PN-AAU-305

Country Development Strategy Statement

FY 1984

ROCAP

January 1982

Agency for International Development
Washington, D.C. 20523

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R O C A P

COUNTRY DEVELOPMENT STRATEGY STATEMENT

FY 1984-88

February, 1982

FOREWORD

The continuing crisis in Central America dictates that this year, as last year, the ROCAP CDSS address issues of immediate concern as well as those of the period covered by the Strategy Statement (FY 1984-1988).

ROCAP believes that it has the responsibility as the regional office to describe the current problems in their total regional dimensions, offer estimates of the external resources needed to deal with the problems and suggest possible approaches to their solutions. Because the resource requirements far exceed the funding available through AID, we have adopted this approach in the hope that it will provide a framework for discussing AID assistance, in the aggregate, as part of a coordinated donor assistance program and a means for achieving consistency in the use of AID resources provided through regional and bilateral channels.

In spite of the additional financial assistance which entered the region in 1981, the economic crisis described in last year's CDSS has deepened sharply and the situation is worsening at an alarming rate. In order to provide a separate analysis of this situation, this year's CDSS is divided into two major sections: one of immediate concerns; the other, of medium-term interests. Part I describes some of the socio-political and economic causes of the crisis, the macro-economic dimensions of the problem, the resource gap that must be filled if the deficits are to be made up and proposes a ROCAP strategy and program to address some elements of the crisis. Part II of the Statement deals with selected regional problems not directly related to the current situation, presents the 1984-1988 ROCAP strategy for dealing with them and estimates the resources that will be required to implement a program based on that strategy.

I. The Nature of the Crisis and U.S. Interests

The underlying cause of social unrest and political instability in Central America is the widespread demand of large numbers of people in the region for fundamental changes in the system which is perceived as having ignored their needs, trampled basic human rights, and failed to address long-standing inequities. Dramatically reduced purchasing power and spreading unemployment are providing further impetus to radical involvement by many. The fact that some elements of the society have resorted to violence and armed struggle, supported and encouraged by forces outside the region, should not obscure the more fundamental fact that Central America is in the throes of an indigenous social revolution which will, almost certainly, change the traditional power structure. The upheaval can be expected to continue until new relationships are established and a new power structure is consolidated. The process is most advanced in Nicaragua, where control of the machinery of government has been achieved by force of arms, but where the power relationships among the government, labor, the private sector, and the church have not yet been clearly defined. It is least evident in Costa Rica where democratic traditions and more equitable distribution of income and wealth have alleviated many of the causes of social unrest.

The U.S. has an important national interest in the kind of power structure which emerges. At issue, in a fundamental sense, are basic social values such as the primacy and dignity of the human person and respect for basic human rights; participation in the process of political decision-making; and equitable access to work, social services and property which permit individuals to contribute to and share more equitably in the benefits of economic and social development. It is important to the U.S. national interest that the new social structures which evolve are ones which incorporate and defend these basic social values which are the basis of the U.S. society. If the socio-political systems which emerge in Central America represent a rejection of those values, the interests of the United States will be adversely affected in the extreme, not merely in terms of economic and security interests as we traditionally define them, but in terms of the credibility of our basic value system throughout the world. The Central American people generally share a value system very close to our own and their current struggle reflects the desire to see those values accepted and institutionalized as operating principles of the social system. But the outcome is in doubt because Marxist-Leninists have seized on the struggle as a means of grasping power and imposing their own system of social organization.

The challenge to U.S. foreign policy in the region is to find ways to identify and support the forces for change that are oriented toward the evolution of a new system based on, and protective of these basic social values. This is not an easy task because of the polarization which has already taken place. Leftist forces inimical to a democratically-oriented society have been able to play with increasing success on the desperation of discontented groups to gain their sympathy and support for change through violence and force of arms. In Guatemala and El Salvador, the insurgents with training, financing and arms from abroad, are bent on demonstrating the inability of the security forces to control their operations and prevent terrorist attacks designed to cripple the economic system by periodic bombings of banks, factories, commercial buildings, power installations, bridges and transport facilities.

Indiscriminate repression and atrocities against the left, moderates and innocent bystanders by extreme rightist forces who oppose all change in the system has increased the polarization. Elements in the middle who are supportive of the basic social values have been murdered, forced to flee their countries or have become less inclined to take any sort of action to support constructive change lest they be identified as subversives or in the fear that any new power structure emerging may be worse than the old. Still another group simply does not perceive social conditions as a root cause of widespread discontent with the system and the basis of the present political turmoil, and places all of the blame for the area's problems on an international leftist conspiracy and communist agitation.

The process of defining and institutionalizing a new social order in Central America is likely to be lengthy, and the opportunities for supporting democratic forces for social change limited until the violence subsides and the political picture is clarified. During this period, the importance of maintaining the development progress already achieved cannot be over emphasized. Those who seek to change the power structure by violent means focus much of their effort on disruption of the economic system. Thus, the maintenance of production, income and employment has a basic political dimension, and the current stagnation and deterioration of the Central American economies and of the regional trading system must be viewed in these terms.

The further deterioration of the economies of the Central American countries will play into the hands of those fomenting change through violence by increasing social unrest and the political instability of the region. The main task of international development assistance -- and particularly the

U.S. -- in the short and medium term, therefore, is to help the Central American countries to maintain levels of production, income and employment and the regional system which has enabled them to attain these levels, thereby preserving the progress achieved thus far and assuring the existence of a base from which to continue development efforts once the political situation so permits.

The Central American countries are facing a conjunction of factors that have brought the region as a whole to a point of serious crisis. The world economic recession, the contraction of demand for traditional exports, the increased price of imports, particularly petroleum, high interest rates and accumulated foreign indebtedness are some of the principal factors which have drained international reserves, reduced fiscal revenues and constrained bank credit. These contractionary forces, along with increasing violence and political instability, have generated reinforcing movements such as the decline of private investment, capital flight, and drying up of external credit. These elements in combination have brought the regional generally to a "no growth" or negative growth situation. The economic climate is now one in which discontent and radical solutions thrive.

An important element of this dismal picture is the Central American Common Market (CACM). The expansion of intraregional trade and the development of an industrial sector resulting from the creation of the CACM was a major dynamic element for growth during the 60's and much of the 70's. Under the onslaught of contractionary economic forces and political divergence, intraregional trade declined in 1981 (even in nominal terms) and is likely to decline further in 1982. Thus, the CACM now faces a serious threat of further disintegration. The major problem of the moment is that with international reserves exhausted and currency convertibility lost, intraregional trade cannot be financed. El Salvador and Nicaragua have accumulated large debts in the C.A. Clearing House and creditor nations (mainly Guatemala) are unable, because of their own balance of payments problems and declining reserves, to continue financing intraregional trade. Countries have thus been forced to adopt defensive measures which restrict trade and, in essence, foster a process of reestablishing obstacles to trade that move the C.A. countries back toward the conditions which existed prior to the General Treaty.

If this process continues, it will not only aggravate the political problems by reinforcing the contractionary process throughout the region, but will also confront new governments which may come to power with unmanageable problems which will threaten their ability to govern.

Moreover, the disintegration of the CACM will create conditions which will make it difficult to design effective, longer-term assistance programs to stimulate extraregional exports and encourage foreign private investment. It will move the countries toward an autarkic development approach which, given the limited size and scope of national markets, is virtually a condemnation to continued dependence on traditional exports and high vulnerability to external market forces. With similar resource bases and economic structures, autarkic national development emphasizes the competitive features of the national economies — a situation likely to create frictions and antagonisms among the nations and further aggravate political differences.

The most important consideration, however, is that the functioning of the CACM is essential to the preservation of the private industrial sector and to the longer term prospects of the region's ability to resume a growth path. In short, the whole question of the ability of the private industrial sector to take advantage of trade liberalization or investment incentives offered by the United States and to have exports become the key impetus to renewed growth becomes academic unless the private industrial sector can survive the present crisis, as does the ability of the private sector to act as a moderating political force since the private industrial sector has the bulk of the most progressive businessmen in the area.

Two high priority (and interrelated) assistance needs emerge from our analysis: (a) the need for fast-disbursing balance of payments assistance to provide the private industrial and agricultural sectors with the foreign exchange reserves required to import essential raw materials, intermediate goods and spare parts from outside the region; and (b) the need for external resources to finance intraregional trade in order to support an adequate level of income, and employment in the private industrial sector and to maintain the main pillar of the integration movement. For their part, the C.A. countries must be required to adopt certain corrective steps designed to gradually reduce the disequilibrium in their overall balance of payments, and to remove the obstacles (e.g., balance of payments measures adopted unilaterally and misaligned foreign exchange rates) that impede the free flow of intraregional trade.

This problem has been uniformly and consistently recognized by the governments of the Central American countries. Because of its fundamental importance to all of them, it is a problem which transcends political differences and is the issue on which all five countries have been working together in periodic meetings of Ministers of Economy and Central Bank Presidents, in an effort to find a solution. In the next section, we will examine this problem in more detail, look at alternative solutions, and make some specific recommendations.

II. Economic Overview of the Crisis

The seriousness of the current economic crisis and its impact throughout the region can be quickly demonstrated through a review of the following key statistical measures: the balance of payments, net international reserves, fiscal deficits, and GDP growth. For each, the data show that the economy has been badly shaken. Without outside assistance the crisis will deepen, building with it considerable danger of seeing much of the progress achieved over the past two decades lost as the various governments' ability to finance production requirements declines and the mechanisms needed for trade collapse.

1. The Balance of Payments

Since 1979, the countries in Central America have experienced a significant deterioration in their current account position and, in 1981, each experienced a substantial current account deficit. Between 1979 and 1981, the region's consolidated current account deficit increased from \$744 million to \$1.9 billion (155%); another 8% increase in the deficit (to \$2.1 billion) is projected for 1982. Over the same period, the region's combined balance of payments deficit increased from \$320 million to \$688 million (115%), and an increase to \$750 million is projected for 1982 (the Central American Monetary Council estimates the deficit may climb to as high as \$1 billion in 1982).

The following table summarizes the overall balance of payments situation as of Dec. 81 (in millions of current U.S. dollars).

	Deficit (-) or Surplus (+) on current Acct.				Overall Balance of Payments Deficit			
	1979	1980	19[illegible] (Proj.)	1982 (Proj.)	1979	1980	1981 (Proj.)	1982 (Proj.)
Guatemala	-206	- 163	- 531	- 505	- 15	- 250	-343	-251
El Salvador	132	- 86	- 227	- 344	-108	- 196	- 59	-237
Honduras	-192	- 321	- 299	- 354	- 17	- 61	- 97	- 76
Nicaragua	124	- 365	- 374	-	- 80	- 169	- 34	
Costa Rica	-602	- 661	- 511	- 526	-100	- 456	-155	-150
TOTAL	-744	-1596	-1942	-2103 1/	-320	-1132	-688	-748 1/

Although dismal, these figures significantly understate the severity of the crisis. A much more serious balance of payments gap was avoided through the forced reduction of imports throughout the region and the imposition of tight foreign exchange controls. In El Salvador, imports declined by 25%-30% in real terms between 1979 and 1981, while in Costa Rica imports were down 22% and in Honduras 4% over the same period. In Nicaragua, imports declined by 20% in real terms in 1981. Thus, to a large extent, the adjustment to the region's substantial balance of payments disequilibrium has taken the form of a contraction of income and employment, and is not reflected in the deficit statements.

2. Net International Reserves

As the region's balance of payments deficit has increased, international reserves, which are used in part to cover the deficit, have declined

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1/ In totalling, it was assumed that the 1982 figure for Nicaragua was the same as for 1981.

sharply. Three countries in the region -- El Salvador, Nicaragua and Costa Rica -- now have negative net reserve balances.

Net international reserves declined from a positive $856 million at the end of 1979 to a minus $60 million a year later. They are estimated to have deteriorated to a minus $385 million at the end of 1981. Thus, reserve reduction is no longer available as a means of financing the region's balance of payments deficits.

	Net Int'l. Reserves ($ Millions)		
	12/31/79	12/31/80	Latest Date
Guatemala	698.3	413.1	229.0 1/ (12/30/81)
El Salvador	126.3	- 69.9	- 97.0 (8/31/81)
Honduras	116.2	55.1	31.9 (8/31/81)
Nicaragua	-192.6	-362.8	(-363.0) 2/
Costa Rica	117.0	- 95.3	-186.3 (12/31/81)
TOTAL	856.2	- 59.7	-385.4 2/

1/ As calculated by the Central Bank of Guatemala. Net international reserves were only $60 million according to the IMF formula.

2/ No data for Nicaragua are available. Net international reserves were assumed to be the same as at the end of 1980 in summing.

3. Fiscal Deficits

From 1979 to 1981, the budget deficits of the five Central American countries have increased, with the combined deficit growing from $640 million to $1.5 billion. Approximately, the same level is projected for 1982. As a result, resources available to meet private investment demand have been significantly reduced. Guatemala has cut back its planned investment expenditures for 1982, but in El Salvador and Honduras the deficits are scheduled to increase substantially:

	Central Govt's Overall Budget Deficit (-) ($ Million)			
	1979	1980	1981 (Proj.)	1982 (Proj.)
Guatemala	- 148	- 368	- 698	- 453
El Salvador	- 24	- 199	- 191	- 384
Honduras	- 74	- 193	- 196	- 352
Nicaragua	- 125	- 189	- 275 1/	N/A
Costa Rica	- 269	- 328	- 105 2/	- 109 3/
TOTAL	- 640	-1277	-1465	-1498 4/

1/ Converted at the official rate of ₡10 to $1.

2/ Converted into dollars at ₡20 to $1 (for 1981).

3/ Converted into dollars at the current free market rate of ₡40 to $1 (for 1982).

4/ Nicaragua's 1982 deficit was projected at $200 million in totalling, though no data for Nicaragua are available at this time.

The causes of the rapid growth of the region's fiscal difficulties include:

a. Increased expenditures for employment generation in response to social unrest and political pressures -- particularly in Nicaragua and El Salvador. In both countries, the governments felt compelled to expand public sector employment to partially offset contraction in the private sector.

b. Substantial increases in current expenditures related to the need to staff completed capital projects.

c. Increases in living costs which have led public employees to demand and obtain substantial increases in wages and fringe benefits in Costa Rica, Honduras and El Salvador.

d. Stepped up security expenditures in all countries of the region, with the possible exception of Costa Rica.

e. Reduction in tax collections, including collections from income tax, import duty collections on non-essentials and, particularly, from the coffee export tax.

4. GDP Growth

The various factors described above have resulted in the stagnation -- and, in some countries, a significant decline -- in the level of the real GDP over the period 1979-1981. This represents a major change from the pattern set over the past twenty years when annual growth rates throughout the region have been about 5%. As shown below, Guatemala is the only country which expects to have a positive, albeit minimal, real GDP growth rate. The other countries in the region will experience either zero or sharply negative growth rates.

	Real GDP Growth Rate (%)		
	1979	1980	1981 (Proj.)
Guatemala	4.5	3.5	1
El Salvador	- 1.5	- 9.6	- 9.5
Honduras	6.7	2.4	0 to -2.0
Nicaragua	-24.0	10.7	0
Costa Rica	4.9	1.2	- 1 to -2

III. The Strategic Importance of Intraregional Trade

Since its establishment in 1960, the Central American Common Market has generated a phenomenal expansion (3,450%) of intraregional trade and has stimulated the development of the manufacturing sector and the growth of private investment. Between 1960 and 1980, the total value of intraregional trade increased from $32.7 million to $1,160 million or at an average annual compound rate of 20%. Between 1960-1968, when intraregional trade expanded at an annual rate of 29% in current prices, value added by the manufacturing industry increased, in real terms, at an average compound annual rate of 8.7%, and private investment spending by 7.6%.

The creation of the regional market and the opportunities it provided for trade expansion were the major dynamic elements for growth and integration of the economies of the region during the 60's and early 70's. Despite the damage done to the institutional system of the Integration movement by the El Salvador-Honduras war, regional trade continued to expand at impressive rates until the late 70's. The expansion of intraregional trade reflected principally the growth of the manufacturing sector which was stimulated by the opening of the regional market.

An analysis of recent trade data shows that 87% of all intraregional trade consists of manufactured products.[1/] Thus, in 1980 the value of the portion of intraregional trade attributable to manufactured goods was approximately $1 billion. Moreover, 63% of the region's total exports of manufactured products were destined for the regional market.

Thus, the functioning of the regional market is critical to the economic viability of the manufacturing sector. The empirical evidence is conclusive. The decline of intraregional trade in 1981, principally as a consequence of the inability to finance it, has led to employment reductions and plant closings throughout the region. The prospect of a contracting regional market is in itself a strong disincentive for private investment in an already unfavorable investment climate.

The principal cause of the decline in trade is the serious balance of payments difficulties being experienced by the countries of the region with the consequent inability to finance intraregional trade. In response to trade deficits, reserve losses and pressures on exchange rates, countries have adopted unilateral measures to meet balance of payments problems.

Traditionally, the Central American countries have been careful to give special consideration to goods originating elsewhere in the CACM when adopting measures to protect their balance of payments position. Tariff surcharges, import licensing and exchange control measures usually have been directed at

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1/ In estimating the value of manufacturing exports traded intraregionally, only the amount of value added by processing was counted in estimating the value of foodstuffs.

goods originating outside the CACM. In recent months, however, the deficit nations have taken steps to reduce all imports, including those from the CACM. Thus, Honduras' import duty surcharge of 10% on consumer goods and 5% on raw materials was applied regardless of source or origin. Nicaragua levied a set of consumer taxes on selected products. According to SIECA, most of the products selected consisted of imported goods, including goods from the CACM, thus discriminating against CACM versus Nicaraguan goods. Import licensing and exchange control measures applicable to current transactions are in force in Nicaragua, El Salvador and Costa Rica.

The basic problem is that currency convertibility has been lost as a consequence of the decline or disappearance of reserves in some countries. Exporters require payment in hard currency but importers cannot obtain foreign exchange. Clearing house balances must be settled in hard currencies and exporters now demand payment in advance of shipment to deficit countries such as El Salvador and Nicaragua. Creditor countries such as Guatemala holding large and apparently uncollectable accounts in the clearing house, are unwilling to extend additional credit especially when they see their own balance of payments problems growing. Costa Rica, normally with a small surplus in the CACM, cannot finance trade or even pay for its imports because of its negative reserve position. Financing is not available from the Central American Monetary Stabilization Fund because its resources are fully loaned.

In an effort to deal with the problem of financing intraregional trade, the Central Americans, in May of 1981, established the Central American Common Market Fund as a separate operation in CABEI for the purpose of financing intraregional trade deficits. The Fund began operations with proceeds of a

$50 million loan from BLADEX, which has already been utilized. In January, 1982, the Central Americans agreed to capitalize the Fund with up to $100 million of local currency resources in the hope that IDB would find a way to provide at least an equivalent amount of hard currency. Without hard currency resources, the Fund will be ineffective, but the Central American countries do not have foreign exchange resources with which to capitalize the Fund. Thus, external assistance to the Fund, or through some other mechanism for financing intraregional trade, is necessary to keep the Common Market functioning.

Preservation of the Central American Common Market is an agreed objective of all five Central American governments and is earnestly desired and strongly supported by the private industrial sector. Despite the intensity of political frictions, the Central Bank Presidents, Ministers of Economy and Vice-Ministers of Integration have continued to cooperate in an effort to deal with the immediate crisis. They have consistently emphasized to donor agencies that the balance of payments and intraregional trade problems are top priorities which must be addressed.

ROCAP is convinced that maintaining the Common Market is essential to the economic and social development of the countries of the region. It is imperative to arrest the deterioration of the market because failure to do so will:

-- lead to disinvestment and further weakening of the industrial sector and thus erode the potential for achieving economies of scale and expansion into new export markets.

-- render trade concessions and investment incentives contemplated in the Caribbean Basin Initiative ineffective.

-- reverse the movement toward free trade in the region.

-- leave in place a series of new obstacles to trade and perhaps generate new ones, thus moving the Central American countries back toward the pre-CACM days.

-- lead to further economic contraction with attendant income reduction, increased unemployment, and psychological impact on the lower income groups and thus add to the social unrest and political dissatisfaction which is already widespread.

-- complicate the already difficult problems of new governments coming to power and threaten their political support and stability.

-- erode the institutional as well as the structural economic base for reviving and eventually restructuring the Common Market.

To prevent further deterioration of the Common Market it is necessary to confront the problem of financing intraregional trade. This problem should be dealt with in the larger context of a program to deal with the anticipated balance of payments gap of the region as a whole. However, because the resource requirements are very large and because the problem is complicated by the varying conditions and peculiar difficulties which the member countries face, it will require a coordinated approach of all interested donors and the channeling of resources through both regional and national institutions.

IV. Outline of an Approach to the Region's Macroeconomic Problems

Given the magnitude of the region's balance of payments deficit projected for 1982 -- in the range of $750 million to $1 billion -- it is clear that the U.S. can be expected to contribute only a fraction of the amount required. Thus, there is a key role for the Donor Coordination Group established late last year as part of the Caribbean Basin Initiative to address the foreign exchange gap problem of each Central American country. That Group, which, thusfar, includes the IBRD, the IMF, the UNDP and ECLA, is chaired by the IDB. Work groups already have been established to begin studying technical assistance requirements. To be most effective, we recommend that the Group be expanded to include the U.S., Canada, Mexico and Venezuela. These donors were not represented at the first meeting in January of 1982, and we urge that all appropriate steps be taken to involve them in the work that is getting under way.

The most pressing need for donor coordination is in the area of fast-disbursing balance of payments assistance. We recommend that the agenda of the Group include the following priority items:

a. Determine the appropriate order of magnitude of each country's net foreign exchange resource gap over 1982-83. The projection would assume that real GDP growth should be equal, at a minimum, to the rate of population growth to prevent further declines in the real per capita GDP.

b. Define the self-help measures that each C.A. government should adopt to cope with the disequilibrium in its balance of payments and fiscal accounts; and to revitalize the private sector.

c. Estimate the magnitude of the private sector's credit requirements, particularly for working capital purposes in terms of both domestic currency and foreign exchange resources; and determine what measures international donors and the region's central banks could take to mobilize the necessary credit resources and channel them to the private sector to enable it to rebuild its working capital and replace canceled foreign credit lines,

d. Develop an agreed program (among donors) to help meet the region's foreign exchange gap. Specifically, how much can each donor contribute to each C.A. country that qualifies? Through what mechanism would the assistance be channeled, for what purposes and on what terms?

We would recommend that the various issues raised above be examined by the Donor Group in separate negotiations with each of the five C.A. countries as responsibility for monetary-fiscal policy and for economic planning is still the prerogative of the various governments. On the other hand, there are a number of issues that have a regional focus and should be discussed by the Donor Group with the Central American Monetary Council and CABEI. These include:

a. Impress upon the C.A. countries the need to review protective balance of payments measures adopted unilaterally that interfere with intraregional trade and hence aggravate the balance of payments problems of the region.

b. Assist CABEI in its efforts to obtain resources for the Central American Common Market Fund set up last summer by the Central Americans to finance intraregional trade; and assist CABEI in obtaining long-term loans for regional development projects.

c. Review the suitability of current exchange rates and exchange control measures, and examine what measures could be taken jointly by all countries to help cope with the balance of payments problem.

The development of an effective approach to the region's balance of payments and credit problems will involve use of all available mechanisms and sources of financing. Most of the assistance will no doubt be channeled to the region through bilateral mechanisms and programs. The main sources of bilateral economic assistance include:

- IMF standby or Extended Fund Facility arrangements;
- AID bilateral balance of payments assistance coordinated with IMF standbys;
- IBRD Structural Adjustment Loans;
- Credits for oil imports under the Mexican-Venezuelan agreement;
- Export-Import Bank, PL480 (Title I) and Housing Investment Guarantee loans.

In last year's CDSS, ROCAP suggested that total loans from these various sources could amount to $600 million to $700 million a year in both 1982 and 1983 (see Illustrative Assistance Table on Page 22). The 1982 gap is now expected to be slightly larger. However, it is already clear that these greater needs have been anticipated by the Caribbean Basin Initiative and are reflected in the $300 million Supplementary Assistance package for the Caribbean that is currently before Congress. In addition, the guarantee system for short-term commercial bank credit to finance the importation of essential raw materials, intermediate goods and spare parts for manufacturing, industry and agriculture, which is also being considered as part of the CBI, will make a significant contribution toward financing this gap, and ROCAP fully supports its development. Nonetheless, even if the full $300 million guarantee authority were used for Central America, it would only meet 60 to 75 percent of the total regional requirement for this type of credit.

We see two major elements of a regional economic assistance program which will complement and expand the coverage of these initiatives:

a. To bolster support for the private industrial sector and encourage producers to export to hard currency countries, we propose the establishment of a revolving foreign exchange fund. The fund would be designed to finance the importation of raw materials and intermediate goods for the production of merchandise destined for extraregional markets. To achieve this objective, credits to Central American producers, plus interest charges, would be repayable only in dollars or other hard currencies and, thus, would be self-perpetuating in the sense that the fund would not periodically run out of foreign exchange. ROCAP proposes to create such a fund through a loan to CABEI. There are two primary reasons supporting this strategy: (1) CABEI can use the U.S. and other donor contributions as leverage to obtain additional funds from U.S. commercial banks; and (2) it provides a mechanism for channeling resources to qualified private [redacted] cal reasons, the U.S. does not want to make bilateral loans or increase the current level of direct U.S. development assistance.

Under the Rural Agribusiness loan, CABEI has established a mechanism for channeling resources to the central banks and national private banks and has four years of experience in managing a fund with characteristics similar to the one proposed here. We have been working closely with CABEI to improve its performance under the Agribusiness loan and progress has been made over intraregional trade which, as we have noted, may break down completely in the absence of financing for the outstanding deficit balances.

V. The U.S. Role

The U.S. is already contributing to resolving the region's macroeconomic problems through new or expanded ESF programs for El Salvador, Costa Rica and Honduras. In our view, the omission of Guatemala in this effort is a serious mistake because of that country's importance to intraregional trade and the moderating influence which the private sector there can have in that country's political direction. It is equally important to support the large and influential private sector for its positive impact on the national and regional economy. We would also recommend that the U.S. consider providing resources, through regional channels, to set up funds to finance imports of raw materials and intermediate goods to manufacturing industries which export to hard currency countries as described above.

Finally, ROCAP would recommend that AID and State re-examine their position with respect to a U.S. contribution to financing intraregional trade. If the Donor Coordination Group decides to provide funds to CABEI for that purpose, we believe that the U.S.G. should not refuse to participate. In addition to the fact that U.S. participation would be a forthcoming and positive response to proposals consistently advanced by Central American officials and by the private sector, it would give the U.S. a vehicle for influencing the terms and conditions governing the use of the resources. U.S. participation would signal U.S. interest in keeping alive Central American cooperation on regional problems and stimulate further efforts in this direction.

It is not suggested that the U.S. economic assistance -- or international donor assistance generally -- be offered unconditionally. In a number of cases, effective self-help measures are essential if economic assistance is to be more than a stop-gap measure. For example, contributions to the CA Common Market Fund by any or all donors should be conditioned upon a thorough review of the measures recently adopted by the Central American countries to improve their balance of payments position by restricting imports, thereby impeding the flow of intraregional trade. The assistance should be conditioned upon the removal of obstacles inimical to such trade. Moreover, any ESF bilateral assistance for balance of payments purposes should be conditioned on the countries negotiating -- and complying with -- a standby or EFF agreement with the IMF.

ROCAP CDSS

FY 1984 - 1988

Part II

The ROCAP Strategy for the CDSS Period

The economic aspects of the crisis, if not the political effects as well, will extend well into the CDSS period. Even under ideal conditions, it will require several years to begin to undo the economic damage done thus far. Of necessity, a part of the ROCAP strategy during FYs 1984-1988 will continue to address some of the problems resulting from the crisis. The balance of the strategy will address itself to problems of a longer-term nature not directly related to the crisis, but which constitute real impediments to economic growth of the region.

Some of the specific ROCAP functions during the period will be:

- Assisting regional institutions and programs which support growth through integration to sustain and continue their operations during the crisis.

- Helping the industrial sector meet its credit requirements to enable it to maintain regional trade for the well-being of the area and continue extraregional exports for improvement in the general balance of payments situation.

- Developing analysis, information and programs aimed at reducing selected long-term constraints to regional economic growth, particularly those in agriculture, energy and environment.

During the period 1984-1988, as in the past, ROCAP will undertake projects only when it is clear that the activity will be more effective at the regional than the national level, when a regional activity can support national programs, or when there are evident economies of scale in a regional approach to solving common problems, e.g., pest control, planning or agricultural research, where lessons learned at the regional level are applicable in more than one of the countries of the area.

These activities will often be experimental or exploratory in nature and will include studies, surveys and testing of prototype programs of common regional interest, designed to provide data and recommendations which can be used at the national level.

The following sections describe the proposed ROCAP program for the CDSS period. They have been developed so as to conform with these basic criteria.

Private Sector

I. The Problem

A development assistance strategy which relies heavily on the functioning of a market economy and a major role for private investment as a dynamic force for growth faces particularly difficult problems in Central America at the present time. Beset, in some countries, with a concerted attempt by the violent left to disrupt the economic system, by a poorly defined and constantly shifting policy framework imposed by the government, by concentrating markets as a result of declining income levels and by problems of financing intraregional trade and import requirements, the private industrial sector generally feels itself under seige and perceives an increasing possibility of virtual elimination.

The prevalence of these sentiments has been adequately documented in the ROCAP-sponsored survey report, "Views of the Private Sector in Central America and Panama on its Problems and Implications for U.S. Policy."

In principle, the strategic importance of the private sector in the future growth and development of the region can be persuasively argued on both economic and political grounds. Broadening and diversifying the incipient industrial sector and achieving better structural balance among the economies of the Central American countries is a function in which the private sector is, theoretically, the best agent for moving the process. The industrial establishment now in place under private management provides a base from which to expand into extraregional markets. Careful studies indicate that there is considerable potential for developing profitable new industries in the region, based on dynamic comparative advantage, for supplying both the regional market and for entering new markets. Industrial expansion increases private sector opportunities for expansion and specialization in the service industries and, thus, provides alternative employment opportunities for surplus agricultural labor, thereby facilitating improvement in agricultural productivity.

On the political side, a strong, well-organized, dynamic and social-minded private sector could be expected to enhance political stability by supporting honest, capable and responsive governments. It should be able to exercise a constructive influence on economic policy and act as a moderate liberalizing force in the political spectrum.

The problem is that, historically, the private sector generally in Central America has shunned a significant role in the political process, except to lodge protests against government actions or policies which threaten vested interests. The attitude can hardly be characterized as "enlightened capitalism" since it more faithfully reflects the <u>laissez-</u>

faire approach of an earlier period in Europe and the U.S. which opposed "government interference" in such areas as minimum wage laws, maximum hours of work, social insurance, labor organization, etc.

Of more immediate concern, however, is that the conditions necessary to spark a new wave of private investment in the region are almost totally absent. As our survey results indicate, the primary concern of the private sector at the moment is survival. Almost no one is willing to undertake new investments. This is not surprising because the investment climate is indeed bleak. The major elements affecting the investment climate are: 1) the risks arising from the unstable political situation and the spread of terrorist activities, especially those aimed at factories, commercial establishments, electric generating and transmission facilities, transport facilities, to name a few; 2) the changing policy framework and the uncertainties regarding government policy affecting the private sector; and 3) the economic uncertainties arising from world market conditions and the contractionary effect on the Central American economies. As a consequence, private sector investment has declined by 24% between 1978 and 1980. In the same period, significant capital flight -- perhaps as much as $500 million per year -- has taken place. Declining reserves and increasing debts have caused commercial credit sources to dry up, so that producers who might otherwise be able to maintain production levels cannot obtain raw materials and other imports needed to do so.

II. ROCAP Strategy and Program

A development assistance strategy to support the private sector and enable it to play a significant and constructive role in the further growth and development of the region must, first of all, help to resolve the problems of intraregional trade which, as we have indicated in the first section of this document, is of critical importance to maintaining the size and viability of the industrial sector. Over the longer term, it must contribute to improving the investment climate in the relatively near future and, eventually, influence the orientation of the private sector toward a more socially-conscious and constructive role in the society.

This is obviously an undertaking of gigantic proportions which far exceeds the capacity of AID. Hence, the U.S. efforts to support the process through trade concessions, commercial credit guarantees and mobilization of resources from the U.S. private sector are important initiatives which need to be pursued and sustained. The effort to strengthen private sector organizations in Central America and influence their orientation through closer contacts and working relations with U.S. private sector organizations is another important tactic in the general strategy.

ROCAP's role is necessarily modest. As an element in dealing with the immediate crisis in the CACM, we have proposed U.S. participation in a regional fund to finance intraregional trade and a revolving foreign exchange fund to assist financing of import requirements for Central American producers who export outside the CACM. Such financing, in conjunction with other donors, would enable us to exert additional influence on some of the policy decisions that need to be taken by the Central American governments to improve the conditions affecting the investment climate.

We will continue to support programs to finance agro-industries, such as those we now have with CABEI and with LAAD. While CABEI's ability to move the agro-industry loan has been slow in developing, we have seen some improvement and will continue to work closely with the Bank to stimulate better performance.

We are, at the present time, discussing with a special unit of CABEI, the possibility of developing a mechanism for identifying specific private investment opportunities and testing investor interest. If such a mechanism can be developed, we see it as an excellent opportunity to move the Bank more toward financing private productive investment. Product selection would emphasize exploitation of Central American resources, labor intensive techniques and import susbtitution with potential for export outside the regional market. We envisage that well-defined investment opportunities in which Central Americans are willing to invest will open the door for participation by U.S. firms through technical assistance, technology transfer and direct investment.

There is a broad area of regional policy which needs to be addressed, but which is unattended because of the debility of the regional integration mechanisms. We will be looking for opportunities to enter this area. If the electoral processes now under way bring a set of governments to power that decide to renew the integration process which all profess to want, we will seek ways to support and influence such a development because of its importance to the general investment climate and the promise that it offers for resuming the growth process of the Common Market.

As a contribution to the objective of organizing and influencing the attitudes of the private sector, we see the private sector assessment as providing a basis for dialogue among concerned U.S. agencies and, within

AID, among the USAID Missions in the region on private sector problems and, hopefully, a vehicle for stimulating dialogue and self-analysis in the private sector itself. We believe the initiatives taken by Caribbean/Central American Action and the U.S. Chambers of Commerce with the Central American Chambers this past year can be consistent with assessment recommendations on improving the organization and image of the private sector and starting a more productive dialogue with the public sector at the policy level. We believe these efforts should be developed on a bilateral basis at first, but subsequently a role for regional private sector organizations and ROCAP may develop based on economies of scale. ROCAP will be working closely with the private sector through the Regional Chamber of Industry (FECAICA) on a proposed new Industrial Energy Efficiency project which may set a precedent for future projects to provide technical assistance to industry in other areas; for example, in export marketing.

Agriculture

1. The Problem

Agriculture is the dominant activity of the region. It embraces approximately half of the population and employs sixty-five percent of the labor force. The sector generates 22 percent of the region's GDP and is the primary source of the region's foreign exchange earnings.

All of the countries of the region have a food deficit, and food self-sufficiency is unlikely to be achieved within the next two decades. Income from major export crops of coffee, cotton, cattle, sugar and bananas, is poorly distributed, as is access to productive land.

The fundamental problems in the regional agricultural sector continue to be low productivity and high unemployment and underemployment. The high rate of population growth, which is estimated to increase from 23 million to 40 million over the next two decades, is exacerbating these problems by putting greater demands on the basic supporting resources of soil, water, forests and watersheds. Given current trends, the ability of the sector to meet demand for increasing domestic food supplies and to maintain foreign exchange earnings from agricultural exports is not promising. Overcoming these problems will require attacking both low productivity and the lack of alternative productive employment for rural people.

The major constraints to increasing productivity and rural employment include inadequate and ineffective public and private agricultural institutions, ineffective and restrictive national agricultural policies, insufficient public and private investment and inefficient use of the region's human and physical resources. The weaknesses of the institutions are the result of a serious shortage of well trained, problem oriented staff, inadequate budgetary support and the absence of effective linkages between those responsible for establishing policies, those responsible for generating relevant technologies and those responsible for moving improved technologies through adaptation to adoption at the farm level.

II. ROCAP Strategy and Program

In addressing the varied constraints to increasing productivity and rural employment in the region, we recognize that bottlenecks such as access to land, organizing producer groups, small-scale irrigation, credit, production inputs, marketing systems, and national policy determinations are most appropriately addressed at the national level. There are, however, development concerns and complementary activities common to several, if not all, of the countries in the region which can be more effectively and efficiently addressed through regional institutions on a region-wide approach. It is this limited, but important role on which ROCAP's regional program will focus.

Some of the appropriate complementary activities include development of improved agricultural technologies, strengthening of national counterparts, improving the generation and interchange of regional information and expertise, developing pest control measures for crops, and strengthening regional institutions to enhance their ability to assist national activities.

In serving this function, ROCAP will work through regional institutions such as CATIE and IICA which were created to help national institutions in their development efforts.

The central theme of our strategy over the CDSS period is to support, at the regional level, four areas of activity:

-- Development of improved, appropriate technology for use by public and private national institutions;

-- development of human resources;

-- strengthening and refining data/information collection, analysis, storage and dissemination capability to support policy and program decisions and actions at the national level; and

-- technical services in support of regional and national institutions.

By the end of the CDSS period, we anticipate that improved farming systems methodologies will have been widely introduced at the national level with a core staff trained to carry on the work. Additionally, production alternatives for non-traditional export crops will be developed and under validation, and a pest management program in coffee will be operational and serving as a model for adapting to other key commodities. We anticipate that data/information systems of regional and national institutions will be linked and more widely used to support studies by the Central American Agricultural Secretariat as well as for policy and program decisions at the national level. In achieving these objectives, we anticipate that the technical capacity of the participating institutions will have been significantly improved.

A. Technology Development

Relevant technology is a prerequisite for improved productivity and it is generally acknowledged that the national research systems of the region currently have a very limited capacity to undertake systematic development of technology. It remains doubtful that they will have adequate resources to attempt the development of a full-scale basic research system in the foreseeable future. Indeed, whether such an attempt should be undertaken is questionable. Rather, their limited resources can best be applied to strengthening their ability to adapt developed technology to site-specific areas and to assist its adoption by farmers.

ROCAP's strategy has been, and continues to be, to address the existing technology constraints by assisting in the development and transfer to national entities of relevant technology. The on-going ROCAP projects in fuelwood, small farm production systems and coffee pest control are designed to achieve this objective. At the same time, by working closely with national institutions and personnel on individual farms at the country level, these activities are strengthening the national capacity to conduct, adopt and extend field level research.

During the CDSS period, ROCAP will explore other technology gaps that can best be addressed at the regional level. One promising possibility is in the area of pest management which currently is beset with mounting problems such as excessive use of toxic pesticides, pesticide poisonings, and elevated pesticide residues which pose serious dangers for humans, animals and the environment. The lack of standard policies and services relative to inspection, quarantine and residue levels seriously inhibit trade both within and outside the region. Based upon the knowledge and experience developed in putting together an integrated system for controlling coffee pests, ROCAP will seek to expand this methodology to other high priority commodities of the region.

B. Human Resources Development

In order to strengthen the human resource base of the regional and national institutions, both formal and informal training are integral activities in each of ROCAP's technology development efforts. Short-term training has been provided to several hundred national technicians as well as to cooperating farmers. Although ROCAP anticipates that short-term training will continue to be a key input in future projects, we see the need for a revitalized effort in training at all levels if the region is to mobilize its limited resources effectively and be capable of sustaining development efforts. Training at the organizational and administration level represents a key need. We will be exploring alternatives of how to address this critical constraint and expect to develop at least one project in this area during the CDSS period.

Another area of training to be investigated is the use of auto-tutorial or other instructional modules to introduce and/or reinforce training objectives in many agricultural techniques and methodologies required in implementing agricultural development programs. A survey within the region of national agricultural personnel at all levels of responsibility indicated that, on the average, no person remained in their assigned positions more than 1.4 years. Consequently, it has been necessary to repeat training courses at frequent intervals to maintain acceptable performance. This traditional form of training is costly and a more efficient, cost-effective method must be developed. The feasibility of using this known technology in one or more project-specific areas will be explored.

C. <u>Data/Information Collection, Analysis and Dissemination</u>

There continues to be a need for strengthening the national and regional institutional capacity to collect, manage, analyze and use agricultural data/information in support of research, planning and policy activities. To enhance access to more pertinent data/information in a cost-effective manner, there is also the need for increased cooperation and collaboration among national and regional institutions.

ROCAP has been addressing this need beginning with the PIADIC project which has provided training to national technicians in collection, storage, management methodologies and analysis of socio-economic, scientific and technological information. A variety of software programs have been installed at IICA as well as at the national level where necessary hardware is available. Currently, ROCAP is building upon the PIADIC data programs by including, where appropriate, an element for data enhancement in each new project. In the coffee pest control project, for example, a relevant bibliography has been developed and a preliminary program for predicting successive outbreaks of coffee rust has been developed for testing as data becomes available. If successful, the principle of the program can be extended to other pest management problems.

ROCAP anticipates that the data/management activity will be both utilized and expanded by the agricultural secretariat project, especially in the area of data/information analysis pertinent to planning and policy alternatives.

Although the necessary basic structure and technologies have been established, there remains a need to continue to update, revise and promote multi-institutional cooperation in order to realize the potential contribution this system can make to both national and regional entities. ROCAP intendes to continue supporting these efforts as part of future projects.

D. Technical Services

At the present time, ROCAP is providing technical backstopping to USAIDs and national institutions in the areas of forestry and pest management. This effort will be maintained for a minimum of two to three additional years, or until the professional capability can be installed within regional institutions and the services are available to the USAIDs and other interested groups. The current approach is aimed at filling immediate needs while encouraging development and enhancement of the skills within the region.

Energy

1. The Problem

Central America continues to confront a situation where local commercial sources of energy fall considerably short of the growing demand for its use. In the 1980 study "Energy Development in Central America" conducted by the Mitre Corporation, the cost and supply of imported oil and the availability and cost of fuelwood for rural areas were identified as the two major energy problems facing the region. At the 1981 Regional Energy Conference, Central American country representatives confirmed this finding, but also noted that the growing problem of rural energy was not being attacked by major national programs and that the principal users of oil -- transportation and industry -- were receiving little or no national level attention.

Imported oil is used to meet 40 percent of the regional requirements for electricity generation, transportation, and industry; however, between 1973 and 1981 Central America's oil import bill increased more than elevenfold to an estimated $1.2 billion (25 percent of total export earnings) and now is a major contributor to the balance of payments problem and, thus, to the region's economic crisis.

Guatemala is the only country in the region with known oil deposits. The extent of the reserves is not yet known, but they are not expected to provide a solution to the need for imported oil. In the short to medium-term, therefore, this problem is expected to continue, with demand increasing while prices remain at current levels and likely going higher. The Mitre Study projected that regional petroleum requirements will increase by a factor of 2.5-3 over the next 20 years, assuming historical petroleum demand growth rates for both developing and advanced countries.

Fuelwood is also a principal energy source, supplying 49 percent of regional energy. Up to 80 percent of all Central American households are estimated to burn wood or charcoal for cooking, heating and light. As demand has increased, the supply of fuelwood has decreased and caused a corresponding rise in price. Fuelwood now represents a major cost for most rural families, amounting to as much as 25 percent of monthly expenditures in some cases. Also, the cutting of trees for fuelwood is not only reducing supply but also contributing to deforestation, watershed degradation and erosion, all of which affect agricultural production.

The regional response to the energy problem thus far has been to place investment priority in the development of hydro and geothermal sources, as shown in the following table:

Investments in Central America Energy Projects in 1980
(In millions of Dollars)

	G	ES	H	N	CR	TOTAL
Hydroelectric	129.7	81.5	80.0	-	55.0	348.2
Geothermal	4.1	6.1	0.3	2.6	2.7	15.8
Thermal Electric	0.4	-	3.6	-	-	4.0
Transmission Lines	13.7	2.1	-	13.3	15.2	44.3
Hydrocarbons	56.2	-	-	-	-	56.2
Non-Conventional Fuels	-	-	-	0.2	-	0.2
	204.1	89.7	85.9	16.1	72.9	468.7

(Source: Tenth Report on the Inventory of Regional Infrastructural Projects in Central America through December, 1980, SIECA 81/INF/PF/16, Published November 1981. (Updated with $32 million IDB loan for transmission lines, approved November 5, 1981).

While important, these investments alone will not solve the region's energy problems. Some 80 percent of all imported oil is for uses other than electric power generation. Yet, no major investment program has been undertaken by any of the governments to save or find substitutes for energy used in transportation, industry or in rural areas. Two reasons explain this situation: first, the economic condition of the countries severely limits the funding available to invest in developing new energy technologies and, second, there is uncertainty as to which of many alternate paths to petroleum substitution and woodland conservation are economically most attractive. Answers to such questions require elusive cost and benefit figures that take into account environmental and social externalities of varying subtlety. Often, the Central American governments and the private sectors lack ready answers and adequate technology.

II. ROCAP Strategy and Programs

Although inter-relationships exist between the imported oil and fuelwood problem -- for example, the use of biogas to replace oil in a factory or wood in a rural kitchen is a possible solution to deal with both problems -- the relative scales of the problems and the costs and methods for attacking them require separate strategies and projects. In both cases, regional institutions can have an important role in providing information and technology to national energy institutions and, eventually, in helping develop and backstop national programs in areas such as fuelwood production from fast-growing tree species, alternative energy sources, conservation and production, and transportation.

Leading into and throughout the CDSS period, therefore, the ROCAP strategy will be to focus on these problems utilizing the economies of scale in addressing common problems on a regional basis. Project activities will concentrate on regional institutions to develop both their internal technical capability, as well as their capacity to provide assistance to national institutions in the region. In addition, ROCAP proposes to include one full-time direct-hire specialist on its staff to design programs, monitor project activities, and provide assistance to the bilateral USAIDs on energy matters.

A. Rural Energy

The Fuelwood and Alternative Energy project will continue to be the focal point of ROCAP's rural energy program. The collaborative effort of ICAITI and CATIE to develop fast-growing tree species to use for fuelwood, efficient means to burn the wood, and alternative energy sources is progressing well. During the CDSS period, priority will be given to demonstrating the technologies developed under the current project and to enhancing the capability of both institutions for disseminating results at the national level.

An important aspect of ROCAP's strategy is assuring that ICAITI and CATIE have the capability to help national governments and the USAIDs develop plans and investment programs for rural energy programs. We also believe that the private sector can have an important role in this area and that efforts are needed to promote their involvement. Toward this end, a project will be considered that would build on the results of the Fuelwood project and would develop the capacity and mechanisms for ICAITI and

CATIE to provide policy and technical assistance, as well as to backstop national programs and the programs of PVO or other private sector organizations interested in rural energy projects. In view of the region's economic problems, the need to develop sources of financing for such programs is critical. As the funds required would be primarily local currency, the possibility of the Mexican/Venezuelan Trust Fund as a source will be examined.

B. Imported Oil

1. Industry

Industry consumes about 25% of oil imports and presents a tangible opportunity for energy savings through improved energy efficiency. It has been conservatively estimated that 10 - 15 percent energy savings in industry can be achieved by the adoption of relatively simple and inexpensive efficiency measures. A 10 percent improvement in energy efficiency by industry in the region would cut approximately $40 million from the annual oil import bill.

To capitalize on this potential savings and its impact on the balance of payments situation, ROCAP is currently developing a project to improve industrial energy efficiency. The project, which will be active through most of the CDSS period, is designed to create an awareness of the severity of the problem facing industry and to provide the means for most industries to take positive action in dealing with the problem.

The project represents ROCAP's first attempt to utilize the private sector as a major element in project implementation. In addition to developing the technical skills of ICAITI and the information base of

SIECA/COMENER, the Regional Federation of Chambers of Industries and the national chambers and associations of industry will be responsible for promoting the participation of industries in the project and encouraging the adoption of conservation measures and energy efficient machinery. The institutions are already cooperating closely in a survey of 3,000 industries throughout the region. The results of the survey will provide baseline information for the project. ROCAP believes that data from the survey and experience with the project over the first two years will convince the commercial banking system to provide credit for energy technologies which industries will be installing. The appropriateness of a ROCAP loan to CABEI to help mobilize commercial bank lending will be examined.

2. Transportation

As the largest user of imported oil (46%), the transportation sector cannot be ignored if meaningful measures are to be taken to reduce the energy problem and its impact on the balance of payments. Despite the opportunities which exist for improving energy efficiency and the Mitre study estimate of potential savings on the order of 15 - 25 percent, this is the most difficult sector in which to institute changes needed to realize the savings. The industrial energy efficiency project will initiate some efforts to get industry to reduce transportation costs and will also examine government policies on using more efficient vehicles.

The greatest challenge in the transportation sector, however, is to find a liquid fuel to substitute for imported oil. To date, the economics of wood-based methanol and sugar-based ethanol have not been favorable and involve problems of deforestation and competing with export and food crops. A recent ROCAP-funded study by Solar America, however, indicates that sorghum or Sudan grass can be grown on marginal pasture lands and still be produced in quantities sufficient to make the production of ethanol economically feasible. Over the CDSS period, ROCAP will fund additional research and study in this field which will not only identify opportunities for investment but will also prevent uneconomic policies and investments. A small joint research project with CATIE and ICAITI along these lines is one idea being considered.

C. Training

Most of the region's expertise in energy is located in the national electric companies. To deal adequately with the energy problem, however, this expertise must be broadened to include specialities such as non-conventional energy production and energy efficiency. Some training has started under ROCAP, USAID and other donor projects, and AID/W training opportunities are available from time to time. ROCAP believes, however, that there is a need for a better planned and coordinated approach for developing the human resources needed over a sustained period of time which would give particular emphasis to improving energy planning and providing a variety of experts in alternative energy technologies. ROCAP will explore this need further with the USAIDs, UNDP and the regional institutions during the CDSS period and will examine the possibility of proposing a training project which would begin to meet the anticipated requirements.

Environment

1. The Problem

Environmental problems in the region have become increasingly serious during the past several years. In September, 1980, the Central American Mission Director's Coordinating Committee recommended that ROCAP undertake a Regional Environmental Assessment (Doomsday Study) based on the preparation of individual Country Environmental Profiles (CEPs) for each of the six countries. The objective of the Assessment was to impress upon Central American decision-makers and donor institutions the seriousness of environmental problems. To assist ROCAP in this effort, a Regional Environmental Management Specialist (REMS) was assigned to the Mission. Under his direction, Environmental Profiles have now been completed for Panama, Honduras, and Costa Rica. A CEP is currently being developed for Guatemala. The Environmental Profiles for Nicaragua and El Salvador are still in the planning stage, but they are expected to be completed, at least in an abbreviated fashion, during 1982, so that the Regional Assessment and a detailed regional strategy can be prepared in 1983.

The picture emerging from the CEPs and USAID project efforts related to the environment is alarming. If present trends in natural resource exploitation and degradation continue, and population growth proceeds at the current rate, the six CA/P countries will be less stable, both economically and ecologically, by the turn of the century than they are today. Great stresses on the environment and a very adverse impact, particularly on rural people, are clearly visible ahead.

Of the many environmental problems currently being identified, the impact on farm lands, natural forests and water supplies are considered to be the most serious. Others, such as the extinction of plant and animal species, are also serious problems, but economic and ecologic implications are not yet well understood.

During the next two decades, population growth in the rural areas will result in the subdivision of existing arable land resulting in smaller farms. Soils will become increasingly less fertile due to over-cropping both on uplands and in the valleys. The deterioration of agricultural soils is already occuring through erosion, loss of organic matter, desertification, compaction by grazing, salinization, alkalinization, chemical contamination by pesticides and water logging. The amount of crop land affected by these phenomena has not yet been fully measured, but the damage is widespread.

The "agricultural frontiers" of unsettled, fertile, virgin lands no longer exist in Central America. The remaining unopened lands are found in areas of broken topography, fragile soils, excessive rainfall or other extreme climatic conditions. The availability of arable land will, therefore, not increase substantially in the future and most of the needed increase in food production must come from higher yields and more intensive agricultural methods, rather than from the extensive agriculture traditionally practiced throughout the Isthmus.

Rural population growth, migration and other factors are placing tremendous pressure on forest resources. Significant losses of the tropical forest reserves of the region have continued and even accelerated as the demand and uses for forest products and fuelwood have increased. The trends indicate that by the year 2020, all of the remaining natural forests of the region will be either gone or so degraded as to be of no commercial significance. Progress in reforestation and the development of forest industries has been painfully slow, with the possible exception of Honduras.

By the year 2000, it is expected that population growth and density effects alone will cause requirements for water to nearly double. As a result, regional water shortages will become more severe. In all of the countries, water supplies will become increasingly less dependable and more contaminated as a result of deforestation and the conversion of protection watersheds to other uses. The development of new water supplies will become more costly and difficult virtually everywhere. In many cases, opportunities for investment in needed infrastructure projects such as hydroelectric dams, irrigation systems, and municipal water supplies will be seriously limited or lost altogether because of the impact of deforestation and sedimentation on the quantity and quality of water available.

II. ROCAP Strategy and Program

The above problems indicate that improved environmental management must ultimately be addressed at the policy level within a broad framework of national economic and social goals. Such management must become an integral part of rural development and land-use planning and decision-making. Specific attention should be given to policies and improved technologies for watershed, rangeland and forest management, and for the protection of forest lands and key watersheds because of the link they provide between natural resource availability and the growing demand for food, fodder, fuel and water.

Over the CDSS period, the ROCAP strategy will be to focus on developing integral management technologies and practices aimed at halting natural resource depletion, and on enhancing the capability of regional and national institutions to identify and analyze environmental problems and to collect information needed for policy formulation. Project activities, beginning with the FY 1983 Watershed Management for Sustained Energy Production grant, will emphasize the development of the technical capacity of appropriate regional institutions and, in particular, their ability to provide assistance to national level institutions. Throughout the CDSS period, ROCAP will also continue to provide technical assistance in environmental management to the bilateral USAIDs.

A. Regional Institution Building

The countries in Central America and Panama largely lack the institutional and legal/administrative capacity and technical expertise necessary to implement improved resource management practices and programs. Over the long-term, institutional strengthening may well be the single most important factor in protecting the natural resource base of the region.

A high priority for ROCAP, therefore, is the development of a project, possibly in FY 1984, which would enhance the ability of regional institutions to provide technical assistance and to carry out courses in several key environmental areas such as agro-forestry and watershed management. Regional institutions which would participate in the project include CATIE, ESNACIFOR in Honduras, and the Tropical Science Center in Costa Rica. Areas where project assistance will focus include:

-- Management practices and principles, criteria for selection and action plans for the establishment and maintenance of proper land use;

-- Environmental inventory, analysis and use of different classification systems for forests, coastal zone areas, streams and rivers, wildlife and national park areas, etc.;

-- Documentation and technical information for project support;

-- Environmental monitoring techniques, giving high priority to physical-chemical properties for air, land, and water; and

-- Integration of environmental studies into public policy formulations, and development impact analysis capabilities.

B. Information Gathering/Dissemination and Policy Formulation

Key information gathering and dissemination efforts will continue to be required in order to better understand the causes, trends and consequences of resource degradation and depletion, as well as the status of institutional capabilities and technologies needed to combat such environmental problems. An improved information base is also necessary in order to refine policies and lead the way toward more appropriate and cost-effective development assistance.

1. CEPs and the Regional Assessment

Within this context, ROCAP will continue to assist in the development of the environmental information base through the preparation of the CEPs and the Regional Assessment. By 1984, all of the countries in the region will have developed a country environmental profile and participated in the development of the Regional Assessment that will clearly outline environmental problems and define action plans. These documents should serve as dynamic planning and policy instruments that can be updated and revised as needed. As well as being useful in promoting multi-institutional and cooperative efforts, these documents will also help in the formulation of future USAID and ROCAP strategies.

The CEPs and the Regional Assessment should also help in the establishment of a broad-based international effort to address the environmental problems of Central America. Toward this end, a regional conference is planned for late 1983 which will focus on the results of the Regional Assessment and what follow-up steps should be taken by regional and national institutions as well as by international institutions such as FAO, IBRD, and AID.

2. CRIES Environmental Information System

By 1984 the CRIES (Comprehensive Resources Inventory and Evaluation) system will have been developed to a point where new natural resource information from the countries can be both stored in a data-bank and analyzed on the basis of any one of a number of geographical units (i.e., watersheds, municipalities, country, regional). This system will constitute an operational monitoring and assessment capability that can be used for the management of natural forests, water resources, general land use, etc. on both a country-by-country and regional basis. ROCAP plans to continue the limited support needed for the development of the CRIES system so that it can provide these services to appropriate regional and national institutions.

C. Assistance and Backstopping for Bilateral USAIDs

There are numerous AID natural resources/forestry/rural development projects now ongoing or planned for the region which will have important direct or indirect impacts upon the natural resource base and sustainable productive capacities. Most of these projects have common problems and needs concerning implementation, evaluation, planning, training, research and technical assistance. ROCAP's experience in providing the assistance of environmental and forestry specialists over the past year indicates that regionally-provided technical assistance is needed and is a valid ROCAP role. The alternative -- strengthening each bilateral Mission as appropriate -- is an unlikely solution in light of current agency funding limitations and personnel ceilings. Further strengthening of ROCAP capabilities to provide such assistance, therefore, appears to be a cost-effective and feasible approach to maximizing the favorable impact of AID projects on the environment.

Housing

I. The Problem

The high population growth rate in Central America -- only Costa Rica has an annual growth rate of less than 3 per cent -- and rural to urban migration are putting increasing pressure on the region's urban areas. The urban population currently is growing at twice the rate of the rural population, and this trend is expected to continue for the next two decades.

Between 1950 and 1980, the population of Central America more than doubled. The number of urban centers (over 10,000 in population) grew by a factor of five, and the number of small urban centers (10,000-50,000 in population) more than tripled. The capital cities in the region now accommodate 60-70 percent of their respective country's total urban population.

The accelerated population and urban growth rates of the past thirty years have created a burden that the formal housing institutions cannot carry. The number of new housing units financed and produced by public and private institutions are insufficient to meet demand. As a result, most housing in the region is being financed and produced by an informal sector which operates outside the channels of the formally-constituted housing institutions. Most of this housing, which is usually found in uncontrolled settlements where urban services are not available, is substandard, overcrowded, and in violation of established construction and density norms.

A study of basic shelter needs in Central America, prepared in 1980, developed the following estimate of the projected housing deficit through the year 2000.

Country	Total	New Shelter	Upgrading
Costa Rica	617,000	306,000	311,000
El Salvador	1,337,000	701,000	636,000
Guatemala	2,146,000	1,094,000	1,052,000
Honduras	1,046,000	499,000	547,000
Nicaragua	691,000	333,000	358,000
C.A. Total	5,837,000	2,933,000	2,904,000

Efforts to improve housing conditions in Central America must confront not just the need for new housing, but also the unsatisfied or partially unsatisfied need of those living in below standard conditions.

The need to mobilize funds to meet the needs for upgrading and new shelter by the year 2000 is on the order of $15 billion. Funds required for just upgrading of dwellings amount to about $5 billion and would meet the needs of about half the households calculated in the projected housing deficit.

Programs to attempt to meet these needs would include several elements:

-- An increase in the financial and productive capacity of formal housing institutions.

-- An emphasis on lower cost solutions to maximize the units constructed and which can be afforded by a larger portion of the population.

-- An effort to provide more funds for the upgrading of existing units through home improvement loans.

II. ROCAP Strategy and Program

AID's experience has shown that the initial effort to establish such minimum cost programs along the above lines is best carried out with a bilateral AID loan. For a variety of reasons, including the direct leverage that can be applied, bilateral efforts are more effective in inducing the adoption of new institutional procedures and shelter programs which address the needs of the poor. They are also preferable when the loan must be complemented by extensive technical assistance to implementing institutions not accustomed to working at the end of the housing market.

The existence of a regional development bank in Central America, CABEI, has permitted AID to develop a combined program of regional and bilateral housing assistance loans to address the shelter needs of the region's population and, in so doing, to increase the total amount of resources available. The program is an attempt to enhance and strengthen the impact of AID's contribution to the solution of shelter problems in each of the five Central American countries by making full and effective use of a unique regional resource.

The advantage of utilizing a regional financial institution like CABEI lies in the Bank's potential ability to mobilize increasing resources for housing finance. It is able to borrow, particularly from sources outside Central America, amounts superior to that of any national housing finance institution in the region. As a result, it has the potential to mobilize funds to finance housing programs from these sources in addition to those funds which can be mobilized by individual national housing finance institutions. For example, CABEI established a Housing Fund in 1963 in order to increase the flow of resources into mortgage financing. The bank has invested the resources of the Housing Fund through the purchase of mortgages generated by various housing finance institutions in Central America. This activity has come to be known as CABEI's secondary mortgage market program. AID has supported this activity with $91 million for general regional lending, which amounts to about one third of all AID assistance for housing in the region.

CABEI is currently implementing a $75 million shelter program for the five countries, financed in part by a $25 million AID contribution (Project 596-HG-005). In designing this project, AID took into account over fifteen years of efforts fo finance housing in Central America through CABEI with the expectation that this project would provide the basis for further lending to CABEI to support national housing programs. Several major reforms or improvements in CABEI's operations are expected as part of the program and would result in CABEI having:

1. A solid ongoing financial base for its Housing Fund, one that

would make greater use of CABEI's general borrowing as a source of funds for housing;

2. The capability to provide support to the capital mobilization efforts of the national housing finance institutions;

3. A capability to respond better to the housing needs of the poor in Central America; and

4. Greater agility and better coordination in the internal operation of CABEI's housing program.

Although progress in carrying out these reforms has not been as rapid as expected, we believe there are reasonable prospects of making sufficient progress to justify major new HIG programs toward the end of the CDSS period. To achieve this objective, we will be working closely with CABEI over the next two years with particular emphasis on: (1) encouraging the Bank to attract and direct additional funds to finance housing in Central America through regional and international borrowing; and (2) helping CABEI become a more efficient and expeditious channel for AID housing finance assistance.

PART III: PROGRAM RESOURCES
PROPOSED ASSISTANCE PLANNING LEVELS
($ 000)

	1982	1983	1984	1985	1986	1987	1988
Agriculture and Rural Development	3,900	11,000	3,850	3,000	16,000	18,500	18,500
Research/Training/Institution Building	3,600	3,050	2,350	1,000	2,500	2,000	2,000
Diversification/Agro-Industry	--	7,700 1/	1,300	1,500	12,500 1/	16,000 1/	6,000 1/
Agricultural Policy	300	250	200	500	500	--	--
Agricultural Trade	--	--	--	--	500	500	10,500 1/
Nutrition - Outreach Program	350	342	--	--	--	--	--
Energy	2,300	2,400	2,800	2,405	1,950	1,600	5,000
Fuelwood and Alternative Energy	1,400	1,400	1,800	1,155	400	300	--
Industrial Conservation	900	1,000	1,000	1,000	1,000	1,100	5,000 1/
Alternative Fuels	--	--	--	250	550	200	--
Private Enterprises	11,000	12,500	11,000	13,900	1,700	1,000	--
Export Promotion	10,500 1/	12,500 1/	10,500 1/	13,500 1/	--	--	--
Technology Transfer	--	--	500	400	700	--	--
Management Training	500	--	--	--	1,000	1,000	--
Environment	--	1,400	1,600	2,050	2,950	2,500	1,000
Watershed Management	--	700	1,000	1,000	1,300	1,000	--
Fuelwood Production	--	700	600	600	600	--	--
Natural Resource Management	--	--	--	450	1,050	1,500	1,000
PD&S	400	358	400	395	400	400	500
Total Grants	7,950	9,000	9,650	8,750	12,000	9,000	4,000
Total Loans	10,000	19,000	10,000	13,000	11,000	15,000	21,000
Total	17,950	28,000	19,650	21,750	23,000	24,000	25,000
Housing Guaranty (non-add)	--	--	--	(20,000)	--	(20,000)	--
TOTAL BY AID FUNCTIONAL ACCOUNT							
Agriculture, Rural Development and Nutrition	6,350	12,900	5,850	3,950	16,200	18,700	18,750
Education and Human Resources	500	--	--	--	1,000	1,000	--
Selected Development	11,100	15,100	13,800	17,800	5,800	3,300	6,250
TOTAL	17,950	28,000	19,650	21,750	23,000	24,000	25,000

1/ Includes loan

USDH Staffing Requirements

FY 1982

The fast-breaking nature of economic events and increased AID/W requirements for macro and microeconomic analysis at the regional and national levels necessitated the addition of a second economist to the ROCAP staff this fiscal year. With the addition, ROCAP should be fully capable of meeting the increased demand for assistance and reporting.

For FY 1983

ROCAP has responded to regional requirements for technical assistance in the areas of non-traditional energy and environment and natural resource conservation for some four years using contract personnel to assist the USAIDs, national governments and regional institutions.

In view of the increased activity planned in these fields, the need to develop program strategies and to design and implement projects, the technical assistance requirement is seen as a long-term one. We propose that, beginning in FY 1984, these two positions be staffed by U.S. direct-hire personnel, rather than contract employees.

ROCAP STAFFING

U.S. Direct Hire	FY 82	83	84	85	86	87	88
Director's Office	2	2	2	2	2	2	2
Program - Capital Development	2	2	2	2	2	2	2
Economic Analysis	2	2	2	2	2	2	2
Agriculture	2	2	2	2	2	2	2
General Development	2	2	2	2	2	2	2
Environment	-	-	1	1	1	1	1
Energy	-	-	1	1	1	1	1
Controller's Office	3	3	3	3	3	3	3
Supply Management	1	1	1	1	1	1	1
Housing	2	2	2	2	2	2	2
	16	16	18	18	18	18	18