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Economic Opportunity in the Northern Triangle

U.S. Government Support for Private Sector-Led Development

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Background and Introduction

The Northern Triangle countries of Guatemala, Honduras, and El Salvador face numerous political and economic issues that contribute to the overall instability of the region. Existing issues of weak governance, lack of security, and unequal economic growth have been exacerbated by the Covid-19 pandemic and by two hurricanes that struck the region in November 2020. Given the high levels of poverty, violence, and instability in the area, the humanitarian crisis in the Northern Triangle has only increased in intensity over the last year. In a [survey](#) conducted by the World Food Programme in January 2021, nearly 15 percent of those surveyed indicated they were making concrete plans to migrate from their home country, up from 8 percent in 2018. Recent apprehensions at the U.S. [border](#) support these figures, with over 900,000 migrants being apprehended to date in 2021.

Economically, the Northern Triangle is one of the poorest regions in the Western Hemisphere. All three of the countries [rank](#) in the bottom 6 of the 32 countries in Latin America and the Caribbean by [GNP per capita](#). In 2020, Guatemala had a GNP per capita of \$4,603, El Salvador of \$3,799, and Honduras of \$2,406, with the Northern Triangle GNP per capita average being about \$3,603. Climate change and the Covid-19 pandemic have caused all three countries to recently experience steep economic declines, further compounding existing challenges. By 2050, the average temperature of Central America is [expected to increase](#) by one to two degrees, which will exacerbate the negative impact of climate on the weather patterns, rainfall, and soil quality that farmers and local economies depend upon. Broad economic disparities exist within these countries, and all have underdeveloped regions—such as Guatemala’s Western Highlands—where the standard of living is far lower than elsewhere in the country. The average

formal unemployment rate for these three countries witnessed a significant increase between 2019 and 2020, from 4 percent to 7 percent, in part due to the pandemic. However, the high rate of **informal employment** in the Northern Triangle—77 percent on average—is the more notable factor contributing to the push for migration.

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Another important characteristic of Northern Triangle countries is the significant portion of the population made up by youth between the ages of 15 and 29. Young people comprise the largest part of the **population** in these countries: 30 percent in Guatemala and Honduras and 28 percent in El Salvador. However, this is also the group that is least able to find educational, employment, or training opportunities, with nearly 28 percent of the **youth population** unable to access any of these three.

Instability in the region, combined with the lack of economic opportunity and the youthful population, has caused significant migrant flows from the three countries to the United States. Starting under President Obama, several administrations have sought to tackle the so-called “root causes” of migration to reduce the number of migrants crossing the southern border. Recently, the Biden-Harris administration released its **U.S. Strategy for Addressing the Root Causes of Migration in Central America**; the strategy has five pillars, the first of which is “Addressing Economic Instability and Inequality.” The core of this pillar consists of improving the business-enabling environment, partnering with the private sector, and increasing investment in the region.

Total **inflows of foreign direct investment** (FDI) to the Northern Triangle countries have been decreasing, with 2019 numbers for Guatemala at \$998 million, Honduras at \$947 million, and El Salvador at \$662 million. Panama and Costa Rica remain the main recipients of FDI in Central America. However, increased foreign assistance and FDI are necessary to build economic opportunity in the Northern Triangle countries. Vice President Kamala Harris’ *Call to Action*, launched in May 2021, includes commitments like partnerships with 12 private-sector companies and organizations that have agreed to strengthen their investment into economic development opportunities in the Northern Triangle countries, such as Mastercard, Microsoft, Chobani, and Nespresso. However, these must be only the beginning of U.S. investment in the region.

Critical to the success of these efforts is building the local private sector, especially the small and medium-sized enterprises (SMEs) that form the backbone of most economies. Yet, in the Northern Triangle, SMEs face significant barriers to growth, including access to finance—either local or foreign—and the risk of criminal extortion as a result of growth. In all three countries, the overall investment and business climate remains weak. These challenges limit the size of the formal economy, with many businesses simply not registering with the government because of the time it takes to do so. Informal SMEs do not pay taxes and are limited in their ability to access finance; this in turn reduces the size of the tax base and constrains the amount of resources local governments can tap. SMEs also face a major disincentive to grow, because the larger they become, the more they become a target for criminal extortion by regional gangs.

To support broad-based economic growth in the region, the U.S. government will need to work closely with local governments, multilateral entities such as the World Bank and Inter-American Development

Bank (IDB), and the private sector. The U.S. government has several tools that it can bring to bear for these efforts, including the U.S. Agency for International Development (USAID) and the U.S. International Development Finance Corporation (DFC). Working together, these agencies can break down the barriers to growth and mobilize additional capital that will help SMEs thrive in the Northern Triangle.

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This paper presents an analysis of existing barriers to growing the SME sector in the Northern Triangle, elaborates opportunities for investment, reviews current U.S. government support for economic development, and concludes with a series of policy recommendations.

Barriers to SME Growth in the Northern Triangle

Within the three countries of the Northern Triangle, there are significant barriers that prevent small and medium sized enterprises (SMEs) from growing and creating jobs. This includes a lack of access to capital, a weak business and investment climate, lack of entrepreneurship training and skills, corruption, and lack of physical security due to gang- and drug-related violence. While there is significant investor interest in Latin America and the Caribbean, there are relatively few investors who target the Northern Triangle—even among impact-minded investors who seek to generate social impact in addition to a positive financial return. Investors avoid the Northern Triangle because of the high level of risk. Because of the internal barriers outlined below, and due to a lack of local knowledge that would help them better understand the nuances in the Northern Triangle, investors who focus on the region typically turn to safer geographies (e.g., Panama or Costa Rica).

ACCESS TO FINANCE

SMEs in the Northern Triangle lack access to the finance they need to grow their businesses.

In Guatemala, for example, SMEs face a \$14 billion financing gap. This means that they are unable to access working capital, make investments in new technology, or put in place other types of infrastructure that will support growth. This is especially severe for women-owned businesses. The Northern Triangle is largely a capital-starved region, with most FDI flowing to Mexico, Costa Rica, Panama, and Colombia. Even local capital is largely invested in non-SME related finance or focused on opportunities abroad because of the risks associated with the region.

BUSINESS AND INVESTMENT CLIMATE

The three countries of the Northern Triangle all rank low on the World Bank's annual *Doing Business* report. Honduras ranked the lowest at 133, Guatemala at 96, and El Salvador at 91; all of them ranked significantly lower than the regional average. *Doing Business* examines 11 indicators that contribute to the ease with which SMEs in a particular country can operate within the formal economy. For the purposes of this paper, four indicators are worth highlighting: starting a business, getting credit, enforcing contracts, and resolving insolvency. The table below summarizes the rankings for the three Northern Triangle countries.

Table 1: Select *Doing Business* Indicators for the Northern Triangle

	Starting a Business	Getting Credit	Enforcing Contracts	Resolving Insolvency
Honduras	170	25	154	143
Guatemala	99	15	176	157
El Salvador	148	25	126	92

Source: World Bank, “Honduras,” *Doing Business*, database, <https://www.doingbusiness.org/en/data/exploreeconomies/honduras>; World Bank, “Guatemala,” *Doing Business*, database, <https://www.doingbusiness.org/en/data/exploreeconomies/guatemala>; World Bank, “El Salvador,” *Doing Business*, database, <https://www.doingbusiness.org/en/data/exploreeconomies/el-salvador>.

As the rankings indicate, it is challenging in all three countries for entrepreneurs to start a business, which limits the size of the formal sector. While the three Northern Triangle countries score well on how easy it is to get credit, this only applies to formal businesses—and much of the SME sector is informal, limiting their ability to access formal financial services. Finally, the region ranks near the bottom when it comes to enforcing contracts and resolving insolvency; these are two critical indicators for investors when assessing potential risks if their investment goes bad.

TRAINING AND SKILLS

Many SMEs in the region lack the training and skills needed to attract private investment. This includes accounting standards, corporate governance, and other skills that would enable SMEs to access finance. This lack of skills and training further restricts these SMEs to the local market and prevents them from joining international supply chains. This mostly affects youth, local producer cooperatives, and smallholder farmers (SHFs). As an example, the agricultural sector is an important driver of economic growth in the Northern Triangle, but it also faces chronic underdevelopment of its human capital. Targeting technical assistance to this sector will be critical to creating investment opportunities.

Opportunities for Investment

The Northern Triangle does possess significant economic opportunities if married with the necessary private capital. Agriculture and the domain of climate and green energy stand out as two of the main areas for which investment can stimulate impactful economic opportunity, not only in the targeted sectors but in further sectors as well.

AGRICULTURE

SHFs make up the backbone of the agricultural sector in the Northern Triangle. Given that over 10 percent of the GDP of countries in the region is derived from agriculture, that 25 percent of the population is employed by agriculture, and that SHFs make up 50 percent of agriculture exports, there is a large opportunity to help SHFs help close the gap in living income through investment in these local agricultural cooperatives. For example, Heifer International and Small Enterprise Assistance Funds (SEAF), working through a recent joint venture, are currently working with CrossBoundary to address these opportunities for investment. SHFs in the region have four main areas in which they need assistance: transparency of market prices, improved logistics and access to markets, low-cost innovation to adapt to climate change, and access to capital and technical assistance. The DFC and USAID do already invest into building economic prosperity through both agriculture and agribusiness, but given the exponential growth opportunity that could arise from this sector, it deserves increased attention from these agencies.

One successful example of agriculture investment in Guatemala is the local cooperative of Nueva Kerala, which partnered with Heifer International in 2014 and received investment from Heifer Impact Capital in 2019. Nueva Kerala identified opportunities for investment that would be helpful, such as flexible loan options or USAID grants that are tied to loans with flexible investment structures and grace periods for repayment.

CLIMATE AND GREEN ENERGY

In the climate and green energy space, innovation in new technologies and youth entrepreneurship programs can inspire the new generation to contribute to the growth of economic opportunities in the region. Increased investment into renewable energy is beneficial both for combating climate change and for increasing economic opportunity, as it creates high-paying jobs and decreases the regional dependence on agriculture. The DFC and USAID are already investing in critical infrastructure and clean energy in the Northern Triangle, but they could continue to pursue increased investment in this space to build economic opportunity at the same time as building climate-resilient infrastructure.

A successful example in the innovation space is Kingo Energy, an SME that provides solar power for people living in off-grid communities in Guatemala and Colombia. Kingo Energy's success in attracting capital investment stems from the fact that, as an innovation SME tied to Cuatro Grados Norte (the Silicon Valley version of Guatemala), it has access to a broad network abroad for investment. Local cooperatives and SHFs in the interior of the country, however, do not have the entrepreneurship skills that some innovation SMEs possess, nor the ability to build capacity or the vision to scale their companies to international markets. Creating entrepreneurship programs to strengthen human capital may allow for increased investment in SMEs due to greater capabilities for envisioning company expansion on the international scene.

Current U.S. Government Engagement with SMEs in the Northern Triangle

Since the Obama administration, the United States has committed significant foreign assistance resources to aid in the economic and social development of the Northern Triangle. These efforts have been supported by Congress, who have authorized and appropriated funds to tackle the root causes of migration. Between 2016 and 2021, [Congress appropriated](#) over \$3.6 billion in assistance to the Northern Triangle.

Both the DFC and USAID currently operate in the Northern Triangle countries through several initiatives and investment opportunities. There are, however, significant barriers to attracting capital to the region, which exacerbates the lack of economic opportunity facing citizens in these countries. Internal barriers within these countries include minimal access to finance, an overarching weak business and investment climate, a lack of entrepreneurship training and skills, and a security dilemma resulting from the risk of criminal extortion. From the perspective of outside investors, however, external barriers to investment include a lack of projects at scale given the size of these markets, a risk-averse investor approach, and a lack of local knowledge. U.S. government agencies will need to work closely together to support local efforts to address these barriers and provide catalytic financing that will attract additional private capital to the region.

CURRENT U.S. GOVERNMENT ASSISTANCE: USAID

USAID has long been active in the Northern Triangle, working closely with El Salvador and Guatemala to advance economic and social development in the wake of those two countries' civil wars. These efforts have intensified in recent years, with large assistance programs in all three Northern Triangle countries under the direction of USAID. In May 2021, USAID launched a new Northern Triangle Task Force focused on increasing the security, prosperity, and governance of the region via partnerships with the private sector and civil society. Under this effort, USAID programming will seek to:

1. Generate economic opportunity through job creation, entrepreneurship, support for SMEs, and engagement with SHFs;
2. Build secure communities by reducing the threat of violence and creating opportunities for at-risk youth;
3. Promote greater government accountability by working with civil society to reduce corruption;
4. Mitigate the effects of climate change; and
5. Provide humanitarian assistance to help the region respond to natural disasters.

In response to the humanitarian crisis, in April 2021, Vice President Harris **announced** that the U.S. government would provide \$310 million in additional assistance to Northern Triangle nations, with \$255 million dedicated exclusively to meeting humanitarian needs. USAID will provide \$125 million of this aid—\$54 million for Guatemala, \$55 million for Honduras, and \$16 million for El Salvador—to assist with food insecurity and economic recovery. In addition to this emergency assistance, USAID continues to provide long-term support designed to tackle corruption, build accountable governance systems, increase domestic resources (e.g., taxes), provide access to basic human services, and encourage reforms targeting the business and investment climate.

For instance, through the Guatemala Entrepreneurship and Development Innovation initiative beginning in June 2021, USAID will provide up to \$40 million over three years for a Young Women’s Empowerment Initiative. They are also providing \$48 million to **increase economic opportunity** by supporting private sector entrepreneurs and innovators seeking technology-driven solutions to challenges in the region, as well as by supporting affordable housing, agribusiness, and SMEs.

CURRENT U.S. GOVERNMENT ASSISTANCE: DFC

The DFC is the U.S. government’s development finance institution and can provide a variety of financial products, including loans, loan guarantees, equity, and grants. This support is used to derisk potential investments in such a way as to make them more palatable to private investors who might have a lower risk tolerance. Created in 2018, the DFC is a consolidation of the Overseas Private Investment Corporation (OPIC) and USAID’s Development Credit Authority (DCA). OPIC previously had a significant presence in Central America and across the wider Latin America and Caribbean region, which is now taken up by the DFC.

In the Northern Triangle, the DFC provides investment support that addresses critical development challenges with the goal of stabilization. DFC investments in the region include small business development, critical infrastructure, and clean energy and water, among other key sectors. The DFC has also made significant commitments in the region via its 2X Women’s Initiative, seeking to drive additional financing to women-owned businesses. Under 2X Americas, the DFC has invested **approximately** \$1 billion in support of greater women’s economic empowerment throughout the region. In the Northern Triangle itself, the DFC provides investments that are designed to help unlock financing for SMEs. This includes a \$200 million **financing investment** to Guatemala’s Banco Industrial with the purposes of increasing loan opportunities for SMEs led by women. For example, this loan facility has provided financing to a meat seller, who was then able to introduce cold storage to her business; in another example, financing a footwear manufacturer made it possible for her to introduce new equipment that improved production times.

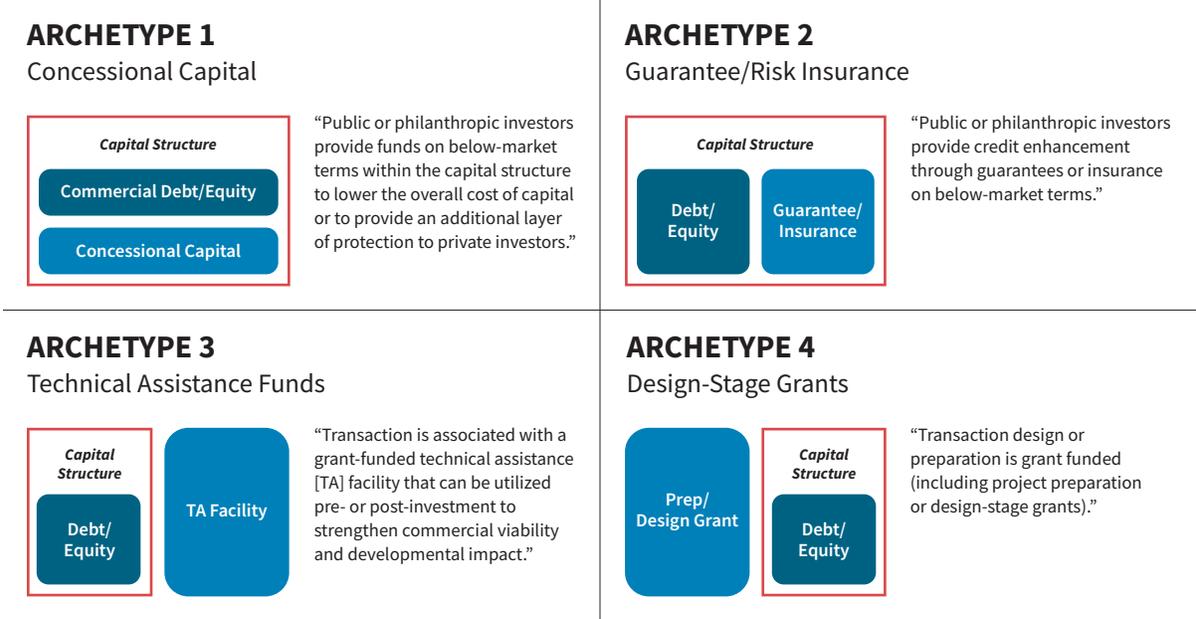
The DFC also recently approved a \$100 million loan to the Central American Bank for Economic Integration that will support lending to financial intermediaries in order to create greater access to finance for SMEs across the Northern Triangle. This **loan facility** is meant to support on-lending for SMEs in the region and help them maintain operations in the face of the economic challenges brought on by the Covid-19 pandemic.

Earlier, DFC’s predecessor agency, OPIC, partnered with Catholic Relief Services and Azure SA (a social enterprise based in El Salvador) to finance Azure Source Capital (ASC). This is a blended finance facility that seeks to provide increased access to clean water through the rehabilitation and expansion of existing infrastructure in rural areas of the Northern Triangle, starting in El Salvador. ASC recently expanded to Honduras. OPIC provided a \$4 million loan to the financing facility (out of a project total of \$10 million); Azure is structured to provide both financing and technical assistance to potential borrowers, and it aims to bring clean water to 300,000 people.

Blended Finance

Because of the risks associated with the SME sector in the Northern Triangle, USAID and the DFC will need to rely on blended finance to attract private capital. Convergence, a platform for blended finance, identifies four “archetypes” of blended finance that investors can use; some or all these might be useful for a given project, depending on the stage and viability of a specific investment and the needs and barriers of relevant investors or donors. These factors can be summarized as follows.

Figure 1: Archetypes of Blended Finance



Source: Archetype definitions come from “Blended Finance,” Convergence, <https://www.convergence.finance/blended-finance>.

These four archetypes are not mutually exclusive, and a deal may be structured using a mix of them to derisk it to attract private capital. An example deal might include concessional capital alongside technical assistance (TA) funds, either to strengthen the viability or development impact of the project or at the project preparation stage. Making better use of blended finance structures in the Northern Triangle could be a critical path to attracting greater private capital.

Policy Recommendations

The U.S. government views Northern Triangle countries as strategically significant because of the impact that irregular migration has on the southern U.S. border. Beyond that, the United States has significant economic relations with all three countries via the Central America Free Trade Agreement (CAFTA).

Successive presidential administrations have identified job creation and economic opportunity as critical to reducing the flow of migrants. Most recently, the U.S. government has also embraced the concept of nearshoring investment in the region—not a silver bullet, but a valuable tool that could help reduce the flow of migrants over time when used in conjunction with the other pillars of the recently announced White House strategy for the Northern Triangle.

Critical to the success of the economic growth pillar will be supporting SMEs in the region, as they work as the backbone of local economies. The U.S. government should prioritize reforms and programs that will reduce the barriers to growth that SMEs face in Guatemala, Honduras, and El Salvador. There are clear investment opportunities—especially in agriculture and green energy—but perceived risks mean that private capital is scarce. USAID and the DFC should find flexible and creative solutions to enable greater access to finance for SMEs, with a blended finance approach at their core where appropriate. Both agencies must also build partnerships with the private sector—both local and international—to leverage their supply chains, financing, and knowledge.

The U.S. government should prioritize reforms and programs that will reduce the barriers to growth that SMEs face in Guatemala, Honduras, and El Salvador.

This report makes three key high-level recommendations.

1. The DFC should create blended finance facilities that will derisk investment and attract additional private capital to the region.

The DFC should create a blended finance facility designed to derisk potential investments in the Northern Triangle. Ideally, the facility would work across the three countries and would target specific sectors, such as agriculture. There is clear opportunity in the region, but investors—both local and foreign—remain largely risk-averse. This is a prime example of where the DFC should use its catalytic capital to make potential investments more attractive to private investors.

The fund should be jointly structured between the DFC and USAID, with the DFC providing a substantial amount of financing within the facility (from \$150 million to \$200 million) and USAID providing a certain amount of grant funding (roughly \$10 million) to provide technical assistance and, in some circumstances, first-loss guarantees. These activities should target agriculture, green energy, and other sectors that could provide significant development impact alongside positive financial returns.

USAID's grant resources could provide first-loss guarantees and technical assistance. First-loss guarantees remain an underutilized tool by both USAID and the DFC; this fund could provide a test case for first-loss guarantees and help prove the case that, under certain circumstances, this type of guarantee is helpful in mobilizing private capital. Given the risks associated with the Northern Triangle, this is an ideal area to test first loss. Technical assistance is also critical to help SMEs in the region develop the appropriate skills and training to make them more attractive to future investors. The DFC is limited in the amount of TA it can provide, which means USAID should step in to provide it alongside DFC financing.

When approaching investments under this facility, the DFC will need to offer increased flexibility in its terms and be prepared to take more risk. The DFC already offers some flexibility through grace periods on loans and lower interest rates than local financial institutions offer, but more could be done, including the

use of first-loss guarantees (in concert with USAID) and offering loans in local currency. Under the BUILD Act, the DFC can make financing available in local currency, but to date this remains an underutilized tool. While El Salvador’s use of the U.S. dollar should naturally spur investment, financing in the local currency can be an effective tool in both Guatemala and Honduras. Given the overlapping objectives for development and foreign policy in the Northern Triangle, this is an area where the DFC should bring all its tools to bear. This is not to suggest that the DFC should take risk for the sake of risk; rather, it should take calculated risk that will increase development impact and drive greater economic growth across the region.

The DFC will face the challenge of building a pipeline of investable SMEs if it creates a blended finance facility in the Northern Triangle. To help build that pipeline, the DFC should establish partnerships with non-traditional entities—such as nongovernmental organizations—that already have a significant presence in the region. This includes some partners that the DFC or OPIC partnered with previously, such as Catholic Relief Services, but the DFC could also explore partnerships with the Pan-American Development Foundation, as it has a significant presence in the Northern Triangle and a large network of partners who could offer potential investment pathways for the DFC.

The DFC should also explore potential partnerships with local wealthy individuals and families, many of whom seek investment opportunities outside of the Northern Triangle. Much like foreign investors who perceive a high level of risk in the region, these individuals seek less risky investments abroad. The DFC has an opportunity, however, to engage these individuals and families to derisk investments and find pathways for them to invest into their own economies.

2. USAID should prioritize reforms that improve the enabling environment for business and investment.

Parallel to creating a blended finance fund to reduce risk for investors, USAID should prioritize a reform of enabling environment conditions that will make the Northern Triangle more attractive to investors over time. The White House strategy on addressing the root causes of migration includes a pillar to address economic insecurity and inequality. Core to this pillar is creating a better enabling environment for economic growth. USAID should take the lead in designing and implementing programs that improve the overall environment for business and investment. This should include the following:

- Creating the conditions for an increase in the formal economy by making it easier for businesses to be registered.
- Improving local commercial law codes to make resolving insolvency and enforcing contracts easier. This should be coupled with improving local commercial courts and ensuring that these are free of corruption.
- Prioritizing other governance and rule of law reforms—including anti-corruption efforts—that have a negative impact on economic growth. The White House strategy includes these as other pillars, and USAID should develop approaches to tackle these challenges.
- Increasing security protection for local SMEs to reduce the risk of criminal extortion and gang violence.

Absent USAID’s support for broad-based reform—in tandem with its local partners—the region’s SMEs will continue to languish and hold back the growth needed to create more jobs and economic opportunity.

3. The DFC and USAID should support regional efforts to connect the Northern Triangle to larger economies in the region, particularly Colombia and Mexico.

Due to the lack of large-scale investment projects in the Northern Triangle, it would be beneficial for El Salvador, Guatemala, and Honduras to have regional connections to the larger surrounding economies that do attract private capital. As it stands, these countries do not have large enough markets to attract serious

investment. Established connections with larger economies in the region, like Colombia and Mexico, would help them attract increased investment as well as create a more stable region overall. The DFC and USAID should work to connect existing and new investments between the Northern Triangle and its more economically powerful neighbors. Partnerships with these larger economies would not only attract increased investment to the region but would also contribute to an increase in local knowledge that will be necessary for sustained investment in the long term. ■

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