
RATING PERSPECTIVE

Central American Bank for Economic Integration (CABEI)

Rating rationale and politico-economic risks in Central America

Introduction

The Central American Bank for Economic Integration (CABEI, long-term senior debts: A+/Stable) is a multilateral development bank (MDB) established in 1960 for the purpose of assisting economic and social development in five Central American countries (El Salvador, Honduras, Guatemala, Costa Rica, Nicaragua). As one of the few providers of long-term funds in the region, CABEI provided 47% of the total loans made available to the region by MDBs in the last five years. The amount offered by CABEI was larger than those of the International Bank for Reconstruction and Development (IBRD) and the Inter-American Development Bank (IDB). JCR upgraded its rating on CABEI from A to A+ in May 2007. The upgrading was mainly based on JCR's view that CABEI's creditworthiness has been significantly improved by the incorporation of Panama and the Dominican Republic as Non-Founding Beneficiary Members (NFBM), that the quality of its loan portfolio has been enhanced by the favorable economic indicators in the member countries and the debt forgiveness given to heavily indebted poor countries by IDB and that its organizational function has been strengthened. On the other hand, the rating was constrained mainly by the political and economic risks inherent in the regional countries and the high percentage of outstanding loans to the private sector in comparison to those of other MDBs. The outlook was kept stable. This was based on JCR's view that the political and economic situation in the member countries will stay stable in the medium term and that CABEI's fiscal structure will improve further.

This report reviews the rationale behind the rating and analyzes the political and economic situations in the Central American countries, which are CABEI's major shareholders as well as main borrowers.

1. Rationale behind CABEI rating

1.1 An overview of CABEI

The Central American region has a longer history of efforts for regional integration than other regions. In the 19th century, El Salvador, Honduras, Guatemala, Costa Rica and Nicaragua constituted a single nation, called the Federal Republic of Central America. In the 1960s, these five countries joined hands to establish the Central American Common Market (Mercado Comun Centroamericano: MCCA) for the purpose of promoting regional economic integration. CABEI was founded in 1960 as an MDB for fund procurement in the region upon establishment of MCCA.

CABEI's founding member countries were El Salvador, Guatemala, Honduras and Nicaragua. Costa Rica became a member in 1963, bringing the number of its regional member

countries to five. The first amendment of its charter in 1989 opened the way for capital subscription by extra-regional countries. Seven countries (Mexico, the Republic of China or Taiwan, Argentina, Colombia, Spain, the Dominican Republic and Panama) were extra-regional members as of the end of 2006. The second charter amendment in 1998 allowed CABEI to accept Non-Founding Beneficiary Members (non-regional countries eligible for CABEI loans). By the end of 2006, Argentina, Colombia, the Dominican Republic and Panama had dual status as NFBM and extra-regional members. Belize held only NFBM status.

CABEI has its headquarters in Tegucigalpa, the capital of Honduras, with its representative offices located in the four other regional countries. Based on the provisions of its charter, CABEI enjoys several privileges including exemption from debt moratoria and restrictions on asset transfers. CABEI is dedicated to the purpose of promoting an economic integration and balanced economic and social development of its member countries. It also plays the role of promoting provision of external development funds to the regional economies in cooperation with other multilateral and bilateral aid organizations. From the viewpoint of economic integration, CABEI has been making a great contribution to economic and social development in the Central American region by increasing the number of beneficiary countries and by supporting regional development projects under the Puebla-Panama Plan (PPP).

1.2 Capital structure

As of the end of 2006, CABEI's authorized capital stood at US\$2.0 billion (44.1% of total assets), of which US\$1.723 billion (38.0% of total assets) was subscribed. The latter comprised US\$404 million in paid-in capital (8.9% of total assets) and US\$1.319 billion (29.0% of total assets) in callable capital. The five regional member countries together held 71.5% of its shares on a paid-in capital basis. CABEI's capital structure has been strengthened by the presence of relatively high creditworthy countries, such as the Kingdom of Spain, the Republic of China (Taiwan) and Mexico among its extra-regional members. The paid-in capital has been on the constant increase since its foundation. This proves the strong commitments by both its regional and non-regional members. It also indicates that CABEI's presence as a reliable community-based fund provider is all-important and indispensable for the development of the Central American member countries. Requirements for CABEI loans have been gradually spreading among non-regional Central and South American countries. Its capital structure has further strengthened as Panama and the Dominican Republic made their

RATING PERSPECTIVE

first special contributions as NFBMs in 2006. Argentina, Colombia and Belize have been paying their special contributions as NFBMs since 2005.

CABEI's capital adequacy ratio on a BIS basis was quite high at 41.2% as of the end of 2006, which is substantially higher than its strict internal norm of 35%. This norm itself is higher than those of other MDBs.

1.3 Asset quality

CABEI's total assets stood at US\$ 4.54 billion at the end of 2006, up 19.9% over the year before. Its outstanding balance of loans stood at US\$3.68 billion, up 15.7%, which was equivalent to 81% of its total assets. CABEI is the leading MDB in the Central American region, providing 47% of the loan disbursements made by MDBs in the region from 2000 through 2004.

CABEI's credit exposure had concentrated on the five regional member countries until 2006. From 2007, CABEI's country-to-country loan portfolio is likely to diversify since it has started extending loans to beneficiary countries. The Bank's loan exposure to the private-sector borrowers (financial institutions and businesses without sovereign guarantee) has increased to 44% of the total loan balance, which is higher than those of other MDBs. The Bank is poised to meet such increasing loan demand from the private sector but intends to avoid excessively expanding its exposure to the private sector. In fact, it is planning to reduce its exposure to the private sector from 44% to 36% by utilizing more syndicated loans.

Despite the higher sovereign risks of its member countries, CABEI's asset quality has been kept at extremely good levels. The non-accrual loan ratio (1) has been kept quite low, less than 1% since 2003. Especially, CABEI has never written off any of its public-sector loans, a sure indication of the strength of its preferred creditor status. Private-sector loans in non-accrual status accounted for a low 1.3% of the total private-sector loans and the ratio of such loans to the total loan portfolio was quite low at 0.6% at the end of 2006. The loan-loss provision ratio to the total loan outstanding stood at satisfactory 3.6%.

The Bank's credit risks generally improved in 2006. The ratio of credit exposures classified as satisfactory increased from 88% to 94% of the total private-sector credit exposures, according to its internal credit risk classification. Sovereign risks also significantly improved amid the favorable economic growth in the region in 2006. Nicaragua and Honduras reached the completion point of enhanced HIPC initiative (2) in 2004 and 2005, respectively, and were granted debt service relief by all creditors including CABEI. The debt reduction by CABEI was primarily through debt rescheduling, exemption of interests accrued before 1997 and withdrawal from the World Bank HIPC Trust Fund, which was established with contributions from the advanced economies. In addition, IDB decided in March 2007 to exempt an additional US\$1.4 billion of debt owned by Honduras and

US\$984 million of debt owned by Nicaragua. These debt reductions have contributed a great deal to the improvement of CABEI's asset quality. Since CABEI is not allowed under provisions of its charter to extend new loans to HIPC countries from its ordinary financial resources, it provides concessional loans to Honduras and Nicaragua through a special social development fund named FETS (Fondo Especial para la Transformacion Social de Centroamerica), whose account is strictly separated from its ordinary financial resources.

Credit risks of other countries are also improving, which will be reviewed in detail in Chapter 2 dealing with political and economic risks in the Central American region.

1.4 Quality of liability

A breakdown of CABEI's liabilities indicates that 50% of the total liabilities had been borrowings until 2004. Means of fund procurement have been diversified rapidly since 2005. In 2006, borrowings and issued bonds each accounted for 30% of the total liabilities. About one half of the borrowings came from public financial institutions of highly creditworthy countries such as United States, Japan and some of the EU countries, which makes CABEI's debt structure more stable. Moreover, the maintenance of good relationship with such non-regional governmental financial institutions means that CABEI can hope for their continued support when the Central American region should face economic difficulties. In keeping with its improved creditworthiness, CABEI has been stepping up its fund procurement in the financial capital market in recent years. In 2006, it issued bonds denominated in six different currencies — the US dollar, Hong Kong dollar, New Taiwan dollar, Japanese yen and Colombian peso. The outstanding balance of preferred liabilities as of the end of 2006 grew 61.3% from the year before. Such diversification by area and currency has resulted in rapidly reducing the Bank's fund procurement cost, which is significantly contributing to improving its operational efficiency.

1.5 Financial regulations and profitability

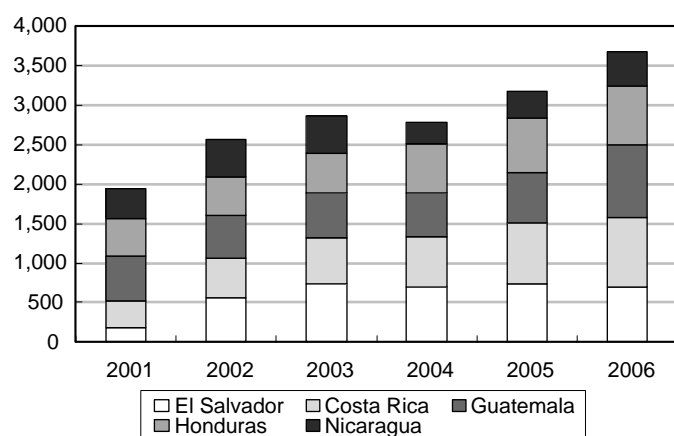
CABEI operates in a conservative way in keeping with its strict internal guidelines. Its leverage ratio (1.8), gearing ratio (2.2) and interest coverage ratio (1.45) were adequately satisfactory in 2006. Liquid assets were kept at a level more than enough to meet six months of obligations. Like other MDBs, CABEI is not a profit-oriented institution. However, thanks to the above-mentioned strong support from the member countries and prudent financial operations, it has been registering a stable profit each year. Latest figures put its ROA at 1.6% and ROE at 4.9%. Its asset liability management is basically sound with risks related to interest rate, foreign exchange rates and maturity periods properly hedged. In recent years, CABEI has been strengthening its own organizational functions with emphasis on the risk management unit and begun introducing several internal control programs.

Chart 1. Comparison of main fiscal indicators with other Multilateral Financial Institutions (2006)

	Corporación Andina de Fomento (CAF)	Central American Bank for Economic Integration (CABEI)	International Bank for Reconstruction and Development (IBRD)	Inter-American Development Bank (IDB)
Rating	AA-	A	AAA	AAA
Paid-in capital/Total assets	41.0%	37.0%	17.2%	29.8%
Loan outstanding/Paid-in Capital	1.9	2.0	2.7	2.6
Financial debt/Paid-in Capital	1.5	1.3	2.6	2.5
Non performing ratio	0.0%	0.6%	1.0%	0.1%
Provisions for loan losses/Loan receivable	2.3%	3.8%	2.2%	0.2%
Interest coverage ratio	1.9	1.5	0.4	1.1
Administration cost/Total asset	0.5%	0.8%	1.0%	0.9%
ROA	3.2%	1.7%	1.34%*	0.4%
ROE	9.3%	4.9%	5.05%*	1.3%

Sources: CABEI, CAF = Financial results (at the end of Dec. 2006), IBR, IDB = Financial results (at the end of June 2006)

* ROA and ROE of IBRD are calculated by net income before adjusting net unrealized gains (losses) on non-trading derivative instruments.

Chart 2. Loan approvals by country (US\$ mn)


Source: CABEI Financial Statements 2006

2. Political and economic risks in Central American Region

2.1 An Overview of the Central American Region

The Central American region refers to an isthmus linking the North and South American continents. It consists of seven countries: El Salvador, Honduras, Guatemala, Costa Rica, Nicaragua, Panama and Belize. These seven countries and the Dominican Republic have a combined population of 54 million (10% of the total population of the Latin American and Caribbean countries: LAC). Its total land area is 620,000 square kilometers (3% of LAC's). Its nominal GDP is US\$38.7 billion (5.0% of LAC's). Per capita GDP (in PPP terms) is US\$5,164 (as compared with the LAC average of US\$7,142).

Thus, the region is one of important economic blocs in the entire LAC. The region has geographical advantages: (1) it is close to the United States, (2) it serves as a relay point between North and South Americas and (3) it has access to both the Atlantic and Pacific oceans. On the other hand, the region is often hit by massive natural disasters such as hurricanes and earthquakes that bring heavy economic damage. The region is strongly united because of its historical background. It has been seeking economic and social integration at the initiative of the System of Central American Integration (Sistema de la Integración Centroamericana: SICA). In 2001, the region and Mexico forged a system of mutual economic and social cooperation by launching a diversified development scheme dubbed the Puebla Panama Plan (PPP), which calls for the development of infrastructure and human resources.

This chapter reviews political and economic risks of CABEI's seven regional and non-regional member countries in Central America: Honduras, El Salvador, Guatemala, Costa Rica, Nicaragua, Panama and the Dominican Republic (hereinafter referred to as the region).

2.2 Macroeconomic and political situations

The region registered an average economic growth rate of 7.3% in real GDP terms in 2006, substantially higher than the LAC average. It is noteworthy that the region's annual GDP growth rate outpaced the LAC average in the last decade except in 2004 (Chart 3). In particular, the region's growth rate has been accelerating since 2003. The main factors behind this are the higher expansion of fixed capital investment and goods and services exports in the 2003-2006 period

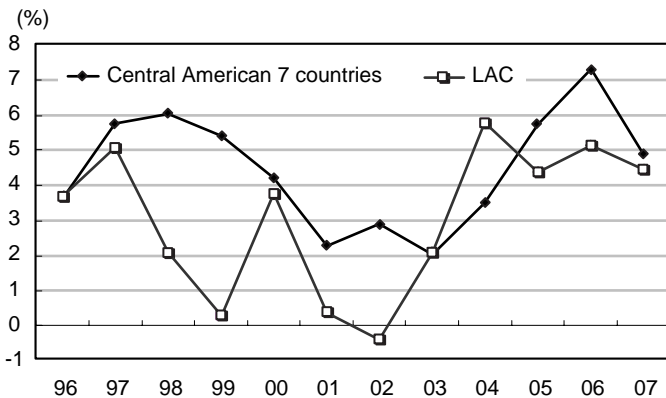
RATING PERSPECTIVE

than in the 1999-2002 period. Instead, public expenditures and imports slowed down over the same period (Chart 4). The annual inflation rate in the region has been staying lower than 10% since 1997 except in the Dominican Republic and Costa Rica (Chart 5). As for the balance of payments, while other LAC countries saw improvement of the terms of trade amid higher commodity prices, the region suffered a moderate deterioration of the terms of trade (Chart 6). In this situation, the region managed to reduce the current account deficit by counterbalancing the trade deficit with the transfer account surplus centering on remittances from migrant workers and the services account surplus primarily from tourism (Chart 7). The region's transfer account surplus brought by remittances has been constantly increasing year after year with the sole exception of Costa Rica. The region's reliance on the US economy is not as high as Mexico's (Chart 8). However, the share of exports to the United States to its total exports is increasing every year and most of the migrant workers from the region find jobs in the United States. The region's integration with the US economy will further accel-

erate with the effectuation of DR-CAFTA (free trade agreement between the United States and the region except Panama). The higher unemployment rate, sluggish growth of inward foreign direct investment except Costa Rica and lower competitive edge are some of the challenges facing the region. The region's economic growth may somewhat slow down after 2007 but is likely to stay higher than the LAC average as the US economy looks headed for a soft landing.

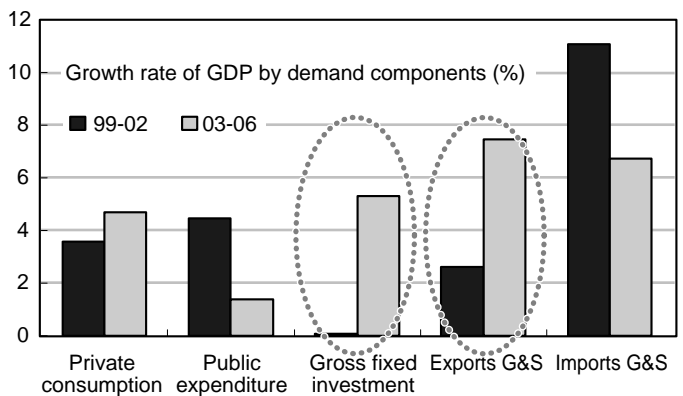
All the current administrations in the region, except Nicaragua's Ortega administration inaugurated in 2006, are right-wing and pursue a pro-American, free trade policy line. While the Ortega administration is left-wing, it is also committed to the free trade principle and gives priority to cooperation with the other Central American countries. The political situation in the region is likely to continue stable in the foreseeable future. Meanwhile, due to the income disparity and higher unemployment rate in the region, crimes involving guns are on the increase in urban areas. The deteriorating public safety could have negative impacts on the regional economy.

Chart 3. Real GDP growth rate



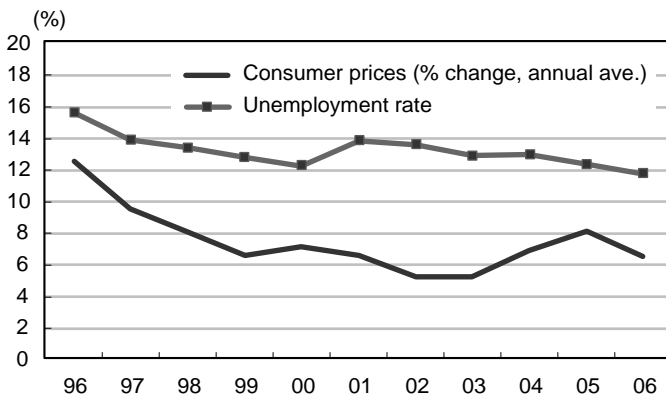
Source: EIU

Chart 4. Exports and gross fixed investment grow rapidly



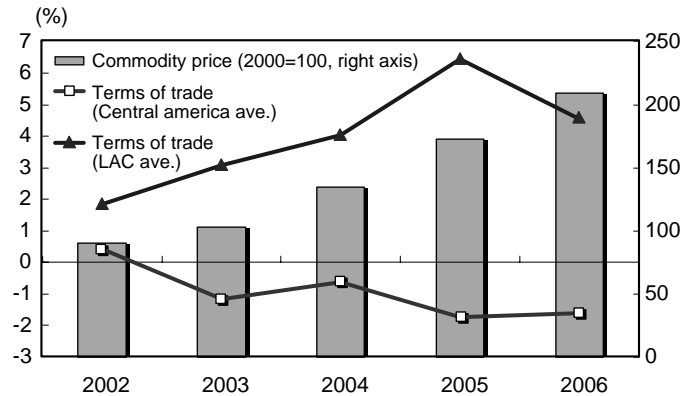
Source: EIU

Chart 5. Inflation rate and unemployment rate



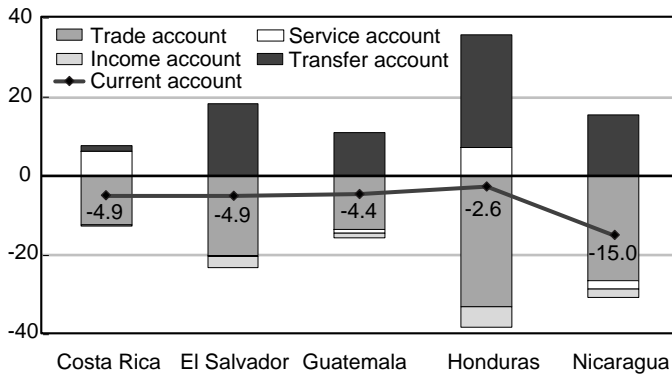
Source: EIU

Chart 6. Terms of trade has gradually worsened



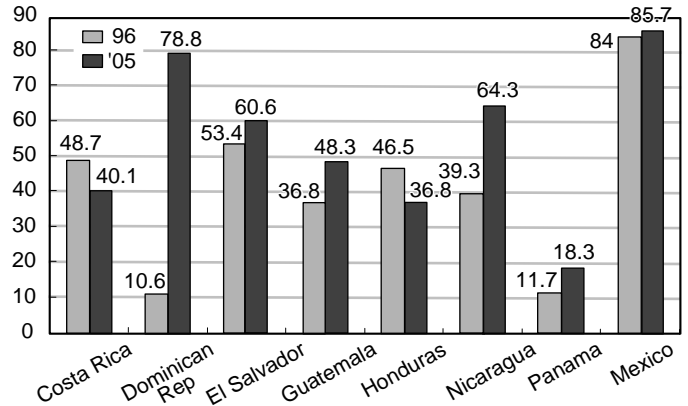
Source: EIU

Chart 7. Current Account by country (% of GDP)



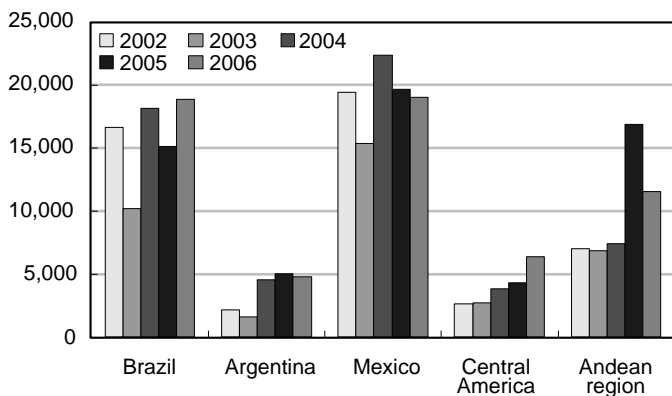
Source: EIU

Chart 8. Exports to US/Total exports (%)



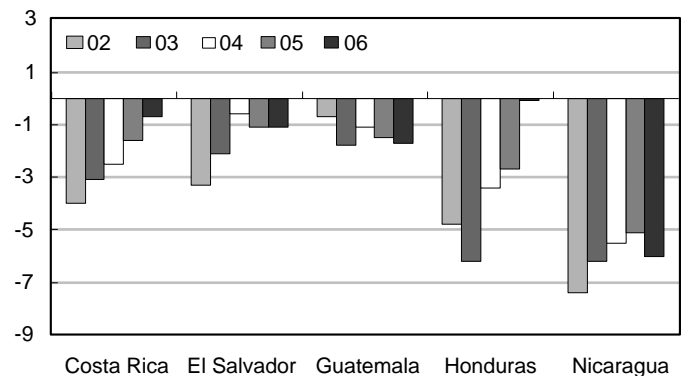
Source: EIU

Chart 9. Inward foreign direct investment (US\$ mn)



Source: ECLAC foreign investment 2006

Chart 10. Fiscal balance/GDP (%)



Source: CABEL

2.3 Fiscal balance and Public debt

Both annual budget expenditures and revenues in the regional countries are just less than 20% of GDP. In the recent past, tax revenues have been low at around 10% of GDP and the fiscal deficit high at an average 4% of GDP. Each country is trying to reduce the fiscal deficit by expanding revenues. Honduras and Nicaragua have made significant improvement on their fiscal position by implementing tax reforms in accordance with the Poverty Reduction Strategy Paper (PRSP). Both countries have reduced the fiscal deficit to about 2% of GDP. Other regional countries have been keeping their annual fiscal deficit below 3% of GDP. Except Honduras and Nicaragua which have been designated as HIPCs, all regional countries have been managing to keep their gross public debt below 50% of GDP. Honduras and Nicaragua have pushed ahead with vigorous economic and fiscal reforms, reaching the completion point of the enhanced HIPC Initiative in 2004 and 2005, respectively, and were granted debt service relief by all creditors including CABEL. The ratio of the external debt to the public debt is still higher than 50% in Guatemala, Nicaragua and El Salvador.

El Salvador's gross public debt is relatively small in size, but attention needs to be paid to its higher public debt/exports ratio and debt service ratio.

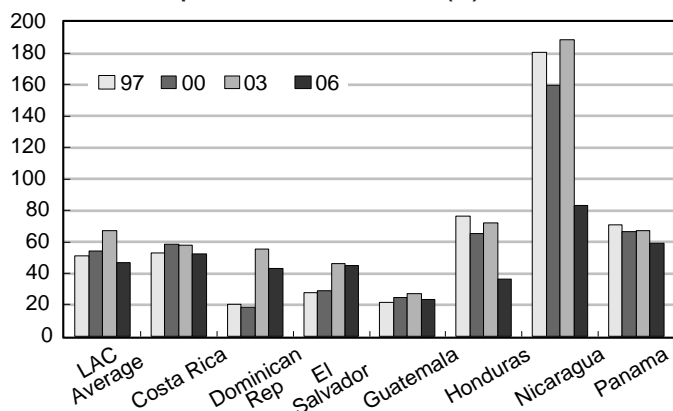
2.4 Monetary Policy

Dollarization has been in progress in the region except Guatemala. Especially, Panama and El Salvador chose to use the US dollar as their national currency in 1904 and 2001, respectively. Although Costa Rica, Honduras and Nicaragua maintain a crawling peg system, dollarization has been making headway in their financial system. When the region experienced hyperinflation in the 1980s, confidence in the local currencies took a plunge, which in turn has accelerated the process of dollarization. Dollarization has contributed to stabilizing the inflation along with the structural reforms carried out in the 1990s. On the other hand, it should be noted that the effectiveness of monetary policy is limited in the economy like Costa Rica, where dollarization has been facilitated while the exchange rate system based on a crawling peg is maintained.



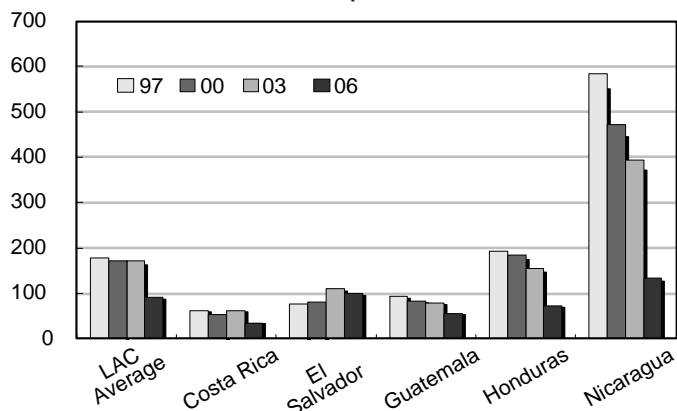
RATING PERSPECTIVE

Chart 11. Gross public external debt/GDP (%)



Source: Ministry of Finance

Chart 12. Gross external debt/Exports of G&S



Sources: EIU, CABI

Chart 13. Public debt profile

	Public debt/GDP (%)		
	05	06	07e
Guatemala	18.5	18.8	19.6
El Salvador	44.6	45.4	44.2
Honduras	56.2	36.9	20.9
Nicaragua	148.5	116.4	89.1
Costa Rica	55.4	51	46.2

	Public external debt/GDP (%)		
	05	06	07e
Guatemala	11.7	11.2	10.9
El Salvador	29.3	30.7	29
Honduras	52.3	32.4	15.8
Nicaragua	115.2	87.5	64.5
Costa Rica	18.9	16.5	15

Sources: CABI, EIU

	Public external debt/Exports (G&S) (%)		
	05	06	07e
Guatemala	69.2	62.7	59.9
El Salvador	147.1	162.1	150.9
Honduras	254.2	156.1	75.4
Nicaragua	623.3	443.6	330
Costa Rica	51.7	44.7	40.1

	Debt to service ratio (%)		
	05	06	07e
Guatemala	6.8	8.9	9.1
El Salvador	22.1	22.9	19.2
Honduras	11.6	6.6	5.7
Nicaragua	10.4	8.7	8
Costa Rica	3.4	3	2.6

Chart 14. Exchange rate system

	Dollarization	Crawling Peg	Floating
Guatemala		Yes	
El Salvador	Yes		
Guatemala			Yes
Honduras		Yes	
Nicaragua		Yes	
Panama	Yes		

Chart 15. Main fiscal indicators for Central American Bank for Economic Integration (US\$ mn)

	2002	2003	2004	2005	2006	
Total assets	3,244	3,568	3,459	3,783	4,538	
Total lending	2,560	2,868	2,789	3,179	3,678	
Provisions for loan losses	(187)	(110)	(110)	(122)	(133)	
Net lending	2,373	2,758	2,680	3,057	3,545	
Authorized capital	2,000	2,000	2,000	2,000	2,000	
Subscribed capital	1,408	1,408	1,608	1,608	1,723	
Callable capital	1,036	1,036	1,236	1,224	1,319	
Paid-in capital	372	372	372	384	404	
Comprehensive income	16	14	15	13	11	
Reserves	736	800	936	993	1,049	
Special contribution	0	0	0	1	2	
Net income	64	137	56	57	73	
(Statutory Ratio)						
Shareholder equity/Total assets	%	27.1	27.0	29.1	33.8	33.9
BIS capital ratio	%		47.5	49.2	44.9	41.2
Gearing ratio (*1)	times	1.9	2.0	1.9	2.1	2.2
Leverage ratio (*2)	times	1.4	1.5	1.4	1.5	1.8
ROE	%	5.4	10.3	4.1	4.0	4.9

*1 Total amount of Loans, guarantee and securities investment/Shareholders' equity (less than 3)

*2 Financial debt outstanding/Shareholders' equity (less than 3.5)