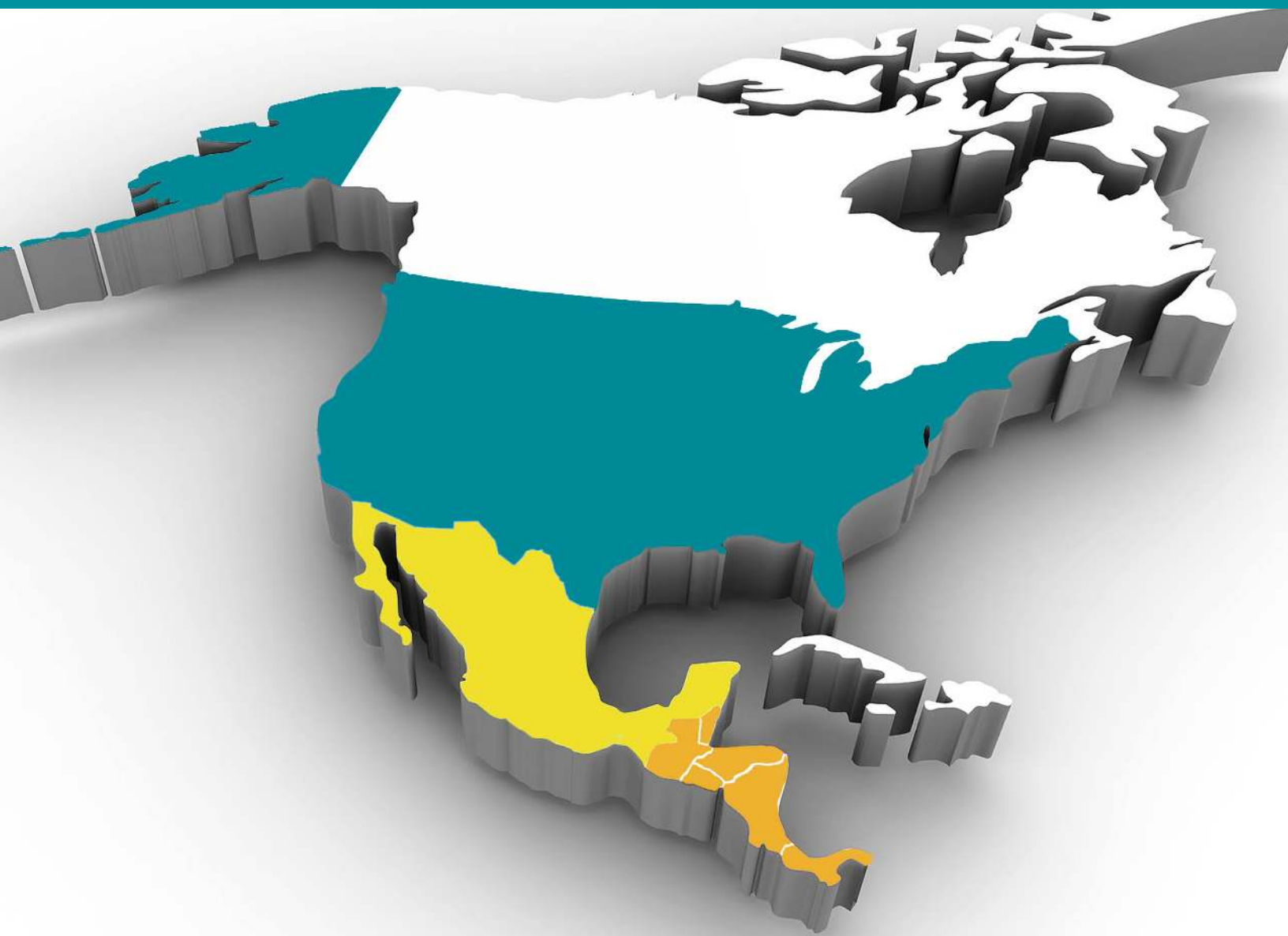


THE REGIONAL MIGRATION STUDY GROUP

CENTRAL AMERICAN DEVELOPMENT: TWO DECADES OF PROGRESS AND CHALLENGES FOR THE FUTURE

By Hugo Beteta



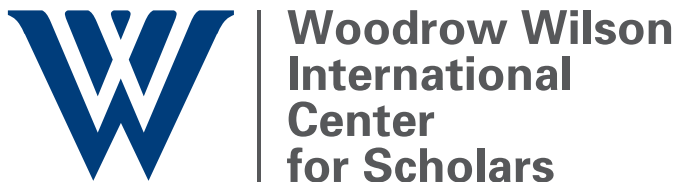
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CENTRAL AMERICAN DEVELOPMENT: Two Decades of Progress and Challenges for the Future

By Hugo Beteta
Economic Commission for Latin America and the Caribbean

August 2012



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Executive Summary

Over the past two decades, Central America has undergone an extraordinary transformation — from a region characterized predominantly by rural and agricultural populations into one where the majority of people reside in urban areas; from societies with autocratic governments and periodic civil wars into ones with peaceful transitions between democratically elected governments; and from volatile, resource-dependent economies into stable global exporters. Despite these gains, important challenges remain. The region has not generated sufficient employment to keep pace with demographic growth, large income inequalities persist even as poverty has declined modestly, and violence and public insecurity have increased.

The region's most notable successes of the past two decades include:

- **Stable economic growth.** Economic growth in Central America has been much less volatile than the rest of Latin America and the subregion has not experienced an economic contraction since 1982. Prior to the recent global economic crisis, previous global and regional recessions — such as occurred in the United States in 1991-92, in Mexico in 1994, in East Asia and Russia in 1998, and globally in 2001-02 — largely bypassed Central America. Inflation has been stable and, unlike Mexico and Latin America's Southern Cone, Central America has maintained a positive fiscal balance for over two decades.
- **Trade integration.** During the 1990s, the countries of Central America made significant progress toward integrating their economies with one another, and with the rest of the world. A common market was launched in 1990 with the long-term aim of establishing a customs union. And in 2004 the subregion signed a free trade agreement with the United States and the Dominican Republic, known as CAFTA-DR. Exports and imports now account for 70 percent of the subregion's gross domestic product (GDP), a much higher share than in the rest of Latin America (40 percent). Critically, the goods that the subregion exports have changed as well: today nearly two-thirds of Central American exports are manufactured goods compared to a predominance of raw materials two decades ago.
- **Poverty and inequality.** Poverty has decreased across the subregion, mostly with declines in the population living in extreme poverty. Guatemala, Honduras, and Nicaragua have made the greatest gains in reducing poverty while in El Salvador poverty rates dropped during the 1990s but remained stable during the 2000s. Over the past two decades, inequality fell modestly in El Salvador and Guatemala, and more dramatically in Honduras, Nicaragua, and Panama.

Despite these achievements, challenges remain. In particular, Central America remains highly vulnerable to the external economic climate. Trade integration may have accentuated this longstanding vulnerability by exposing the subregion to economic shocks elsewhere. For example, remittances from the region's growing emigrant population, which is concentrated in the United States, have contributed to decreasing poverty and are estimated to have reduced current account deficits in the region by between 10 and 20 percentage points. But the migrant population is also vulnerable to changing laws and regulations as well as the economic climate in destination countries. Over 300,000 Central Americans are estimated to reside in the United States on temporary humanitarian visas known as Temporary Protected Status (TPS), and about 1.3 million lack legal immigration status.

Central America also remains highly vulnerable to natural disasters and climate change. About 8.4 million Central Americans reside in areas exposed to hurricanes, which have wreaked devastation on several occasions over the past two decades. Studies from the Salvadoran and Costa Rican governments estimate that if sea levels rise between 13 and 110 centimeters, substantial coastal populations could be displaced.

Finally, despite the end of civil wars across Central America, violence and public insecurity are on the rise. The subregion is increasingly caught at the intersection of the international narcotics trade between South and North America, and modest successes in Mexico's war against drug traffickers and organized



crime appear to be pushing some illicit activity into Central America. Estimates from the Inter-American Development Bank suggest that violence and insecurity reduced the subregion's economic output by 14.2 percent.

Over the coming decade, three priorities appear particularly pressing if Central America is to build upon its considerable progress of recent years. First, the subregion's exporters must continue to diversify their products and the destinations of their exports to reduce dependency upon a single (sometimes vulnerable) market. Second, businesses must focus on continuing to move toward higher-value activities where the subregion may have a comparative advantage — for instance in industrial agriculture and biofuels. Finally, in order to achieve these goals, governments in the subregion must work with the private sector to invest in research and development and, critically, to enhance human capital stock.

I. Overview

Over the last 20 years, the countries of Central America have drastically changed their strategies for economic growth and adopted measures promoting economic liberalization, trade, and export diversification away from agriculture commodities with a view to creating an attractive destination for foreign investment and a favorable environment for trade. These policies included public-sector fiscal austerity and reduced state intervention in the economy to promote private-sector growth, particularly in the export sector.

The development model adopted across Central America during the 1990s drew its inspiration from the “Washington Consensus,” which came to dominate theoretical and political discourse within and outside of the subregion.¹ Countries undertook structural reforms that were expected to bring about greater economic growth, primarily through export-led development and private initiative. There has not been an exhaustive analysis of the outcome of this model in Central America, but the available evidence points to mixed results.²

Central America has undergone profound and seemingly constant change in recent years. Within two decades, there has been a shift from predominantly rural and agrarian societies to urban ones. Countries with autocratic systems and civil wars have been transformed into democratic societies with peaceful transitions of power, including in the countries engaged in civil conflict as recently as the early 1990s. Simultaneously, demographic change — notably through emigration and rapid aging — has profoundly altered the population structure. These changes provide evidence of the subregion's economic vitality, but also point to new challenges.

The current economic climate, dominated by an international crisis and shifting global balance of power, has exposed the limitations and weaknesses of the present economic model in place across much of Central America and, indeed, may accentuate them. At the same time, the crisis opens up the possibility of forward-looking reforms. Central American countries are confronting the challenge of responding creatively at the national and subregional levels to these emerging policy issues.

This report aims to contribute to the debate on the future of development in Central America. Its objective is to show that the development model that the subregion has followed over the last 20 years

1 For a review, see John Williamson, *Latin American Adjustment: How Much Has Happened?* (Washington, DC: Institute for International Economics, 1990).

2 An assessment of the performance of Latin America and the Caribbean in the 1990s can be found in *Una década de luces y sombras: América Latina y el Caribe en los años noventa*, published by the UN Economic Commission for Latin America and the Caribbean (ECLAC) in 2001. The economic review contained in this document is still valid, with some additional elements from the current decade. Furthermore, the unique features of each Central American country's individual performance must be mentioned.



has had limited capacity to address pressing challenges, including job creation and substantial reduction of poverty and inequality, and to guide Central America along the path to faster and more sustainable economic growth, while simultaneously promoting a more equitable distribution of benefits.

II. Policy Achievements

This section summarizes some of the most important achievements of Central American countries during the past 20 years in the area of economic and social development policy; in many cases, their significance stems from the fact that they reversed the negative trends of the 1980s. Many of these policy achievements have helped solidify the basis for greater and more sustainable growth in the years ahead.

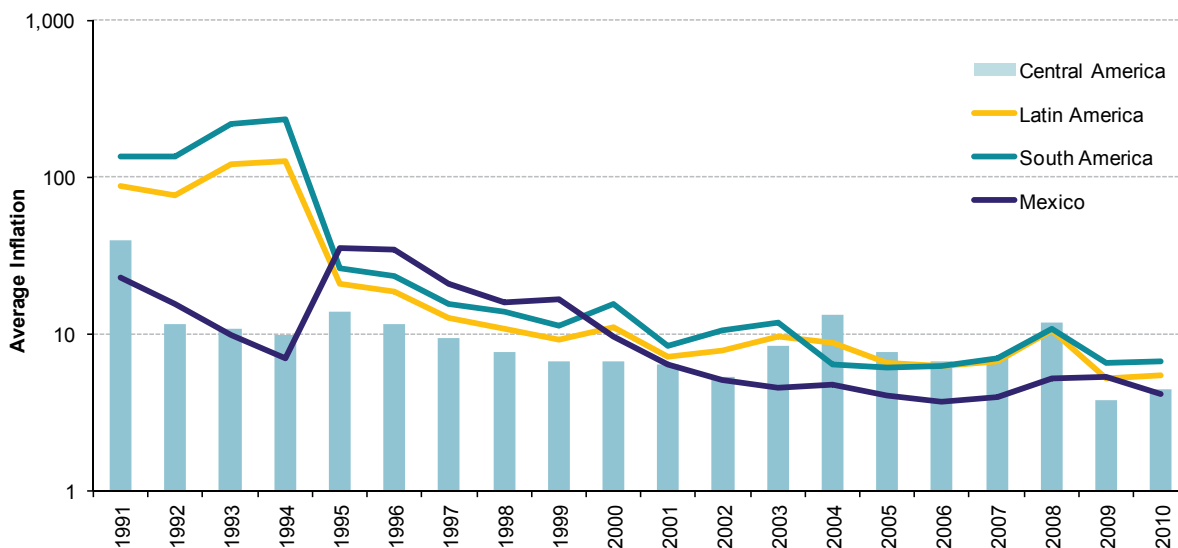
Three economic policy achievements stand out in particular:

- The consolidation of macroeconomic stability
- Progress toward global and regional trade integration
- Falling levels of poverty and extreme poverty.

A. Macroeconomic Stability

Emphasis on macroeconomic stability policies emerged from the volatile economic trends of the 1980s and early 1990s. These policies were successful and, as Figure 1 shows, for much of the past two decades Central America has experienced lower inflation rates than the rest of Latin America and the Caribbean.

Figure 1. Average Inflation in Latin America, 1991-2010

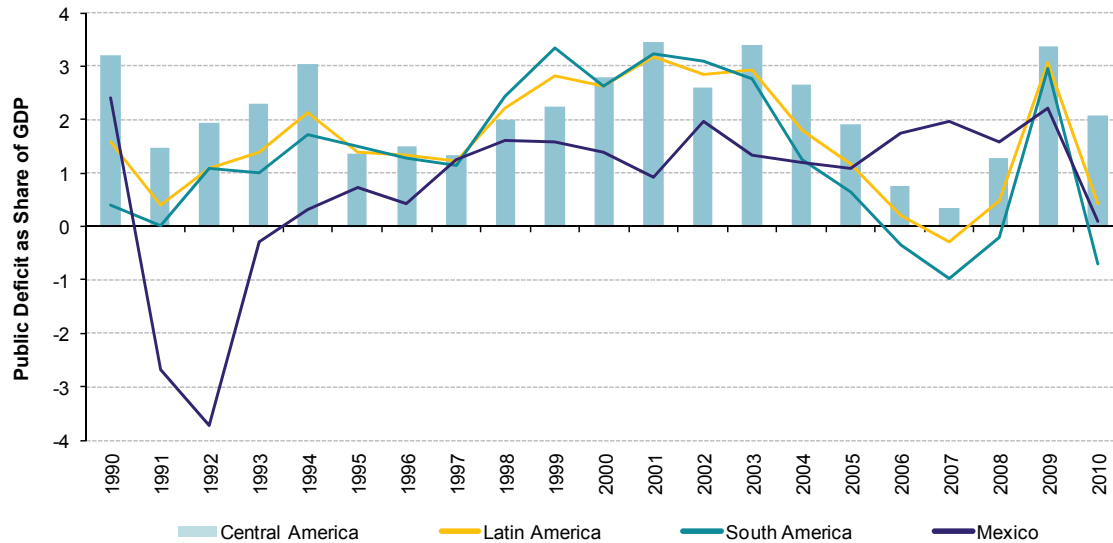


Note: Annual percentage variation, logarithmic scale.

Source: International Monetary Fund (IMF), "World Economic Outlook" 2011 database, www.imf.org/external/pubs/ft/weo/2011/01/weodata/index.aspx.

Figure 2 shows that the public deficit of Central American governments has remained below 3 percent of gross domestic product (GDP), on par with the share elsewhere in Latin America and a below the level that is generally considered sustainable in the long term. However, there was a slight deterioration in public finances in the second half of the 1990s, when the region's deficits nearly reached 4 percent of GDP. This upward trend changed course after 2001, falling to 0.3 percent by the end of the period. The financial crisis at the end of the 2000s decreased tax revenues and forced governments to spend more. As a result, spending toward the end of the decade offset much of the progress that had been made to such an extent that by the end of 2009, the public deficit once again had surpassed 3 percent of GDP.

Figure 2. Public Deficit in Latin America, 1990-2010



Note: Share of GDP, simple average.

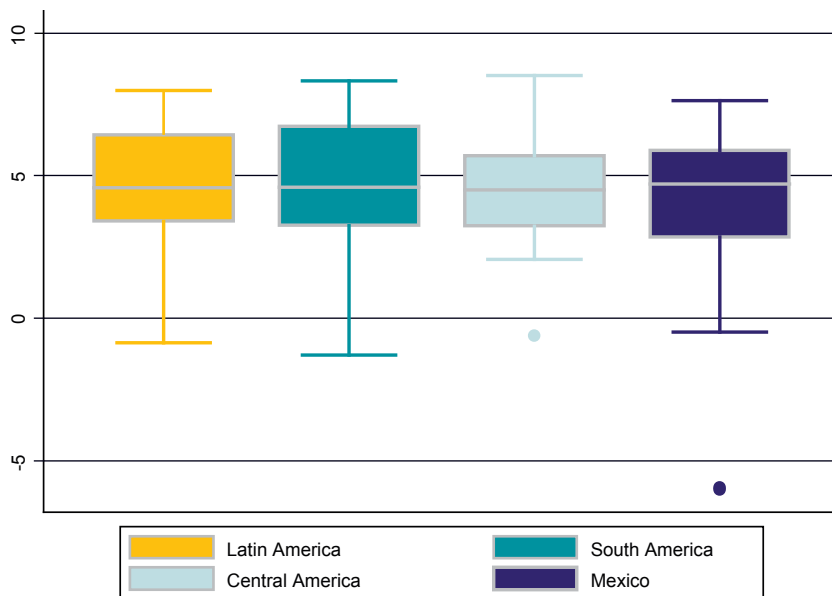
Source: Economic Commission on Latin America and the Caribbean (ECLAC/CEPAL), "CEPALStat" 2011 database, <http://websie.eclac.cl/infest/ajax/cepalstat.asp?idioma=i>.

Progress toward achieving nominal stability led to economic growth in Central America that was much less volatile than elsewhere in Latin America. Figure 3 illustrates the spread of Latin American growth rates between 1990 and 2008. The upper and lower bounds of the columns show the first and third distribution quartiles respectively, while the line inside the column shows the median annual growth rate. The high and low points of the vertical lines show sample extremes.

Although the median growth rate in Central America is below the norm for Latin America and the Caribbean, the figure clearly shows that the inter-quartile range (the height of the column) and extreme rates are not as large. Indeed, the great crises of the last 20 years — such as in Mexico in 1995 and in Argentina in 2002, which caused economic activity in some countries to contract sharply — did not have a large impact in Central America. Moreover, since 1982 Central America has not had negative growth rates for any year. With the exception of the current contraction of the US economy, the US crises (1991-92, 2001-02) did not trigger recessions in Central America. The productive sector's demonstrated stability is a significant asset for the future.



Figure 3. Per Capita GDP in Latin America, 1990 to 2008



Note: As a yearly percent variation, using data expressed in international dollars.
Source: IMF, "World Economic Outlook," 2011 database.

B. Trade and Financial Liberalization

Over the course of the 1990s, Central American countries signed a series of agreements to strengthen the process of subregional integration. Starting with this institutional framework, which prioritized open regionalism, Central American integration efforts have focused on perfecting the region's free trade zone and establishing a customs union.³

In this same period, the countries negotiated various free trade agreements, both bilaterally and at the subregional level. Initially they embarked on a unilateral process of tariff relief and import control elimination followed by accession to the General Agreement on Tariffs and Trade (GATT) and participation in multilateral negotiations (the Uruguay and Doha Rounds).⁴ More recently, they have pursued bilateral free trade agreements. The most relevant treaty is perhaps the agreement signed by Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica, and the Dominican Republic with the United States in 2004 (CAFTA-DR). Beyond CAFTA-DR's commitment to market access, the agreement envisions a range of regulatory measures promoting the formation of a Central American customs union. The recent associative agreement between the European Union (EU) and Central America (El Salvador, Costa Rica, Honduras, Nicaragua, Guatemala, and Panama) which was signed at the May 2010 EU-Latin America and Caribbean (LAC) summit is likely to reinforce this process.⁵ The accord includes a free trade agreement and aims to strengthen the integration process in Central America by calling for greater political dialogue between the states and promoting greater economic growth through increased investment and trade liberalization.⁶

3 ECLAC, *Visión Estratégica de Centroamérica y su Inserción Internacional* (LC/MEX/L.895) (Mexico City: ECLAC, unpublished 2009d).

4 With the exception of Nicaragua, which has been a member since 1950, the other Central American countries joined GATT/WTO in the 1990s.

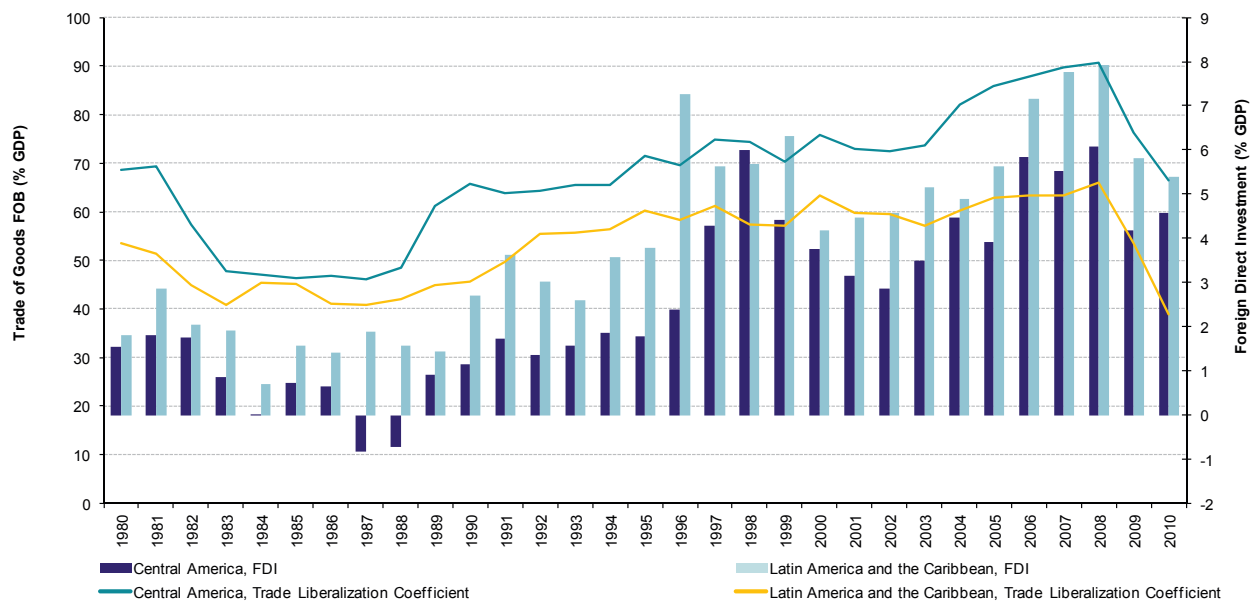
5 European Commission, "Central America," <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/central-america/>.

6 Association of World Council of Churches Related Development Organizations in Europe (APRODEV), "EU - Central America Association Agreement," www.aprodev.eu/index.php?option=com_content&view=article&id=92&Itemid=43&lang=en.

As a consequence of greater participation in global markets, Central America experienced notable growth in the value of international trade and in the flow of foreign direct investment (FDI). Several Central American countries created special tax incentives to attract FDI, especially for investment geared toward exports, and signed reciprocal international FDI agreements. Others created customs-free areas and different programs for the temporary admission of imports, such as for assembly production and asset improvement. Changes to the productive structure are reflected in the list of the ten most exported products. In 1990s, of the ten main products exported to the United States, eight were commodities (bananas, coffee, beef, pineapple, and shellfish, among others), and the other two were manufactured textile clothing goods.⁷ In 2007, by contrast, seven goods came from different manufacturing industries — notably electronics, medical devices, and garments.

As Figure 4 demonstrates, after experiencing stagnation in the 1980s, the value of trade in goods (exports plus imports) in Central America practically doubled within 20 years, approaching nearly 70 percent of GDP, significantly higher than the average level for the rest of Latin America (40 percent). These data show that Central America is much more open to international trade than its neighbors. As a result Central American exports grew significantly — from 1990 to 2008 they recorded an average annual growth rate of 9.7 percent. FDI growth has been more volatile. During the early 1990s, FDI growth was driven primarily by the privatization of public assets and, later, by international trade integration. Toward the end of the decade, the Asian crisis and the US recession in 2001 slowed FDI inflows but it began increasing again after 2002. Overall between 2000 and 2007 FDI remained slightly below 3 percent for Latin America as a whole but surpassed 5 percent in Central America.

Figure 4. Trade and Financial Liberalization in Latin America and the Caribbean (% GDP), 1980-2010



Source: World Bank, *World Development Indicators 2011* (Washington, DC: World Bank, 2011), <http://data.worldbank.org/data-catalog/world-development-indicators/wdi-2011>.

The significant trade liberalization of the last 20 years has not significantly altered the composition of Central America's export market (see Figure 5). As during the early 1990s, more than half of Central American exports go to North American Free Trade Agreement (NAFTA) member countries, mainly the United States, and to Central American Common Market (CACM) countries.⁸ Within Central America, there are important differences: Nearly one-third of Salvadoran and Guatemalan exports go to the regional

⁷ Based on the ten-digit harmonized system. The source of information is the Module to Analyze the Growth of International Commerce (MAGIC) software developed by ECLAC; see ECLAC, "Qué es MagicPlus?," www.eclac.org/magic.

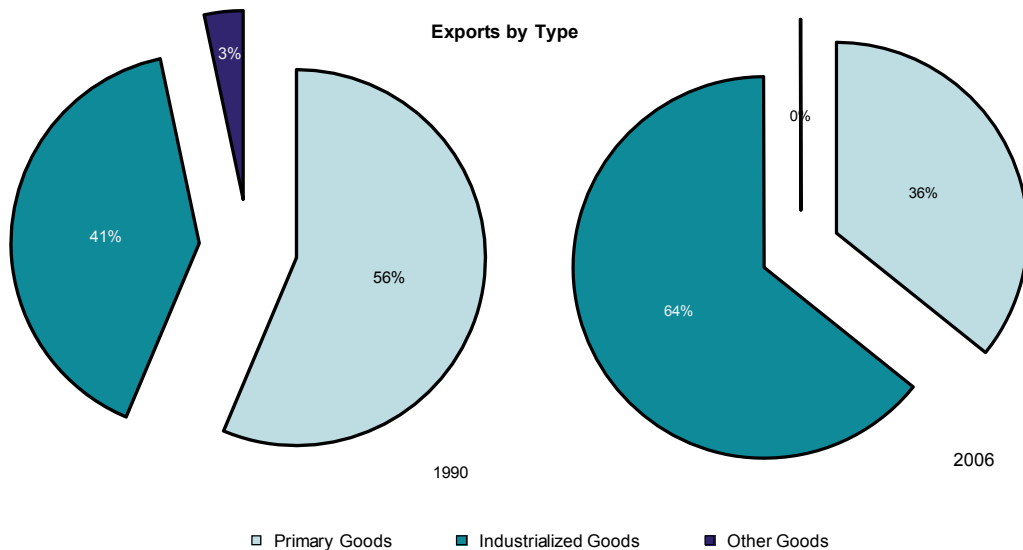
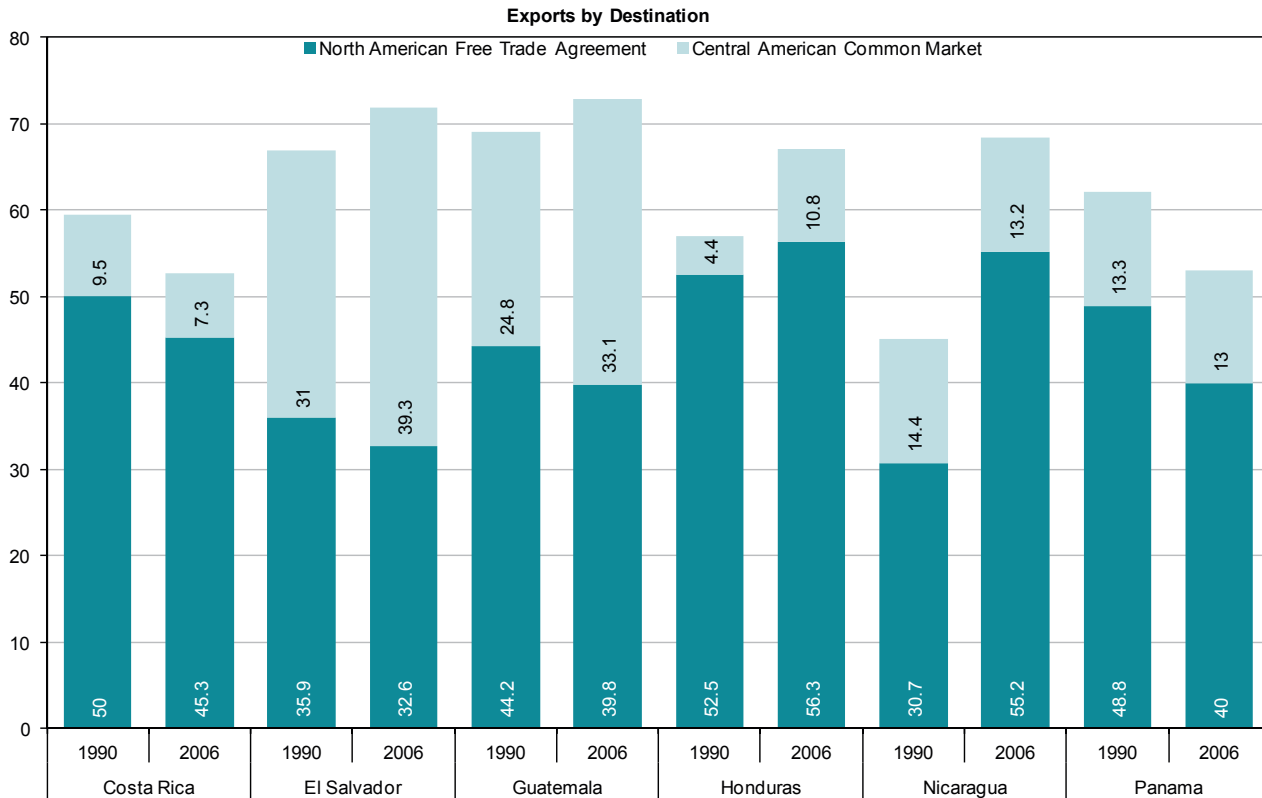
⁸ North American Free Trade Agreements (NAFTA) member countries include Canada, the United States, and Mexico. Central American Common Market (CACM) countries include Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.



common market, while Nicaragua relies heavily on exports to the United States.

In recent years, the subregion has successfully overcome the agro-export model of the past and has made the transition to an export structure dominated by manufactured goods. Figure 5 demonstrates that while in the 1990s primary goods accounted for more than half of total exports in goods, by 2006 their share had fallen to one-third. Over the same period, the production and export of manufactured goods — above all textiles — has increased, particularly among exports to the United States. Exports to the European Union, Central America’s second-largest trading partner, still consist mainly of primary goods.

Figure 5. Central American Export Composition by Destination and Product (%), 1990 to 2006

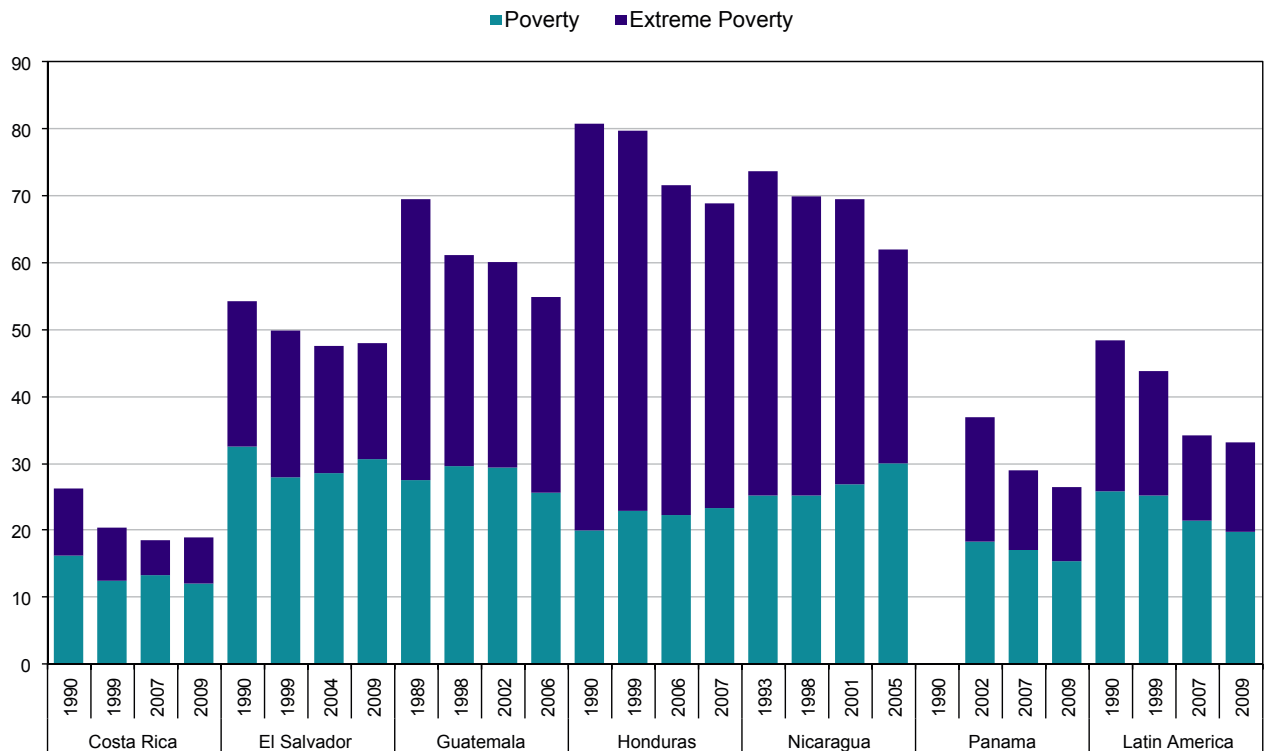


Source: ECLAC, *Social Panorama of Latin America, 2008*, www.eclac.cl/publicaciones/xml/3/34733/PSI2008-SintesisLanzamiento.pdf.

C. Poverty

Across Central America significant progress has been made in reducing poverty over the past two decades. From 1989 to 2009, poverty fell throughout the region (see Figure 6). Guatemala stands out with a decline of more than 15 percentage points, followed by slightly lower declines in Honduras and Nicaragua. Nevertheless, extreme poverty has remained at relatively high levels, and, in the case of Costa Rica, it even increased in 2009, compared to earlier in the decade. By contrast, significant poverty reduction progress can be seen in Honduras and Nicaragua, where rates of extreme poverty fell more than 10 percentage points from 2000 to 2009.

Figure 6. Poverty and Extreme Poverty in Central America, (Share of Total Population), 1989 to 2009



Note: Total poverty includes poverty and extreme poverty.

Source: ECLAC, using household survey findings from the respective countries.

Despite the region-wide successes in reducing poverty, there are substantial differences across countries. Costa Rica and Panama have poverty levels that are lower than the Latin American average. In Costa Rica, for example, the poverty rate is around 18.6 percent, or half of the subregional average. In Guatemala, Honduras, and Nicaragua, by contrast, more than half of the population lives in poverty. In the case of El Salvador, the registered levels are on par with the Latin American average.



III. Obstacles to Central American Development

Despite the region's achievements, notable obstacles remain to Central America's development prospects. Five short-term challenges in particular are relevant: the growing costs of crime and insecurity, low savings and a reliance on external finance, persistent inequality and poverty, continued vulnerability to external economic shocks, and overreliance on migration and remittances.

A. Crime and Insecurity

Recent studies identify crime and insecurity as the most important obstacle to Central American development. Beyond the effects on individuals' physical, psychological, and emotional well-being, crime and insecurity also have important consequences for productivity and economic growth. These costs include costs incurred in anticipation of crime (e.g., residential and business security, insurance, electronic surveillance), costs incurred as a consequence of crime (e.g., property loss, productivity loss, medical and mental health care costs, physical theft), and costs incurred in response to crime (e.g., law enforcement, administration of justice, incarceration).⁹ Estimates from the 1990s in Europe and North America suggest that crime costs developed countries between 3 and 7 percent of GDP.¹⁰

The costs of crime and insecurity are typically higher in developing countries. For instance, a 2008 report to the National Council for Public Security (CNSP according to its Spanish acronym) within the Office of the President of El Salvador estimates that in 2006, violence cost Central America \$6.5 billion, or about 7.7 percent of GDP.¹¹ There is substantial variation across countries: Violence cost 11 percent of GDP in El Salvador, 10 percent in Nicaragua and Honduras, 8 percent in Guatemala, and 4 percent in Costa Rica.¹²

Another study by the Inter-American Development Bank (IDB) concluded that the social cost of crime, including stolen goods, amounted to 14.2 percent of GDP in Latin America in the 1990s.¹³ According to the IDB study, nearly half of the costs of violence are "intangibles," that is, the effects of crime on investment and productivity. The magnitude of the security problem in the subregion, where, with exception of Costa Rica, robbery and extortion can have a direct impact on economic growth, has forced the authorities in charge to increase public spending to combat these activities, to such an extent that in 2007 countries spent from 1.7 percent of GDP (Costa Rica) to 2.3 percent of GDP (El Salvador) on security and justice.¹⁴ In the case of El Salvador, more recent studies conducted by joint teams of US and Salvadoran government experts concluded that insecurity is a factor that restricts growth possibilities.¹⁵

9 Sam Brand and Richard Price, "The economic and social costs of crime" (Home Office Research Study 217, Home Office Economics and Resource Analysis Unit, London, 2000),

<http://webarchive.nationalarchives.gov.uk/20110218135832/rds.homeoffice.gov.uk/rds/pdfs/hors217.pdf>.

10 Michael J. Mandel, Paul Magnusson, James E. Ellis, Gail DeGeorge, and Keith L. Alexander, "The Economics of Crime," *Business Week*, December 13, 1993, 72-5, 78-81; Ted R. Miller, Mark A. Cohen, and Brian Wiersema, *Victim Costs and Consequences: A New Look* (Washington, DC: National Institute of Justice, US Department of Justice, 1996),

www.nij.gov/pubs-sum/155282.htm; Ting Zhang, *Costs of Crime in Canada 2008* (Ottawa: Department of Justice Canada, 2008), www.justice.gc.ca/eng/pi/rs/rep-rap/2011/rr10_5/rr10_5.pdf; Horst Entorf and Hannes Spengler, *Crime in Europe: Causes and Consequences* (Berlin, Heidelberg and New York: Springer-Verlag, 2002).

11 Consejo Nacional de Seguridad Pública (CNSP), Presidencia de la República, *Los costos económicos de la violencia en Centroamérica* (San Salvador: CNSP, 2008), www.ocavi.com/docs_files/file_538.pdf.

12 Ibid.

13 Juan Luis Londoño and Rodrigo Guerrero, "Violencia en América Latina: Epidemiología y Costos" (Documento de Trabajo R-375, Inter-American Development Bank, Washington, DC, 1999), www.iadb.org/res/publications/pubfiles/pubr-375.pdf.

14 United Nations Development Program (UNDP), *Abrir Espacios a la Seguridad Ciudadana y el Desarrollo Humano: Informe sobre Desarrollo Humano para América Central 2009-10* (San José, Costa Rica: UNDP Latin America and the Caribbean, 2009), http://hdr.undp.org/en/reports/regionalreports/latinamericathecaribbean/Central_America_RHDR_2009-10_ES.pdf.

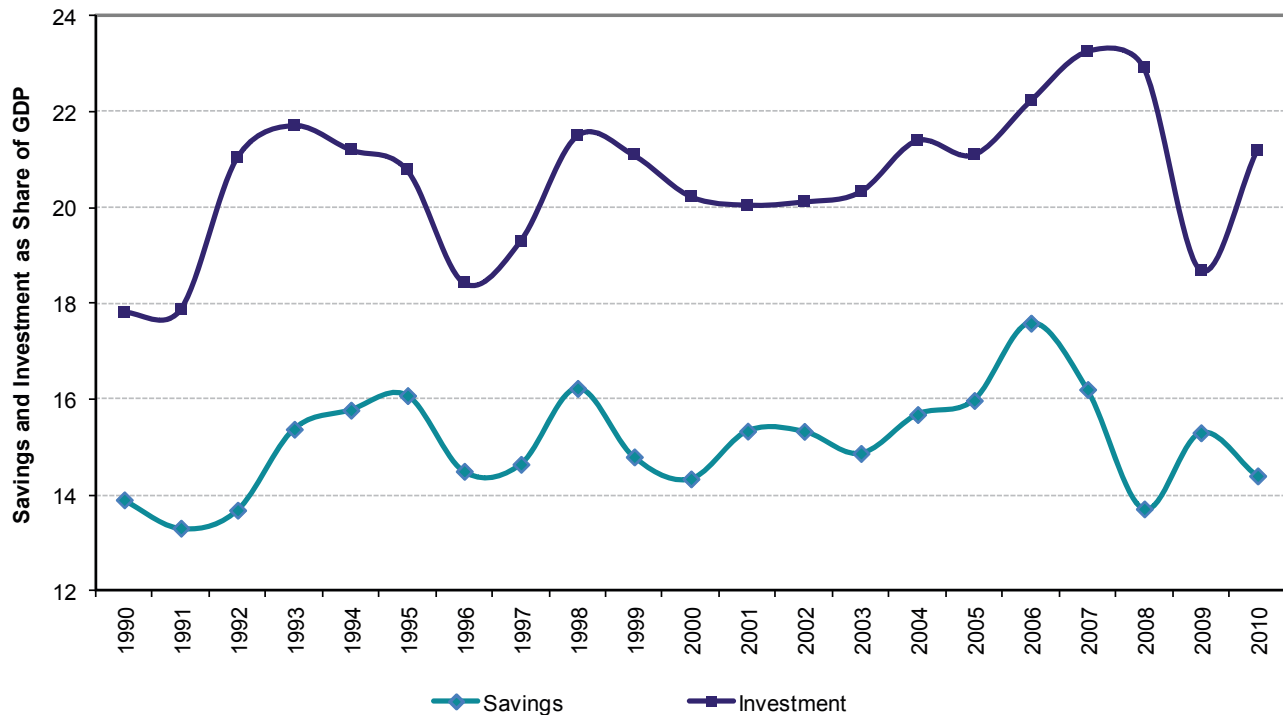
15 US Department of State, *Partnership for Growth Joint Country Action Plan 2011-2015* (Washington, DC: US Department of State, 2011), http://photos.state.gov/libraries/elsalvador/92891/octubre2011/Joint_Country_Action_Plan.pdf.

B. Low Savings and Reliance on External Finance

Another challenge facing Central American economies is low savings. As Figure 7 shows, at the beginning of the 1990s domestic savings accounted for just under 14 percent of GDP before rising modestly in the early 1990s and then remaining between 14 and 16 percent of GDP for much of the next decade. As external economic conditions improved and the region prospered, domestic savings increased between 2003 and 2006, eventually reaching nearly 18 percent of GDP. Since then, however, domestic savings have declined — due in part to the global economic crisis — and in 2008 they dropped below 14 percent of GDP. They have since recovered modestly although not to prerecession levels.

After strong fluctuations in the 1990s, investment increased over the last decade, peaking at 23 percent of GDP in 2008. Given the gap between investment and savings, which has averaged around 5 percent of GDP over the past two decades, it is clear that Central America relies heavily on foreign investment to finance economic growth. In particular, FDI was a pillar of the economic development model prevalent across Central America in recent years. On average between 1990 and 2010, Central American countries received 3.6 percent of annual FDI inflows to Latin America and the Caribbean although they accounted for a slightly smaller share of the region's GDP (3.2 percent).

Figure 7. Savings and Investment in Central America as Share of GDP, 1990 to 2010



Source: ECLAC/CEPAL, "CEPALStat" database.

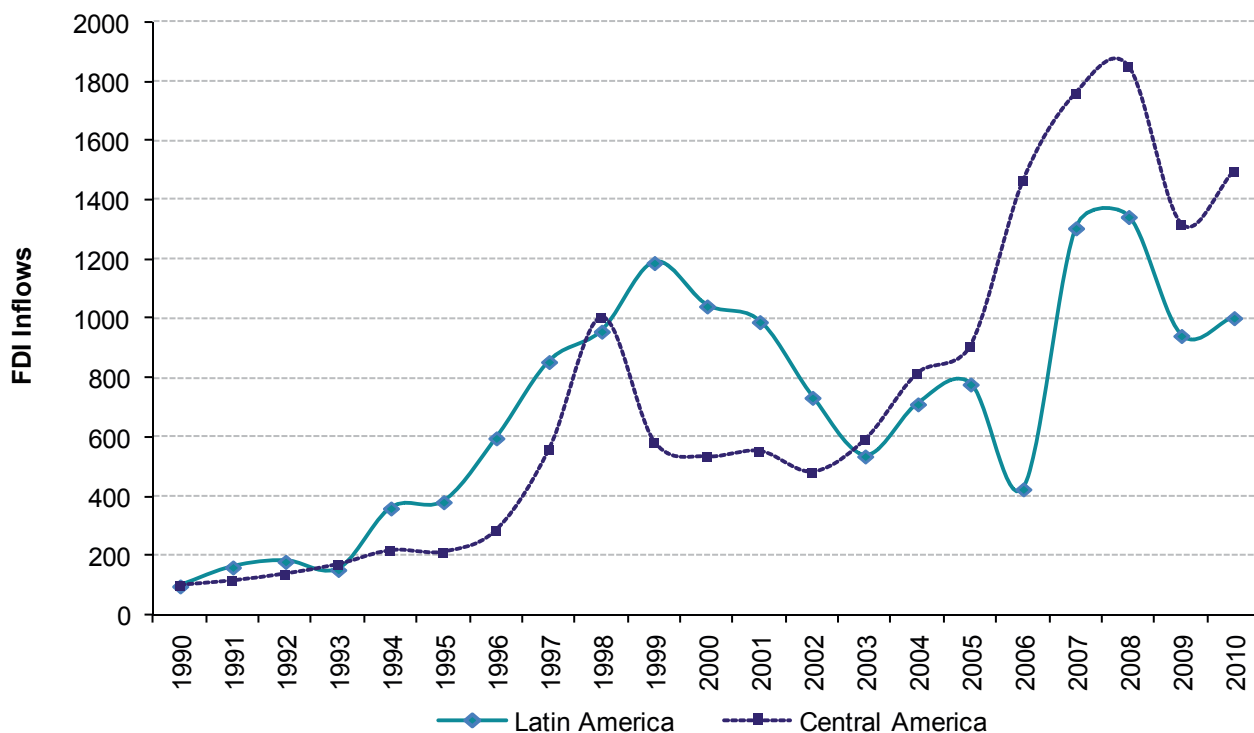
FDI inflows to Central America reflect the attractiveness of the region as a destination for investment, but are also highly vulnerable to global economic cycles. Foreign investment in the region demonstrated risk aversion in the period between the Asian and Argentine crises and fell as a result of the US recession from 2001 to 2002, although with a slight lag. The recent global economic crisis predictably resulted in lower FDI inflows to Central America in 2008-09. But the recent crisis was unlike previous periods of financial turmoil: for many international investors the attractiveness of certain developing and emerging economies actually increased. While FDI may not reach its precrisis levels for some time, the region



remains attractive for a large pool of investors.¹⁶

Central American governments were eager to attract FDI, often by offering generous tax benefits to investors. On balance, analysis of these investment incentives point to positive and negative outcomes. Efforts to attract FDI into the region have helped countries such as Costa Rica and Panama diversify their export bases and increase exports.¹⁷ Nonetheless, government policies intended to attract FDI through tax incentives have also yielded negative results. Although there are only a few estimates regarding the effect on general government revenues of tax exemptions intended to attract foreign investment, one study from the Office of the Superintendent of Tax Administration of Guatemala estimates that in 2006 these incentives equaled 12.5 percent of GDP and 118.2 percent of total tax revenues.¹⁸ The fact that tax deductions can exceed total revenues illustrates the generosity of some Central American countries' incentives to foreign investors.

Figure 8. Foreign Direct Investment Inflows to Latin America/Caribbean and Central America, 1990-2010



Note: 1990=100.

Source: ECLAC/CEPAL, "CEPALStat" database.

Finally, there is a clear trend in the makeup of total investment: Private investment has increased while public investment has declined (see Figure 9). During the early 1990s, public investment accounted for nearly 30 percent of the total, but by 2010 its share had halved to 15 percent. Cuts in public investment by the government were originally replaced by private investment, but investor disaffection with emerging markets, as well as a growing antiprivatization atmosphere by politicians and citizens resulted in less private investment.¹⁹ The declining share of public investment largely explains the deterioration of public

16 ECLAC, *Enfrentando la Crisis: Istmo Centroamericano y República Dominicana, Evolución económica en 2008 y perspectivas para 2009* (Mexico City: ECLAC, 2009), www.cepal.org/publicaciones/xml/4/35814/L904.pdf

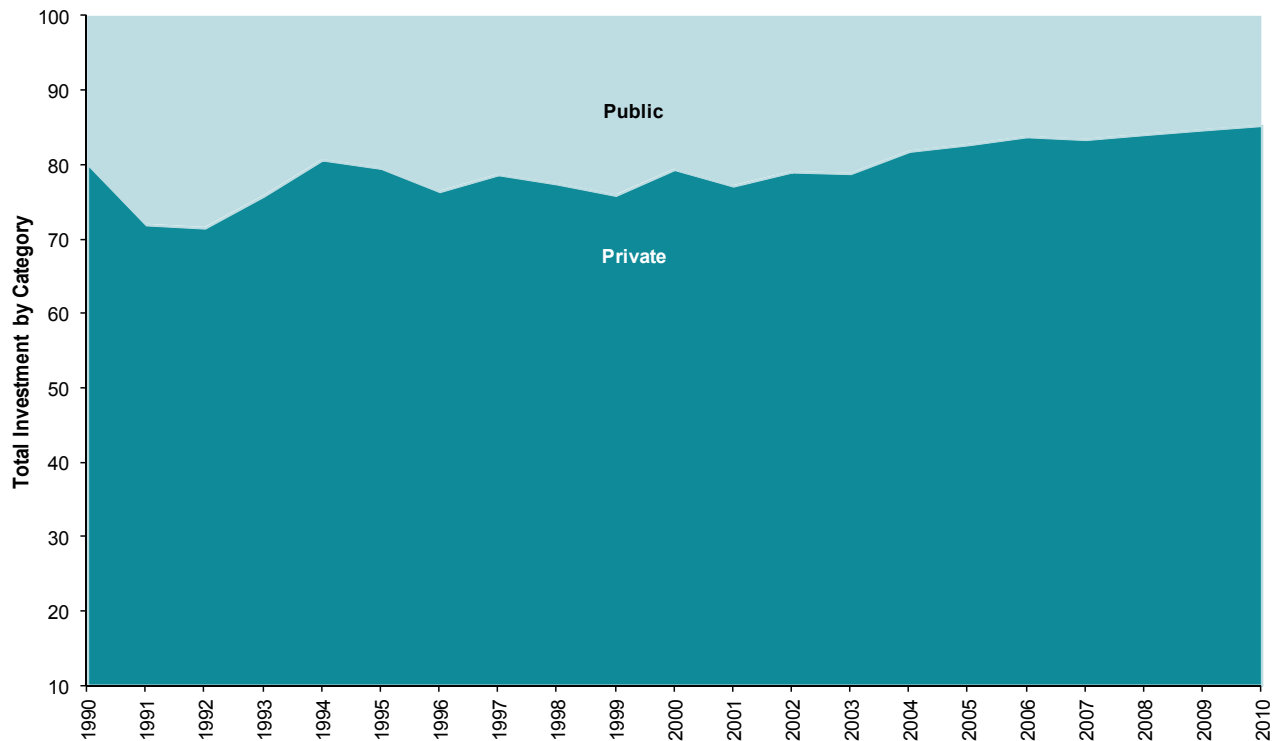
17 ECLAC, *Foreign Direct Investment in Latin America and the Caribbean 2010* (Santiago: ECLAC, 2011), www.cepal.org/publicaciones/xml/0/43290/2011-323-LIEI-WEB.pdf

18 ECLAC, *La integración económica Centro Americana y sus perspectivas frente a la crisis internacional* (Mexico City: ECLAC, 2009), www.eclac.cl/publicaciones/xml/9/38219/L954.pdf

19 Marianne Fay and Mary Morrison, *Infrastructure in Latin America and the Caribbean: Recent Development and Key Challenges* (Wash-

infrastructure over the past two decades.²⁰ In 2005, only 13.9 percent of all the roads in Central America were paved.²¹

Figure 9. Public and Private Investment in Central America, 1990-2010



Source: ECLAC/CEPAL, “CEPALStat” database.

C. Inequality and Poverty as Obstacles to Growth

In general, Central American countries are characterized by simultaneous large inequalities and high concentrations of wealth; nearly half the region’s population lives in poverty. These realities are a substantial barrier to the region’s economic and social development. Over the past two decades, however, there has been substantial progress toward reducing poverty across Central America. Still, important obstacles remain.

Poverty reduction in Central America occurred through different mechanisms. A recent ECLAC study shows that between 2002 and 2007, poverty declined in Guatemala, Honduras, and Nicaragua primarily as a result of rising incomes, while in El Salvador and Panama poverty reduction is primarily explained by more equitable income distribution.²² (Of course, income growth and more equitable income distribution are complementary and are both essential to sustainable poverty reduction.) Another important difference is the source of income: In Guatemala, El Salvador, and Honduras remittances drove income gains, while in Nicaragua, Costa Rica, and Panama poverty reduction was propelled by earned income.

ington, DC: The World Bank, 2005), http://siteresources.worldbank.org/INTLAC/Resources/LAC_Infrastructure_complete.pdf.

20 Ricardo J. Sanchez and Gordon Wilmsmeier, *Bridging infrastructural gaps in Central America: prospects and potential for maritime transport* (Santiago: ECLAC, 2005), www.eclac.cl/publicaciones/xml/6/22906/lcl2386i.pdf.

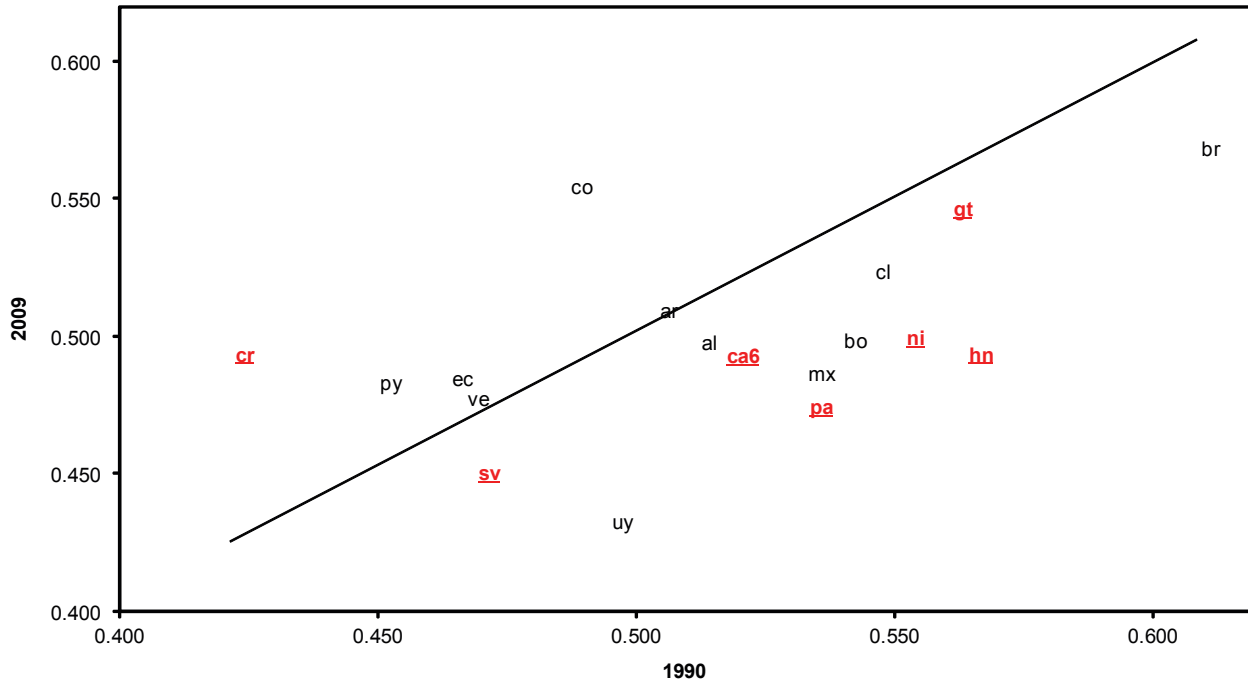
21 Ibid.

22 ECLAC, *Social Panorama of Latin America, 2008* (Santiago: ECLAC, 2008), www.cepal.cl/publicaciones/xml/3/34733/PSI2008-SintesisLanzamiento.pdf.



Overall, trends in inequality in Latin America over the past two decades were mixed. Figure 10 shows the Gini coefficient in 1990 and 2009 for the region: Countries above the 45-degree line became more unequal over this period, while the ones below reduced inequality.²³ All of the countries of Central America experienced declines in inequality over the period.²⁴ However, inequality declined modestly in Guatemala and El Salvador while the most significant progress took place in Honduras, Nicaragua, and Panama.

Figure 10. Changes in Inequality in Latin America, Gini Coefficient, 1990 and 2009



Notes: Includes only urban areas. Central American countries are indicated in red. CR=Costa Rica, GT=Guatemala, HN=Honduras, NI=Nicaragua, PA=Panama, SV=El Salvador, and CA6=all six countries.

Source: ECLAC/CEPAL, "CEPALStat" database.

D. Maintaining Macroeconomic Stability and Reducing External Vulnerability

As previously described, over the past two decades Central American countries made substantial progress toward achieving macroeconomic stability, mainly by maintaining stable public balance sheets and prices. In terms of public finances, Central American countries recorded an average deficit of less than 1 percent of GDP between 2006 and 2008, and none of the six countries has recorded a deficit of more than 4 percent in the last 18 years. Moreover, inflation remained under control, remaining in the single digits over the last decade, with the exception of 2008 when it averaged 10 percent due to rising international energy and food prices.

In spite of the subregion's healthy public finances, Central America has experienced persistent and elevated balance of payments and current account deficits. Figure 11 illustrates these so-called "twin deficits." Each point shows tax revenues and the current account balance for a given year; a line connects the points revealing the course of the two indicators. The top panel illustrates data for the 1990s and the bottom panel illustrates data for 2000-10.

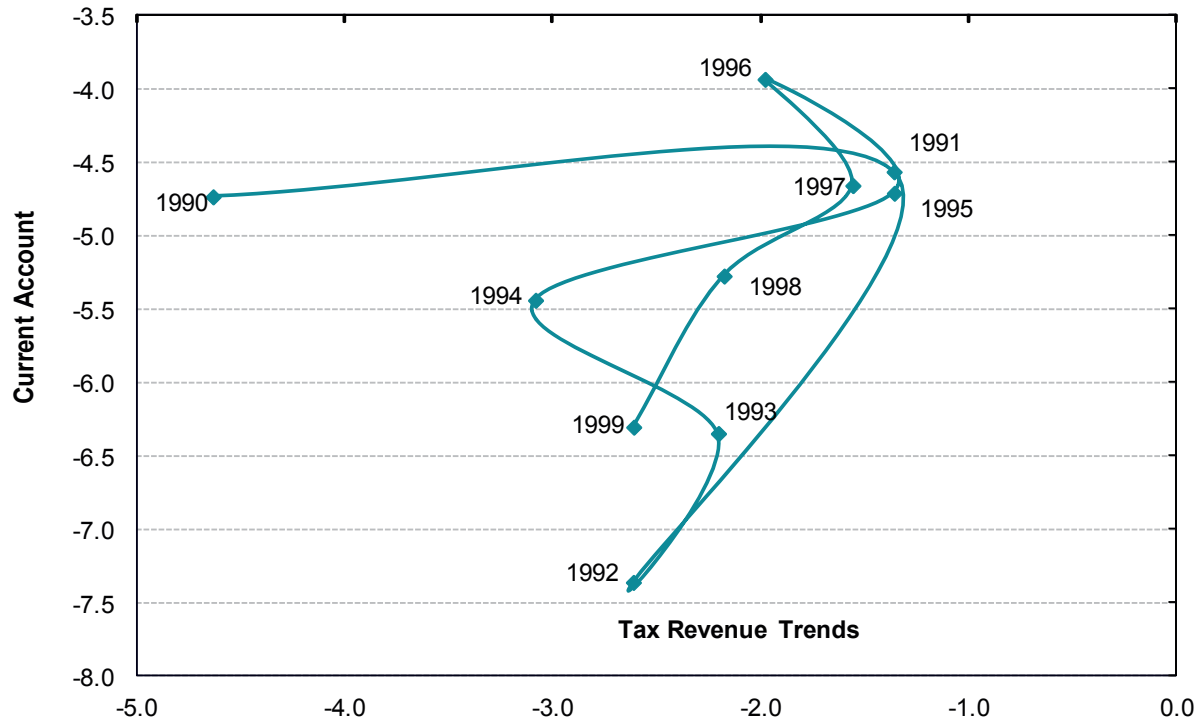
In the 1990s, public debt ranged from 1 percent to 3 percent of GDP (with the exception of 1990), while

²³ The Gini coefficient is a relative measure comparing a country's income and population distributions. A Gini coefficient of 0 corresponds to complete equality while a Gini coefficient of 1 corresponds to complete inequality.

²⁴ This analysis includes only urban areas. The Gini coefficient is likely to be higher if rural areas are included.

foreign debt remained between 4 percent and 8 percent of GDP. For the first decade of the 21st century, two big trends stand out. First, public debt improved every year, staying below 1 percent in the four years prior to the global economic crisis, but it rose to above 3 percent in 2009 and 2010. By contrast, foreign debt over the first five years of the decade remained consistently between 4 percent and 6 percent of GDP. This began to change in 2006. In 2007 and 2008 foreign debt increased to 7 percent and 9 percent of GDP, respectively.

Figure 11. Central Government Current Account and Public Finance Trends in Central America as Share of GDP, 1990-99 and 2000-10



Source: ECLAC/CEPAL, "CEPALStat" database.

These deficits are the consequences of the structure of Central American economies, which rely on high volumes of imported goods, and on the export of goods that rely on low-cost unskilled labor. Along with low domestic demand, heavy dependence on US consumers, and reliance on imported food and energy, these characteristics of the Central American economy make the subregion extremely vulnerable to economic shocks originating abroad. For example, expenditures on oil rose from roughly \$6.9 billion in 2006 to \$11.2 billion in 2008, falling to \$7.5 billion in 2009, before rising again to \$9.3 billion in 2010, reflecting the volatility of international energy prices over the period.

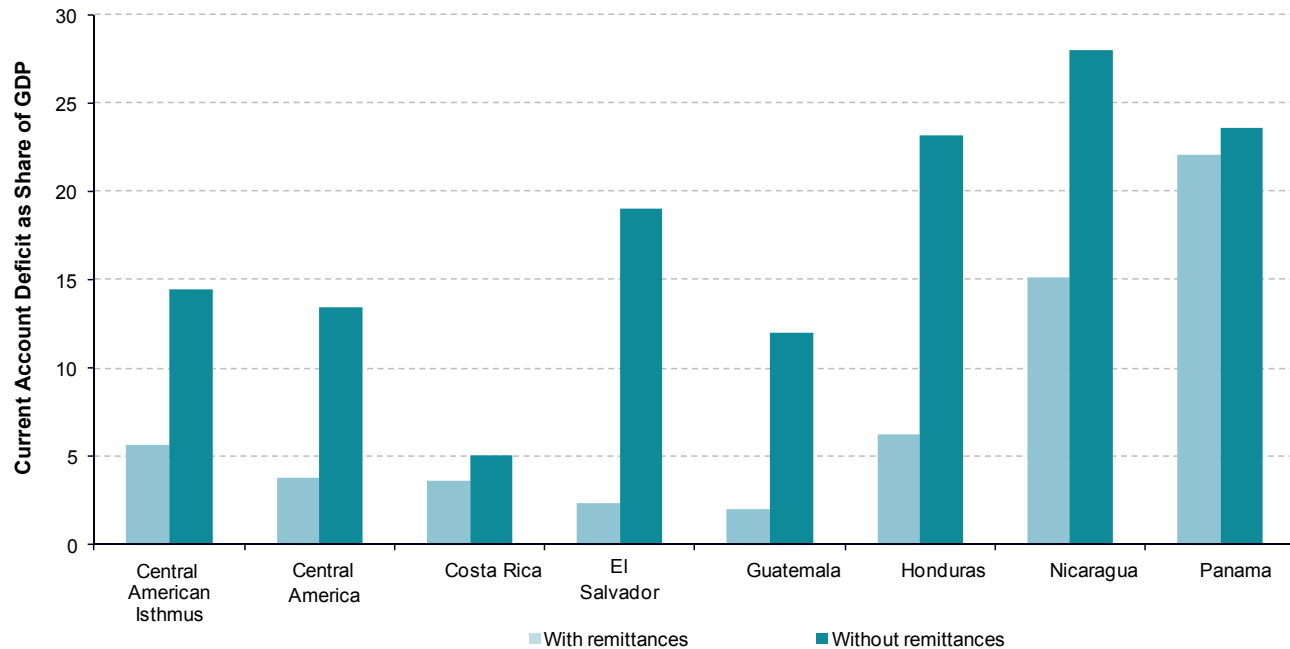
The steady inflow of migrants' remittances to Central America was a key element offsetting growing trade deficits. Prior to the economic crisis, remittances increased at annual rates of more than 20 percent, ultimately reaching nearly 20 percent of GDP for countries such as El Salvador and Honduras. Figure 12 illustrates the current account deficit in 2010 under two scenarios: the first accounting for remittances and the second excluding remittances. On average for Central America, remittances reduce the current account deficit by about 10 percentage points of GDP.

The importance of remittances as an engine of private consumption is an additional source of volatility in many Central American economies. Since remittance inflows depend on both the needs of remittance recipients and the income of migrants abroad, US economic conditions and fluctuations in the US economy have wide-ranging implications for domestic demand in Central America. Although remittances



demonstrated countercyclical behavior during the recession of 2001 to 2002, they contributed to economic contraction during the most recent crisis.

Figure 12. Current Account Deficit in Central America as Share of GDP With and Without Remittances, 2010



Source: ECLAC/CEPAL, “CEPALStat” database.

Overall, Central American countries continue to be highly vulnerable to external economic conditions despite notable success in achieving macroeconomic stability over the past 20 years. This vulnerability is due, in part, to the subregion’s productive structure relying heavily on low-cost exports and, in part, to its openness to and dependence on capital inflows from abroad. Over the coming decade, a critical challenge for Central America will be to maintain macroeconomic stability while also reducing its structural vulnerability to external conditions and foreign actors.

E. Reliance on Migration and Remittances

For Central America, migration serves as an escape valve insofar as domestic labor supply exceeds demand. In the absence of robust job creation within the subregion, and particularly the lack of decent jobs,²⁵ a growing number of Central Americans seek employment abroad. Since the 1990s, there has been a constant upward trend in the outflow of Central Americans looking for work in the United States, Canada, Europe, and to a lesser extent, certain countries within the subregion — notably Costa Rica.

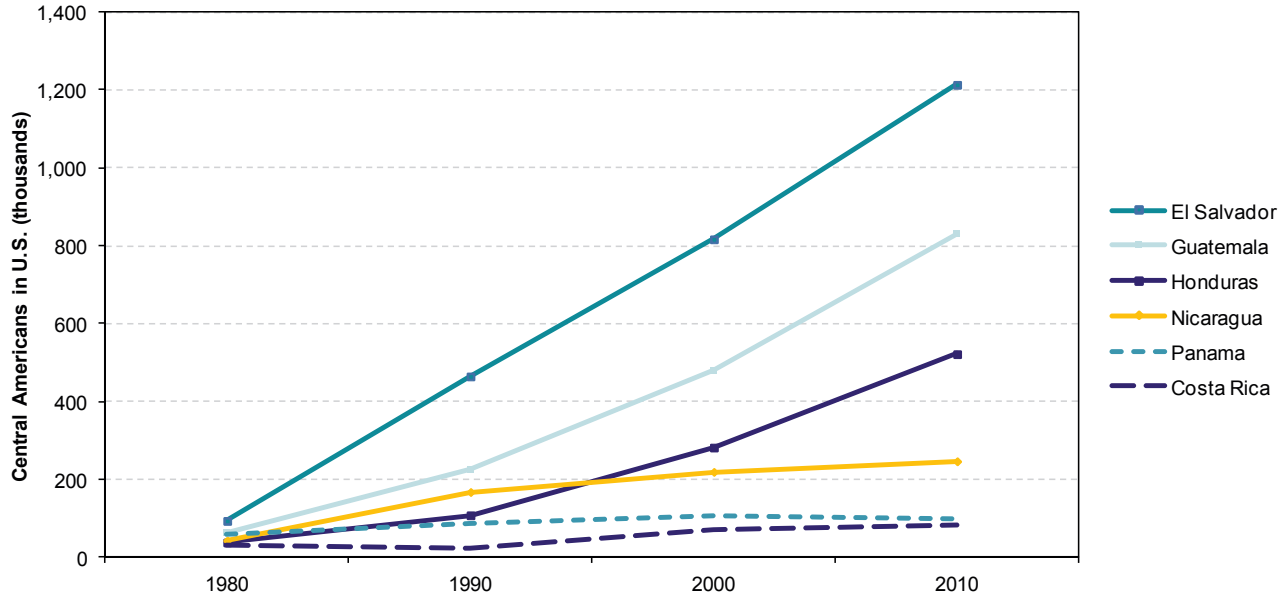
Historically, Central American migration and interregional and external population displacement were closely related to civil wars and natural disasters, such as earthquakes and hurricanes. Large-scale migration abroad started with the Nicaraguan, Salvadoran, and Guatemalan civil wars of the late 1970s and early 1980s. With the end of these wars, migration continued due to a shortage of decent jobs and economic opportunities. Figure 13 shows the number of Central American immigrants in the United

²⁵ According to the International Labor Organization (ILO), decent work is defined as employment that offers remunerative pay with social protection, where workers’ rights are respected. The definition entails four strategic objectives: main principles of international labor standards and laws; work and income opportunities; social protection and social security; and social dialogue. See ILO, *Report of the Director General: Decent Work* (Geneva, ILO, 1999), www.ilo.org/public/english/standards/reim/ilc/ilc87/rep-i.htm.



States from 1980 to 2010 and indicates very clear upward trends for Salvadorans, Guatemalans, and Hondurans. About one-tenth of Central American immigrants in the United States reside in the country on temporary humanitarian visas — known as Temporary Protected Status (TPS) — and an additional two-fifths lack legal immigration status.²⁶

Figure 13. Central American Immigrants in the United States, 1980 to 2010



Sources: Aaron Terrazas, “Central American Immigrants in the United States,” *Migration Information Source*, January 2011, www.migrationinformation.org/USfocus/display.cfm?ID=821. Updated with data from the US Census Bureau’s 2010 American Community Survey.

The remittances that migrants send to Central America mitigate poverty, soften fluctuations in household consumption, promote investment in human capital, and spill over into local economies.²⁷ Migration abroad can limit growth in domestic labor supply raising wages for workers who remain.²⁸ But it also can exacerbate inequality, and the reliance on foreign remittances makes recipient countries vulnerable to external economic and political shocks, particularly since migrants often encounter precarious working conditions and face limited political rights.²⁹

26 Aaron Terrazas, “Central American Immigrants in the United States,” *Migration Information Source*, January 2011, www.migrationinformation.org/USfocus/display.cfm?ID=821.

27 Pablo Acosta, Cesar Calderon, Pablo Fajnzylber, and Humberto Lopez, “What is the Impact of International Migrant Remittances on Poverty and Inequality in Latin America?” *World Development* 36(1) (2008): 89-114 estimates that remittances help mitigate poverty in Latin America with different initial conditions of inequality. The authors conclude that in a representative country of the region, where remittances reach nearly 6 percent of GDP with a Gini coefficient of 0.5, a 1 percentage point increase in the remittance/GDP ratio would reduce poverty by nearly 0.08 percent in the poorest countries and by up to 1.12 percent in the wealthiest. See Dean Yang, “Are Remittances Insurance? Evidence from Rainfall Shocks in the Philippines,” *World Bank Economic Review*, Vol. 21 (2), May 2007, 219-48; Ernesto Lopez Cordova, “Globalization, Migration and Development: The Role of Mexican Migrant Remittances” (INTAL/ITD Working Paper No. 20, Inter-American Development Bank, Washington, DC, October 1, 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=668126; German A. Zarate-Hoyos, “Consumption and Remittances in Migrant Households: Towards a Productive Use of Remittances,” *Contemporary Economic Policy* 22, no. 4 (2004): 555-65; and Bradford Barham and Stephen Boucher, “Migration, remittances, and inequality: estimating the net effects of migration on income distribution,” *Journal of Development Economics* in 55 (3) (1998), 307-31, <http://ideas.repec.org/a/eee/deveco/v55y1998i2p307-331.html>.

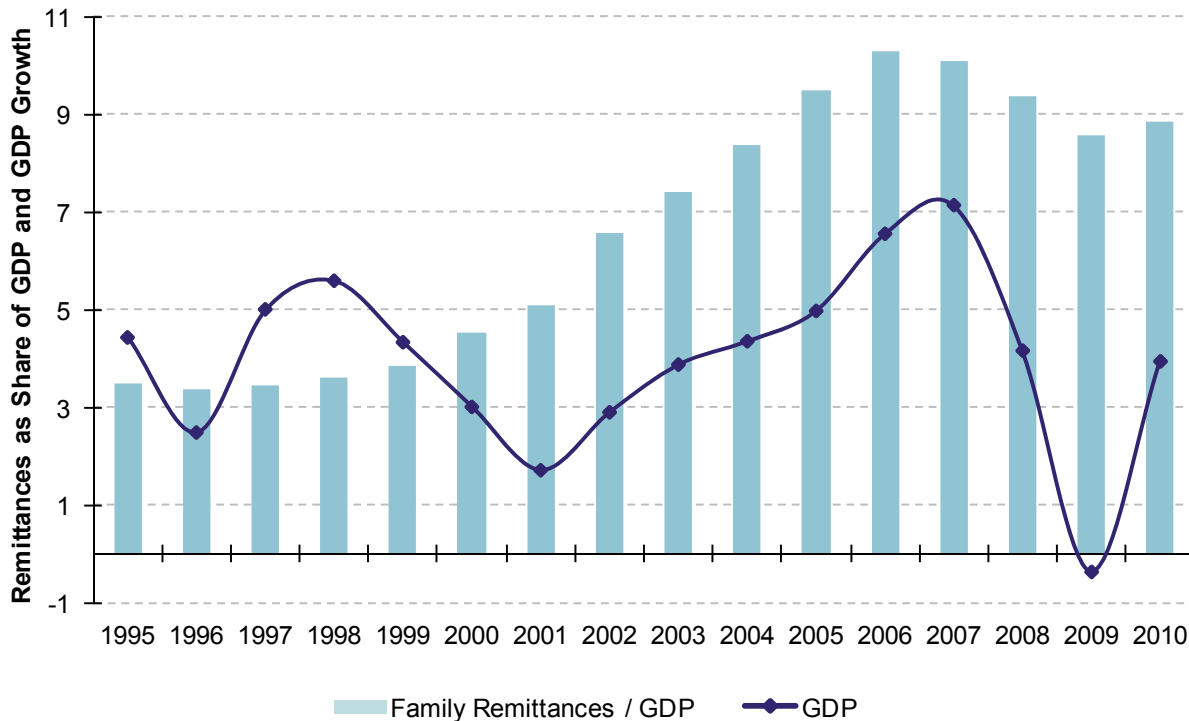
28 On Mexico, see Prachi Mishra, “Emigration and Wages in Source Countries: Evidence from Mexico” (Working paper 06/86, International Monetary Fund, Washington, DC, 2006), www.imf.org/external/pubs/ft/wp/2006/wp0686.pdf. There is no empirical evidence on the wage effects of emigration in Central America, but anecdotal reports from El Salvador suggest that in high emigration regions, wages have increased for some workers.

29 Sarah Gammage and Monica Orozco, *El trabajo productivo no remunerado dentro del hogar: Guatemala y México* (Santiago,



The growing importance of migration and remittances as a household survival strategy for Central America — as well as the external vulnerability they imply — are illustrated by Figure 14, which shows remittance flows as a share of GDP. For Central America, remittance flows peaked at nearly 10 percent of GDP in 2006 before falling for three consecutive years during the US economic crisis. Remittances are particularly important in several countries of the subregion, accounting for nearly 17 percent of GDP in El Salvador and 20 percent in Honduras.

Figure 14. Remittances as Share of GDP and GDP Growth in Central America,* 1995 to 2010



* Includes Dominican Republic.

Source: ECLAC/CEPAL, “CEPALStat” database.

Overall, migration and remittances are critical to the well-being of many Central American households and communities, but they also reveal the shortcomings of economic policies that shift the need to absorb surplus national workforce to foreign demand for labor. In the short term, the success of “exporting” labor depends on the availability of jobs in host countries and on immigrant reception policies — all largely beyond the control of policymakers in the subregion.

IV. Long-Term Challenges: Shifting Risks and Opportunities

In the long term, three challenges pose both risks and opportunities for Central America: (1) a shifting global economic order in the wake of the recent financial crisis, (2) rapidly advancing climate change, and (3) demographic shifts in Central America.

Chile: ECLAC, 2008), www.eclac.cl/publicaciones/xml/0/34730/Serie_103.pdf; Theodore P. Lianos and Jennifer Cavounidis, “Immigrant Remittances, Stability of Employment and Relative Deprivation,” *International Migration* 48, no. 5 (2010): 118-41.



A. *The Post-Crisis World and its Repercussions for Central America*

For Central America, the transformation of the global economy as a result of globalization poses a significant challenge. First, the economic rise of China, India, and other Asian countries with an abundance of cheap labor cast doubt over the viability of Central America's current export-led development model. Asian competitors face cheaper cost structures and, accordingly, are pushing out Central American producers. Second, the booming international demand for commodities (notably food and energy) — and the resulting increase in their prices — weakens the subregion's terms of trade since Central American economies are net importers of these products. Rising oil and food bills between 2007 and 2011 are the most prominent example of this phenomenon.

The global economic crisis that erupted in 2007 prompted policymakers to reconsider many of the assumptions that drove economic and development policy over the past two decades. Perhaps most importantly, the crisis has caused many to question the assumption that state intervention in markets should be avoided. In some instances, such as in the US housing industry, state subsidies clearly led to market distortions. In other instances, however, state intervention contributed to solutions — for example, the US government's role in rescuing and reforming the country's automotive industry. In the years ahead, the state is likely to play a more proactive role in the economy in many parts of the world, including Central America.

Most observers agree that the post-crisis world, at least in the medium term, will be characterized by economic instability. Timid efforts at reforming the financial system, the virtual absence of interest by the United States and Europe in reforming the international financial architecture, and rising debt in advanced industrial economies point to uncertainty in financial markets and regulatory frameworks — all of which inhibit business decisions and, as a result, reduce employment and increase poverty. An evolving global economic order where emerging economies are expected to play a greater role in international decision-making further contributes to uncertainty.

After five years of relatively robust economic growth, the Central American economy in 2009 contracted for the first time since 1982. The economic crisis is likely to have lasting consequences in Central America and the subregion's potential for growth will slow for the foreseeable future due to weak global demand and risk aversion in credit markets.

B. *Climate Change, Disasters, and the Environment*

There is broad consensus that climate change³⁰ threatens nearly every human activity: Farming, forestry, and ecosystem yields will fall, and uncontrolled fires, crop damage, soil erosion, livestock deaths, and harm to coral reefs will increase. The impact on water resources will result in greater water demand, problems of water quality, supply contamination, water shortages, and salinization.

In economic terms, climate change is an externality at the global level and, as Alicia Barcena of ECLAC argues, climate security is a global public good that requires protection.³¹ In particular, spending on climate change prevention, adaptation, and mitigation is expected to rise significantly, though likely not in linear fashion. Greater infrastructure investment will be necessary, especially in coastal areas, to contend with the consequences of climate change.

Central America contributes relatively little to climate change — it has very low carbon emissions — but

30 According to the United Nations, climate change is defined as the “change of the climate which is attributed directly or indirectly to human activity that alters the composition of the global atmosphere and which is in addition to natural climate variability observed over comparable time periods.” See Intergovernmental Panel on Climate Change (IPCC), *Climate Change Synthesis Report* (Geneva: IPCC, 2007), www.ipcc.ch/publications_and_data/ar4/syr/en/contents.html.

31 Alicia Bárcena, “Institucionalidad y financiamiento para los bienes públicos globales: el caso del cambio climático,” (Santiago, Chile: ECLAC, 2009 unpublished).



is highly vulnerable to the effects of climate change as much of the subregion is in the path of hurricanes and the population is concentrated in low-altitude coastal areas and on many islands. Nearly 8.4 million Central Americans live in areas that are at high risk for hurricane activity and the economic impact of hurricanes is much larger on small economies.

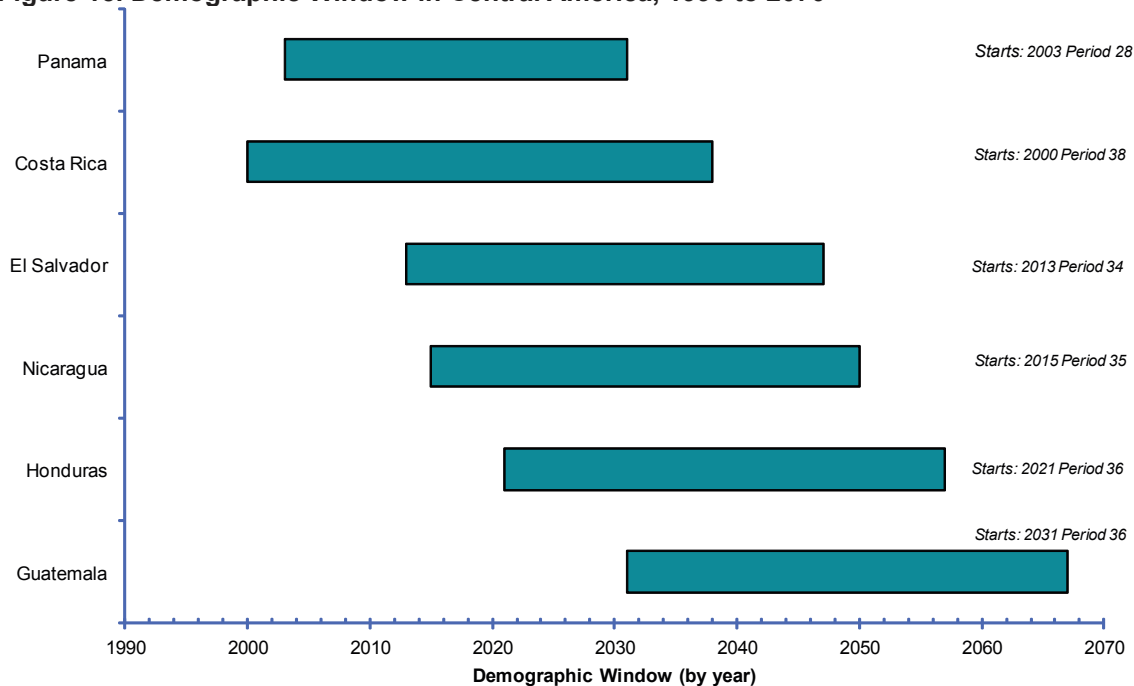
The net effect on public finances will be varied, but is unlikely to be positive. Hence, climate change's economic impact should be viewed as a contingent liability. On the spending side, the occurrence of social and infrastructure emergencies will rise sharply. It will also be necessary to subsidize certain economic sectors and agents, to steer people's behavior toward the transition to a low-carbon economy. With respect to tax policy, taxes must be used to make climate change-inducing technologies and industries more expensive. In short, fiscal policy's dual role will entail cushioning the impact on people, while at the same time giving them incentives to move to a more environmentally friendly economy.

C. Demographic Change

Two worrisome long-term demographic trends loom on the horizon for Central America: rapid aging, and low-coverage, low-quality social protection systems.³² Although the demographic transition from relatively youthful to older societies is less advanced in Central America than elsewhere in Latin America, the number of elderly is expected to rise and the number of young people is expected to fall across the subregion. As a result, significant opportunities are emerging from the increasingly favorable ratio between the people currently working and those who are dependent on them — a phenomenon known as the “demographic window.”

Figure 15 presents the dependency ratio at its most beneficial phase (the demographic window) for Central American countries. The most economically advanced countries (Costa Rica and Panama) have already entered the demographic window phase, while El Salvador, Nicaragua, and Honduras are expected to do so within the next decade. For Guatemala, these favorable demographics are at least two decades in the future.

Figure 15. Demographic Window in Central America, 1990 to 2070



Source: ECLAC, Population Division (CELADE), “Population Projections, 2010 Revision,” www.eclac.cl/celade/proyecciones/basedatos_BD.htm.

32 Sandra Huenchuan, ed., *Envejecimiento, derechos humanos y políticas públicas* (Santiago: ECLAC, 2009), www.eclac.org/publicaciones/xml/4/36004/LCG2389-P.pdf.



The demographic transition opens a window of opportunity for investing in education quality, improving the integration of youth into the workforce, and increasing worker productivity. In this objective, Central American countries will face many of the same challenges as the developed countries, and in particular, how to finance the education of a rapidly growing youth cohort. Moreover, for many countries — particularly in Southern and Eastern Europe — the demographic transition has not translated into sustainable prosperity. Avoiding these risks will be a critical challenge for Central America.

V. Elements of a New Development Agenda for Central America

Since the 1980s, Central American countries embarked on a series of reforms inspired by the “Washington Consensus” and succeeded in drastically reducing state interference in the economy and opening domestic markets to global competition. Exports accelerated, but many national economies were impaired by greater reliance on imported inputs rather than on local suppliers. The growing disenchantment with the record of the past two decades has led the subregion to seek a new growth strategy based on a more objective evaluation of the limitations and failures of markets, and of the positive role the state may play in overcoming these shortcomings.

In order to fully benefit from the opportunities of an evolving global economy, there is a need for a new generation of economic policies in Central America.

One critical conclusion is that countries can get stuck in natural resource production and low-wage value chains if there is no concerted effort to diversify exports and move toward greater value-added industries. A second conclusion is that there is no single, universally valid recipe for economic growth. Although many developing economies face common challenges — poverty, inequality, and underemployment — the challenges preventing growth can be quite different. In some cases businesses may face challenges securing financing while in others the burden of foreign debt may limit investment and in still others scarce public infrastructure (physical and human) may limit investment returns.

Moving forward, Central American countries face the challenge of moving into higher value-added production. This does not imply immediately abandoning the current model, since industries such as manufacture assembly and agriculture provide a vital source of employment in the subregion. However, building local capacity will lead to better use of technology and will make the area more attractive as a source of skilled-labor intensive goods. In the food and agriculture industry, there are opportunities to move toward the production of more sophisticated products and incorporate marketing services (e.g., logistics, packaging, transportation, and distribution). There are also opportunities in agricultural input production (e.g., machinery, seeds, agrochemicals, and technical support services).

Beyond agriculture and manufacturing, international trade in services — of which Central America has a growing market share — offers opportunities for diversifying exports. The subregion is an attractive destination for business outsourcing and subcontracting opportunities thanks to its geographic proximity to the United States and the relatively low cost of skilled labor. It also offers enormous potential as a tourism destination.³³

³³ Although professional services, computers, IT, architecture, engineering, medicine, and advertising generally offer better



In order to fully benefit from the opportunities of an evolving global economy, there is a need for a new generation of economic policies in Central America — for instance, to reduce gaps in access to public services and improve the quality of those services. Strengthening the capacity of business to adapt is important as well, as is increasing investment in human resources, science, and technology.³⁴ Public policy plays a key role in taking advantage of the opportunities described above.

With respect to international and regional integration, Central America must look beyond the United States where demand is expected to remain stagnant for the foreseeable future. The negotiation of the Associative Agreement with the European Union is a positive step in this direction, although demand for Central American products and services is likely to remain weak in Europe due to the continent's economic turmoil. Central America has developed some economic linkages with growing economies in South America — notably Argentina, Brazil, and Chile — and should begin developing economic relations with Asia. However, this will likely pose new challenges as Central America has recently competed directly with many Asian economies for export markets. Thus, it is essential to identify complementarities between Central America and Asia.

salaries than manufacturing, substantial human and physical capital must be developed before Central America can achieve a competitive advantage in these industries. See Santiago Martinez, Alberto Jardon, Jose Maria Navarro, and Patricia Gonzalez, "Building industrialization: robotized assembly of modular products," *Assembly Automation*, Vol. 28, no. 2 (2008): 134–42, www.emeraldinsight.com/journals.htm?articleid=1722580.

34 ECLAC, *Social Panorama of Latin America*, 2008.



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About the Author



Hugo Beteta is Director of the Subregional Headquarters in Mexico of the United Nations Economic Commission for Latin America and the Caribbean (ECLAC). He is a member of the Regional Migration Study Group convened by the Migration Policy Institute (MPI) and Latin American Program/Mexico Institute of the Woodrow Wilson International Center for Scholars. Previously, he served for two years as Secretary of the Inter-American Development Bank (IDB), Minister of Public Finances of Guatemala, and head of Guatemala's Planning and Programming Ministry. As a member of Guatemala's Council of Ministers, he served as a member of the IDB and World Bank Governors Assemblies, and Alternate Governor of the International Monetary Fund (IMF).

Mr. Beteta has undertaken a wide range of research projects on community development, renewable energy, housing, electrification, water and sanitation and local (municipal) finances, among other sectors. He was a founding member of the Solar Foundation, where he served as Executive Director from 1993 to 1999; the foundation works with government agencies, the private sector, international organizations and civil-society groups on renewable energy policies and projects, national environmental policies, and projects for the generation of income in environmental management.

Mr. Beteta obtained a bachelor's degree in civil engineering from Rafael Landivar University in Guatemala, where he later served as Dean of the Economic Sciences faculty and Vice Chancellor for Administration. He graduated with honors from the University of Michigan with a master's in civil engineering and regional planning and also studied development economics and political economics at the doctoral level at the Massachusetts Institute of Technology.

Among other honors, he received the order Isabel la Católica from Spain in 2008 for his contribution to the Ibero-American dialogue and was recognized by the World Bank in 2007 as one of ten "Reformers of the Year." He has also been a Fellow at the Fulbright Commission, the Aga Khan Foundation, the MIT Voorhees Foundation, and the MacArthur Foundation.

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