INTER-AMERICAN DEVELOPMENT BANK
CONSULTATIVE GROUP MEETING FOR
THE RECONSTRUCTION AND TRANSFORMATION
OF CENTRAL AMERICA

Preliminary Assessment by the IMF and the World Bank Staff of the Balance of Payments Situation and External Financing Gaps in Selected Central American Countries

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Overview

Hurricane Mitch has had a seriously adverse impact on overall economic activity, poverty and living standards of the population, and the balance of payments position—mainly in Honduras and Nicaragua, but also in El Salvador and Guatemala. As indicated in the UN report, the humanitarian toll has been enormous, with for example more than 75 percent of the population in Honduras affected by the storm and its repercussions. In the four countries as a whole, about one quarter of the total population has been affected. We should emphasize that the estimated balance of payments and other effects are still under review by the staffs of the Fund, the Bank, and the authorities, and are subject to change. The estimates presented below are a first effort to quantify the magnitude of the assistance needed by these countries from the international community.

- The combined current account deficit of the four countries (including transfers) is expected to widen to about US$2.3 billion (6 percent of GDP) in 1998 and to US$2.6 billion (6½ percent of GDP) in 1999. This compares with an annual average deficit of US$1.8 billion (about 4½ percent of GDP) a year that had been envisaged prior to the hurricane. Projections for 2000 point to some moderation of the combined deficit to about 6 percent of GDP.

- The total external financing gap of the four countries could amount to about US$600 million in 1999 and US$450 million in 2000.

Most of the deterioration in the current account deficit in 1999–2000 is expected to stem from a sharp fall in exports (particularly banana, coffee, and other agricultural crops) reflecting the damage to these crops caused by the widespread floods. In aggregate, exports are projected to decline in 1999 by US$800 million (2 percent of GDP) relative to the level that had been expected prior to the hurricane The decline in net receipts from exports of services, including the maquila sector and tourism, is expected to be less marked. The projections also point to an increase in total merchandise imports of US$500 million to US$12 5 billion in 1999 as a result of the hurricane. These estimates reflect, in part, the assumption that there will be an increase in imports of food, medicines, and other emergency assistance, as well as materials for the reconstruction efforts.

The estimated financing gaps for 1999–2000 are defined *after* taking into account expected disbursements from already agreed loans, rescheduling agreements with the Paris Club and other creditors, and compensation payments by insurance companies. The gaps are expected to be closed largely with grants, concessional financing, possible additional debt relief, and other assistance, including in the form of the Central American Emergency Trust Fund to be financed by donors (including international financial institutions and the private sector) that has recently been established at the World Bank to help service loans from multilateral institutions.

Since work is still ongoing, and some Fund staff missions have only just returned from the affected countries, estimates of the effects of the hurricane on key economic indicators are still very tentative. Estimates of real GDP growth for 1998 and 1999 have been marked down sharply in the case of Honduras, and less so for Nicaragua, El Salvador, and Guatemala; also inflation and unemployment will likely be higher; and fiscal deficits will widen.

The Fund is assisting the affected countries in meeting their additional financing needs through a combination of (i) emergency assistance (Honduras and possibly Guatemala); (ii) the augmentation of the existing ESAF arrangement in the case of Nicaragua; (iii) a Stand-By Arrangement with El Salvador which was approved in September 1998; and (iv) a planned, new ESAF arrangement for Honduras in 1999. Some of these countries may be eligible for loans related to export shortfalls under the Compensatory and Contingency Financing Facility (CCFF). In addition, in the cases of Honduras and Nicaragua, the staffs of the Fund, the World Bank, and the IDB, in collaboration with the authorities plan to update as soon as conditions permit the estimates of debt sustainability analyses in the context of the HIPC Initiative, taking into account the effects of the hurricane, and to present these estimates to their respective Boards.

It should be pointed out that the authorities' response to the devastation caused by the hurricane has not been confined to addressing immediate needs and seeking external assistance to support this task. The governments of the affected countries have reaffirmed their commitment to continue to follow prudent economic policies and pursue structural reforms. Indeed, in the case of Honduras and Nicaragua, the governments—despite the pressing demands associated with disaster relief and reconstruction—have continued to push ahead with legislation supporting reforms in the areas of privatization, the tax system, and the financial sector. The governments of the affected countries believe that policies aimed at consolidating macroeconomic stability, increasing prospects for private investment, and deepening structural reforms that address constraints to growth, while at the same time strengthening social programs, will play a key role in restoring confidence in their economies and aiding in the recovery.

Honduras

Initial estimates indicate that the external current account deficit is expected to widen to about US$420 million in 1998 (7½ percent of GDP), and US$445 million in 1999 (8½ percent of GDP), compared with 2½ percent of GDP a year contemplated prior to the hurricane, owing mainly to the projected decline in exports and higher imports related to emergency food and medicines, reconstruction activity, and the restocking of inventories For 2000, the deficit is projected to fall to 7 percent of GDP. On this basis, balance of payments financing gaps are expected to amount to US$364 million (7 percent of GDP) in 1999, and US$300 million (5 percent of GDP) in 2000. These estimates are defined after taking into account estimates of debt relief from Paris Club creditors, and of compensation payments by insurance companies. However, the estimates of the financing gaps do not take into account debt relief from other creditors, proceeds from the Central American Emergency Trust Fund, and new commitments by donors.

Estimates of the damage to the economy are still being prepared. However, first approximations are that real GDP growth could fall to 3 percent in 1998 and turn negative in 1999, compared with a projected rate of growth of 5–6 percent a year in the pre-hurricane scenario Unemployment is likely to rise as workers in the agricultural and manufacturing sectors could be laid off pending the rehabilitation of crops and factories. Also, inflation is expected to increase to 15–20 percent a year in 1998–99, compared with 14 percent in 1998 and 10 percent in 1999 projected earlier. In the fiscal area, the overall deficit of the central government could widen to 4 percent of GDP in 1998 and 7–8 percent in 1999, from 2½ percent of GDP contemplated prior to the hurricane, financed largely by external grants and concessional loans. The deterioration would reflect both a sharp loss in revenue as well as the expenditure related to the repair and reconstruction of infrastructure.

The Fund, the World Bank and other institutions and donor countries are providing assistance to help meet the immediate priorities of providing food, shelter, and health care to the homeless and displaced persons, preserving public health, and repairing essential infrastructure. In this connection, the Fund's Executive Board approved on December 7 a disbursement of SDR 47.5 million (US$66 million) under the Fund's emergency assistance policy. Also, the staff of the Fund and the Bank expect to visit Tegucigalpa in January 1999 to assess more fully the economic effects of the disaster, and on that basis discuss a revised macroeconomic framework which could be supported by a loan under the ESAF. Also in early 1999, the Fund, the World Bank, and the IDB will undertake jointly with the authorities an assessment of the external debt situation and requirements for debt relief in the context of the HIPC Initiative.

As noted above, the authorities are determined to refocus their attention shortly on pursuing the policies and reforms that had been agreed with the staff in the context of an ESAF-supported program Even during the current emergency period, the government has been pressing ahead with reforms aimed at privatization, encouraging private investment in key sectors, including mining and tourism, and strengthening supervision over the financial system.

The government believes that an ESAF-supported arrangement, aimed at consolidating macroeconomic stability, and deepening structural reforms could play a key role in restoring confidence in the economy.

Nicaragua

Preliminary estimates by the Fund staff indicate that the effects of hurricane Mitch could lead to a widening in the external current account deficit by about US$50 million in 1998 (about 2.5 percent of GDP) and US$150 million a year in 1999-2000 (about 7 percent of GDP) and to external financing gaps of a similar magnitude. The deterioration in the external position would reflect mainly the projected loss in export receipts from coffee, shrimp and non-traditional exports, and higher imports related to disaster relief and reconstruction needs. It is expected that the gaps would be filled through a combination of grants, concessional lending, private capital inflows and a downward adjustment in the targets on net international reserves. Also, Fund management intends to propose that the Fund provide additional financing to Nicaragua through augmentation of the existing ESAF arrangement.

Regarding other economic effects of the hurricane, estimates of real GDP growth for 1998–99 have been revised downward from 5½–6 percent a year to about 4 percent in 1998 and 5 percent in 1999 owing mainly to the estimated losses in agricultural production. Inflation is projected to rise to 16 percent in 1998, but is expected to decline to 10–12 percent in 1999 as food supplies normalize. Prior to the hurricane, it was envisaged that inflation would average 8 percent a year. In the fiscal area, preliminary estimates indicate that the hurricane would result in virtually no slippage in 1998, with the original program targets for the public sector saving position and the overall deficit still being met. For 1999 and 2000, the pre-hurricane scenario had envisaged that the overall deficit would narrow to 5 percent and less than 4 percent of GDP, respectively. However, Fund staff is discussing with the authorities possible adjustments to the fiscal program because of the needs associated with the reconstruction effort, and for additional social expenditures.

The authorities recognize that a sustained recovery will require maintaining sound economic policies, and have reiterated their commitment to the policies and objectives of the economic program supported by the current ESAF arrangement. Within this framework, the authorities are intensifying their efforts to help finance part of the additional reconstruction and social programs through expenditure and revenue measures. On the revenue side, the government would submit to the National Assembly a reform to the tax system raising excises on cigarettes, liquor, and soft drinks, and is continuing its efforts at improving tax administration. On the expenditure side, the government plans to pursue efforts aimed at shifting resources from lower priority areas to reconstruction work. Moreover, in the area of structural reform, the focus in 1999 will be on privatization, the strengthening of the financial system, the reform of social security, and the strengthening of governance in the areas of transparency of public sector accounts, property rights, and judicial sector reform.

Guatemala

Preliminary estimates point to a widening of the external current account by ½ of a percentage point of GDP (to 5½ percent of GDP) in 1998, and by 1 percentage point of GDP (to 6¼ percent) in 1999, reflecting a projected decline in agricultural exports and higher imports associated with the reconstruction effort. The higher current account deficits are expected to be covered with additional grants and concessional loans mainly from official sources. The staff expects that there will be an external financing gap amounting to US$75 million (0.4 percent of GDP) in 1999, but at this time, no financing gap is envisaged for 2000

While the effects of the hurricane and subsequent rain storms have been much less severe than in the other affected Central American countries, the damage to crops and infrastructure, particularly in some rural communities, has been significant. Overall, the hurricane is estimated to have dampened real GDP growth only slightly in 1998 (from 4 8 percent to 4.6 percent), and the projection for 1999 has been scaled down to 3.8 percent, from a previous estimate of 4 2 percent. The lower growth estimates reflect damage to agricultural crops (including bananas, coffee, cardamon, and melon), reduced shrimp production, and a decline in tourism. Partly offsetting these effects, activity in other sectors such as construction and transport is expected to grow faster in 1999 than previously projected. Inflation is not expected to be affected significantly, although some shortages of basic commodities may raise slightly the 12-month rate of price increase to 7–7½ percent by the end of 1998. Seasonal unemployment could increase slightly owing to losses in plantation crops, but this effect may be offset by a pickup in the demand for labor in the construction sector. Regarding the fiscal position, emergency relief and reconstruction costs are expected to raise central government expenditure by about ½ of a percentage point of GDP in 1998 and 1 percentage point in 1999. As revenue is not anticipated to be affected significantly, the overall deficit of the central government would widen to 1½ percent of GDP in 1998 and to about 3 percent in 1999.

The authorities are discussing with the World Bank, the IDB, CABEI, and bilateral donors the possible reallocation of resources available under existing project loans to help finance reconstruction efforts. Also, they are discussing with Fund staff a possible purchase under the Fund's emergency assistance policy, which could amount up to 25 percent of quota, or the equivalent of US$53 million. In addition, privatization proceeds may be used to help cover the needs for counterpart domestic financing of additional public investment projects.

The authorities remain committed to ensure that the progress being made in implementing the social and institutional programs of the peace accords will be sustained over the medium term within a framework of macroeconomic stability. To this end, the government is intensifying its efforts to mobilize domestic resources, and is working with business and labor groups and political parties toward a fiscal pact, as had been announced at the recent Consultative Group Meeting for Guatemala in Brussels in October 1998. The aim of the pact would be to achieve as wide a consensus as possible on actions to strengthen tax revenue over 1999–2002 with the objective of reaching the target level of 12 percent of GDP that has been established in the peace accords, while continuing to shift spending toward the social sectors.

El Salvador

Estimates by the staff are that the effect of hurricane Mitch on the balance of payments in El Salvador would be small in 1998, i.e., a deterioration in the current account deficit of about ¼ of a percentage point of GDP relative to the level of 1 1 percent of GDP envisaged in the program supported by the current Stand-By Arrangement, which covers the period September 1998–end-1999. While exports of coffee and nontraditional exports to other Central American countries are being affected adversely, and imports of foodstuffs would be higher than programmed, these factors would be partially offset by higher remittances from abroad and lower oil imports owing to the decline in world oil prices. In the capital account, large proceeds from privatization are expected to be offset partially by prepayments of public debt and larger than programmed outflows of private capital related in part to the recent turmoil in emerging markets As a result of the somewhat larger external current account deficit and the weaker capital account, net international reserves are expected to increase by US$290 million in 1998, compared with US$400 million envisaged in the program.

The external current account is projected to widen to 1 8 percent of GDP in 1999, compared with a decline to about 1 percent envisaged in the pre-hurricane projections. Coffee exports are projected to decline because of a slow recovery in export volumes associated with the impact of the hurricane and a decline in international coffee prices, while sugar export volumes are expected to be lower than in 1998 because of the flood damage to the plantations. At the same time, nontraditional exports are projected to grow at a slower pace than in recent years because of expected lower demand from the other affected countries in Central America, while imports would increase somewhat faster than envisaged originally, mainly because of higher imports of foodstuffs and cereals. The post-hurricane scenario incorporates a somewhat higher level of external grants already committed by official donors and an increase in remittances from Salvadorans living abroad. Most imports associated with the rehabilitation and reconstruction of damaged infrastructure are expected to be financed by the reallocation of existing project loans from multilateral institutions and bilateral creditors. Because of the relatively strong foreign reserve position, the wider external current account deficit in 1999 would be financed by keeping net international reserves unchanged at close to US$1,750 million, compared with a reserve accumulation of US$120 million that was envisaged in the Stand-By Arrangement.

Mainly because of the impact of the hurricane on the agricultural and manufacturing sectors, real GDP growth is now projected at 3½ percent in 1998, compared with 4 percent in the program. At the same time, consumer prices, which had risen by only 1.9 percent through October, are now expected to increase by about 4 percent during 1998 due to the one-time impact of the hurricane on food prices

The government's macroeconomic framework for 1999 is being revised in consultation with Fund staff to incorporate the effects of the hurricane, while policies will continue to aim at maintaining macroeconomic stability and the pace of structural reforms. Real GDP growth is now projected at 3½–4 percent in 1999, compared with 4½ percent envisaged previously. The revised program would aim at containing inflation to 4 percent in 1999. Fiscal policy would seek to accommodate within the pre-hurricane fiscal targets the costs associated with assistance to the most vulnerable groups affected by the hurricane, as well as those related to the repair of basic infrastructure, through a shift in expenditure priorities..

Table 1. Honduras: Preliminary Balance of Payments

	Pre-Hurricane		Post -Hurricane		
	1998	1999	1998	1999	2000
	(In millions of U.S. dollars)				
Current account (including transfers)	**-129**	**-139**	**-420**	**-445**	**-405**
Overall balance (negative sign indicates a deficit)	**50**	**-56**	**-265**	**-184**	**-220**
Gap after hurricane 1/			**253**	**364**	**300**
	(In percent of GDP)				
Current account (including transfers)	**-2.4**	**-2.6**	**-7.7**	**-8.4**	**-7.0**
Overall balance	**0.9**	**-1.0**	**-5.1**	**-3.5**	**-3.7**
Gap after hurricane			**5.9**	**7.0**	**5.1**
Memorandum items:					
External public debt					
(In millions of U.S. dollars)	3,629	3,518	3,700	...	...
(In percent of GDP)	68	66	80	...	...
Gross international reserves					
(In millions of U.S. dollars)	653	833	591	771	850
(In months of imports of goods and services)	3.0	3.6	2.6	3.2	3.6

Sources: Data provided by the Central Bank of Honduras; and Fund staff estimates.

1/ The financing gaps are calculated after taking into account proceeds from insurance claims (estimated at about US$290 million in 1999), and the expected rescheduling of maturities by Paris Club creditors. The gap before taking these items into consideration would amount to almost US$800 million (15 percent of GDP) in 1999. The gap for 1999 includes a provision for an increase in net international reserves of US$180 million.

Table 2. Nicaragua: Preliminary Balance of Payments

	Pre-Hurricane		Post -Hurricane		
	1998	1999	1998	1999	2000
	(In millions of U.S. dollars)				
Current account (including transfers)	**-610**	**-529**	**-661**	**-679**	**-723**
Overall balance	**-116**	**-15**	**-136**	**-146**	**-189**
Gap after hurricane			**50**	**150**	**155**
	(In percent of GDP)				
Current account (including transfers)	**-28.3**	**-24.0**	**-31.4**	**-30.6**	**-31.0**
Overall balance	**-5.5**	**-0.7**	**-6.5**	**-6.6**	**-8.1**
Gap after hurricane			**2.3**	**6.8**	**6.6**
Memorandum items:					
External public debt					
(In millions of U.S. dollars)	6,088	6,160	...	...	...
(In percent of GDP)	28.7	28.4	...	...	...
Gross international reserves					
(In millions of U.S. dollars)	366	561	338	547	673
(In months of imports)	1.2	3 0	0.8	2.6	3.6

Source: Fund staff estimates.

Table 3. Guatemala: Preliminary Balance of Payments

	Pre-Hurricane		Post-Hurricane		
	1998	1999	1998	1999	2000
(In millions of U.S. dollars)					
Current account	-920	-1,032	-1,023	-1,270	-1,290
Overall balance	385	300	320	225	150
Gap after hurricane			65	75	0
(In percent of GDP)					
Current account	-4.8	-5.1	-5.4	-6.2	-5.7
Overall balance	2.0	1.5	1.7	1.1	0.7
Gap after hurricane			0.3	0.4	0.0
Memorandum items:					
External public debt					
(In millions of U.S. dollars)	2,972	3,284	2,996	3,447	3,841
(In percent of GDP)	15.6	16.1	14.7	15.3	15.8
Gross international reserves					
(In millions of U.S. dollars)	1,509	1,745	1,445	1,720	1,870
(In months of imports)	3.6	3.9	3.5	3.7	3.6

Sources: Bank of Guatemala; and Fund staff estimates.

Table 4. El Salvador: Preliminary Balance of Payments

	Pre-Hurricane		Post -Hurricane		
	1998	1999	1998	1999	2000
	(In millions of U.S. dollars)				
Current account (including transfers)	-129	-120	-162	-232	-254
Overall balance	400	120	290	0	10
Gap after hurricane			0	0	0
	(In percent of GDP)				
Current account (including transfers)	-1.1	-0.9	-1.4	-1.8	-1.9
Overall balance	3.3	0.9	2.4	0.0	0.1
Gap after hurricane			0.0	0.0	0.0
Memorandum items:					
External public debt					
(In millions of U.S. dollars)	2,613	2,798	2,662	2,895	3,082
(In percent of GDP)	21.5	21.5	22.4	22.9	22.8
Gross international reserves					
(In millions of U.S dollars)	1,862	1,982	1,752	1,752	1,762
(In months of imports of goods and services)	6.9	7.0	6.6	6 2	5.7

Sources: Central Reserve Bank; and Fund staff estimates.