

Public Sector Practice

# Unlocking the economic potential of Central America and the Caribbean

The region has seen rapid growth over the past 15 years, but a number of trends could affect whether the economies continue to grow.

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Over the past 15 years,<sup>1</sup> the economies in Central America and the Caribbean (CAC) recorded an average annual GDP growth of around 4 percent, higher than the growth rates achieved by the Latin American average and most developed economies, but well below most other developing regions; regions such as South Asia and sub-Saharan Africa—and countries such as China or India—exhibited average annual growth of more than 5 percent during this period.

However, growth has not been sustained by all CAC countries. In fact, only three countries (Costa Rica, the Dominican Republic, and Panama) have

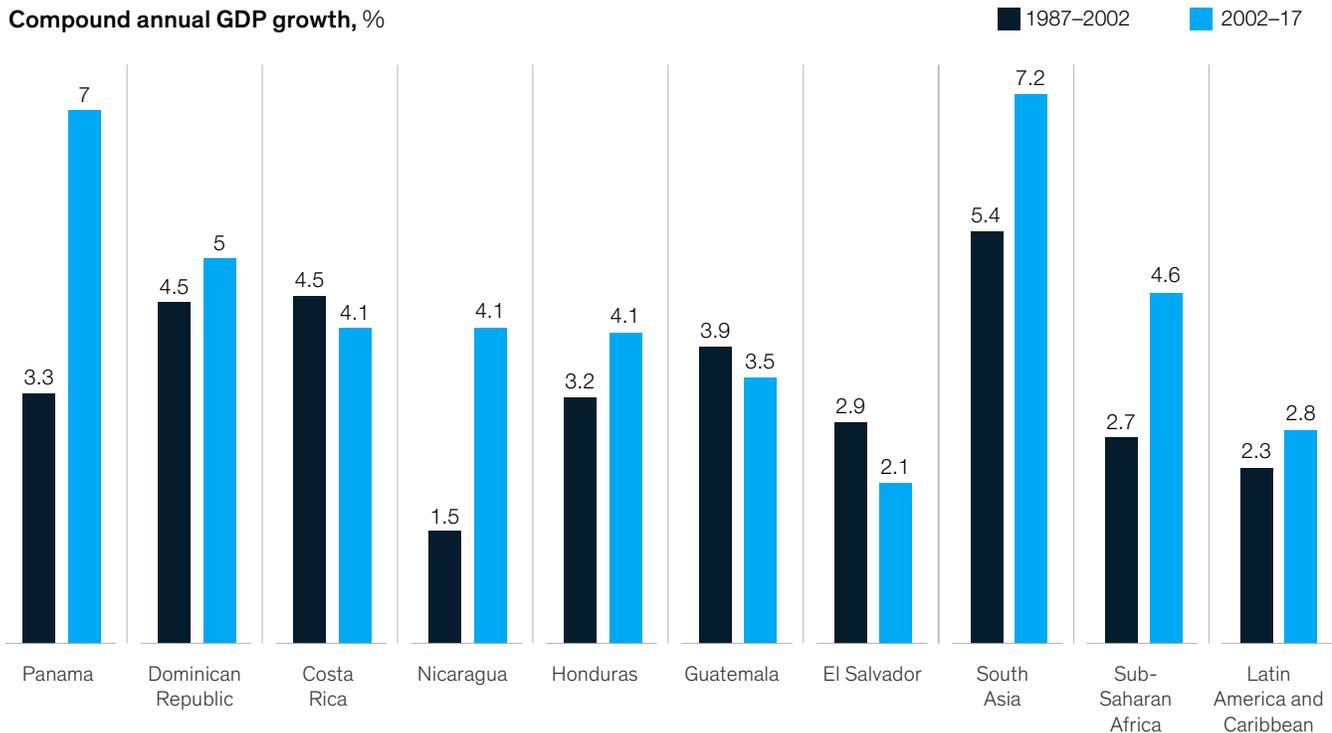
grown above the regional average over the last 30 years, and only the former two exhibited higher than average growth rates in both analyzed periods. Indeed, most nations have presented high volatility in economic growth since 1987 (Exhibit 1).

### Factors that drive the dynamism of Central America and the Caribbean

What has enabled the CAC region to have achieved faster growth than the rest of the Latin American countries? One of the distinctive factors has been rapid productivity growth: in the last 15 years, productivity has grown at more than 2 percent

Exhibit 1

## The Central American and Caribbean region has grown faster than Latin America but lags behind other developing economies.



Source: McKinsey analysis

<sup>1</sup> Comprised of the period between 2002 and 2017; does not include Aruba, Cayman Islands, Cuba, Curacao, Haiti, or Turks and Caicos due to the lack of data for some years.

per year, representing more than half (56 percent) of the growth of the region's GDP—substantially above the average for Latin America, but still lagging far behind global champions such as Asia's booming economies.

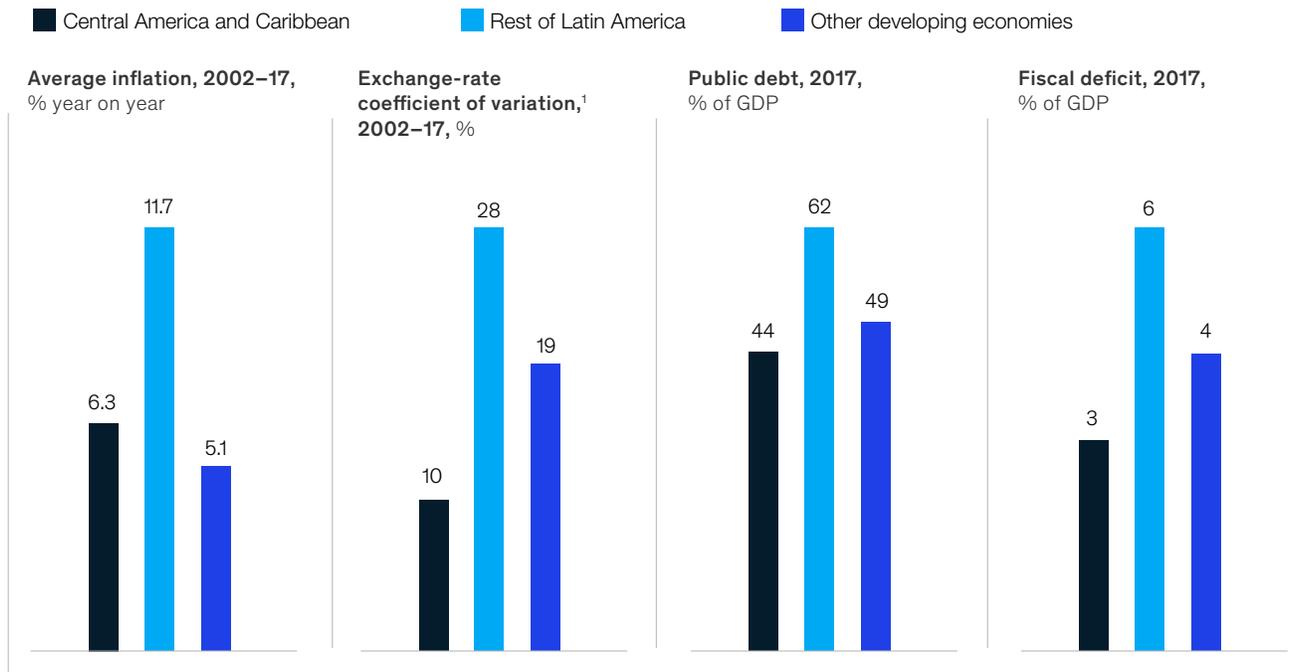
In addition, the relative macroeconomic stability of CAC countries reflects sound monetary and public-finance policies (Exhibit 2).

There's also a clear trend among CAC countries to develop an increasingly service-focused economy. The importance of the services sector in the region is widely recognized by

institutions such as the Development Bank of Latin America, Economic Commission for Latin America and the Caribbean, Inter-American Development Bank, and Organisation for Economic Cooperation and Development.<sup>2</sup> Although this approach has shown good results, most countries across the region have shown a premature drop in their levels of industrialization. The dynamics of industrial growth have recently changed due to the automation of processes, significantly reducing the labor intensity of typical manufacturing occupations—however, it remains an important lever of growth in several high-growth developing economies.

Exhibit 2

**The Central American and Caribbean region has mostly outperformed Latin America and other developing economies with respect to the macroeconomic environment.**



<sup>1</sup>Standard deviation divided by mean.

Source: International Monetary Fund; World Bank

<sup>2</sup> According to the Inter-American Development Bank, in its 2013 report *Innovation and the new service economy in Latin America and the Caribbean*, "The productivity of the services sector is increasingly important to promote growth and equity"; and, in their joint publication *Latin American Economic Outlook 2013: SMEs policies for structural change*, the Development Bank of Latin America, Economic Commission for Latin America and the Caribbean, and Organisation for Economic Cooperation and Development "advocate that the economies of Latin America diversify the exports of the services sector, which offers more opportunities in the medium and long term."

Growth in CAC has also been driven by high levels of investment and household consumption when compared with the rest of Latin America and the global average. Household consumption is partly explained by the high value of remittances received in a majority of CAC countries: except for Costa Rica, Panama, and Trinidad and Tobago, remittances represent on average 11 percent of GDP, compared with the global average of less than 1 percent. On the other hand, a high trade-balance deficit remains a main factor of lag, both regionally and in the fastest-growing countries.

### Four growth archetypes

We classified the CAC countries into four archetypes, according to their current income level and economic growth over the last 30 years: stars, emerging, falling behind, and laggards (Exhibit 3).

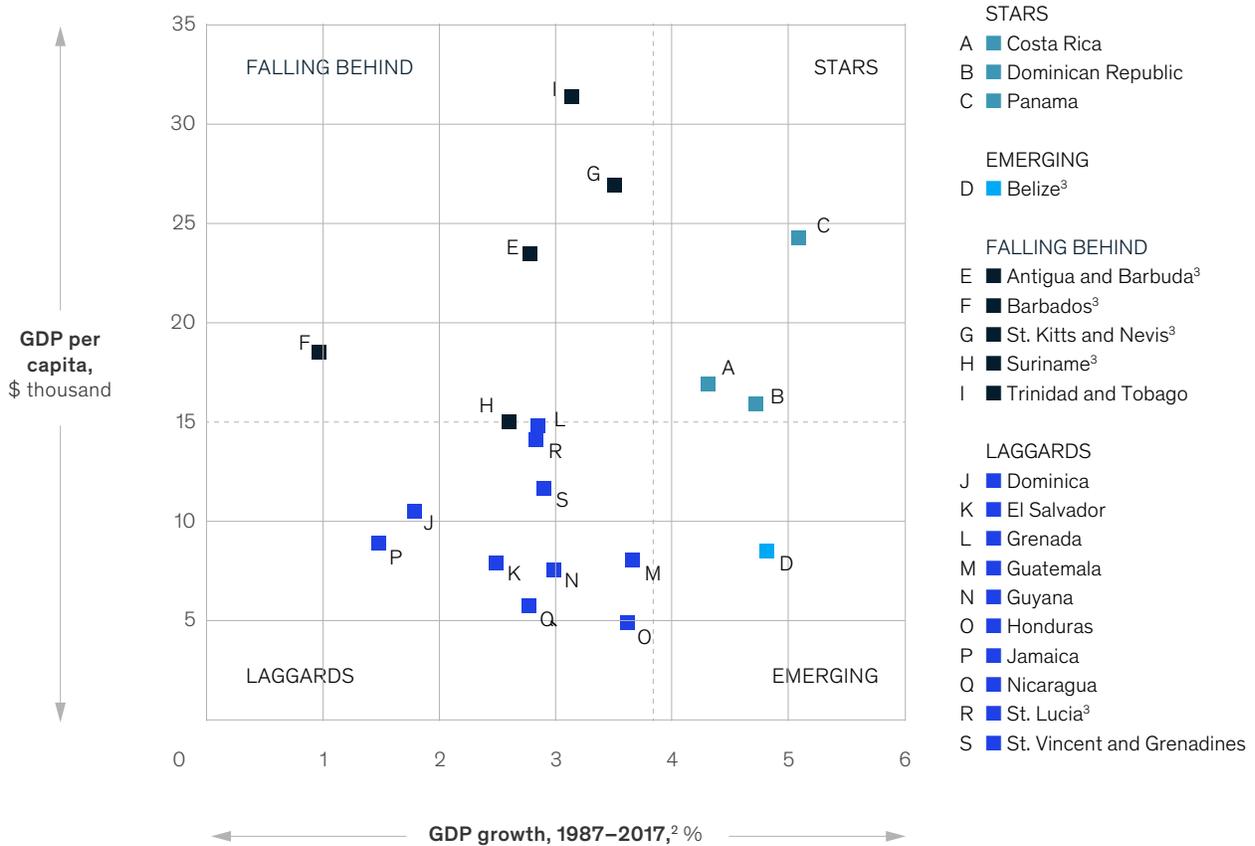
#### What have been the key success factors of the “star” countries?

Countries classified as “stars” have benefited from a rapid increase in productivity, high levels of investment, and a model of growth focused on service sectors:

Exhibit 3

## The Central American and Caribbean countries can be classified into four archetypes based on income level and growth over the past 30 years.

GDP per capita<sup>1</sup> compared with GDP growth<sup>2</sup>



<sup>1</sup>2017 purchasing-power parity.

<sup>2</sup>1987–2017 compound annual growth rate.

<sup>3</sup>Small Caribbean nations aggregated in archetype analysis under “other Caribbean” as a “laggard” group of countries as a result of average GDP growth and GDP per capita.

Source: World Bank

- Productivity represented more than 60 percent of GDP growth since 2002 (versus 18 percent in other CAC countries), growing at more than 3 percent per year.
- In 2017, investment represented 30 percent of GDP, registering an annual growth of more than 7 percent between 2002 and 2017.
- The average annual growth achieved by the service sector was more than 5 percent over the past 15 years, representing nearly two-thirds of the economy—allowing star countries to avoid the effects of falling commodity prices and overall volatility.

#### **The challenges of the “falling behind” and “laggard” archetypes**

The nations that fall within the “falling behind” and “laggard” archetypes face important challenges:

- Stagnant productivity growth: 0.5 percent average growth since 2002.
- High dependence on commodities: natural-resource rents in countries such as Guyana and Suriname represent 20 to 30 percent of GDP, and agriculture accounts for 10 to 15 percent

of GDP in countries like Guatemala, Honduras, and Nicaragua.

- Low levels of investment: 18 percent of GDP in 2017, down from 21 percent in 2002.

#### **Seven trends affecting the region**

As discussed, CAC has grown at a faster rate than the regional average, mainly driven by rapid productivity growth, a strong service sector, high levels of investment and household consumption, and macroeconomic stability.

However, this growth could be affected by global and regional changes. We have identified seven key trends that are changing the supply-and-demand dynamics: declining fertility rates, the digital revolution, sophistication of global demand, looming insecurity, rising public debt, rapid urbanization, and market diversification (see sidebar “Migration in Central America and the Caribbean”).

#### **Declining fertility rates**

Declining fertility rates could negatively affect the economy of the region, given its growth structure. According to the latest UN forecasts, CAC’s demographic pyramid will be flattened by 2050,

#### Sidebar

### **Migration in Central America and the Caribbean**

**An increase in migration flows** is a particularly important aspect in regard to Central America and the Caribbean (CAC), with more than 400,000 new immigrants since 2000. The flows have been inward and outward. Flows into CAC have been mostly from within the region, from South America, and from the United States to the three-star economies in CAC (which accounted

for 45 percent of all immigrants to CAC in 2017). For outward flows, in 2017, 92 percent of all emigrants from Nicaragua and the countries of the Northern Triangle had Costa Rica, Mexico, or the United States as a final destination.

The effects of migration will depend on governments across the region—

whether they can turn the challenge into an opportunity. It is important that recipient countries design effective integration policies, and that emitting countries develop strategies to mitigate the risk of talent drain and to create opportunities for a vulnerable population.

and it is therefore expected that the working-age population will see growth rates decrease to only about 1 percent per year by 2030. This will hinder the region's capacity to grow, given several economies' heavy dependence on the demographic dividend, and will require further efforts to boost productivity.

### **Digital revolution**

According to the McKinsey Global Institute's January 2017 report *Harnessing automation for a future that works*, the rising automation of work activities, despite having the potential to boost global productivity by 0.8 to 1.4 percent per year by 2065, also generates a latent risk of labor displacement. However, the benefits of new technologies for users and businesses would contribute to further economic growth and job creation, allowing society to promote inclusive growth policies. Apart from this, the digital revolution also presents a key opportunity to transform government productivity—from enabling data-driven decisions to the digitization of end-to-end processes and the reinvention of government interactions with citizens and businesses.

### **Sophistication of global demand**

Most of the region's economies have an export sector based on low-value-added products and services, while the larger and more dynamic sectors of CAC countries are being affected by a global shift in demand toward more sophisticated goods and services. Based on current export portfolios, most countries should strive to find opportunities for diversification, including an important transformation of the quality of education, which would enable building the human capital required to meet the needs of the new demand.

### **Concerns about safety**

Crime and feelings of being unsafe have reached epidemic levels in the region. Some countries, such as El Salvador and Honduras, experience homicide rates similar to that of war zones. Behind this is the development of organized crime, including “maras,” or gangs, as a main figure—a consequence of the geographical fatality of the region as a natural drug

corridor between producer countries and consumer markets. However, there is some good news for most CAC countries, where homicide rates have dropped dramatically since 2015 (for example, in El Salvador, rates have fallen by almost 50 percent, from 103 to 60 homicides per 100,000 inhabitants, and in Honduras, by about 30 percent, from 60 to 43).

### **Rising public debt**

The growing pressure on public spending and high levels of government debt are tightening the resources of governments around the world. With some exceptions, such as Costa Rica and Trinidad and Tobago, most countries in the region seem to have learned from the mistakes of the past and have increased their fiscal discipline—but the vulnerability of public debt remains a priority.

### **Rapid urbanization**

CAC will be the fifth most urbanized region in the world by 2030 (77 percent of the population will live in cities, similar to Europe), but the infrastructure hasn't accompanied this rapid process. According to the World Bank, rapid urbanization in the region has posed several challenges including “inadequate housing, vulnerability to natural disasters, and low economic growth in urban centers.” The swiftly changing urban landscape has also contributed to the development of organized crime. CAC has an opportunity to learn from more urbanized regions and plan for appropriate social and economic development of its main cities as urban migration continues to accelerate. Closing the infrastructure gap will be one of the key challenges.

### **Market diversification**

Although international trade has expanded to emerging (mostly Asian) markets in recent years, CAC economies are still highly dependent on trade with the United States, in addition to their export industries depending on a few commodities and low-value-added products. However, the region has about 40 percent of all the free-trade agreements signed in Latin America, making it a region with a high potential for commercial integration with global fast-growing markets.

## How to foster sustainable growth in Central America and the Caribbean

The seven trends present both challenges and opportunities for tackling development needs across CAC. We believe three key factors could present a path forward to promote inclusive and sustainable growth in the region: incorporating lessons learned from regional success stories, boosting competitiveness to capture the value at stake, and strengthening connectivity and cooperation between the public and private sectors in the region.

### Incorporating lessons learned from regional success stories

Most countries in the region have success stories in terms of sector development. Among them, six stories were studied in detail:

- Costa Rica as the main destination for foreign direct investment in business-support services in Latin America
- the fast-growing medical-device-manufacturing sector in Costa Rica that accounted for more than \$4 billion in exports in 2018, strongly driven by the country's long-standing investment in education and technical skills, distinctive investment-promotion capabilities, and attraction of anchor investors
- the booming tourism sector in the Dominican Republic, the second-largest tourist destination in Latin America, boosted by investor-driven infrastructure investments and attractive anchor products and incentives
- the logistics industry in Panama that accounts for 19 percent of the world total in dead-weight tonnage, capitalizing on the Panama Canal to develop a world-class, diversified, and strategic sector for the country
- apparel manufacturing in Honduras, the leading exporter of T-shirts to the United States, propelled by deep specialization and public-private coordination to create competitive clusters
- wire-harness manufacturing in Nicaragua, taking advantage of competitive labor costs and an attractive legal framework to boost exports by five times within five years (see sidebar "The recent crisis in Nicaragua" for information about political instability affecting the country)

To estimate the economic potential of incorporating regional lessons learned, we analyzed the level of exports per capita in each success story, the feasibility of developing similar sectors in each CAC country, and the potential impact of achieving best-

## Sidebar

### The recent crisis in Nicaragua

The recent political crisis in Nicaragua threatens to hinder the strong growth that the economy had been achieving in recent years (the latest forecasts from the International Monetary Fund point to

a 4 percent contraction in the Nicaraguan economy in 2018).

This forecast allows us to distill an important lesson for the region: apart from designing

and implementing strategies aimed at fulfilling the economic-growth potential of each country, political and social stability is a necessary condition to achieve sustainable development in the long term.

in-class regional levels. We estimate that learning from regional success stories could boost exports of goods and services (excluding commodities) across CAC by up to \$140 billion by 2030 (Exhibit 4).

Apart from strengthening its export portfolio, the region should focus on expanding its access to the main markets in Asia, as well as increasing its penetration to the European Union. It should be noted that no CAC country has free-trade agreements with Japan, and very few have signed a trade agreement with China or other main countries across the Asia–Pacific region—high-growth markets that would offer new opportunities for diversification and foster competition and innovation in the region.

**Boosting competitiveness to capture the value at stake**

To remain competitive, there are five key factors

that the region must strengthen to respond to global trends: human capital, infrastructure, access to credit, innovation and technology, and the government and business climate.

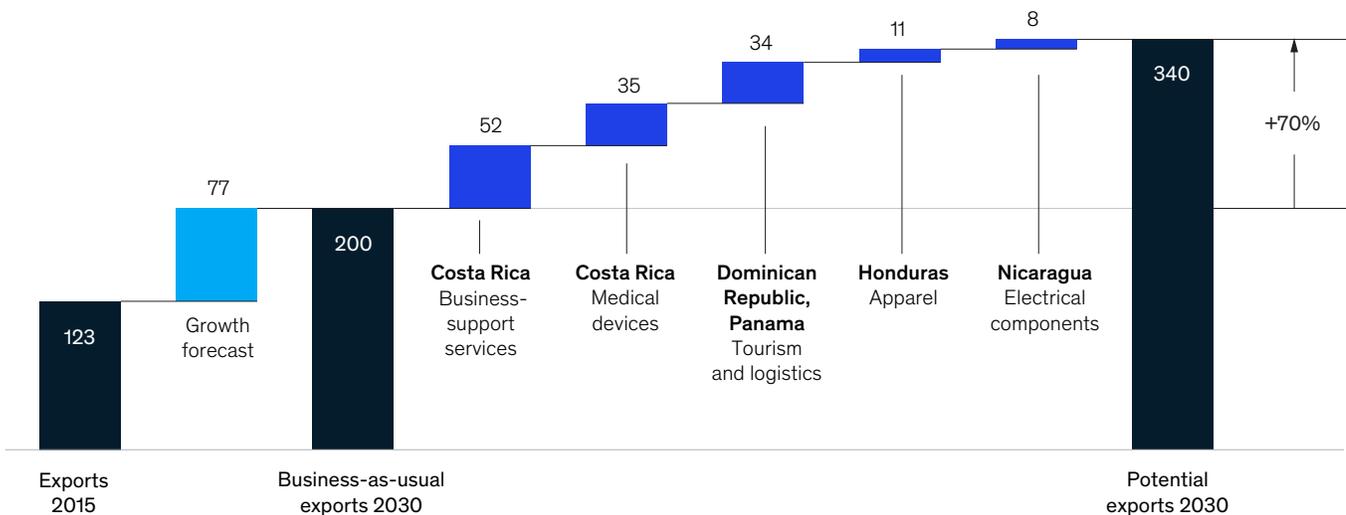
To understand how prepared the CAC is in each of the five dimensions, we conducted a diagnostic based on figures from the Global Innovation Index, World Bank, and World Economic Forum. A comparative analysis, relative to averages in Latin America and globally, shows a lag in all areas with respect to the global average, but with key gaps on two: human capital, and innovation and technology (Exhibit 5).

In order to boost **human capital**, the region should broaden the talent base and prepare for the jobs of the future by promoting science, technology, engineering, and mathematics (STEM) education; improving technical and vocational education systems, to become more agile and connected

Exhibit 4

**Learning from regional successes could boost the Central American and Caribbean region’s noncommodity exports by up to \$140 billion by 2030.**

Annual potential exports for Central American and Caribbean region,<sup>1</sup> 2030, \$ billion



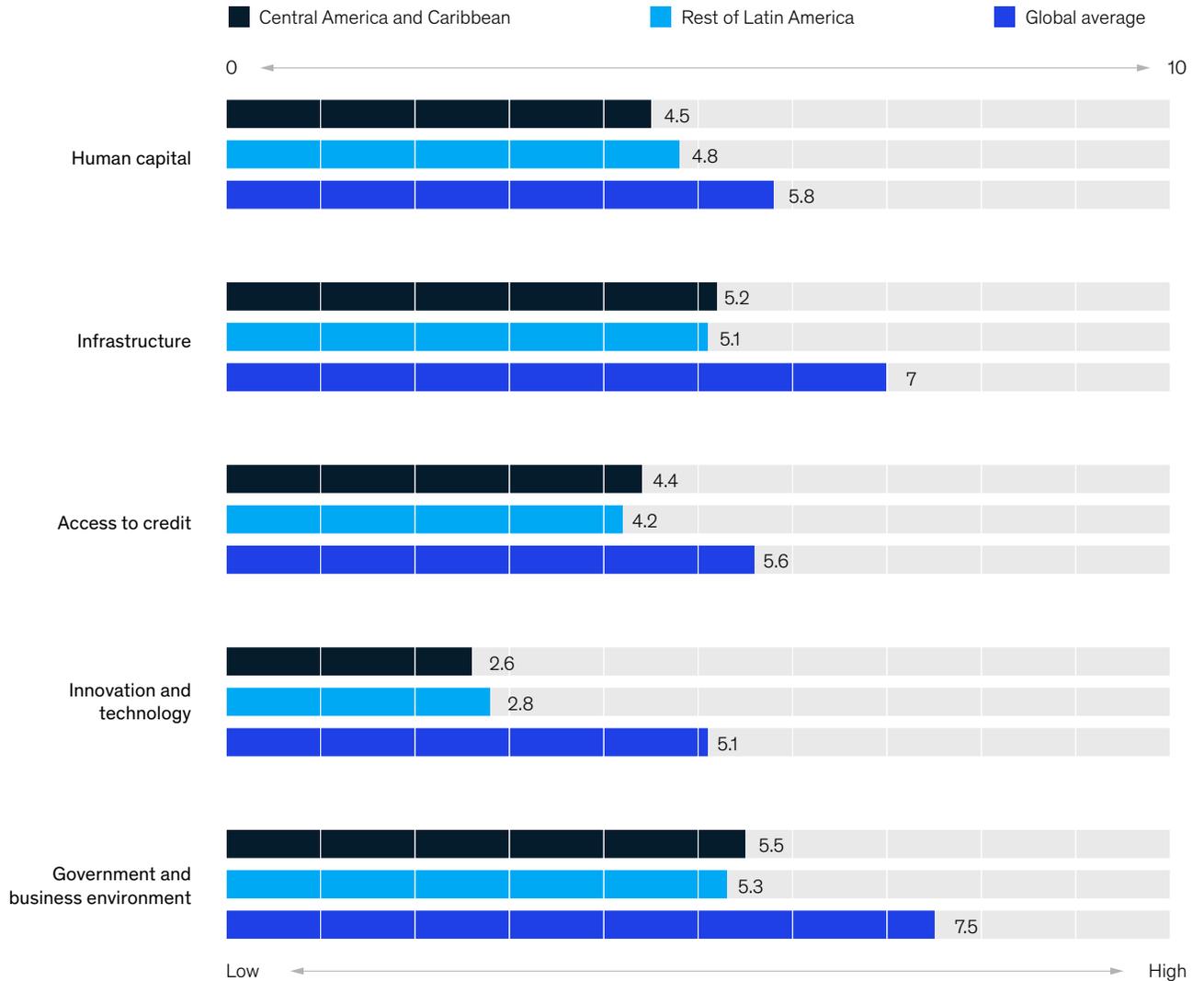
<sup>1</sup>Potential achieved if region matched exports per capita in each sector of case-study countries, adjusted by feasibility of developing sector in each country; commodities not taken into account.

Source: Expert interviews; IHS Global Insights; International Trade Centre Trade Map; World Bank

Exhibit 5

**The Central American and Caribbean region mostly lags behind others in important indicators, such as human capital and innovation and technology.**

Composite indicators by fundamentals area, index 1–10, 10 = highest or best



Source: Global Innovation Index; World Bank; World Economic Forum

to the current demands of the labor market, by following an education-to-employment programs lens; and addressing gender parity, particularly in STEM areas.

Regarding **infrastructure**, CAC could enable growth by strategically prioritizing and executing

key projects in transportation and trade-related infrastructure and in basic infrastructure, and by strengthening urban planning.

To improve **access to credit**, economies should facilitate investment by allowing capital to flow where it can be used most profitably, by

# The success of a new economic and social-development model requires both commitment from the public sector and the perspective of the private sector.

incorporating capital into the banking system and thus increasing average saving rates and extending financial services to firms, especially small and medium-size enterprises (SMEs).

**Innovation and technology** can be strengthened with the improvement of digital readiness, particularly by boosting digital infrastructure and regulations, digitizing government processes, and developing digital government strategies, as well as promoting innovation clusters and ecosystems and developing an innovation pipeline.

Regarding the **government and business climate**, efforts should focus on facilitating business development (particularly focused on SMEs) and modernizing public institutions—by tackling high informality levels; addressing security and corruption outbursts; eliminating unnecessary bureaucracy; pursuing fiscal, customs, and labor reforms; and modernizing and strengthening government capability building.

## **Strengthening connectivity and cooperation between the public and private sectors**

The success of a new economic and social-

development model requires both commitment from the public sector and the perspective of the private sector.

Regarding the public sector, the region should adjust the legal and regulatory framework to improve the business environment, link budgets with the development strategy, provide support, and focus on eliminating obstacles to implementation.

The private sector should bring its perspective to develop and deploy market-driven initiatives and investments, focus strategic priorities, and generate productive and sustainable jobs.

By promoting vocational education programs, and with public–private training that leverages the capacities of formal training, the region could address human capital and thus benefit from greater cooperation. Technical on-the-job training via the private sector would help to close the gap between supply and demand of talent.

Boosting intraregional connectivity—improving transportation infrastructure, enhancing trade facilitation, and strengthening commercial

agreements among different countries—and intergovernmental coordination would allow CAC to leverage its economic and demographic potential. In 2017, CAC countries<sup>3</sup> had a cumulative GDP of close to \$400 billion and comprised more than 65 million people, making the region the 19th largest economy in the world and 23rd most populated.

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CAC has an enormous potential to boost its growth in the medium and long term. This potential must be translated into a tangible impact for families and businesses across the region. This means ensuring that the growth model is inclusive: creating job opportunities that match labor-supply characteristics; formalizing large sectors, such as construction, trade, and agriculture; promoting SME growth and entrepreneurship; and fostering stronger linkages between multinationals and the local value chain. These are among the key initiatives required to ensure that economic growth trickles down to the entire population.

Governments should design and effectively implement public policies and regulations that enhance competitiveness and capture trade synergies between countries, ensuring that the potential translates into inclusive growth for the entire population of the region. They can also

coordinate key stakeholders to align demand and supply in labor markets.

Companies should promote greater collaboration within the region to strengthen local value chains, work with governments to define national and regional economic-development strategies, and, in general, adopt a longer-term vision of policies and growth initiatives. Business leaders can also act as spokespersons for the private sector, expressing their concerns and interests in conversations with external stakeholders.

Individuals also have responsibilities. Citizens must actively participate in development efforts and demand accountability. Students need to be informed about the needs and changes of the labor market, to pursue training in areas that can lead to employment. Workers must be proactive in acquiring new skills to stay relevant in the digital revolution.

We do not underestimate the scope of the changes needed to fulfill this potential. CAC economies have a difficult task ahead that can only be achieved through leadership and cooperation among all stakeholders. Shaping a new inclusive and sustainable growth agenda that leverages and strengthens ties can enable the rise of the region in upcoming years.

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<sup>3</sup> Not including Aruba, Cayman Islands, Cuba, Curacao, Haiti, or Turks and Caicos.

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