
**BALANCE OF TRADE AND PAYMENTS IN CENTRAL AMERICA,
PROSPECTS FOR THE CACH AND RECOMMENDATIONS FOR ROCAP**

By

William Loehr

February 9, 1990

OUTLINE

INDEX

EXECUTIVE SUMMARY	1
INTRODUCTION	
SECTION 1: THE BALANCE OF TRADE AND PAYMENTS IN CENTRAL AMERICA	
Summary	1
1.1 Background	3
1.2 Trade in Central America	5
1.3 Conclusions	28
Appendix: Trade and Exchange Restrictions in Central America.	30
SECTION 2: REAL EFFECTIVE EXCHANGE RATES IN CENTRAL AMERICA	
Summary	1
2.1 The Real Exchange Rate Concept	4
2.2 Real Exchange Rate Calculations	7
2.3 Real Exchange Rate Comparisons	12
2.4 Appreciation and "Overvaluation"	21
2.5 Conclusions	22
APPENDIX A:	25
Real Effective Exchange Rate Derivations	
APPENDIX B:	32
Real Exchange Rates and Overvaluation	
B.1 Real Exchange Rate Appreciation and Overvaluation	
B.2 REER, Devaluation and Adjustment	
B.3 Devaluation and the General Supply Response	
B.4 Internal Competitiveness	
B.5 Commodity Specific Responses	

B.6 International Market Changes

B.7 Information from Parallel Markets

SECTION 3: CAMARA DE COMPENSACION CENTROAMERICANA

Summary	1
3.1 The Camara de Compensacion Centroamericana	3
3.2 The EEC Program	7
3.3 Observations on the EEC Program	11
3.4 Conclusions	25

SECTION 4: PROSPECTS FOR THE CACM

Summary of Sections 4 and 5	1
4.1 What Happened to the CACM?	3
4.2 Trends in Individual Countries	9
4.3 Is the CACM Viable?	16
4.4 Integration without a Customs Union	25
4.5 An Integration Strategy in Central America	

SECTION 5: A ROLE FOR ROCAP 34

5.1 Encouragement to trade reform	36
5.2 Trade Promotion without formal "Integration"	43

BIBLIOGRAPHY

EXECUTIVE SUMMARY

The objectives of this study were:

1. Update the so-called "Checchi Report" (1985) which dealt mainly with trade and payments in Central America.
2. Analyse the evolution of real exchange rates for the region's currencies.
3. Describe and evaluate a program initiated by the EEC to reactivate the Camara de Compensacion Centroamericana (CCC).
4. Evaluate the prospects for the Central American Common Market (CACM) and identify the areas in which ROCAP activities can promote productive regional cooperation.

Since each of these topics could constitute a separate study, each section is preceded by its own executive summary. Thus, sections may be removed from the overall study and they will stand on their own.

In the process of addressing these points there is a secondary objective of examining and responding to recent major studies that have been done on economic integration in Central America by The World Bank (1989) and Zuvekas (1989). Reference to these are made throughout this study as appropriate.

TRADE AND PAYMENTS

Section 1 reviews the economic conditions facing the Central American countries through 1989, and focuses on the period 1980-89. It updates some of the analysis in the "Checchi Report" (1985). Some major conclusions are:

1. Comparisons of CACM activities are often made with what they were in 1980. 1980 is not a good year for comparison. Reasons for this are:
 - Coffee prices reached an historic peak in 1977, but were generally very high for the 1976-80 period. These prices are likely to never return.
 - Other commodities prices were also extraordinarily high in about 1980 and declined thereafter.
 - Nicaraguan imports from other Central American countries were extremely high in 1980. These were so high that they distort our view of "regional" economic events.
2. Analyses should focus on individual countries rather than on aggregate data for the CACM. This is primarily due to the distorting influence of Nicaraguan imports in about 1980 on the aggregate for the region. Also,

each country is unique. When we aggregate to the regional level we lose sight of the special characteristics of each country.

3. Integration in Central America, as measured by the proportion of trade occurring internally, did not increase after about 1970.
4. Within the region, excluding Nicaragua, (ie. within the CACM-N) integration, measured by relative trade proportions, did not decrease until about 1985. Proportional trade reduction within the CACM-N during 1980-84, was about the same as it was for non-regional trade, and about what one would expect given changes in GDP. Proportional trade reduction during 1985-89 was very large.
5. Proportional trade reduction within the CACM during 1985-89 was probably not due to discriminatory tariff policy. Countries maintained tariff preferences for regional trading partners.
6. Exchange controls and special taxes and surcharges were important determinants of proportionally reduced regional trade. Also, all countries made special arrangements to manage trade with Nicaragua.

REAL EXCHANGE RATES

In Section 2 we review the derivation of real effective exchange rates (REER). We then present REER calculations for Costa Rica, El Salvador, Guatemala and Honduras. These are compared to REER calculations from other sources. No matter the source the conclusions are:

1. The Lempira and the Salvadoran Colon have appreciated greatly since about 1980.
2. Guatemala's devaluations in 1985 and late 1989 have allowed a real depreciation of the quetzal of about 50% compared to 1980. Guatemala's exchange rate management could be improved.
3. Costa Rica has managed a real depreciation of the Colon of about 50-60% compared to 1980. Costa Rican exchange rate management appears reasonably efficient.

We then explore the difference between real appreciation of an exchange rate and "overvaluation". A currency can only be considered overvalued if either of two conditions exist:

1. If there is a persistent loss of foreign exchange reserves, or,
2. the maintenance of foreign exchange reserves is unsustainable.

If a devaluation were to be chosen as a means to adjust to a sustainable external balance, factors additional to REER appreciation should be considered. Information available indicates that real devaluations in excess of the post-1980

appreciation in the REER are necessary. Reasons for this include the following:

- 1) the cost of resource reallocation has probably increased in recent years.
- 2) The internal terms of trade have shifted against exports.
- 3) Little is known about commodity-specific responses that could be expected.
- 4) Parallel markets have often discounted currencies sharply once an unsustainable reserve position appears.
- 5) International market changes preclude simply returning to the relative price structure of the past.

Both Costa Rica and Guatemala have devalued and have found that to sustain their external balances, nominal exchange rates must adjust by more than enough to simply return to a REER of the late seventies. Both countries are maintaining exchange rates that are devalued by about 50-70% more than is necessary to simply return to the REER of 1980. El Salvador has devalued in 1986, and is in the process of devaluing again at the end of 1989. Honduras too is in the process of devaluation as this report is written. Indeed, neither El Salvador nor Honduras has choice, for their external balances are clearly unsustainable.

CAMARA DE COMPENSACION AND THE EEC PROGRAM

In Section 3 we review the function of the Camara de Compensacion Centroamericana (CCC) and the reasons for it falling into disuse in the mid-1980s. We then review a program, supported by the EEC, to reactivate the CCC. The main characteristics of the EEC program are:

1. Intraregional exports are subsidized with ECUs donated by the EEC.
2. Participating central banks offer lines of credit for payments clearing.
3. Automatic loans are granted monthly to debtor countries and automatic loans are offered (through the lines of credit) by creditor countries.
4. Special loans are available for debtor countries unable to service their automatic loans in the medium term.
5. All loans and credits are multilateral. That is, they are loans to or credits from the "system". They are not loans and credits between central banks.
6. An EEC condition for participation is that countries must agree to specific policy reforms and a specific timetable for pursuing them.

Conclusions on the EEC project include the following:

1. There is no indication that the lack of a clearing mechanism, or credits for financing trade clearing is a major obstacle to trade.

2. The system supported by the EEC would work well where balances are small and roughly zero over the medium term. But, bilateral balance, or even regional balance should not be the objective of policy. Rather, countries should pursue policies that yield them overall equilibrium in their balance of payments.
3. A major problem with clearing payments exists between El Salvador and Costa Rica. Financing of a trade clearing mechanism may help Honduras increase its imports. A new clearing mechanism would do little for trade between Guatemala and Costa Rica, and between El Salvador and Guatemala. Nicaragua is in no condition to participate in the proposed scheme, and Honduras and El Salvador are in marginal condition to do so.
4. Under some conditions, the proposed scheme of automatic loans could lead to paralysis and breakdown for the system.
5. Any increased trade that did occur under the system would be very inefficiently financed, since the program would automatically finance trade imbalances existing on already occurring trade, and is not, and cannot be, restricted to new trade.
6. To the extent that countries free trade and payments among themselves as specified in the program, trade may expand.
7. The EEC has insisted that without reform, countries cannot participate. This is a strong point for the proposal.
8. The fundamental problem remains: without a reasonable realignment of exchange rates vis-a-vis world markets, and without countries pursuit of sound macroeconomic policies which include exchange rate flexibility, a clearing mechanism like the one embedded in the CCC cannot work. With reasonable exchange rates and appropriate macro policies, including exchange rate flexibility, a CCC-like mechanism may work, but under those circumstances it would be of only marginal utility.

PROSPECTS FOR THE CACM

Section 4 analyses prospects for a reactivation of the CACM. Reasons for the decline in the CACM are:

1. The protective structure of the CACM was based on import substitution industrialization (ISI). This created a strong anti-export bias and increased the regions vulnerability to economic disturbance.
2. The economic crises affecting each country beginning in about 1979-80 were initiated by:
 - Economic mismanagement,
 - Recessions in the developed countries,

- political/military violence
 - declining international terms of trade
3. Macroeconomic disequilibria brought on by the crises were worsened by the anti-export biases inherent in ISI.

Since 1980, each country has pursued different strategies toward regaining macro equilibrium. There is almost universal agreement on what should be done. Main policy measures required are:

- reduce anti-export biases,
- liberalize trade,
- reduce exchange controls,
- manage reasonable exchange rate policies,
- adjust fiscal deficits and inflation.

Costa Rica has made considerable progress in implementing these policies. Guatemala has made less progress. El Salvador has attempted reform, but is hindered by political/military events. Honduras and Nicaragua have done little, though the recent change in government in Honduras will probably bring important reforms with it. Each country must proceed as it is able whether or not their actions are compatible with the constraints of the CACM.

The CACM is a customs union. A customs union requires a common external tariff and duty-free trade internally. Neither condition has existed for some time in Central America. Thus, the CACM in effect, no longer exists.

Section 4 recommends a strategy for integration without a customs union. Main ingredients in that strategy include:

1. A free trade area (FTA) is a preferable form of economic integration for Central America. An FTA requires duty-free trade internally, but allows independent tariffs for outside trade.
2. Conditions should be promoted that would lead to an FTA.
3. An FTA would be promoted if the trade and payments reforms already begun independently in Costa Rica, Guatemala and El Salvador were to meet the objectives set by those countries. In fact, if they meet their objectives they will be very close to having a common external tariff as well.
4. Special attention must be directed toward policy reform in Honduras and Nicaragua. Neither could now participate in any formal integration scheme.
5. Subregional trade agreements should be promoted.
6. Any measures that make regional or subregional trade more efficient promotes integration, whether or not these measures fall within formal agreements.

ROCAP ACTIVITIES

Section 5 recommends several activities that ROCAP might become involved in to promote regional integration. These activities are recommended based on the points stated above and on the limitations facing each country. Activities are based on the observations that, first, countries must pursue reforms and do it at their own pace, second, regional free trade can be maintained and conditions will not be "right" for a common external tariff for 3-5 years, third, regional trade can be made more efficient despite lack of formal "integration" schemes. Activities could include:

1. Activities to encourage reforms in trade and payments.

- promote the exchange of comparative information on reforms, exploiting experience elsewhere,
- support comparative evaluations of effective protection,
- examine the effect of removing exchange controls,
- encourage cooperation within sub-regional trade groups,
- consider alternative integration arrangements,
- support maintenance of a free trade area regionally, while individual tariff reforms occur.

2. Trade promotion without formal integration.

- Support removal of "obstacles" to trade, other than tariffs,
- direct attention to removal of transport and potential energy problems,
- promote the interactions now developing between SIECA and the private sector,
- consider regional trading arrangements that could be strengthened with Panama.

INTRODUCTION

The purpose of this study is to provide ROCAP with recommendations on ways that it can best support regional integration in Central America. To support these recommendations, the study examines background trends in economic events and in economic policy. In so doing, the study examines several topics which could have been the objects of separate studies. Indeed, this report is composed of sections which can stand alone as independent studies. Therefore, in addition to the executive summary which precedes the overall study, there are shorter executive summaries for each section. Also, in cases where sections would be extraordinarily long due to the consideration of technical background material, the latter is relegated to appendices. Four parts of the study can stand alone. These are:

SECTION 1: The Balance of Trade and Payments in Central America.

SECTION 2: Real Effective Exchange Rates in Central America.

SECTION 3: The Camera de Compensacion Centroamericana.

SECTIONS 4-5: Prospects for the CACM, and, A Role for ROCAP.

SECTION 1: THE BALANCE OF TRADE AND PAYMENTS IN CENTRAL AMERICA

Summary	1
1.1 Background	3
1.2 Trade in Central America	6
1.3 Conclusions	28
Appendix: Trade and Exchange Restrictions in Central America.	30

SECTION 1

THE BALANCE OF TRADE AND PAYMENTS IN CENTRAL AMERICA

SUMMARY:

Section 1 reviews the economic conditions facing the Central American countries through 1989, and focuses on the period 1980-89. It updates some of the analysis in the "Checchi Report" (1985). Some major conclusions are:

1. Comparisons of CACM activities are often made with what they were in 1980. 1980 is not a good year for comparison. Reasons for this are:
 - Coffee prices reached an historic peak in 1977, but were generally very high for the 1976-80 period. These prices are likely to never return.
 - Other commodities prices were also extraordinarily high in about 1980 and declined thereafter.
 - Nicaraguan imports from other Central American countries were extremely high in 1980. These were so high that they distort our view of "regional" economic events.
2. Analyses should focus on individual countries rather than on aggregate data for the CACM. This is primarily due to the distorting influence of Nicaraguan imports in about 1980 on the aggregate for the region. Also, each country is unique. When we aggregate to the regional level we lose sight of the special characteristics of each country.
3. Integration in Central America, as measured by the proportion of trade occurring internally, did not increase after about 1970.
4. The CACM is extremely small. Honduras has not been a member since 1970. After about 1982 Nicaragua has not been an effective participant. Thus, only three countries remain: Costa Rica, El Salvador and Guatemala.
5. Within the region, excluding Nicaragua, (ie. within the CACM-N) integration, measured by relative trade proportions, did not decrease until about 1985. Proportional trade reduction within the CACM-N during 1980-84, was about the same as it was for non-regional trade, and about what one would expect given changes in GDP. Proportional trade reduction during 1985-89 was very large.
6. Proportional trade reduction within the CACM during 1985-89 was probably not due to discriminatory tariff policy. Countries maintained tariff preferences for regional trading partners.

7. Exchange controls and special taxes and surcharges have been important determinants of proportionally reduced regional trade. Also, all countries made special arrangements to manage trade with Nicaragua.

Introduction:

The purpose of this section is to provide an update to the study by Saidi and Loehr (1985), normally referred to as the "Checchi report". That study contained a general description of economic changes occurring in Central America, particularly those associated with trade and exchange rates, and this section will provide an update on these dimensions. The Checchi report also evaluated a proposal to finance trade balance clearing mechanisms in Central America, upon which we will comment again in Section 2.

In the discussion of economic changes in Central America we believe that it is very important to keep in mind the diversity of the region and the unique experience of each country. No single country is very similar to any of the others. Thus, we will rarely refer to data aggregated to the level of "Central America". Too often important changes for one country may be swamped by regional trends. On other occasions, the performance of one country, when aggregated with the others, can give the impression that there are regional changes occurring when in fact they are only in one country. Much information is lost in the process of aggregation, so, as general principle we will not aggregate.

1.1 Background

An evaluation of trade and payments in Central America (or anywhere else) must keep in mind the overall environment in which changes are occurring. The main feature of the Central American

economic landscape is the severe recession that all countries entered, beginning in about 1979 or 1980. Table 1.1 shows some of the recent history on real GDP and real GDP per capita (PCY). The period from 1980-84 is approximately the time when all countries of the region were clearly in recession. The table shows the annual rate of change for both GDP and PCY for 1980-84 and for the years since. The change in GDP was negative over the 1980-84 period in Costa Rica, El Salvador and Guatemala. Honduras and Nicaragua's GDP was increasing very slowly. However, in no case was there positive growth in per capita income.

For most countries economic difficulties have persisted. Costa Rica seems to have reversed its negative growth, in both GDP and PCY after 1985, but per capita growth continues to be very slow. El Salvador has eked out some minimal growth of GDP but remains more or less stagnant in per capita terms. Guatemala's recession lasted longer than most of the others, with GDP declining through 1985 and remaining stagnant in 1986, but PCY declining sharply through 1986. Honduras has done better than the others in terms of avoiding an overall decline in GDP and achieving some real growth, but extremely slow growth there contributes to stagnation in PCY. Nicaragua's case is a bit different in that its recession occurred earlier than elsewhere, and is attributable to its revolution which occurred in 1978 and 1979. Between 1977 and 1980, GDP declined by about 30% and PCY dropped by 40%. Thus, the figures in Table 1.1, indicating slow growth in GDP for Nicaragua in the 1980-84 period, represents

slow growth from a severely depressed base. The Nicaraguan situation deteriorated even further in 1985 and 1986, with GDP dropping in both years before recovering very slightly in 1987. Per capita income has dropped in all years for Nicaragua since 1978.

The damage that has been done to real per capita incomes in the region can be seen in Table 1.2. There we show the real per capita income recorded in 1979 and in 1987 for each country. Data are those reported in the IMF's, International Financial Statistics (IFS). Note that per capita income in all countries is far below what it was a decade ago. Even in the countries that have been reasonably successful in pulling themselves out of the recession of the early 1980s, Costa Rica and Honduras, PCY is still about 11-12% below 1979 levels. El Salvador's per capita income is severely depressed, and Guatemala and Nicaragua are not far behind. Such large declines in per capita income are very difficult to recover from. To illustrate, we have calculated the rate at which GDP would have to grow, assuming population growth rates implied by IMF data,¹ to return to the 1979 levels of per capita income over a five-year period. In general, real GDPs would have to grow at about 5.5 to 7% per annum to achieve that objective. The Central American countries have not grown at those rates for a five-year period for over twenty years. Thus, it is

¹ Population growth rates were those implied in the population figures appearing in the IMF's, IFS Yearbook, 1989. Rates of change were calculated for the 1980-87 period. The rates assumed were: Costa Rica, 3.1%, El Salvador, 1.5%, Guatemala, 2.9%, Honduras, 3.4% and Nicaragua, 3.6%.

unlikely that per capita income will recover to 1979 levels for a very long time.

1.2 Trade in Central America

The general balance of trade and payments:

An examination of basic elements of the balance of payments for the Central American countries reveals four important features. First, while current account balances have been persistently negative and large during the last decade, there has been some tendency toward improvement in the past few years. In most cases, negative current account balances were largest during 1980 and 1981, and with the possible exception of 1987, current accounts have improved since. Second, variations in trade balances roughly explain variation in current account balances. Third, balances on the services account are persistently large and negative. Furthermore, services balances do not vary by large amounts and in general, the negative balances on the services accounts are larger than the negative trade balances. Thus, it appears that it is the services balances that set the general level of the current account balances, while it is the trade balance that causes the current account balance to vary. Fourth, transfers have become increasingly important.

Table 1.3 shows the data on current accounts and its components, the trade, services and transfer accounts. The data cover the period from 1979 to 1988. The table is analogous to Tables 2.1 through 2.5 in the Checchi report, which carries these

TABLE 1.1

GDP AND GDP PER CAPITA GROWTH RATES FOR CENTRAL AMERICA
IN REAL TERMS FOR 1980-1988

GDP GROWTH:						
	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS	NICARAGUA	
1980-1984	-0.3	-3.3	-1.3	0.4	1.2	
1985	1.0	2.0	-1.0	3.2	-0.1	
1986	4.6	9.6	0.5	2.7	-0.4	
1987	3.0	2.6	3.1	4.2	1.5	
1988	a 2.9	d 0.9	c 3.5	3.9		
GDP PER CAPITA GROWTH:						
1980-1984	-2.2	-6.1	-4.2	-3.1	-2.6	
1985	-1.7	0.7	-3.7	-0.1	-7.3	
1986	1.9	-1.0	-2.2	-0.3	-3.7	
1987	0.3	0.0	0.4	1.1	-1.7	
1988	b 0.2	d -1.0	c 0.6	b 0.0		

SOURCES: 1980-1985 FROM THE CHECCHI REPORT

1985-1987 FROM ZUVEKAS (1989)

OTHERS: a. IMF, IFS COUNTRY TABLES

b. GDP FROM IFS, DIVIDED BY POPULATION GROWTH IMPLIED IN ZUVEKAS

c. Cámara de Industria de Guatemala (1989)

d. IMF estimates (1989)

TABLE 1.2
REAL PERCAPITA INCOME IN DOLLARS OF 1985

	PCY IN 1979	PCY IN 1987	PERCENTAGE CHANGE IN PCY
COSTA RICA	1787	1570	-12.1
EL SALVADOR	1529	1165	-23.0
GUATEMALA	1669	1350	-19.1
HONDURAS	910	a 817	-11.0
NICARAGUA	1581	1235	-21.7

SOURCE: IMF, IFS YEARBOOKS
a. HONDURAS' PCY IS FOR 1988

TABLE 1.3

CURRENT ACCOUNT BALANCES IN CENTRAL AMERICA, 1979-1988

		CURRENT ACCOUNT	TRADE BALANCE	SERVICES BALANCE	NET TRANSFERS
COSTA RICA	1979	-550.2	-315.1	-255.3	12.2
	1980	-663.9	-374.3	-304.1	14.6
	1981	-409.1	-88	-340.2	27.1
	1982	-297.1	64.1	-324.1	37.1
	1983	-316.2	-22	-359.1	64.9
	1984	-251.1	4.6	-292.6	40.9
	1985	-291.2	-61.9	-202	63.6
	1986	-160.6	-39.6	-271.5	71.3
	1987	-397.9	-141	-304.0	105.9
	c 1988	-142.0	-55	-350.4	242.6
EL SALVADOR	1979	21.4	177.6	-207.6	51.4
	1980	30.6	170.4	-196.7	40.9
	1981	-250.4	-100.3	-210.4	60.3
	1982	-152.4	-121.0	-201.3	170.7
	1983	-20	-74.3	-225.1	271.5
	1984	-53.5	-100.6	-172.5	307.6
	1985	-20.7	-216	-156.3	343.6
	1986	116.9	-124.4	-142.1	303.3
	a 1987	-232	-403	-31	372
	a 1988	-219	-404	-42	296
GUATEMALA	1979	-205.6	-100.3	-151.9	126.6
	1980	-163.3	47.2	-320.3	169.0
	1981	-572.7	-240.7	-414.9	90.9
	1982	-399.1	-113.9	-347.9	62.7
	1983	-223.9	35.7	-290.2	30.6
	1984	-377.4	-50	-356.1	20.7
	1985	-246.3	-17	-249	19.7
	1986	-17.6	160	-260.8	75.1
	1987	-442.5	-355.3	-200.5	193.3
	1988	-446.4	-360.4	-300.2	222.2

TABLE 1.3 CONTINUED

		CURRENT ACCOUNT	TRADE BALANCE	SERVICES BALANCE	NET TRANSFERS
HONDURAS	1979	-192.1	-26.9	-105.6	20.4
	1980	-316.0	-103.0	-234.5	21.5
	1981	-302.7	-114.0	-215.4	27.6
	1982	-220.3	-4.2	-254.1	30
	1983	-225.2	-66.5	-203.2	44.5
	1984	-374.3	-147.0	-240.1	22.2
	1985	-292.6	-89.6	-260.2	57.1
	1986	-219.2	17.2	-201.2	50.9
	1987	-265.3	-31.9	-299.1	66.1
	c 1990	-229.4	-23.7	-340.7	136
NICARAGUA	1979	100.2	227	-130.4	91.6
	1980	-379.1	-352.5	-150.5	123.9
	1981	-514.3	-422.6	-162	70.9
	1982	-469	-315.8	-204.7	51.5
	1983	-429.3	-349.5	-172	91.9
	1984	-639.3	-413.9	-351	89.7
	1985	-759.4	-490.7	-344.6	83.9
	1986	-693	-479.3	-320.3	114.6
	1987	-742.1	-530	-320	123.9
	1988	-714.0	-611.5	-253.3	150

SOURCES: CHECCHI REPORT FOR DATA 1979-1983
 IMF, IFS FOR 1984-1987, EXCEPT FOR NICARAGUA WHICH GOES TO 1986.
 a. IMF memo to Executive Board, March 15, 1989
 b. Cámara de Industria de Guatemala (1989)
 c. Consejo Monetario Centroamericano, Boletín Estadístico 1988

figures back to 1969. Notice that the services account for all countries is negative and in most cases larger in magnitude than the trade balance. To a large extent the services balance reflects interest payments on foreign-held debt, though it also contains data on other important variables such as the net result of drawback operations and profit repatriation. For Costa Rica net service payments peaked in the 1980-83 period and in Guatemala in 1981. In both cases net payments on services accounts have improved, though only slightly. For Honduras and Nicaragua, negative services balances continue to grow. Only in El Salvador has there been an improvement in the net balance on services account.

Transfers seem to be growing for all countries. Most important is the case of El Salvador where transfers have been very large. Indeed, transfers to El Salvador have occurred at such a rate that in 1986 and 1987, the current account was in surplus despite large trade deficits. While much of the favorable transfer balance is due to remittances by Salvadorans living abroad,² most of it is attributable to AID's ESF program. Surely the ESF programs are contributors to the improved transfer pictures for Costa Rica, Guatemala and Honduras as well.

Trade balance fluctuations can be traced in part to fluctuations in the prices of the commodities that Central

² Remittances by Salvadorans living abroad have been estimated by AID/El Salvador to be in the range of \$458 to \$573 million per year. Most of that enters El Salvador unrecorded. Balance of payments records only about \$150 million per year.

American countries export. Coffee prices are probably the single most important commodity price for Central America. Coffee prices peaked in 1977, but were at very high levels for the 1976-80 period. Coffee prices peaked again in 1986, though the peak was somewhat lower and short-lived. In the meantime (ie. 1981 to 1985) coffee prices were below the levels of the late 1970s, but were at no time as low as they were before 1976. One can see the effect of favorable coffee prices on the data. In all countries of the region, trade balances and therefore current account balances improved in 1986. It may also be the case that the extra-sharp deterioration of the trade balances in 1987 were a result of high coffee prices in 1986. If governments were convinced that the coffee prices of 1986 would persist, then they would assume that foreign exchange availability would be as good in 1987 as in 1986, and they would allocate foreign exchange accordingly.³ When coffee prices failed to stay at 1986 levels, export proceeds turned out to be "too low", relative to the foreign exchange allocated for imports. It is certain that 1989 will not turn out to be a good year for coffee exports. During the year, the International Coffee Agreement dissolved and coffee prices fell to levels of the early 1970s.

Movements in coffee prices imply that 1980 may be a poor year for comparing trade-related data on Central America. As indicated in the preceding paragraph, 1980 marks the end of the

³ All Central American countries had foreign exchange controls in 1987. Foreign exchange is allocated according to government priorities in each case.

"coffee boom" of the late 1970s. It may be unreasonable to expect that coffee prices will ever again return to the level of the 1976-80 period, and particularly unlikely that they would return to their peak in 1977. Other commodity prices reinforce this observation. Beef prices peaked in 1979-80, Cotton in 1980, bananas in 1980-83 and sugar in 1979-80.⁴ While quota allocations have much to do with foreign exchange earnings in these commodities (particularly with sugar), commodity prices were particularly high in 1980 or in immediately preceding years. For this reason (and others stated below) we do not believe that comparisons with 1980 alone are very useful. While comparisons with 1980 may serve to illustrate some minor points, when it comes to major questions such as those having to do with changes in overall trade performance, or growth in GDP, comparisons with 1980 (or even with the 1977-80 period) are rather misleading. Furthermore, to set out short-term goals that would restore the conditions of 1980 would be naive at best.

Trade Patterns:

It is a fairly common assertion that trade within the CACM declined after 1980. On the basis of total value of exports this is certainly true, but on the basis of trade proportions, it is not. In the following exercises we will see some of the utility in viewing the region as being composed of individual countries rather than being simply an aggregate of five. Aggregation loses

⁴ These statements are based on the commodity price information contained in the IMF, IFS Yearbook, 1989.

important information. The experience of Nicaragua has been so different from the other four countries that, when Nicaraguan data are aggregated with the others, the aggregate information gives a distorted impression of what has occurred in the region.

Exports of each of the Central American countries⁵ to the CACM are shown in Table 1.4. The table is calculated in two ways. The first is to take the conventional definition of the CACM as being composed of five countries. The second is to define the region excluding Nicaragua, a grouping which we refer to as the CACM-N. The reason for doing this is to illustrate that the picture one gets of integration within the region is quite a bit different when Nicaragua is excluded.

But why exclude Nicaragua if it is part of the CACM? First, in the period 1979 to 1983, Nicaraguan imports from the other

⁵ All data representing exports and imports for Central America come from the IMF's Direction of Trade Statistics Yearbooks for various years. At first an attempt was made to use SIECA's data from documents such as "Cuatro decadas de evolucion del Comercio intracentroamericano" (agosto, 1989). However those data have great inconsistencies. Main problems are three. First, data on exports by one country are often much different from the corresponding import figures for its trade partner. Differences are often too large to be explained by the fob/cif differential. Second, there are many cases where the imports of one country are less than the corresponding export figures for a trade partner. This of course cannot be explained by any fob/cif differential, nor does it seem to be explained by the poor recording of the timing of transactions. Third, The SIECA data do not come close to matching the data in Direction of Trade. The latter is a well respected source of trade data, and all data are processed and "cleaned" in a routine manner. Though some small inconsistencies remain, these can often be explained by the timing of transactions.

Thus, we have used data from DOT. To "average out" any inconsistencies, that is to make all exports equal imports between partners, we have taken averages of exports and imports between pairs of countries.

TABLE 1.4

EXPORTS WITHIN THE CACM

	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS	NICARAGUA	TOTAL CACM
1974	100	144.5	167	27.6	91.6	530.0
1975	100.5	131.5	175.5	30.5	92.6	530.6
1976	121	156	202	37	110.7	630.7
1977	160.5	175.5	242	43	134	755
1978	170	219	279.5	50	146.4	864.9
1979	170.5	260	327.5	62	90.2	910.2
1980	272.5	259	476	90.5	76.4	1172.4
1981	235	168.5	424.5	63.5	78.6	902.1
1982	167	167.5	348.5	54.5	52.2	709.7
1983	199.5	162.5	330.5	62.5	35.9	790.9
1984	190.5	148.5	297	40.5	34.9	719.4
1985	147.5	92	222	33.5	20.9	515.9
1986	109.5	90	140	32.5	20.4	400.4
1987	114	117	105.5	37.6	26.0	400.6
1988	122	132	210	40.5	32.6	537.1

EXPORTS WITHIN THE CACM-H

	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS	TOTAL CACM-H
1974	61	190.5	127	15.6	312
1975	65.5	182.5	141.5	10.6	320
1976	76	119	164	23	302
1977	104.5	136.5	201	29	471
1978	124	190	241.5	30	593.5
1979	130.5	237	295.6	47	710
1980	140.5	204	379	57.5	709
1981	151	150.5	355.5	42.5	701.5
1982	120	150.6	303.5	46.6	620.5
1983	150.5	147.5	279.5	52.6	630
1984	162.5	143.5	270	37.6	613.5
1985	120.5	89	209	22.5	441
1986	97.5	93	141	20.5	352
1987	102	110	176.5	23.6	412
1988	106	124	200	23.6	453.6

TABLE 1.5.A

EXPORTS TO NICARAGUA (IN MILLIONS OF DOLLARS) BY:

	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS
1974	39	36	40	12
1975	35	29	34	12
1976	45	37	30	14
1977	56	39	41	14
1978	46	29	30	12
1979	40	23	32	15
1980	124	55	96	33
1981	84	30	69	21
1982	47	17	45	8
1983	41	15	51	10
1984	28	5	27	11
1985	27	3	13	11
1986	12	5	7	12
1987	12	7	9	14
1988	16	8	10	17

EXPORTS TO NICARAGUA AS PERCENTAGE OF EACH TOTAL:

	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS
1974	37.50	24.49	24.54	44.44
1975	32.71	20.42	20.12	40.00
1976	34.62	21.02	20.11	36.04
1977	32.10	10.06	10.39	31.02
1978	25.70	12.39	14.84	24.00
1979	22.73	8.75	10.46	23.44
1980	45.93	10.50	21.77	35.07
1981	35.15	14.56	16.95	29.50
1982	28.14	9.77	13.31	14.29
1983	20.60	8.93	15.94	16.13
1984	14.43	3.10	9.44	23.40
1985	10.00	3.16	6.34	33.33
1986	11.00	5.62	6.00	37.50
1987	11.01	6.42	6.12	37.04
1988	11.94	6.50	6.06	43.59

TABLE 1.5.0

TRADE BALANCES WITH NICARAGUA AS SEEN BY:

	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS
1974	6	14	21	2
1975	-2	4	20	-2
1976	1	6	23	-3
1977	7	4	25	-5
1978	-11	-12	9	-10
1979	-2	-9	12	-2
1980	91	44	80	19
1981	90	20	54	0
1982	25	10	31	-1
1983	21	12	39	6
1984	12	2	12	7
1985	10	1	5	7
1986	7	4	-4	8
1987	9	5	-5	9
1988	5	6	-6	11

7/2/88

Central American countries increased dramatically. Second, in the same period, the cordoba became extremely overvalued in real terms and the other Central American countries sharply reduced their imports from Nicaragua. Third, the resulting trade deficit for Nicaragua with the region could not be settled by Nicaragua for lack of foreign exchange. Fourth, Nicaragua accumulated large debts to the other countries of the region. Since it could not service these debts, the main creditor countries, mainly Costa Rica and Guatemala, stopped all trade with Nicaragua, except that which could be cleared by barter. In the process the clearing mechanism centered on the Camara de Compensacion Centroamericana broke down because it never was designed as a credit source, let alone the manager of debt arrears. (see the Checchi report for details) Finally, Nicaragua is not now a member of the CACM in any functional sense, and has not been since 1984. It cannot service the old debts accumulated in the early 1980s. It does not have foreign exchange available to create confidence among its trade partners that it will clear payments when due and major changes within Nicaragua to reintegrate itself with the region will be protracted. For practical reasons, it is necessary to get on with the task of revitalizing the economies of Central America, leaving Nicaragua aside.

Examine Table 1.4. The top part shows intraregional exports using the conventional definition of the CACM. Notice that Nicaragua's regional exports fell off sharply after 1978. Meanwhile, Nicaragua's imports from the other CACM countries grew

considerably, to peak in 1980. Indeed, the data in Table 1.5, part A, show that exports to Nicaragua tripled for Costa Rica and Guatemala and doubled for El Salvador and Honduras, all in one year (ie between 1979 and 1980). These regional exports stayed relatively high through 1983, after which they were cut back sharply. This would not make much difference to aggregate regional trade patterns if exports to Nicaragua were only a small proportion of exports of the other CACM countries. But this is not the case. The lower part of Table 1.5.A indicates that exports to Nicaragua were a rather large proportion of the total of regional exports for the other countries. The data in Table 1.5, part B, show that for the period 1980-84, all the other countries ran trade surpluses with Nicaragua that dwarf any previously observed trade imbalances. It was the accumulation of these unsettled imbalances that eventually led to the collapse of trading relationships between Nicaragua and the other Central American countries.

Returning to table 1.4 we see the effect of removing the influence of Nicaragua from the data by examining exports for the CACM-N. Exports for that four-country group also peaked in 1980, and declined to 1988, when there was a slight upturn. However, the drop in intra-regional exports was not as great proportionally as it appeared to be when Nicaragua was included. Note that for the CACM, the changes in intra-regional exports were:

1974-80	+121%
---------	-------

1980-84 - 39%

1984-88 - 25%

For the CACM-N, intra-regional exports changed by the following percentages:

1974-80 +152%

1980-84 - 22%

1984-88 - 25%

Within the CACM-N there appears to be more "integration" occurring before 1980, in that intra-regional exports grew at a faster pace (152%) than they did for the CACM (121%). Also, when trade declined after 1980, there was less "disintegration" within the CACM-N. Intra-regional exports within the CACM-N dropped by 22%, while with the effect of Nicaragua included, intra-regional exports dropped by 39%. Indeed, 44% of the entire drop in trade for the CACM is attributable to Nicaragua alone. Furthermore, for the CACM-N the drop in intra-regional exports was only slightly more than the drop in per capita incomes for the region, a result that one would expect given "normal" income elasticities of demand for imports. Also, exports for the CACM-N to the rest of the world fell by about the same proportion, indicating that there might not have been any "disintegration" at all. There was a general, worldwide decline in exports, not a decline restricted to the region. From 1984, the decline in intra-regional exports is about the same for the CACM as it is for the CACM-N. This is not surprising since by 1984, most trade with Nicaragua had been stopped by the other countries.

TABLE 1.6.A

COSTA RICA, PERCENTAGES OF EXPORTS TO:

	CACH	CACH-N	US	OTHER
1974	29.60	16.21	35.41	40.30
1975	21.70	15.72	45.20	39.00
1976	21.96	15.54	42.96	41.50
1977	21.01	15.20	33.29	51.42
1978	21.99	17.32	34.90	47.79
1979	10.04	15.21	30.01	45.97
1980	27.52	17.04	30.62	44.34
1981	23.71	16.77	35.39	47.04
1982	19.17	14.56	35.44	50.00
1983	23.11	19.27	33.41	47.32
1984	19.60	17.33	30.03	43.04
1985	15.40	12.93	40.69	46.30
1986	9.26	0.25	45.20	40.47
1987	9.70	0.00	46.92	45.26
1988	10.92	9.74	45.00	45.25
AVERAGE 74-80	22.30	16.05	30.46	45.50
AVERAGE 81-84	21.42	16.90	35.77	47.25
AVERAGE 85-88	11.36	9.93	43.72	46.35

EL SALVADOR, PERCENTAGES OF EXPORTS TO:

	CACH	CACH-N	US	OTHER
1974	31.75	26.00	20.34	45.67
1975	27.63	23.30	20.66	40.04
1976	24.41	20.32	34.36	45.32
1977	22.10	10.93	33.00	47.27
1978	27.69	25.12	23.77	51.10
1979	21.50	20.00	20.33	51.67
1980	27.66	23.74	43.25	33.00
1981	25.05	22.95	17.73	59.32
1982	24.09	23.02	36.36	40.62
1983	22.67	21.07	39.39	39.53
1984	21.90	21.35	37.92	40.73
1985	13.99	13.61	40.37	30.02
1986	12.11	11.51	49.73	30.77
1987	17.52	16.59	44.39	39.02
1988	17.05	16.09	39.79	43.32
AVERAGE 74-80	26.12	22.49	31.50	46.01
AVERAGE 81-84	23.03	22.10	32.05	45.05
AVERAGE 85-88	15.37	14.65	45.57	39.70

TABLE 1.6.0

GUATEMALA, PERCENTAGES OF EXPORTS TO:

	CACH	CACH-N	US	OTHER
1974	28.50	23.12	35.34	41.54
1975	27.13	22.92	24.20	52.00
1976	24.07	20.91	36.90	42.11
1977	18.79	15.00	33.51	50.61
1978	23.51	20.74	30.16	49.10
1979	24.62	22.63	30.47	46.90
1980	29.07	24.20	29.56	46.16
1981	33.20	29.21	19.27	51.51
1982	30.10	27.26	20.47	44.20
1983	27.61	24.20	36.55	39.17
1984	26.12	24.25	39.23	36.52
1985	20.69	19.63	36.71	43.66
1986	18.01	16.99	46.19	36.01
1987	13.96	13.22	47.22	39.56
1988	15.20	14.49	40.56	44.95
AVERAGE 74-80	25.21	21.50	31.47	47.03
AVERAGE 81-84	29.20	26.25	30.00	42.07
AVERAGE 85-88	16.98	16.03	42.67	41.26

HONDURAS, PERCENTAGE OF EXPORTS TO:

	CACH	CACH-N	US	OTHER
1974	10.34	6.02	49.40	44.50
1975	9.90	6.19	53.61	40.21
1976	9.57	6.27	50.49	35.25
1977	8.63	6.05	50.60	43.35
1978	8.31	6.44	50.64	34.92
1979	8.72	6.02	59.11	34.00
1980	11.10	7.41	55.03	37.56
1981	9.75	7.07	56.44	36.49
1982	8.30	7.27	53.10	39.55
1983	9.39	8.00	56.00	36.00
1984	6.14	4.77	54.17	41.06
1985	4.19	2.04	50.64	46.52
1986	3.55	2.25	49.70	47.98
1987	3.00	2.40	53.44	44.17
1988	4.11	2.36	50.32	47.32
AVERAGE 74-80	9.51	6.46	54.98	38.56
AVERAGE 81-84	8.42	6.78	54.95	38.27
AVERAGE 85-88	3.91	2.46	51.04	46.50

TABLE 1.7.A

COSTA RICA, PERCENTAGES OF IMPORTS FROM:

	CACH	CACH-H	US	OTHER
1974	15.83	11.79	36.10	52.11
1975	16.57	11.07	36.30	51.75
1976	17.53	12.53	36.70	50.69
1977	16.45	12.24	35.39	52.37
1978	10.59	14.11	36.23	49.66
1979	15.16	12.54	31.34	56.12
1980	16.02	13.07	35.05	51.00
1981	12.57	10.04	34.30	55.66
1982	12.65	10.45	36.51	53.04
1983	12.12	10.31	30.56	51.13
1984	10.45	9.12	36.04	54.05
1985	0.39	7.63	34.93	57.44
1986	9.26	0.86	35.96	56.10
1987	0.45	7.05	37.20	54.07
1988	0.09	7.37	39.27	53.36
AVERAGE 74-80	16.45	12.59	35.32	52.00
AVERAGE 81-84	11.95	9.90	36.65	53.47
AVERAGE 85-88	0.55	7.93	36.06	55.21

EL SALVADOR, PERCENTAGES OF IMPORTS FROM:

	CACH	CACH-H	US	OTHER
1974	20.74	17.63	32.10	56.37
1975	22.07	19.51	32.75	47.74
1976	23.62	20.38	29.04	49.70
1977	22.22	19.23	30.44	50.33
1978	23.26	20.00	31.99	47.93
1979	24.74	22.00	29.12	40.00
1980	32.96	32.19	20.21	47.60
1981	30.99	30.20	25.75	43.98
1982	30.46	29.00	27.41	42.71
1983	26.15	25.90	32.66	41.44
1984	26.00	25.77	33.37	40.06
1985	22.50	22.42	33.99	43.59
1986	17.65	17.56	35.09	46.54
1987	17.14	16.99	33.39	43.62
1988	16.07	16.73	42.31	40.96
AVERAGE 74-80	24.37	21.67	29.49	40.83
AVERAGE 81-84	29.40	27.96	29.00	42.25
AVERAGE 85-88	10.56	16.43	37.90	43.68

TABLE 1.7.0

GUATEMALA, PERCENTAGE OF IMPORTS FROM:

	CACH	CACH-N	US	OTHER
1974	17.40	15.10	32.70	52.20
1975	14.19	12.52	35.05	52.49
1976	12.70	11.19	37.29	51.60
1977	9.06	8.40	34.99	56.53
1978	16.10	14.16	30.71	55.13
1979	18.35	17.25	32.61	50.13
1980	13.50	12.71	34.09	52.40
1981	11.60	10.00	34.14	55.07
1982	15.42	14.56	31.44	54.00
1983	19.02	18.97	32.50	48.59
1984	12.91	12.00	28.85	59.94
1985	7.63	7.06	31.34	61.60
1986	10.20	9.34	41.62	49.04
1987	10.65	9.69	40.62	49.69
1988	10.32	9.36	43.45	47.19
AVERAGE 74-80	14.61	13.06	34.02	52.92
AVERAGE 81-84	14.94	14.00	31.53	54.39
AVERAGE 85-88	9.70	8.86	39.26	51.00

HONDURAS, PERCENTAGE OF IMPORTS FROM:

	CACH	CACH-N	US	OTHER
1974	10.79	8.30	41.62	50.00
1975	12.07	9.74	43.85	46.41
1976	13.02	9.63	45.41	44.95
1977	12.26	9.29	44.46	46.25
1978	13.16	10.34	43.28	46.30
1979	11.75	9.89	44.25	45.06
1980	10.25	8.90	42.99	48.03
1981	12.49	11.27	42.06	46.67
1982	12.57	11.42	39.97	48.61
1983	12.00	12.30	36.27	51.35
1984	10.35	9.97	37.94	52.09
1985	9.00	8.64	41.24	50.12
1986	6.23	5.77	49.14	45.09
1987	5.90	5.34	54.45	40.21
1988	5.40	4.70	57.17	38.04
AVERAGE 74-80	12.01	9.46	43.69	46.04
AVERAGE 81-84	12.05	11.26	39.86	49.68
AVERAGE 85-88	6.65	6.13	50.58	43.37

Table 1.6 shows export patterns for Costa Rica, El Salvador, Guatemala and Honduras (ie. the CACM-N). Patterns are described in terms of the exports going to either the CACM, the CACM-N, the U.S. or the rest of the world, labeled "other". Compare the columns for the CACM and the CACM-N. If we note the proportion of total exports going from each country to the CACM, we note that in each case there was a decline beginning in 1980. Smaller proportions of exports were directed toward the CACM in the 1981-84 period, and much smaller proportions in the years 1985-88. The picture is not the same for the CACM-N. The proportion of exports directed toward the CACM-N does not drop in the 1981-84 period. Indeed, for three of the countries in the group, the proportion of exports directed to the CACM-N increases. Only in El Salvador does the proportion drop, but there only by a little. Three main points stand out:

1. If we use the proportion of trade directed internally as a measure of economic integration, then the level of integration actually grew for the CACM-N, up until 1984. It clearly declined thereafter.
2. While the data for the CACM seem to indicate a relative disintegration of trade for Central America starting in 1980, they do not. The data primarily reflect a disintegration of normal trading relationships with Nicaragua.
3. The absolute level of trade occurring in the region declined after 1980 no matter what group is considered.

The main decline is caused by Nicaragua ceasing normal trading relationships with the region. Absolute declines occurred elsewhere, but these were roughly proportional to declining trade with other world areas.

For the reasons indicated above, we do not consider it productive to attempt to analyse aggregate data for Central America as a region, especially without removing the influence of Nicaraguan data. Nicaragua is a special case and should be treated as such. To retain Nicaragua in any aggregate figures dealing with Central America is to muddle whatever analysis is being done.

Tables 1.6 and 1.7 show that important shifts have occurred in CACM-N trade since about 1985. These are:

1. Intra-regional trade has declined proportionally, whether we consider exports (table 1.6) or imports (table 1.7) but the decline began only in about 1985. On the basis of regional trade patterns one could not build the case that there was disintegration of trading relationships within the four-country group before 1985.
2. After 1985 there has been a proportional shift in trade toward the U.S. Only Honduras increased its proportion of exports destined to "other" countries and this is almost entirely due to exports of bananas. Only Costa Rica imports proportionally more from "other" countries, but it has not reduced its share of imports

coming from the U.S. Some of the shift in trade toward the U.S. is probably associated with the components of AID flows that must be spent in the U.S. This would particularly affect El Salvador, where the proportion of trade with the U.S. has increased dramatically.

There is a generally held belief in Central America that important trade barriers have been erected that discriminate against regional trade, and that these barriers are to blame for decreased regional trade. The Checchi Report examined changes in trade and exchange restrictions through 1983 and found that, while there were trade and exchange restrictions, and that they increased after 1980, they did not generally discriminate against regional trade. On the contrary, the new restrictions were generally not applicable to regional trade. Furthermore, the Checchi Report examined the proportions of imports for each country originating within the CACM. Had trade restrictions been discriminatory, against intra-regional trade, the proportion of imports originating within the CACM would have dropped for the countries imposing restrictions. The Checchi Report found no evidence of discriminatory restrictions of this kind.

Our Table 1.7 shows the proportions of each country's imports originating in the CACM-N.* Signs of having erected new

* Again, it would be very distorting to include Nicaragua in the calculations. That would show that the proportion of imports originating in Central America, would have dropped starting in about 1978, with the drop accelerating after 1980. But that is only the effect of the Nicaraguan trade. The other Central American countries did discriminate against Nicaragua by cutting off trade with her, except through automatically balancing

discriminatory restrictions do not appear until 1985. After that date, the proportion of imports originating in the CACM-N fell sharply. This reopens the question as to whether or not effective and new restrictions on trade and payments have been imposed by each of the CACM-N countries. Surely, this shift could be explained by other variables but discriminatory restrictions could be important. In the appendix to this section we survey new trade and payments restrictions that have been applied since 1984. In general, that survey uncovers no important discrimination in the form of tariff restrictions, against imports from the region by any country. Indeed, tariff preferences for imports from Central America have been retained. There are some instances where countries have instituted export promotion schemes which make it more advantageous for their own exporters to seek markets outside Central America. This is particularly true in the case of Costa Rica.

The main discrimination against regional trade was probably indirect. Beginning in about 1980, all countries of the region developed severe foreign exchange shortages. There are two possible responses to this. First, a country can adjust the value of its currency, which in this case meant devaluation. A new, devalued value for a currency would then serve as a device to ration the foreign exchange that is available, while simultaneously creating conditions that would make more foreign

barter. But this is well known and well understood. It should not blur our vision of what occurred elsewhere.

exchange available in future. Except for Costa Rica, all countries were reluctant to devalue. But even in the case of Costa Rica there continued to be a shortage of foreign exchange. It takes time for a devalued currency to increase the availability of foreign exchange and Costa Rica was staggering under a debt burden that demanded all the foreign exchange that could be generated, just for debt service. Secondly, exchange controls can be used to ration foreign exchange. Even with its devaluations, Costa Rica relied on exchange controls during the early 1980's as a temporary measure to get through its worst crisis years. The other countries had to use exchange controls because of their unwillingness to devalue. Furthermore, as their currencies became progressively more overvalued in real terms, exchange controls had to be made more limiting. Only those countries able eventually to devalue and maintain the real devaluation (ie. Guatemala and Costa Rica) were able to relax exchange controls. Honduras, the country least willing to devalue, currently has the most constraining exchange controls

The exchange controls, as implemented in each country probably constituted the main obstacle to intra-regional trade. To put the controls into effect, each country established lists of imports, ranked by priority. Highest priority would go to "necessities" such as medicines and food; next priority to imported inputs. Lowest priority went to consumer and "luxury" goods. But it is precisely trade in consumer goods in which intra-regional trade had specialized. Indeed, 90-95% of the trade

among the Central American countries was composed of consumer goods (World Bank, 1989:12), the very goods assigned lowest priority by every country's foreign exchange allocation scheme. Vulnerability of the Central American economies to these restrictions was probably heightened because of the ISI strategies promoted by the CACM. Those ISI strategies were designed to protect highly the production of consumer goods. That production was based largely upon imported inputs. Thus, when the crisis came, production was very dependent on imported inputs and it was these imports that received priority in the allocation schemes, so that domestic production could continue.

A final observation should be made from Tables 1.6 and 1.7. While the economies of the countries of Central America appear to have achieved significant integration prior to 1985, the degree of integration does not appear to have increased after about 1970.⁷ This statement is at odds with conventionally held views in the region. If we include as part of the operational definition of integration, proportionally increased trade among members, then we can measure progress at integration by observing whether there are increases in the proportion of trade occurring among members. It is not enough to measure the absolute level of trade among countries, for that alone does not tell us anything about the strengthening or weakening of trading ties among countries. The proportion of each country's trade occurring among

⁷ A similar observation has been made by the World Bank (1989) and by PRODESARROLLO (1989).

members (ignoring Nicaragua) did not change in any significant way between about 1970 and 1985. The period between 1970 and 1980 was one of general trade expansion, and trade with the rest of the world expanded at about the same pace as intra-regional trade. The countries were participating in an overall expansion of world trade and trade with themselves was only part of it. Thus, we take issue with the conventional view that economic integration became greater up until about 1980. For us the degree of integration did not change after 1970.*

The nature of regional integration changed greatly in about 1980. That year marked the peak for Nicaraguan imports from the region and the accumulation of a debt that has never been repaid. As a result, by about 1983 Nicaragua was no longer a participating member of the CACM. Since Honduras has not been a member of the CACM since 1970, the departure of Nicaragua left the CACM as consisting of only three countries. Thus, by the mid-1980s little remained of the CACM that had been envisioned in the

* One could easily build the case that the degree of integration with the rest of the world occurred at a more rapid pace for Central American countries than it did with the region. If we focus on international transactions rather than on trade, as a measure of the degree of integration, and furthermore on the proportions of transactions with the rest of the world versus Central America, we would see greater integration with countries outside the region.

Recall the figures of Table 1.3 on the current account balance for the region. The current account balances are a result of three kinds of transactions, those having to do with trade, services and transfers. Capital transactions occur in the capital account. There are very few intra-regional transactions in other than the trade account. Furthermore, these non-trade transactions have expanded greatly since 1970. Thus, the proportion of transactions occurring within the CACM has declined over the years. By this measure, integration in the region has decreased.

1960s.

1.3 CONCLUSION

Section 1 reviews the economic conditions facing the Central American countries through 1989, and focuses on the period 1980-89. It also updates some of the analysis in the "Checchi Report" (1985). Some of the major conclusions are:

1. Comparisons of CACM activities are often made with what they were in 1980. 1980 is not a good year for comparison.

Reasons for this are:

- Coffee prices peaked in 1977, but were generally very high for the 1976-80 period. These prices are likely to never return. Thus, the Central American countries had extraordinary foreign exchange earnings and economic growth. Similar coffee prices may never recur.

- Other commodities prices also peaked in about 1980 and declined thereafter.

- Nicaraguan imports from other Central American countries were extremely high in 1980. These were so high that they distort our view of "region" economic events.

2. It is more revealing to examine data on individual countries than it is to examine an aggregate for the CACM. This is primarily due to the distorting influence of Nicaraguan imports in about 1980 on the aggregate for the region. Also, each country is unique, and when we aggregate to the regional level we lose sight of the special

characteristics of each country.

3. Integration in Central America, as measured by the proportion of trade occurring internally, did not increase after about 1970.

4. Within the region, excluding Nicaragua, (ie. within the CACM-N) integration, measured by relative trade proportions, did not decrease until about 1985. Proportional trade reduction within the CACM-N during 1980-84, was about the same as it was for non-regional trade, and about what one would expect given changes in GDP. Proportional trade reduction during 1985-89 was very large.

5. Proportional trade reduction within the CACM during 1985-89 was probably not due to discriminatory tariff policy. Countries maintained tariff preferences for regional trading partners. Rather, exchange controls and special consumption taxes and surcharges were responsible for proportionally reduced regional trade. All countries made special arrangements to manage trade with Nicaragua.

APPENDIX TO SECTION 1

TRADE AND EXCHANGE RESTRICTIONS IN CENTRAL AMERICA

The purpose of this appendix is to survey changes that have been made in the restrictions governing trade and payments within Central America. This is in response to the commonly held view that one of the main reasons for a decline in intra-regional trade is that each country has erected barriers discriminating against regional trade. Our main source for this survey is:

IMF, "Exchange Arrangements and Exchange Restrictions, Annual Reports, for various years, 1985 through 1989.

Contrary to the title of this source, it comments on changes in tariffs and other trade barriers as well as on exchange restrictions. To the extent that we rely upon other sources, we will refer to them in the text. We will survey changes in policy by country and chronologically; then assess whether or not there has been any systematic bias against trade within the region.

One should keep in mind the situation existing at the beginning of the period under study, which is 1984 to the present. In 1984, payments clearing through the Camara de Compensacion Centroamericana (CCC) had all but ceased. Massive unserviced debts by Nicaragua, primarily to Costa Rica and Guatemala had caused the latter two countries to begin withdrawal from use of the CCC. El Salvador was having difficulty clearing payments and Honduras, while its trade was small, was recognized to have an overvalued currency. Both Costa Rica and Guatemala

were in the process of structural adjustments that involved devaluations and export promotion. All these factors make 1984 a year of considerable uncertainty. See the Checchi Report for details.

COSTA RICA

1984:

By 1984, Costa Rica had a unified exchange rate. Purchases and sales of other Central American currencies were effected on the basis of quotations in colones, taking into account the value of those currencies in terms of US dollars in the parallel exchange markets of the respective countries. The effect of this procedure was to cause a de facto devaluation of the other Central American currencies as far as trade with Costa Rica was concerned. Payments to member countries of the CACM continued to be made through the CCC, though payment was made in dollars.

Imports were not licensed, though registration was required. There was an exception made for goods originating within the CACM, which were exempt from the registration. In addition to regular import duties, which in general were non-existent between Costa Rica and the other CACM countries, the following taxes were levied on trade:

1. a stamp tax of 3% of the customs duty,
2. a sales tax of 10% ad valorem (with some exemptions),
3. selective consumption tax of 10, 12, 50 and 75% depending upon the "essentiality" of the goods in question,
4. 10% surcharge on capital goods originating outside the

CACM.

5. 12.5% surcharge for consumer goods originating outside the CACM.

6. a 2% surcharge on goods originating in the CACM.

Thus, on the basis of special taxes and surcharges, there is a clear preference for goods originating within the CACM. The tax on CACM goods is small (ie 2%) and it is smaller than special taxes on goods from other areas.

Tax credit certificates (CATs) were made available to exporters of nontraditional exports to areas outside the CACM. CATs were valued at 15% of the fob value of qualifying exports and are freely negotiable. In addition, exporters qualifying for CATs also qualify for certificates for increases in exports (CIEX) The latter are equal in value to from 1% to 10% if the fob value of the increase in exports over the preceeding year, and are redeemable in cash (in colones). The provision of CATs and the CIEX would clearly discriminate against trade with Central America. These instruments create a strong incentive for Costa Rican exporters to export outside the region if they can.

The only arrangement to discriminate directly against Central American trade was to establish special arrangements for exports to Nicaragua. Exports to Nicaragua were permitted to Nicaragua only in cases of advance payment in dollars, barter, or against letters of credit confirmed by major international banks. This arrangement is clearly in response to the debt arrears accumulated by Nicaragua and its inability to service that debt

with Costa Rica.

1985:

Beginning from May 20, 1985, settlements in respect of all trade with Central American countries are required to be made in dollars. One should recall the context within which this occurred. Costa Rica was owed very large amounts by Nicaragua associated with the latter's inability to clear payments through the CCC. El Salvador was having difficulties clearing payment and was experiencing considerable economic chaos at the time. Guatemala had lost control of the value of the quetzal and great uncertainty existed there. Honduras had a serious overvaluation problem, but traded little with Costa Rica in any event. Imports from the CACM continued to be exempt from registration requirements, and taxes and surcharges on trade remained as they were in 1984. The value of CATs was increased for some trade, but CATs and CIEXs remained unavailable on exports to the CACM. The old CAT value of 15% of fob was retained for exports destined to the US, but was increased to 20% for exports to countries other than the US. Restrictions on payments for exports to Nicaragua were retained.

1986:

Conditions remained the same as they were in 1985, with the exception of some changes in the taxes and surcharges on trade. In addition to the taxes already mentioned, special tax treatment was created for imported inputs and capital goods. For imported inputs, if nominal protection is less than 10%, a surcharge is

added to raise it to 10%. For capital goods, if nominal protection is less than 20%, a surcharge is added to bring it to 20%. The surcharge on goods originating in Central America was changed too. For Central American goods, the surcharge was 2% provided that the surcharge on similar goods from outside the region were at least 2%.

1987:

Conditions in 1987 remained the same with the exception that the protection on imports of inputs and capital goods was limited to minima of 8% and 10% respectively, by levying surcharges where nominal rates were less than these amounts. Import surcharges for consumer goods originating in Central America were eliminated.

1988:

During 1988, conditions remained as they had been with the exception that the stamp tax on imports was replaced by a tax of 1% of import value. Meanwhile, the maximum tariff rate was reduced to 80%, as part of a trade reform aimed at reducing the maximum tariff rate to 40% over three to five years.

1989:

The main change during 1989 is that Costa Rica and Guatemala have agreed bilaterally, to clear payments between them through the mechanisms of the CCC. By 1989, Guatemala had made considerable strides in managing the quetzal, and in fact imbalances between the two countries were rather small. Thus, while settlement is to be in dollars, it is not necessary for Costa Rican exports to be liquidated in dollars for each

transaction.

In summary, in Costa Rica, the measures taken discriminate against trade within Central America indirectly, mainly through the operation of the CATs and CIEXs. These are only available to exporters of nontraditional goods to areas other than Central America. Furthermore the incentives created by the CATs are substantial. To qualify for CATs, the exports in question need only have a domestic value added of 30%. Thus, exports just meeting this criterion receive an export subsidy equal to about 50-67% of domestic value added depending on destination, as long as the destination is not Central America. CIEXs add to that subsidy. These factors would tend to reduce Costa Rican exports to the region, though they would tend to promote exports in general. Costa Rican exports to the region would be further slowed by the requirement (beginning in May, 1985) that all settlement for exports to the region be made in dollars.

The system of taxes and surcharges on imports show a continued preference for goods from Central America. Costa Rica has erected a series of taxes and surcharges on imports, which are the equivalent to import duties. In all cases however, taxes are either not levied on goods originating in Central America or the taxes that do exist are very low compared to equivalent goods originating elsewhere.

EL SALVADOR

1984:

By 1984, El Salvador was in the process of devaluing the

colon. A legal parallel market for foreign exchange was established in 1982. Commercial banks were allowed to deal in the parallel market, but the central reserve bank (BCR) was prohibited from doing so. Nevertheless, since the banking system in El Salvador is nationalized, the parallel market cannot be considered a "free market". An active black market also existed (and still exists) in El Salvador and the colon in that market exchanged at a rate of about C 4.20 per dollar at the end of 1984. Part of the process of devaluation was to transfer transactions, little by little from the official market to the parallel market. Indeed, over the next few years, the struggle with devaluation would predominate on El Salvador's economic landscape.

Several steps on the path to devaluation seemed to discriminate against trade with the CACM. Foreign currency accounts could be opened by some exporters of nontraditional exports to countries outside the CACM. This would be to their advantage because it would protect them from the coming official devaluation, the size of which was still unknown in 1984. During the year a series of lists were published, authorizing that certain percentages of export proceeds could be sold in the parallel market, for specified types of exports. In general, proceeds from nontraditional export sales outside Central America received a slight advantage in that a higher percentage of them were exchangeable at parallel rates. One must note, that these were incentives for Salvadoran exporters, who were dealing from a

position of competitive weakness. The Salvadoran colon was so overvalued that despite these incentives there was not much of an impact on exporters.

On the import side, preferences were maintained for imports from the CACM. When imports were transferred to the parallel market, it was imports from outside the region that were transferred first. Goods from the CACM were also exempt from import surcharges of 30% on the applicable import duty, and a selective consumption tax of from 5 to 30 percent, both of which were charged on imports from other countries.

1985:

During 1985, the move toward devaluation continued in more or less the same fashion. In general the same conditions existed, except that the proceeds from exports to the CACM were permitted to be exchanged in the parallel market fully. The main feature of 1985 is probably the confusion and chaos associated with the proliferation of lists permitting differing proportions of transactions to be subject to different exchange markets. It was probable that this procedure deterred trade, no matter the trade partners involved.

1986:

The colon was devalued to C 5 per dollar on January 22. Simultaneously, imports were increasingly restricted. Priority lists were published indicating high priority items that could be imported, and other lists prohibiting the importation of many items. Importation was also restricted by requiring high prior

deposits, and restricting the use of means of payment other than letters of credit. It became a requirement that all imports be paid for with 90-day letters of credit. However, imports from the CACM were generally exempt from these restrictions. Payments could be affected in a number of ways unavailable to importers from other areas. Imports of "nonessential goods" were made subject to a consumption tax ranging from 10% to 125%, though most CACM goods were exempt.

1987:

Conditions remained more or less unchanged in 1987. The only major change of note was that exporters of nontraditional goods were again permitted to open accounts denominated in dollars. (normally referred to as "cuentas dolares") These dollars could be used for their own imports or could be transferred to other importers who met certain (limiting) criteria. Cuentas dolares were available to exporters to the CACM.

1988:

During 1988 restrictions on imports were relaxed and the use of cuentas dolares was expanded. Exporters of nontraditional goods also qualified for "certificates for discounting taxes", which were equal to up to 20% of value added in the export activity. These were not transferrable.

During 1988, El Salvador struck a bilateral agreement with Guatemala that trade between them could be transacted in whatever currency was acceptable to the exporter and importer, and at whatever exchange rate they could agree on. In effect this

created a limited free market in foreign exchange, operating mainly along the border between the two countries.

1989:

It became clear at the end of 1988, that the colon was overvalued and that its official exchange rate could not be sustained at C 5 per dollar (see Loehr, Protasi and Vogel, 1989). Thus, during 1989, movement toward devaluation began again. The use of cuentas dolares was expanded so that more people could transact in that market. Also, banks were allowed to intermediate there. By the time the political violence of late 1989 began (on November 11) most transactions were occurring in this "parallel" market. The exchange rate then was about C6.40 per dollar.

In summary, El Salvador did not appear to discriminate against intra-CACM trade. Except for a few short periods, preferences were given to CACM trade. During the periods when preferences seemed to have been eroded, the preferences were related to a changing situation on the road to devaluation. These episodes were short-lived and probably did little to damage trade within the CACM.

GUATEMALA

1984:

The main feature governing international payments in 1984 was the nature of the then existing three-tiered exchange system. Guatemala was taking the first steps toward devaluation of the quetzal by establishing three markets. First was the official market where most transactions occurred. The rate there was 1

quetzal per dollar. The second was an auction market, where the central bank would buy dollars from banks and auction them off periodically. (While this auction market was created legally, no transactions in it occurred in 1984). The third was a banking market, where the value of the quetzal was allowed to devalue in accord with market forces (though it is not likely that this was a "free market") In the banking market, the quetzal was devalued by about 50% compared to the official market by the end of 1984.

Most exporters were required to surrender their foreign exchange at the official rate, though exporters to the CACM were allowed to exchange their proceeds at the banking rate, an obvious incentive to export to the CACM. Payments with regional countries were still being cleared through the CCC, though transactions with Nicaragua were required to be carried out in dollars. Imports in general require registration with the central bank, but imports from the CACM are exempt from this requirement. Imports from Honduras are dealt with in accordance with bilateral agreements. Finally, all imports originating outside the CACM were subject to an import surcharge of 30% of the applicable duty.

1985:

By the end of 1985, many transactions had been transferred to the banking market. In that market, exchange rates rose to about Q 2.91 per dollar by the end of the year. Preferences for Central American trade continued through the operation of the banking market for exports to Costa Rica, El Salvador and Honduras.

Arrangements were made for barter transactions with Nicaragua.

1986:

By the end of 1986, some stability had returned to the quetzal. Guatemala instituted a "regulated" foreign exchange market within which most transactions would occur. The central bank would intervene in that market to set the value of the quetzal, which exchanged there at Q 2.5 per dollar at the end of 1986. There was retention of the banking market, but the premium on dollars there dropped to only a few percent. While export proceeds from transactions with Central America were largely channeled through the regulated market (60%) the remainder continued to qualify for exchange in the more favorable banking market.

The main event of 1986 was that on June 6, Guatemala withdrew from the CCC. Henceforth, trade transactions with other Central American countries were required to be settled in dollars. In addition, the Central American common external tariff was reformed and some tariffs reduced in the process. Some export taxes were added, including a 4% tax on nontraditional exports to Central America.

1987:

During 1987, there was considerable unification of the exchange rate at about Q2.5 per dollar. This rate existed in both the regulated market and the banking market. Bilateral agreements were struck with each of the regions central banks on settlement of trade balances, and transactions in general continued to be in

dollars. A small tax of 4% was introduced on all imports, though imports from CACM countries were exempted.

1988:

The exchange rate was unified in the regulated market at Q 2.7 per dollar. Otherwise conditions remained the same in 1988.

In summary, Guatemala tended to retain preferences for trade with Central America throughout the period. The only negative step in this regard was withdrawal from the CCC. Exports to the CACM were generally granted access to the most favorable exchange rates and imports remained free of duties and taxes that were otherwise applied to imports from other areas.

HONDURAS

1984:

Most of the conditions existing in 1984, are carried over from 1983 and before. Honduras is not a formal member of the CACM. Rather, Honduras participates partially in the CACM by having struck bilateral agreements with each of the CACM countries. The bilateral agreements commit Honduras to act as if it were a member, but give it more flexibility to pursue policies that would normally not occur within the confines of the treaty establishing the CACM. Honduras has never adhered to the concept of a common external tariff, and has maintained tariffs on imports from other Central American countries. Banknotes of the other Central American countries are bought and sold at parity by the Honduran central bank and payments are settled through the CCC in the domestic currency of the paying country. In effect,

the combination of these two rules implies that for Honduras, payments are settled in dollars.

Import permits are normally required in Honduras. However, the transaction size, beyond which a permit is required is higher for the CACM (ie. \$25,000) than it is for imports from other countries (ie. \$5,000). Most imports from outside the CACM are subject to import duties, but imports from the CACM are also subject as well. Import duties on goods from the CACM, which are set by bilateral agreement, are generally less than they are on goods from other countries. Nevertheless, these range up to 35%. Some goods are subject to a customs surcharge of 12% of the normal duty and a consular surcharge of 8% of the fob value.

1985:

One important change was introduced in 1985. On March 19, a parallel exchange market was introduced for trade transactions with the rest of Central America. Exporters to Central America were allowed to retain their foreign exchange proceeds in special deposit accounts denominated in the region's foreign currencies. Amounts in these accounts could be used for payments for imports from Central America and could be transferred to other importers at freely negotiated exchange rates. The effect of this latter provision was to introduce a devaluated Lempira to trade in Central America.

1986:

During 1986, the free market in local currencies was modified in response to payments problems with Nicaragua and with

Guatemala's withdrawal from the CCC. The free market continued to be available to exporters to El Salvador and Costa Rica⁹.

Honduras struck a special agreement with Nicaragua whereby trade transactions would be settled each three months, in dollars. The effect of this is to limit Honduras's credit to Nicaragua, since the latter was generally the deficit country. Trade transactions with Guatemala were to be conducted in dollars.

1987:

During 1987, the basis for market-determined exchange rates among regional currencies was broadened. Trade transactions in the region were permitted to be carried out in local currencies, by barter, or from dollar proceeds arising from exports to the region.¹⁰ This arrangement made settlement through the CCC unnecessary and Honduras withdrew from participation in the CCC in February. A bilateral clearing arrangement was agreed upon with Guatemala whereby outstanding balances were cleared every two months. The central bank forced a manageable balance with Guatemala by permitting imports only when exports to Guatemala had taken place. Transactions with Nicaragua continued to be carried out under the bilateral agreement struck in 1986.

In December, 1987, a system of CETRAs was introduced. Under this system, commercial banks issue CETRAs to exporters when they surrender their nontraditional export proceeds to the bank.

⁹ The implicit exchange rate in this market at the end of 1986 was L 2.4 per dollar.

¹⁰ The implicit exchange rate for the Lempira at the end of 1987 was L 2.7 per dollar.

CETRA's are denominated in Lempiras, and the holder has preferential access to foreign exchange at the official rate. The value of the CETRA is determined by the central bank, based on the value added in the production activity generating the export. CETRA's are transferrable once, at a negotiated rate, and must be used within four months. The effect of the introduction of CETRA's is to institute a partial devaluation of the Lempira. This reinforces the partial devaluation associated with free exchange of Central American currencies, introduced in 1985.

1988:

During 1988, the only major change had to do with the broadening of the use of CETRA's. Beginning in August, 1988, the proportion of CETRA's issued per dollar of nontraditional exports was set at 40%. The time period within which CETRA's had to be used was extended from four months to seven. Furthermore, commercial banks were permitted to intermediate in the CETRA market. The effect of this was to transfer a significant part of foreign exchange transactions to a parallel market.

No important changes occurred with regard to exchange arrangements or trade restrictions specifically aimed at Central America.

1989:

By the end of 1989 important changes had occurred in Honduras. Beginning in about September 1989, the central bank increasingly lost control of the foreign exchange market. Due to extreme foreign exchange shortages at the central bank, attempts

were made to intervene in the market for CETRAS. Intervention was intended to direct more dollars to the central bank and to keep the premium on CETRA dollars from rising. Collusion between the central bank and private banks was rumored to have kept the CETRA dollar premium below what the market would have determined. The response of the private sector was to simply ignore the central bank. By early 1990, exporters were refusing to deliver their export proceeds to the central bank and were exchanging them in the black market instead. Indeed, the central bank had lost its ability to influence exchange rates by the end of January, 1990, and the prevailing exchange rate was the black market rate at about 4 Lempiras to the dollar.¹¹ Thus, by early 1990, a devaluation has occurred in Honduras, statements of the central bank notwithstanding.

In summary, Honduras is not a true member of the CACM, but acts as a member by virtue of a series of bilateral agreements. Honduras has maintained duties on imports from other Central American countries throughout the period, though these duties are lower than those applied to imports from other countries. These duties generally did not change during 1984-89. Incentives for Honduran exporters to seek markets in Central America were strengthened somewhat, though they have been restricted by an

¹¹ AID/Honduras reports that normal central bank procedures and regulations should cause a flow of about \$50-60 million per month to the central bank. By late 1989 the actual flow had fallen to about \$2-3 million and in January, 1990, may not surpass \$1 million. For comparison, monthly petroleum imports, which are eligible for foreign exchange at the official rate, normally run about \$5-6 million.

increasingly overvalued lempira. By early 1990 however, the Central Bank of Honduras had lost the ability to determine exchange rates. There has been an effective devaluation of the Lempira to about 4 Lempiras to the dollar.

An overall summary:

Over the period 1984-1989 there does not appear to have been any tendency for Central American countries to discriminate directly against intra-regional trade by the imposition of tariffs and taxes. The major exception has to do with the export promotion schemes of Costa Rica, which provide a subsidy to exports destined outside the region. However, even in the Costa Rican case there are no observable restrictions discriminating against imports from the other Central American countries. A second major exception is that of trade with Nicaragua. Payments difficulties that we have described elsewhere, caused all the other countries to limit trade with Nicaragua.

Throughout the period, many steps were taken that would have encouraged trade in the region. When countries levied import surcharges and extra taxes on imports, imports from the CACM were generally exempt. Guatemala, Honduras and El Salvador took steps to liberalize regional exchange rates. Costa Rica had already done this beginning with the steps she took in 1981. Liberalized exchange rates encourage trade because, in addition to getting the "prices right", payments imbalances clear automatically. Overall, one would not expect that changes in trade and payments restrictions during the 1984-89 period would have discriminated

against Central American trade.

The main restrictions that grew during the period were exchange restrictions. These tended to prohibit imports of goods that were considered to be unnecessary or luxury goods. They tended to discriminate against many final consumer goods. Since these are the kinds of goods that predominate in regional trade, there has been an indirect discrimination against regional trade. Exchange restrictions are therefore probably to blame for much of the deterioration of trade within Central America.

SECTION 2: REAL EFFECTIVE EXCHANGE RATES IN CENTRAL AMERICA

Summary	1
2.1 The Real Exchange Rate Concept	4
2.2 Real Exchange Rate Calculations	7
2.3 Real Exchange Rate Comparisons	12
2.4 Appreciation and "Overvaluation"	21
2.5 Conclusions	22
APPENDIX A:	25
Real Effective Exchange Rate Derivations	
APPENDIX B:	32
Real Exchange Rates and Overvaluation	
B.1 Real Exchange Rate Appreciation Overvaluation	
B.2 REER, Devaluation and Adjustment	
B.3 Devaluation and the General Supply Response	
B.4 Internal Competitiveness	
B.5 Commodity Specific Responses	
B.6 International Market Changes	
B.7 Information from Parallel Markets	

SECTION 2

REAL EXCHANGE RATES IN CENTRAL AMERICA

Summary:

In Section 2 we review the derivation of real effective exchange rates (REER). We then present REER calculations for Costa Rica, El Salvador, Guatemala and Honduras. These are compared to REER calculations from other sources. No matter the source the conclusions are:

1. The Lempira and the Salvadoran Colon have appreciated greatly since about 1980.
2. Guatemala's devaluations in 1985 and late 1989 have allowed a real depreciation of the quetzal of about 50% compared to 1980. Guatemala's exchange rate management could be improved.
3. Costa Rica has managed a real depreciation of the Colon of about 50-60% compared to 1980. Costa Rican exchange rate management appears reasonably efficient.

We then explore the difference between real appreciation of an exchange rate and "overvaluation". A currency can only be considered overvalued if either of two conditions exist:

1. If there is a persistent loss of foreign exchange reserves, or,
2. the maintenance of foreign exchange reserves is unsustainable.

If a devaluation were to be chosen as a means to adjust to a sustainable external balance, factors additional to REER appreciation should be considered. Information available indicates that real devaluations in excess of the post-1980 appreciation in the REER are necessary. Reasons for this include the following:

- 1) the cost of resource reallocation has probably increased in recent years.
- 2) The internal terms of trade have shifted against exports.
- 3) Little is known about commodity-specific responses that could be expected.
- 4) Parallel markets have often discounted sharply currencies, once an unsustainable reserve position appears.
- 5) International market changes preclude simply returning to the relative price structure of the past.

Both Costa Rica and Guatemala have devalued and have found that to sustain their external balances, nominal exchange rates must adjust by more than enough to simply return to a REER of the

late seventies. Both countries are maintaining exchange rates that are devalued by about 50-70% more than is necessary to simply return to the REER of 1980. El Salvador has devalued in 1986, and is in the process of devaluing again at the end of 1989. Honduras too is in the process of devaluation as this report is written. Indeed, neither El Salvador nor Honduras has a choice, for their external balances are clearly unsustainable.

Introduction:

This section analyses movements in real exchange rates for Central America, over the period 1974-1989. The work is divided into three main parts. In part one, calculations of real exchange rates for each of four Central American countries, Costa Rica, El Salvador, Guatemala and Honduras are shown. Nicaragua is not shown for two reasons. First, Nicaragua has ceased to be a functional part of the CACM as indicated above. Second, Over the past several years there has existed a panoply of exchange rates in Nicaragua, with differences between individual rates sometimes becoming as large as a factor of fifty or more. To calculate real exchange rates under those circumstances would be futile. In the end the same conclusion would be reached in any event, namely, that the cordoba has suffered real appreciation by large amounts most of the time.

As part of the real exchange rate exercise, the concept of real effective exchange rates is introduced and explained only briefly. The detailed logic leading to real effective exchange rate calculations is explained in Appendix A.

In part two, comparisons are made between the real exchange rates observed in Central America. Comparisons are also made with other real exchange rate calculations. Part three discusses the concept of exchange rate overvaluation as opposed to appreciation. It discusses the conditions that should be considered in determining an appropriate exchange rate when overvaluation exists. Again, technical background material is

relegated to an appendix (ie. Appendix B).

2.1 The real exchange rate concept

Calculations of "real exchange rates" (RER) are often used to help evaluate the international competitiveness of countries. The main idea behind RER calculations is to adjust the nominal exchange rate for movements in domestic and foreign prices. The objective is to obtain an index of changes in the relative purchasing power of a currency, given:

1. changes in the nominal exchange rate between the currency of the country in question (the "home country") and other currencies, and
2. changes in price levels between the home country and the outside world.

Just as we would not want to base statements about prices on only one element in a price index, we would not want to base statements about the real purchasing power of a currency only on its real change relative to another currency. Thus, we use the concept of a real effective exchange rate (REER). The REER represents a weighted average of the relative purchasing power of a currency relative to a number of other currencies. The other currencies are normally those of the "home country's" main trading partners, and the weights normally represent the relative importance of trade partners in total transactions. In this study, the price indices used to calculate the REER are those found in Table 2.1. The logic behind calculations of the REER is found in Appendix A. Finally, the REER is presented as an index

number so that comparisons can be made across different currencies. The index is constructed so that a decrease in the index represents real appreciation of the currency in question. Intuitively, real appreciation implies a decrease in the price of foreign exchange when measured in local currency. Thus, the index declines when appreciation occurs.

TABLE 2.1
PRICE INDICES, 1900=100

	U.S. PROD. PR.	JAPAN WHOLESALE	GERMANY IND. PRODS.	C.R. CPI	EL S. CPI	HOND. CPI	GUATEMALA CPI
1974	0.59	0.74	0.79	0.50	0.46	0.58	0.54
1975	0.65	0.76	0.82	0.68	0.53	0.63	0.61
1976	0.60	0.80	0.85	0.70	0.59	0.66	0.60
1977	0.72	0.81	0.88	0.73	0.66	0.71	0.76
1978	0.70	0.79	0.89	0.77	0.74	0.76	0.82
1979	0.80	0.85	0.93	0.84	0.85	0.85	0.92
1980	1.09	1.00	1.00	1.00	1.00	1.00	1.00
1981	1.09	1.01	1.00	1.37	1.15	1.09	1.13
1982	1.11	1.03	1.14	2.60	1.20	1.19	1.13
1983	1.01	1.01	1.16	3.45	1.45	1.29	1.19
1984	1.15	1.01	1.19	3.86	1.62	1.35	1.23
1985	1.15	1.00	1.22	4.44	1.90	1.40	1.46
1986	1.11	0.90	1.19	4.97	2.62	1.46	1.99
1987	1.14	0.87	1.16	5.81	3.27	1.60	2.24
1988	1.19	0.86	1.18	7.02	3.91	1.86	2.48
1989	1.25	0.89	1.21	8.48	4.70	2.33	2.78

SOURCE: IMF, INTERNATIONAL FINANCIAL STATISTICS, YEARBOOK, 1989

IN THE U.S., JAPAN AND GERMANY, WHOLESALE PRICE INCREASES FOR 1989 ARE ASSUMED TO BE 4.9%, 3.3% AND 3% RESPECTIVELY.

SEE: THE ECONOMIST NOVEMBER 18-24, 1989.

FOR THE CENTRAL AMERICAN COUNTRIES, INFLATION RATES IN 1989 ARE ASSUMED TO BE:

COSTA RICA: SAME AS IN 1988

HONDURAS: 25%. SOURCE, AID/HONDURAS. AID ALSO ESTIMATES 16% IN 1988.

EL SALVADOR: 20%. SOURCE, AID/EL SALVADOR.

GUATEMALA: 12%. SOURCE, BANCO DE GUATEMALA, DPTO. INTERNACIONAL

TABLE 2.2

REAL EFFECTIVE EXCHANGE RATE INDICES FOR CENTRAL AMERICA

	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS
1974	1.022	1.289	1.066	1.037
1975	0.953	1.185	1.046	1.048
1976	0.984	1.188	0.992	1.054
1977	1.014	1.148	0.953	1.035
1978	1.040	1.094	0.959	1.052
1979	1.066	1.063	0.958	1.048
1980	1.000	1.000	1.000	1.000
1981	3.311	0.946	0.961	0.989
1982	1.991	0.937	1.021	0.940
1983	1.538	0.822	0.938	0.814
1984	1.602	0.820	1.150	0.843
1985	1.550	0.798	1.617	0.810
1986	1.512	0.805	1.556	0.759
1987	1.596	0.684	1.458	0.715
1988	1.554	0.580	1.475	0.631
1989	1.504	0.589	1.838	0.523

2.2 Real Exchange Rate Calculations

The results of REER calculations for Costa Rica, El Salvador, Guatemala and Honduras are shown in Table 2.2. The weights used in constructing the indices shown are the share of each trade partner's total non-oil trade. The choice of weights does not appear to be a very important one since the same general picture emerges when alternatives are used. Recall in reading the tables that a declining index implies appreciation of the currency in question. Furthermore, given the data supporting these calculations, not too much importance should be placed on small changes of a point or two in the second decimal place.

The REER for Costa Rica show basically, two periods. The first occurs during 1974 through 1980; the second 1981 to the present. In the first period, which entailed a nominal devaluation in 1974, there is no significant movement in the REER, and on the basis of that alone, there was no apparent loss of competitiveness. However, during the late 1970's Costa Rica's current account balance had deteriorated sharply, in large part due to large fiscal deficits. The trade balance had deteriorated as had the services balance. Costa Rica had borrowed heavily to support large public expenditures and the "debt crisis" caught up to Costa Rica in 1981. By that time, despite what the REER may have indicated, the situation was unsustainable. (We will have a more to say about sustainability below). In 1981, the colon was devalued from a nominal rate of 8.57 per dollar to over 36 per

dollar by year-end. Since 1981 it is interesting to note that there has been little change in Costa Rica's REER. Continual minidevaluations have adjusted for the differences between internal and trade partner inflation.

The Salvadoran colon appreciated in almost every year, except in 1986 when there was a real depreciation due to the change in the official exchange rate from C2.50 per dollar to C5.00 per dollar. Since the data used in calculating the index included a blend of official and parallel rates for the colon in the years 1982-85, the real depreciation associated with the devaluation of the official exchange rate in 1986 does not appear to have been very great. The real depreciation of the colon associated with the devaluation was effectively only about 5%, since by the end of 1985, most transactions had been shifted to parallel markets. One should note that the shift toward the parallel market, which occurred over the 1982-85 period, slowed, but did not stop real appreciation of the colon. The trade weighted index dropped from a value of 1.29 in 1974 to .95 in 1981, indicating about a 26% appreciation in real terms. Thus, appreciation of the colon is not a phenomenon that has been confined to the 1980s. Between 1982 and 1985, the drop in the index was much slower than it had been in earlier years as El Salvador began to shift increasingly greater numbers of transactions into the parallel market.

The most important observation on these series of numbers is the last. Real appreciation of the colon since the devaluation in



1986, has been so great that all gains from the devaluation have been reversed. Indeed, the gains in competitiveness associated with the shifts to parallel markets during 1982-85 as well as the gain associated with the devaluation, have apparently been lost. The reason for this is the very rapid inflation occurring in El Salvador compared to the relative price stability in the U.S., Japan and Germany and the continued devaluations of currencies in Guatemala and Costa Rica. The exchange rate that we have used for 1989 reflects a policy in El Salvador of again shifting transactions to a parallel market (the so called "cuenta dolares") where the colon exchanged at about 6.5 per dollar in early November 1989.

Guatemala has been a relatively low-inflation country and so, REER measures do not show much change before about 1984. However, it is not clear that our supporting data are very good for the early 1980s. The CPI for Guatemala indicates almost total price stability for the 1981-82 period. This is generally a period of high world-wide inflation, and it is difficult to believe that some of it would not spill over to Guatemala. We have been unable to uncover any reason why the CPI for that period might be incorrect so we are taking it on face value here.¹ Thus, there is implied a real depreciation for the quetzal in 1982, as inflation hits the rest of the world, but not

¹ We have had conversations about this with central bank personnel, former central bank officials, AID and SIECA personnel. No explanation for the anomalous CPI in 1982 has been uncovered.

Guatemala.

The first nominal devaluation of the quetzal occurred in 1985, amid considerable instability in foreign exchange markets. After maintaining an official exchange rate of one quetzal to the dollar for over fifty years, the Bank of Guatemala withdrew from officially supporting the currency in late 1984 and early 1985. Guatemalan's had no experience with a free exchange rate and a chaotic period ensued where the quetzal dropped below four quetzales per dollar sometime around June of 1985. By year-end, greater quiet returned to exchange markets, the Bank of Guatemala had regained reserves, and began again to intervene in that market. During 1986-1988 the quetzal was restabilized (and rates unified) at 2.5 quetzales per dollar.

Again in late 1989 the Bank of Guatemala withdrew from supporting the quetzal, and for the same reason as it had in 1985. It had run out of reserves with which to intervene. This time Guatemalans had some experience with a more flexible currency. The quetzal devalued, but not chaotically as it had done in 1985. In calculating the REER we have assumed that an exchange rate of 3.6 quetzales per dollar existed at year-end, and this has the obvious effect of showing a real depreciation in the REER.

One of the main differences between Guatemala and Costa Rica, the only two countries to have made any real adjustment in their currencies, is that Costa Rica has an exchange rate policy, whereas Guatemala does not seem to have one. Costa Rica has

institutionalized a process of having minidevaluations to keep up with relative inflationary differences. Guatemala seems to want to peg the value of the quetzal, without taking the steps that would be required to do so. Inevitably, the Bank of Guatemala runs out of reserves and cannot support a peg. At that point they withdraw and let freer markets set a new value for the currency.

Honduras has never had a change in the official exchange rate. It has had relatively slow inflation, especially prior to 1981, though rates have been higher of late. AID/Honduras estimates that inflation there has been about 16% in 1988 and 25% in 1989. They also warn that the inflation figures published by the Central Bank for those years are very inaccurate. Despite the relatively low inflation in Honduras, compared to that in other countries of the region, inflation has still exceeded that in developed countries. Thus, over the past ten years there has been a very gradual real appreciation of the Lempira. Then, beginning in about 1985 real appreciation has accelerated. Our REER figures for Honduras indicate that the lempira has appreciated by almost 50% since 1980.

Important changes are in process for exchange rates in Honduras. By late 1989, the central bank had lost control of the exchange rate. Exporters were refusing to deliver foreign exchange to the central bank and were selling it on the black market. Under normal circumstances, the central bank's rules would imply monthly deliveries to it of about \$50-60 million. AID/Honduras reports that in late 1989 deliveries dropped to

\$2.5-3 million. In January, 1990, less than \$1 million may have arrived at the central bank. The central bank has therefore run out of reserves and can no longer influence the exchange rate. Almost all transactions are occurring in the black market, and it is only a matter of time before the authorities recognize that for all practical purposes, there has already been a devaluation in Honduras.

In Honduras today the black market rate of exchange is the predominant exchange rate. That rate is about 4 Lempiras per dollar. At that rate, the REER for Honduras would return to about what it was in 1980. For reasons that we will explore below, this is not likely to be a sufficient devaluation to restore competitiveness to the Honduran economy.

2.3 Real Exchange Rate Comparisons

Every set of REER calculations are different from every other set and ours are no exception. Differences are caused by the countries that are chosen for comparison, the base years used, price indices and weighting systems. Thus, we should insure that the calculations presented here are comparable to those produced by others, though we would not expect them to be exactly the same.

Table 2.3 compares our REER numbers with those appearing in the Checchi Report, through 1984 (the last year covered by the Checchi Report). The Checchi Report methodology differed from that used here in its choice of trade partners, price indices and weighting schemes. The table converts the Checchi results to a

base year of 1980, from the original base used then, of 1978. Results of this study are about the same as those of the Checchi report for Honduras. Our calculations show less real appreciation in El Salvador during the 1980-84 period, but that is because we take into account the gradual shift of transactions to the parallel market in that period. The Checchi Report did not. The Costa Rican figures show a difference for 1981, where our figures show a much larger real depreciation of the colon than the Checchi figures do. We have used year-end figures, and the Checchi report used year average figures. During 1981, the colon was devalued from 8.57 to the dollar to 36.09 at year end. The average exchange rate for the period was 21.76 colones per dollar. Had we too used the year's average exchange rate our REER index would have stood at 1.99, which is very close to the Checchi result. Finally, in Guatemala there are differences in our results in 1982 and 1984. In 1984, the Checchi Report used the official exchange rate of one quetzal per dollar. Our figures used the weighted average of the official and parallel rates which was 1.17 quetzales per dollar for 1984. Thus, our figures show a real depreciation of the quetzal for 1984, rather than the slight real appreciation shown in the Checchi Report. The difference in 1982 has to do with the still-unresolved issue of why the Guatemalan CPI shows no inflation in 1982.

Table 2.4 compares our REER calculations with those appearing in the World Bank study (1989, Table C.8) We have converted the World Bank figures to the same base as ours for

TABLE 2.3

COMPARISON OF THIS STUDY WITH CRECCHI

	CRECCHI	THIS STUDY	
1974	1.06	1.06	GUATEMALA
1975	1.04	1.06	
1976	0.98	0.99	
1977	0.95	0.95	
1978	0.99	0.96	
1979	0.98	0.96	
1980	1.00	1	
1981	0.90	0.96	
1982	0.91	1.02	
1983	0.92	0.94	
1984	0.96	1.15	
1974	1.00	1.04	HONDURAS
1975	1.03	1.05	
1976	1.03	1.05	
1977	1.03	1.03	
1978	1.00	1.05	
1979	1.05	1.05	
1980	1.00	1	
1981	0.94	0.99	
1982	0.80	0.94	
1983	0.85	0.81	
1984	0.84	0.84	
1974	0.92	1.02	COSTA RICA
1975	0.94	0.95	
1976	0.95	0.98	
1977	1.00	1.01	
1978	1.04	1.04	
1979	1.06	1.06	
1980	1.00	1	
1981	1.94	3.31	
1982	1.86	1.99	
1983	1.67	1.54	
1984	1.79	1.6	
1974	1.24	1.29	EL SALVADOR
1975	1.16	1.19	
1976	1.14	1.19	
1977	1.12	1.15	
1978	1.11	1.89	
1979	1.07	1.06	
1980	1.00	1	
1981	0.88	0.95	
1982	0.81	0.94	
1983	0.77	0.82	
1984	0.72	0.82	

TABLE 2.4

COMPARISON OF THIS STUDY WITH WORLD BANK (1989)

	WORLD BANK	THIS STUDY	
1970	0.90	0.96	GUATEMALA
1979	0.97	0.96	
1980	1.00	1	
1981	0.90	0.96	
1982	0.79	1.02	
1983	0.83	0.94	
1984	0.84	1.15	
1985	1.29	1.62	
1986	1.21	1.56	
1987	1.23	1.46	
1988	1.19	1.47	
1978	1.08	1.05	HONDURAS
1979	1.02	1.05	
1980	1.00	1	
1981	0.90	0.99	
1982	0.84	0.94	
1983	0.77	0.81	
1984	0.73	0.84	
1985	0.74	0.81	
1986	0.77	0.76	
1987	0.83	0.72	
1988	0.84	0.63	
1978	1.21	1.04	COSTA RICA
1979	1.09	1.06	
1980	1.00	1	
1981	2.00	3.51	
1982	1.20	1.99	
1983	1.20	1.54	
1984	1.26	1.6	
1985	1.35	1.55	
1986	1.45	1.51	
1987	1.66	1.6	
1988	1.72	1.65	
1978	1.08	1.09	EL SALVADOR
1979	1.06	1.06	
1980	1.00	1	
1981	0.87	0.95	
1982	0.83	0.94	
1983	0.74	0.82	
1984	0.70	0.82	
1985	0.70	0.8	
1986	0.79	0.81	
1987	0.72	0.68	
1988	0.69	0.58	

TABLE 2.6

COMPARISON OF THIS STUDY WITH INF FIGURES

	INF COSTA RICA	THIS STUDY COSTA RICA
1970	1.16	1.04
1980	1.00	1
1985	1.24	1.55
1986	1.30	1.51
1987	1.52	1.6
1988	1.66	1.55
1989*	1.59	1.5

	INF EL SALVADOR	THIS STUDY EL SALVADOR
1970	0.86	1.09
1980	1.00	1
1985	0.81	0.8
1986	0.73	0.81
1987	0.66	0.68
1988	0.60	0.50
1989*	0.63	0.50

	INF GUATEMALA	THIS STUDY GUATEMALA
1970	1.16	0.96
1980	1.00	1
1985	1.24	1.62
1986	1.30	1.56
1987	1.52	1.46
1988	1.66	1.47
1989*	1.59	1.04

	INF HONDURAS	THIS STUDY HONDURAS
1970	0.86	1.05
1980	1.00	1
1985	0.81	0.81
1986	0.73	0.76
1987	0.66	0.71
1988	0.60	0.63
1989*	0.63	0.52

FOR THE INF, 1989 DATA ARE OF JUNE, 1989

62

comparison. The Bank figures differ from ours in that they were calculated quarterly, and we only show here the figures for the fourth quarter of each year. Ours are end-of-year figures. The Bank figure for 1988 is for the second quarter of that year. Our results for El Salvador are about the same as the Bank's. For Costa Rica and Guatemala the Bank shows greater appreciation of each country for the years, 1981-84, and greater depreciation for the years 1985-88. The reason for this is that the Bank includes in its calculations many non-Central American currencies, and many other than the dollar. Since the dollar appreciated against all other major currencies during the 1980-85 period, currencies that were pegged to the dollar appreciated as well. When the dollar depreciated precipitously against other major currencies during 1985-88, so did those that were tied to the dollar. The Lempira is tightly tied to the dollar and so it would be expected to show greater real appreciation 1980-84 in the Bank figures than in our own. We show greater appreciation of the lempira in the 1986-88 period than the Bank shows because we are assuming inflation in Honduras to be greater than what the official figures report. Though the Costa Rican colon was adjusted often, it too would register less depreciation relative to what our figures show during the 1980-84 period and relatively more depreciation during 1985-88. The Guatemalan quetzal was pegged rigidly to the dollar in the 1980 period, and we therefore see relatively greater real appreciation in the Bank figures than in ours. Once Guatemalan devaluation began in 1985 one sees real

depreciation in the quetzal in both sets of figures. Indeed, the degree of depreciation is about the same in the two sets of data.

Table 2.5 compares our results with some produced by the IMF. The IMF calculations were based upon data as of the end of June, 1989. Thus, their figure for Guatemala in 1989 does not show the real depreciation that ours does, because they could not foresee the Bank of Guatemala floating the quetzal in November. With this in mind, our figures are approximately the same as the IMF's for Costa Rica, El Salvador and Guatemala. We show considerably more real appreciation for the Lempira in 1989 than the IMF does, due to our assumed inflation rate of 25%.

Bilateral real exchange rates (RER) for Costa Rica, El Salvador, Guatemala and Honduras are shown in Table 2.6. Among them there are six pairs of countries; thus six RER. Recall that if one currency has an RER that appreciates, the other currency of the pair must depreciate by the same proportion. Therefore, when the table gives an RER for the exchange rate of Costa Rica with Honduras (for example), one need only invert the figure to get the RER of Honduras with Costa Rica. The RER of Costa Rica with Honduras, in 1989, was 2.89. Therefore the RER between Honduras and Costa Rica is .35. (ie. $1/2.89$) The conclusion either way is that the Lempira has appreciated in real terms against the Costa Rican colon by about 65% since 1980.

TABLE 2.6

SUMMARY OF CENTRAL AMERICAN BILATERAL EXCHANGE RATE INDICES

	COSTA RICA WITH:		GUATEMALA WITH:		HONDURAS WITH:	
	EL SALVADOR	HONDURAS	GUATEMALA	HONDURAS	EL SALVADOR	EL SALVADOR
1974	0.79	1.00	0.93	1.07	0.85	0.79
1975	0.81	0.99	0.90	1.03	0.90	0.87
1976	0.84	0.94	0.97	0.97	0.86	0.89
1977	0.90	0.97	1.04	0.93	0.86	0.92
1978	0.97	0.99	1.06	0.93	0.91	0.90
1979	1.01	1.01	1.10	0.92	0.93	1.01
1980	1.00	1.00	1.00	1.00	1.00	1.00
1981	3.53	3.35	3.47	0.96	1.02	1.05
1982	2.10	2.15	2.04	1.05	1.07	1.01
1983	1.95	1.89	1.75	1.00	1.12	1.03
1984	1.95	1.95	1.52	1.20	1.20	1.00
1985	1.84	1.90	1.00	1.02	1.70	0.93
1986	1.81	2.02	1.10	1.03	1.64	0.90
1987	2.27	2.23	1.25	1.79	1.82	1.82
1988	2.50	2.46	1.21	2.03	2.13	1.85
1989	2.41	2.89	0.96	3.02	2.51	0.83

General observations that can be made on the bilateral BFRs are:

1. The Salvadoran colon has appreciated against all other currencies.
2. The Lempira has appreciated considerably against the quetzal and Costa Rica's colon.
3. Guatemala and Costa Rica have stayed about even. For most of the 1980-89 period the colon maintained a slight depreciation against the quetzal (compared to 1980). Large depreciations for the colon occurred in 1981-83, when Costa Rica was devaluing the colon officially, but Guatemala had not yet begun to do so. Guatemala devalued in 1985, but never by as much as Costa Rica had, in real terms, relative to 1980. Guatemala's devaluation of 1989 was not sufficient to prevent real appreciation vis a-vis the colon.

These observations would lead to the conclusion that, all else equal, Honduras would be running increasingly large deficits with all the other countries and El Salvador would run somewhat larger deficits with Costa Rica and Guatemala. Costa Rica and Guatemala should have a trading relationship that is reasonable stable, except for the years when Costa Rican devaluations occurred without corresponding adjustment in Guatemala. (ie. 1981-84 and 1989)

We note in Table 2.7, where we display the six possible

trade balances, that we get what we expect in the Costa Rica vs. Guatemala case. Costa Rica tends to run a deficit with Guatemala, and has done so for years, except during the 1981-84 period. El Salvador indeed runs a deficit with the others, but we would expect it to be increasing. Rather, against Costa Rica it is not. The reason is that Costa Rica is concerned that El Salvador will fall into arrears in settling payments. Thus, Costa Rica requires that payment by Salvadoran importers be made in advance, in dollars. The result is reduced trade, and of course a manageable balance, the Costa Rican objective. El Salvador improved its balance with Guatemala somewhat with its nominal devaluation of 1986, but the deficit is again growing as the effect of the devaluation is well offset by inflation². Trade between Honduras and the others is very small. Its deficit with both Guatemala and Costa Rica is limited by the same requirement applied by Costa Rica to El Salvador. Trade between Honduras and El Salvador is close to nil.

² El Salvador and Guatemala have taken steps to remove any difficulties in clearing payments which are related to exchange rates. By a bilateral agreement, importers and exporters doing business across the El Salvador/Guatemala border can strike contracts in any currency, at any exchange rate at whatever prices can be agreed on for the goods. Thus, either exchange rates or the prices of goods adjust. Trade balances are liquidated automatically.

TABLE 2.7

TRADE BALANCES BETWEEN CACM COUNTRIES, AS SEEN BY THE FIRST COUNTRY LISTED:

	COSTA RICA VS. EL SALVADOR	COSTA RICA VS GUATEMALA	COSTA RICA VS HONDURAS	EL SALVADOR VS GUATEMALA	EL SALVADOR VS HONDURAS	GUATEMALA VS HONDURAS
1974	-7.5	-12.5	2.5	0.5	0	13
1975	-4.5	-14.5	7.5	-9.5	0	11
1976	-6.5	-15	7.5	-16	0	10
1977	-3.5	-14	9.5	-31.5	0	10.5
1978	-12	-14.5	11.5	-6.5	0	15
1979	-19.5	-16	12.5	1.5	0	10.5
1980	-13.5	-30.5	11	-87.5	0	20.5
1981	10	5.5	23	-117	0	30
1982	12.5	7	13	-75.5	-5.5	24
1983	16.5	30	20	-54	-6.5	29
1984	17	13.5	39	-74.5	-7.5	20
1985	22.5	-6.5	25.5	-80.5	-4	24
1986	3.5	-5.5	10.5	-29.5	-0.5	6.5
1987	2.5	-16	12	-34.5	-1	0
1988	5.5	-10	12	-42	-1.5	9.5

2.4 Real Exchange Rate Appreciation and "Overvaluation":

Observations of REER are not sufficient to determine whether or not a currency is overvalued. REER are simple observations of fact and do not carry implications as to what exchange rates "ought" to be. The factors that one would want to consider in addition to REER are discussed in Appendix B. In general those factors include:

1. whether the country's reserve position is sustainable,
2. supply responses to appreciation and potential devaluation,
3. internal competitiveness of traded and non-traded goods,
4. commodity-specific responses,
5. international market changes,
6. information from parallel markets.

After considering these factors for Central America, one is led to the conclusion that, for those countries that have suffered from real appreciation, devaluations are called for. Also, devaluations are likely to have to be greater than that which is would only restore the REER of 1980. The two countries that have devalued and maintained real depreciation compared to 1980, Costa Rica and Guatemala, have had to devalue by 50-60% in real terms compared to 1980, in order to sustain their external position. El Salvador and Honduras are in need of devaluation and real depreciation. If they were to seek real depreciations similar to those of Costa Rica and Guatemala, they would have to

depreciate their currencies by about 50-60% in real terms compared to 1980. This implies an exchange rate of about 5.5 to 6 lempiras to the dollar and about 15 salvadoran colones per dollar.

2.5 CONCLUSIONS

In Section 2 we review the logic and calculations behind deriving real effective exchange rates (REER). We then present REER calculations for Costa Rica, El Salvador, Guatemala and Honduras. These are compared to REER calculations from other sources. No matter the source the conclusions are:

- The Lempira and the Salvadoran Colon have appreciated greatly since about 1980.

- Guatemala's devaluation in 1985 and late 1989 have allowed a real depreciation of the quetzal of about 50% compared to 1980. Guatemala's exchange rate management however could probably be improved.

- Costa Rica has managed a real depreciation of the Colon of about 50-60% compared to 1980. Costa Rican exchange rate management appears reasonably efficient.

We then explore the difference between real appreciation of an exchange rate and "overvaluation". A currency can only be considered overvalued if either of two conditions exist:

1. If there is a persistent loss of foreign exchange reserves, or,
2. the maintenance of foreign exchange reserves is unsustainable.

If a devaluation were to be chosen as a means to adjust to a sustainable external balance, factors other than REER appreciation should probably be considered. The little bit of information that is available indicates that, given the changes occurring in Central America in the early 1980's, where all currencies had a tendency toward overvaluation (except Costa Rica's), devaluations in excess of the appreciation in the REER were probably necessary. Reasons for this include the following:

- 1) the cost of resource reallocation has probably increased in recent years.
- 2) The internal terms of trade have shifted against exports.
- 3) Little is known about commodity-specific responses that could be expected.
- 4) Parallel markets have often discounted sharply currencies, once an unsustainable reserve position appears.
- 5) International market changes preclude simply returning to the relative price structure of the past.

In the end the record is mixed. Both Costa Rica and Guatemala have devalued and have found that to sustain their external balances, nominal exchange rates must adjust by more than enough to simply return to a REER of the late seventies. Both countries are maintaining exchange rates that are devalued

by about 50-70% more than is necessary to simply return to the REER of 1980. El Salvador has devalued in 1986, and is in the process of devaluing again at the end of 1989. Indeed, El Salvador had no choice, for its external balance is clearly unsustainable (see Loehr, Protasi and Vogle, 1989). Honduras too is in the process of recognizing the devaluation that has taken place despite the efforts of Honduran officials to maintain an unchanged "official" exchange rate.

APPENDIX A

REAL EFFECTIVE EXCHANGE RATE DERIVATIONS

Real bilateral exchange rates are determined as follows. Let E denote the nominal exchange rate of the currency in question, expressed in units of the domestic currency per unit of the foreign currency. In the case of El Salvador, E is C5.00 per US\$, about C2.00 per quetzal, and so forth. Let P be the domestic price (or a price index) of a bundle of domestic goods and P' the foreign price (or index) of a bundle of foreign goods. The real bilateral exchange rate is defined as:

$$RER = E \times (P' / P)$$

This expression states the price of the foreign bundle of goods in domestic currency relative to the price of the domestic bundle of goods. Typically, rather than actual prices we use price indices, with given base years, to make comparisons of RER over time.

For example, let us assume that we are comparing the El Salvador's colon with the U.S. dollar, between the years 1980 and 1986. In 1980, $E = 2.5$ colones per dollar and in 1986, $E = 5.0$ colones per dollar. If we use a price index, such as the consumer price index, we could set the index so that the "base year" is the same in both countries. Thus, if 1980 is the base year, in either case the CPI = 1.00 in 1980. In 1986 the CPI in El Salvador had risen to 2.62 and in the U.S. the CPI had risen to 1.33. Therefore, the RER in 1980 was:

$$RER = E \times (P' / P) = 2.5 \times (1.00 / 1.00) = 2.5$$

and the RER in 1986 was:

$$\text{RER} = 5.0 \times (1.33/2.62) = 2.54$$

The interpretation of this comparison is that the U.S. goods that cost Salvadorans C2.5 worth of their own goods in 1980, in 1986 cost Salvadorans C2.54 worth of their own goods. If the exchange rate had not changed then the RER in 1986 would have been:

$$\text{RER} = 2.5 \times (1.33/2.62) = 1.26$$

This indicates that U.S. goods that cost Salvadorans C2.5 worth of their own goods in 1980, would have only cost them C1.26 worth of their own goods in 1986. The reason for this is simple. Inflation in El Salvador was much more rapid in the 1980 to 1986 period than it was in the U.S. Indeed inflation in El Salvador was approximately twice as fast. Had the exchange rate not changed the colon would have experienced a real appreciation against the dollar. That is, Salvadorans would have been able to buy relatively more U.S. goods than Salvadoran goods in 1986 than they did in 1980, with a given amount of money. In fact they would have been able to buy about twice as much in the U.S. as they could have bought in El Salvador, with a given amount of colones, when compared to 1980. Changing the exchange rate from C2.5 to the dollar to C5.0 to the dollar offset the shift in relative prices that had occurred over the period.

With rigidly fixed nominal exchange rates, movements in the RER are entirely due to movements in the domestic and foreign price levels. The RER for the domestic currency would fall (appreciate) or rise (depreciate) according to whether the

inflation rate at home is higher or lower than inflation in foreign countries. With adjustable nominal exchange rates, changes in the RER are attributable to both nominal exchange rate changes and to movements in relative prices.

Often RER are expressed as index numbers to facilitate comparisons across countries or across time periods. We will be doing that in our later presentations. The important thing to remember is that the way we are calculating RER in this study an increase in the RER, or its index number, implies an increase in the relative price of foreign goods (a depreciation of the currency). A decrease in the RER indicates a decrease in the cost of foreign goods, and an appreciation of the currency. Also, an appreciation of one currency implies a depreciation of the currency to which it is being compared.

Measures of RERs obviously depend upon the choice of the measure of price. Published price indices are not strictly comparable across countries. The non-comparability arises for a variety of reasons such as the frequency of observation, differences in weighting patterns for the goods entering the price indices, price controls, taxes, etc. For these reasons one would not want to stress minor differences in price index changes, though major relative shifts among price indices normally reflect real differences in relative price behavior. In Central America only consumer price indices are generally available across countries. Thus, for the Central American countries, only consumer price indices have been used in real

exchange rate calculations in this study. However, wholesale price indices are preferable because they represent the prices of tradeable goods, whereas consumer price indices include the prices of many non-tradeable goods and services. Thus, as suggested by Edwards (1989), when calculations include price considerations in developed countries, wholesale price indices are used. The price indices used in all calculations are displayed in Table 2.1 in the main body of this section.

The discussion above has focused on the calculation of bilateral real exchange rates. It is more useful to consider the evidence from multilateral real exchange rates. These are referred to as nominal effective exchange rates (NEER) and real effective exchange rates (REER). The NEER is an index of the domestic currency price of a basket of currencies, just like a price index reflects the price of a basket of goods and services. The NEER does not adjust for relative price changes. The REER accounts for both nominal changes in the price of the basket of currencies and changes in the relative prices of goods.

Considering the price of a basket of currencies avoids possible pitfalls or hasty conclusions based only on one bilateral exchange rate. One does not want to conclude that the inflation rate is 50% per year just because the price of one commodity has increased by 50%. Similarly, one does not want to state that a currency has appreciated in currency markets just because it has appreciated against one currency. The NEER and REER are useful indicators because they consider changes against

"relevant" currencies and weight them in order of importance.

The formula for the Nominal Effective Exchange Rate is:

$$NEER_t = \sum (w_j * R_t * E_{jt})$$

where w_j = the weight assigned to currency j , R_t = value of one unit of a numeraire currency (in this case the US dollar) in terms of domestic currency at time t , E_{jt} = value of a unit of the currency of trade partner j at time t , expressed in units of the numeraire currency (ie. expressed in terms of US\$ per unit). The result of this calculation is the price in local currency, of a fixed basket of currencies.

The formula for the Real Effective Exchange Rate is:

$$REER_t = NEER_t / P_t$$

where:

$$P_t = \sum w_j (P_{it} / P_{jt})$$

P_{it} is the price index for the home country at time t , and P_{jt} is the price index for trade partner j at time t . The result of the calculation is the local currency cost of a given bundle of goods in the trade partner countries. Throughout the later parts of the report we express the REER as an index number with the base 1980=1.00

The NEER and REER have to be based upon prices of other "relevant" currencies and they must be weighted in order of importance. Two methodological issues arise. First, which other currencies should be considered and second, how should they be weighted. These questions are similar to those arising in the construction of a price index, since one has to decide which

items will have their prices monitored and how each item's price will be weighted when they are aggregated into one index. On the first issue, the currencies selected for inclusion are those of the countries which are major trade partners of the Central American countries. Since we eventually intend to compare Costa Rica, El Salvador, Guatemala and Honduras, we wanted to include countries with which all four conduct a significant part of their trade. In this way we could make some statements about the kind of competition that each country faces in the markets where the others are active.

Most of the trade of Central American countries is conducted with either themselves, the U.S., Japan or Germany. Occasionally other countries appear in the trade patterns of individual countries. Costa Rica has significant trade with Panama, but Panama uses the US dollar as a currency. Similarly, most countries have considerable trade with Venezuela or the Netherlands Antilles, but those transactions have to do with oil imports and are also denominated in dollars. To the extent that dollars are already considered in REER calculations it is not necessary to include this other dollar-denominated trade. (Though one might reasonably argue for weighting dollars more heavily in the calculations). Some countries have trade with Italy, the Netherlands, the UK and Spain, but others do not. Thus, we chose to make the REER calculations, using as trade partners only the other Central American countries, the U.S., Germany and Japan. An experiment was carried out to see if REER calculations were

affected significantly if several of the other countries mentioned were added. The results were barely affected.

The second problem is to choose a weighting scheme which represents the relative importance of trade partners. Most of our discussion will be with regard to REERs, using as weights, the relative importance of each country in "the home country's" total trade over the period 1980-1984. For example, if the U.S. received 50% of El Salvador's exports, and supplied 50% of El Salvador's imports, it would be weighted .50. We use primarily the trade weights in our discussions because they appear more general. However, we have calculated the REER using two alternative weighting schemes. One of those uses weights representing relative imports and the other weights represent the relative importance of exports to trade partners. The choice of weighting scheme makes little difference to our general conclusions.

APPENDIX B

REAL EXCHANGE RATES AND "OVERVALUATION"

Real exchange rate observations alone are not sufficient to determine a reasonable exchange rate policy. Other factors are equally important. In this appendix we will discuss the distinction between real exchange rate appreciation and the concept of exchange rate "overvaluation". We will then discuss the use of REERs as a guide to the setting of reasonable exchange rates and consider other indicators which might prove useful in addition to REERs.

B.1 Real exchange rate appreciation and overvaluation.

Real exchange rate (REER) observations are simple, and rather mechanical, statements of fact. Inherent in them are no judgements about what exchange rates ought to be. To say that exchange rates are "overvalued" is to make a judgement that in order to meet some objective, the value of the local currency in international transactions is too high and that it should be lowered (ie. devalued). The objective that is normally sought is balance of payments equilibrium. For our purposes here we will define balance of payments equilibrium as a balance of payments position which is sustainable in the long run without persistent loss (or gain) of foreign exchange reserves. Thus, a balance of payments position may be sustainable even though it contains a negative trade balance, if there are offsetting positive flows in the capital or transfers accounts, and where the positive flows can be sustained.

An REER which appreciates may contribute to a balance of payments situation which is not sustainable, but it does not guarantee one. For example appreciation of the REER reduces the relative cost of imports and reduces the relative return to exporting. Thus, imports expand and exports drop, creating a negative gap in the trade balance. A negative trade balance could also result from expansive monetary or fiscal policies which take place in the absence of REER appreciation. In either case, assuming a currency which is pegged to some external standard, imports that exceed exports imply a loss of foreign exchange. Whether or not this situation is a disequilibrium situation depends upon what happens in other parts of the balance of payments. The balance of payments is not intended to balance account by account, but rather, to balance overall, with changes in foreign exchange reserves serving as a residual balancing item. Thus, if sustainable changes occur in other accounts, which provide foreign exchange to match the exchange losses due to the trade account, then no disequilibrium exists. If no disequilibrium exists then the currency is not "overvalued".

When a balance of trade is negative, several sources may provide the foreign exchange to prevent a net loss of foreign exchange. Foreign exchange costs of maintaining the negative trade balance may be covered by private capital flows, foreign borrowing, grants or other transfers. A negative trade balance may be a permanent and sustainable situation if any other source of foreign exchange provides a balancing supply of foreign

exchange on a sustainable basis. As long as there is no net change in foreign exchange, and the situation can be considered sustainable, there is no disequilibrium. A currency is not overvalued if the level of grants, loans, etc, needed to cover a trade deficit, can be considered permanent, even if internal inflation exceeds foreign inflation and REERs have shown appreciation.

Much of the discussion above hinges upon the term "sustainable". Surely, borrowing to maintain foreign exchange reserves when trade deficits exist cannot be considered "sustainable" if by that we mean permanent. Similarly, foreign exchange reserves that result from ESF flows cannot be considered permanent either, so exchange rates existing when ESF flows are present, may not be equilibrium rates even when reserves are stable and black market premia are small. However, a situation can be considered sustainable if steps are taken to correct the trade deficit over time, and if alternative sources of foreign exchange are managed to cover reserve losses in the meantime. Again, a currency cannot be considered overvalued if there is some sustainable balance of payments position which can be achieved without exchange rate changes.

When imbalances in any part of the balance of payments cannot be offset by sustainable, opposite imbalances in other parts, reserves will either be lost or accumulated. The currency of the country concerned can then be considered over or under valued, relative to some external peg. For example, consider a

negative trade balance which cannot be offset by other foreign transactions. The demand for foreign exchange (the demand for imports) exceeds the supply of foreign exchange (the demand for exports). As in any other supply and demand imbalance, the price of foreign exchange would rise. A rise in the price of foreign exchange is the same as a drop in the price of the domestic currency, a devaluation of the domestic currency. If the exchange rate is pegged to some external standard, the price of foreign exchange is not permitted to rise. Thus, demand for foreign exchange continues to exceed supply, and the excess demand is satisfied by the central bank. There is a corresponding loss of foreign exchange reserves. The domestic currency is then "overvalued" relative to the exchange rate that would prevent reserve losses and restore a sustainable equilibrium.

In general, anything that causes the demand for foreign exchange to exceed the supply causes a currency to become overvalued if the currency is rigidly pegged to an external standard and if no sustainable, offsetting supply and/or demand measures exist to prevent reserve loss. Similarly, the reverse is true. Given a rigidly pegged currency, anything causing the supply of foreign exchange to exceed demand cause the accumulation of foreign exchange and the currency will be "undervalued". It would be undervalued relative to the value that would equate supply and demand.

Appreciation of the real effective exchange rate makes any disequilibrium more difficult to correct. Real appreciation

causes the demand for foreign exchange to be greater than it would otherwise be since it makes imports seem relatively cheap to domestic residents. Similarly, appreciation reduces the supply of foreign exchange since exports appear relatively costly to foreigners. If an appreciated REER is combined with other problems causing exchange loss, the overall problem is aggravated. Greater amounts of compensatory foreign exchange are required for any given problem in the presence of appreciation of the REER than in its absence.

B.2 REER, Devaluation and adjustment

In the typical case facing a developing country, disequilibrium occurs when demand for foreign exchange exceeds supply (ie. a balance of payments deficit exists) and reserves are lost in attempts to maintain a fixed exchange rate. The reason for the deficit may include a number of factors including an appreciation of the REER. Thus, if devaluation is considered as a policy measure to help correct the disequilibrium then changes in the REER may serve as a guide in determining the amount of the devaluation.

Many problems would arise in using only changes in the REER as a guide to determining the amount of a devaluation. First, to recommend a devaluation based upon changes in a REER, one would have to build a case that the balance of payments existing in the base year was a sustainable one and that all relevant conditions existing at the time of the devaluation are the same as they were in the base year. Second, structural changes occurring between the

base year and the present may preclude returning to some former productive structure should only changes in relative prices be corrected. Third, usually changes in the REER were caused in the first place by monetary and fiscal policies that were inadvisable but that may be difficult to reverse. Fourth, when there have been differential productivity trends across countries and/or sectors, REER may provide little guidance as to how to improve competitiveness.

In using REER indices as a guide to establishing exchange rates it may be necessary to go beyond restoring relative prices to those existing in some base period when the country's external position was considered sustainable. The experience of the IMF has been (IMF, 1984) that if domestic and external conditions are more adverse than in the base period, as through deterioration in the external terms of trade or natural disaster, there will normally be a need for a decline in domestic absorption and an improvement in competitiveness beyond that of the base period. The tradable goods sector may have to expand beyond its previous size. Moreover, in cases of longstanding disequilibrium, during which the balance of payments deficit has been held to financeable levels only through severe restrictions, competitiveness may have to be enhanced beyond the level recorded in any recent period. The implication is that countries may have to devalue by more than the amount indicated by appreciation in the REER to restore competitiveness.

If one were to try to determine the appropriate rate of

exchange for a currency, some analysis beyond real exchange rate changes would be required. The most important considerations would be those related to:

- general supply responses
- internal competitiveness
- commodity specific responses
- international market changes
- information from parallel markets.

We will deal with each of these in turn.

B.3 Devaluation and the general supply response.

The primary gain hoped for from devaluation is that exports will expand and imports contract. The normal reasoning is that devaluation shifts relative prices in favor of traded goods and against non-traded goods. Immediately after a devaluation, import prices rise by the full extent of the devaluation as do the rewards from exporting when measured in local currency. There is therefore an incentive to reallocate resources in favor of export production or import substituting activities and away from non-traded activities. Within each set of activities there will also be an incentive to shift from activities that are intensive in their use of imported inputs to those that use relatively more domestic inputs. If there are no constraints to these resource reallocations, exports will eventually expand and imports contract, eliminating the trade imbalance. In general, a favorable supply response depends upon:

- i) use of idle resources,

- ii) increased productivity due to more intensive use of resources,
- iii) reallocation of resources from non-tradables to tradables,
- iv) reallocation within tradables from import substitution to export activities.

Under most circumstances the first two sources are most important in getting a favorable supply response from a devaluation. The second two factors are more important for a long run response, and are most powerful where resource mobility is high. Unfortunately, it is likely that in Central America, the cost of resource reallocation is high and is probably higher now than it was say ten or twelve years ago. Thus, a devaluation based upon changes in REER alone are not likely to provoke a supply response that one would have expected then.

The high cost of resource reallocation has always plagued developing countries, but is probably particularly problematic for Central American countries. In large or developed countries, reallocation of existing capacity can be made in favor of activities yielding net exports. In developed countries, exports are manufactured goods where domestic production is a large part of total production. Thus, in developed countries, in response to an exchange rate change, reallocation can occur within existing industries. In developing countries where exports are mostly primary products and where domestic consumption is a small part of total production, resource reallocation usually has to occur between industries. Often reallocation must be between an

existing, primary producing activity and other activities that barely exist in the developing country setting. Thus the cost (including the cost of uncertainty) is much higher in developing countries than in developed or large ones.

In Central America these costs of resource reallocation are probably much higher now than they were ten or fifteen years ago. The costs have been aggravated by the decline in the importance of the Central American Common Market and, for El Salvador and Nicaragua, they are aggravated, further by the destruction caused by civil war. In the sixties and seventies, economic activities were put in place to serve the CACM. Many of these activities no longer take place or have been sharply reduced. The CACM probably encouraged the "wrong" activities in the sense that those activities were not efficient ones with which to enter world markets. Many of these activities have ceased or have been sharply curtailed.³ In addition, many other productive ventures have been destroyed by war and political upheaval. Compared to

³ One often hears the argument that since investment has already been made in production equipment, designed to produce for the CACM, that that equipment should not sit idle. Rather, production should be protected and those activities now idle should be reactivated.

This statement is in conflict with one of the simplest principles of economics. Investments in production equipment are fixed costs. Fixed costs are irrelevant to production decisions. Decisions to operate a firm depends upon whether marginal revenue (in most cases, marginal revenue and price are equal) exceeds variable production costs. One of the reasons why there is idle production facilities in the CACM is that the investments made are so inefficient that variable production costs exceed the price that can be charged for output. Firms that cannot cover variable production costs should not operate. Their fixed costs should be written off.

ten or fifteen years ago, when Central American countries try to reallocate resources, they must more often reallocate between a reduced set of existing activities and a larger set of non-existing ones. When the CACM was thriving, in response to a currency realignment, reallocation could also occur among activities aimed at the regional market. Now that kind of reallocation is proscribed. The net result of these changes is that each country may have less flexibility than it has had in the past. Resource allocation is more costly than it was, and restoring price relationships based on the past (via restoring REER values) is unlikely to restore the same level of allocative efficiency.

The cost of resource reallocation has probably increased for most Central American countries. Shifts in the internal terms of trade caused by devaluation may be largely offset by:

-cost increases. This is particularly likely where wage increases quickly match devaluation-induced price increases in export and import substitution activities.

-Credit restrictions. Credit is now restricted as part of general stabilization programs. These programs⁴ are probably needed for this purpose. Nevertheless it raises the cost of resource reallocation. Furthermore, credit was implicitly subsidized in the past.

⁴ Costa Ricans will claim that there are no credit restrictions in Costa Rica. This is simply not true. The government speaks of unrestricted credit at the same time that it speaks of "guaranteeing" specific proportions of credit to preferred sectors of activity.

-The time preferences of investors have probably become much shorter in recent years than they have in the past. Thus, resource reallocation, which is a long-run venture, would look increasingly less attractive to investors, all else equal.

Structural or technological changes may occur, making real exchange rate changes an imprecise guide to appropriate exchange rate determination. For example, technological changes may cause the imported component in production for export to rise relative to some base year. Returning to the REER of that year will not restore the same relative cost structure that existed then. A shift to imported inputs may also occur if domestic inputs become unavailable, if the cost of domestic inputs rise or if there is a decline in the quality of domestic inputs. On the surface it would appear that all these conditions exist to some extent in each Central American country. It is also worth noting that world trade is now more active in both inputs and final products. Compared to a generation ago. Firms tend to use more imported inputs and sell their final goods in more competitive markets. These conditions would argue for exchange rate depreciations that exceed the real appreciations in REER alone.

Changes in the Central American Common Market (CACM) have probably also had an impact. A decade ago, inputs purchased in the CACM could be treated much like domestic inputs. Barriers to trade within the CACM were low to non-existent, and payments were easier to affect within the CACM than outside. Now imports from

CACM countries are much like they are from outside countries. Some barriers exist to trade and payment is more difficult. The fact that Guatemala and Costa Rica have made large real depreciations of their currencies and now let the market set their exchange rate levels, makes importing from them much like importing from anywhere else for Salvadorans and Hondurans. Thus, for El Salvador and Honduras, there has been something analogous to a shift from domestic inputs to imported ones insofar as trade with the CACM is concerned.

Each of these factors raises the cost of resource allocation and calls into question the response that could be expected from a return to real exchange rates that existed in the past. It is particularly important to recognize that the amount of uncertainty and instability that all countries have gone through in recent years, must have raised the risk perceived by investors. Thus, they would apply higher implied discount rates to their investment decisions and preclude many long term investments that they would have made in the past.

B.4: Internal Competitiveness

Before determining an appropriate level for an exchange rate, one would want to know about the internal competitiveness of traded goods versus non-traded goods. Since a devaluation will shift the internal terms of trade in favor of traded goods production, one would want to be assured that the terms of trade are shifted far enough to induce resource reallocation in that direction. In effect we are interested in the traded goods

ability to compete with non-traded goods for resources. An exchange rate level should be sought which raises the profitability of traded goods production relative to non-traded goods, and by enough to provide producers with the incentive to make the switch.

Macro data on internal terms of trade are difficult to come by. Usually data are available on traded commodities but they are difficult to get for non-traded goods. A useful index of the internal terms of trade, and the relative competitiveness of traded goods production, is the ratio of the prices of traded to non-traded goods. Some of these data are available for El Salvador and were analysed in Loehr (1988). They showed that In El Salvador there had been a significant shift in the internal terms of trade favoring non-traded goods between 1978 and 1984. Some competitiveness was restored to the production of traded goods when devaluation occurred in 1985-6, but that has quickly eroded.

B.5: Commodity Specific Responses

In many developing countries the production of tradables is concentrated in a few major commodities. Central American countries are typical in this regard. One would want to know the production response that one could expect to provoke from alternative exchange rates in the important industries. It would be useful to be able to estimate, for alternative exchange rates, whether or not major industries could employ resources to earn foreign exchange profitably, and if so, how much they were likely

to produce.

One important method for conducting this kind of analysis is to employ a so called "domestic resource cost" (DRC) analysis. The DRC approach is to estimate the cost of earning a dollars worth of foreign exchange in terms of the amount of domestic currency expenditure that would have to be incurred. Thus, the DRC comes up with an implicit exchange rate for each activity. Any activity that has a domestic resource cost which is below the actual exchange rate can export profitably. Furthermore those industries have an incentive to expand production up to the point where domestic resource cost is equal to the cost of foreign exchange. DRC analysis allows a ranking of activities in order of competitiveness (ie. by comparative advantage) and can be used to construct a supply and demand schedule for tradable goods. As far as we are aware, no DRC analysis has been done for any of the Central American countries. Alternatively, studies of so-called "effective rates of protection" could yield similar insight into comparative. These studies remain to be done as well.

B.6: International Market Changes

When the international terms of trade (TOT) have shifted against a country, and the shift is a permanent one, adjustment to the new market conditions is required. Unfortunately, adjustment to a balance of payments disequilibrium caused by a deterioration of the TOT may be more difficult than adjusting to the same magnitude of a disequilibrium caused by relatively high inflation. Adjustment to higher inflation requires simply

reestablishing initial relative prices. This may be done by returning to a real effective exchange rate level that was consistent with equilibrium before relative prices changed. In the presence of a permanent deterioration of the external terms of trade however, adjustment involves increasing the profitability of traded goods over and above what it was prior to the TOT deterioration. Thus, if devaluation is chosen as the tool for adjustment, a larger devaluation is required in the case where the disequilibrium is due to TOT deterioration rather than relatively high domestic inflation. There may also be a complicating factor in that inflation-induced devaluations may be better anticipated by the private sector, and adjustment may proceed smoothly. By comparison, TOT declines may be harder to anticipate and adjustment may be more abrupt and costly.

One frequently encounters the idea that a large part of Central America's economic problems are due to a decline in the terms of trade. However, few reliable data exist on the terms of trade for the region. Often, when one hears statements about the terms of trade the speaker is really referring to a specific price that has changed, not to a properly constructed index of the TOT. This kind of casual empiricism can obscure policy dialog more than enlighten it.

The Central Bank of El Salvador (BCR) publishes a series on the international terms of trade for El Salvador. AID/El Salvador reports that the data are not always consistent with what is known about individual prices, and occasionally there are

inconsistencies between price indices and unit values in the BCR's "Revista". Nevertheless, if one is to refer to data to support a statement about the TOT, then in El Salvador at least, one must allude to the BCR series. There is no other.

The BCR series only goes through 1984, but indicates that overall, the TOT have declined for El Salvador. However, an examination of the individual price indices (see Loehr, Protasi and Vogel, 1989, for details) that make up the TOT index reveal that:

1. Almost all variation in the overall export price index is due to variations in coffee prices. The prices for the other items that El Salvador exports have not changed much and together have not generally declined.
2. The overall import price index rose, but almost all of the increase was associated with petroleum prices. There are eight other import prices in the index; some rose; some fell, but none exhibited much of any trend.
3. If one had data for the period since 1984, it would probably show a slight drop^s in the export price index, since coffee prices in 1989 were a bit below their 1984 level, and the import price index would have dropped a significant amount due to declining oil prices. Overall the TOT index probably rose (ie. improved) in the 1984

^s There would have been a great improvement in any TOT index for El Salvador in 1986 due to extraordinarily high coffee prices in that year. Unfortunately, those prices have fallen subsequently.

89 period.

If there is any conclusion about the terms of trade that can be reached in the case of El Salvador it is that the problem with the TOT is narrowly based on coffee and oil prices. Also, there are no very convincing data that the TOT have declined throughout the 1980s. Data on Costa Rica's TOT⁶ for the 1980-88 period show exactly the pattern that we are predicting for El Salvador. The TOT declined after 1980, stayed depressed 1981-83, rose to a new peak in 1986, at a level more favorable than that of 1980 and then dropped back to a level approximately that of 1980 during 1987 and 1988. Exclusive of coffee and oil prices the TOT probably would not have changed much one way or the other (as far as exchange rates go, this exclusion is irrelevant). Given that export and consumption patterns are similar in the rest of the region to what they are in El Salvador and Costa Rica, it is not likely that the terms of trade is a general problem.

B.7 Information from Parallel Markets

Information from parallel markets is frequently used to help guide exchange rates in official markets. It is well known that in legal parallel markets, where exchange rates put a premium on foreign exchange, equilibrium rates fall between official fixed rates and parallel rates. As the volume of transactions becomes relatively large in the parallel market, the equilibrium rate approaches the parallel rate. Black markets, where volume is normally rather small, usually reflect an extreme depreciation

⁶ Calculated by the World Bank, but provided by AID.

for the domestic currency. In some cases (eg. in El Salvador in early 1989) a black market may show only very small premia on foreign exchange while at the same time overvaluation and need for devaluation exist. Unsustainable conditions, such as sales of reserves by the central bank, very tight liquidity and very large transfers may drive black market rates to converge with official rates. This condition calls for devaluation despite lack of signs from the black market.

SECTION 3: CAMARA DE COMPENSACION CENTROAMERICANA

Summary	1
3.1 The Camara de Compensacion Centroamericana	3
3.2 The EEC Program	7
3.3 Observations on the EEC Program	11
3.4 Conclusions	25

SECTION 3

CAMARA DE COMPENSACION CENTROAMERICANA

Summary:

In Section 3 we review the function of the Camara de Compensacion Centroamericana (CCC) and the reasons for it falling into disuse in the mid-1980s. We then review a program, supported by the EEC, to reactivate the CCC. The main characteristics of the EEC program are:

1. Intraregional exports are subsidized with FCUs donated by the EEC.
2. Participating central banks offer lines of credit for payments clearing.
3. Automatic loans are granted monthly to debtor countries and automatic loans are offered (through the lines of credit) by creditor countries.
4. Special loans are available for debtor countries unable to service their automatic loans in the medium term.
5. All loans and credits are multilateral. That is, they are loans to or credits from the "system". They are not loans and credits between central banks.
6. An EEC condition for participation is that countries must agree to specific policy reforms and a specific timetable for pursuing them.

Conclusions on the EEC project include the following:

1. There is no indication that the lack of a clearing mechanism, or credits for financing trade clearing is a major obstacle to trade.
2. The system supported by the EEC would work well where balances are small and roughly zero over the medium term. But, bilateral balance, or even regional balance should not be the objective of policy. Rather, countries should pursue policies that yield them overall equilibrium in their balance of payments.
3. A major problem with clearing payments exists between El Salvador and Costa Rica. Financing of a trade clearing mechanism may help Honduras increase its imports. A new clearing mechanism would do little for trade between Guatemala and Costa Rica, and between El Salvador and Guatemala. Nicaragua is in no condition to participate in the proposed scheme, and Honduras and El Salvador are in marginal condition to do so.
4. Under some conditions, the proposed scheme of automatic loans could lead to paralysis and breakdown for the system.
5. Any increased trade that did occur under the system would be very inefficiently financed, since the program would automatically finance trade imbalances existing on already occurring trade, and is not, and cannot be, restricted to new trade.

6. To the extent that countries free trade and payments among themselves as specified in the program, trade may expand.
7. The EEC has insisted that without reform, countries cannot participate. This is a strong point for the proposal.
8. The fundamental problem remains: without a reasonable realignment of exchange rates vis-a-vis world markets, and without countries pursuit of sound macroeconomic policies which include exchange rate flexibility, a clearing mechanism like the one embedded in the CCC cannot work. With reasonable exchange rates and appropriate macro policies, including exchange rate flexibility, a CCC-like mechanism may work, but under those circumstances it would be of only marginal utility.

Introduction:

The Checchi Report evaluated the functioning of the Camara de Compensacion Centroamericana (CCC) and a proposal put forward at that time (1985) for AID to finance a fund for clearing payments in Central America. Now, the European Economic Community (EEC) is planning to provide funding of a type that is similar to what had been proposed earlier. Thus, it seems reasonable to review the way the CCC functions and the EEC program. Therefore, in this section we will first, review the observations and conclusions of the Checchi Report. Second, we will describe the program put forward by the EEC. Third, we will provide a brief evaluation of the EEC program.

3.1 The Camara de Compansacion Centroamericana

Details on the functioning of the CCC can be found in the Checchi Report. In summary, the CCC was established in the early 1970's to facilitate the clearing of payments imbalances within the CACM. Activities of the CCC are overseen by the Consejo Monetario Centroamericano (the "Consejo"), and the CCC is located at the Central Bank of Honduras. Main features of the CCC were designed as follows:

1. The CCC would be informed by the region's central banks of all payments transactions. The CCC would then keep a running record of the transactions and the country-by-country balances implied.
2. Regular settlements of imbalances were made every six months (in June and December). In settlement, each

country was expected to clear balances in foreign exchange (ie. in dollars). However, settlement could be in any form agreed upon by any pair of central banks.

3. Extraordinary settlements were conducted whenever any single central bank had accumulated a balance in its favor exceeding \$12 million.
4. The CCC was not a credit mechanism. It was a mechanism through which each central bank offered short-term trade credits to the other central banks of the region. If any credits with terms longer than six months arose out of regional trade, it was a matter between central banks.

In the early 1980's the the clearing of trade balances drifted away from the CCC. By the late 1980s only a small percentage of trade cleared through this mechanism, though the institution survives. The reasons why the CCC fell into disuse include the following:

1. During the 1979-84 period, Nicaragua had extremely large deficits with the region, particularly with Guatemala and Costa Rica. Rather than settle those imbalances in cash, the central banks of Costa Rica and Guatemala extended credit to Nicaragua.
2. By about 1984, it became clear that Nicaragua would never be able to pay off the trade-related debts that it had accumulated. These debts totaled around \$600 million.

3. Honduras too was running chronic deficits with Costa Rica and Guatemala, and had difficulty at times clearing payments at the regular, six-month interval. El Salvador had similar difficulties, but the imbalances were not as chronically large as Honduras's.
4. Guatemala had difficulties in making payment on deficits accruing mainly with Costa Rica, especially around 1984 and 1985. This was in large part due to the fact that Guatemala's international reserves were held in the form of Nicaraguan dollar-denominated obligations to the Banco de Guatemala. When it became clear that Nicaragua would not pay, most of Guatemala's reserves "disappeared".
5. Central banks became unwilling to put themselves in a position again, where unservicable debts may arise during the course of payments clearing. All central banks recognized potential payments problems in the region and so each central bank began to insist on bilateral clearing, central bank to central bank, rather than the multilateral clearing offered by the CCC.
6. The accumulation of the debt within the CCC system created a monetary problem for the system's main creditors, Guatemala and Costa Rica. In the process of accumulating the debt, payments are made in local currency to the exporters in surplus countries, without

any corresponding sale of foreign exchange to the central banks. (World Bank, 1989:62) Thus, there is a net expansion in domestic credit. This was occurring precisely at a time when both Guatemala and Costa Rica were in monetary crises brought on by other factors. The debt problem made their monetary management task all the more difficult.

7. Even in 1990, some of the conditions exist which caused the clearing mechanism to fall into disuse. Nicaragua has not undergone the reforms necessary to participate. Honduras has maintained an overvalued currency and has been very slow to make adjustment. El Salvador has been unable to stop the tendency toward overvaluation of the colon, and political instability there throws considerable doubt on what the future trading relationships of El Salvador will be.

The proposal for creating a fund, with AID support, to finance clearing trade balances in the region, thereby reestablishing a role for the CCC, was criticized for the following reasons:

1. The main problem causing trade imbalances was misaligned exchange rates. The financing facility would do nothing to adjust exchange rates.
2. Any credit flowing from the financing scheme would go to those countries with the most overvalued currency. This would act as a "reward" for not devaluing when the

latter is called for. In practice, credit from the financing would have gone to El Salvador to cover its imbalances with Costa Rica and Guatemala.

3. There was no indication that the clearing mechanism stimulated trade, and trade stimulation was the primary, hoped-for benefit.
4. There were no trade promotion policies or measures associated with the proposed financing facility.
5. Providing financing for the CCC would be an inefficient way of stimulating trade even if there were some trade-stimulating measures associated with the program, since the financing would have to cover existing trade imbalances resulting from existing trade. There is no practical way to separate imbalances resulting from new trade as opposed to existing trade.

For the reasons stated, the Checchi report recommended against AID financial support for the CCC.

3.2 The EEC program

The main sources of information that we have on the EEC project come from interviews with EEC representatives, in San Jose, including interviews with the EEC ambassador, Fernando Cardesa G. Interviews were supplemented with three main documents.

1. Acuerdo, between the Central American ministers responsible for economic integration, presidents of central banks and representatives of the EEC. Signed on 8, September, 1989. This document contains three "anexos" describing how the program would function. These were signed on the same date.

2. EEC document entitled, "Proyecto para la recuperacion del comercio intrarregional en centroamerica" dated 7/09/89.

3. Consejo Monetario Centroamericano, "Esbozo sobre el programa de reactivacion del comercio intracentroamericano, que ha sido elaborado con la colaboracion de la Comision de las Comunidades Europeas". (no date, but about November 1989).

The scheme designed by the EEC retains most features of the already-existing CCC, and retains supervision of the CCC by the Consejo. Furthermore, any preexisting debt among the Central American countries is precluded from access to financing flowing from the system. Features of the EEC program which change institutions and procedures include:

1. The Acuerdo names a "banco agente" which is the Banco de Guatemala. The banco agente is to hold and manage any funds dedicated to the program and/or arising out of its operations. It also receives and makes any payments associated with the operation of the program.
2. Any debts and or credits arising out of the program are multilateral. That is, debtor countries contract debt with the system, not with individual central banks. Creditor countries lend to the system, not to individual central banks.
3. Each central bank creates a line of credit to the system. The line of credit is in local currency and the amount varies by country. Quotas of each country, specified in dollars, are:

Costa Rica	30 million
------------	------------

El Salvador	30 million
Guatemala	35 million
Honduras	15 million
Nicaragua	15 million

Thus, a total of \$125 million in lines of credit are available to the system, to be managed by the Banco de Guatemala.

4. The EEC plans to contribute 120 million ECU (\$142 million) over the first three years of the operation of the system. Contributions each year must be approved by the European parliament. For 1990 45 million ECUs (\$53 million) has been appropriated.
5. Liquidations of trade imbalances will be done monthly. Liquidations will not be in cash, but in the form of automatic loans. Each month, when balances with the system are determined, debtor countries receive an automatic loan for the amount of their deficit. The automatic loan is to be amortised over no more than three years, in quarterly installments.¹ Countries with net credits to the system each month, make an automatic loan to the system. These too are amortised over no more than three years with payment quarterly.
6. During the first months of operation of the system, automatic loans are limited to one eighth of the

¹ The effect of this is also to create a three-month grace period for each automatic loan.

deficit country's quota, per month. The sum of automatic loans is limited to 100% of each country's quota.

7. Special loans are available to countries whose automatic loans have summed to 75% or more of their quota. Special loans cancel the outstanding balance of automatic loans and are amortized over five years, with semi-annual payments². Granting of special loans will be contingent upon the recipient country taking steps to eliminate its payments imbalance.
8. All loans are denominated in dollars and carry an interest rate equal to LIBOR (6-month) plus one percent for debtors, and LIBOR for creditors.
9. A counterpart fund is established gradually. Each month, the banco agente remits to each central bank a sum of ECUs equal to 10% of that country's regional exports. The central banks simultaneously deposit with the system (ie. with the banco agente) an amount in local currency equal to the value of ECUs received.
10. The value of deposits in the counterpart fund are protected from devaluation by the following procedure. First, each central bank declares an exchange rate. Second, if an exchange rate is changed, a new rate is declared. Third, after a new rate is declared, an amount of local currency is deposited to return the

² Thus, a six-month grace period.

total value of the deposit to what it had been in dollars before the new declaration.

11. Participation in the system is limited to those countries which agree to a set of reforms and specific steps that will be taken to remove all barriers to trade and payments in the region. Participants must also agree to pursue macroeconomic policies that are consistent with operation of the system.

3.3 Observations on the EEC program.

The main features of the EEC program have to do with the extension of credit and the development of the counterpart fund. One of the main things to note is that the credit offered by the program is not credit backed up by hard currency, yet the credit is denominated in dollars. Whenever an automatic credit is given, it involves a loan to a debtor country and a loan to the system by a creditor country.³ This is similar to what had occurred under the old clearing mechanism, except that then the period within which the "automatic credits" existed was up to six months. Under this scheme the period is up to three years. Security for the country automatically giving a loan (a surplus country) is that the system will make good on its promise to pay as specified. Security for the system is the promise that the debtor country will repay as specified. Thus, the ultimate success of the system relies upon the willingness and ability of debtor countries to

³ The country which automatically offers credit to the system may not be the country with which the country automatically receiving credit runs a bilateral deficit.

repay their loans.

Note that there is no role in the automatic credit scheme for hard currency (ie. ECUs). Rather, the ECUs are used to help generate a counterpart fund. As ECUs are paid out, a fund denominated in local currency accumulates. In the short run, before the counterpart fund develops, the ECU contributions of the EEC are on deposit with the Banco de Guatemala to guarantee payment to creditor countries. The current plans are for a three-year program and the EEC expects that at the end of three years, the counterpart fund will be of adequate size to handle any credit needs. Implicit in all this is the presumption that currencies making up the counterpart fund will be acceptable as a means of payment. This implies the expectation that Central American currencies will be convertible with each other by the end of a three-year period. In the meantime, for the first three years of the program, ECUs will normally be on deposit as guarantee to creditor central banks.

Special loans, which are amortized over five years, and which absorb automatic loan balances, go to deficit countries. There is no corresponding "special loan" that central banks must offer to the system. Since a special loan wipes out the automatic loan balance for a deficit country, the deficit country can keep receiving automatic loans after receipt of a special loan. However, there is nothing like a "special repayment" that is made to creditor countries, nor are they required to offer special loans to the system. Thus it is possible, that after a special

loan, debtor countries are receiving new automatic loans, while the balance of automatic loans extended from creditor countries exceed the limits placed on this kind of lending. The acuerdo directs no attention to this problem.

What incentive do creditor countries have to offer automatic loans to the system, when the system's ability to repay those loans is ultimately a function of a debtor country repaying its loans? At first there is a clear incentive. During the first two years, the banco agente will remit to each country an amount in ECUs equal to 10% of its regional exports. Thus, the creditor receives hard currency and the promise to pay for any trade imbalance in the future. In return the creditor country contributes to the counterpart fund in its own currency. Debtor countries too receive ECUs equal to 10% of their exports and are therefore in better condition to service their debts to the system. In either case, countries earn extra hard currency with regional exports. To receive the extra ECUs a country must be a participant in the program and must agree to the automatic loans.

When the program ceases to remit ECUs in relationship to exports it is not clear that creditor countries will have an incentive to participate. Then, when they offer an automatic loan to the system, they will receive in return a promise to pay a balance in dollars from a system that owns no dollars. The promise to pay will be only as good as the confidence that the creditor has in the debtor's ability to service debt in hard currency, combined with the confidence that the system will use

hard currency received from debtors to repay the creditor. Unfortunately, this is the very condition that faced the CCC before when confidence broke down and the payments mechanism became moribund.

The system proposed by the EEC would work adequately where balances were small and where balances were zero over the medium term. (ie. over a year or two) If balances were approximately zero over the course of a year or two, then countries receiving automatic credits for a few months, would have them cancelled in other months when they were running surpluses. Part of the EEC plan is to place conditions on participating countries, requiring them to make adjustments that would bring balances to roughly zero. There is a problem with this. The balance of payments is not designed to balance, country by country, nor region by region. Indeed, the balance of payments need not balance trade at all. The only balance of concern is that the way balance is achieved be sustainable. In fact, all countries of the region, especially Costa Rica, and to a lesser extent Guatemala and El Salvador, are taking steps to achieve balances that are sustainable, by opening themselves to world trade. There is no reason to believe, that a result of this opening will be trade balances in the region that are approximately zero.

We have created an example to demonstrate some of the problems that the system proposed might encounter. It is labeled "Example 1". Consider the case of El Salvador. In 1988, El Salvador ran a deficit with Guatemala of about \$50 million, \$2

million with Costa Rica and about \$1 million with Honduras. That implies a monthly average deficit of about \$4.4 million. Since in its first year, the system will only offer automatic credits equal to one eighth of a country's quota, automatic credits would be limited for El Salvador. El Salvador's quota is \$30 million. Therefore it qualifies for monthly automatic credit of only \$3.75 million. If all country's are members of the CCC system, then they must have removed trade barriers between them and other members. The reason for El Salvador's small negative balance with Costa Rica is that the latter has imposed payments restrictions against El Salvador. If Costa Rica is a participant, then it must have removed these restrictions and a trade imbalance of about \$20 million is likely to open in favor of Costa Rica. This is approximately the imbalance existing before the imposition of these restrictions in 1986. In any event, El Salvador will only qualify for \$3.75 in automatic credit per month.

Note that El Salvador's ability to receive automatic credit is not changed by Costa Rica's participation, but its deficit is. When normal trade is opened up with Costa Rica, El Salvador's deficit opens by about an additional \$18 million, which falls outside the CCC system and presumably must be attended to out of current resources. But this is not even the thrust of this example.

In the table that we have labeled Example 1, we make the following assumptions:

1. El Salvador receives \$3.75 million in automatic credit

per month.⁴

2. The automatic credits are amortized in quarterly payments, over three years, at LIBOR plus 1% (ie. at 9.4% as of the end of 1989). Each month's automatic loan is treated as a separate loan.

⁴ Surely there are conditions attached to El Salvador's participation in the scheme. Presumably, if El Salvador is making the adjustments required, its deficit may fall. However, the monthly deficit assuming "normal" trade with Costa Rica would at first imply a deficit of almost \$6 million per month. This could fall considerable and still be in excess of the \$3.75 million that El Salvador qualifies for as an automatic loan. In any event, adjustment takes time, and our example is for an 18 month period. Whether significant adjustment could take place in that time period is questionable.

**EXAMPLE 1. EL SALVADOR RUNS \$3.75 M DEFICIT WITH THE SYSTEM
UNCONSTRAINED**

MONTH	MONTHLY IMBALANCE	PAYMENTS ON AUTO LOANS	AUTOMATIC LOAN BALANCE	SPECIAL LOANS	SPECIAL LOAN AMORTIZATION	SPECIAL LOAN BALANCE	TOTAL LOAN BALANCE
1	3.75	0.03	3.75				
2	3.75	0.06	7.50				
3	3.75	0.43	10.91				
4	3.75	0.45	14.32				
5	3.75	0.48	17.73				
6	3.75	0.04	20.00				
7	3.75	0.87	23.06	23.06		23.06	23.06
8	3.75	0.03	3.75			24.05	27.80
9	3.75	0.06	7.50			24.24	31.74
10	3.75	0.43	10.91			24.43	35.34
11	3.75	0.45	14.32			24.62	38.94
12	3.75	0.48	17.73			24.81	42.54
13	3.75	0.84	20.81		3.53	21.48	42.27
14	3.75	0.87	23.86			21.65	45.51
15	3.75	0.89	26.93			21.82	48.75
16	3.75	1.26	29.66			21.99	51.65
17	3.75	1.28	32.39			22.16	54.54
18	3.75	1.30	35.11			22.33	57.45

3. It is assumed that interest is paid monthly.⁵
4. It is assumed that loan principal is amortized in equal installments.

The table shows figures for an 18 month period. In each month the deficit financed by automatic credits is \$3.75 million. An automatic loan balance grows, and column 4 shows the accumulation at the end of each month. The accumulation is the result of taking on a new automatic loan in each period adjusted by any payments that have occurred.

Under this scenario, El Salvador would qualify for a special loan in the seventh month of operation of the scheme. A country qualifies for a special loan when the balance of its automatic loans exceeds 75% of its quota. Thus, in the month when El Salvador's automatic loan balance exceeds \$22.5, it qualifies. The scenario assumes that a special loan is given⁶ for the full amount of the outstanding automatic loan balance existing in the month when El Salvador qualifies (ie. in month seven). This creates a special loan balance, and reduces the automatic loan balance to zero. The automatic loan balance then begins to accumulate as it had from the start. We have assumed that the

⁵ This makes the calculation easier. If interest were to accumulate during the months when no payments are due, or if interest is capitalized at the end of grace periods, the situation described in the example gets worse.

⁶ The presumption is that even if El Salvador has agreed to take steps to adjust, seven months is too short for the adjustment to have paid off. The whole idea of the special loans is to provide more time for adjustment to work.

special loan carries the same interest rate and that amortization occurs over five years. Payments are assumed to occur each six months, and interest accumulates through the six-month period to be paid with the regular payment.

Note that by the end of 14 months, El Salvador would qualify for another special loan. If it did not receive one its automatic loan balance would quickly exceed El Salvador's quota (ie. by month 17). By month 18, El Salvador owes the system about \$57.5 million. (This figure is little affected by receipt of another special loan in month 14)

Whether or not the system breaks down after 18 months depends largely upon whether the countries that have been offering automatic credits all along continue to be willing to do so. Recall that El Salvador has deficits with all three of the other countries. However, automatic credits must be offered only by countries with a surplus vis-a-vis the system, so Honduras, a deficit country with the system, would not be offering automatic loans. As trade existed in 1988, 94% of El Salvador's Central American deficit was with Guatemala. If 94% of the automatic loans by the system to El Salvador were matched by automatic loans by Guatemala to the system, then Guatemala would have lent at least \$54 million to the system. It is intended that automatic loans by central banks to the system be limited to 100% of their quota, but in this scenario, automatic lending by Guatemala greatly exceeds its quota. Indeed, automatic lending by Guatemala exceeds its quota by month 11. In fact Guatemala's automatic

lending to the system would be greater than this example alone implies. In 1988, Guatemala ran trade surpluses with both Honduras and Costa Rica, so some additional automatic lending would be associated with that. A final observation is that the EEC will have put into the system only 45 million ECUs (\$53 million) in the first year. It is presumed that this amount gets paid out to generate the counterpart fund. We should assume that another 40 million ECUs are contributed in the second year as well. By the time 18 months have passed however, much of that contribution will too have been disbursed. Thus, the outstanding debt of El Salvador (\$57.5 million) will most likely exceed the total amount of hard currency in the system by a considerable margin.

Under this scenario, the Banco of Guatemala is likely to be an unwilling participant. El Salvador has run up a debt with the system, not directly with the Bank of Guatemala. Furthermore, the ability of the system to service the loans made automatically by the Banco de Guatemala would be in question. Where would hard currency come from to service this debt? Guatemala would be in no need of the soft currencies accumulating in the counterpart fund, for it runs a trade surplus with all the other regional economies, so these would not be reasonable for loan settlement. If Guatemala chose to limit automatic credits as soon as the credits that it had offered exceeded its quota, how would the system function? The documents are unclear.

The example illustrates another important observation on the

program. In the example there is no trade expansion. Credit is given, payments are cleared, the system is used. In fact the system is overused and would probably break down given the overuse. Nevertheless, the example is based on 1988 trade with no assumptions about trade increases. If the program results in trade increases, the financing of those increases will be extremely inefficient, because the financing offered applies to existing trade as well as new trade. The two cannot effectively be separated. Also, the program could give the illusion that it is doing something productive, since it will be used (at least at first), even though what it is doing may simply be shifting payments clearing from one mechanism (or set of mechanisms) to another.

The example illustrates that there may be some difficulties associated with running the program as it is described in the documents. But one could also question the need for a formal, multilateral clearing mechanism in the first place. Examine the trade and clearing mechanisms set up among the regions countries. One would not see any overwhelming reason for a multilateral clearing mechanism.

Nicaragua could not now participate without substantial reforms that she is not now apparently willing to make.

Honduras, has a deficit with Guatemala and Costa Rica, but it always has had. Even in the early 1970's, long before trade declined and the payments mechanism fell into disuse,

Honduras ran a deficit with these countries. Furthermore, the deficit today is not much different in size from what it was then. An improved payments clearing mechanism would probably boost imports into Honduras, but is unlikely to help Honduran exports. The main problem for Honduras is a considerably overvalued exchange rate and not a lack of payments clearing mechanisms per se. Honduras has a surplus with El Salvador, but the total amount of trade is so small that it is inconsequential.

El Salvador has run a large deficit with Guatemala throughout the 1980s. However, those two countries have recently worked out an arrangement (Acuerdo de Tela) whereby settlement is facilitated. Both have agreed that importers and exporters on both sides, can buy and sell currencies freely, and can strike contracts in any currency that is agreeable to them. Thus, there are currently no payments restrictions between Guatemala and El Salvador that require special mechanisms.⁷

⁷ The arrangement between Guatemala and El Salvador has an automatically balancing mechanism built in. That is, there is a free exchange rate between the colon and the quetzal. Even where both governments choose to peg their currencies, traders are free to deal in the otherwise black market. If black market rates do not provide incentive for one party to a transaction, the prices of the goods are adjustable. With adjustable exchange rates and prices, exchange occurs and payments clear automatically. In practice, border trade between the two is conducted in dollars.

The private sector response to the arrangement between Guatemala and El Salvador is very positive. They respond favorably to being able to settle transactions as they please, with minimum central bank involvement. Both central banks require

Between El Salvador and Costa Rica there are indeed barriers to trade. Costa Rica has restricted exports to El Salvador except insofar as Salvadoran importers can pay, in advance, in dollars. This arrangement forces a balance between the two, which is Costa Rica's objective, but probably limits trade*. A smoother payments mechanism would probably be trade promoting but without a realignment of the Salvadoran colon, an expanded clearing mechanism would turn out to be a mechanism to finance Salvadoran imports of Costa Rican goods.

Guatemala and Costa Rica have already reached bilateral agreements on clearing trade imbalances. Indeed, the CCC is used as part of the clearing mechanism. Perhaps as a result, trade deficits between the two countries, as a percentage of total trade have been declining since the early 80s. To the extent that the EEC-financed project came into being it would simply replace a system that is already in place and functioning. No increase in trade could be expected from simply rearranging the clearing mechanism.

Unfortunately problems have arisen with the arrangement between Guatemala and Costa Rica. On February 1, 1990, the Banco de Guatemala announced that the Costa Rican authorities have

only that trade be registered for statistical purposes. See CEPAL, (1989)

* In fact total trade between the two is greater than it was in the early 1980s.

suspended the agreement to settle payments in local currency. Henceforth only dollars will be used in settlement. It is likely that instability in the exchange rate for the quetzal in early 1990 has provoked this move on the part of Costa Rica. Once the quetzal regains some stability and the central bank of Guatemala is better able to specify clearly a foreign exchange rate policy, the Costa Ricans should once again agree to settlement in local currency. The Guatemala/Costa Rica arrangement illustrates that where currencies have been realigned to reflect something closer to equilibrium values, payments clearing occurs spontaneously. No special mechanism is needed. Where realignment has not occurred, or instability due to a lack of policy direction exists, no special mechanism can help much.

The EEC program contains in it the proviso that participating countries must agree to undertake specific steps toward removing trade barriers among themselves. The discussion of specific steps and timetables for action are currently under discussion by ministers for integration. Furthermore, it is the intention of the EEC Commission to withhold participation from countries that fail to honor the reforms and/or the timetable agreed to. This is a very positive attribute of the EEC program. However, it is not clear how quickly countries are willing to act and the incentive to action associated with the program is very small compared to the reforms that would be needed. Particularly in Nicaragua, Honduras and El Salvador there are basic structural problems that exist, and governments have been very

slow, and usually reluctant, to take the steps compatible with free trade and payments between themselves and partners. Without reform, and even with slow-paced reform, the system proposed by the EEC will quickly break down, along the lines illustrated in our Example, above.

3.4 CONCLUSION

In Section 3 we review the function of the *Camara de Compensacion Centroamericana* (CCC) and the reasons for it falling into disuse in the mid-1980s. We then review a program, supported by the EEC, to reactivate the CCC. The main characteristics of the EEC program are:

1. Intraregional exports are subsidized with ECUs donated by the EEC.
2. Participating central banks offer lines of credit for payments clearing.
3. Automatic loans are granted monthly to debtor countries and automatic loans are offered (through the lines of credit) by creditor countries.
4. Special loans are available for debtor countries unable to service their automatic loans in the medium term.
5. All loans and credits are multilateral. That is, they are loans to or credits from the "system". They are not loans and credits between central banks.

Conclusions on the EEC project include the following:

1. There is no indication that the lack of a clearing mechanism, or credits for financing trade clearing is a

major obstacle to trade.

2. The system supported by the EEC would work well where balances are small and roughly zero over the medium term. But, bilateral balance, or even regional balance should not be the objective of policy. Rather, countries should pursue policies that yield them overall equilibrium in their balance of payments.
3. A major problem with clearing payments exists between El Salvador and Costa Rica. Financing of a trade clearing mechanism may help Honduras increase its imports. A new clearing mechanism would do little for trade between Guatemala and Costa Rica, and between El Salvador and Guatemala. Nicaragua is in no condition to participate in the proposed scheme, and Honduras and El Salvador are in marginal condition to do so.
4. Under some conditions, the proposed scheme of automatic loans could lead to paralysis and breakdown for the system.
5. Any increased trade that did occur under the system would be very inefficiently financed, since the program would automatically finance trade imbalances existing on already occurring trade, and is not, and cannot be, restricted to new trade.
6. To the extent that countries free trade and payments among themselves as specified in the program, trade may expand.

7. The EEC has insisted that without reform, countries cannot participate. This is a strong point for the proposal.
8. The fundamental problem remains: without a reasonable realignment of exchange rates vis-a-vis world markets, and without countries pursuit of sound macroeconomic policies which include exchange rate flexibility, a clearing mechanism like the one embedded in the CCC cannot work. On this point we are at one with the World Bank (1989: 68-70) With reasonable exchange rates and appropriate macro policies, including exchange rate flexibility, a CCC-like mechanism may work, but under those circumstances it would be of only marginal utility.

SECTION 4: PROSPECTS FOR THE CACM	
Summary of Sections 4 and 5	1
4.1 What Happened to the CACM?	3
4.2 Trends in Individual Countries	9
4.3 Is the CACM Viable?	16
4.4 Integration without a Customs Union	25
4.5 An Integration Strategy in Central America	
SECTION 5: A ROLE FOR ROCAP	34
5.1 Encouragement to trade reform	36
5.2 Trade Promotion without formal "Integration"	43

SECTION 4

PROSPECTS FOR THE CACM

Summary:

Section 4 analyses prospects for a reactivation of the CACM. Section 5 recommends several measures that ROCAP can take to promote regional cooperation. Reasons for the decline in the CACM are:

1. The protective structure of the CACM was based on import substitution industrialization (ISI). This created a strong anti-export bias and increased the regions vulnerability to economic disturbance.
2. The economic crises affecting each country beginning in about 1979-80 were initiated by:
 - economic mismanagement,
 - recessions in the developed countries,
 - political/military violence
 - declining international terms of trade
3. Macroeconomic disequilibria brought on by the crises were worsened by the anti-export biases inherent in ISI.

Since 1980, each country has pursued different strategies toward regaining macro equilibrium. There is almost universal agreement on what should be done. Main policy measures required are:

- reduce anti-export biases,
- liberalize trade,
- reduce exchange controls,
- manage reasonable exchange rate policies,
- adjust fiscal deficits and inflation.

Costa Rica has made considerable progress in implementing these policies. Guatemala has made less progress. El Salvador has attempted reform, but is hindered by political/military events. Honduras and Nicaragua have done little, though the recent change in government in Honduras will probably bring important reforms with it. Each country must proceed as it is able whether or not their actions are compatible with the constraints of the CACM.

The CACM is a customs union. A customs union requires a common external tariff and duty-free trade internally. Neither condition has existed for some time in Central America. Thus, the CACM in effect, no longer exists.

Section 4 recommends a strategy for integration without a customs union. Main ingredients in that strategy include:

1. A free trade area (FTA) is a preferable form of economic integration for Central America. An FTA requires duty-free trade internally, but allows

- independent tariffs for outside trade.
2. Conditions should be promoted that would lead to an FTA.
 3. An FTA would be promoted if the trade and payments reforms already begun independently in Costa Rica, Guatemala and El Salvador were to meet the objectives set by those countries. In fact, if they meet their objectives they will be very close to having a common external tariff as well.
 4. Special attention must be directed toward policy reform in Honduras and Nicaragua. Neither could now participate in any formal integration scheme.
 5. Subregional trade agreements should be promoted.
 6. Any measures that make regional or subregional trade more efficient promotes integration, whether or not these measures fall within formal agreements.

Section 5 recommends several activities that ROCAP might become involved in to promote regional integration. These activities are recommended based on the points stated above and on the limitations facing each country. Activities are based on the observations that, first, countries must pursue reforms and do it at their own pace, second, regional free trade can be maintained and conditions will not be "right" for a common external tariff for 3-5 years, third, regional trade can be made more efficient despite lack of formal "integration" schemes. Activities could include:

1. Activities to encourage reforms in trade and payments.

- promote the exchange of comparative information on reforms, exploiting experience elsewhere,
- support comparative evaluations of effective protection,
- examine the effect of removing exchange controls,
- encourage cooperation within sub-regional trade groups,
- consider alternative integration arrangements,
- support maintenance of a free trade area regionally, while individual tariff reforms occur.

2. Trade promotion without formal integration.

- Support removal of "obstacles" to trade, other than tariffs,
- direct attention to removal of transport and potential energy problems,
- promote the interactions now developing between SIECA and the private sector,
- consider regional trading arrangements that could be strengthened with Panama.

4.1 WHAT HAPPENED TO THE CACM?

Before one can begin to prescribe policy for the Central American region, one must understand the principles upon which the CACM foundered. Much has been written on the subject (eg. World Bank, 1989) and we provide only a reminder here.

The main characteristic of the CACM in its early years was that it was based on a principle of import substitution industrialization (ISI) supported by a common external tariff (CET). When first established (in 1961) the CET tended to be set at levels which were closer to the highest levels already-existing in the region, rather than being set at the average. In the early years (up until about 1970) there was an increase in industrial production as countries exploited the protected internal market. By the late 1960's however, growth from further import substitution had been largely exhausted (Bulmer-Thomas, 1979; PRODESARROLLO, 1989). The ISI in the CACM did not meet its objective of promoting industrialization. Rather, the bulk of manufactured exports by Central American countries remained internal. Most manufactured products exported by Central American countries were sold to CACM partners. Furthermore, about 90-95% of manufactured goods were consumer goods. No transition was made from serving the small, internal market, to export activities outside the region.

Protection of manufacturing activities within the CACM at times has been extreme. Nominal tariff rates, which ranged up to

about 100% on many goods, though typically 70-80%, did not represent the true levels of effective protection in the region. One important practice raising effective protection was the tendency to give duty exonerations to imported inputs, yet maintaining duties on finished goods. Adding to this were quantitative restrictions, overvalued exchange rates, and differential taxes. Estimates of effective protection have put levels at rates exceeding 200% in some cases.¹

The economic crises, into which all countries entered in about 1978-1980, were precipitated by a combination of bad luck and economic mismanagement. Commodities prices had been very high in the late 1970's. These provided ample foreign exchange, revenues from export taxes and from the import duties that were collected on the resulting imports. Beginning in about 1978, commodities prices fell. Coffee prices began the slide, but it was followed shortly thereafter by other important prices such as those of sugar, cotton, meat, bananas and others. At the same time growth had slowed in the developed countries; recessions occurred there in 1980-82, and the demand for Central American exports softened. As the terms of trade shifted adversely, and

¹ The World Bank (1989) cites studies placing effective protection in Costa Rica at 288% and another at "over 200%". Monge and Corrales (1988) put effective protection in Costa Rica at over 500% on manufacturing activities aimed at the domestic market. Effective protection has been put at 178% in Honduras after taking into account non-tariff barriers (World Bank, 1989). Some sectors in Honduras may be protected by effective rates exceeding 300% (PRODESAROLLO, 1989:95) PRODESAROLLO also shows that in El Salvador exportables receive negative effective protection averaging about 29% while importables are subject to effective protection averaging 41%, but ranging as high as 282%.

demand for Central American exports dropped, current account and fiscal deficits occurred simultaneously. Fiscal deficits brought on inflation and, with currencies pegged to the dollar, currencies became greatly overvalued. As a stopgap measure, countries resorted to borrowing internationally to keep levels of public expenditure from falling despite fiscal deficits. This added fuel to the inflationary fires and, when interest rates reached historic high levels in the early 1980's, countries were burdened additionally with heavy debt service.

Economic mismanagement prevailed in the crises. Governments consistently ran fiscal deficits that were financed through inflationary monetary emissions by central banks. Unused to inflation of the magnitude then observed, most countries responded with sets of administrative controls to ration credit, control prices, allocate foreign exchange, limit imports, etc. All were reluctant to devalue their currencies, and all but Costa Rica remain reluctant even today. Honduras has not yet yielded to reasonable economic principles on its exchange rate, and El Salvador and Nicaragua are very slow to yield. Guatemala does so, but only after much self-destructive delay. In general, a failure to adjust or slowness to do so, has slowed economic recovery in the region.²

² It has been shown statistically that the deterioration of the current account of the balance of payments in Central America is due to a combination of domestic and external factors. Failure to correct budgetary deficits and to adjust currency values have been the main domestic problems. Deterioration in the international terms of trade and, in the early 1980's, slow growth in the developed countries were the main external factors causing

A final stroke of bad luck was the political violence and instability that hit the region starting in about 1978 with the Nicaraguan revolution and persisting in El Salvador today. Guatemala too suffered conditions approaching civil war in the early 1980's and is not yet free from political turmoil. Since part of the main problem in Central America is a fiscal one, the necessity to maintain internal stability, and indeed in two cases to wage civil war, lends to fiscal problems. In the cases of El Salvador and Nicaragua, civil war is probably the most important contributor to fiscal problems and the growth problems that flow from them.

Under the pressure of the economic difficulties of the early 1980's, policies associated with the CACM proved an additional burden. The ISI policies of the CACM had diverted the region from developing an export orientation in products other than the traditional ones, the prices of which were now in retreat. Levels of effective protection had become so high that developing an export orientation had become particularly difficult. When foreign exchange became scarce, those choosing to not devalue their currency were pressed to allocate foreign exchange to those uses felt to be of high priority. Continued purchases of the consumer goods which the CACM had promoted were no longer high priority. Finally, differences in the rates at which regional currencies appreciated in real terms caused bilateral payments imbalances to develop very quickly and for institutions such as

deterioration in the current accounts. See Loehr (1987)

the CCC, which were not designed to deal with these problems, to become of little use.

Throughout their period of difficulties, the Central American countries have demonstrated a persistent preference for maintaining regional cooperation. The signs of this are abundant. First, during the period when Nicaragua was in great need of imports from the region, and had no ability to pay for them, Guatemala and Costa Rica allowed Nicaragua to accumulate arrears (recall Section 3). This was done in spite of difficulties in these two creditor countries, and was based on the faith that Nicaragua would correct its problems. Only when the latter faith dissolved and the problems of Guatemala and Costa Rica persisted were these two forced to cut normal commercial ties with Nicaragua. Second, institutions set up to serve the CACM continue to receive support from each country, albeit irregularly and in somewhat reduced amounts. Third, countries have struck bilateral agreements (eg. between Costa Rica and Guatemala) or subregional agreements (eg. Tela Agreement) on an ad hoc basis as conditions allow. Finally, regional meetings and conferences on trade in the area continue to be well attended, and as the private sector is increasingly involved they too show considerable enthusiasm for maintaining regional preferential trading ties. (see CEPAL, 1989) These indicate a continual search for the means for productive regional cooperation. Overriding this interest however is the realization by each country that, as their economic difficulties persist, they can not afford to relinquish any of

the policy independence that is normally associated with economic integration. One must assume that those Central American countries that were able to resume "normal" economic growth, would again show considerable interest in re-formalizing some form of economic integration.

The questions before each of the Central American countries now are two. First, what must be done to restore economic growth. Second, given what must be done to restore growth, is there a role for economic integration and the CACM. The first question has already been answered resoundingly by each country. To restore growth each must take steps to promote exports. This recommendation is not new (see Bulmer-Thomas, 1979; Lizano and Sagot, 1984) but most countries have been slow to take serious measures in this direction. The main steps toward export-oriented growth are:

- liberalize trade,
- reduce exchange controls,
- adjust exchange rates and maintain exchange rate flexibility,
- reduce price distortions caused by internal controls on prices, interest rates, directed credit, arbitrary regulation, antiquated fiscal systems, etc.

It has become clear to most countries that the anti-export bias imparted by the protective structure of the CET, combined with each country's domestic modifications of protection cannot be offset by simply offering special export incentives. Monge and

Corrales (1988) have shown that in Costa Rica, despite export incentives (from CATs, CEIXs, etc.) exporters still face disincentives when compared to producers for the domestic market. Schenone (1988) has demonstrated the same factor for El Salvador. The fact that even Costa Rica's export promotion measures, which have been very aggressive, cannot offset the general anti-export bias of the CACM's ISI strategy, lends support to the idea that the entire ISI approach must be deserted to open the Central American countries to export markets abroad.

As it has existed in the past the CACM is incompatible with what countries must do and with what they are now doing to restore growth. The import substitution orientation of the CACM is not compatible with much of the trade liberalization that must accompany an export orientation. The CET cannot survive as it has been in the past. Schenone's assessment of the case of El Salvador (1988:77) pertains in the case of each of the countries of the region:

"La adhesión de El Salvador al arancel externo común centroamericano es un serio obstáculo a la reducción del sesgo anti-exportador y la apertura de la economía hacia los mercados mundiales."

The main objective of the remainder of this section is to search for points of compatibility between what countries must do to restore growth and a reactivation of economic integration in Central America.

4.2 TRENDS IN INDIVIDUAL COUNTRIES

Each country in the region is taking steps to reactivate its

own growth. Recent history has shown, that when the Central American countries are confronted with a choice to either act independently to foster their own growth or to defer to regional interests, it is the former that is chosen. None of the countries of the region are now designing policies specifically because they promote economic integration. Rather, all countries are acting in their own self interest. Regional considerations account for little. That is not to say that what is in the self interest of individual countries is incompatible with economic integration. Rather, it is said so that the reader can understand best the motivations of policy makers in each country. The economic conditions faced by each country are such that policy makers must identify what is best able to promote their own country's welfare and then to take appropriate action without waiting for any group approval.

In Costa Rica, tariff reform is well underway. The objective of reform is to decrease the level of protection and its dispersion. Over the years, Costa Rica had imposed several layers of import surcharges and special taxes and fees, which made the level of import protection, in tariff-equivalent terms, much different, and higher than the CET. Because of these tariff-equivalents, Costa Rica has not adhered to the CET since the late 1970's. (Lizano and Sagot, 1984) Costa Rica began a structural adjustment program in 1985. One of the first steps was to impose surcharges on imports where tariffs were very low, thereby reducing tariff dispersion. At that time tariff ceilings

(including surcharges) were about 200%. (World Bank, 1989) Beginning in 1987, top tariff rates would be reduced, at six-monthly intervals, over three years, to a top rate of 10%. Over the same period, a target tariff floor was set at 5% and most exemptions would be discontinued.³

Costa Rica has also made considerable progress in adjusting the value of the colon and administering continued adjustments that are compatible with export promotion. Mini-devaluations now occur frequently to keep up with relative purchasing power differentials between Costa Rica and a group of trade partners. One result of successfully adjusting the value of the colon is that many of the most cumbersome exchange controls have been eliminated.

El Salvador was at a point of transition when violence and open warfare, recurring in November, 1989, interrupted progress on economic reforms. The Cristiani government came to power in June, 1989 with the intention of taking steps to open the country to trade. The main ingredients in that program were a coordinated tariff reform and currency adjustment. (See Schenone 1988a and 1988b and Harberger and Wisecarver, 1989) The tariff reform is similar to that in Costa Rica in that it is designed to reduce the overall level of protection and to reduce dispersion. In October, 1989, steps were taken to reduce maximum tariffs to 50%

³ Exceptions have been made for textiles, garments and shoes, where adjustment is to occur over five years instead of three. Essential medicines may be subject to duties of less than 5%.

and, where they are less than 5%, minimum tariffs were to be raised to 5%. Within eighteen months tariffs would be adjusted further to 20% maximum and 15% minimum. Furthermore it was the government's intention to eliminate all duty exemptions, except to exempt duties on inputs to production for export, without distinction between exports of traditional and non-traditional goods.⁴

Simultaneous with the liberalization of imports was to be devaluation in real terms of about 40% from the real exchange rate of late 1988. This was to be accomplished by devaluations in excess of inflation at each point when the tariff structure was adjusted. In the early months of the Cristiani administration there were currency adjustments that constituted a devaluation in everything but name. Most transactions were shifted over from official markets at C5 per dollar to the banking market (cuentas dolares) at about C6.4 per dollar as of mid November, 1989. It was the intention of the government to let the colon devalue more in that banking market. Furthermore, for the first time, El Salvador's government was willing to consider entering into a standby arrangement with the IMF to help the country's adjustment. Meetings were held in early November 1989 to discuss the conditions that the IMF would attach to a standby agreement.

⁴ There is a side benefit to these reforms in that the measures proposed would raise revenue. Currently, tariff revenue as a percent of imports is only about 5% and revenue as a percent of dutiable imports is only 8%. This is due to the large amount of imports that enter El Salvador under duty exemptions. Exemptions applied to over half of all goods imported prior to the Cristiani administration.

One of those was that the colon would be devalued to something in the area of C7.5 per dollar by early 1990.

Guatemala has begun pursuit of tariff reforms that are similar to those begun in Costa Rica. Tariff ceilings that have been as high as 150% have now been capped at 70%. It is Guatemala's intention to establish a range for tariffs of 5% to 40%, and to do that over a three-year transition period.

Guatemala has not been as explicit as either Costa Rica or El Salvador in terms of how it will manage exchange rates. There does not now seem to be an exchange rate policy other than occasionally allowing the free market to set a new value for the quetzal. The occasion that brings this about has been (in both 1985 and 1989) when the central bank has run out of reserves and exhausts its ability to influence exchange rates. It is encouraging that Guatemala is willing to adjust the value of the quetzal when it becomes fundamentally overvalued, but the methods used to seek new values could be more efficient and less disruptive.

Honduras has not reformed tariffs in the same way as the other countries. Recall that Honduras has not been a regular member of the CACM since it withdrew in 1970. Its regional trade functions on the basis of a series of bilateral agreements. Honduras has not adhered to the CET and has traditionally levied tariffs against Central American imports (albeit at reduced rates). By the early 1980's, Honduras's tariff revenue had been seriously eroded due to the fact that many duties were specific

duties and they had been eroded by inflation. Also, the number of duty exemptions was very high. About one half of all imports were duty exempt. To restore revenue, Honduras began to levy a series of surcharges, which by the mid-1980s accounted for about 75% of all tariff revenue.

For Nicaragua tariffs are irrelevant. Nicaragua has established a centrally managed economy within which tariffs are no longer a means of protection. In addition, exchange rate policy has been very poorly handled. Inflation has been very high and the Cordoba has normally been extremely overvalued. Multiple exchange rates exist with large differences between legal rates and usually an enormous premium on dollars in the black market. These conditions are simply incompatible with any form of normal, market-oriented trade and with the kind of economic integration that might occur in the region.

In conclusion, the examination of individual countries leads to the observation that each has determined that it is in its own best interests to set an independent tariff policy. No country now adheres to the CET and none plan to do so. CEPAL (1989) quotes an unidentified viceminister as observing that "de hecho hay hoy dia cinco aranceles en Centroamerica." Tariff adjustments where they are occurring are moving countries toward lower tariffs with less dispersion. Honduras and Nicaragua have been reluctant to liberalize trade, whereas the other countries are planning significant reforms. Exchange rates are also being adjusted and made more flexible. Again, Honduras has done so only slowly as

has El Salvador. Nicaragua may be beginning greater exchange flexibility. Meanwhile Guatemala and Costa Rica have made considerable strides on this dimension.

The main observation that one can make, based upon the actions of each country, is that the CACM does not now exist. The main pillars of the CACM originally were the CET and freedom from duty within the region. The CET no longer exists, and apparently has not existed for some time (Lizano and Sagot, 1984:67). Since about 1980, countries have imposed extra duties and surcharges which are equivalent to tariffs. Often these measures carried names other than "tariff" so that the illusion of a CET could be maintained. Tariff-like protection has also been afforded by selective consumption taxes which have fallen on many goods, some of which are produced in the region. Since about 1986, countries have been more willing to drop the illusion that there is a CET in the region. All countries are now in the process of revising tariffs and tariff-like equivalents.

Remnants of duty-free trade within the region still exist. In many cases of surcharges and special taxes, trade within the CACM has been exempt. In most cases, since duties within the CACM were zero, when minimum duties are imposed in an effort to reduce tariff dispersion, duties within the region are set at minimum levels. Exchange controls are probably the most restrictive element in regional trade. However, removal of exchange controls is part of the overall trade liberalization in each country. Furthermore, exchange controls become unnecessary in those

countries that successfully adjust the value of their currency. Therefore, exchange controls are likely to be reduced or dropped entirely in the course of trade and tariff reform. Thus, while there is not now free trade internally in Central America, the main impediment to trade is likely to disappear or be reduced sharply.

If the countries of the region are successful in achieving the reforms they have specified, conditions will be much improved for once again formalizing some form of integration scheme. The reformers, Costa Rica, Guatemala and El Salvador, are seeking lower tariffs and less dispersion. In the process they plan to dismantle exchange controls and better manage exchange rates. The latter factors are primarily responsible for the disintegration of the CACM. Furthermore, the reformers are after tariff structures that are very similar. Within three to five years, Costa Rica and Guatemala plan to have the same tariff structure. In effect they will have a common external tariff. El Salvador's plan is somewhat more ambitious than the other reformers, but El Salvador is likely to have greater difficulty in implementation. After reform, the reformers should be able to reestablish some kind of formal integration scheme involving common external tariffs, without the anti-export bias that had been inherent in the CACM's CET.

4.3 IS THE CACM VIABLE?

The Central American Common Market (CACM) is a misnomer. The regional economic grouping in Central America has never been a

"common market", for that term implies integration beyond anything that has ever been attempted in the region. A common market is a regional economic grouping that not only establishes free trade among members and common external tariffs toward third countries, but also encompasses common institutions in taxation, monetary affairs, customs, fiscal policy and a number of other areas.

The CACM, at its peak, could best be described as a customs union. A customs union is defined as a regional economic grouping of countries within which there is free trade and which imposes a common external tariff on imports from non-members. The customs union that was the CACM does not now exist. Whether or not the customs union can and should be revived depends upon the benefits to be expected from a customs union. To assess the viability of the CACM we would do well to keep in mind some of the characteristics of a customs union and some of the conditions necessary for one to prosper. It is not our intention here to reproduce a theoretical treatise on the costs and benefits of a customs union. That is available elsewhere. (see Allen, 1961; Robson, 1984) Rather, we will review some aspects of customs unions, skipping theoretical material, but focussing upon what can be expected of a customs union and the conditions that affect our expectations.

The potential gains from a customs union fall generally into four categories. These are:

1. Improved resource allocation.

2. Cost improvements associated with achieving economies of scale.
3. Terms of trade improvements achievable by countries acting together rather than separately.
4. Other gains associated with improved income distribution, technological advance, economic growth, economic stability, and provision of public goods.

We have listed the fourth category, which may be termed simply "other", as a collection of effects which may occur, but which are not addressed specifically by economic theory. In this fourth category, there may exist benefits (and costs) but economic theory has little to say about what they are. The idiosyncracies of each case will determine whether or not net benefits exist in the "other" category.

Economic theory does have something to say about the first three areas for possible gain. We will deal with them in reverse order. First, the terms of trade effect can occur if the customs union is large enough that collectively the countries involved have some price effect over the goods that they import. Where the customs union countries occupy a large segment of the market for any single import there may be a favorable terms of trade effect. In the case of the CACM there is not likely to be a significant terms of trade effect owing to the small demand placed on the world supply of most goods, even by the CACM as a group.

The second factor deals with economies of scale. Theoretically, economies of scale would be available to the CACM.

since the combined regional market is so much larger than the market of any single country. However, one cannot overly generalize about the availability of economies of scale, for each good has a unique production function and the possibilities for economies of scale vary widely. For the production of many goods, even the combined Central American market is not large enough to achieve economies of scale. One need only recall that the combined regional GDP is only on the order of \$30 billion, which is roughly equivalent to that of a medium-sized city (of about 1.7 million people) in the U.S.⁵ Furthermore, since demand in Central America reflects the low per capita income of the area, the demand for industrial goods would be much less than it is in a U.S. or European city with an equivalent GDP. It is in the industrial goods category that economies of scale might be expected to exist, but it is precisely in industrial goods that markets are rather small in Central America⁶. Thus, the opportunities for achieving economies of scale may be rather limited in the region.

Finally, comes the question of the effect of a customs union on allocative efficiency. Economic theory conventionally measures

⁵ The combined Central American GDP is about the equivalent of the gross product of a city somewhat smaller than Denver, Colorado and about the same as that of Vienna, Austria.

⁶ Also, Lachler (1989:14) has shown that growth in manufacturing in developing countries is not related to market size. Apparently, even very large developing countries do not possess markets large enough for economies of scale to be an important factor in manufacturing growth. His work does show that growth in manufacturing is positively related to an export orientation

the potential for benefits from a customs union in terms of the balance between "trade creation" and "trade diversion". Trade creation is defined as the shift in the source of supply of a good from a high-cost supplier to a lower-cost supplier. The opposite is trade diversion. Trade creation may occur when two countries join a customs union, and where before, both produced the same goods, protected by their individual tariffs. Upon creating a customs union, thereby eliminating tariffs between them, the high-cost producer of the goods in question will begin to import from the lower-cost union partner, and reduce its own production. The shift from the high-cost producer to the lower cost producer is trade creation. For the union as a whole, it improves allocative efficiency because production is reduced in the least efficient location and increases in the more efficient location⁷. Trade diversion occurs if, after creating the customs union, one of the members begins to import something from another member, what it used to import from some third country. The reason for importing from the third country before forming the union would have been that that country was relatively more efficient than the union member and could therefore sell at a lower price. Thus, where there is trade diversion, imports shift

⁷ While there is a net efficiency gain for the union, one should note that the union member from which trade is shifted suffers a loss in employment and production, while the country to which trade is shifted gains on these dimensions.

from a low-cost supplier to a higher cost supplier.*

It has long been known that few groupings of developing countries possess the conditions that would promote trade creation over trade diversion when forming a customs union. (see Allen, 1961; Lachler, 1989) The conditions for raising the likelihood that trade creation will predominate after forming a customs union are:

1. The larger the economic area included in the customs union, the closer the elimination of internal tariffs comes to free trade. The larger the area, the greater the probability that the area will include the low cost supplier of many products.
2. Relative to pre-existing tariffs, the lower the common external tariff (CET) the more likely it is that trade creation will occur. With a "low" CET, and free internal trade, most shifting of sources of supply will be internal, from high-cost suppliers to lower-cost ones. A relatively high CET will cause many union members to switch from outside sources of supply to higher-cost internal ones, thereby causing trade

* Note too that the costs of trade diversion fall differently upon countries. The country which ceases to buy from a low-cost, world supplier and diverts trade to a higher-cost union partner, pays more for its imports. Prior to union, importers paid world price plus whatever import duty was due. After union they pay a price that is higher than world price, but pay no import duty. Thus, importers may even pay less in total, but the country pays more and revenue from tariffs falls. Meanwhile, the country to which trade is diverted sees a rise in production and employment. One country loses while the other gains. It can be shown that losses exceed gains.

diversion.

3. Where countries produce and trade similar items before the formation of the customs union, there is greater opportunity to shift from high-cost to low-cost sources of supply after the union is formed. Where countries produce different items, it indicates that before the union, each is already being supplied from low-cost suppliers elsewhere. In the latter case, trade diversion will result from forming a union.
4. Where prospective union members both produce an item, the greater the production cost differences in the areas where production overlaps, the greater the potential for shifting to a lower-cost source of supply.

The Central American region is typical of many groupings of developing countries in that it does not possess the characteristics that would lead to a high likelihood of net trade creation. Nor were these conditions in tact when the CACM was first formed in 1961. The economic area within the CACM is not large. When the CACM was first formed, the CET tended to reflect the upper range of protective levels then existing in the region. (World Bank, 1989) Whereas most of the countries in Central America produced some similar items before forming the CACM, these items tended to fall in agricultural and food products categories. Unfortunately, it was not in these products that the individual countries wanted to specialize, and most agricultural

goods were excluded from internal duty-free treatment. Individual countries attempted to set up industrial activities to produce items that were different from what was produced elsewhere in the region. Indeed, the internal policies of the CACM were almost explicitly designed to cause trade diversion, by establishing industries that would divert purchases from low-cost suppliers in the rest of the world to the higher-cost suppliers in Central America.

Even if the conditions exist for achieving net trade creation, this is only a necessary condition for welfare improvements within a customs union. It is not a sufficient condition. Net trade creation is the result of having summed the gains from trade creation with the losses from trade diversion. Any customs union will have both simultaneously. While on balance, trade creation may predominate for the union overall, it is not likely that trade creation will occur for each member. There will be some gainers and some losers among members, and some equitable way of distributing gains and losses must be found before one can unambiguously state that there has been a welfare improvement. Trade diverting shifts will be particularly of concern because the countries diverting their trade will lose tariff revenue and pay more for their imports. (for details see Robson, 1984)

In Central America it is not likely that conditions exist that would promote trade creation through the formation of a customs union. Indeed, it is not likely that these conditions

exist in most of the developing world (Allen, 1961; Vintcos, 1978) and not likely that these conditions existed when the CACM was formed. If these conditions do not exist, and customs unions are formed anyway, trade diversion, and welfare deterioration will result. In the words of one student of economic integration (Robson, 1984:151) "...integration among developing countries may appear at best irrelevant and at worst positively harmful."

Most studies of static efficiency in the CACM conclude that on balance, trade diversion has occurred. Cline and Delgado (1978) reason that on balance trade diversion predominated early on in the CACM⁹, but expected dynamic gains to yield net benefits in the longer run. The World Bank (1989: i. iv) and Baran (1989) conclude that trade diversion has exceeded trade creation. Furthermore, those who have studied the dynamic effect of integration in the CACM generally conclude that the import substitution phase of integration had run its course by the late 1970s. Dynamic gains were found to be either extremely small (Brada and Mendez, 1988), had been pretty much exhausted early on

* Cline's method of estimating trade creation and diversion (Chapter 3 in Cline and Delgado, 1978) probably counted some trade diversion as trade creation. The method observed the change in the ratio of imports to total consumption and defined trade creation as that change times consumption. But the ratio can also change due to trade diversion. When trade is diverted, regional imports appear cheaper to regional importers because they continue to pay the CET on imports from outside the region, but do not pay duties on imports from the region. Thus, they may increase their total imports as trade is diverted. Cline's ratio would thereby rise as a result of trade diversion, not trade creation. Cline recognized most of the problems with his measurements, but admits that little could be done about them due to data limitations.

(Bulmer-Thomas, 1979) or were based upon very fragile conditions (Bulmer-Thomas, 1979; Viatsos, 1978). Mendez and Rousslang (1989) are able to show statistically, that when one takes into account the imperfect substitutability between goods produced in the CACM and goods produced outside the CACM, the CACM would have increased welfare for its members by dissolving itself as of 1979.

4.4 INTEGRATION WITHOUT A CUSTOMS UNION

As we indicated in section 4.2, the customs union that was originally the CACM, no longer exists. Each country has gone its own way in setting tariffs independently of the others. Yet, a remnant of the CACM remains, and that is a general absence of tariff barriers within the region. Thus, the CACM now resembles a free trade area (FTA), which is defined as a grouping of countries that have eliminated tariffs among themselves, but which each maintain independent tariff policy vis-a-vis third countries.

The question that immediately arises is whether the Central American countries are better off with an FTA, rather than the customs union that they had before? Indeed, in some cases it can be shown (Robson, 1984) that an FTA is preferable to a customs union in terms of expected efficiency gains.

An FTA requires that countries involved establish rules of origin. Since each maintains its own tariff policy, without rules of origin, imports from third countries would simply enter the FTA through the member country with the lowest tariffs. However, even strict rules of origin cannot prevent "trade deflection",

which refers to an indirect replacement of internal production with goods originating outside the FTA. ¹⁰ Trade deflection offsets some of the trade diversion that is normally associated with a customs union.

It can be shown (Robson, 1984: 21-30) that on the basis of efficiency, a free trade area is better than a customs union because of trade deflection. Furthermore, trade deflection cannot be prevented by rules of origin. The limiting case, where an FTA and a customs union are equivalent, is where the customs union sets a CET which is equal to the lowest tariff existing among

¹⁰ To illustrate trade deflection, consider two countries, H and L, that form an FTA. Assume that the importation of some good M, is protected by a tariff in each country, but that the tariff on M is higher in H than it is in L. Thus, the price of M is higher in H than it is in L, and the marginal costs of production are higher in H than in L. Upon forming the FTA, H will shift some of its purchases of M to L. This would be trade diversion since before, H would have bought M in world markets from the cheapest source of supply. Country L must then increase its production of M to serve the H market, and L will continue to serve the H market as long as the price there is higher than it is at home. In fact, producers in L will use as much as their capacity to serve H as they can because the price in L is limited by the lower tariff there. If L uses all of its production capacity to serve markets in H, satisfying the rules of origin, it can nevertheless satisfy its own demand by importing M. As long as H retains the higher external tariff on M, it will pay L to export M to H and supply its own needs from imports. This is trade deflection. The trade diversion that occurred when H began to import M from L instead of importing it from world markets, is offset by trade deflection. The latter redirects purchases of M back toward the lowest cost source of supply.

Suppose that instead of an FTA, L and H had formed a customs union and set a common external tariff on M equal to the average of the two pre-existing tariffs. Thus, the CET is higher than L's original tariff. Again there will be trade diversion in favor of L, but now there can be no deflection to offset it. Producers in L face the same price in L and H. Increases in production in L are stimulated by increased protection, but there is a welfare loss equal to the full extent of trade diversion.

members. This is important in the Central American case, since the CET set by the CACM tended to be nearer to the higher tariff levels that preexisted in the region. Furthermore, reestablishing the CACM as a customs union would probably entail agreeing to a CET which is higher than the minimum tariff now existing for some members. Compared to a CACM with high average tariff levels, (ie. a high CET) a FTA in which some members have low tariffs is preferable from a resource allocation perspective. In general:

"...the customs union alternative is inferior to the free trade area alternative. This conclusion is in fact generally valid for the alternative of a tariff-averaging customs union and a free trade area, irrespective of the particular market conditions assumed." (Robson, 1984: 27)

Conditions in Central America are probably conducive to forming a free trade area. While non-tariff barriers now inhibit trade, there are still few tariff barriers in the region. It would probably be productive for those countries pursuing reforms to keep the duty-free intraregional trade that they now have. A common external tariff would probably hinder reform where it is occurring, so formation of a customs union now is not likely to be productive. Therefore, formation of an FTA should be considered by the reforming countries now. In three to five years when reforms have run their course, it may be appropriate to reform a customs union.

4.5 A STRATEGY TOWARD INTEGRATION IN CENTRAL AMERICA

The strategy developed here is based on several observations. First, it is more productive to examine the conditions affecting individual countries than it is to try to

examine aggregate conditions for "Central America". After all, there are only five small countries involved and each is unique. Second, the CACM no longer exists. There is no customs union in Central America. Third, Central America never possessed and still does not possess the conditions necessary to form successfully a customs union. Fourth, there may be gains from a free trade area in Central America. Fifth, all countries of the region would gain improved prospects for economic growth if they opened themselves to international trade, managed more flexible exchange rate policy and achieved macroeconomic stability. Sixth, all countries have demonstrated a continuing interest in strengthening regional trade ties. However, given their own current economic difficulties none can afford to relinquish the policy independence that would be required by formal economic integration. Finally, each country will pursue its own interests related to resumption of its economic growth. Regional considerations are not now of great importance in designing each country's growth strategy.

The strategy suggested for improved integration in Central America is:

1. Admit that the region is composed of five, independent countries, each of which will pursue what it identifies as its own best path to economic growth.
2. Nicaragua is a special problem. Its macroeconomic problems are enormous and solutions to them are distant. Without reforms in Nicaragua it cannot participate in any meaningful

economic integration in the region. Any integration strategy that requires waiting for reform in Nicaragua is doomed to inactivity.

3. Honduras has not been a member of the CACM, it trades little with the others and has never conformed to the constraints of the CET. Honduras has not offered duty free trade to other regional nations. It is the most in need of reform of the other four countries. Honduras has been very slow to open itself to trade and to pursue policies promoting exchange rate flexibility and macroeconomic stability. Pressures are mounting for Honduras to initiate reforms.
4. Meanwhile the other three countries should not wait to begin their own reforms. Delay by any country implies that eventual integration is delayed. Also, each country will have to reform at its own pace anyway. The policy sequence required, trade liberalization and removal of exchange controls and quantitative restrictions makes macroeconomic control all important. The ability of each country to reform will be determined by their ability to gain macroeconomic control over their own fiscal condition.
5. El Salvador seems to have the willingness to reform, but is frustrated by the civil war. Expecting El Salvador to condition its policies on any regional integration schemes is naive.
6. Guatemala and Costa Rica have initiated reforms of their tariff and trading systems, exchange rate determination and

macroeconomic management. They should be encouraged to continue. Fortunately, both are seeking the same tariff reform, roughly over the same period.

7. When Costa Rica and Guatemala, and if El Salvador, complete the reforms that they have begun, they will have the basis for forming a free trade area. In fact they will be very close to having formed a customs union since all are seeking similar reforms, though they are doing so at their own pace and they are doing it to achieve primarily domestic objectives. Creation of conditions compatible with a free trade area are coincidental.
8. Guatemala, Costa Rica and El Salvador should agree that after they have reformed their trade and payments systems, it would be in their combined interest to form a free trade area. They should make it clear that if Honduras and Nicaragua reform as well, they would be willing to welcome those countries in the FTA as well. Currently, without substantial reform, Honduras and Nicaragua simply cannot effectively participate in any reasonable regional trading arrangement.
9. No attempt should be made to distort the reforms occurring in Guatemala, Costa Rica and El Salvador to induce them to conform to some preconceived concept of economic integration. Rather, each should be encouraged to reform as best they can based purely on national interests. It is important that each country that is willing and able to

reform, should do so with haste. They should not wait for others.

10. As they have been reforming, Costa Rica, Guatemala and El Salvador have normally made provisions for regional trade. That is, they have taken steps to insure that regional trade remain duty free, no matter what happens with their individual tariff structures. In fact, as each country approaches its individual tariff goals, it becomes progressively easier to offer duty-free treatment to regional trading partners. The dialog among these three countries, about maintaining duty-free treatment for each other, while pursuing their own tariff objectives has not been very well focussed. Focus should be encouraged.
11. Sub-regional arrangements which provide some elements of integration should be encouraged. For example, Costa Rica and Guatemala have agreed bilaterally to clear trade imbalances occurring between them, and this is being done through the CCC. The Tela Agreement, between Guatemala, El Salvador and Honduras, commits the three to allowing trade between them to be conducted in national currencies and/or in dollars, at whatever exchange rates are found agreeable to the transacting parties, without intervention by central banks¹¹. Subregional agreements are valuable to integration

¹¹ The Tela Agreement has been of considerable benefit to El Salvador and Guatemala. There is a "border market" existing between the two where goods and currencies are exchanged in a relatively free market. Since the prices of both goods and currencies are flexible, trade automatically clears. The

in the region because they recognize that across-the-board agreement on all issues is not practical, but that there are some areas in which regional cooperation can continue in ways that are compatible with national interests. They also allow expression of a continued interest in close economic ties within the region.

12. There will be a major payoff to the non-reforming countries from the reforms of those that are successful. Successful countries will remove exchange controls and special taxes and surcharges. These are now a major barrier to trade in the region and will benefit all countries whether they reform or not.
13. After the reforms that are now under way in Guatemala and Costa Rica run their course, both countries will have the basis for a customs union between them. Both will have the same tariff structure. They will have few mutual barriers to trade. They will have reasonable means for payments settlement without need for special institutions. Indeed, they have already agreed bilaterally to many of these conditions.
14. Guatemala and Costa Rica should not be encouraged to form a customs union, despite the fact that they will have one coincidentally. They should be encouraged to formalize a FTA. They should be encouraged to hold membership in the FTA

arrangement has not been particularly useful for trade with Honduras, since the Lempira is widely recognized to be very overvalued and unstable. (see CEPAL, Octubre de 1989:12)

FTA. They would not be consistent with a customs union.

Given the civil war in El Salvador it must be assumed that reforms there will occur more slowly than they will in Costa Rica and Guatemala. When reforms are complete, hopefully within three to five years, the question of setting a common external tariff among reforming countries should be reopened.

15. Regional activities could be initiated to seek integration outside the confines of a traditional customs union. Many barriers to trade exist in the region that have nothing to do with whether or not a customs union or FTA exist.

Activities can be aimed at the provision of regional public goods and/or at reducing the cost of trading in the region.

Some problem areas that come to mind include:

- environmental problems,
- bureaucratic problems at borders.
- health and safety requirements that differ across countries,
- documentation for exports and imports could be standardized,
- transportation problems could be addressed.

SECTION 5
A ROLE FOR ROCAP

Over the next three to five years ROCAP would do well to maintain a broad view of "economic integration". In the past, economic integration has been viewed as the formation, maintenance and growth of the CACM, where the CACM was defined as a specific set of customs treatment creating a customs union. The CACM now exists in name only. Nevertheless, economic integration can proceed outside of the constraints normally associated with the CACM. Economic integration should be redefined to include any measures taken to promote improved economic linkages among the Central American countries. Over the next three to five years, these linkages will be promoted best by focusing on non-tariff issues and by allowing tariff issues to be settled by the normal evolution of each individual country's tariff reforms. Costa Rica, Guatemala and El Salvador have begun reforms that will eventually lead to improved conditions for formalizing regional trading arrangements. Honduras is probably about to begin reforms that are similar to those of the other reforming countries. Nicaragua is in need of reform, but is reluctant to begin them. Without reform, Honduras and Nicaragua are incapable of entering into any integration scheme, whether we refer to the traditional CACM or the integration schemes that may come out of the reforms elsewhere.

Within three to five years, conditions in the region should be compatible with reinstituting a formal integration

arrangement. Reforms in each country are being pursued independently, but they all lead to similar results. If they are successful, reforms will create conditions that would make economic integration more productive than it has ever been. All reforming countries intend to remove anti-export biases. All seek lower tariffs with less dispersion. The tariff floors and ceilings that all are seeking are similar, so a common external tariff should be almost an automatic outcome¹. All seek removal of exchange controls and reasonably managed exchange rates. At that time agreement to a CET would not have inherent in it the anti-export bias that the former CET had. In the meantime, there is little reason for maintaining duties on interregional trade. A free trade area can exist among reforming countries while they go about revisions in their overall trade and payments regimes.

ROCAP should act on the principle that trade within the region should compliment trade with the rest of the world, rather than substitute for trade with the rest of the world. The CACM attempted to substitute regional trade for world trade and has failed to support growth in the region. Each country is now attempting to emphasize world trade and none will be enthusiastic about participating in regional integration schemes if they are not complimentary with their individual efforts to open themselves to trade. ROCAP's approach should recognize:

1. Individual countries are, and will be, modifying their

¹ Costa Rica and Guatemala are seeking exactly the same tariff structure. If they are successful, they will have a common external tariff automatically.

tariff structure, normally seeking lower average protection and less dispersion in protection.

2. After individual countries have reformed their tariff structures, something which will occur over three to five years in Costa Rica, El Salvador and Guatemala, conditions will be much improved for creating complementarity between regional and world trade. Indeed, in the process of reform they will create conditions approximating a common external tariff.
3. Formal integration schemes, such as a free trade area, are likely to be compatible with the reformed tariff structures that reforming countries seek. However, formal integration schemes are not necessary to increase the complementarity between regional and world trade. Other means of regional cooperation are available.

The general approach that is suggested therefore is to encourage individual countries to reform their trade regime, (point one above). In so doing, conditions are created that improve prospects for regional trade (point two). Meanwhile steps can be taken to improve the complementarity of regional and world trade, outside the confines of a formal integration scheme (point three).

5.1 Encouragement to trade regime reform:

Individual countries are often thwarted in their efforts to reform their trade regimes by a lack of basic analysis and by

unfamiliarity with the experience of similar countries. The bilateral AID missions normally provide technical assistance on trade reform and other issues aimed at the specific conditions of the countries in which they operate. That technical assistance infrequently takes a comparative approach to trade regime reform. Many AID officials and their staffs lack information on the details of trade regimes and trade reforms occurring elsewhere. They normally have some passing knowledge of these, but systematic knowledge is lacking. Furthermore, policy-makers in each country often lack information on what measures are reasonable to implement and how to implement them. ROCAP can develop a comparative perspective that can support bilateral AID missions and policy-makers in the region. Some activities include:

1. Mechanisms for the exchange of experience among participants in economic reforms could be created. It is frequent that public officials are in agreement that certain steps should be taken in general but they are uninformed on the specific steps that should be taken. Much effort is wasted reinventing measures that have already been applied elsewhere. Also, confidence is often less than it could be if officials believe they are attempting something that has never been tried before. The experience of neighboring countries, or other similar countries is often partially transferrable, but officials are often uninformed.

Efforts should be made to get people together to focus upon specific issues, where there is some experience to be exploited. For example, Costa Rica now has considerable experience managing a flexible exchange rate. Central bank personnel (and others) in other countries lack confidence that they too could manage a flexible exchange rate. They would benefit from communication with Costa Ricans who already have this experience and who are well informed as to what will happen should flexible exchange rates be attempted. Another example has to do with financial reforms leading to positive real interest rates. Those involved normally span the public and private sectors. Questions arise immediately as to how financial reforms should be carried out. What operational difficulties should be expected? Are there management problems? What institutional reforms are required? What about timing and policy coordination? There are other Latin American countries and people who have experience with these issues. Regional participants in reform would gain by knowing about their experience.

AID personnel in the bilateral missions² often

² The bilateral AID missions must take the lead in helping countries pursue trade and trade-related reforms. There is little direct role for ROCAP. The reforms called for require action on many dimensions, and policy packages must be designed that are comprehensive and suitable for the specific conditions facing each country. Policies in one sector (such as in the trade sector) cannot easily be separated (and normally not separated at

lack systematic, comparative studies of the reforms with which they are working. They usually have a general knowledge of alternatives, but lack details of the specific steps that may be recommendable given the experience of comparable countries. ROCAP could provide comparative studies and/or access to people with an explicitly comparative view of solutions to problems facing each country. If ROCAP were to get into this activity, studies should be narrowly focused on substantive issues. For example, comparative studies on "trade reform" would be too broad and not of much use. Studies on some subset of trade and payments reform would be more useful. (For example, a focused study could be on procedures to liberalize exchange rates for current transactions while simultaneously retaining controls on capital transactions until full liberalization can occur)

2. Estimates of effective protection in each country are often unavailable. Currently each country has only a vague notion of the level of protection offered by their current trade regime. Countries are modifying their tariff structures and inventing export promotion

all) from policies elsewhere. For example trade policies have revenue impacts, thus, trade policy is intimately related to fiscal policy, public budgets, taxes and tax reform, finance, etc. Only the bilateral missions are close enough to each situation to clearly assist in designing policy packages suitable to each country.

mechanism without very good information as to how these affect incentives for trade. Protection is being changed by adjustments in tariffs, exchange rates, exchange controls, etc. with little more than faith supporting the conclusion that these will meet the objectives of reform. Ultimately we will want to know how reforms have affected protection in the region and whether reforms remove anti-export biases. Without systematic study of effective protection, and how it is affected by the reforms as they occur, we will not be able to make any strong statements about overall protection. Reducing effective protection is considered a prerequisite for developing competitive export activities. In this case there is the added benefit, that reduced effective protection can provide the basis for a more market-oriented regional integration movement.

There has been a beginning in the study of effective protection in the region. The SIECA/ROCAP research program has produced one important study on the subject (PRODESARROLLO, 1989). That study is only a beginning and follow-on projects are suggested in it. Also, work by Monge and Corrales (1988) estimates effective protection in Costa Rica and Berlinski has made estimates for Honduras. Their work could be extended to the regional level. On the regional level,

estimates could be made in ways that are comparable. As it now stands, studies are not directly comparable across countries. These efforts should not be "one-shot" efforts, but should be used to monitor progress in reducing effective protection in the region.

3. Studies should also be done on the effect of exchange controls on effective protection and regional trade. Exchange controls have probably been the single most destructive influence on regional trade. Furthermore, whether or not formal integration schemes are in effect, exchange controls will continue to affect regional trade. This information is also useful to each country because they are probably being damaged individually by the existence of exchange controls.
4. ROCAP can encourage trade-and-payments-related agreements within sub-regions of Central America. Currently only Guatemala, Costa Rica and El Salvador have conditions and policies in common that may serve as grounds for sub-regional agreements. For example, the Tela Agreement has been useful to improving trade and payments settlement between Guatemala and El Salvador. Guatemala and Costa Rica have cooperated in payments clearing. There may be grounds for incorporating El Salvador into the latter arrangement. These arrangements are important because they take into account the reforms occurring in each country and set

precedent for broader agreements in the future.

Particular attention may be directed to the payments arrangements between Guatemala and El Salvador for border trade. This arrangement seems to represent a "free market", is almost unaffected by central bank regulation, and seems to be suitable to entrepreneurs. The arrangement may well serve as a model of a simple, effective way to encourage regional trade. However, little is known about the arrangements that businesspeople are making and how well the arrangement serves them. A carefully done study of this arrangement should be welcomed by regional policy makers.

5. Studies could be begun on the alternative forms that formal integration measures will take. Particular emphasis could be focused on a free trade area. Such studies should take into account the likely evolution of trade and payments regimes in each country and not assume that the CACM will simply be "reactivated" as it existed in the past. Sub-regional integration schemes should be considered. Indeed, only three countries could now participate in formal integration schemes. (ie. Costa Rica, El Salvador and Guatemala.)
6. As countries reform their tariff structure they should consider maintaining duty-free treatment for regional trading partners. In effect, a regional free trade area could be maintained while reform occurs. Currently

there exist no studies of this possibility, nor are any being done in the individual countries. ROCAP could study the effect of maintaining a FTA while each country reforms its tariff structure. Such a study should consider an FTA which applies to the region as whole and, alternatively, applies to some subregions.

7. ROCAP should clearly distinguish between two elements that have been associated with "economic integration" in the region. These are, 1. the common external tariff and, 2. duty-free trade internally. ROCAP should disassociate itself from programs and policies that cling to the common external tariff. ROCAP should take care that when the term "integration" is used, it is not meant to imply a common external tariff.

5.2 Trade promotion without formal "Integration":

The activities specified above are designed to encourage individual countries to make reforms that will eventually make more formal integration possible. Meanwhile, there are steps that can be taken that would make regional trade more efficient no matter what the formal integration schemes are. These measures would improve regional trade even if the countries never again get together in a formal agreement. Also, they are complimentary with world trade because they would improve the efficiency with which the Central American economies operate. Activities which come to mind, but which do not constitute a comprehensive list include the following:

1. Support should be offered for the removal of non-tariff and non-financial barriers to trade. An important study by SIECA has already identified many obstacles to trade that are largely bureaucratic. The "Estudio sobre los obstaculos al comercio en centroamerica" (Zepeda, 1989) has identified problems associated with customs and border crossings, transportation, documentation, bribery, smuggling and others. Attention to these problems would make an important contribution to making trade more efficient within the region. SIECA should suggest specific steps toward alleviating these problems and ROCAP should consider supporting steps toward this end.
2. Particular attention should be focused on problems of transportation. All businessmen in the region complain of transportation difficulties. ROCAP may begin by taking an inventory of the transportation problems and identify those that are amenable to solution. If some of these problems can be solved by international agreement, then ROCAP should support steps necessary to strike agreement among the requisite countries.
3. Throughout the region there is concern, that once economic growth resumes there will be a severe shortage of electric power. A shortage of electric power would greatly inhibit almost any export competitiveness that is developing in the region. ROCAP is involved in

assessing the power sector in the region and should be encouraged to continue doing so. Specifically, ROCAP may become more active in seeking regional transmission and power sharing agreements.

4. Within the past few months, SIECA has been opening a dialog with the private sector. This has been represented by a series of conferences and meetings. This seems to be the first time that SIECA has drawn the private sector into developing its own view of "integration". Without this interaction, SIECA is in danger of becoming a peripheral organization. Only if private sector concerns can be incorporated in SIECA's activities, will the organization be able to resume its role in charting a course for development in the region. Thus, this new dialog should be encouraged.
5. 1990 may be the right time to examine possible regional linkages that can be formed with Panama. It is obvious that changes will occur in Panama. Also, AID/Washington and the congress will be looking for initiatives that affect Panama. Panama has existing bilateral treaties with the other Central American countries. It is possible that these bilateral treaties can be "multilateralized" so that Panama is integrated into the free trade area that will probably evolve in Central America. Furthermore, with proper rules of origin, it is possible that a free trade arrangement

with Panama would create a demand for exports by the other regional nations (though that remains a matter for research to determine). By at least looking into this issue, ROCAP may be able to seize upon an initiative that would be "popular" in Washington and be of service to export promotion for the region.

BIBLIOGRAPHY

- Allen, R.L. (1961)
"Integration in Less Developed Areas," KYKLOS, XIV:2,
pp. 315-35.
- Baran, Y.M. (1989)
"Harmonizing Tax Policies in Central America" The World
Bank, WPS 308.
- Berlinski, J. (1987)
"Honduras, la proteccion implicita en actividades de la
industria manufacturera." (mayo)
- Brada, J.C. and Mendez, J.A. (1988)
"An Estimate of the Dynamic Effects of Economic
Integration," REVIEW OF ECONOMICS AND STATISTICS,
(February) 163-167.
- Bulmer-Thomas, V. (1979)
"Import Substitution v. Export Promotion in the Central
American Common Market (CACM)," JOURNAL OF COMMON
MARKET STUDIES (November)
- Camara de Industria de Guatemala (1989)
"Evolucion de la Economia Guatemalteca durante el
periodio 1984-1988." (agosto)
- CEPAL, (1989)
"Encuesta de opiniones empresariales," (Mexico, D.F.)
- Cline, W. and Delgado, E. (1978)
(eds.) ECONOMIC INTEGRATION IN CENTRAL AMERICA,
(Washington: Brookings)
- Edwards, S (1989)
REAL EXCHANGE RATES, DEVALUATION AND ADJUSTMENT,
(Cambridge: MIT Press)
- Harberger, A. and Wisecarver, D. (1989)
"Suggestions for Economic Policy in El Salvador." (San
Salvador: FUSADES)
- IMF (1989)
Memorandum to Executive Board, September 21, 1989
- IMF (various dates)
INTERNATIONAL FINANCIAL STATISTICS, YEARBOOK
- IMF (various dates)
EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS, ANNUAL
REPORTS.

- IRELA (1988)
"A New Stage in Central American Integration?: The Institutional Dimension," Institute for European-Latin American Relations, Dossier No. 16, (November, 1988)
- Lachler, U. (1989)
"Regional Integration and Economic Development," World Bank, Industry and Energy Department Working Paper, Industry Series Paper No. 14 (November)
- Lizano, E. and Sagot, M. (1984)
COSTA RICA Y LA INTEGRACION ECONOMICA CENTROAMERICANA (San Jose: Academia de Centroamerica)
- Loehr, W. (1987)
"Current Account Balances in Central America 1974-84: External and Domestic Influences," JOURNAL OF LATIN AMERICAN STUDIES, (19) pp.87-111.
- Loehr, W. (1988)
"Real Exchange Rates in El Salvador," for USAID/El Salvador (February)
- Loehr, W., Protasi, J.C. and Vogel, R. (1989)
"El Salvador's Foreign Exchange Rate System: Problems, Alternatives and Recommendations," for USAID/El Salvador (January)
- Loehr, W. and Norton, R.D. (1989)
"A Review of Policy Packages for El Salvador," for USAID/El Salvador (July)
- Maciejewski, E.B. (1983)
"'Real' Effective Exchange Rate Indices: A Reexamination of the Major Conceptual and Methodological Issues," IMF STAFF PAPERS (Sept)
- Mansur, A.H. (1983)
"Determining the Appropriate Levels of Exchange Rates for Developing Countries," IMF STAFF PAPERS (December)
- Mendez, J.A. and Rousslang, D.J. (1989)
"Does the Central American Common Market Benefit its Members," ECONOMIC INQUIRY, XXXVII (July) pp. 473-87
- Monge G., R. and Corrales Q., J. (1988)
POLITICAS DE PROTECCION E INCENTIVOS A LA MANUFACTURA AGROINDUSTRIA Y ALGUNOS SECTORES AGRICULTORES EN COSTA RICA, (San Jose: ECONOFIN)

- PRODESARROLLO, S.A. (1989)
 "Los problemas del nivel de proteccion efectiva en centroamerica" Estudio elaborado para el programa ROCAP/SIECA-CEIE (Octubre de 1989)
- Richter, C. (1987)
 "Status Report on Trade in Central America: A Statistical Update and a Proposed Role for ROCAP in Improving Regional Trade Policies," (Guatemala, July)
- Robson, P. (1984)
 THE ECONOMICS OF INTERNATIONAL INTEGRATION. (2nd ed.) (London: George Allen and Unwin)
- SIECA, (1989)
 "Elementos de una estrategia de integracion para el desarrollo de centroamerica," (Guatemala, diciembre)
- Saidi, N. and Loehr, W. (1985)
 "Research on a Trade Financing Facility for Central America-Balance of Trade, Payments and Real Exchange Rates in the CACM, 1965-1984," for USAID/ROCAP (Washington: Checchi and Company)
- Schenone, O.H. (1988a)
 "Diagnostico de la Politica de Comercio Exterior y del Sector Industrial en El Salvador," (San Salvador: FUSADES) Octubre.
- Schenone, O.H. (1988b)
 "Recomendaciones de Politica Industrial para El Salvador," (San Salvador: FUSADES) Diciembre.
- Vaitsos, C.V. (1979)
 "Crisis in Regional Economic Cooperation (Integration) among Developing Countries: A Survey," WORLD DEVELOPMENT, (6) 719-69.
- World Bank (1989)
 "Trade Liberalization and Economic Integration in Central America" Trade, Finance and Industry Division, March 10, 1989.
- Zuvekas, Jr., C. (1989)
 "Central America's Foreign Trade and Balance of Payments: the Outlook for 1988-2000," AID/LAC, Staff Working Paper, No. 1 (Washington) May.