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DEVELOPMENT ASSISTANCE PROGRAM

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Revised ROCAP

DEPARTMENT
OF
STATE

DECEMBER 1975

DEPARTMENT OF STATE
AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

December 16, 1975

MEMORANDUM

TO: Holders of Revised ROCAP DAP of December 1975

FROM: Lawrence E. Harrison
Director, ROCAP

SUBJECT: General Declassification Schedule applicable to revised DAP

The revised ROCAP Development Assistance Program of December 1975 is classified CONFIDENTIAL and is subject to General Declassification Schedule of Executive Order 11652, automatically downgraded at two-year intervals and declassified on December 31, 1981.

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ROCAP DEVELOPMENT ASSISTANCE PROGRAM (DAP)

SUMMARY

Central American integration is less significant for U.S. interests than we judged it to be in the early years of the Alliance for Progress. Development as such no longer dominates our Latin American policy, although it is still an important element in our relations with Central America. While significant economic growth benefits have accrued to the Central American countries from integration, the political, institutional, and juridical dimensions of the Central American Common Market (CACM) have been stagnant since the 1969 war between El Salvador and Honduras. Indeed, serious integration problems predated the war.

Because of its impulse to growth and its enhancement of the economic viability and political stability and strength of these five small countries, integration is clearly in the U.S. interest. But it is not indispensable.

There is virtually no prospect of any dramatic advance in the current uncertain pace of integration. Efforts since 1972 aimed at a major restructuring of the CACM are not likely to come to fruition, at least not for several years. Progress, if it comes, is more likely to result from specific initiatives to solve problems or exploit opportunities.

In these circumstances, we conclude that ROCAP should pursue a modest-cost, targets of opportunity strategy which includes projects supportive of further integration; projects, supportive of bilateral mission efforts, which promise economies and efficiencies of scale; and centralized services to the bilateral missions.

At the same time, ROCAP proposes to undertake with SIECA a study which could lead to a significant new ROCAP-supported initiative in integration: the expansion of intra-regional trade in agricultural products.

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I. U.S. INTEREST IN CENTRAL AMERICAN INTEGRATION

A. Background of U.S. Support

Prompted in part by the revolution of rising expectations, the Central American governments in the early 1950's began to ponder their development prospects as small, isolated and undiversified economies. Integration[1/] offered the possibility of a larger market, more diversified production, and a stronger bargaining posture vis-a-vis the rest of the world. The integration movement was started with the creation of the Organization of Central American States (ODECA) in December, 1951. Soon thereafter, the Ministers of Economy of the five countries began to meet, studies of integration possibilities were undertaken, and a negotiating process was started.

The United States was not an early proponent of Central American integration[1/]. That role fell to the UN's Economic Commission for Latin America (ECLA), particularly ECLA's regional office in Mexico. In the post World War II era, ECLA followed the thesis that all countries were either industrialized and wealthy or raw material producers and poor. Import substitution was the key to industrialization. But when applied to Central America, the prescription ran into the obstacles of small national markets. Regional integration was the answer.

By 1959, a Multilateral Free Trade Treaty had been negotiated, but the extent of exceptions to the free trade list and the failure of Honduras and Costa Rica to ratify discouraged the integrationists, who were further stymied by a reduction in ECLA financing.

1/ The term "integration" as used in this paper refers to a condition resulting from cooperative efforts of the CA countries to remove barriers to the free movement in the region of goods and productive factors, to harmonize monetary and fiscal policies, and generally to develop institutions and policies that strengthen the area's economy and its position vis-a-vis other countries and regions. There are of course varying degrees of economic integration: free trade areas, common markets, customs unions, and economic unions. At this stage the state of CA integration is characterized by a common market (including a uniform external tariff) freely trading most of its industrial products, relatively free movement of capital, very limited mobility of labor, and several integration institutions.

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Concurrently, however, the United States, which had looked askance at the monopolistic and protectionist aspects of the ECLA formula, began to take a more positive interest in regional integration. In part this reflected the estimate that the Latin Americans themselves were determined to work toward a free trade area. But the principal spur was a general deterioration in U.S./Latin American relations, and, in particular, events in Cuba. By 1959, the U.S. was ready to offer support to regional integration.2/

Although our offer was accompanied by conditions which were not wholly compatible with the Central Americans' own integration plans while under ECLA's guidance, the prospect of sizable U.S. assistance helped to smooth over these differences. A few months after the U.S. conditions had been stated, President Lemus of El Salvador joined President Eisenhower in a pledge of support for Central American integration. By the following year, the Central Americans had negotiated and signed a General Treaty for Economic Integration. They quickly proceeded to establish an integration secretariat (SIECA) and an integration bank (CABEI), while, for its part, the U.S. set up a regional office (ROCAP) with instructions "to support the Central American integration program."3/

B. The Shifting Rationale for U.S. Support

The stated rationale for U.S. support to Central American integration in the 1960's was to promote "the accelerated economic and social development of the Central American region." 4/ The principal reason for our decision was the belief that integration would enhance the political and economic viability of Central America, thereby leaving it less susceptible to experimentation with extremism. Beyond this, we judged that integration was the wave of the future and that, if we supported it,

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2/ The U.S. conditions, as set forth by Undersecretary of State Douglas Dillon to the OAS Committee of Twenty-One, were, in brief outline, that integration schemes should: (a) aim at trade creation and increased productivity; (b) provide for scheduled elimination of barriers to intraregional trade; (c) be "GATTable"; (d) aim at increasing competition; (e) provide for free flow of labor and capital; and (f) provide for financing trade in convertible currencies.

3/ Joint STATE/AID Circular 294, October 2, 1962.

4/ Ibid.

[redacted]

it would be possible to influence its evolution in ways that would be compatible with our interests.

Looking back over the past 15 years, there appears to have been some foundation for these motivating beliefs. There is convincing evidence that integration has increased the rate of economic growth. And there is substantially greater political dialogue among the five countries than there was prior to establishment of the CACM, which has probably had moderating effects on national policies and increased Central America's ability to defend its interests in its relationships with the rest of the world.

But the less-developed world, and particularly Latin America, look much different to us in 1975 than they did in 1960. Our interest in development today is less related to its insulating effect against communism and more to its potential (1) to contribute to more positive relationships between the rich countries and the poor countries; (2) to contribute to the solution of critical problems of global scope (e.g., food, energy, environment); (3) to contribute to the furthering of U.S. economic interests; and (4) to reflect our humanitarian values.

Both against the background of our shifting national view of development and the sporadic evolution of the CACM over the past 15 years, less significance attaches to Central American integration in terms of U.S. interests than was the case in the early sixties. At that time, integration was the keystone of U.S. policy toward Central America. Today, with trade and investment issues increasingly sharing the spotlight with development issues in the dialogue between the U.S. and Central America[5/], and with Central American integration in a period of

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5/ Whereas trade and investment issues may now dominate the relationship between the U.S. and South America (and Mexico), development issues are still very prominent in the U.S.-Central American relationship.

[redacted]

prolonged stagnation[6/] integration is, in terms of U.S. interests, useful but not indispensable. Should the CACM collapse, which we think is unlikely, the political consequences would be quite limited: there is little for the United States to gain from integration that we do not already enjoy in our relationship with our five friendly neighbors. Some economic growth would be sacrificed, which, particularly measured in the long term, could reach significant levels, with attendant economic (e.g., in terms of U.S. exports to Central America) and perhaps political costs for the U.S. But even in the absence of integration, some economic growth will continue, and it would be difficult to argue that the difference in growth rate with and without integration would decisively affect U.S. interests.

While it is not indispensable, integration is closely supportive of U.S. economic and political interests, principally because of its significant impulse to growth and its enhancement of the economic viability and political stability of these five small countries, but also because the region's ability to further its interests is probably greater as a whole than as a sum of the parts. So long as there is a reasonable possibility of further progress in integration, it is in the U.S. interest to support the process. But the support must be equilibrated to the pace with which the Central Americans are prepared to move ahead.

6/ In our several references to the "stagnation" of integration, we do not mean that there has been a cessation of economic growth as measured by intraregional trade, development of the region's physical infrastructure, GDP, value added by manufacturing and investment. On the contrary, our data through 1974 (presented below), indicate that most of these indicators point to continued growth, though at a somewhat reduced rate since mid-1974. What has been stagnating is the process of modifying the legal, institutional and policy framework tying the countries of the region closer together and gradually moving them toward the integration ideal of an economic union. That process reached a peak in the mid-sixties, encountered difficulties in the late sixties, and was set back by the outbreak of the El Salvador-Honduras war. While there has been some catching up, no real progress in this sense has taken place over the last six years.

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II. ECONOMIC TRENDS AND PROSPECTS

A. Growth Trends Over 1960-1974

The average annual compound growth rates for the region's Gross Domestic Product (GDP), private and public investment and value added by the manufacturing sector, are presented in Table 1. The data refer to growth in real terms, i.e., after discounting inflation.

Note that the growth of GDP over the fourteen year period following the establishment of the common market (1960-1974) has been quite satisfactory. The average annual growth rate over this period was 5.8%. (The 1951-1960 growth rate was 4.5%, but world market prices for Central American exports were more favorable in the latter period.) The most rapid growth was experienced over the first 5 to 6 years immediately following the establishment of the common market. Over 1960-65, the average annual GDP growth rate was 6.4%. It declined significantly (to 5.3%) over 1965-70, then recovered to 5.7% over 1970-74. Growth performance was not even among the countries of the region. It was highest in Nicaragua and Costa Rica (6.9% and 6.5%, respectively), a satisfactory 5.8% in Guatemala and 5.6% in El Salvador, but significantly lower (4.1%) in Honduras.

Total investment (private plus public) increased at nearly 8% a year over 1960-74. The growth rate of public investment was substantially higher than private investment (10.7% versus 6.8%); however, since private investment is 2.3 times the size of public investment, it played a more important part in the growth of GDP. Note that like the GDP, investment grew very rapidly over 1960-65, declined sharply over 1965-70, then recovered over 1970-74. Value added by manufacturing increased by 7.6% a year over 1960-74. As a proportion of the region's GDP, the manufacturing sector increased its share from only 13.5% in 1960 to nearly 18% in 1974. All countries except Honduras experienced rapid growth in manufacturing. The growth was most rapid in Nicaragua, followed by Costa Rica, El Salvador, and Guatemala, in that order. It was lowest by far in Honduras (see Table 1). Guatemala and El Salvador started with the largest industrial base and continue to dominate the manufacturing sector--and CACM exports. While Honduras also made some progress with its manufacturing industry over the last 14 years, the industrialization gap between that country and the rest of the CACM has widened.

Table 1

Growth Trends in GDP, Investment and Value Added by the Manufacturing Sector in Central America

Over 1960-74

Average Annual Compound Growth Rates (In Real Terms)

	1960-74	1960-65	1965-70	1970-74
GDP, Region	5.8	6.4	5.3	5.7
Guatemala	5.8	5.3	5.8	6.4
El Salvador	5.5	6.8	4.5	5.3
Honduras	4.1	5.1	4.3	2.6
Nicaragua	6.9	10.2	4.2	6.2
Costa Rica	6.5	6.5	7.0	5.9
Investment, Region	7.8	10.2	4.8	8.6
Private	6.8	9.2	4.8	6.5
Public	10.7	13.5	5.0	14.5
Value Added by Manufacturing, Region	7.6	8.8	7.5	6.3
Guatemala	7.3	7.1	8.1	6.6
El Salvador	7.5	10.7	5.7	5.9
Honduras	4.4	2.6	4.9	6.0
Nicaragua	9.7	14.2	8.0	6.3
Costa Rica	8.1	8.2	9.5	6.2

Source: Based on following data:

For 1960, 1965 and 1970 (all items) SIECA, VI Compendio Estadístico Centroamericano 1975, (Tables [illegible] to 198).
For GDP in 1974, Research Department of Central Bank in each country.
For Investment and Value Added by Manufacturing in 1974, SIECA, Centro America: Estadísticas Macroeconómicas 1971-1974. (Statistical Annex II.) February 11, 1975.

The Central American Bank for Economic Integration (CABEI) has played a major role in the development of the area's physical infrastructure, particularly of the intraregional road network, and has made a significant contribution to laying the basis for industrial growth. Between 1961 and 1973, CABEI financed the construction of 1,200 kms. of paved roads, accounting for 35% of the 3,422 km. expansion of the total paved road network for Central America during that period. This road network has added an important north-south trading dimension to what was in the 1950's, with the exception of the Pan-American Highway, essentially an east-west (capital city to port) traffic flow.

Trends in Central American exports over 1960-1974 are summarized in Table 2: Note that intraregional exports (Item A) increased from CA$33 million in 1960 to CA$[illegible] million in 1974, representing an average annual compound growth rate of 22%. During that same period, Central America's exports to the rest of the world increased at an average annual rate of 13%. However, as a percent of total Central American exports, intraregional exports peaked in 1970 at 27.2%. In 1973 and 1974 they were in the range of 23-24% of total exports.

The growth of intraregional agricultural trade lagged considerably behind that of manufactures since formation of the CACM. Table 2A illustrates that agricultural trade responded to the integration stimulus only in the early years of the Common Market. Between 1968, the last year of full economic integration, and 1973, agricultural trade has stagnated. A 33% increase did take place in 1974, but this was wholly attributable to price factors.

The sluggish performance of regional agricultural trade over 1968-1973 is partly the reflection of neglect of the sector during the 1960's when industry was the "sweetheart" of economic planners and private investors alike. More recently, as a greater share of public and private resources has begun to be focused on alleviating lagging agricultural growth, regional trade has been inhibited by measures to achieve national autarky in food production--currently judged by the countries as the best way to meet food shortfalls--integrationist rhetoric of the agriculture ministers notwithstanding. CA governments have

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Table 2

Central America: Total Exports

(Millions of CA$)

	1960	1966	1970	1973	1974 1/	Average Annual Compound Growth Rate 1960-74
I. Total	440.1	836.9	1098.0	1682.0	2164.0	
A. To CACM	32.7	174.7	299.1	388.5	525.0	22.0%
B. To Rest of World	407.4	662.2	798.9	1293.5	1639.0	10.4%
1. Major Primary Products	362.0	592.0	713.6	1090.7	1328.1	9.7%
a. Coffee	234.5	287.4	347.3	490.0	581.0	6.7%
b. Cotton	37.4	184.0	87.1	147.0	255.0	14.7%
c. Bananas	61.9	107.0	151.9	214.0	209.0	9.1%
d. Sugar	6.8	24.9	39.3	88.0	131.0	23.0%
e. [illegible]	[illegible]	83.7	87.3	122.7	100.1	19.2%
f. [illegible]	[illegible]	24.6	39.7	40.0	52.9	10.5%
2. Other Products (B-1)	45.4	69.2	85.3	[illegible]	[illegible]	[illegible]
CACM as % of total (A/I)	7.4	20.9%	27.2%	23.1%	24.3%	

1/ Preliminary

SOURCES: For 1960, 1966, 1970 and 1973, SIECA VI Compendio Estadístico Centroamericano, 1975, p. 307. For 1974, as estimated by Research Department of Central Bank in each country, except for exports to CACM which source is SIECA in Integración en Cifras May 1975.

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Table 2A

Trends in Central American Intraregional Trade of Agricultural and Manufactured Products 1962-1974

(In Millions of C.A. Pesos)

	(1)	(2)		(3)	
		Agricultural[1]		Manufactured Products	
Year	Total	Value	Per Cent of Total	Value	Per Cent of Total
1962	50.8	25.1	49.4%	25.7	50.6%
1963	72.1	26.1	36.2%	46.0	63.8%
1964	106.2	32.4	30.5%	73.8	69.5%
1965	135.5	40.3	29.7%	95.2	70.3%
1966	174.7	46.6	26.7%	128.1	73.3%
1967	214.0	56.4	26.4%	157.6	73.6%
1968	258.3	65.7	25.4%	192.6	74.6%
1969	249.0	57.3	23.0%	191.7	77.0%
1970	299.1	65.5	21.9%	233.6	78.1%
1971	276.4	57.5	20.8%	218.9	79.2%
1972	306.7	59.8	19.5%	246.9	80.5%
1973	388.5	62.9	16.2%	325.6	83.8%
1974	525.0	84.0	16.0%	441.0	84.0%
		(Annual Growth Rate)			
1962-1965	39.0%	17.1%		55.0%	
1966-1969	12.5%	7.1%		14.4%	
1970-1974	15.1%	6.4%		17.2%	

1/ Includes the following NAUCA categories: 0 Food Products
1 Beverages and Tobacco
4 Vegetable and Animal Oils and Fats

While these include processing in some cases, most of the value reported relates to value added by agriculture.

SOURCE: SIECA, for 1962-1973, VI Compendio Estadístico Centroamericano 1975, (pages 310 and 311). For 1974, Integración en cifras, May 1975.

preferred to close their borders to exports, sacrificing foreign exchange, in order to keep food prices low to consumers. Moreover, ignorance about market opportunities for exchange of agricultural produce with their CACM partners and transportation problems have further moved governments to look inward for solutions to their food shortage problems.

With regard to the composition of the region's extraregional exports, note that Central America's exports to the rest of the world still consist predominantly of primary products. In 1974, exports of the major primary products accounted for 81% of total extraregional exports (based on Table 2).

This is in sharp contrast to the composition of intraregional trade which consists overwhelmingly of manufactured products (see Table 3). Note that in 1973[7], manufactured products accounted for 93% of all goods moving in intraregional trade. Moreover, the trend has been upward: the proportion of manufactured goods was 85% in 1965. While the exportation of manufactured goods to extraregional markets has also risen, it is still only 16% of total extraregional exports (item 2c of Table 3).

There can be little doubt that there is a close correlation between the growth of intraregional trade and the rate of industrialization in Central America over the past fourteen years. We have noted (a) the rapid growth in value added by manufacturing, (b) the dramatic increase in intraregional trade, (c) the fact that the intraregional trade consists almost entirely of manufactured goods, and (d) the high growth rate of both private and public investment. The formation of the common market with its uniform external tariff and free trade within the region have promoted manufacturing activity through import substitution, which was the intent of the framers of the common market's policies and institutions in the late fifties.

Has import substitution run its course? The data on this point is inconclusive. Total intraregional trade has continued to increase rapidly in recent years--by 27% in 1973 and 35% in 1974, although at least in the latter year, price increases played a significant role. However, a substantial

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7/ The last year for which data on composition of intraregional trade are available.

Table 3

Importance of Manufacturing Sector in C.A. Exports

- Millions of C.A. $ -

	1966	1973
1. Total Intraregional Trade	174.7	385.5
a. Manufactured Products	148.6*	360.5
b. Agricultural and Primary Products	26.1*	25.0
c. 1 a. as % of Total	85.0%*	92.8%
2. Total Regional Exports to Outside Markets	662.2	1293.5
a. "Other" Products 1/	69.2	202.8
b. Agricultural and Primary Products 2/	593.0	1090.7
c. 2 a. as % of Total	10.5%	15.7%

1/ Other products not included in "b". There is no data on manufacturing exports as such for exports to extraregional markets.

2/ Includes coffee, cotton, bananas, sugar, meat and wood.

* Breakdown based on an analysis by SIECA covering 92% of total intraregional trade in 1966.

SOURCE: For Intraregional Trade in 1966: SIECA, Area de Libre Comercio No. 70 (January 1968); for 1973 SIECA, Informe de Labores No. 18 (April 1974).

For Extraregional Exports in 1966, SIECA, Serie Estadísticas Seleccionadas de C.A. y Panamá No. 11, (Nov. 1970); for 1973 C.A. Mission's reports to Institute Washington as cited in ROCAP's "Economic Assessment of the CACM Region 1971-75" as of March 1975.

slowdown was experienced in the first quarter of 1975[8/]. It is not yet clear whether this substantial first quarter deceleration is a temporary phenomenon or whether it signals a reduction in opportunities for import substitution.

It might be premature to conclude, at this stage, that import substitution opportunities have been exhausted. The data in Table 4 illustrate the growth in the production of intermediate products, particularly chemical products, non-metallic minerals, basic materials and metal products, paper and printing. These are assuming a very important role in the region's intraregional trade. The region is far from having fully exploited its ability to meet the internal demand for intermediate goods. In fact, the process of import substitution at this level has only begun. It is true, however, that for several categories the growth rate during the period 1965-69 was higher than for 1969-73.

In spite of the opportunities provided by the production of intermediate goods, most economic analysts are convinced that a 20% plus annual growth rate in intraregional trade cannot be expected to continue much longer. If a deceleration in the growth rate does not occur in 1975, it is highly likely to set in later this decade. In recognition of this fact, a consensus has developed that the region should diversify its exports, raise their quality and gear up to marketing them abroad. Such an export drive must be based on product lines in which the region has or can acquire a comparative advantage.

Development of new exports to extraregional markets will involve a sustained effort by the governments of the region. Exporters should be encouraged through technical assistance and credit on favorable terms. Reductions in the uniform external tariff rates on imports of finished manufactured goods would also be helpful since that would reduce the de facto subsidies presently provided to producers for the internal market, a policy that has been discouraging the allocation of resources to industries capable of generating exports oriented toward outside markets.

8/ Rates of increase between first quarters of 1973-75 are as follows:

1973-74	45.8%
1974-75	2.6%

[redacted]

Table 4

Trend in Value Added by Raw Materials, Intermediate and Capital Goods

Over 1960-73

*

- In Current C.A. Pesos -

	1960	1965	1969	1973	Absolute Increase 1960-73	Average Annual Growth Rate 1960-73	1965-69	1969-72
Textiles	24.4	48.3	69.7	95.6	70.2	11.0	9.6	7.9
Wood and Cork	13.9	20.5	26.9	41.6	30.7	9.4	7.0	13.5
Paper and Paper Products	1.4	6.8	12.0	20.4	19.0	2.0	15.3	11.2
Printing	7.2	11.1	16.5	26.4	19.2	10.0	10.4	12.0
Leather and Leather Products	4.3	4.7	5.3	10.7	6.4	7.3	13.3	6.5
Rubber Products	3.7	5.7	10.6	15.1	11.4	13.6	22.5	7.4
Chemical Products	16.6	36.3	55.2	77.3	57.7	12.2	11.5	7.2
Petroleum Derivatives	5.3 1/	12.9	20.0	38.4	33.1 2/	1... 2/	11.6	9.2
Non-metallic Minerals	12.8	23.7	34.5	49.1	36.3	10.9	7.6	9.2
Basic Metals	0.2	2.7	2.3	30.8	30.6	47.0	-1.1	90.0
Metal Products	8.1	16.7	38.2	34.0	25.9	11.6	23.0	-11.0
Machinery Other than Elect.	1.3	3.3	9.9	13.1	11.3	19.3	30.6	7.3
Electrical Machinery	1.2	4.1	13.1	18.0	16.8	33.0	34.0	8.3
Transport Equipment	5.6	7.5	12.3	18.2	12.6	9.5	13.2	10.3

* This data is not available in constant prices; however, there was little inflation through 1973.

1/ This figure corresponds to 1963, the first year for which Petroleum Derivatives were reported.

2/ Corresponds to period 1963-73.

SOURCE: SIECA: VI Compendio Estadístico Centroamericano 1975, Table 200.

[redacted]

In conclusion: While import substitution is not likely to provide the same impulse to growth in the future as it has in the past, the process of import substitution has not ended. We expect a shift from the exclusive production of finished manufactured goods to a gradual expansion in the production of intermediate goods. A serious effort, however, must be made to diversify production and exports, and orient the latter increasingly to outside markets, not only because this is a requirement to maintain high growth rates, but also to encourage the production of labor-intensive agricultural products in which the area has an obvious comparative advantage.

B. Benefits and Costs from Integration

By no means all of the growth experienced by the region over 1960-74 can be attributed to integration. SIECA noted in its Decade Study that the real average annual growth rate of Central America's GDP rose from 4.5% during the 1950's to 6.5% over 1962-68, and estimated that the CACM accounted for about 1.6% of the increase in the rate.[9] Donald Mudelland estimated that the common market's contribution to the average annual GDP growth rate over 1962-68 was between 0.6 and 0.75%.[10] More recently, a thorough study of the benefits and costs of integration was undertaken by William R. Cline of the SIECA/Brookings Unit.[11] This study does not attempt to estimate the impact of integration on growth, but rather quantifies the major welfare benefits and costs.

The major benefits consist of "trade creation" (increased imports from partners in place of higher-cost local production), improved utilization of the labor force, economies of scale and foreign exchange savings. Other important benefits[12]

9/ El Desarrollo Integrado de Centroamerica en la Presente Decada, Vol. I INTAL, 1973, page 18.

10/ The Central American Common Market Praeger, New York, 1972, pages 88-89.

11/ Benefits and Costs of Economic Integration in Central America, (Preliminary Draft) by William R. Cline of the Brookings Institution, July, 1974.

12/ These include the positive impact of integration on private investment, the "structural transformation effect" which results from the expansion of the region's manufacturing plant, and the "efficiency-prodding influence" resulting for increased competition from firms within the region.

have not yet been measured. The major economic costs of integration include the "trade diversion" effect (reduced importation of some goods from outside the region and their replacement by higher-priced goods produced within the region) and the "trade suppression" effect (imports of some products will be reduced owing to higher tariffs).

In arriving at its calculation of net benefits, the SIECA/Brookings Unit deducted the "trade diversion" and "trade suppression" cost effects from its estimate of the four benefits described in the previous section. As indicated above, certain important benefits have not yet been quantified and had to be left out of the calculation. The SIECA/Brookings study came to the conclusion that for the period of 1959-68, the net annual welfare gains measured so far amounted to CA$110 million. This represents a considerable net benefit as it constitutes 2.3 [13] of the region's Gross Domestic Product in 1968.

The SIECA/Brookings study confirms, however, that the benefits from integration have not been evenly distributed among the countries of the region. The greatest benefits by far were obtained by Guatemala and El Salvador. Far lesser benefits were obtained by Costa Rica, Nicaragua and Honduras. This conclusion might yet be modified when the dynamic effects of integration (on private investment and structural transformation) are taken into consideration in a subsequent study. At this point, the best available information indicates that, while all Central American countries have benefited from integration, and while the total benefits to the region as a whole were very significant, the benefits have been unequally distributed, with Honduras situated at the bottom of the list.

C. Economic Relations Between the CACM and the United States

The dramatic expansion of intraregional trade resulting from the abolition of the internal tariff barrier and the establishment of the common external tariff has given rise to the expectation that the region's imports from the outside world, including the U.S. would be depressed.

13/ This proportion is not to be interpreted as representing the portion of the GDP growth rate attributable to integration.

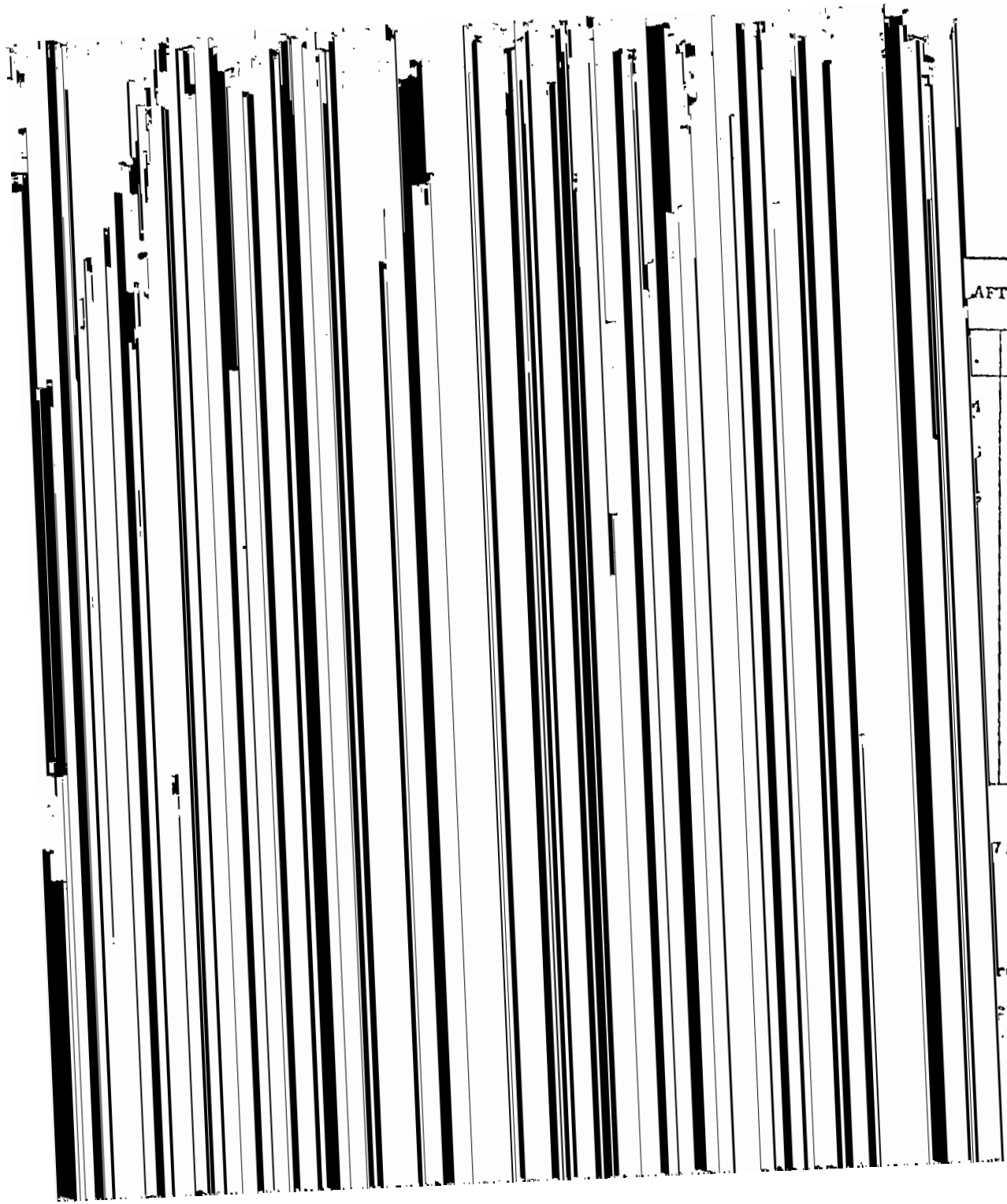
Data on trends in the region's imports from outside sources between 1963 and 1974, with breakdown by area of origin, are presented in Table 5. Over this eleven-year period, the region's total commodity imports have more than quadrupled, indicating an average annual compound growth rate of 13.7%. Imports from the U.S. increased at an average annual rate of almost 12%. The share of the region's imports originating in the U.S. declined from 50 to 41%, while the share of Japan, and particularly of the LAFTA countries, increased substantially. This shift in shares, however, must be attributed to considerations unrelated to integration, such as productivity and cost.

Admittedly, the above data are not conclusive proof that integration has not hampered the growth of U.S. exports to the region since we do not know what the trend in U.S. exports to Central America would have been without integration. There can be no doubt, however, that U.S. exports to the CACM have risen very substantially over the past eleven years, that the growth rate of these exports has far outstripped the rate of increase of the region's GDP, and that they are related to the region's accelerated economic development.

Trends in interest and dividend payments as well as in private investment must also be considered. Total net interest and dividend payments effected by Central Americans on foreign investments increased from CA$11.7 million in 1960 to CA$167.7 million in 1974 (Table 6). This indicates an average annual compound growth rate of 21% in these net payments over the fourteen-year period. Note that these payments represent a debit in the region's balance of payments, and a credit in the balance of payments of the recipient countries. Unfortunately, there are no data for the share that went to the U.S. Assuming that this share declined from 80% in 1960 to 70% in 1973[14/], net U.S. earnings on interest and dividend payments would have increased at an average annual compound growth rate of 20%.

The flow of direct private investment to C.A. (from all sources) increased from CA$21 million in 1960 to CA$72 million in 1973, or at an average annual compound rate of 10%.

14/ Based on data on trends in total foreign investments in Central America, broken down by source, contained in Gert Rosenthal's study on "The Role of Private Foreign Investment in the Development of the Central American Common Market", Tables III-2 and III-7, 1972 (unpublished).



AFTA[2]		Others[3]	
.	% of Total	$C.A.	% of Total
4	5.2	100.5	17.3
	5.9	126.1	16.7
	6.1	131.9	16.2
	7.2	132.8	16.3
	7.3	138.3	14.8
	8.9	163.2	15.9
	10.8	188.9	17.5
	12.7	166.6	11.4
	17.3	274.2	11.4

7.0% 9.5%

ruguay and Venezuela.

erland, Sweden,
.ria.

, Nov. 1973, Tables
1974. For 1974,

[redacted]

Table 6

Total Net[1/] Interest and Dividend Payments Effected by Central America on Foreign Investment and Estimated Interest and Dividend Payments on U.S. Investment

- Millions of SC.A. -

Year	Guatemala (1)	El Salvador (2)	Honduras (3)	Nicaragua (4)	Costa Rica (5)	Total CA Interest & Dividend Payments (6)	Estimated Payments to U.S.[2/] Each Year (7)
1960	10.4	3.9	-8.5	1.9	4.0	11.7	9.4
1965	17.5	7.7	13.1	12.7	13.4	64.4	51.5
1970	42.2	8.8	22.6	28.1	13.6	115.3	80.7
1971	44.0	10.2	22.7	31.6	14.6	123.1	86.2
1972	47.6	10.9	19.3	36.3	34.9	149.0	104.3
1973	48.4	8.4	21.3	41.9	41.1	161.1	112.8
1974 P	47.2	19.9	4.3	50.5	45.8	167.7	117.4

P = Preliminary

1/ Obtained after deducting receipts of dividends and interests on C.A. investments abroad.

2/ The U.S. share was estimated as follows: for 1960-65, 80%; for 1966-74, 70%. This distribution was based on the data provided by Gert Rosenthal in a study entitled "The Role of Private Foreign Investment in the Central American Common Market", Tables III-2 and III-7, 1972 (unpublished).

SOURCE: SIECA, for 1960 to 1973 VI Compendio Estadístico Centroamericano 1975, (Balance of Payments Tables, pages 351 to 356). For 1974, Centro América: Estadísticas Macroeconómicas 1971-1974 (Feb. 1975).

CONFIDENTIAL

[redacted]

While there are no figures for the United States, it can be assumed that U.S. capital constitutes a major part of direct private investment flows to the region. The book value of U.S. investments in the region is estimated to have increased from $343 million in 1960 to $653 million in 1973.[15]

The conclusion that emerges from this brief review of economic trends between the CACM and the U.S. is that the available statistical evidence does not support the contention that integration has depressed the growth rate of U.S. exports to the region. On the contrary, the rapid growth of U.S. exports to the CACM between 1960 and 1973 creates a presumption to the contrary. Of particular significance is the dramatic increase in the flow of dividend and interest payments that has occurred over this period, and which represents a credit in the U.S. balance of payments.

How important a place does the region occupy as a market for U.S.products and a recipient of U.S. investments? It is clear that, in spite of the growth trends of recent years, the C.A. region absorbs only a very small proportion of total U.S. exports, and accounts for only a very small proportion of the value of total U.S. overseas investments. In 1974, U.S. exports to the CACM constituted only 1% of total U.S. exports while the book value of total estimated U.S. direct investments in the C.A. region amounted to only 0.6% of the book value of total U.S. direct investments abroad as of 1973.[16]

These data may understate somewhat the economic importance of the C.A. region to the U.S. in view of the fact that the region is an important supplier of some important

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15/ Source: For 1960, Gert Rosenthal Op.Cit., Table III-6 and III-7. For 1973, Survey of Current Business, August 1974, Vol. 54, Part II, page 18.

16/ Source: For U.S. exports to the CACM, Survey of Current Business, August 1975, and Highlights of U.S. Export and Import Trade, March 1975. For U.S. Investment in C.A., Survey of Current Business, August 1974, Vol. 54,Part II, Page 18.

[redacted]

primary products, particularly coffee, sugar, bananas, meat and cotton. It is nonetheless clear from the foregoing that the main rationale for continued U.S. support for C.A. integration is not the importance of the C.A. region to the U.S. economy (which is obviously limited). The key elements in the rationale are that (1) integration is an important instrument in the economic development of the region, and (2) the U.S. has a stake in the peaceful development of the area and in its political stability.

D. Growth Prospects

What are the region's long-term growth prospects with and without further progress in the area of integration?

We should start by recognizing that the gains already achieved through integration are probably irreversible. The most likely choice is between the status quo and a further strengthening of integration. Thus even under the status quo assumption, we would expect faster growth in the areas of intraregional trade, investment, value added by manufacturing, and the development of the regional physical infrastructure than would have been possible if the countries of the region had attempted to develop as separate economic entities.

No study has been made to quantify growth prospects with full integration in comparison with growth prospects under the status quo. Of greater relevance is an analysis of the impact on economic growth of gradual progress toward integration, since this, rather than full integration, is likely to be the only politically feasible alternative to the continuation of the status quo.

While we cannot quantify the impact of further progress toward integration on the region's economic growth rate, the following considerations suggest that the impact of such progress would be significant:

a. Resolution of the El Salvador/Honduras dispute would pave the way to Honduras's rejoining the CACM. This would open the southern highway to El Salvador's exports, expand the

[redacted]

market for the products both of Honduras and of El Salvador, and increase Honduras's attractiveness to both foreign and regional investors.

b. Improvement of the integration machinery and increased cooperation among the C.A. countries would contribute to growth by eliminating, or at least substantially reducing, periodic interference with the free movement of goods across national borders (e.g., Nicaragua's recent restrictions on imports of textiles, apparel and shoes). It would also reduce the threat of imposition of unilateral exchange control measures or exchange rate readjustments, which have accompanied several balance of payments crises in Costa Rica in recent years. Improved coordination of monetary and balance of payments policies could head off problems before they reached crisis proportions.

c. Free competitive movement of agricultural commodities, particularly grains and perishable fruit and vegetable crops, will stimulate a more efficient allocation of scarce land resources to their production on the basis of comparative advantage, with income and price benefits for both producers and consumers.

d. Further improvement of the integration framework could be expected to promote the continued rapid development of production facilities of intermediate products. Some sizeable projects might never get off the ground without some indication of progress toward the reconstitution of a five-country common market. (There is evidence that Central American and foreign investors, in light of the CACM's uncertain future, are reluctant to invest in facilities whose output would be primarily oriented toward the regional market.)

III. POLITICAL TRENDS AND PROSPECTS

A. Successes, Stresses and War

In the early 1960's, following the signing of the General Treaty for Economic Integration, Central America experienced a period of rapid economic growth. Both trade and manufactures

expanded sharply. However, as pointed out by Isaac Cohen Orantes in his book, "Regional Integration in Central America", this was a kind of integration with substantial benefits and few costs. A truly regional economy, one which would require significant compromise and sacrifice, did not emerge. Friction developed among the five countries. The agriculture sector lagged, and the benefits of integration were unequally distributed among countries, between urban and rural sectors, and among social groups. The CACM, a limited mechanism, was not designed to solve many of the problems which underlay these imbalances.

Several abortive attempts were made in the late 1960's to deal with some of those problems, which contributed the El Salvador/Honduras war, and to carry integration further. In early 1969, CACM's Economic Council (the five Ministers of Economy) appeared to have achieved a significant breakthrough. In its Resolution No. 54 of March 22, 1969, it adopted a plan to expand the sphere of economic cooperation by establishing a customs union and a capital market, promoting extraregional exports and improving the coordination of policies relating to manufacturing, agriculture, infrastructure and monetary management. However, this action came too late to head off the effects of pent-up animosities and jealousies brought on by the imbalances among the Central American partners. The plan had hardly surfaced when war broke out in July 1969 between Honduras and El Salvador. Implementation of Resolution No. 54 was blocked, and the whole integration effort was seriously shaken.

B. Failure of Reconciliation

Three months after the fighting between El Salvador and Honduras had stopped, all five Foreign Ministers met again in an attempt to establish a "Modus Operandi" to salvage and expand the benefits of the regional movement. Although the attempt failed, four of the countries (except Honduras) continued to function as a free trade zone. They established a "Normalizing Committee" to exercise the function of the CACM's Economic and Executive Councils, and to develop proposals for rebuilding the integration system. Several additional attempts were made, culminating in the present effort, which stems from

the "Tripartite Meeting" (of Economic and Finance Ministers and Presidents of the Central Banks' held in Guatemala in December, 1972. At that meeting, the "Tripartite" established a High Level Committee (CAN) to review the proposals set forth in an exhaustive and ambitious SIECA study, 'The Integrated Development of Central America in the Present Decade' or "Decade Study". For the symptoms of disintegration, this study prescribed a massive dose of further integration, both economic and social. Subsequently, the CAN was directed by the five Presidents to produce a draft treaty for a Central American Economic and Social Community. At their meeting in November 1975, the Presidents told the CAN to finish the job by January, 1976.

C. The Principal Obstacles

1. Nationalism

While they share a common origin, there are significant political, economic, and social differences among the five countries. While it is clear that there is far more political, economic, and social contact than before 1961, the differences may have been reinforced by the snowballing of nationalist sentiment, particularly in the poorer countries, since World War II. To be sure, the five countries share a common language and at least important elements of a common culture. But this is a culture which emphasizes individualism a culture which does not attach high value to cooperation and compromise.

Symbolic of the problems that nationalism poses for Central American integration are:

a. the widespread pursuit of autarkic agricultural policies in response to burgeoning food import requirements.

b. the unwillingness of Guatemala and Nicaragua to interconnect their electricity grids with Honduras if the price is dependence on Honduran generating facilities.

c. Guatemala's apparent unwillingness to construct a road which would give it access to Puerto Cortez in Honduras (or perhaps better said, give Puerto Cortez access to Guatemala').

[redacted]

d. Costa Rica's recent pursuit of an expansionary monetary policy, serious consequences for integration notwithstanding.

e. the almost complete absence of multinational Central American ownership of C.A. corporations.

The 64 dollar question for Central America is: How much give is there in the nationalism which dominates policy-making? Until Central American political leadership gives content to its own integrationist rhetoric, the prospects are not bright for anything more than the status quo with respect to integration.

2. Limited Constituencies

Related to the nationalism issue is the fact that integration is not supported vigorously by the locuses of power in any of the countries. No significant political party places integration among its major immediate goals. The armies and the landed and principal monied elites, some industrialists excepted, are not pressing for or leading the integration movement. The agricultural sector plays a comparatively small role in integration. Labor, while on balance supportive, is too weak. The intellectual community, including the universities, is primarily concerned with basic political, economic, and social issues which are largely beyond the reach of integration. And the Church is both weak and unconcerned.

There is, however, in addition to the industrialists, an important constituency for integration among the technocrats. High and second level officials of Economic Ministries and Central Banks, and of Chambers of Industry and of Commerce, seem to appreciate the limitations of small markets, and the advantages of regional cooperation in achieving bargaining leverage both in the marketplace and among nations. The problem is that their interest is not paralleled by other government entities and, most importantly, by the political leadership.

[redacted]

3. El Salvador-Honduras Dispute

The most visible and immediate obstacle to progress on integration is the El Salvador/Honduras impasse. Honduras insists on a "global" solution, specifically including a clear and final demarcation of the border, based primarily on a historical rationale. El Salvador espouses a "progressive" approach, settling issues one-by-one, leading to the eventual resolution of the border question on a pragmatic basis. Meanwhile, trade between the two neighbors is halted, the Pan American highway is blocked for El Salvador, which in turn has blocked a needed capital increase for the regional integration bank (CABEI). Although Presidents and Ministers of all five countries meet frequently, and while sophisticated elements in both countries recognize the costly irrationality of the status quo, no one seems to be willing to take on the risks of a jingoist backlash to a rational initiative. It is now more than six years since the war.

4. The Problem of "Balanced" Growth

Underlying the El Salvador/Honduras dispute and the problem of limited constituencies is the problem of "balanced" growth. That is, integration must be patently beneficial to all five partners, with benefits distributed reasonably equitably. Some countries have benefited significantly more than others, bringing on jealousies and controversies which give rise to obstacles. Aside from the Honduran example, Nicaragua also feels threatened by the industrial exports of Guatemala, El Salvador and Costa Rica. Attempts to stem this flow by quotas or by border harassment increase friction. Pressures for autarky or ties outside the region arise. Lacking at present is a system for applying the measures necessary to promote balanced growth.

D. National Attitudes and Ideologies

The principal actors in Central American Integration are, of course, the five national states, not the integration institutions (such as SIECA, CABEI, etc.). All give frequent

and high level rhetorical support to integration, but each nurtures a particular and in some ways unique viewpoint on the question of regionalism.

Guatemala, historically the senior partner in the Isthmus, is both the most likely to progress alone and the most able to profit from integration, because of its greater size and more developed infrastructure. Guatemala's present government appears to appreciate the opportunities to be had from the larger, more stable, protected markets, from the economies in scale, and from the greater resource base and bargaining leverage available through integration. It is in the difficult position of being expected to exert leadership in the region, while not wanting to appear to be dominant. But, as the largest country and currently with the most vigorous economy, it may consider itself able to move acceptably alone.

El Salvador has been a supporter of some aspects of integration because its small size and population pressure compel its interest in the free movement of people and capital, particularly the former. El Salvador's leadership has been unwilling or unable in order to break the integration road-block, to make concessions on her claims to a few square miles of marginal frontier mountain land in dispute with Honduras. El Salvador has attempted to bring pressure on Honduras by blocking further capitalization of CABEI. Yet the Salvadorans took no retaliatory action for over five years against Honduras's blocking of the Pan American Highway, presumably in the hope that forbearance would lead to progress toward reconciliation--and integration. El Salvador and Guatemala have been the principal beneficiaries of integration.

Honduras, the least developed partner, seeks to reduce the gap with her neighbors. It requires assurance that it will be accorded special treatment as a pre-condition to integration, out of its own development aspirations and in the reasonable belief that the country would be taken over by Salvadoran and Guatemalan entrepreneurs and workers if the true C.A. community were established prematurely. Although surveys show that Honduras has benefited from the CACM, the Hondurans focus more on the far greater benefits which accrued to her neighbors.

Like El Salvador, Honduras has few hopeful alternatives to regional integration, but, unlike her more vigorous neighbor, is unprepared to commit herself to that alternative. Meanwhile, Honduras has entered into bilateral trading agreements with Guatemala, Nicaragua, and Costa Rica.

Nicaragua's unique political structure has made that country the region's most stable. General Somoza, like other Central American leaders, has paid extensive lip service to the ideals of regionalism. But, though he has attempted to reconcile Honduras and El Salvador, his pragmatism and personal economic interests have made the depth of his commitment to integration suspect. Aware of the impediments and pitfalls, his government and Costa Rica's are the least likely to be hustled into a quixotic stance in the cause of Central American unity.

Costa Rica, with reason, considers itself more advanced than the other four and tends to be condescending toward them. It entered the CACM reluctantly, fearful that the process would move it toward the lowest common denominator. While all Costa Rican presidents since 1960 have given rhetorical support to the CACM, Costa Rican actions (e.g., pursuit of regionally destabilizing economic policies, tardy approval of the San Jose Protocol's tax surcharge) have established it as a reluctant partner. The current GOCR position on integration is not hopeful: Costa Rica is prepared to move forward when the other Central American countries provide the same services and benefits to their workers that Costa Rica does to its own. Meanwhile, Costa Rica is exploring broadened trade relationships with Panama, Colombia, Venezuela, and the Caribbean Islands.

E. Prospects for Integration

In current and foreseeable circumstances there is little prospect of any dramatic change in the pace of Central American integration. Trade patterns may be irreversible, resting on the vested interests involved in $600 million of regional trade, most of it in manufactures. While the countries can find extra-regional sources for their imports, and often at lower cost, comparable alternative markets for their industrial exports are not available, in many cases because much of Central America's protected production is not cost-competitive in world markets.

The integration institutions with the exception of ODECA are functioning and are receiving increasing albeit still inadequate support from governments; and the unstable world economic situation is forcing greater attention to the needs for cooperative measures of economic defense and leverage. This in part explains the increased frequency of meetings at the Chief of State and ministerial levels.

But the facts remain:

1. Restructuring of the CACM has been discussed by the High Level Committee for more than two years, while a new draft treaty has been under review for one year without conclusion to date (although a deadline has now been set);

2. Few observers believe that a merger restructuring will be possible for the foreseeable future, even with a solution to the El Salvador/Honduras problem.

3. It has been more than six years since the war.

In these circumstances, some kind of mild draft treaty--or perhaps amendments to the existing General Treaty--may very well appear in 1976, as scheduled. But their ratification and implementation will be a long term proposition, probably not resulting in significant changes. Progress, if it comes, is much more likely to occur as a result of specific initiatives aimed at solving problems or exploiting opportunities.

Other possible scenarios exist, but they are unlikely:

-- prompt ratification of a new integration treaty with rapid movement toward a customs union, tariff reform, coordinated economic policies, strengthening of CABEI, creation of supranational machinery, etc.

-- a four-nation community, moving ahead without Honduras, but with the door open for her later participation.

[redacted]

-- further fracturing of the CACM, e.g., Nicaragua deserts because of its poor trade balance. Trade is governed by bilateral agreements.

IV. STRATEGY

> "To force the pace of integration is...to attempt to accomplish the impossible, given the existing structure of power in the countries of the CACM. But if the pace of integration cannot be forced, it is still worthwhile to patch over some of the more glaring inequalities and inefficiencies, to create a viable though less than perfect programme of integration. Sidney Dell wrote over a decade ago, '...if there is any region in the world that could benefit from economic integration that region is Central America.' His observation is equally valid today." 17/
>
> Eduardo Lizano and I.N. Willmore

To summarize the preceding sections:

1. Progress on Central American integration is not essential to the protection of U.S. interests; indeed, our major interests would not be seriously affected by collapse of the CACM.

2. Major integration reform is unlikely for the foreseeable future, even should the Honduras/El Salvador conflict be settled.

3. There have been significant economic growth benefits attendant to integration for all countries, although not in equal measure, not without some costs and not to all production factors. However, the stagnation of the integration movement means that increases in these benefits are likely to be smaller in the future.

17/ "Second Thoughts on Central America: The Rosenthal Report," Journal of Common Market Studies, March, 1975.

[redacted]

4. While Central American integration is not essential to U.S. interests in the Isthmus, both our political and economic interests would be served by further progress.

Given U.S. interests, and the uncertain prospects for Central American integration, what is the appropriate role for the U.S. and, particularly, ROCAP?

A. Options

We see four strategy options:

1. Phasedown or phaseout of the regional program (and ROCAP).

2. A targets of opportunity strategy, with ROCAP supporting useful regional activities but without expectation of major advances, at least in the short run. The program focus would be on institution building and economies of scale attendant to projects at the regional level. The presumption is that a modest technical assistance program would be continued and that loans would be made occasionally.

3. Concentration on one significant opportunity which offers the possibility of a major short-run advance in the integration movement. This option could involve a substantial loan program.

4. A major U.S. effort to revive the integration movement.[18/]

18/ Interestingly, Lizano and Willmore observe, "...it remains to be known why the United States, which excelled in the role of external catalyst for so many years, has not made any effort to resolve recent crises."

B. Pros and Cons

1. Phasedown or Phaseout

Pros:

a. May have shock effect: dramatizes need for Central Americans to help themselves.

b. Will reduce demands for limited AID resources.

Cons:

a. Would be risky: could be a serious psychological blow to integration.

b. Would be unlikely to result in significant progress on integration.

c. Could involve perceptible political and economic costs to the U.S. in Central America (i.e., the Central Americans would conclude that the U.S., which had a major role in forming the CACM, had reduced its interests in the Isthmus, continuing bilateral programs notwithstanding).

d. Could be interpreted throughout the Hemisphere as evidence that the U.S. is backing away from its support of Latin American economic integration.

e. Will require USAIDs to make other arrangements for some services (e.g., engineering, legal, procurement) which might be more costly and/or less efficient.

1a. Variant (proposed by Foreign Service Inspectors): Expand ROCAP's Diplomatic Function and Reduce its Development Function.

Pros: a. Will continue some tangible evidence of support for Central American integration.

b. Will reduce demands for limited AID resources.

Cons: a. There are limited opportunities for diplomatic dialogue at the current stage of evolution of the integration movement.

b. The shift of focus would reduce or eliminate U.S. opportunities to influence and support the development dimension of integration, which is currently far more significant than the political dimension.

c. The shift, even with the continued existence of a ROCAP, would be viewed by Central Americans as a setback for integration and evidence of flagging U.S. support.

2. Targets of Opportunity

Pros: a. Would demonstrate that the U.S. is hanging in there with the Central Americans.

b. Would require limited grant and loan resources.

c. Would permit some long-term institution building and provide some opportunity for economies of scale in AID programming.

Cons: a. Unlikely to contribute significantly to revival of the integration movement.

b. Unlikely to contribute significantly to development, at least in the short-or mid-term.

3. Concentration on one Significant Opportunity

Pros: a. Could contribute significantly to revival of integration.

b. Could contribute significantly to development.

c. Could enhance the U.S. image in Central America.

Cons: a. Such opportunities are hard to find.

b. Would increase demands on limited AID resources.

c. Taken alone, would neglect longer-term institution building and potential for economies of scale.

4. A Major U.S. Effort

Pros: a. Might result in a revival of the integration movement 'although its durability would be suspect'.

b. Would demonstrate heightened U.S. interest in the area.

Cons: a. It is unlikely that U.S. effort can substitute for Central American will, if lasting results are sought.

b. Major new demands might be placed on AID resources, quite possibly out of all proportion with availabilities or priorities.

C. Recommendations

1. That we pursue Option 2, which is essentially what we've been doing since 1973, when our last loans were made to CABEI. This will provide the U.S. with an opportunity both to support and influence integration at modest cost.

2. That, in addition, we explore, consistent with Option 3, the possibility of concentrating AID resources on removing obstacles to a significant expansion of intraregional trade in agricultural products, processed and unprocessed.

D. Criteria for ROCAP Programs

Most ROCAP projects fall within the Food and Nutrition category. Because regional institutions execute the projects, they usually do not directly reach AID's target group, although in all cases, this group is ultimately a beneficiary. However, while much of what ROCAP does helps Central America's rural poor, we believe that the Mandate is best applied bilaterally and that ROCAP's primary focus must be on the integration movement, which is, after all, the reason for ROCAP's existence (and one which has its own statutory basis). If a project which is important to integration has benefits for both small and large farmers, we would hope that this would not become a significant issue. Similarly, if a development possibility arises which is potentially significant for integration but is not related to the Mandate, we would expect that AID/W will accord it a competitive priority.

We identify three kinds of activities in which we judge it appropriate for ROCAP to engage. The line between the first two is not always a clear one.

1. Projects which Further Regional Integration

Such projects will normally involve both regional institutions and regional policies. While they must be coordinated with the bilateral USAIDs, they may involve objectives which are not directly relevant to bilateral programs. Examples: technical assistance for SIECA, the agricultural trade initiative (see below).

2. Projects which Directly Support Bilateral Programs and which Lend Themselves to Regional Application because of Potential Economies and Efficiencies

For such projects (e.g., the regional agricultural research cluster, support of INCAP), the closest possible coordination with the USAIDs is indispensable.

3. Centralized Services to the Bilateral Missions

This aspect of ROCAP's role was reviewed in depth by the Central American Task Force in 1973 and 1974. It was reviewed again by ROCAP and the USAIDs in November, 1975, and there is a consensus that the current servicing arrangements (in terms of people, not projects) are generally appropriate and adequate.

E. Program Structure

1. Food and Nutrition

a. Expanded Agricultural Trade

A seven-week review of integration trends problems, and prospects with U.S., international and agency, and Central American (regional institutions and national governments) officials has illuminated one possibility which, should it materialize, would be a major step forward in Central American integration and supportive of bilateral efforts: expansion of regional trade in agricultural products.[19]

The agricultural sector has received limited attention in the integration process thus far. The 1965 Tarifa Protocol, which set up a Central American grains system, has been only partially implemented. Whatever trade there is in agricultural products is limited, is often the object of prejudicial government action, and consequently often takes the form of contraband. The integrationist rhetoric of the Ministers of Agriculture in their recent meetings notwithstanding each of the countries is pursuing a policy of agricultural autarky.

19/ We have examined--and rejected--three other possibilities: (1) infrastructure (rejected because foreseeable financing requirements can probably be met by CABEI, IDB, and IBRD; also because infrastructure is not likely to provide a major new impulse to integration); (2) industry (rejected because the principal obstacles to industrial expansion are more psychological (uncertainty over the CACM's future) and political (e.g., the location of large new industries, the amount of tariff protection) than financial); (3) promotion of exports outside the region (rejected because such a program may well be more effectively handled at the national level, and then principally by the private sector; also because of the limited success of prior efforts).

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The benefits of opening up agricultural trade could be great: more efficient production in countries increase specialization according to comparative advantage; lower prices to consumers; greater probability of non-traditional agricultural exports outside the Common Market; better management of regional surpluses and deficits; expanded employment opportunities; a major new constituency for integration.

But the costs--particularly the political ones--and problems are also likely to be substantial: e.g., what do you do about the thousands-probably tens and perhaps hundreds of thousands--of farmers whose inefficiency has been subsidized by high national support prices which may well drop under a regional scheme? Are the Central American capable of setting up and running a regional agricultural institution or institutions when their corresponding national institutions are among the weakest? Are the countries prepared to accept increased dependency on one another?

While there are a number of partial studies of agricultural trade in Central America, and while some relevant data are available, the issue has not been addressed head-on, particularly in terms of the kind of cost/benefit analysis which would be necessary to interest the countries in a major new initiative. There is at the technical and ministerial level in all countries substantial interest in, and indeed enthusiasm for, studying the possibilities.

We propose to make funds available to SIECA to contract with a group of prestigious Central American professionals, at least one from each country, to do the cost/benefit analysis, and to develop recommendations to the governments with respect to policies, programs, and institutional arrangements. We believe that this work can be completed in less than a year.

If the study demonstrates the feasibility of major progress, and if it is clear that the governments are interested in pursuing the opportunity, we will prepare a plan,

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incorporating the study, which will relate proposed AID and perhaps other institution inputs to the steps the governments will take. We will present this plan to AID W before proceeding further with project analysis and design work.

The FY 76 Congressional Presentation contains a $15,000,000 loan entitled Regional Agricultural Marketing. We do not propose to move ahead with such a loan in the absence of significant measures by the governments to expand regional trade in grains. Should the governments be prepared to take such measures, we would then want to modify the loan to conform to the recommendations of the SIECA study described above. The modified loan might include, among other things, the financing of grain stockpiles and storage facilities. This would probably mean an FY 77 loan, an interim report for which accompanies this PAP. The interim report obviously must be speculative, as it anticipates the SIECA study.

Similarly, we do not propose to move ahead on the FY 77 Regional Wholesale Markets loan in the absence of significant measures by the governments to expand regional trade in fruits, vegetables, meat, eggs, milk, etc. Once again the SIECA study will be crucial, and the PRP that accompanies this PAP must be speculative.

Both of these projects, and possibly related technical assistance, will be addressed as revised PRP's in the plan, mentioned above, that we would present to AID W. It is possible that projects for subsequent years will also be identified. Once the plans were approved, we would then proceed to the PP stage on the FY 77 projects, and start the analysis/design process for subsequent year projects.

Because the agricultural trade initiative confronts some major political and administrative obstacles we are far from certain that a major new program will in fact materialize. However, we judge that there is enough of chance, and that the returns could be so significant, that the study would be well worth the modest investment. To maximize the probability that C.A. governments will respond to the program, we may want to consider packaging the A.I.D. loans.

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b. Agricultural Research and Services at the Regional Level

There is interest among the USAIDs, ranging from modest to intense, in the possibility that economies can be achieved and progress furthered by agricultural technical assistance activities at the regional level in support of national institutions and programs. Underway are the Research and Information project with IICA and the Fish and Multiple Cropping projects with CATIE. The principal question about these projects is the extent to which national institutions will make use of them; a related question is the extent of need for an intermediate agent between international and national research institutions. We intend to emphasize these aspects in evaluation of the projects.

c. Nutrition

While most of the USAIDs are actively interested in this FY 76-79 project, they have questions about its relationship to their own nutrition activities. We consequently plan on holding a meeting in Guatemala in January with representatives of each USAID present to modify the PP according to USAID needs. The revised PP should be in Washington shortly thereafter.

d. Rural Sector Management Improvement

Four of the five USAIDs want to go ahead with this FY 76 and fifth quarter project. The fifth has already made direct arrangements with INCAP for the same kind of program.

e. Mediterranean Fruit Fly

We still do not know enough about the economic costs of the infestation, the costs of control or eradication, and the best techniques to employ, to say whether AID should get involved, and if so, how. USDA is working on a study which should be available in the next several weeks, but we are not certain it will answer all our questions. We may have to finance a study of our own.

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f. Agri-Business Loan

Four of the five USAIDs are actively interested in ROCAP's pursuing this project, principally because they see the development of agro-industry as important in their countries and are concerned that funds available in national institutions are insufficient. The loan is being prepared for the FY 77 shelf. Should the SIECA agricultural trade study not prove out, or should the governments not be prepared to follow through on the recommendations of the study, then the agro-industry loan would probably be the only possible FY 77 ROCAP loan.

g. Land Sale Secondary Mortgage Market

This possibility was mentioned in the FY 76 PES and an IRR was reviewed and commented on by AID/W early in 1975. Three of the USAIDs are actively interested in it being pursued as a pre-feasibility study. We hope to arrange for the study within the next few months.

2. Education and Human Resources Development

a. Technical Assistance for SIECA

We believe that a continuing technical assistance relationship with SIECA has a high priority, and we plan on extending the SIECA/Brookings contract in FY 77. Before addressing the detailed scope of the new contract, which will have to be negotiated next summer, we plan on an evaluation of progress to date and have requested LA/DR/HS to arrange for an AID/W economist to perform the evaluation early in the Spring. The evaluation will emphasize both the quality of the work and its utilization.

The Secretary-General of SIECA has indicated that he attaches great importance to the establishment of a research center in SIECA. Other Central American technicians share his view. Although the Congressional Presentation sheet emphasizes agriculture, our support for a research center may well require that we move outside the mandate. Consistent with the earlier discussion of ROCAP's role, we feel that this should not be an issue.

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One issue that we believe [illegible] priority consideration for inclusion in the list of [illegible] dies is the question of the adequacy of current economic policies as a stimulus to growth and employment creation. In a time of consensus as to the need for rapid export diversification and expansion outside the CACM, the effect of current tariff and exchange rate policies should be examined with a view toward determining whether adjustments in these and perhaps other policies might not better respond to this consensus.

b. Transfer of Technology

Before concluding negotiations of this FY 76-78 project, we plan to have an independent consultant suggest some alternative approaches and/or modifications to the current design. The objective is to assure that we have the benefit of the latest thinking on how best to approach this opportunity.

3. Selected Development Problems

a. Housing

Our emphasis continues on low-cost housing. We will be evaluating the $46 million HG with principal emphasis on the low-cost component. Full draw-down is projected by January, 1979.

We will be shortly evaluating the housing technical assistance project to determine whether financial support after FY 76 is appropriate.

4. Over the Horizon: Projects That Cross Borders

We have generally, if vaguely, identified a kind of activity which may be appropriate for post-FY 77 lending. Several observers have noted that there may be opportunities to undertake projects that cross borders in both the physical sense and in the sense of capitalization. Irrigation,

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timber exploitation, and fishing (e.g., in the Gulf of Fonseca) are examples of the former; another way of characterizing the latter would be facilitation of the establishment of Central American multinational corporations. There is only one such corporation of significance in the entire Isthmus. These are nothing more than ideas at this point; they might well fall outside the mandate; but they might also be important to integration.

F. Our Future Relationships with CABEI and IDB

At the request of the MDCC, ROCAP has been working on an analysis of CABEI's performance and prospects, a second draft of which has been distributed to the Mission Directors. Its principal findings:

1. CABEI is a growing and profitable institution. Its earnings during the period FY 1970-1975 were as follows:

FY 1970	$ 3.4 million
1973	4.5 "
1974	5.3 "
1975	7.6 "

During the same period, cumulative loans increased from $327.7 million to $624 million; cumulative disbursements increased from $193.5 million to $357.4 million; and net worth increased from $45.5 million to $78.4 million. In FY 1975 both new loans and disbursements reached record highs.

2. Even were it to receive no additional capitalization or loans, CABEI would continue to be a profitable institution although obviously, its capacity to finance new projects would be severely constrained.

3. There are fair prospects for additional concessional lending to CABEI by IDB, and perhaps AID. The IDB is studying a formula that will permit it to channel at least some resources to CABEI. CABEI is likely to expand its borrowing in international capital markets.

4. CABEI has operated most successfully in infrastructure projects.

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5. CABEI's lending to the private [illegible] is subject to some criticism, particularly on the grou[illegible] bureaucratic sluggishness.

In these circumstances, we see no re[illegible]n why AID should continue to consider itself the prim[illegible] patron of the bank. We believe that ROCAP should con[illegible] loans to the bank when it is a convenient and economical [illegible]s of achieving priority program objectives (e.g., in agri[illegible]ural trade). Should this mean a suspended period witho[illegible]ans for CABEI (as has happened since 1973), so be it.

(With respect to the proposed CABEI [illegible]cial Development window, we have advised CABEI's president [illegible] (1) if a study demonstrates the need; (2) activities will [illegible] duplicate those financed by other institutions; and (3) th[illegible]ntries support it, we are prepared to recommend to AID/W [illegible] Social Progress Trust Fund reflows be made available to the [illegible] window.)

Similarly, as loan 012 approaches [illegible] final disburse-ments, we wish to avoid any impression of [illegible]inuing financial responsibility for INCAE. If INCAE can [illegible] our program purposes (e.g., the Rural Sector Management Improvement project), fine. If not, fine.

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