in the Dominican Republic (6.5%).<sup>7</sup> Furthermore, CABEI estimates that the lowest inflation rates would take place in El Salvador and Panama (2.6%), while the country with the highest rate would be Nicaragua (6.0%).

### *Public Finance*

The downturn in economic activity has weakened the fiscal account balance by creating an imbalance between shrinking tax revenues and increased spending, as a countercyclical policy. On one hand, at December 2009, revenues decreased by around -9.7% in Central America, in particular by the reduction of import related fees and taxes. In contrast, expenditures continued to grow, albeit to a lesser extent, as a means of a government dynamic instrument of domestic demand.

<sup>7</sup> World Economic Outlook, April 2010. Table A-7.

The sharp contraction in tax revenues increased the regions' fiscal deficit, reaching values higher than 4.0% of GDP. The widening of the deficit has forced governments to resort to foreign debt and in particular to internal debt, consequently substantially increasing the public debt to GDP ratio.

In cases such as the Dominican Republic, the structural weaknesses associated with tax collection and the energy sector has generated additional pressures on the public financial accounts. In general, the deterioration of the fiscal performance plays a major threat to the countries' macroeconomic stability over the medium-term.

Fiscal Accounts						
Country	Accumulated Variation (percentage)					
	Total Revenue			Total Expenditure		
	2007	2008	2009*	2007	2008	2009*
Guatemala	14.6	5.1	-11.9	10.6	6.9	0.2
El Salvador	10.2	9.4	-13.1	9.1	11.9	7.5
Honduras	19.7	14.3	-9.0	30.0	14.1	-0.9
Nicaragua	12.4	8.2	-2.8	8.0	13.6	-0.3
Costa Rica	33.5	7.4	-7.0	19.7	9.7	16.0
Dominican Rep.	23.5	-0.9	-9.8	20.5	23.6	-8.3

Source: SECMCA and Central Banks.  
\* Latest data available.

Fiscal Deficit and Foreign Public Debt (percentage of GDP)						
Country	Deficit *			Foreign Debt *		
	2007	2008	2009	2007	2008	2009
	Guatemala	-1.4	-1.6	-3.2	12.4	11.2
El Salvador	-0.2	-0.6	-3.6	26.7	26.4	30.5
Honduras	-2.9	-2.4	-6.1	16.4	16.7	17.1
Nicaragua	-3.3	-4.1	-4.8	59.5	55.2	60.7
Costa Rica	0.6	0.2	-3.0	13.3	12.7	11.8
Panama	-0.8	-1.2	-4.2	41.8	36.7	38.3
Dominican Rep.	0.2	-3.4	-3.4	18.4	20.0	23.4

Source: Own calculations based on Central Banks data.  
\* Central Government.

Given the deterioration of fiscal accounts, the countries focused on achieving fiscal reforms that would enable them to address the sharp decline in revenue and meet the growing expenditure requirements. To date, there have been reform processes in all countries with varying degrees of progress (Honduras and Costa Rica are the countries that are lagging behind in the process due to the recent changes in government).

The challenge for governments is very palpable since fiscal deficits have reached levels not seen since the eighties. In that sense, governments should be cautious in implementing measures, so as not to impose a constraint on the economic recovery process.

### Banking Sector

The Central American financial system also suffered the consequences of the global crisis, reducing its retained earnings in 2009. Liquidity constraints at the international level decreased financial intermediation by imposing higher fund costs, while internally the bank imposed greater restrictions on credit access and increased provisions for non-performing portfolios.

The rising unemployment level in the region and the fall of international remittances limited the public's capacity to pay, affecting default levels as a percentage of the total portfolio. In most countries, this meant an increase in impaired debts and respective provision of reserve requirements, especially in those entities that grew very aggressively in high-risk segments in recent years. All this has influenced a drop in the bank's profitability indicators.

In 2009, regional growth of deposits amounted to just 3.9% in cumulative terms, significantly below the 6.3% growth reported in December 2008; a result induced by the greater need for liquidity by the public. In addition, the credit portfolio decreased -0.6%, well below the growth of 10.9% recorded at the end of 2008. For its part, the indicator of nonperforming loans (NPL) as a percentage of total loans increased significantly, going from an average of 2.4% in 2008 to 2.9% in 2009. Yet despite the upturn in this indicator, the regional banks retained reserves in excess of the amount of nonperforming loans (114.1%).

Banking Sector*				
	Accumulated variation (percentage)			
	Credit	Deposits	Equity	Portfolio arrears / Total credit
	2007	29.3	17.5	19.5
2008	10.9	6.3	14.8	2.4
2009	-0.6	3.9	6.9	2.9

Source: SECMCA - Statistics and Indicators.  
\* Central America and Dominican Republic.

At this point in particular, it is necessary to highlight the dynamic supervisory and regulatory role of the Superintendence of Banks in the different countries during the year. The strengthening of the regulatory framework of financial systems and the implementation of more stringent measures prevented the crisis from

causing bankruptcies and systemic problems in the region. The new regulations focused on executing efficient risk management through greater requirements for granting credit and greater levels of provisioning in the face of asset impairment.

Liquidity constraints forced central banks to take financing at a cost significantly higher than prior to the crisis, which resulted in higher interest rates for the public. Moreover, the deteriorating economic environment and new regulations have reduced the willingness of banks to take active operations, thereby limiting the growth of loans and consequently of interest income.

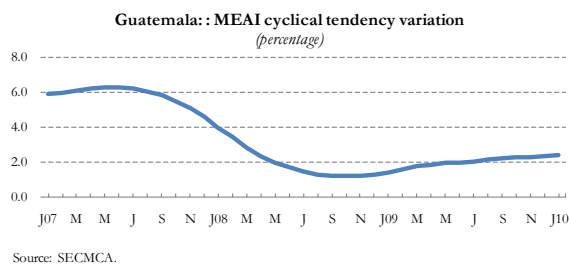
It is not easy to conclude on the level of crowding out that would have occurred in recent months, driven by the need for domestic financing by governments. At first, it did not have any effect as the business and household sectors restricted their demand for credit, which left funds available for governments. However, crowding out is a more realistic threat in the coming months, especially if the governments' domestic debt grows and if the business sector begin to reactivate investment.

The results of the financial system will be closely linked to the evolution of the macroeconomic conditions and the stability of international financial markets. Meanwhile, a further deterioration of banks' loan portfolios could be expected (or remain unchanged in the best-case scenario), and the reserve requirements would account for a higher share of the banking revenues.

### III. Performance by Country<sup>8</sup>

#### Guatemala

The year 2009 marked a severe economic slowdown reducing GDP growth to 0.6%. According to statistics from the Bank of Guatemala (Banguat), this rate is significantly lower than the average reported during the triennium of 2006-2008, when GDP showed an expansion of approximately 5.0%. Despite the slowdown, Guatemala was one of the few countries in the region that reported growth at the end of 2009.



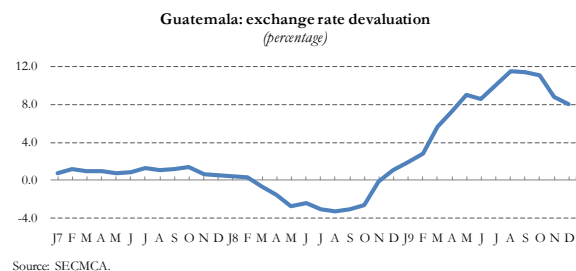
The cyclical tendency of the MEAI reached a value of 129.9 in January 2010, slightly higher than last year's figure (127.1), equivalent to a 2.2% growth rate. Compared to the same period in 2009, this behavior suggests slight increases in production volumes and marginal improvements in the behavior of economic activity. Contrasting the other countries in the region, Guatemala did not report a single negative figure in terms of economic activity. Furthermore, it has been consistent in showing a slow and gradual recovery to date.

The general price level fell due to lower activity and the fall in input prices. At the end of 2009, cumulative inflation stood at -0.3% contrasting the 9.4% in 2008. Guatemala had not registered a year-end negative rate for approximately 30 years. Note that in general, high inflation rates recorded during the two years were incised by the rise in international oil prices. By March 2010, the cumulative inflation rate amounted to 2.9%,

<sup>8</sup> Information obtained from Central Banks, Finance Ministries, Treasuries, Ministries of Economy, Chambers of Commerce, Exporters and industry, Central American Executive Secretariat of the Monetary Council, agencies and independent analysts.

reflecting the pressures of greater economic dynamics.

Concerning the exchange rate, the accumulated depreciation recorded -7.1% and -7.8% in annual terms. During 2009, the currency depreciated for 10 months until the trend changed in mid-October. Banguat intervened only to prevent abrupt changes, and opted for the market to determine the value of the currency. At March 2010, the nominal exchange rate reported a cumulative appreciation of 4.4%, which was the result of seasonal effects of the nominal exchange rate and the main foreign exchange flows, and the increase in net income of private equity, and changes in expectations from economic agents.



Regarding foreign trade, exports in 2009 reached US\$7,231.3 million, which amounted to a year on contraction of -6.5%. This result was significantly lower than growth reported in 2008 (12.2%) and was mainly associated with the decline in sales of goods to Central America and other products to the world that was partially offset by the observed increase in exports of the country's principal products. In January 2010, exports reflect a growth of 37.3% compared to the amount registered in January 2009. This result was impacted by higher exports of main products and sales of other products to the world.

Imports totaled US\$11,525.6 million in 2009, reflecting a contraction of -20.8%. This behavior is explained by a fall of -16.5% in the average price of imports, as well as a -7.6% decline in trading volume. It can be noted that the decrease in prices was incised by the decline in oil prices compared to the high prices recorded in 2008, and by the collapse commodity prices. In January 2010, imports reported an annual growth of 11.1%. This surge was mainly due to higher purchases of raw materials and intermediate

products for industry and agriculture, as well as fuels and lubricants.

The trade balance has improved because the fall in imports exceeded that of exports. Despite the latter, during 2010 remittances and tourism receipts will be insufficient to cover the current account deficit. Considering that remittances will be limited by changes in the employment levels of the United States. Remittances, which have accounted for about 12.0% of GDP, recorded a cumulative contraction of -9.3% at end of 2009, and during the first quarter of 2010 reflected a year on year contraction of -2.8%.<sup>9</sup>

FDI experienced an estimated contraction of -7.5% by the end of 2009. Despite this slowdown, there are items that continue to focus on the dynamic; such as the industrial, transportation, communications, services (call centers), and agricultural sectors, the latter to a lesser extent. According to the latest Global Competitiveness Report of the World Economic Forum,<sup>10</sup> Guatemala is the second country in the world where crime and violence impose higher costs to businesses, which impairs the country's attractiveness for FDI.

Due to the deteriorating global economic environment and its impact on the economy, central government revenue showed a downward trend. At the end 2009, the cumulative change over the same period last year amounted to -4.4% (-4.7% income tax),<sup>11</sup> while in February 2010 there is evidence of a change in trend reporting an expansion of 7.1% over the same period of 2009, primarily due to increased tax revenues (7.3%). Moreover, spending growth was influenced by the prioritization policies of social spending (46.1% of total expenditure) implemented by the authorities as a tool to lessen the impact of the crisis that expanded spending by 8.3% in 2009. At February 2010, expenditures continued to expand and reported a rate of 20.1% over the same period in 2009.

---

<sup>9</sup> According to the International Organization for Migration (IOM), the largest percentage of remittances is allocated for consumption. A similar pattern occurs in the rest of the region.

<sup>10</sup> Pg. 358, Table 1.13 Business Costs of Crime and Violence.

<sup>11</sup> In 2009, the tax burden fell to 10.5% (11.3% in 2008).

Consistent with the above, Guatemala reported an increase in its fiscal deficit, rising from -1.7% in 2008 to -3.2% of GDP at the end of 2009. In order to cover the fiscal gap, the government opted for acquiring domestic debt through trading of securities and sought the advancement of loan disbursements from international agencies. Hence, the tax issue will remain of great importance during 2010, so authorities should aim at strengthening tax administration and increasing taxation. According to the monetary program, the fiscal deficit could be reduced to 3.1% of GDP in 2010.

In relation to the financial sector, the impact on financial intermediation was less than originally projected. The year 2009 was a year of challenges for Guatemalan banking, as it was a period of great financial prudence, which led to the reorganization of bank corporate government focusing on risk management. Additionally, according to the Superintendence of Banks (SAT), the changes in rules and regulations has led to the consolidation of a mature and prudent financial system.

The balance sheets reported growth in asset and liability accounts. At the end of 2009, total deposits increased by 10.3% reaching US\$11,544.5 million, of which 18.7% are denominated in foreign currency. Similarly, investments registered a growth of about 8.0%, principally in government and central bank securities that were financed with foreign deposits and lines. Moreover, private sector credit is estimated to have grown 1.1%.

In regards to nonperforming loans, there has been a significant increase from 2.5% up to 3.7%. These levels are still in manageable ranges, since the supervisory authorities have implemented changes in regulations that aim to strengthen the provisions and reserves created in case of portfolio deterioration, as well as in their capital adequacy. The year 2010 will focus on preventive supervision and corrective measures.

Regarding the outlook for 2010, ECLAC forecasts a growth of 2.0%, the World Bank of 1.6%, while the IMF of 2.5%. CABEI forecasts that GDP growth will be between the range of 1.3% and 2.3%.

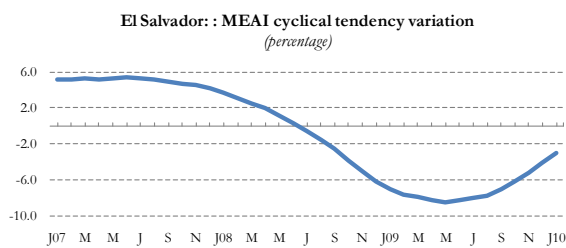
Regarding inflation, the IMF considers it will be 3.3%, while CABEI estimates inflation at 3.6% ± 1%.

**El Salvador**

El Salvador was the most affected country in Central America, reflecting the sharpest contraction since the eighties. According to figures from the Central Bank, the gross domestic product reported a contraction of -3.5% in 2009.

Over the past year, economic performance was influenced not only by the global economic and financial crisis, but also by the political uncertainty caused by the presidential elections and subsequent change of the government. Additionally, there was much hesitation on the tax reform process, and questions arose about the direction of public policies. To date, as during all of 2009, the government has not yet published its Five Year Plan.

In January 2010, there was an annual decrease of -3.0% in the cyclical tendency of the Volume of Economic Activity Index (VEAI). Among the major sectors, those most affected were hospitality, community and social services, as well as mining. However, there has been a change in trend since June 2009. Yet at January 2010, there has been an accumulated 17-month contraction.



Source: SECMCA.

Overall, the data suggests that the contraction rate in GDP will eventually ease. Yet, to date, El Salvador is the only country in the region that continues to report negative figures.

At the end of last year, overall annual inflation stood at -0.2%, contrasting the 5.5% recorded in 2008. This reduction was reflected primarily in food and non-alcoholic beverages, transportation,

and goods. The decline in inflation was due in part to the fall in aggregate demand and the deflation in international prices of oil and commodities. At March 2010, cumulative inflation reached 0.9%, illustrating the increasing pressures from housing, water, electricity, gas and other fuels.

Foreign trade has experienced a sharp slowdown. In 2009, exports fell by -16.5% (*maquila* fell by -22.9%), mainly due to a decrease in demand from the United States. At February 2010, exports reported a year on year growth of 11.0%, driven mainly by higher sales of traditional products. Furthermore, imports reported a sharp drop of about -25.6%, a behavior associated with the slowdown in domestic production because of lower aggregate demand and falling oil and commodity prices. At February 2010, imports recorded an annual growth of 9.9%, mainly due to an increase in demand for consumer and intermediate goods and crude oil and its derivatives.

Regarding capital flows, FDI reflected a balance of approximately US\$430.6 million at the end of 2009, which amounted to a fall of -45.1%. These resources relate mostly to investment in new projects, contrasting the already established purchases observed in previous years when banks were bought by international entities. Furthermore, remittances decreased -8.5% during 2009, mostly because of the high Hispanic unemployment levels in the United States. Remittances amounted to US\$848.4 million at the end of the first quarter of 2010, which amounted to a 0.6% growth.

The sharp fall in imports has affected tax revenue. According to information from the Ministry of Finance, there was a sharp deterioration in income in the central government accounts compromising fiscal performance over the medium term. Current revenues reported a fall of -13.1% (-9.6% income tax) compared to the figures obtained during 2008, while current expenditure expanded by 9.1% creating liquidity problems for the government administrative transactions. At February 2010, current income reported a 3.6% increase in current expenditures and an expansion of 5.3% compared to the amount recorded in the same period of 2009.

At the end of 2009, total public debt amounted to US\$11,173 million, a 14.9% increase over the balance registered in 2008. Of this total, 58.6% is external debt that grew by 12.2%. These figures reflect the importance of tax reforms, because if they are unable to compensate for the drop in revenue, there will be more pressure to pursue additional debt to cover the gap.

Since dollarization in 2001, the country has experienced an increase in its internal and external vulnerability that has resulted in higher living costs. However, it has dramatically reduced exchange rate and market risks, resulting in greater price stability and reduced interest rates. Nevertheless, controversy remains about whether dollarization would accentuate the gravity of the crisis, a question lacking accurate answer.

Moreover, the financial system has been characterized by a credit crunch (especially in the productive sector) and by having excess liquidity that have been used to diversify the investment portfolio and to repay external credit lines. Central Bank figures show that in 2009 assets declined by -2.7% settling at US\$13,306 million (64.0% of the assets correspond to loans). In addition, liabilities decreased by -3.7% to US\$11,310 million. On the liabilities side, deposits continue to be the primary public source of funding (89.5%).

The loan portfolio experienced a decline of -6.4% in 2009 settling at US\$8,579 million being housing, consumer, and commercial sectors reflecting the greatest dynamism. For its part, non-performing loans have increased significantly over the past 12 months, from 2.8% to 3.7%, being housing and consumption the most affected sectors. Furthermore, the low financial intermediations the deterioration of the portfolio, and higher provision levels have consumed earnings.

Regarding the outlook for 2010, ECLAC forecasts a growth of 2.0%, the World Bank of 0.8%, while the IMF of 1.0%. CABEI forecasts that GDP growth will be between the range of 1.3% and 2.3%.

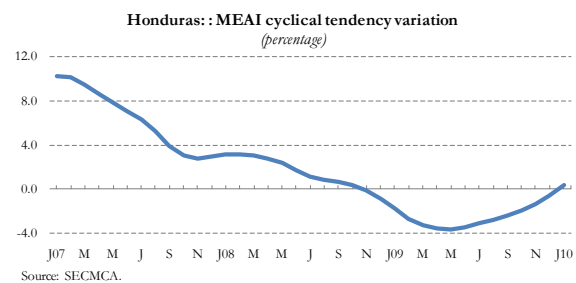
Regarding inflation, the IMF considers it will be 0.5%, while CABEI estimates inflation at 2.6% ± 1%.

## Honduras

Unlike the other countries of the region, Honduras was not only affected by the deteriorating international economic conditions but also by the internal political conflict resulting from the events of June 28, 2009. Thus, GDP growth for 2009 amounted to a strong reduction in economic activity standing at -2.1%.

The political crisis led to repeated closing of the borders. The measures taken against Honduras affected trade throughout the entire region that led to important losses for employers and paralyzed the negotiations for the Association Agreement with the European Union (EU). In addition, the international crisis hampered the pursuit in obtaining resources, and foreign exchange flows were reduced due to lower remittances, exports, tourism, FDI, among other sources. Meanwhile, the government did not have the dedication or the resources to assume leadership on public investment projects that might have softened the onslaught of the two crises that were affecting the country.

The entrepreneurial component was affected in all its sectors. Activity decreased as the result of a fall in domestic demand, lower purchases by the United States, and lower intra-regional trade. These factors led to an evident deterioration of *maquila*, construction, industrial, tourism, and commercial activity. In January 2010, after fourteen consecutive months of negative behavior, the cyclical MEAI tendency showed a slight growth of 0.3%, consistent with the slowdown in the rate of contraction observed since June 2009.



The indicator's recovery has been driven by the following sectors: agriculture, forestry and fishing,

banking and insurance, miscellaneous services, manufacturing, and mining. In contrast, trade and construction activities recorded a negative contribution.

Although there is clear impairment of the MEAI in Honduras during 2009 and a slow recovery during 2010, one should note that its economic performance was not as deteriorated as those recorded by other countries in the region. Furthermore, during the more severe months of the crisis, entities such as The Economist Intelligence Unit (EIU) predicted a GDP contraction up to -4.4%, which did not occur.

In 2009, accumulated inflation rose to 3.0%, significantly contrasting the rate observed in 2008(10.8%). This rate is among the lowest levels recorded in the last 22 years. At March 2010, pressures on the consumer price index have begun to rebound, registering an accumulated inflation of 4.0%.

During almost all of last year, there was great uncertainty as to whether it would be possible to maintain the exchange rate between the lempira and the dollar. Despite all expectation, the exchange rate did not depreciate, although there was a decline in international reserves. The maintenance of parity during 2009 provides no guarantee at all that it will continue in 2010. The currency issue as well as fiscal reforms relating to taxes and public expenditures will be one of the outstanding issues addressed by the new authorities.

As in the other countries in the region, there was a decrease of total exports (-20.1%) exceeded by a further sharp fall in imports (-30.6%), causing the trade gap to reduced by - 35.6%. In January 2010, exports showed a growth of 7.4%, while imports reported a -1.8% contraction. Furthermore, remittances contracted by -11.2% compared to the flow recorded during 2008, while FDI recorded the biggest decline, falling by -46.2%. Thus, the current account deficit stood at -4.0% of GDP, less than the -12.9% observed in 2008

Moreover, the broadening of the tax base will be one of the crucial issues to be considered by the administration of President Porfirio Lobo this year. At the end of 2009, current spending

increased 9.0%, mainly in salaries and wages that led to an increase in the fiscal deficit, a deficit magnified by the fall in tax revenue (-7.6%). In this sense and by the closure of external sources of funding, the government will have to continue to use the domestic debt market by issuing bonds to finance the gap.

The financial and banking sectors also suffered the effects of the crisis. Liquidity constraints at the international level made it difficult to obtain resources under favorable conditions, which led to reduced credit access, consequently generating lower bank intermediation and lower levels of profitability. On the one hand, private sector credit reported a recovery between July and August, interrupting the marked downward trend, accumulating at December a growth of 1.2% influenced by the expansion of loans in domestic currency, which contrasted with the reduction in dollars. On the other hand, deposits reflected a slight variation associated to the political situation, a situation that was quickly corrected. At December 2009, total deposits grew by 3.0%, while flows of credit barely grew at 1.2%. Because of the political crisis, it was possible to speculate banking problems in Honduras, rumors that fortunately did not materialize.

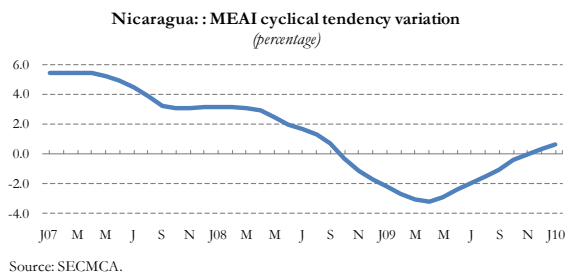
Regarding the outlook for 2010, ECLAC forecasts a growth of 1.5%, the World Bank of 1.8%, while the IMF of 2.0%. CABEI forecasts that GDP growth will be between the range of 2.3% and 3.3%.

Regarding inflation, the IMF considers it will be 5.1%, while CABEI estimates inflation at 4.6% ± 1%.

## **Nicaragua**

The consequences of the global recession were evident in the Nicaraguan economy mainly through the collapse of its foreign trade, a domestic demand slowdown, lower financial market dynamics, the contraction of international capital flows, and the depressed labor. According to the Central Bank of Nicaragua (BCN), the economy contracted -1.5% during 2009.

In January, the MEAI cyclical tendency expanded by 0.7% in annual terms, consistent with the growth trend of economic activity shown in recent months. This behavior was derived from the good performance of the fishing, farm, energy, and water sectors. Conversely, reductions continue to be observed in the production of construction materials, commerce, finance, industry, transportation, and communications, which continue to have an impact on the contraction of activity.



Because of the slowdown in aggregate demand and the fall in commodity prices, inflationary pressures eased to historical levels. At the end of 2009, accumulated inflation rose to 0.9%, significantly contrasting the 13.8% reported in 2008 (in recent years, Nicaragua has been the country of the region with the highest inflation rate, and this figure is the lowest reported in the last 31 years). This variation was the net result of the increase in prices for education, communications, and transportation that was partially offset by the lower prices of food and non-alcoholic beverages. At the end of the first quarter of 2010, cumulative inflation amounted to 3.6% due to a rise in the prices food and non-alcoholic beverages, as well as in fuel.

Regarding the exchange rate, the BCN continues to implement its fixed exchange rate policy based on daily mini-devaluations (fixed exchange rate - crawling peg), accumulating an annual change of 5.0%.

Regarding foreign trade, BCN figures indicate that the flow of exchanges deteriorated approximately by -16.6% in respect to the levels in 2008. At December, imports reported a sharp drop reaching -21.9%. The decrease in imports was more than three times the contraction of exports (-6.6%). On the one hand, the reduction in

imports was a result of the sharp contraction in demand from the industrial sector and lower costs in the oil bill, due to the relative stability of international market prices. As of the sharp fall in imports, the trade deficit declined by -28.3% to US\$1,803 million. In the January-February 2010 period, export of goods recorded an increase of 22.9%, while imports contracted by -37.1%.

Remittances totaled US\$768.4 million at December, equivalent to a reduction of -6.1% in respect to the flow accumulated in the same period of 2008. The decline was the lowest in the region, due in part to the fact that an important amount of remittances come from Costa Rica and not just the United States, as occurs with other countries. At February 2010, remittances reported a fall of -0.8% compared to the amount registered in February 2009. With regard to capital flows, FDI totaled US\$414.6 million in 2009, approximately equivalent to a -33.8% reduction in annual terms. The largest decline was concentrated in the communications and industrial sectors, the latter mainly regarding free trade zones.

With regard to public finances, there exists a deterioration of the public sector deficit because of the poor evolution in tax revenues. The collection results were lower than the target set by the authorities, reaching a rate of 1.7% of total revenue for 2009. Although spending was reduced to 4.5%, the reduction measures failed to offset the fall in revenue deteriorating further the balance.

The deceleration in tax revenue was directly associated to the lower collection of import taxes, mainly import related sales and custom duties. With the general slowdown in tax revenue, collection grew by 2.0%. In order to deal with the deterioration of the fiscal account caused by the crisis, the government and the principal economic sectors agreed to continue in 2010 with the adoption of the Tax Negotiation Act and partial reform to the Fiscal Equity Law.

Regarding the domestic financial system, the crisis has affected the volume of financial intermediation; reflected in lower allocation of credit, further deterioration of the portfolio, and lower accumulated earnings. The banks focused

on a better risk evaluation through more prudent credit placing policies, they also developed areas for the administration and recovery of the portfolio. In addition, there were greater efforts to increase efficiency in expenditures and reuse of staff. The banks also showed ingenuity in the process of new product design and marketing channels that has redefined the way of doing business.

Although banks, to date, are characterized to be liquid and solvent, the levels of profits have been reduced significantly. At the end of 2009, total assets of the domestic financial system recorded an increase of 5.0%. This behavior was induced by investments in securities and available funds. For its part, liabilities increased by approximately 5.0%. This behavior was based on growth in obligations with the public, followed by other obligations with other institutions and other financing.

At the end of 2009, total deposits rose by 14.5% compared to the balance in 2008. These deposits financed 100% of the loan placements. For its part, the loan portfolio decreased by -7.9% over the amount registered in 2008. Furthermore, there was accounting reclassification of loan portfolio balances, increasing the amounts in the classification of restructured and extended loans. Regarding the default rate, this amounted to 3.2% that is 0.3 percentage points higher than that recorded at the end of 2008. This index would be greater if the effects of portfolio renegotiations, being made by the supervised financial institutions, were not considered.

Regarding the outlook for 2010, ECLAC forecasts a growth of 2.0%, the World Bank of 1.7%, while the IMF of 1.8%. CABEI forecasts that GDP growth will be between the range of 1.0% and 2.0%.

Regarding inflation, the IMF considers it will be 5.1%, while CABEI estimates inflation at 6.0% ± 1%.

**Costa Rica**

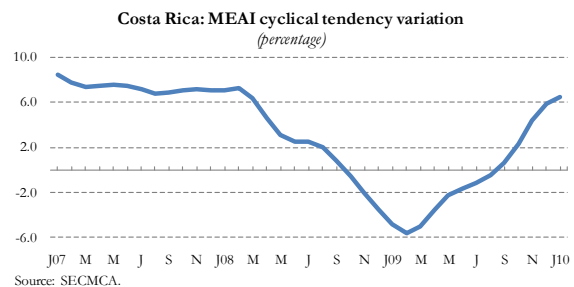
The Costa Rican economy suffered from the slowdown in global activity and reduced its GDP

to 1.3% in 2009. This result was impacted by the fall in exports due to lower international demand as well as a fall in tourism. Along with El Salvador and Nicaragua, these economies were hit the hardest by the global economic crisis.

At February 2010, the MEAI trend cycle amounted to 239.2, equivalent to an expansion of 6.4% (representing growth for the sixth consecutive month). This result confirms the recovery path that economic activity has followed for several months. In this sense, Costa Rica was the country that initiated the recovery process in the region.

The exports sector and free trade zones were the most affected by the slowdown, but are starting to report better dynamics; among them the production of microprocessors (Intel) and medical and infusion products. It is estimated that some of the new dynamic is being influenced by the revival of demand in the United States, the emergence of new buyers such as China,<sup>12</sup> and the use of nearby markets such as Panama.

The performance is certainly heterogeneous across sectors, both in the fall as in the incipient recovery. The recovery is due to better performance in various sectors such as manufacturing, business services, financial services, transportation, storage, and communications. In contrast, mining, construction, and hospitality services continue to contract, but at a lower rate.

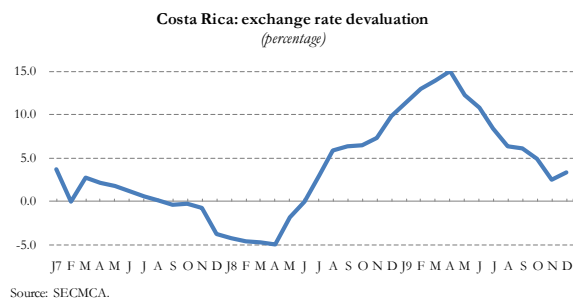


Similar to the other countries in the region, Costa Rica benefited from the reduction in inflationary pressures. In recent years, along with Nicaragua and Honduras, it was one of the countries with

<sup>12</sup> Costa Rica is also negotiating a Free Trade Agreement with Singapore.

the highest inflation rate. According to the Central Bank, inflation fell to 4.0% at the end of 2009, a figure not seen since 1971. This figure amounted to a reduction of 9.9 percentage points in respect to the rate reported at the end of 2008, and was induced by the drop in food prices. At March 2010, inflationary pressures have picked up causing the cumulative rate to reach 5.8%.

In terms of foreign exchange, the colon reported an accelerated depreciation during the first seven months of 2009, forcing a continuous Central Bank intervention in defense of the exchange band's upper limit. However, since the second semester, the evolution of the adjustment of the exchange rate market was determined mainly by the decision of the economic agents in the retail and wholesale markets. To date, the tendency has reverted and the colon has begun to appreciate. During 2009, the Costa Rican and Guatemalan currencies were those that showed more volatility in the region, behaving somewhat erratically.



Foreign trade reported a fall in the cumulative trade balance of -55.6% compared to the deficit observed at the end of 2008 (US\$-5,867.9 million). This improvement in the balance is associated to the fall of -25.9% in the nominal value of imports, which considerably exceeded the reduction of -7.5% in exports of goods. On the one hand, the dynamics of imports are associated to the lower oil bill as well as in lower purchase of inputs. Meanwhile the value of exports was due to a reduction in agricultural productions and the fall in the export value of pharmaceutical products and electric appliances, among others. In February 2010, exports reported an increase of 13.3%, while imports grew 18.5% compared to February 2009, demonstrating better dynamics of the domestic production system.

The entry into force of the DR-CAFTA with the United States as of January 1, 2009 did not offset the impact of the crisis on the commercial front (let us recall that it had entered into force in previous years for the other countries in the Agreement). In order for Costa Rica to take the full advantage of the treaty, it will have to wait for a full economic recovery to take place in the United States.

The fiscal accounts reflected a strong deterioration associated to low tax revenue, together with the expansion of public expenditures. Central government data indicates a cumulative deficit of -3.4% of GDP in 2009. Total revenues decreased by -4.8% over the same period in 2008, mainly due to lower revenues from duties on imports (-25.6%). Furthermore, tax revenues fell from 18.3% in 2008 to -5.1% in 2009.

Meanwhile, total expenditure reported an expansion of 19.3% in 2009. This growth was mainly associated to the extraordinary adjustments of wages and the transfer of resources for non-contributory pension schemes. In addition, current and capital transfers to social assistance programs generated pressures on spending. It is in this regard that the government should promote fiscal reform to reduce imbalances.

As to the financial system, this year has been characterized by credit constraints arising from lower funding sources and the implementation of a more prudent placement policy. At December 2009, total credit grew by 2.9%, a rate that proved to be much lower than that accumulated in 2008 (33.8%). This figure was the net result of the 8.8% expansion in credit loans denominated in local currency, which was partially attenuated by the contraction of -3.6% in dollar denominated loans.

Although the credit growth rate has been significantly reduced, the sectoral structure of the amounts has not changed. The housing, consumer and commerce sectors continue to concentrate the greatest flows of resources as a proportion to the total portfolio (around 65.0%). Meanwhile, deposits showed a growth of 15.0%, reflecting a decrease of -10.7 percentage points from the outcome in 2008.

Regarding the outlook for 2010, ECLAC forecasts a growth of 3.5%, the World Bank of 2.1%, while the IMF of 3.5%. CABEI forecasts that GDP growth will be between the range of 3.7% and 4.7%.

Regarding inflation, the IMF considers it will be 4.9%, while CABEI estimates inflation at 5.3% ± 1%.

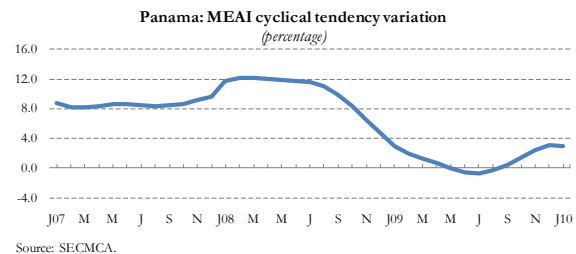
### Panama

The world recession has caused the Panamanian economy to record the worst deceleration in the last eight years. According to figures from the Ministry of the Economy, Panama closed the year 2009 with a growth rate of 2.4%. A figure that shows a growth dynamic well below that recorded in the 2007-2008 period, when rates of 12.1% and 10.7% were reported, respectively. Despite the slowdown, Panama was one of the few Latin American economies that managed growth during 2009.

The positive result of the GDP in 2009 was associated to a series of megaprojects that the current administration has been carrying out for several years in the areas of transportation and communications (which represent close to 23.0% of GDP), led by the multimillion dollar expansion of the *Canal*. In addition, the entry of new operators in the mobile market contributed to the positive performance. The performance deterioration was due to a reduction of port and the Colon Free Trade Zone activity, and the transit reduction through the Canal.

According to data from the General Comptroller of the Republic, the MEAI cyclical trend in January 2010 amounted to 196.04, which was equivalent to a growth rate of 2.95%.<sup>13</sup> The sectors with the best performance were transportation, storage and communications, electricity and water, personal and social community services, construction, and exploitation of mines and quarries. This rate is significantly lower than that reported in the pre-

crisis period in which the average exceeded 10%. The rebound in activity during recent months broke the downward trend that had continued since the second half of 2008, when the product began to shrink.



Just as in the other countries of the region, inflationary pressures were reduced in Panama. Inflation stood at 2.4%, reflecting a drop from the high figure recorded in 2008 (8.7%). It should be mentioned that Panama is characterized by reporting one of the lowest inflation rates in the region, resulting from the dollarization of its economy. At the end of March 2010, the inflation rate recorded an annual increase of 2.7%.

In relation to foreign trade, during 2009 imports reported a marked contraction of -13.4% in cumulative terms that was associated to a generalized fall in purchases of capital, intermediate, and consumer goods. Exports reported a more pronounced drop (-28.3%), due to lower sales of produce such as melons, watermelons, bananas and coffee. Panama was the only country in the region experiencing deterioration in the trade balance, since the fall in exports surpassed that of imports.

In 2009, the Panamanian government made efforts to improve tax collection in order to raise funds to finance public investment programs without having to turn to greater levels of deficit. In this context, the observed economic dynamics combined with tax reforms, presented a good outlook for government fiscal performance. According to preliminary figures, it is estimated that revenues increased by 0.75 percentage points of GDP, the government deficit closed at 2.2% of GDP, and central government debt had been maintained at around 40.0% of the GDP in 2009.

<sup>13</sup> Database of the National Institute of Statistics and Census (INEC).

It should be stressed that the fiscal reform promoted by the government is innovative and to a certain measure risky, as it extends the tax scope for the first time to commercial activities in the Colon Free Zone, a controversial policy subject in Panama.<sup>14</sup> This, together with other fiscal measures, emphasized the government's willingness to strengthen the medium term fiscal stability and commitment to improve capacity for generating revenue to support the public investment programs in the coming years without incurring to greater fiscal deficits.

The financial system has remained solid, despite the reduction in the levels of earnings. According to figures from the Superintendence of Banks (SBP), the private sector credit portfolio showed a slight accumulated expansion of 1.3% that has been financed through deposits (6.8%). The indicator of non-performing loans as a percentage of total portfolio recorded a reduction of -0.2 percentage points, reaching 1.2%. The legal liquidity index at year-end stood at 69.5%. Bank profits showed a downward trend compared with the levels recorded in 2008, so that the ROA and the ROE settled at 1.4% and 11.8%, respectively. Over the past year, Panamanian banks showed moderate growth, reflecting a consolidation of market confidence in their national and international securities and its stability.

Regarding the outlook for 2010, ECLAC forecasts a growth of 4.5%, the World Bank of 2.7%, while the IMF of 5.0%. CABEI forecasts that GDP growth will be between the range of 3.5% and 4.5%.

Regarding inflation, the IMF considers it will be 3.3%, while CABEI estimates inflation at 2.6% ± 1%.

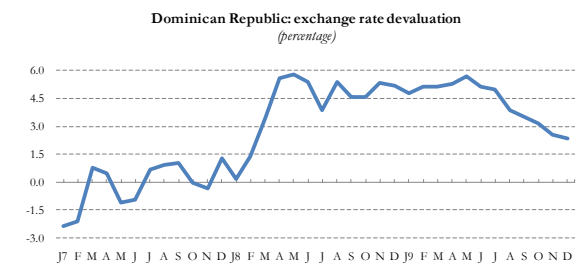
**Dominican Republic**

During 2009, the Dominican economy successfully stood up to the global crisis due to policy measures implemented by the monetary authority. However, the economy showed

ambiguous behavior and managed a 3.5% at the end of the year. This figure is substantially higher than the estimated range (0.5% - 1.5%) that the IMF had confirmed in the last Article IV Consultation report published in November 2009. In this sense, the Dominican economy has joined the group of countries in the region that presented growth in 2009.

The first quarter was characterized by the deepening effects of the crisis that reflected a contraction in GDP growth due to the fall in aggregate demand. As of April 2009, the combination of expansionary monetary policies by the monetary authority,<sup>15</sup> helped initiate the recovery of the credit channel and encouraged businesses in the targeted sectors. This recovery came about in a framework of exchange rate stability, which reported a devaluation of hardly 2.0%.

The price level was preserved during 2009 registering an inflation rate of 5.8%. Meanwhile, inflation during the first quarter of 2010 was 2.3%. Thus, given the seasonality of the economy, in 2010, inflation will remain within the limits set in the monetary program (6.0% - 7.0%).



Source: SECMCA.

In relation to foreign trade, the trade balance recorded a relative improvement, as total imports fell -30.3% exceeding the -27.0% fall in export revenue (one of the heaviest falls in the region). This result coupled with the generalized drop in tourism income, remittances, and free trade zones, led to an improvement in the current account balance reducing it to 5.2% of GDP. The preliminary figure for the current account deficit

<sup>15</sup> A combination of cuts in the policy rate, a reduction in the reserves requirement, modification of prudential standards and provision of liquidity, as well as the temporary closing of the window to the public, led to an important fall in the rate of interest.

<sup>14</sup> Tax increases were approved for companies in the Colon Free Zone, the tobacco companies, casinos, and insurance companies.

(US\$2,200 million) is estimated to be entirely covered by foreign direct investment inflows, which totaled approximately US\$2,066 million. At February 2010, exports of goods recorded an increase of 11.4%, while imports grew 14.2% a result consistent with the economic recovery process seen in recent months.

During the first three quarters of 2009, fiscal policy had a contractive profile. At September 2009, the fall in tax revenue accumulated -10.0%, which was compensated by a greater fall in government expenditures.<sup>16</sup> The consolidated public sector deficit amounted to 2.0% of GDP, equivalent to a fall of 1.0 percentage point. Structural problems in the tax field and in the energy sector accounted for a large burden on public finances. On the one hand, it is estimated that a large proportion of tax revenues recorded during 2009 and part of last year are associated with excessive use of tax exemptions contained in competitive promotion laws. On the other hand, structural weaknesses continue to generate excessive losses to state-owned enterprises responsible for energy distribution, subsequently the subsidies to cover the losses during the year amounted to 1.0% of GDP. During the first quarter of 2010, revenues have improved registering a growth of 6.6%.

The year 2009 was a good year for the Dominican financial system, which was characterized by strengthening its soundness and stability in the aftermath of the turbulence experienced during the first quarter. In that sense, there were many achievements for the entire system, in particular the banking sector. The banking sector currently has high profitability and solvency levels that exceed the parameters established by the Basel Committee and the prudential standards in the Dominican Republic.

At the end of 2009, in a context of global financial turmoil, the Dominican financial system managed to expand its assets by 12.5%, deposits by 16.4% and equity by 10.0%. Additionally, the reduction in market interest rates facilitated the access of companies and household to credit, prompting a

sharp recovery of bank credit. In this context, it is expected that the credit growth rate in national currency will reach approximately 13.0%.

At this point in particular, attention should be drawn to the contribution of monetary policy implemented by the Central Bank. Growth was significantly greater than those rates reported by the Central American economies. For example, countries like El Salvador, Nicaragua, and Guatemala reported falls in the levels of private loans, while Costa Rica and Honduras obtained growth rates lower than 5.0%. It is noteworthy that 80.0% of total credit extended by Dominican banks focused on the productive sectors (agriculture, commercial, construction and manufacturing), and a good part of the difference went to personal and consumer loans.

The achievements of the financial sector were reflected in the performance indicators. The quality of the portfolio, measured through past due indebtedness, totaled 4.3% (recall that Dominican banks are still suffering the aftermath of the banking crisis of 2003) and the coverage of non-performing loans stood at 103.9%. The banks managed to weather the crisis by remaining liquid and well capitalized.

Because of the actions taken during 2009, private sector credit in national currency maintains an annual growth of 16.4% at March 2010. This dynamism of the credit has been driven by more affordable interest rates, among other reasons. Along with this behavior, the financial sector reflects improvements in its main management indicators.

Regarding the outlook for 2010, ECLAC forecasts a growth of 3.5%, the World Bank of 2.4%, while the IMF of 3.5%. CABEI forecasts that GDP growth will be between the range of 4.2% and 5.2%.

Regarding inflation, the IMF considers it will be 6.5%, while CABEI estimates inflation at 4.0% ± 1%.

Finally, it is important to mention that the performance of the Dominican Republic during 2010 could be affected by the reconstruction of Haiti, as has been demonstrated in the days

<sup>16</sup> IMF Executive Board, 2009 Article IV Consultation with the Dominican Republic.

subsequent to the earthquake. The Dominican Republic has played a leading role in the recovery, and appears to be the platform from which the international community channels resources to support Haiti. This massive mobilization of resources undoubtedly ends up benefiting to not only Haiti but also the Dominican Republic.<sup>17</sup>

---

<sup>17</sup> For example, cement production, which experienced a noticeable decline in 2009, will probably recover rapidly.

The report on Belize will be included as of the next *Economic Trends & Outlook*.

The Office of the Chief Economist of CABEI publishes this report every half year. It is accompanied by a PowerPoint presentation that is updated every two months. Both documents can be consulted in the Bank's web page at [www.bcie.org](http://www.bcie.org). The Spanish version is also available.

To request presentations of this report, please contact: (504) 240-2246 or by e-mail at [oejbcie@bcie.org](mailto:oejbcie@bcie.org). This is a service that the Bank offers governments, business chambers, and associations of civil society in the region.