CENTRAL AMERICAN CAPITAL MARKETS

Prepared for:

Regional Office for Central America and Panama

Bureau for Private Enterprise
Financial Markets Project
940-2005

October 1987

Arthur Young
A MEMBER OF ARTHUR YOUNG INTERNATIONAL

ACKNOWLEDGMENTS

In writing this report we have benefited greatly from the contributions of many experts in the field. Special thanks are due to Ernesto Fernandez-Hollman for his advice and assistance throughout the preparation of the report. Stimson Eveleth, Drago Pamucina, Marion Thomson, and Onofre Torres along with Ernesto Fernandez-Hollman conducted the field research and contributed to the initial draft report. Joseph Borgatti, in his role as advisor to ROCAP, provided useful suggestions for improving the report, and with Ernesto Fernandez-Hollman, co-authored the design of the regional investment company.

Special thanks are due also to Michael Lofstrom, Private Sector Officer at ROCAP, for his thoughtful review and support at all stages of the study. We are also grateful to Jim Dry, Project Officer at PRE, who reviewed the initial drafts of the report and provided helpful suggestions that have improved our final product. Joseph Carroll also provided valuable support as the PRE Project Officer at the outset of the study, and through the initial drafting of the report.

Responsibility for final preparation of the report, and for the errors of omission and commission included therein, rests with the following Arthur Young personnel: Flora M. Painter, Bob Rourke, Claudia Robinson, and Laird Johnson.

CENTRAL AMERICAN CAPITAL MARKETS

Page

/ /

CENTRAL AMERICAN CAPITAL MARKETS

I. INTRODUCTION

This study was prepared for the Regional Office for Central America and Panama (ROCAP). The main objectives of the study were:

- to determine the barriers to obtaining capital for financing expansion of private enterprise in Central America;

- to determine the need for and the feasibility of establishing a regional venture capital company as recommended by the National Bipartisan Commission on Central America (NBCCA); and

- to identify actions that might be taken by USAID missions and ROCAP to increase the availability of capital required for expansion of the private sector in the region.

A. Background

Historically, agricultural exports have constituted the mainstay of the Central American economies. Exports of commercially grown crops--cotton, coffee, sugar, and bananas-- and beef sales abroad have accounted for most of the region's export earnings, most of the government tax revenues, and a large share of the national income. Dependence on this narrow economic base, however, has left the region vulnerable to sharp swings in commodity prices.

The formation of the Central American Common Market (CACM) in 1960 gave new impetus to the Central American economies as it stimulated industrial growth, promoted economic diversification and provided an important source of new employment in the cities. The results of economic integration were quite impressive. According to statistics compiled by economist Richard S. Newfarmer, the total value of intra-regional trade rose at an annual rate of 25% in the 1960s and 15% in the 1970s.[1] The CACM had the added benefit of creating a regional identity based upon a network of businessmen, administrators, and technicians who could think in terms of a regional economic strategy rather than in terms of narrow national goals.

---

[1] Richard S. Newfarmer, "The Economics of Strife," in Morris J. Blachman, William M. Leogrande, and Kenneth Sharpe, eds., Confronting Revolution: Security through Diplomacy in Central America (New York: Pantheon, 1986) p. 213.

Beginning in 1979, the Central American countries entered a period of severe economic contraction which continues to the present. As shown in Table 1, annual GDP growth rates have been very low since 1981. Moreover, on a per capita basis, GDP growth rates have been negative for most of the countries in the region during the 1981-1985 period. (See Table 2.) The principal causes of this decline were three:

1. External Shocks

The characteristic openness of the Central American economies left them vulnerable to changes in the international economy. The quadrupling of oil prices in 1979, coupled with weak prices for the region's export crops led to a sharp deterioration in the terms of trade, as shown in Table 3. In addition, the recession in the industrial countries cut deeply into the volume of Central American exports.

These problems were compounded by the rise in world interest rates. Between 1980 and 1982, Central America's debt-service payments as a percent of export earnings roughly doubled, rising from 11.4% in 1980 to 27.6% in 1982.[2] The foreign debt problem assumed different dimensions in each country. Costa Rica, which had contracted large amounts of private debt and exhibited high debt-service ratios was forced to reschedule its foreign debt in 1982. Panama also had relied heavily on foreign loans and experienced severe problems. Other countries fared somewhat better. (Foreign debt tables are provided in Appendix B.)

2. Regional Military Conflicts

The civil wars in Nicaragua and El Salvador provided the second blow to the Central American economies. The Sandinista victory in Nicaragua and the increase in violence in other countries of the region created a massive crisis of investor confidence. The perception that political conflicts might spread, combined with other problems such as exchange rate rigidity, trade restrictions and the deteriorating economic climate itself, provoked a capital flight unprecedented in the history of the region. Private investment in gross fixed capital declined substantially during 1980-1983, and private capital flows have been overwhelmingly negative since 1979. (Table 4 shows gross domestic investment by country for 1980-1985.) In addition, foreign investment has declined sharply and almost no new private commercial loans have been extended except as part of debt reschedulings. Finally, private firms in all countries were reported to be investing heavily outside the region.[3]

---

[2] Ibid., p. 216.

[3] Ibid., p. 219.

The political risk arising from uncertainties about the future political stability of Central America continues to be a major obstacle to private investment in the region. This concern was raised by many businessmen interviewed throughout the region.

3. Regional Disintegration

The collapse of the CACM, which began with tensions between El Salvador and Honduras in 1969, was hastened by political turmoil in Nicaragua and El Salvador and by the shocks arising from changes in the international economy. The final blow to the common market resulted when some countries, such as Nicaragua, began to run large trade deficits with other member countries. This came about when abrupt shifts in relative prices brought on by reluctant currency devaluations gave some countries new cost advantages over others and interrupted traditional trade patterns. The surplus countries became wary of financing the growing trade deficits of their trading partners and halted trade credits, which heightened political tensions within the CACM.

Differences in currency valuation policies and in foreign exchange controls continue to be an important barrier to the growth of private enterprise in the region, as they limit intra-regional trade and inhibit formation of the larger market that would enable industry to achieve economies of scale and operate at near full productive capacities. Moreover, few businessmen and investors are willing to add to the normal risk of any investment the risks associated with over-valuation of currencies, and uncertainties regarding exchange rates.

The small size of the market in each country prevents industries from achieving the economies of scale that would enable them to operate more efficiently and profitably. In the face of the high risk created by limited market opportunities, entrepreneurs understandably expect very high returns. Therefore, it is important that the countries follow compatible trade and currency policies to promote the flow of goods and capital throughout the region. Yet, each country appears to be pursuing a policy of "go it alone" as far as expansion of its financial markets and business base are concerned. Little is being done to encourage intra-regional trade as evidenced by the lack of any significant support for special trade accounts or instruments that could be used to circumvent the problems that have arisen from the misalignment of currencies.

In the team's opinion, the current policies of the Central American governments are directed more toward preserving markets that have been shrinking with the collapse of the CACM, than to trying to recover the progress that was achieved through the common market. Because the national goals of the countries are incompatible in many instances, they obstruct the flow of capital and goods within the region. Policies pertaining to foreign exchange and imports and disparate tax laws discourage business start-ups and foreign investment. In some cases, public sector investment in manufacturing and service industries has crowded out local private investors. All these factors have decreased the attractiveness of investing in the region.

In nominal terms, intra-regional exports fell by 18% in 1981 and 32% in 1982, according to statistics compiled by the United Nations Economic Commission on Latin America. (Table 5 shows CACM exports between 1980-1984.) Moreover, since the Central American countries were among their own principal trading partners, income losses have multiplied throughout the region. According to some estimates, a fall in 1% of the exports of any one country precipitates a 0.4% to 1.0% fall for the other Central American countries, and a 1.6% to 2.5% fall in the product for the region as a whole.[4]

The political and economic risks created by the Nicaraguan civil war and the decline of the CACM have had an important impact on investor confidence. These conditions have given rise to defensive postures and nationalistic attitudes among the countries in the region that create even greater barriers to the initiation and expansion of business in the area. The costs and benefits of the Central American Common Market have been the subject of considerable debate among academic, political, and economic circles in Central America and elsewhere, and an evaluation of these is beyond the scope of this paper. Nevertheless, the team strongly believes that the lack of cooperation on economic matters among countries in Central America constitutes a major barrier to the economic revitalization of the region. This is not to imply that Central America should return to the "protectionist" policies associated with import substitution industrialization or that the countries should neglect extra-regional trade. However, in pursuing a policy of "going it alone," the countries of Central America are ignoring advantages that geography has dealt to each country in terms of natural land routes, access to ports, or climatic conditions favoring certain crops. Furthermore, this policy ignores the demographics of the region and the importance of economies of scale to countries that individually present very small markets.

Other important barriers to private investment in Central America were also noted by the team in its field work in the region. In particular, they noted:

- The absence of any major source of investment capital for new ventures, and the lack in some countries of medium-term funding for new investment and for the expansion of existing enterprises. This is true with the exception of USAID and other donor institution sources of finance which are provided, in many cases, at a lower cost than that of sources available in the marketplace.

- The shortage of innovative financial services institutions committed to the financing of new, and often riskier, investment opportunities, and to the development of money and capital markets as opposed to traditional lending.

---

[4] Ibid.

- The presence of administrative obstacles and bureaucratic procedures which inhibit the creation of new enterprises and promote monopolistic and oligopolistic competitive structures.

The low level of investment activity in Central America has been attributed by some to the unavailability of term credit to finance the typical medium- and long-term capital needs of businesses. The findings of the team indicated that this is not an accurate description of the situation in general.

Funds are available to finance business activities, but mainly on traditional commercial bank lending terms. These terms are appropriate for the short-term working capital needs of an on-going business, but in general, they are inappropriate for financing start-ups and expansion of existing operations in the current economic environment. Since financing new ventures and factory expansions is vastly more risky and difficult than traditional short-term lending, the conservatism of commercial banks is undertandable in view of the fiduciary responsibility that they have to their depositors. The problem is that, in many cases, the development banking institutions that were established to provide capital for higher risk ventures have tended to acquire significant non-performing portfolios over time which, in the long run, limit the viability of these institutions as important sources of risk capital. In addition, many of the development banks in the region, with the exception of LAAD, have not fully mastered cash-flow lending techniques and have tended to rely heavily on collateral to justify extensions of credit. As a result, viable investment opportunities are passed by. Furthermore, since development banking is, by definition, inherently riskier and less profitable than commercial banking, development banks in the region prefer to engage in commercial banking activities whenever they are allowed to do so (i.e. FIASA in Guatemala). This "commercial banking" orientation is reinforced by the previous experience of the managers and staff of these banks which tends to be concentrated in public service and commercial banking activities.

The financial markets of Central America were perceived by the team to be rudimentary and underdeveloped. In general, access to these markets is restricted to the wealthy minority. By and large, financial products and instruments are limited by anachronistic legislation and regulatory environments that discourage financial innovation. In addition, corporate equity is closely held and is not available as a savings medium for the general public. This is due to the general absense of securities legislation in the region and to the presence of legislation which, intentionally or unintentionally, often provides significant incentives to financing projects through debt rather than equity. As a result, ownership of corporate equity is seen primarily as a means of corporate control rather than as a source of passive investment income. The situation is further complicated by tax, banking, and company laws which tend to perpetuate the status quo. As a result, the mobilization of financial resources for investment purposes, outside of closely held economic groups, is very difficult at best.

The uncertainty and instability that characterize the current economic and political climate in Central America have also affected the level of investment in the region. These environmental problems provide economic groups with little incentive to initiate and/or increase investments in the region. The probable result, unfortunately, is that disinvestment in some economic areas has occurred.

B. Methodology

This study was conducted for the Regional Office of Central America and Panama (ROCAP) by Arthur Young & Company under the Financial Markets Project (940-2005) managed by the Bureau for Private Enterprise. The findings and recommendations included in the report are based upon information that was obtained in the field and through investigative research.

Major portions of the field work for the study were conducted during the period January 26, 1987 through February 25, 1987. Follow up field work was conducted through June, 1987. The primary objective of the field work was to determine first hand from businessmen in Central America their descriptions of each of the barriers to increased investment in the six A.I.D.-assisted countries in Central America: Belize; Costa Rica; El Salvador; Guatemala; Honduras; and Panama.

Research for the study also included an extensive survey of secondary sources. Many of the resources were used initially to prepare the Descriptive Summary: Central American Financial Markets, which provided background to the field work. Additional research was conducted to complement the Descriptive Summary and to substantiate the information obtained in the field, much of which was anecdotal because it was based upon personal observation and experience. Much of the statistical information contained in the report is drawn from the most recent reports of the International Monetary Fund, the World Bank, and the Inter-American Development Bank.

The study differed from those typically performed for A.I.D. and other donor institutions in two respects. The first was the composition and experience of the members of the study team. Each of the members of the field team has 20 or more years of practical experience as a commercial or investment banker, much of which was obtained in either Latin or Central America. Two of the members of the team are Central American by birth and also are active investors in the region.

The other distinguishing feature of the study is that it relied, to a considerable extent, on information obtained from local businessmen and other investors in the region. Public officials were included in the interviews, but the majority of personnel interviewed were businessmen. This approach differs from that of most previous studies which relied almost exclusively on interviews of public officials for an assessment of capital and overall market conditions in the region. It was established early in the design of this study that the most useful source of information on the conditions that are considered inimicable to investment in the region, and the actions that are required to improve the situation would be the business and investment communities, i.e., the very individuals that would be the initial participants and, therefore, responsible for any increases in the level of investment in the region. For that reason, the recommendations presented in the report draw heavily upon the explanations provided by members of the business community for their participation, or lack thereof, in the local economy. The secondary data relied on for this study complemented the information obtained in the field, but tended to be descriptive rather than prescriptive, and due to the usual delays in publishing and distribution was not as topical as the businessmen's observations on the rapidly changing economic environment in Central America.

In our opinion, the value of this study does not rest on its academic content, but rather on the insight it provides into the "real" sources -- businessmen and investors themselves -- who take a practical view of the problems of Central America and for whom the barriers to financial market development are very real and important. By relying on the practical experience and observations of the individuals who will be making the investment decisions in Central America, we have developed what we perceive to be a more realistic and action-oriented strategy for increasing investment in Central America.

The findings and recommendations presented in the report reflect a consensus of the team members. The initial findings from the interviews conducted in each country were reviewed and discussed in meetings involving the entire team. Questions raised by the team on the reliability or conclusiveness of specific findings were resolved by follow up visits or interviews. The team and authors are confident that the overall assessment of the financial markets and their effects on business activity in Central America presented in this report is accurate. The team is equally confident that if the recommendations suggested in the report are carried out, they would contribute in a major way to the expansion of the financial markets and business activity in the region. The best test of that claim, in our opinion, is to solicit the reactions of Central American businessmen to the report. And for that reason, we suggest that this report be distributed for comment to a wide audience of businessmen in each of the countries covered by the report.

On September 21 and 22, 1987, team members met in Guatemala City with representatives from ROCAP and the USAID missions in Central America to discuss the draft report. Their comments, suggestions, and criticisms were incorporated into this final version of the report to the maximum extent possible.

II. BACKGROUND:

FINANCIAL MARKET POLICIES, INSTITUTIONS, AND MECHANISMS

A. POLICIES

This section on tax, foreign exchange, and interest rate policies is provided solely as background to highlight the importance of such policies and the complexity of the issues involved. The section relies primarily on reports published by the World Bank and the International Monetary Fund which are available for sale to the general public. Moreover, it does not purport to be a broad ranging discussion of the literature on these subjects, nor does it intend to draw, or suggest that any conclusions be drawn, on whether, or to what extent, these policies are appropriate to the present situation in Central America.

Although the level and incidence of taxation in the countries of Central America are generally regarded as relatively low, the perceptions of the businessmen and investors interviewed in the study are that tax policies in the region hinder investment. In particular, they noted a bias in tax policies towards public sector financing over private sector financing and a bias towards debt rather than equity financing. The impact of fiscal policy on investment and economic growth is complex, and the limited scope of this study did not permit a detailed analysis of the impact of individual tax laws in each country on investment incentives. Therefore, the study does not discuss specific tax laws in the individual country sections, although it does recommend that a thorough review of tax policies needs to be undertaken to determine how specific laws may be affecting investment and the development of a capital market in Central America.

This section also deals with foreign exchange and interest rate policies. While the specific policies of each of the countries in the study are described in the individual country sections, this section presents a more general discussion of the importance of foreign exchange and interest rate policies: how they can affect the level of investment in a country; how they can inhibit export growth and therefore economic expansion; and, how they can contribute to the flight of capital.

With the exception of Panama, where the US dollar serves as the medium of exchange and movements in domestic interest rates are largely determined by international interest rates, most of the Central American countries have shown a tendency to support overvalued exchange rates and to maintain rigid interest rate policies, even after the crisis in 1979 and beyond highlighted the need for changes in both of these important policy areas.

More recently, some countries in the region have begun to move towards more liberal foreign exchange and interest rate policies. Costa Rica, in particular, which was forced to undertake larged devaluations of its currency in 1981 and 1982, has adopted a crawling peg system of mini devaluations since 1985 to maintain a more realistic valuation of the colon. In addition, Costa Rica has moved toward liberalization of interest rate policies. The Government of El Salvador has also expressed its intention to pursue a more flexible exchange rate policy. However, interest rates in El Salvador have been fixed at levels which have become sharply negative. Guatemala also has been singled out for maintaining a very rigid interest rate policy, although in the foreign exchange area it has moved toward simplification and unification of its exchange rate system. Honduras, more than any of the other countries, has been singled out for its unwillingness to adjust the value of the Lempira, which is highly overvalued.

1. Tax Policies

While the level and types of taxation are clearly not the only factors affecting economic growth and welfare, the relationship between fiscal policy and economic performance is important, although largely indirect. In general, taxation affects economic performance through the capital, labor, and product markets. Taxation affects the amount of capital available by encouraging or discouraging domestic savings and foreign investment, and may also divert investment and labor from one sector of the economy to another. Taxation also affects the level and productivity of employment by influencing such decisions as individual choices between work and leisure (or housework), the intensity of effort on the job, and employers' decisions on technology. Moreover, taxes affect a firm's ability to expand and diversify through their impact on input costs and managerial behavior, and may also influence such less tangible factors as entrepreneurship and technical progress.[5]

A 1983 World Bank study of tax policies in 20 countries by Keith Marsden, examined the causal relationships between the level and types of taxes and key growth determinants in the areas of investment, exports, employment, productivity, and innovation. The study concluded that tax policy affected economic performance in two ways: a) by influencing the aggregate supply of the main factors of production by raising or lowering their net (aftertax) returns; and b) by influencing the efficiency of resource utilization (total factor productivity). Lower taxes resulted in higher real (after tax) returns to savings, investment, work, and innovation, and higher returns

---

[5] This discussion of tax policies is based on Keith Marsden, Links Between Taxes and Economic Growth: Some Empirical Evidence, World Bank Staff Working Papers No. 605 (Washington, D.C.: The World Bank, 1983).

stimulated a larger aggregate supply of these factors of production and thus raised total output. Second, properly focused and designed fiscal incentives encouraged transfer of resources from less productive to more productive sectors and activities, thus increasing overall efficiency of resource utilization.[6] Overall, the study found that countries with lower taxes experienced more rapid expansion of investment, productivity, employment, and government services, and had better growth rates than "high tax" countries.[7]

According to the study, high corporate income taxes had a negative impact on growth. In addition, in some countries, dividend taxes acted as a "double tax" on corporate income, reducing the total amount of investment funds available and discouraging corporate investment. In contrast, lower corporate taxes and low social security contributions allowed companies to retain a higher proportion of their earnings to finance internal expansion. In turn, employment and productivity responded positively to higher levels of investment, spurring the process of capital deepening (higher capital/labor ratios) and allowing adoption of modern technology.[8]

Tax policy also influenced the pattern of investment with consequent effects on overall economic efficiency. Corporate tax holidays and import duty concessions to investors in priority areas, in particular export production, resulted in higher growth rates. In general, the study found that tax alleviation offered to exporters resulted in increased domestic and foreign investment. In contrast, taxes on major export commodities deterred foreign investors and diverted domestic capital into unproductive activities such as real estate speculation. Moreover, the low tax countries studied succeeded in expanding and diversifying their exports, and, with one exception, increased or maintained their share of world markets. High taxes, on the other hand, hindered companies' ability to compete in world markets by squeezing profits, by making protected home markets more attractive to entrepreneurs, by raising costs in potential export areas, and by discouraging foreign investors who could have brought marketing, technological, and managerial know how needed for export success.[9]

In general, production for export as well as for domestic consumption can encourage more efficient allocation of resources, permit exploitation of economies of scale, generate technological improvements in response to competition from abroad, and contribute to increased employment. The study found that policies providing exporters with duty-free imported inputs facilitated the growth of exports, particularly labor intensive manufactures where competitive material costs are critical for successful penetration of international markets. In contrast, high

---

[6] Ibid., p. 11, 29-30.

[7] Ibid., p. iii.

[8] Ibid., pp. 12, 19, 21.

[9] Ibid., pp. 15, 21-22.

tariff protection, especially on finished goods, had the effect of removing the competitive stimulus for efficiency in the production of domestic substitutes and frequently led to failure to achieve economies of scale in areas of potential comparative advantage.[10]

Historically, "technical change," in the sense of improvements in technology and managerial techniques and product innovations, has been a major factor in economic growth. The study found that, in general, lower taxes provide entrepreneurs with the resources and stimulus to launch new firms and/or new products and to introduce or develop new technology. Technical change can also be encouraged by such policies as exemptions from indirect taxes and tariffs for exporters, tax exemption of royalty payments under technical agreements, and special depreciation allowances and/or tax credits for investment in research and technical development facilities.[11]

2. Interest Rate Policies [12]

Interest rates are an important element in determining the demand for domestic financial assets, the levels of domestic saving and investment, and the current and capital accounts in the balance of payments. Their degree of importance varies among countries, however, because of differences in the level of development of financial markets, the extent of separation of saving and investment decisions, and the amount of freedom allowed inward and outward capital movements.

In general, developing countries have been reluctant to permit interest rates to be determined in the market. This reluctance can be traced to concerns over imperfections in financial markets, to the fact that in many countries financial institutions are state controlled, and to a desire to use interest rates to further various policy objectives rather than allowing them to bring the underlying demand for funds into equilibrium with their supply.

Accordingly, there has been a tendency in developing countries to try to hold interest rates down, often below current rates of inflation. However, as a 1983 study by the International Monetary Fund points out, "repression of interest rates produces lower rates of saving, of investment, and

---

[10] Ibid., pp. 26-28.

[11] Ibid.

[12] This discussion of interest rate policies is based on James A. Hanson and Craig R. Neal, Interest Rate Policies in Selected Developing Countries, 1970-1982, World Bank Staff Working Papers No. 753 (Washington, D.C.: The World Bank, 1985) and International Monetary Fund, Interest Rate Policies in Developing Countries, Occasional Paper No. 22 (Washington, D.C.: IMF, October 1983).

hence, of economic growth than would result from equilibrium interest rates, chiefly because domestic financial savings are discouraged in favor of either the accumulation of goods or of foreign assets" (capital flight).[13] Subequilibrium interest rates not only discourage domestic financial saving, but also distort investment decisions by encouraging businesses to make investments with low rates of social return, such as the accumulation of inventories, rather than investing in new plant and equipment. Moreover, "real interest rates that are substantially negative over a protracted period ... exert a destabilizing influence over the entire economy," intensifying inflationary pressures by increasing excess demand for goods and services and thus reducing the availability of credit necessary to finance investment and sustain economic growth.[14]

For these reasons, the financial policy advice most often given developing coutries is to maintain positive real interest rates, that is, nominal interest rates in excess of inflation. This has to be done carefully because interest rates that are too high tend to lower economic growth by reducing investment demand, even though funds to finance investment may be available. Moreover, as a 1985 World Bank report points out, positive real interest rates in and of themselves are no assurance that the financial system is efficiently allocating resources.[15]

Intervention in financial markets, the World Bank report argues, "commonly fragments markets, distorts incentives with explicit and implicit subsidies, and burdens the system with counterproductive taxes. Moreover, economic and financial rates of return often diverge due to macroeconomic and pricing policies."[16] The difficulties inherent in administering interest rates led the report's authors to conclude that a narrow concern for raising real interest rates to positive levels "should give way to broader concerns for improvements in the financial system as a whole and for greater consistency between financial and macroeconomic policies."[17]

In particular, the report recommends greater market orientation in the financial sector. The market-oriented perspective focuses on reducing the size of subsidies passed through the financial sector and increasing reliance on interest rates for the mobilization and allocation of resources. Market-determined rates, the report notes, will not only be positive in real terms but will also reflect differences in risk, maturity, and cost.[18]

---

[13] IMF, Interest Rate Policies, p. 19.

[14] Ibid.

[15] Hanson and Neal, Interest Rate Policies, p. iii.

[16] Ibid.

[17] Ibid.

[18] Ibid., p. vii.

3. Exchange Rate Policies

The exchange rate constitutes one of the most important prices in an open economy such as that of the Central American countries under study. According to the World Bank, there are two separate but related reasons for this. First, the exchange rate directly influences the relative price of tradeable goods vis-a-vis non- tradeables. A real currency depreciation, which signifies an increase in the relative prices of tradeables, encourages the production of tradeable goods. In fact, the World Bank has found that exporters respond more vigorously and more promptly to exchange rate changes than to other equally remunerative combinations of policy incentives.

Second, the level of the exchange rate determines the competitiveness of exports and gives producers a clear signal of the gains to be made through exporting. Thus, a realistic exchange rate is needed to maintain and/or enhance the competitiveness of a country's producers of exportable goods vis-a-vis their competitors in world markets.

Exchange rate policies also have a significant impact on the level of capital flight and domestic investment. The most recent literature on flight capital from developing countries in fact cites exchange rate rigidity as the most frequent cause of capital flight. The World Bank has supported this view. According to the World Bank, an overvalued exchange rate, coupled with the expectation of a drastic exchange rate adjustment, is the most important and common motive for capital flight. Beyond a certain point, a real devaluation of the currency appears to be inevitable, triggering speculative outflows of capital which exert additional pressure on the exchange rate.[19]

Even if devaluation is not considered imminent, there are many reasons why an overvalued currency can trigger capital flight. When the exchange rate is set at too high a level, demand for foreign currency will far exceed supply, thereby necessitating strict regulation of the foreign exchange market. In order to gain as complete control over foreign exchange receipts as possible, regulations are promulgated giving the monetary authorities jurisdiction already at the point where foreign currency can be earned. Under such regulations, foreign exchange received in payment for exports must often be converted to the domestic currency at the official exchange rate. Similarly, an official body controls the allocation of foreign exchange, granting access to foreign currency only for specified import purposes. Generally under these circumstances, the export of capital is also subject to official authorization if not completely prohibited. Most individuals and firms are not willing to surrender import and export decisions so completely to

---

[19] Wilhelm Nolling, "Combating Capital Flight from Developing Countries," Intereconomics 21 (May/June 1986), p. 119.

government agencies, and the result is that exchange rate controls are frequently circumvented through various means.[20]

In summary, a realistic exchange rate is needed to permit an adjustment in relative prices, to expand exports, to increase efficiency and to contribute to renewed economic growth in the region. In addition, a realistic exchange rate will deter capital flight and may even encourage repatriation of capital.

Experience with flexible exchange systems in the specific form of floating exchange rates in developing countries is relatively limited, although in recent years a growing number of developing countries have adopted such systems. According to a 1987 study sponsored by the IMF, early experience among developing countries indicates that floating exchange rate systems can function satisfactorily in countries with relatively diverse economic structures, eventhough the depth of their financial systems may be limited. However, as the study notes, exchange rate systems must be adapted to the particular institutional strengths and weaknesses of each country. In particular, floating exchange rate systems have to be supported by the "sustained pursuit of appropriate domestic economic policies to ensure their efficient operation over time."[21]

B. FINANCIAL INSTITUTIONS

The Agency for International Development has been a major force supporting private sector development in Central America, both through its bilateral missions and through programs managed by ROCAP. It provides the largest source of funds for investment and credit. In 1986, A.I.D. provided US$266.8 million to the region, more than any other source of funds: Inter-American Development Bank (IDB) (US$104.9 million), other governments (US$ 27.2 million), and the combined total from international commercial banks, and international bond placements (US$235.2 million). The bilateral Economic Support Fund programs (ESF) keep the respective countries' external accounts barely manageable through the balance of payments support outlays. ESF also represents one of two sources of term credit administered through special facilities to the central banks for further rediscounting to the banking system. The World Bank is providing a second source to countries in which the minimal IMF and rescheduling requirements are in place.

---

[20] Susanne Erbe, "The Flight of Capital from Developing Countries," Intereconomics 20 (November/December 1985), p. 270.

[21] Peter J. Quirk, Benedicte Vibe Christensen, Kyung-Ho Huh, and Toshihiko Sasaki, Floating Exchange rates in Developing Countries: Experience with Auction and Interbank Markets, Occational Paper No. 53. (Washington, D.C.: IMF, May 1987), p. 32.

A.I.D. has also supported other areas of finance, including project and export finance and investment banking, in every bilateral program in Central America. FIDESA in Panama, PIC and COFISA in Costa Rica, FIA in Honduras and FIASA in Guatemala, are all financial institutions which A.I.D. has subsidized both financially and technically. In each instance, the institutions have been capitalized basically through long-term leverage funding at below market rates. On the average, these new institutions are capitalized at between US$15 and US$25 million, with a debt-equity ratio range somewhere between 2.5:1 and 4:1. The equity is usually held by first-rate private groups, financial as well as industrial and commercial.

In spite of this assistance, medium- and long-term financing or equity capital for developmental projects and other private sector investments that involve a greater amount of risk--particularly in light of the prevailing political and economic climate in Central America and the poor state of the CACM-- is generally lacking in the region. Several vehicles established to provide long-term or equity financing, such as FIASA in Guatemala, PIC in Costa Rica, or FIA in Honduras, have been limited in their outreach to new investors. This is partially the result of the limited personnel and financial resources of these organizations relative to the potential demand for risk capital that exists on a regional basis, but is also attributable to the commercial banking training and orientation of the board members and senior management of these institutions. In addition, some of these institutions have not yet fully mastered cash-flow lending techniques and, as a result, tend to rely heavily on collateral to justify extensions of credit.

The Latin American Agricultural Development (LAAD) corporation continues to be an example of successful A.I.D. assistance to the region. LAAD makes term loans in dollars. While LAAD does not lend directly to farmers, it does benefit them indirectly by financing processing plants on a 3-5 year basis. It requires collateral, but usually to the value of the loan, relying on acquaintance with the borrower and analysis of the project. The recent report by the Agricultural Task Force to Guatemala pointed out that while LADD's charter provides for making equity investment, it rarely does so.[22] The reason, at least in part, can be traced to a study conducted in 1982 by Booz-Allen Hamilton which recommends against LAAD participation in equity financing because of limited skills and experience in this activity.

The Central American Bank for Economic Integration (CABEI), which was established in 1960 by the governments of Guatemala, El Salvador, Honduras, and Nicaragua (Costa Rica joined in 1963), has performed far short of all expectations. Although CABEI was patterned after the Inter-American Development Bank, which operates exclusively through the public sector of its member countries, CABEI has engaged in direct credit operations to the private sector. Yet, CABEI has been forced to curtail seriously its direct private sector lending activities because of

---

[22] Economic Perspectives, Inc., "Report of the Agricultural Task Force to Guatemala." (Draft) Prepared for USAID/Guatemala (McLean, Virginia, May 1987), p. 48.

the poor performance of its loan portfolio in this area and the inability of its member countries to meet their annual quota commitments. During the last three years, an average of only $28.8 million in loans per year has been approved by CABEI, compared to an average of $168.9 and $187.8 million during 1979-80 and 1980-81, respectively. Opinion is virtually unanimous among business and political circles of Central America that CABEI has failed to meet the expectations that accompanied its entry into private sector lending. It is almost universally regarded as having managed its private sector lending portfolio very poorly, and as being over-staffed and located in the wrong place. While some see the need for more drastic action, most agree that CABEI should concentrate on infrastructure lending and short-term private lending as it was originally intended to do.

In Central America today, commercial banks are undoubtedly the dominant financial institutions and, overall, the banks are quite liquid. However, commercial banks cannot fulfill the need for capital (long-term funds) to finance the establishment and expansion of business enterprises. Commercial bank lending is primarily short-term, and the bulk of medium- to long-term loans are made to well-known clients of the banks, usually large, well-established companies that present little risk. The reasons for these lending policies are numerous. First of all, commercial banks, by their very nature, are short-term oriented because most of their liabilities, demand deposits, are short-term. In addition, commercial bankers are characteristically "conservative" in the sense that they are very risk-averse. While this "conservative mentality" is understandable in view of the fiduciary responsibility that they have to their depositors, it does not serve to promote the creation and expansion of business because such financing is vastly more risky and difficult than making loans to finance short-term working capital needs. In addition, in the opinion of the team, the cautiousness of commercial bankers in Central America also stems from the lack of competition from other, more innovative financial institutions, and from the lack of adequate training in credit analysis techniques. Another reason is that, in some countries, rigidities with regard to interest rate policies act as a disincentive for banks to make longer-term loans. Furthermore, as one team member has pointed out, short-term lending rates in Central America tend to be higher than long-term lending rates because most long-term funding available in the region is sourced out of international donor institutions at a cost lower than the cost of mobilizing long-term domestic sources. Because of this, interest rates for medium- to long-term loans tend to be lower than rates for short-term loans available through the commercial banking system, and the banks have little incentive to extend medium-term loans. In sum, commercial banks are appropriate institutions for financing the short-term working capital needs of on-going enterprises in Central America. However, their lending policies are inadequate for financing the creation and expansion of new and existing enterprises so crucial to the promotion and sustainment of economic growth in the region.

Other financial institutions in Central America include: financieras, government-controlled development banks, pension funds, credit unions, and insurance companies. The pension funds and the credit unions represent a potential source of equity and debt capital. However, the investment activities of pension funds are restricted by law, and they are not allowed to invest in capital stock. Insurance companies could become an additional source of capital for private investment, but at present are either state-owned or are required to invest large percentages of their funds in government bonds. For the present, however, these organizations are relatively small players in a field dominated by private and state-owned commercial banks.

All the governments in Central America have supported development banks which traditionally have been a source for medium- and long-term development financing. The National Development Corporation (CODESA) in Costa Rica, is a case in point. CODESA was created in 1972 to assist in the establishment of private domestic companies and to assist in the development of a domestic capital market. However, CODESA ran into serious financial difficulties in the early 1980s due to poor investments in subsidiaries, poor management, and large debt service obligations. As a result, the Government of Costa Rica had to suspend CODESA's investment plans and move toward divestiture of the company. Similary, the National Investment Corporation (CONADI) in Honduras, was established to provide long-term credit and equity capital to industrial enterprises. However, it too ran into serious financial difficulties and had to suspend operations in 1982. The examples are numerous. In Panama, the National Finance Corporation (COFINA) was also established in 1975 by the government to provide long-term development financing to the private sector. Its financial position became critical in 1982 and the government had to assume the company's debts. In Belize, the Development Finance Company (DFC) still provides medium-to long-term credit. However, it makes few equity investments and new legislaton has been passed to allow it to operate as a commercial bank which will diminish rather than enhance its role in promoting investment. In Guatemala, BANDESA, the principal agricultural development lender also has serious difficulties. While it does not lack financial resources, it is poorly organized and administered. It follows loan procedures that are marginally acceptable and has a reputation for treating all borrowers heavy handedly--whether lending its own funds or serving as a trustee for funds from A.I.D. or other international agencies. As a result, BANDESA is largely ineffective in servicing its clients.[23] Many of these development banks have received funding from international agencies like the Inter-American Development Bank, the World Bank and A.I.D. These institutions, however, have not been able to respond adequately to the needs of investors for medium- and long-term financing in Central America, and are generally dismissed out of hand as a source of capital by investors. As a result, some of the institutions have sizeable amounts of funds available, but no takers.

In short, institutional sources of investment and venture capital in Central America are virtually non-existent. The existing financial institutions are either unable or unwilling to provide equity capital or the required amounts of medium- and long-term financing of private enterprises. The Central American region is in the midst of a severe economic recession that is bound to bring

---

[23] Ibid., pp. 7, 48-49.

even more political instability to the region. Investment is desperately needed to create new employment, to increase exports to service the foreign debt, and to promote overall economic expansion that will allow increased per capita incomes and better living standards throughout the region. However, new and expanded investment cannot take place in the absence of financial institutions that are oriented towards innovative medium- to long-term investment and that are willing to assume a higher degree of risk in financing new ventures.

C. FINANCIAL MECHANISMS

1. Securitization

Securitization involves the conversion by commercial banks of essentially nonmarketable loans into marketable debt instruments or securities. In recent years, this "securitization" or shift of credit flows from bank lending to marketable debt instruments has become a major trend in international financial markets. Banks in the United States have used securitization very successfully for several decades as a way to increase the liquidity of their home mortgage and automobile receivable holdings.

While there are several reasons for the growth of interest in securitization of international credit flows, the international debt situation has been a principal reason. The debt crisis highlighted the desirability of strengthening and maintaining the liquidity and marketability of bank assets, and encouraged banks to strengthen their capital base by issuing more long-term debt. A secondary market for outstanding bank loans to debtor countries, including Central American countries, already exists.[24]

The securitization of debt is an issue of great relevance to Central America, given the relatively high level of external indebtedness of some of the countries in the region. (The foreign debt situation of each country under study is discussed in the individual country sections. In addition, external debt tables are provided in Appendix B.) Moreover, experience with securitization already exists. Guatemala first experimented with securitization of debt in August 1983, when the Bank of Guatemala issued Stabilization Bonds as a way to pay its foreign exchange arrears. These Stabilization Bonds are freely-negotiable, dollar-denominated bonds issued against an equivalent amount of local currency. They offer interest rates that are comparable to the U.S. commercial banks' prime rate and are targeted to both institutional and individual investors in Guatemala. It is significant that, without any intervention from the government, a secondary

---

[24] For additional information on securitization, see Bank for International Settlements, Recent Innovations in International Banking (April 1986), Chapter 5 and Maxwell Watson, Donald Mathieson, Russell Kincaid, and Eliot Kalter, International Capital Markets: Development and Prospects, Occasional Paper No. 43 (Washington, D.C.: IMF, February 1986), pp. 24-25.

market has developed for these bonds. By issuing Stabilization Bonds, the Guatemalan government in fact converted some of its debt into negotiable securities, which is what securitization of debt is all about. The Guatemalan experience reveals the potential for securitization of debt in other Central American countries. This mechanism could prove to be an important means of attracting flight capital, given the appropriate incentives.

2. Debt/Equity Swaps

In a debt for equity swap a lender redeems sovereign or private debt in local currency at the debtor country's central bank and then invests the proceeds locally. The exchange is usually made at par or at a discount, depending on the agreement with the central bank. Debt/equity conversion programs have been implemented in several countries, including Brazil, Chile, Argentina, Mexico, and the Philippines. The main advantage of these swap programs, from the point of view of the debtor country is that they accomplish two things simultaneously: they retire hard currency debts and they promote productive investment in the country. In addition, because debt/equity conversions depend on debt trading at below face value, there is a built-in discount that provides an advantage to the debtor country.[25]

Argentina has been setting up swap programs as part of its debt rescheduling negotiations. In return for instituting such programs, Argentina hopes to get better terms on its debt rescheduling arrangements. Thus far, Chile's program is considered to be the most successful, although Mexico's, which only began in June 1986, is the largest Chile's debt/equity conversion program is very active because it is the least restrictive and most straightforward, according to Morgan Guaranty Trust Company. Morgan Guaranty has estimated that in 1986, debt/equity swaps could reduce Chile's foreign debt by as much as $1 billion.[26] In Central America, Costa Rica introduced debt/equity swaps on a trial basis. However, the demand for swaps apparently was so overwhelming that the Central Bank had to close the program down because it was not prepared to cope with the large number of applications that were received. Considering the deterioration over the past few years of the foreign debt position of most of the Central American countries under study, the potential of the debt/equity swap mechanism as a partial solution to the debt problems of Central America, particularly of Costa Rica, is obvious.

---

[25] "The Debt Swappers," Euromoney (August, 1986), p. 69. For additional information, see also L.C. Buchheit, "Converting Sovereign Debt into Equity Investment," International Financial Law Review, September 1986.

[26] Morgan Guaranty Trust Company, "Notes on Debt-Equity Swap Programs," World Financial Markets (September 1986), pp. 11-12. See also Intrados Group, "Special Issue on Debt/Equity Swaps," Swaps (October 1987), pp. 1-12.

Table 11 in Appendix B demonstrates some of the potential benefits that could be derived from a debt for equity swap program in Central America. The assumptions behind the hypothetical example presented in the table are that 10% of the public and publicly guaranteed external debt, outstanding and disbursed in 1985, is swapped for equity, and that there is a 90% discount on payments and invested capital.

One possible negative effect of debt/equity swaps is inflation. In order to exchange local currency for foreign debt, the central banks often must print money. This expansion of the money supply could increase inflationary pressures, which are already substantial in some of the countries of Central America. Thus, debt/equity conversion programs must be carried out within the constraints of monetary policy so as to avoid any significant increases in current inflation rates.

3. Trade Instruments

As mentioned in the background section, regional disintegration has had a negative impact on investment and general economic growth in Central America. Differences in currency valuation policies and in foreign exchange controls limit intra-regional trade, which inhibits the formation of a larger market that would enable industries to achieve economies of scale and operate more efficiently and profitably. This constitutes an important barrier to the growth of private investment in the region because limited market opportunities, and uncertainties regarding exchange rates increase the risks of operating in Central America even more. This situation highlights the need for some type of common trade instrument or mechanism that will facilitate trade and thus encourage investment in the region.

The Derecho de Importacion Centroamericano (DICA) is a new payments mechanism for the settlement of trade transactions in Central America. Its use was approved in principle by the participants in the Central American Clearing House in August 1986. DICAs are US-dollar denominated, negotiable and transferable obligations of the central banks, issued at the request of importers to pay for imports from the rest of Central America. DICAs pay no interest and can be redeemed only in the currency of the issuing central bank within a period of 18 months. When endorsed by a third party, DICAs become freely negotiable and can trade at prices which can differ from their nominal value. On the day of redemption, the issuing bank makes payment at the prevailing exchange rate (or average of exchange rates in the case of multiple exchange rates) and it bears the exchange loss/profit arising from any variations in the exchange rate between the date of issue and the date of redemption. Payment in DICAs is subject to acceptance by the exporter, who has the option of using the DICAs to pay for imports from the issuing country.

DICAs are an attempt to securitize trade transactions such that payables and receivables in Central American currencies can be traded on a secondary market at a premium or discount. However, since they must be redeemed eventually by the Central Banks of each issuing country, those countries with overvalued currencies will end up paying out hard currency reserves to support the value of their currencies. When they are unable to do so because of lack of foreign exchange, the Central Banks of the net exporting countries (i.e. Costa Rica) will end up once again owning I.O.U.'s from the other Central Banks. For this reason, realistic exchange rates are necessary for DICAs to work successfully. As long as some Central American governments are unwilling to accept devaluation of their currencies vis a vis the others, there is little hope for use of the DICA on a region-wide basis.

Nevertheless, in the opinion of the team, a DICA-type mechanism is feasible, and its development and use is encouraged to stimulate intra-regional trade in Central America. Honduras and Guatemala, for example, have been experimenting with a reciprocal process of accepting payments for exports into a dollarized account that conveys the right, including a licence, to import an equivalent dollar value of goods. The result has been the creation of a new financial instrument that can be traded at a premium over the value of the dollarized account, because it also conveys import privileges.

4. La Bolsa de Valores/Securities Exchange

With the exception of Costa Rica, there is no well established national Bolsa de Valores in Central America. As a result, there are virtually no data available on secondary market activities in the region. In Honduras, there is support from the government, and also from A.I.D., to promote development of a Bolsa. The Government of Panama is also studying the possibility of setting up a local securities exchange, but there are a number of obstacles to the successful establishment of such an exchange which are detailed in the Panama section. In Guatemala, a group of individuals and corporations has been promoting the development of the Bolsa, which began operations in April 1987. Thus far, the main trading instrument has been the Stabilization Bond.

On the other hand, Costa Rica's Bolsa de Valores has been active since 1964. It is structured as a corporation with nominal shares. Trading volume handled by the Costa Rican securities exchange has increased tremendously over the past few years, which is indicative of the latent investment interest in the region. Although participation by the public sector is still dominant, the increase in the trading volume in recent years is due in part to the significant showing by the private sector, which in 1984 elevated its trading volume by 385% over the previous year.[27] By 1985, the private sector's participation had reached 29% of the total, according to World Bank data.

---

[27] Arthur Young an Co., "Descriptive Summary: Central American Financial Markets" (November 17, 1986), p. II-14.

Activities in the Costa Rican securities exchange are dominated by trading in short-term instruments (less than 6 months). In 1984, this type of activity constituted 86% of all dealings. The main instruments traded in the secondary market in 1984 included: bonds, CDs (denominated both in colones and in US dollars), investment company shares, CDs issued by savings and loan companies, tax credit certificates, utilities-backed certificates, banker's acceptances, and savings certificates. The total volume of secondary market activity amounted to about 2.1 billion (1980) colones, about half the volume of primary market activity. Bonds and CDs denominated in colones were the most heavily traded instruments.[28] At the present time, Costa Rica is the only country in Central America with a well-developed bond market.

As a matter of clarification, it should be noted that the Bolsa de Valores in Costa Rica functions as a place where securities are traded, and not as a stock exchange. The distinction rests on the fact that only a very small proportion of the securities traded on the Bolsa are in fact equities; the vast majority are debt instruments such as bonds and certificates of deposit.

---

[28] Ibid., pp. II-14, 15.

III. COUNTRY SPECIFIC RECOMMENDATIONS

This chapter presents descriptions of the financial market conditions in each of the six countries covered by the study, and identifies the major barriers to expansion of the markets and development of private enterprise in each country. While all of the recommendations can be carried out by each USAID mission independently, there are considerable benefits to be derived from coordinating some of the recommended actions on a regional basis. The value of a regional approach can be appreciated more fully once the commonality of conditions in the countries and the importance of economic cooperation to the growth of all becomes more apparent. To demonstrate how activities at the regional level can assist each of the Central American countries achieve economic growth, we have provided a plan in chapter IV that recommends the actions that should be undertaken regionally to support the activities that are recommended for USAID implementation at the country level.

BELIZE

1. Background

a. The Financial Sector.

The financial sector of Belize consists of the Central Bank, five commercial banks, the Development Finance Corporation, and a number of credit unions. The Central Bank was established in November, 1982 with the primary objective of promoting monetary stability. As set out in the Central Bank Act of 1982, the Central Bank is required to maintain an external asset reserve of at least 40% of the aggregate amount of currency in circulation and of its sight and time deposit liabilities. In addition, the Act limits the capacity of the Central Bank to extend credit to the government. For example, according to IMF data, outstanding loans and advances to the government may not exceed 15% of the projected current revenues of the government for the current year. Also, Central Bank holdings of treasury bills cannot exceed five times the level of the Bank's capital and reserves.

The Central Bank is also charged with setting the minimum cash balances that commercial banks must deposit with the Central Bank (the cash reserves ratio) as well as the liquid asset ratio, which is the proportion of commercial banks' deposit liabilities which must be maintained in the form of approved liquid assets. According to an August 1986 report by the IMF, the cash reserve ratio at the time was 9%, and the liquid assets ratio was 30%. The Central Bank is also authorized to set domestic interest rate levels.

The private banking sector is dominated by four foreign banks--Banco Atlantida, Bank of Nova Scotia, Barclays Bank, and Royal Bank of Canada -plus one newly formed indigenous bank, the Belize Bank of Commerce and Industry. Field work revealed that the system is currently very liquid and commercial banks are refusing interest bearing deposits exceeding 3 months. Lending policies and control over branch credit exposures are controlled by regional offices located outside Belize; and local management has little authority. Lending policies are geared to the extension of heavily collateralized short-term (under one year) self-liquidating trade transactions. It is unlikely that these banks are capable of analyzing and judging the quality of a credit on anything other than easily realizable collateral. It is for this reason that the AID supported rediscount facility at the Central Bank has largely gone unused.

These factors not withstanding, the commercial banks are the major suppliers of credit to the financial system. In 1985, according to World Bank figures, commercial banks provided 71% of total credit to the private sector. The average for the period 1981-1985 was 74%. However, commercial banks reportedly do not lend to the agricultural sector, which produces about 25% of

GDP and 50% of the country's foreign exchange earnings. For all practical purposes they lend neither for mortgages nor for construction. In the team's opinion, it is unlikely that these banks will be willing, or if willing, capable of supplying medium-term credit on a basis which would be acceptable to reasonable and responsible borrowers.

The Development Finance Corporation (DFC) is a semi-autonomous bank which provides medium to long-term development loans, and, in selected cases, equity investment. The DFC borrows abroad to finance its lending operations to the private sector and, until recently, could not receive deposits from the public. Its main sources of funds have been: the Commonwealth Development Corporation (CDC); the Caribbean Development Bank; the European Investment Bank; USAID; and the Government of Belize. Recently, legislation allowing the DFC to operate as a commercial bank and to accept deposits from the public was passed. Thus, the DFC will fall under the supervision of the Central Bank. In 1985, according to World Bank figures, the DFC provided 19.5% of total credit to the private sector. The DFC needs technical assistance and financial resources to improve both loan administration and credit analysis.

There are 22 credit unions in Belize. They may only accept individual deposits, not commercial deposits. Also, credit unions do not quote interest rates in advance; rather, the rates are determined at the end of the fiscal year based on the credit union's performance. Credit union interest rates have been competitive with those offered by commercial banks.[29] According to World Bank data, in 1985 the credit unions accounted for 9.5% of the total credit to the private sector.

Currently, there are no institutional investors serving as a source of equity or term funds.

The GOB has recently adopted a far ranging privatization program. To date, only one state-owned enterprise (SOE) has been sold, but reportedly others are under consideration. The GOB view is that all projects should be able to sustain commercial rates, or liquidated if they cannot. This might be valid if rates were free to float, but in Belize the Central Bank manages both deposit and loan rates.

The information obtained in the field work indicated that there are no serious tax disincentives between most classes of interest income; most interest income is tax free for individuals and taxable for corporations. There is no Company Law or comparable regulations covering the establishment of new enterprises.

---

[29] Arthur Young and Co., "Descriptive Summary: Central American Financial Markets" (November 17, 1986), p. I-11.

The Government of Belize offers a variety of investment incentives, primarily tax holidays and tax forgiveness. Other incentives include relief from import duties and guarantees on repatriation of capital.

Family owned companies dominate the business environment. Accounting standards are reportedly good. Although there is a relatively low level of sophistication, there are some very knowledgeable and talented individuals in the business community.

Field work revealed that the Central Bank rediscount facility established with AID assistance to fund foreign exchange earning projects has been less successful than anticipated. This is, primarily, because the banks have been unable to assess and take the commercial risk. The discount rate is substantially less than the commercial rate, so there is no economic incentive for banks to take the risks. The original line was US$5 million. Currently, US$2 million are outstanding, US$1.5 million is in the pipeline, and US$ 1.5 million is to be deobligated.

b. Foreign Debt.

Economic growth in Belize over the period 1981 to 1985 averaged only 1.2% per year, primarily as a result of a sharp decline in sugar prices, the country's main foreign exchange earner. Consequently, there was a sharp deterioration in the country's balance of payments, and public sector savings declined steadily from 1981 to 1984. This led to a gradual depletion of gross official reserves, and to the accumulation of arrears on external debt service payments during 1983 and 1984.

In mid 1984, the Government was forced to undertake adjustment measures in conjunction with an IMF Standby Program. As a result, the situation improved markedly. According to World Bank data, the current account deficit of the balance of payments was reduced from -12.2% of GDP in 1984 to -8.2% in 1985. In addition, all external arrears were eliminated, foreign reserves increased to about six weeks worth of imports, and public sector savings turned positive to an equivalent of 5.5% of GDP in FY85/86. Nevertheless, Central Government finances remain weak and, as a result, public sector investment has declined steadily. Another effect of the weak fiscal performance of the Central Government has been a rising level of external debt. According to World Bank figures, external debt increased from US$57.0 million (30.9% of GDP) in 1981 to US$88.0 million (46.7% of GDP) in 1985. However, most of this debt has been contracted on concessional terms, with the result that debt service payments have remained moderate. From 1979 to 1984, debt service has averaged only 3.2% of the export of goods and non-factor services.

While Belize's foreign debt has risen rapidly since 1981, there has been a large improvement in the debt's maturity structure. According to World Bank data, the proportion of debt with a maturity of 12 years or less has declined from 26.0% in 1981 to 19.1% in 1985. In addition, there has been a significant decline in the amount of debt contracted from commercial banks and in suppliers' credits. As a result, debt service as a percent of goods and services is expected to decline from 14.4% in 1985 to about 9.9% in 1986. Moreover, the World Bank has projected that external debt will amount to 43.0% of GDP by 1995, compared to 48.1% of GDP in 1986. Debt service is expected to remain relatively modest throughout the period, at about 7% of exports of goods and non-factor services.

c. Capital Flight/Private Sector Investment.

The level of capital flight is reported to be high, but there is some question as to whether what is occurring is real capital flight. Most respondents felt that funds held outside the country were primarily for convenience and trading. Some said that the true flight capital was held by non-Belizean residents, and they were beginning to repatriate these funds with the drop of interest rates in the United States.

One of the principal sources of flight capital is reported to be profits on trade from the non-agricultural sector. Trading profits reportedly are held outside the country, rather than remitted and invested in productive activities. The Government of Belize encourages foreign private investment by maintaining a relatively liberal currency exchange system, regulations which are administered flexibly and fairly, and a fixed exchange rate policy enhanced by a consistent monetary policy.

Opportunities for private sector investment in Belize exist primarily in the tourism and agribusiness industries.[30] Tourism, especially small resort development, presents major business opportunities for Belize. The country has a variety of tourism assets such as the second (after Australia) largest coral reef in the world, 150 miles of largely undeveloped white sand beaches, two hours distance from Miami, and a varied topography with a wide range of flora and fauna. The Government of Belize has given high priority to tourism development, second only to agriculture diversification.

Tourism development is not without its constraints, however. The tourism infrastructure, for example, is very underdeveloped: accommodations are poor, roads are bad, transportation in general is inadequate, etc. In addition, the public resources available to promote Belize as a tourist destination are very limited. According to an Arthur D. Little report, financing for tourism development and hotel expansion is almost nonexistent.

---

[30] Arthur D. Little, Inc., "A Strategy for ROCAP: Country Findings," Vol. II (Cambridge, Massachusetts, December 1985), p.2.

Collateral requirements reportedly are very high and most hotel owners have already pledged most of their collateral to secure existing loans. In addition, the banking industry is not particularly interested in providing long-term financing, since it provides mainly overdraft financing.[31]

In the agribusiness area, there are thought to be a number of investment opportunities, particularly in citrus, cattle, and winter vegetables. An English group reportedly has just purchased the Carver cattle farms and is interested in the Big Falls Ranch, a large rice farm, which has possibilities for partial breakup into small land holdings serviced by the main farm.

Aside from tourism and agribusiness, there are investment opportunities in transportation, where there is a need for and an interest in expanding roads as well as the local airline, and in construction, particularly housing projects. The First National Trust from Germany is developing new parts of Belize and the Rietz group has built 10 resort units and has 10 more under construction as part of a multi-million dollar project. There are other groups Korean, Taiwanese, British, and Guatemalan businessmen interested in ventures in Belize. All of the above argues that there are a number of opportunities for private sector investment in Belize. What may characterize them all is a lack of capital to finance the investments.

d. Interest Rate Policies.

The Central Bank of Belize manages the level of deposit and loan rates by setting minimum lending rates and mandating deposit rates. According to IMF data, interest rates and reserve requirements were increased in 1985 to restrain credit and to foster savings. The cash reserve ratio was raised from 7% to 9% effective March 1, 1985; while the liquidity ratio was raised from 20% to 25% effective March 1, 1985, and then to 30% effective April 1, 1985. At the same time, lending rates were raised by 2 percentage points and rates on deposits and T-bills by 3 percentage points. The increases in interest rates on deposits resulted in a significant expansion of savings and time deposits, and in a corresponding strengthening of the liquidity position of the commercial banks.

In August 1986, according to IMF data, the minimum lending rate for the commercial banks was 14%, and the minimum 3-month time deposit rate was 12%. Since the average inflation rate (as measured by the consumer price index) was 3.7% in 1985 and has continued at about the same level, real interest rates in Belize have been positive. Some interviewees feel that current interest rate policy discourages consumer credit and deposit taking in excess of one month because of the narrowness of the spread in lending and deposit rates.

---

[31] Ibid., p.3.

e. Foreign Exchange/Trade Policies.

The Belize dollar has been pegged to the US dollar at a fixed rate of BZ$2 per US$1 since 1976. According to IMF data, when the US dollar appreciated relative to the currencies of some of Belize's main trading partners during the 1980-1984 period, the Belize dollar appreciated by 22% in real effective terms during that period. While it has depreciated since then as the U.S. dollar has depreciated, in real effective terms the Belize dollar was still appreciated by about 15% in July 1986, relative to 1980, a year when Belize was thought to have a satisfactory overall competitive position. The appreciation of the exchange rate may impede progress toward sustained economic growth and export diversification. Therefore, the exchange rate should be kept under close scrutiny.

In Belize, foreign exchange controls are relatively liberal and the exchange system remains free of restrictions on payments and transfers for current international transactions. Although the importation of certain locally produced goods (for example certain foodstuffs and manufactured products) was prohibited for developmental purposes and certain other imports became subjected to licensing in 1982, the country's trade system is relatively unrestricted and licenses are administered freely.

2. Recommendations

a. Assist the Central Bank in developing its bank examination process.

Given that the major financial institutions are owned by substantial foreign owners (British-Barclays, Canadian-Nova Scotia Bank, and Honduran-Banco Atlantida), the bank supervision responsibilities of the Central Bank traditionally have been directed at assuring compliance with regulations rather than at examining the prudential behavior of banks. Because of the early state of development of the examination process, it is unlikely that the Central Bank could adequately examine sophisticated banking activities. To cite just one example, the Central Bank does not appear to have the analytical skills or capabilities to determine the quality of banks' balance sheets.

The Central Bank will require technical assistance and staff training to increase its capability to conduct rigorous bank examinations. This is a vital function, and Belize cannot hope to develop its financial system without first addressing this area of deficiency in its Central Bank operations. We recommend that USAID/Belize organize a project to provide training in bank examination procedures. One source of assistance in this area is the U.S. Comptroller of the Currency. This office has been conducting training for LDC Central Bank staffs for several years.

b. Provide technical assistance support to the Development Finance Corporation.

The Development Finance Corporation (DFC) is an appropriate vehicle for financing development projects, regardless of its past record. As a development bank, the DFC obtains funds from sources that include the Caribbean Development Bank, AID, European Investment Bank, and Commonwealth Development Corporation. Our review of the DFC indicated that the effectiveness of the organization could be strengthened through a modest level of technical assistance. We recommend that the USAID explore, with the DFC Board of Directors, the possibility of establishing an assistance program that would increase the skills of the DFC staff in project identification, project analysis, and evaluation and project tracking.

The DFC should also seek to improve its financial vitality by making adjustments to its current portfolio (write-downs), and securing a new infusion of capital and/or long-term funding. The DFC will also have to clarify its policies regarding equity participation to be consistent with its newly acquired role as a commercial bank.

As already mentioned, recent legislation permits the DFC to receive deposits from the public and to operate as a commercial bank. As such, it will fall under the supervision of the Central Bank. The Central Bank must, therefore, be prepared to provide investment and funding guidance from a prudential point of view regarding maturity mixes, industry concentration, concentrations to one group, etc., as well as commercial risk.

c. Encourage coordination of development funds.

Development funds are available from IBRD, LAAD, Caribbean Development Bank, Commonwealth Development Corporation, European Development Bank, European Development Fund, and the Caribbean Project Development Facility. These efforts do not appear to be coordinated by any central agency or authority. The Central Bank should be encouraged to assume this coordinating role to achieve the benefits of a comprehensive rather than a piecemeal approach.

We recommend that USAID/Belize work with the Central Bank and provide the necessary technical assistance to establish a development program management unit with the Bank. The principal responsibilities of the unit would be to assemble development program requirements, budget and manage the allocation of funds to activities, and provide accounting and monitoring of project expenditures and accomplishments.

d. Provide assistance in development of tourist industry.

Studies by both the World Bank and Arthur D. Little have cited the tourist potential of Belize. Clearly, tourism would provide an important source of foreign exchange to a country with limited export earnings potential.

We recommend that USAID/Belize continue to explore the opportunities for tourism with the GOB and provide assistance in promoting the industry with potential local and U.S. investors.

e. Encourage formation of local investment companies.

The financial market in Belize is dominated by foreign banks. While the recently formed commercial bank shows promise in developing into a local source of credit, its activities will be focused on lending. As in the other countries in Central America, it is important that the financial market include a source of risk taking and investment capital.

We recommend that the USAID/Belize support the proposed regional investment fund, and encourage local investors to form one or two investment companies that could participate in the fund. These companies would provide a badly needed source of risk capital that could contribute significantly to the development of a tourism industry.

USAID Belize is already pursuing a number of the recommendations presented above, and our findings mainly reinforce the need to continue mission support in the recommended areas. Although Belize could gain substantially from an improved economic relationship with other countries in Central America, the team is well aware of the social and cultural differences that separate Belize from the rest of Central America, and the political resistance that would most likely meet any proposal for participation by Belize in the Central American Common Market. In addition, differences in political developments, and in the level of financial sophistication and deepening relative to other countries in Central America, render some of the regional recommendations presented in section IV inapplicable to USAID Belize.

COSTA RICA

1. Background

a. The Financial Sector.

Costa Rica's domestic banking system was nationalized in 1949. Since then, state banks are the only banks that have been authorized to provide checking accounts. In addition to the Central Bank, there are four state-owned commercial banks: Banco Anglo Costarricense, Banco Credito Agricola de Cartago, Banco de Costa Rica and, Banco Nacional de Costa Rica. The financial sector also consists of a number of private financial institutions (financieras). With the exception of COFISA and PIC, the financieras engage primarily in consumer financing rather than medium and long-term funding for equity placement.

In Costa Rica there are also a number of nonbank financial institutions, such as IFAM, CONAPE, INVU, CCSS, BANHVI, and INS, which operate as autonomous agencies of the state. IFAM provides financing to municipalities, CONAPE makes student loans, and INVU finances housing and urban developments. CCSS is the Social Security Administration and BANHVI is a newly established housing bank. INS is the only insurance company in the country, giving the state a monopoly in the insurance business. INS offers a variety of policies ranging from life insurance to shipping insurance. There is also a National Development Corporation (CODESA), which was created by the government in 1972 to assist in the establishment of private domestic companies that can complement the country's mixed economy. CODESA was also expected to assist in the development of the domestic capital market.

In the early 1980s, CODESA's financial position deteriorated as a result of poor investments in a number of subsidiaries, weak management, and large debt service obligations. As a result, the Government of Costa Rica suspended CODESA's investment plans in 1983 and approved a divestiture program. As part of this program, a private trust fund financed with assistance from USAID was established to purchase CODESA's subsidiaries and use the proceeds of the sales to reduce CODESA's indebtedness with the Central Bank.

Private banks are a relatively new phenomenon in Costa Rica, and their activities are limited by law. The private banks cannot receive demand deposits and time deposits must have a minimum maturity of 6 months. Private sector banks also have limited access to credit lines from the Central Bank. Nevertheless, according to businessmen and others in Costa Rica, they have been able to compete with the state banks and have grown despite the restrictions. The level of resources the private banks command, however, remains small relative to the state controlled banks.

In comparison to banks in other Central American countries, Costa Rica's private banking institutions have been described as quite modern because of the high quality training provided to their managers. In contrast, Costa Rica's nationalized banking institutions are described as being inefficient and poorly managed. Checking services are reportedly very poor. In addition, both the state banks and the state-owned nonbank financial institution (CODESA) have a substantial number of loans in arrears.

A new private financial institution, the Crediticia Group, has been experimenting with a cash management type of account, introduced by the Bolsa and used by all stock brokers, that is expected to test the possibility that private banking firms can offer a demand-like deposit account. By buying and selling shares, customers can deposit and withdraw money on demand. Interest is accrued on a daily basis, with no penalty for early withdrawal. Thus, the cash management type of account facilitates short-term investments (less than one month) at an attractive return.

Even after nationalization, private exchange houses were allowed to continue to deal in foreign exchange. It was not until 1982, following a series of major devaluations of the local currency, that the Legislative Assembly granted the exclusive right to transact such business to the Central Bank, which imposed tight foreign exchange controls. According to some interviewees, such controls on foreign exchange, in addition to the other restrictions placed on private banking activities, have encouraged private financing institutions to establish offshore subsidiaries in Panama in order to provide international trade services. Reportedly, offshore operations have become almost as large as domestic operations and, these have been so successful that they have taken over 50 to 60% of the state bank's foreign trade activity.

Private banks collect US dollar deposits through their offshore affiliates. These dollar deposits account for approximately 50% of their total deposits. They then use these deposits to conduct offshore operations such as international trade financing.

There is concern among some businessmen in Costa Rica that the effect of the existing domestic banking regulations has been to encourage the private banking institutions to extend their activities far beyond what most would regard as prudent banking operations. In other words, the restrictive regulatory atmosphere in Costa Rica has actually resulted in less real control and more risk-taking by the supervised financial institutions. However, the team has received conflicting reports in this regard, and could not substantiate the businessmen's concerns in order to draw any conclusions.

The Central Bank of Costa Rica is responsible for regulating the country's capital market activities. Central Bank authorization is required to issue bonds, but investment certificates can be issued without such authorization. In addition, a company must be registered with the national securities exchange, La Bolsa deValores, before it can have a public placement. This applies only if issues are traded through the Bolsa. There are no restrictions for issues trading over-the-counter.

Costa Rica's securities exchange has been active since 1964. According to World Bank data, the volume of transactions in nominal terms handled by the securities exchange doubled in the past two years. In 1985, trading volume reached the equivalent of US$1 billion, and the private sector's participation reached 29% of the total. Activities in the securities exchange are dominated by trading in short-term instruments. Only 12% of the transactions in 1985 had maturities exceeding 180 days. This preference for short-term instruments stems primarily from uncertainties about the future level of inflation, fears of another major currency devaluation, and competition from short-term government paper, among other reasons.

The four national banks, which are the largest financial institutions in the country, are directly involved in the securities exchange through the four seats they hold. On average, they account for 23% of the volume of securities traded. Government securities are the most frequently traded instruments and no special arrangements have to be made to trade them. On the other hand, like in most international stock exchanges, the listing of securities of private companies is more strictly regulated. The companies must provide extensive documentation of their financial position, future projections, and strategic plans, and other information requested by the General Shareholders Assembly or the Board of Directors. Should either group find the information unsatisfactory, the company will not be allowed to trade its securities in the Bolsa.[32]

According to some interviewees, the large role played by public sector financing has discouraged some private participation in the Bolsa. (The way this works is that the public sector uses the exchange as a medium to raise funds to finance the public deficit, while the private sector is the main source of funds in the exchange. However, the large role of the public sector as"user" of funds, limits the ability of the private sector to raise funds through the exchange. As a result, participation of the private sector in the exchange is mainly limited to that of "source" of funds for the public sector.) Nevertheless, private issues have increased from 2% to 30% of total issues traded in La Bolsa during the last eight years.

Certificates of deposit are the principal source of funds for the private banks in Costa Rica. These certificates are issued on the securities exchange and thereby sold to the general public. Some bankers in Costa Rica expressed concern that if at some point there is a bank "scare" or a run on the banks, they would have difficulty issuing their certificates on the securities exchange. For this reason, they suggested that AID or some international donor agency set up a contingency

---

[32] Arthur Young and Co., "Descriptive Summary: Central American Financial Markets." (November 17, 1986), p. II-13.

line of credit to finance the securities exchange during a time of "illiquidity". In this case, "illiquidity" in the securities exchange implies that the cost of sourcing certificates of deposit to fund the banks' asset portfolios would rise. If the banks are, in effect, funding an asset portfolio with very short-term deposit instruments, a sudden decrease in liquidity in the securities exchange (that is, an increase in their cost of funds) would have serious profitability implications for the banking sector. The bankers hoped that AID or another donor agency would establish a contingency line of credit because they believe that the Central Bank, although willing, might be unable to help the market regain the necessary liquidity due to legal restrictions or political impediments.

In the late 1970s, an Industrial Development Fund (FODEIN) was established as a rediscounting mechanism of the Central Bank with funds from the World Bank and a counterpart contribution by the Costa Rican government. The objective of the fund was to provide term funds to small and medium-sized industrial firms to finance import substitution and export oriented projects. The rationale for the creation of FODEIN was that the commercial banks had limited medium- and long-term resources, were mainly lending to a select group of larger firms, and were providing financing on the basis of physical collateral and guarantees rather than on project feasibility. After some initial difficulties, FODEIN became the principal source of term lending in the industrial sector, particularly in the area of fixed asset investment financing.

Nevertheless, despite FODEIN's rather successful performance, there is some concern that an inadequate supply of funds for export project financing may soon become one of the main constraints on the growth of nontraditional exports. Among the factors that could affect the supply of term funds for project financing negatively are: the poor financial condition and inefficiency of the state controlled banks, which account for about 80% of the financial intermediation in Costa Rica; the likelihood that the Central Bank's credit programs will remain quite restrictive for the private sector, and; the reluctance of many firms to borrow in foreign currency for longer-term investment purposes given the large devaluations of 1981 and 1982.

AID has a history of supporting capital market activity in Costa Rica by assisting various financial institutions such as COFISA, BANEX and PIC. Each of these institutions has received dollar denominated funds from AID which have been used to make medium-term development loans. This type of assistance from AID is very important for the continuing development of capital markets in Costa Rica.

b. Foreign Debt.

In 1979, Costa Rica was confronted by serious economic and political pressures as oil prices doubled, coffee prices slumped, and political turmoil in Central America mounted. This presented serious problems as Costa Rica relied heavily on intra-regional trade, and depended on oil imports for 80% of its energy needs and on coffee exports for more than 25% of its export earnings. To a large extent, Costa Rica responded to these pressures by resorting to increased foreign borrowing on commercial terms, at a time when world interest rates rose sharply. This course of action contributed to the crisis that became apparent in 1981, when the Costa Rican government announced that it would have to suspend all payments on its $2.9 billion outstanding foreign debt, pending its renegotiation.[33]

According to IMF statistics, outstanding external public debt increased by 8% per year between 1981 and 1985, and in 1985 was equivalent to 102% of GDP. During this period, the debt service obligations increased at about 4% per year, reflecting the decline in international interest rates and the substitution of official borrowing on concessionary terms (particularly from the U.S.) for commercial bank debt. In 1985, the burden of external debt service was eased considerably by Costa Rica's debt rescheduling agreement; the debt service ratio declined from 59% before rescheduling to 35% after rescheduling took place. At the end of 1985, Costa Rica's total external public debt outstanding was almost US$3.7 billion.

Costa Rica's external debt has been a major barrier to new investment. The Inter-American Development Bank has projected that for the period of 1984-1988 Costa Rica would have a current account deficit of US$290 million annually. In order to cover this deficit Costa Rica would need an average external capital inflow of US$260 million. Even under the most optimistic assumptions Costa Rica will have a difficult time regaining the per capital net income level it had attained in the 1970s.

c. Capital Flight/Private Sector Investment.

Costa Rica is generally regarded as the most stable country in Central America based upon the relatively long history of its democratic political system. Conditions in Nicaragua present a potential political risk and a risk to investment, but it is not clear to what extent Nicaragua's proximity has affected investors' decisions in Costa Rica. Leftist agitation is relatively minor in the country and, by and large, the negative results of the Nicaraguan social experience have turned Costa Ricans more towards democracy and away from revolutionary movements. Capital flight from Costa Rica in the early 1980s was the result most likely of expectations of a major devaluation of the currency and uncertainties about the rate of return on domestic assets because of a high rate of inflation. According to IDB statistics, the average rate of inflation reached a peak of 90% in 1982.

---

[33] Flora Montealegre, "Costa Rica at the Crossroads," Development and Change 14 (April 1983), pp. 284-285.

Although recent IMF and World Bank reports provided no estimates of capital flight from Costa Rica, Susanne Erbe of the Institut fur Wirtschaftsforschung in Hamburg estimated in a recent article on capital flight from developing countries that about $845 million left Costa Rica between 1976 and 1982, or 37.8% of the country's medium and long-term indebtedness during that period. Erbe, who relied on statistics from the OECD, admits that the methodology she uses to estimate capital flight, which is essentially the same as that used by the Bank for International Settlements, most likely underestimates the level of capital flight since it ignores capital exports that are effected through illegal means, such as smuggling and over and under invoicing.[34] However, it is believed that since mid-1982, when strong AID support for Costa Rica started, there have been substantial capital repatriations.

d. Interest Rate Policies.

In the early 1980s, according to IMF statistics, real interest rates became negative by wide margins, as inflation was high and nominal interest rates remained relatively unchanged. In 1983 as the rate of inflation declined to an average of 32% from a peak of 90% in 1982, real interest rates again became positive. As a result, the stock of private financial savings, including government bond holdings of the nonbank private sector. which had fallen sharply in real terms during 1982, recovered in 1983 and remained approximately unchanged -- at about 36.5% of GDP -- in 1984 and 1985.

Recently, Costa Rica has adopted the most liberal economic policy in the area. In spite of the nationalized banking system, interest rates are now set, to a certain extent, by supply and demand. This is largely the result of the formal capital market where a substantial volume of debt instruments are traded on a daily basis. Consequently, the Central Bank's role in the administration of interest rates has been greatly reduced.

Officially, inflation averaged 10.9% and 12.5% in 1985 and 1986, respectively. Thus, short-term government debt sold, in colones, at rates of 12.5% to 19% (depending on the term) generates positive real rates of return to the domestic investors.

Although interest rates are largely set by supply and demand in the formal capital market, the Central Bank still manipulates the interest rates by specifying limits on the spreads between lending and deposit rates, and by setting a limit of 3% above six-month LIBOR on US dollar loans.

---

[34] Susanne Erbe, "The Flight of Capital from Developing Countries," Intereconomics 20 (November/December 1985), pp. 270-271.

e. Foreign Exchange/Trade Policies.

In Costa Rica, foreign exchange risk has been one of the most important factors affecting domestic investment. Between late 1980 and early 1982, the nominal rate was depreciated about 400%, resulting in a substantial increase in the real exchange rate. This massive devaluation of the colon hurt many investors with short positions in dollars and long positions in colones. The higher real exchange rate, however, was allowed to erode very quickly as adjustments in the nominal rate were allowed to fall substantially behind the domestic inflation rate. This created widespread uncertainty and raised fears of another massive devaluation.

In 1985, the Government of Costa Rica adopted a much more flexible exchange rate policy by moving from a fixed exchange rate system with large devaluations at infrequent intervals to a crawling peg system with mini-devaluations. In 1986, seventeen changes in the rate resulted in a devaluation of 9.8%. Whereas Costa Rica's past history of severe devaluations clearly reduced the country's ability to attract capital and in fact stimulated capital flight, the team found that the crawling peg system has done much to reduce the foreign exchange risk.

Until the early 1980s, firms in Costa Rica had no problems obtaining needed foreign exchange as foreign currency accounts were allowed in the banking system and firms faced no restrictions on external borrowing. However, following the large devaluations of the colon in 1981 and 1982, the Central Bank imposed tight foreign exchange controls. In order to apply for foreign exchange to pay for imports, the equivalent in local currency of 100% of the foreign exchange had to be placed in non-interest bearing deposits with the Central Bank. This requirement has now been reduced to 10%. In addition, transactors must wait until the Bank can allocate the required exchange to them. The waiting time, according to information obtained by the World Bank, can vary from about 5 working days to 6 weeks. Since the Central Bank's foreign exchange position is quite precarious and no priority is given to exporters over producers for the domestic market, access to foreign currency for export production is not automatic. Between February and August 1985, an attempt was made to give exporters of non traditional goods preferential access to foreign exchange through the "cash window" of the Export Financing Fund (FOPEX). However, this "cash window" was discontinued when its initial funds, which were primarily from a World Bank loan, were exhausted.

With its small domestic market and relatively narrow resource base, Costa Rica remains heavily dependent on exports as its main vehicle for growth. In recent years, export performance has been weak, particularly in the area of non-traditional exports, a sizable portion of which previously were destined to the CACM. According to recent data published by the IMF, non-traditional exports as a percent of total exports declined from 42.3% in 1981 to 37.0% in 1985. Such exports, according to data provided by a USAID/Costa Rica representative, represented 28% of total exports in 1986, and are projected to increase to 35% in 1987.

Aside from disincentives arising from Costa Rica's foreign exchange valuation and control policies, the country's export performance has suffered as a result of problems in the CACM. Nicaragua also presents a physical barrier which has hampered Costa Rica's access to and trade relations with Honduras, Guatemala, and Belize. According to World Bank data, non-traditional exports (basically all exports except coffee, bananas, sugar, cocoa and beef) to the CACM declined from US$274 million in 1980 (about 66% of total non-traditional exports) to US$177 million in 1984 (about 51% of the total) and to an estimated US$100 million in 1986 (about 25% of the total). This sharp decline has only been partially compensated for by an increase in non-traditional exports to extra regional markets. According to an Arthur D. Little report, Costa Rican firms have found it difficult to penetrate other markets, especially the U.S. market, primarily because of lack of marketing expertise. With the exception of the largest companies, most firms cannot afford proper market investigations and lack an understanding of what the market wants, pricing strategies and appropriate quality standards, among other things.[35]

Many businessmen interviewed in Costa Rica expressed strong interest in, and support for, reviving the CACM as an open market rather than as the highly protected import substitution-oriented market that it was.[36] This revival of intra-regional trade is seen as crucial to the survival of many industries and to the development of more cost-efficient firms that can take advantage of economies of scale. At this time, many industries designed for production to the CACM reportedly are operating at 30% capacity.

2. Recommendations

a. Encourage GCR to permit private banks to offer the same services as government banks.

As explained earlier, the playing field for private financial institutions and state banks is uneven. The activities of private institutions are limited and under the current conditions there is no incentive for state banks to become more efficient. If private banks were allowed to offer the same financial services as national banks, the banking system as a whole would operate more efficiently and the quality of banking services would improve. This would make financial intermediation more efficient and most likely would increase the level of savings and investment.

We recommend that USAID/Costa Rica continue to engage the GOCR in policy dialogue related to extending the privileges currently accorded to the state banks to the private financial institutions that have been organized. An important achievement has already been made allowing the Central Bank to give loans to private banks from foreign sources. The high level of market

---

[35] Arthur D. Little, Inc., "A Strategy for ROCAP," p. 40.

[36] Ibid.

activity in Costa Rica will support a large banking sector, and the future of financial markets, and indeed, the economy will depend on expansion of capital sources. Constriction of capital sources at this period in Costa Rica's history could have serious consequences.

b. Redirect PIC to fulfill its original role of merchant bank.

The original design developed by AID for the Private Investment Corporation (PIC) envisioned that it would function as a merchant bank and fulfill a very important purpose in providing badly needed investment capital. For a number of reasons, PIC has not functioned as planned. According to one team member, PIC is an institution which was created to perform merchant banking activities, is run by a board of directors that is heavily influenced by commercial bankers, and in effect operates as a development bank. In particular, the organization has experienced serious management problems, which have either contributed to or are the result of a turnover of three CEOs in the same number of years. It has also suffered due to inadequate analysis of project loans. As a result, five out of the 12 projects they have financed are experiencing substantial problems. Of the five problem projects, two are in the process of being liquidated. Another factor contributing to the disappointing performance of PIC can be traced to the fact that the Board of Directors is controlled by individuals with little, if any, experience in investment banking. Under that influence, the PIC has become more oriented towards development banking activities (i.e., lending for development projects as opposed to making investments or taking equity positions in enterprises).

We recommend that AID exercise its "shareholder" role in PIC and do everything within its authority to move the organization back toward its original role of merchant bank as there is a real need for an organization like PIC that can provide investment capital. As PIC operations improve, AID should support extending the functions of the corporation to include "second story" activities. In other words, PIC should lend or invest funds in institutions that meet predetermined capital, management, and financial operating policies. In effect, PIC would jointly venture with other financial institutions in worthwhile investment activities.

c. Assist the GOCR in developing a debt to equity swap program by helping the Central Bank to define investment criteria and establish an effective control mechanism.

Costa Rica has received proposals from a large number of debt holders, and entered into a trial period of exchanging debt for equity positions in local firms. The Central Bank subsequently called a halt to the program when the demand overwhelmed its capacity to evaluate the proposals. As of early 1987, US$200 million in proposals had been submitted, US$70 million had been approved, and US$12 million in deals had been approved. Given the current level of sovereign debt, which the IMF estimated in 1985 to be US$3.7 billion, debt to equity swaps offer considerable potential for infusion of equity into the local private enterprises.

A well designed program, structured to minimize the inflationary effects and speculative activities, offers considerable promise for improving the financial and investment climate in Costa Rica. We recommend that USAID/Costa Rica offer assistance to the Central Bank in the design of a debt to equity swap program that will produce an orderly and appropriate reduction of its foreign debt. However, since the Central Bank already has experience in that regard, we recommend that USAID/Costa Rica concentrate its efforts on assisting the Central Bank in defining investment criteria to identify which investment projects should receive higher priority, and in establishing an effective control mechanism so that the colones obtained through the swap mechanism are invested for the approved purposes.

d. Support introduction of a DICA-type instrument to stimulate intra-Central American trade.

Costa Rica is generally considered to have the best infrastructure in Central America. It also has the advantage of a well-educated human resource base. However, the country is faced with the basic problem of not being able to take advantage of economies of scale. The decline of the common market and the sanctions that have arisen in its place have hurt local industry. Much of the problem can be attributed to the need for an instrument of trade that would eliminate the problems created by the current disparities in exchange rates. A major problem seems to be the inability of the Central American trading partner governments to adopt what, in effect, would be a flexible exchange rate policy where receipts for exports would be valued by the market place on a supply and demand basis.

We recommend that USAID/Costa Rica encourage, through policy dialogue, the acceptance by the GOCR of DICA-type mechanisms for intraregional trade. In the way of incentives, the USAID should consider providing temporary assistance in the form of short-term loans or other extensions of credit to minimize the structural adjustment effects. If this assistance is provided, it should be for a stated period and on predetermined declining basis.

e. Support liberalization and rationalization of financial market laws, regulations and tax policies.

A major handicap in the continuing development of the money and capital market of Costa Rica involves its institutional, legal, financial and tax policies. The nationalized banking system, which has proved to be ineffective in terms of both operations and loan quality, is a heavy burden. Furthermore, there is a strong bias towards public sector financing that is reflected in statutes, fiscal and monetary policies. This bias is most evident in the securities exchange which currently serves as an avenue for government financing instead of private sector financing (even when it concerns productive investments).

Examples of policies which hinder investment and the development of the country's capital market include:

- Interest bearing investments are strongly favored over dividend earning investments since interest for corporations is an authorized expense. This type of policy encourages businesses to obtain debt rather than equity financing.

- The capital structure of a corporation is merely a means of control through voting power. It is unlikely that an equity market of any importance can be developed in this environment.

- Although the costs of documenting short-term debt are low (0.1%), the legal expenses of issuing new equity capital can be as much as 2% of the equity generated.

- Current legislation does not make any provision for the rights of minority shareholders.

The main issues to be addressed in Costa Rica in the future involve strengthening and reenforcement of the achievements accomplished by the private financial institutions and the revision of the legal, financial and tax policies that currently inhibit the development of their activities and introduce a major bias towards funding of government needs rather than private sector investment activities.

These issues are clearly topics for policy dialogue. We recommend that the USAID include these issues in its current agenda with the GOCR. They are very important to the future of Costa Rica and its prospects for returning to and surpassing the economic achievements of the previous decade. For that reason, they are fitting subjects for the exercise of leverage and introduction as conditions of assistance whenever opportunities arise.

EL SALVADOR

1. Background

a. The Financial Sector.

The financial sector of El Salvador consists essentially of the Central Reserve Bank of El Salvador, 10 domestic commercial banks, 4 branches of international banks, and 10 insurance companies. Foreign branches are maintained by Citibank, Bank of America, Bank of London and South America, and Banco de Santander y Panama.

El Salvador's banking system was nationalized in March 1980, with the objective of stimulating economic development and redistributing wealth. The rationale for nationalization was that the financial system, during the previous two decades, had failed to support the economic development of the country, and had not served as a mechanism to restructure the economy.

The Central Reserve Bank of El Salvador, as described in "Ley Organica del Banco Central," is responsible for: promoting and maintaining the orderly development of the economy; coordinating monetary and fiscal policies; maintaining monetary stability, and; supporting the national currency in the international market. The general concensus of Salvadoran businessmen is that the Central Reserve Bank suffers from a lack of leadership and its staff is not trained to perform effectively the numerous functions that it has been assigned. The Bank's credit restraint program, which allows no rediscounting of traditional commercial bank loans to coffee growers, has caused illiquidity in the financial sector. This program was introduced to combat inflation which, according to World Bank figures, was 15% in 1984 and 22% in 1985. The resultant tight money markets have led to the rationing of credit in favor of "preferred" borrowers.

Until 1979, the domestic financial system had sufficient foreign exchange liquidity to meet demand. With the advent of the economic and political crises in 1979, suppliers' credits and credits from foreign commercial banks dried up. The public sector, which was forced to become the major source of credit, responded by creating a number of credit programs managed by the Central Reserve Bank. As of early 1986 there were five such credit lines, funded either by international agencies and/or by the Government. These credits have been crucial to the survival of many Salvadoran industries. However, because almost 90% of the export sales generated by recipient firms have been directed to other Central American countries, many of which either have not settled payments or have paid in inconvertible currencies, the Central Reserve Bank has been unable to sustain rotating funds with hard currencies. In addition, these credits are provided at negative real interest rates in local currency, and the Bank has to assume the foreign exchange risk.

The commercial banking system of El Salvador has been in a state of general decline since nationalization, although some banks reportedly continue to be well managed. (One executive told of being criticized by his management for exceeding his goals!) According to one knowledgeable observer, perhaps half of the banks are illiquid and technically bankrupt due to poor lending practices and lack of vigor in pursuing loan collections for fear of political reprisal. The major beneficiaries of the system are borrowers included in the "productive" activity classification or those with strong political connections. Because bankers are government employees, they are particularly vulnerable to political policies and pressures.

Most foreign banks have left or reportedly are leaving the country, with the exception of Citibank. The USAID has included Citibank in one of the rediscount lines. Local suspicion of the government banks and Citibank's expertise in the foreign trade area have created a niche for Citibank which is expected to widen.

The insurance companies, including some foreign companies, provide life insurance primarily, although they are settling approximately $100 million in claims for earthquake damages. The financial vitality of the insurance companies might be undermined further if the GOES follows through in enacting proposed legislation that would require them to invest their reserves in low yielding government bonds.

b. Foreign Debt.

World Bank figures indicate that El Salvador's total foreign debt increased by 64% from US$1.1 billion in 1980 to approximately US$1.8 billion in 1984. About 75% of the increase took place in 1981 and 1982. In 1983, external debt grew by 11% and it remained virtually unchanged in 1984. Since then, foreign debt has grown very little. The IMF estimates that in 1986, total debt outstanding amounted to almost $1.9 billion. Approximately 85% of El Salvador's foreign debt is sovereign debt with a relatively favorable term and interest rate structure.

The ratio of external debt to exports increased from 93% in 1980 to 150% in 1981, and more gradually thereafter to 210% in 1984, according to World Bank data. Much of this increase has been attributed to the decline in exports from El Salvador. Total debt to GDP increased from 32% in 1980 to 46% in 1984. The IMF has estimated a decline to 44.4% in 1986.

c. Capital Flight/Private Investment.

In 1979, El Salvador entered one of the most difficult periods in the country's history. Plagued by civil war, shrinking activity in the Central America Common Market, rising oil costs, and declining coffee prices, El Salvador suffered a sharp decline across all sectors of the economy. As a result, World Bank data indicate that real GDP per capita fell by 25% during 1979-1982, unemployment rose to an estimated 27%, and export earnings declined by about 35%, from 33% of GDP in 1979 to 20% in 1982.

Beginning in 1979, a series of governments attempted to carry out a number of economic and political reforms, including agrarian reform and nationalization of the banking industry. The impact of these reforms, in addition to growing military and guerrilla violence, led to massive capital flight and to a large exodus of entrepreneurs and professionals. Economist John Weeks of American University has estimated that capital flight during the period 1979-1981 totalled more than US$800 million.[37]

While estimates of capital flight vary, the situation, as in other countries in the region, has stabilized. Capitalists have adjusted their positions such that they are satisfied with the distribution of assets between foreign havens and local use. When money runs short or there is a natural calamity such as the earthquake in 1986, capital flows back into the country to meet the need or the opportunity. Thus, local businessmen no longer cite capital flight as a major problem. The problem that remains is how to repatriate the capital that has already left. Improvement in the political and economic situation in El Salvador since 1982 has led to a mild recovery in private sector investment. According to IMF data, real private investment rose by 12% per year between 1983-1986, as businessmen made the adjustment to operating in an environment of armed conflict and increasing internal demand.

Both the Government of El Salvador and the local business community would like to attract foreign investment in order to accelerate the country's economic recovery. However, the risks associated with the military conflict, the small size of the Salvadoran market, and the constraints on resource availability present major obstacles to foreign investors. In addition, the current investment law discriminates against foreign investment and, among other things, limits annual profit remittances to 10% of registered capital. To overcome these obstacles, the Government is preparing a new foreign investment law to eliminate the existing bias against foreign investment and to ensure convertibility of profits from export sales. In addition, the Government is considering the introduction of an investment insurance plan.

d. Interest Rate Policies.

In El Salvador, interest rates have been fixed at levels which have become sharply negative in real terms. According to IMF data, although the interest rate on 180 day deposits, the reference rate of the financial system, was raised from an annual rate of 12.5% in 1984 to 15% in 1986, the structure of real interest rates has remained highly negative. The maintenance of such negative

---

[37] John Weeks, The Economies of Central America (New York: Holmes & Meier, 1985), p. 191.

real interest rates has led to a continued shift in favor of more liquid assets. Despite this condition the level of disintermediation in El Salvador was reported to be very low.

The Central Bank reportedly would like to increase interest rates as recommended by the World Bank and others. However, the Government may very well decide to decrease borrowing rates according to businessmen and others in El Salvador. Atilio Vieytiz, leader of the Christian Democratic Party in Congress, told the team that his previous two years as Minister of the Economy had taught him a lesson in "populist economics." Mr. Vieytiz sees corporate profits as the key to investment and employment. Therefore, he believes that these and other political ends can best be achieved by lowering interest rates.

e. Foreign Exchange/Trade Policies.

Until 1981, El Salvador maintained a fixed exchange rate system at 2.5 colones per US$1. The maintenance of such a system, at a time of rising inflation, led to a loss of the country's export competitiveness, which became particularly severe in the early 1980s. In 1981, a dual exchange rate system was introduced, which established an official market and the parallel market. In the official market, the colon continued to be pegged to the US dollar at 2.5 colones per US$1, while the parallel rate, in principle, could fluctuate in accordance with market forces. In practice, however, the parallel rate was administered by the banks and remained virtually unchanged at about 4 colones per US$1 until the end of 1985, when it moved to 4.8 colones per US$1.

In early 1986, the Government of El Salvador indicated its intention to pursue a flexible exchange rate policy to improve the country's export competitiveness. On January 22, 1986, the official exchange market and the parallel market were unified at an official rate of 5 colones per US$1. According to IMF data, this involved a 24% depreciation of the colon, which almost restored the real value of the colon to its level at the end of 1980. However, with respect to the currencies of El Salvador's main trading partners in Central America, the real value of the colon remained appreciated by about 25% more than it was in 1980.

The unification of the exchange rate system was accompanied by substantial increases in import controls and exchange restrictions. For example, a limit of $10,000 was set on sight draft financing of imports from outside Central America and a long list of prohibited luxury imports from outside Central America was introduced. In addition, commercial banks' dealings in foreign exchange transactions were curtailed substantially.

In August 1986, the Salvadoran government approved the use of DICAs to facilitate intraregional trade and to complement the Central American Clearing House Arrangement. Imports from other Central American countries can be paid with DICAs, which, in turn, can be used by exporters in other Central American countries to pay for imports from the country which issued the

DICA. Salvadoran authorities expect that the use of DICAs will lead to more balanced trade in Central America.

Since 1979, El Salvador's export performance has been very weak. This is due in part to depressed world prices for a number of the country's important commodity exports and to the maintenance of an overvalued currency. The shrinkage of intraregional trade has also contributed to poor export performance, particularly with regard to nontraditional exports (mainly light manufactured goods) which are sold primarily to the CACM. Since 1982, according to IMF data, the annual percentage growth of nontraditional exports to the CACM has been negative, largely as a result of the loss of competitiveness of the colon in that market. Thus, the pursuit of a flexible exchange rate policy to improve El Salvador's export competitiveness is a key to the improvement of the country's export performance.

f. USAID's Role.

The USAID mission has made considerable progress and has achieved considerable success in addressing many of the barriers that exist to development of the capital market in El Salvador. Some of these activities include

1) Establishing various rediscount lines through the Central Reserve Bank. Some of the lines can be accessed by foreign banks, and active use is reported. The Mission has used good marketing practices such as brochures, and other printed materials to publicize its rediscount lines. It has also set up problem-solving working groups with representatives from government, banks, industry, and its own staff to discuss proposed and ongoing projects.

2) Encouraged extensive (more than 60% of total) use of Central American regional short-term import credit insurance plan. The Mission wants to establish a medium term plan to substitute for forecasted reductions of ESF funds in later years.

3) Developed innovative plans to work around restrictive government policies. The USAID has supported a unique trust fund financing with New York banks to develop inbond assembly operations financing (maquila financing) on an offshore basis to avoid Central Bank restrictions.

4) Increased export activity through policy dialogue. The GOES agreed to increase exporter dollar retention to 60% for manufactures, 40% for agricultural products.

5) Assisted insurance companies in establishing PROINVER to provide coverage of plant and equipment against terrorist acts.

6) Organized a training program for local businessmen. The Mission provided medium-term lending training to 100 bankers through Citibank training facilities in Puerto Rico.

7) Provided financial support to FUSADES foundation to assist its conduct of policy research, and to act as a vehicle for programs such as PRIDEX for maquila projects.

The USAID is also providing support to the GOES and seeking to determine technical assistance requirements related to formulation of a Bolsa in El Salvador and exploration of the opportunities for establishing a debt to equity swap program.

2. Recommendations

a. AID should focus its support of the Bolsa on development of instruments rather than concentrating on regulation.

There is a demand for financing to meet the requirements of productive enterprises which is not being satisfied by state banks. This need can be met by the Bolsa if technical assistance is provided for the development of DICA-type and other tradeable instruments. The Bolsa could be an appropriate source of funds for larger companies that are being squeezed out by the practices of the commercial banks. Development of new instruments (including debt/equity swaps which are beginning to appear) will be required along with modifications to some existing instruments. Clearly, it is important that these instruments have tax treatment at least as favorable as that accorded bank deposits and government securities.

We recommend that USAID/Salvador provide technical assistance in drawing up financial instruments that will meet the trade and other financing requirements of El Salvador. This assistance would have a more significant effect on the development of the Bolsa than the assistance in setting up regulations currently being provided. In this regard, it should be noted that in the United States and in other developed countries, securities regulatory laws were not designed directly to develop the markets; rather they were adopted to cure specific abuses in those countries well after the market had developed. This is a fact of crucial importance in dealing with the issue of regulation of a securities market.

b. Explore the feasibility of establishing a medium-term trade finance insurance program..

The Mission is considering a medium-term trade finance insurance program. Because the government-owned commercial banks are unlikely to qualify for adequate credit lines and there is a good probability that country risk ratings will remain unfavorable, a trade finance insurance program could be very important in stimulating trade. Therefore, we recommend that USAID/Salvador continue to review and encourage the formation of such a trade insurance program.

c. Encourage further export incentives.

One of the most serious threats to El Salvador's future financial position and growth is weak export performance. While not a specific objective of the scope of the Financial Markets program, export promotion is of prime importance and should be included in the incentives to private enterprise already under development. The Mission is well aware of the need for adequate regulations to support the export/trade promotion law recently enacted, and we would recommend only that this topic be retained in the policy dialogue agenda of the mission.

As mentioned earlier, there has been a significant erosion of export competitiveness relative to El Salvador's trading partners arising from inadequate exchange rate adjustments. Therefore, it should be kept in mind that an appropriate exchange rate is the export incentive par excellence and the Government should be encouraged to continue moving towards a system of flexible exchange rates.

d. Continue efforts to require a timely audit of the Central Bank's disbursements of AID funds.

We received conflicting reports from current and potential borrowers on the availability of proceeds from subloans made with AID funds.

The mission has been unsuccessful, thus far, in its attempts to negotiate an agreement which requires a timely audit on the credit line accounts as part of the GOES reporting requirement. Some progress has been made, however, in that the USAID has had an opportunity to visually inspect the Central Bank's books. We recommend that the USAID follow up on the "businessman's audit" of the program to ensure that the Central Reserve Bank is indeed disbursing local currency to qualified borrowers promptly.

e. Engage the GOES in policy dialogue directed at establishing a private commercial banking system.

As mentioned earlier, the commercial banking system is generally in a state of decline since nationalization, although interviewees told team members that some banks continue to be well managed. The current policy of directed credit is creating serious financial problems for companies or industries that are not on the approved list. Especially hard hit are the large enterprises and commerce that are not included in the government's definition of "productive" activities. We recommend that USAID/Salvador renew its efforts and apply any leverage at its disposal to reestablish a private commercial banking industry in El Salvador.

f. Initiate policy dialogue to liberalize the requirements for investment of insurance funds in securities.

Requiring the insurance companies to invest an excessive portion of their reserves in government bonds undermines the financial vitality of the companies, and encourages the government to rely on subsidized financing rather than relying on the market to determine the cost of borrowing to the government. We recommend that the USAID seek through policy dialogue to reduce the level of investment required in government bonds to 10-20%. The additional funds available to the insurance companies for investment could be a major factor in the rapid development of the Bolsa.

USAID/El Salvador is already pursuing a number of the recommendations presented above, and our findings mainly serve to reinforce the need to continue mission support in the recommended areas. The mission deserves praise for its innovative approach and its efforts in encouraging the development of financial markets in El Salvador. Although the mission has had considerable success in addressing some of the barriers to capital market development on a national level, we believe El Salvador would also benefit from support and pursuit of the regional recommendations presented in section IV. In particular, the country would benefit from increased coordination of AID supported private sector activities, a regional training program in financial analysis techniques, and the establishment of a Central American Investment Company which would increase the availability of capital for business expansion throughout the region.

GUATEMALA

1. Background

a. The Financial Sector.

The Bank of Guatemala, created in 1946, operates under the authority of the Monetary Board. As the country's central bank, it is charged with issuing currency, setting the reserve requirements of the banking system, and implementing credit and monetary policies. In addition, as of December 1985, the financial sector comprised 12 private domestic banks, 2 foreign banks, 1 mixed (private/state) bank, 3 state controlled banks, 5 finance companies, and a variety of other non-bank financial institutions, including 14 insurance companies, and 11 warehouse companies.[38]

The commercial banks are involved in both commercial and mortgage banking activities, although the greatest portion, 85% is commercial. Credit extensions are primarily short-term; a 1-year rollover type loan (evergreen loan) is the main credit instrument. According to a May 1987 report of the Agricultural Task Force to Guatemala, the banking system relies heavily on collateral and lenders pay more attention to the guaranteee than to the feasibility of the project.[39] In addition, according to one team member, entry into the commercial banking system is severely restricted. "Capital, competency, and moral qualifications" are not enough to overcome systematic opposition to new entrants from existing banks, which often argue that there is excess capacity in the system. This opposition can only be overcome by political influence and perseverance. Members of the private sector also complain about cumbersome legal requirements for establishing new banks. Reportedly, it takes at least two years to process a request for a banking license, and the new bank has to wait another year before it can complete other bureaucratic procedures and begin operations.

---

[38] From Oscar Alvarez, Luis Arturo del Valle, and Hugo Quinto, "Analisis del Sistema Financiero de Guatemala" (Guatemala City: Hugo Quinto y Asociados), December 9, 1985. Cited in International Science and Technology Institute, Inc., in collaboration with Arthur D. Little, Inc., "A Review of Guatemala's Economy 1968-1985." (Prepared for USAID Guatemala, February 1986), pp. 39-41.

[39] Economic Perspectives, Inc., "Report of the Agricultural Task Force to Guatemala." (Draft) Prepared for USAID/Guatemala. (McLean, Virginia, May 1987), p. 50.

A characteristic feature of the Guatemalan banking system is the concentration of deposits in the hands of a small segment of the population. According to Alvarez, del Valle, and Quinto, 83% of the deposits of the banking system were held by 5% of the depositors in June 1985. Private banks reportedly are established by wealthy individuals for safekeeping of their deposits and as sources of investment capital. Those with no ties to the banking system, or no access to an independent source of wealth, particularly small and medium entrepreneurs, have considerable difficulty in financing investments. A recent report by the International Science and Technology Institute, Inc. in collaboration with Arthur D. Little, Inc. has called into question the efficacy of the commercial banking system as a vehicle for resource transfer in Guatemala. According to this report, "not only has the banking system proven to be ineffective as a mechanism for reaching out to a broader part of the population, but the concentration of resources in financial instruments facilitated capital flight once the economy began to unravel."[40]

The structure of lending in Guatemala is primarily short-term, as commercial banks are the dominant financial institutions and the participation of medium or long-term loans in commercial bank portfolios is very limited. While commercial banks are by their very nature "short-term" oriented because most of their liabilities--demand deposits--are short-term, the problem in Guatemala goes beyond the problem of funding at equivalent interest rates and maturities. The lending policies of the commercial banks are also influenced by the lack of competition in the banking system and by the high concentration of financial resources. Another factor that affects their lending policies is the lack of adequate training and the limited experience of much of the commercial lending staff. As a result, commercial banks prefer to lend only to well established firms or "preferred" customers, or insist on high collateral requirements in excess of the loan amount, and prefer to consider only applications for short-term loans. The consequence of such lending policies is to constrict economic growth by preventing many potential borrowers from obtaining loans for productive investment. In particular, such policies limit severely the borrowing potential of new and/or small investors who might qualify if more emphasis was placed on project analysis than on security.

The financial system of Guatemala is comprised of other financial institutions, including: the financieras, which mainly extend medium-term credit to a small group of individuals and companies; bonded warehouses, which offer certificates of deposit and issue collateralized bonds backed by the goods they keep in storage; and, insurance companies. The insurance companies, by law, must invest 40% of their technical reserves in government securities that are eligible for repurchase by the government's Securities Regulation Fund. While the financieras are allowed to make equity investments, they rarely do so because they consider the risks to be too high. According to the Report of the Agricultural Task Force to Guatemala, the country's financial

---

[40] International Science and Technology Institute, Inc., "A Review of Guatemala's Economy 1968-1985," p. 32.

system is increasingly characterized by financial complexes whereby a bank, financing company, and insurance company are tied together with common shareholders and directors. As a group, these companies reportedly tend to seek the same business, without specializing by economic sector or region.[41]

Another important non-bank financing mechanism in Guatemala is the cooperative. As of December, 1985, there were 900 cooperatives with over 200,000 members. The cooperatives act as financial intermediaries between their members and the formal financial institutions. Their main sources of funds are deposits by cooperative members and subsidized credits from the state-controlled banks. Although the cooperatives play a key role in financing small and medium-sized producers, the financial position of the coooperatives in general is very weak. They have suffered from a high level of loan delinquency and weak credit administration, low profitability, and poor operational and pricing policies.[42]

As a whole, the financial system of Guatemala is relatively undeveloped. There is significant margin for improvement in savings mobilization and resource allocation, and the system suffers from a very limited lending base. As of December 31, 1984, loans above 100,000 quetzales represented 73.3% of total loans (Q876 million out of Q1,195 million), while representing only 7.8% of the total number of loans outstanding (2,300 out of 29,400 total loans outstanding), according to statistics compiled by Hugo Quinto and associates. The financieras present an even higher degree of concentration, with 100 borrowers out of 424 accounting for Q54.9 million of a total of Q62.0 million in loans. In other words, 23.5% of the borrowers absorb 88.5% of the loans. In addition, loans are primarily short-term, and the financial system is oriented toward lending and borrowing rather than investing and risk-taking. Medium-term loans are generally unavailable to potential borrowers. On December 31, 1984 loans with a maturity below a year amounted to Q1,085 million out of a total portfolio of Q1,197 million of the banking system of Guatemala, or almost 91% of the total.[43]

According to a report by the Agricultural Task Force to Guatemala, there is excess liquidity in both the domestic banking system and in the credit lines provided by international agencies. Part of the reason is weak demand arising from a lack of confidence in the political system. However, another important reason is that legal and procedural deficiencies in the delivery of credit and

---

[41] "Report of the Agricultural Task Force to Guatemala," pp. 47 and 52.

[42] Arthur Young & Co., "Descriptive Summary: Central American Financial Markets" (November 17, 1986), p. IV-16; and "Analisis del Sistema Financiero de Guatemala," cited in International Science and Technology Institute, Inc., "A Review of Guatemala's Economy 1968-1985," pp. 40-43.

[43] Hugo Quinto y Asociados, "Analisis de la Actividad Crediticia en Guatemala, Periodo 1981-1984" (April 1986).

capital limit their accessability and/or availability. The Task Force noted, for example, that: legal requirements on document registration are costly and time-consuming; limits on loan amounts per borrower are inappropriate given the size of companies today; collateral requirements on medium-term loans are very high, which precludes otherwise worthy borrowers who might have qualified had there been more reliance on project analysis than on security; the requirement to do cash accounting rather than accrual accounting forces managers to be overly conservative in estimating their lending capability; and credit application forms are too complex. In addition, rigidities with regard to interest rates act as a disincentive for making longer-term loans.[44]

The capital market of Guatemala is in the very early stages of development and it faces some important constraints. Most companies are reportedly family-held or owned by a small group of investors. In addition, there are major tax biases towards investing in financial instruments rather than in the equity and debt instruments of industrial, agricultural or commercial enterprises. For example, interest earned on bank deposits is tax free, while interest on debt instruments issued by private corporations is taxable. Another impediment to capital market development is the absence of credible information on the financial performance of companies. This has contributed to a general lack of interest in equity investments by the public at large. For instance, when the oil companies were required by law to offer shares to the public, there were no takers.

A securities exchange is currently being promoted by an important group of individuals and corporations. Some initial difficulties with the government have been reportedly overcome. The main trading instrument is the Stabilization Bond of Guatemala; total bonds issued amount to about $400 million. The Stabilization Bonds are freely negotiable, dollar denominated bonds issued against an equivalent amount of local currency. They were first issued by the Bank of Guatemala in August 1983 to validate not only previously accumulated debt, but also current requirements for foreign exchange. In addition, a capital market law project is currently under negotiation among government institutions, the local universities, and the private sector for future consideration by the legislature.

Field work in Guatemala revealed that, to date, there has been only moderate interest in subsidized A.I.D. financing, which under proposed programs (Private Enterprise Development) will include guarantees to induce lending to small and medium companies with low collateral. There are several factors which dampen demand for A.I.D. financing in Guatemala, including bureaucratic delays, excessive documentation requirements for application, and overly selective targeting of recipients. It has also been suggested that A.I.D. has a bias in favor of small companies which often results in qualified recipients being too small to be able to adequately use the funds. Other complaints include that A.I.D. wants to obtain funds for development at commer-

---

44 "Report of the Agricultural Task Force to Guatemala," pp. 7 and 46.

cial rates, eventhough the risks are higher, and that in the past, programs have often come on stream when the need is over.

b. Foreign Debt.

Guatemala's foreign debt position has deteriorated significantly in recent years. In the 1970s, Guatemala had contracted debt primarily from multilateral and bilateral sources on concessional terms. In recent years, however, the country has resorted increasingly to foreign commercial borrowing. According to IMF data, foreign commercial banks' share of Guatemala's external public debt increased from 7% in 1981 to 16% in 1985. As a result, debt service payments on medium and long-term public debt increased from 6% of exports in 1981 to 19% in 1985.

Total foreign debt (outstanding and disbursed) at the end of 1985 was estimated by the World Bank at about US$2.6 billion, almost 3 times the 1980 level. As a percent of exports, total debt jumped from 53.3% in 1980 to 207.2% in 1985. While the deterioration in the country's debt profile is due in large part to the heavier utilization of commercial loans and the deterioration in the terms of new borrowing, it is also related to the decline in exports from Guatemala. According to World Bank data, if exports had retained their peak 1980 level instead of falling by almost 30% in nominal terms, the debt to exports ratio would have been less than 150%, compared to the actual 207%.

c. Capital Flight/Private Sector Investment.

Concerns about the political and economic stability of Guatemala itself, and of other Central American countries, have contributed to a sharp decrease in foreign and domestic investment and have exacerbated capital flight. According to World Bank data, Guatemala's gross rate of investment is now 40% lower than in the late 1970s. Private investment in particular has declined significantly since 1978, although public investment has also fallen abruptly since 1982. The sharp decline in private investment has been attributed primarily to political uncertainty, declining export and domestic growth prospects, and a sharp fall in domestic savings.

The World Bank has estimated capital flight from Guatemala in the early 1980s at almost US$1 billion. The causes were primarily three: uncertainties over the political and economic future of the region; widening differentials between external and domestic interest rates; and expectations of a currency devaluation.

In 1986 the government of Guatemala developed a five-year strategy for development and investment. An important aspect of the plan is that it promises reliance on the private sector as an integral part of the economic reactivation process. The government's role will center on creating a supportive policy environment.[45]

d. Interest Rate Policies.

In Guatemala, rigidity in interest rate policies has contributed to capital flight and has affected the banking system's ability to raise financial resources and allocate them efficiently. Maintenance of positive real rates of interest had not been an explicit policy of the monetary authorities, which, until recently, had resisted lifting interest rate ceilings to keep up with inflation.[46] According to World Bank data, between 1982 and June 1986, ceilings were fixed at 9% on deposits and 12% on lending rates. With the rapid rise in inflation from a yearly rate of 7.8% in 1982-84 to 31.5% in 1985, real interest rates became highly negative in real terms. Since June 1986, the gap between inflation and interest rates has narrowed, as interest rate ceilings have been increased by 2 percentage points and inflation has declined to an annual rate of about 15%. Interest rate rigidity has contributed to capital flight and has affected the banking system's ability to raise financial resources and allocate them efficiently.

e. Foreign Exchange/Trade Policies.

In November 1984, due to balance of payments difficulties, Guatemala abandoned the fixed parity of the quetzal vis-a-vis the US dollar in favor of a multiple exchange rate system. A 3-tiered exchange rate market was introduced, consisting of the official market, the banking market, and the auction market. In the official market, the value of the quetzal was pegged at Q1 per US$1, while the banking rate was allowed to fluctuate within a band set by the Bank of Guatemala. In the auction market, which ceased to exist in June 1986, the rate fluctuated in principle according to market forces, but also could be set by the Bank of Guatemala, taking into account developments in the banking market.

The multi-exchange rate system became very complex and resulted in large imbalances in the official and banking markets during 1985. During that year, the average value of the quetzal depreciated by 62% in nominal effective terms, and by 34.5% in real effective terms, according to IMF data. The sharp depreciation of the currency, coupled with rapid expansion of credit and monetary aggregates, led to the acceleration of inflation from 5% (on an end-of-year basis) in 1984 to about 31% in 1985. The multiple currency regime also resulted in uncertainty and contributed to capital flight and to poor export performance.

---

[45] U.S. Agency for International Development, "PID Private Enterprise Development Project, 520-341" (January, 1987), pp. 1 and 3.

[46] International Science and Technology Institute, Inc., "A Review of Guatemala's Economy 1968-1985," p. 46.

In June 1986, the exchange rate system was simplified substantially. A uniform regulated rate of Q2.5 per US$1 was adopted for most merchandise trade, except for some exports to Central America, in contrast to some 30 different rates which prevailed earlier. In addition, the government plans to achieve complete unification of exchange rates by the end of 1987.

Since 1980, the economic and financial condition of Guatemala has deteriorated sharply. According to World Bank data, per capita income was 18% lower in 1985 than it was in 1980. In addition, investment has decreased sharply, exports and imports have fallen drastically, and the external debt has trebled. As the major beneficiary of the CACM, Guatemala has been severely affected by the virtual collapse of the common market. For example, non-traditional exports consisting of manufactured products and agricultural foodstuffs--two thirds of which normally go to the CACM--declined from US $608 million in 1980 to US$387 million in 1985, largely as a result of a 40% drop in exports to other Central American countries.

In mid 1986, as part of its foreign exchange regulations, Guatemala withdrew from the Central American Clearing House and began to require payment in dollars for its exports. Some of its trading partners have retaliated by closing their borders to some Guatemalan products or by denying allocation of dollars for payment. The Derechos de Importacion Centroamericana, DICAs, have been used to alleviate the problem.[47] DICAs are dollar denominated, noninterest bearing, negotiable and transferable obligations of the Central Banks. They are issued at the request of importers to pay for imports from the rest of Central America and are payable in the currency of the issuing central bank within a period of 18 months.

2. Recommendations

a. Support/promote availability of medium-term lending.

Greater access to domestic medium-term loans is crucial to the creation and expansion of new productive enterprises and to the development of a capital market in countries like Guatemala. A study by Nomura Securities, undertaken for the Asian Development Bank to evaluate the prospects for capital market development in Indonesia, for example, highlighted the importance of introducing medium-term lending as the key initial step to development of the market.

As noted earlier, medium-term lending is very rare in Guatemala as the banking system is oriented toward short-term lending and there are few other sources of term financing. However, a positive step toward making medium-term lending more available was taken last year when the government allowed flexible interest rates on medium-term lending if the banks used their own

---

[47] USAID, "PID Private Enterprise Development Project, 520-341" (January 1987), Annex V, p.3.

funding. There are several more actions that might be taken to improve this situation further. The team recommends that the USAID, through policy dialogue, encourage the GOG to:

- Revise current legislation governing mortgage and lien requirements to encourage medium-term lending. For example, collateral requirements should be changed to permit larger medium-term loans than are currently allowed.

- Support establishment of investment companies in Guatemala and creation of new and innovative financial institutions and instruments. (See recommendations (b), (d), and (g) below as well as regional recommendations.)

- Support training of bank personnel in project evaluation, loan management, and debt collection techniques. (See recommendation (f) below.)

The project currently proposed by the mission to provide medium-term loans to small enterprises holds promise of increasing the supply of financing available to these organizations. Demand for these loans is likely to be high if the problems of past efforts, such as long processing delays and excessively detailed applications, can be overcome. Assistance should also be provided by A.I.D. in the areas of loan management and debt collection as a way of helping to keep default rates within reasonable levels. We recommend that the USAID include these requirements in the project design to assure that the loan program meets the expectations of both the Guatemalan entrepreneurs and the mission. The project agreement should also make it clear that the medium-term loans funded through the A.I.D. assistance are not included in the loan to capital ratio of the banks. This will avoid the potentially adverse effects of reducing the amount of loan funds that the banks could make available from their own funds.

b. <u>Assist in establishing venture capital/investment companies.</u>

Development of Guatemala's financial system is being held back by the dominant position and uncompetitive lending practices of the commercial banking sector, and the absence in the financial market of any institutions that are engaged in medium and long-term investments. Although institutions have been established in the past to provide this service, with A.I.D. assistance in some instances, over time these institutions have taken on the characteristics of commercial banks and are not a viable source of the type of financing now required in Guatemala.

Sustained economic growth in Guatemala can only be achieved through expansion of the number and vitality of private enterprises. This expansion will require access to capital and financial market services that are not currently available. There is a need, therefore, to foster the creation and success of organizations that are an alternative source of capital to commercial banks. It should be recognized that commercial banks, because they are likely to view these sources as competitors, will probably oppose the organization of these financial organizations. Because the

Bank of Guatemala regards the commercial banks as its clients, it is likely to join in the opposition to the formation of these organizations.

The previous comments notwithstanding, we recommend that the USAID support the formation of investment companies in Guatemala. This assistance could take several forms. At the policy dialogue level, it would involve discussing changes in tax policies to encourage investment and innovative financing mechanisms. It would also involve encouraging the GOG to maintain an objective point of view regarding the formation of these investment companies, and in considering the position that might be adopted by the Bank of Guatemala.

We also recommend that the mission provide input and support to the establishment of a regional fund that would be a major source of equity and debt capital to the national investment firms. In working with groups of local investors that would organize these local companies, the mission could help to increase the competitiveness of the market by encouraging the entry of groups outside the circle of businessmen that traditionally are involved in A.I.D. projects.

c. Support liberalization and rationalization of financial market laws and regulations.

Guatemala has considerable potential for increasing domestic savings and private productive investment. However, the development of new financial institutions and instruments to facilitate more savings and investment, will require some revision of existing laws and regulations.

Legal and financial policy reform is a prerequisite to money and capital market development. Revisions to laws and policies pertaining to the financial market should focus on eliminating obstacles and biases rather than trying to legislate development by providing special, and often discriminatory inducements to private enterprises.

The policies governing investments by the insurance companies should be revised to facilitate and stimulate their participation in the money and capital markets. Currently, the Central Bank establishes very specific investment policies with limited discretionary margin for investments other than in government securities. As explained earlier, insurance companies are required to invest 40% of their technical reserves in government securities that are eligible for repurchase by the government's Securities Regulation Fund. As of November 1986, these securities paid a maximum of 5% annual interest.

The proposed relationship between the Banco de Guatemala and the local equivalent of the Securities and Exchange Commission (SEC) presents another key issue with regard to the prospects for achieving development of the capital markets in Guatemala. The responsibilities of these two organizations are very distinct and should not be combined under the Banco de Guatemala. Policy coordination between the two can be achieved by providing Banco de Guatemala representation in the local SEC, but putting the authority under the Bank would stifle the development of a securities market. A close interrelationship between the two institutions, as is currently proposed by the local commercial banking community might lead to undue influence by the commercial banks on the local SEC through the Bank of Guatemala. There are numerous conflicts of interest between the money and the capital market players on the one hand, and the commercial banks on the other, which call for their separate supervision and regulation. This type of separation between the central bank and the supervisory/regulatory agency is also suggested by the World Bank in a recent study of the financial sector of Morocco and by the International Finance Corporation in a study of a similar proposal in Portugal.

It is also felt that, rather than establishing an elaborate mechanism to supervise public issues of financial instruments, major reliance should be placed on the use of qualified public accountants to attest to the accuracy of financial statements. This action, if backed up by adequate sanctions to protect against collusion and fraud, would do a great deal to increase investor confidence and interest in publicly owned firms.

While most of these issues can only be addressed through policy dialogue with the GOG, USAID/Guatemala can provide considerable assistance in these areas by making securities specialists available for consultation with the GOG officials. We recommend that the USAID offer to make this assistance available as an incentive to the GOG to consider the issues.

d. Support the negotiability and securitization of debt including debt-equity swaps.

The foreign debt of Guatemala presents a major opportunity to increase the supply of negotiable securities. The possibility of allowing debt-equity transactions should be explored, and probably introduced, within the constraints of monetary policy. This would allow the development of new financial transactions and instruments, promote new investment and alleviate the burden of foreign debt.

A governmental decision to make Guatemala's foreign debt negotiable would immediately supply a much larger pool of securities to the market. This action would intensify the volume of activity and greatly hasten the development of a capital market in Guatemala. Debt equity swaps could be used within a monetary policy framework to promote new investments, create new financial instruments and assist in reducing the country's foreign debt.

The Exchange Stabilization Bonds are practically the only financial instruments traded in and outside La Bolsa. If other foreign debt of Guatemala were securitized it would increase the supply of negotiable securities and enhance capital market activity. Commercial banks have been buying substantial amounts of Exchange Stabilization Bonds for their own accounts recently, which might help to increase the demand for other debt securities.

For many years, central government financing has been completely funded by Banco de Guatemala and the commercial banking system. It is anticipated that during 1987 the central government will issue debt securities directly to the public. The role that the commercial banks and Banco de Guatemala will have in the issue is unclear. However, the Central Bank should eliminate the proposed repurchase guarantee that will be provided with these securities. It will be far better to let the local market generate its own liquidity, determine interest rates, and contribute to the development of a secondary market for these securities. This would also result in the very desirable introduction of a new instrument in the Guatemalan financial market.

USAID/Guatemala can support the development of these additional instruments and the associated expansion of capital market activities in at least two ways. For one, it might offer to coordinate, with the participation of the GOG, discussions between the banks holding private Guatemalan debt and the debtors to discuss the major deterrents and actions required to securitize the debt. By involving itself in the issues at the outset of the discussions, USAID/Guatemala might be able to offer solutions or effect reasonable compromises in a moderating role that would be very consistent with its development objectives. For its part, the mission might also arrange for the services of specialists in securitization or debt to equity swaps to resolve some of the thornier issues encountered by the negotiators.

e. Support increased/improved supervision of review/examination of asset quality.

Regulation of banks is the responsibility of the Superintendencia de Bancos y de Otras Instituciones de Credito. Review of the current procedures and practices of the Superintendencia indicates that it is concerned primarily with assuring compliance with Central Bank regulations. There is little or no effort on the part of regulators to measure or evaluate the solvency, liquidity, and effectiveness of management of the supervised financial institutions. Of particular concern, is the fact that there is no evaluation of assets reported by the bank. In failing to determine a reliable assessment of the financial position of its regulated banks, the Superintendencia is placing depositors at risk and not fulfilling its principal responsibility.

f. Establish a project to train bank personnel in financial analysis of projects, project financing, and financial instruments and market operations.

The conservative lending practices of the commercial banks in Guatemala are due in part to inadequate training and the limited experience of the commercial lending staff. Because these personnel are not well trained in the analysis of project financial projections, particularly in the use of present value and cost benefit techniques, they protect the bank (and themselves) by lending only to very well established firms, or by insisting on collateral in excess of the loan amount, and by considering only applications for short-term loans. As a result, many creditworthy projects are turned down, or are confronted with borrowing costs that are so high that the potential return on a project falls below acceptable levels.

While the lending policies established by bank management cannot be ignored, it is reasonable to expect that a larger number of creditworthy projects would be approved if the lending staff had more confidence in its ability to properly analyze projects. We recommend that USAID/ Guatemala organize a project to provide training in financial analysis, loan management, and debt collection techniques to the staff of the banks in Guatemala. The training should be open to all, but priority might be given initially to the staff of the newer, less established banks in the interests of improving their competitive position and helping to maintain their financial vitality.

g. Provide assistance to the Bolsa project.

A group of individuals and corporations have been promoting the development of the Bolsa, which began operations in April 1987. Although this group has concentrated most of its efforts on the operational aspects of a securities exchange rather than on the overall concept of money and capital markets development, the implementation of the Bolsa is a positive step towards the development of the capital market of Guatemala. Other positive steps include the proposed enactment of legislation governing the operations of the Bolsa.

GOG focus to date has been on operational and regulatory aspects of the Bolsa. If both the private sector and the government continue to concentrate on the operational aspects of a securities exchange rather than on the fundamental issues (encouraging/creating/ facilitating the supply and demand of financial instruments to be traded), an excellent opportunity to develop the financial markets of Guatemala will be missed. A market such as the one envisioned cannot be created simply by passing legislation that authorizes its existence. It requires provision of a favorable climate for investments and financial transactions through appropriate tax laws, regulations, and enforcement of laws governing fraud and misrepresentation.

We recommend that USAID/Guatemala obtain the temporary services of a securities expert to work with the private organizers of the Bolsa and the appropriate GOG officials to develop a better understanding of the types of securities that are appropriate to the Guatemalan market and to gain agreement on the steps required to encourage the introduction of these new instruments.

HONDURAS

1. Background

a. The Financial Sector.

The financial sector of Honduras has grown quite rapidly since 1950, when the Central Bank of Honduras (BCH) was created. There are now 14 private commercial banks, 2 development banks, 1 industrial finance corporation, 7 specialized savings institutions, 8 insurance companies, and 2 credit unions. According to an IMF report, the banking system--including the private and official banks, and the specialized savings institutions--accounts on average for 95% of the total liabilities to the private sector and net domestic assets of the financial system.

The Superintendency of Banks, a semi-autonomous department of BCH is charged with monitoring the financial system. Field work in Honduras revealed that banking regulations are antiquated, oversight procedures poorly developed and inadequate, and enforcement activities poor. While the Superintendency of Banks has made some progress, particularly in the area of training examiners and analysts, efforts frequently have been undercut, reportedly by politically motivated superiors.

The commercial banks are the most important players in the financial system of Honduras. According to World Bank data, they hold 60% of the financial sector's assets, nearly 75% of the deposits, and more than 70% of the short-term external liabilities. Private sector deposits provided 73% of the banks' resources. The remainder is obtained from BCH rediscount lines (12%) and from their own capital and other sources (15%). The banks lend about 83% of their funds: 61% to the private sector and 22% to the public sector.

Since 1980 there has been some increase in competition among the banks in Honduras. New institutions have emerged, newer banks have grown rapidly, and there has been some increased variation across banks in the level of interest rates charged. According to World Bank data, between 1980 and 1984, the collective share of the five largest banks in total commercial bank deposits fell from 75% to 58%, and in the total value of loans granted from 63% to 55%. Nonetheless, effective competition is still limited, as some of the larger banks maintain close links with each other and with some larger industrialists. Assets are still highly concentrated among four banks (Atlantida, BANCAHSA, Ahorro, and Occidente), which together account for 49% of total commercial banks assets.

Other financial institutions include: financieras, which are owned by the commercial banks and are engaged primarily in mortgage lending (typical term 5 years); pension funds, which are principally government controlled; and insurance companies. The primary assets of the pension funds are bank deposits and government securities, although they engage in some consumer and mortgage lending to their members. Insurance companies are permitted to extend loans, and about 50% of their portfolios are in this type of asset. However, they are small players in the credit markets, and make no equity investments. There are no mutual funds in Honduras.

There are two government owned development banks in Honduras: BANADESA and BAMA. BANADESA specializes in agricultural credit, while BAMA finances municipal governments. The National Investment Corporation, CONADI, which provided long-term credit and equity capital to industrial enterprises, suspended financing operations in 1982.

CONADI's financial position had started to deteriorate in the late 1970s, following a major increase in lending to several unprofitable subsidiaries which burdened it with a growing number of non-performing loans. CONADI has equity investments in about 60 enterprises, most of which face serious financial problems. Consequently, the Government of Honduras has decided to privatize CONADI's enterprises. In September 1985, the Legislative Assembly approved a law that provided for the divestment of CONADI's subsidiaries.

The structure of lending in Honduras is primarily short-term. Aggregate figures compiled by the World Bank as of July 1985 show that 65% of outstanding loans by commercial banks (excluding rediscounted loans) had terms of less than 18 months; only 15% had maturities over 5 years. The bulk of longer-term loans is given to preferred clients generally large-scale industries that are considered low risk. The principal source of medium-term credit for investment is the BCH rediscount lines, which are funded both from the central bank's own resources and from foreign borrowing.

The Central Bank of Honduras has developed an important medium-term financing mechanism. Special purpose lines of credit are managed/provided by the BCH either as a direct lender/ rediscounter or as a pass through agent. These lines are funded both from the BCH's own resources and from foreign borrowing. The BCH is currently in the process of disbursing the third medium-term financing loan program from the World Bank. The BCH rediscount lines are the major source of medium-term credit for investment.

Bankers and businessmen interviewed in Honduras generally agreed that there was sufficient liquidity and short-term financing available to meet the needs of the private commercial sector. In addition, they pointed out that loans to economically strong clients, while nominally of a short-term nature, were in fact "evergreen" and could be considered medium to long-term funding. Nevertheless, the pattern of private sector investment financing in Honduras is partly determined by an entrepreneur's ability to self-finance his/her investments due to the limited availability of long-term credits. (The World Bank has estimated that about 32% of private investment is self-financed.) Small entrepreneurs, particularly agriculture and industrial producers, are at a disadvantage in this regard, since they have more difficulty in raising sufficient funds for their initial investment. As a result, they are forced to borrow from money lenders in the "grey" financial market, who reportedly charge 3 or 4 times the average bank lending rate.

b. Foreign Debt.

Honduras has been the recipient of extraordinary aid flows, particularly from the United States. In addition to grants, capital inflows to Honduras averaged nearly 6.1% of GDP in 1980-85 on a net basis. Private capital flows, which became negative in 1981, have been replaced by official capital flows. Official net flows, which averaged US$137 million in 1977-79, more than doubled to about US$284 million in 1985, according to World Bank data. There is some concern that the foreign resources made available to Honduras have not been used to build the country's capital base and foster economic development. Instead, they have been used to finance the public sector deficit, largely for current expenditures unrelated to capital accumulation.

According to World Bank figures, fixed investment declined from 25% of GDP in 1980 to 18% in 1985, as a result of a sharp decrease in private fixed investment from 15% to 7% of GDP. Public fixed investment has also begun to drop.

Despite the growing share of aid on concessionary terms, debt service indicators for Honduras have deteriorated significantly since 1980. According to IMF statistics, outstanding external public debt (including guaranteed debt) increased from US$1.4 billion (about 53% of GDP) in 1981 to an estimated US$2.6 billion (about 70% of GDP) in 1986. The debt service ratio rose from 15% in 1980 to 28% in 1982 and to an estimated 30% in 1986.

c. Capital Flight/Private Sector Investment.

Capital flight has deprived Honduras of significant amounts of resources. According to World Bank estimates, roughly US$336 million left Honduras between 1980 and 1984, an amount equivalent to about 40% of the increase in external debt contracted by the country during the period. Capital flight was most likely triggered by the perception of an overvalued exchange rate and by concerns about the political and economic stability of the region. Since interest rates have been high in real terms in Honduras, it is unlikely that differentials between international and domestic interest rates led to capital flight. According to interviewees in Honduras, flight capital is unlikely to return in the foreseeable future, even under incentive plans, due to fears about the Nicaraguan conflict and about instability caused by high and growing unemployment. At a minimum, it will be necessary to provide insurance against loss from war or terrorist activity in order to attract investors.

In a reversal of the trend of the last decade, which led to an enlarged public sector role in the economy, the Government of Honduras is trying to encourage an enlarged private sector role. Steps in that direction include: privatizing certain government enterprises such as CONADI; streamlining technical support for small scale enterprises, which dominate Honduras' private sector; and creating new support institutions like the Foundation for Private Research and Development (FIDE). FIDE, which was established with assistance from USAID, assists firms in export development efforts, especially in relation to the Caribbean Basin Initiative.

d. Accounting Standards.

Field work in Honduras revealed that published balance sheets are suspect and accounting standards are weak and poorly developed. Owners use many devices to minimize reportable profits. Most firms are closely held.

e. Interest Rate Policies.

In Honduras, interest rate policies are assymmetrical for deposit rates and for loan rates. Deposit rates have been freed since 1981, while loan rates are subject to a ceiling, established according to the source of funds. According to World Bank figures, annual interest rates on savings deposits ranged between 8 and 10% in 1986, while time deposits earned 8 to 14%. On the other hand, ceilings for loans from rediscount lines have ranged between 9 and 17% per year since 1980, while loans from banks' own funds carried a ceiling of 19%, until some months ago when the ceiling was reduced. At the 4.5% rate of inflation prevailing in 1986, the top nominal lending rate implied a real interest rate of 14.5% per year for loans in 1986. The high level of real interest rates in Honduras has been the key instrument in attracting domestic financial savings to the Honduran banking system.

f. Foreign Exchange/Trade Policies.

The Lempira has been pegged to the U.S. dollar in the official market at L2 per US$1 since 1918. The rise in inflation in the early 1980s led to significant appreciation of the lempira, according to both IMF and World Bank reports. While this trend was reversed slightly in 1986, it was not enough to offset the appreciation of the lempira during the previous years. According to an IMF report, there are no taxes or subsidies on purchases or sales of foreign exchange.

The Government of Honduras introduced exchange controls in 1982. This led to the development of a parallel market in which the dollar rose gradually to a peak of L2.8 per US$1 in 1985, a premium of 40% over the official rate. According to World Bank data as of April 1987, the premium dropped to about 13% as a result of increasing foreign exchange earnings from coffee, lower oil prices and international interest rates, and rapid disbursements of US aid. The BCH issues permits for imports from the CACM without providing the corresponding foreign exchange, which can be obtained in the parallel market. Some exporters have also been authorized to retain part of their earnings in foreign exchange. (Exporters to Costa Rica and El Salvador, for example, are allowed to transfer their foreign exchange proceeds to importers at freely negotiated exchange rates.) Therefore, several exchange rates are in effect, arising from the combination of official and parallel rates available in different proportions.

The existing multi-exchange rate system of Honduras has created serious distortions and uncertainties. Producers face uncertainties in relation to both the cost of their imported inputs and their export proceeds in lempiras. This situation helps explain the country's poor export performance. In addition, the Government of Honduras has in effect a system of import surcharges and exemptions that is very complex and further inhibits trade. Finally, interest rates have also been affected as high real interest rates have become a substitute for a more active exchange rate policy.

2. Recommendations

a. Support activities that encourage institutional investors, insurance companies, pension funds and eventually mutual funds, to play an active role in term markets.

It is unlikely that there will be significant development of the medium or long-term capital markets in Honduras until the institutional investors participate in the market. Labor unions and pension funds represent a major source of equity and debt capital that is badly needed as an alternative to commercial lending sources. For example, the funds available for investment from the three largest pension funds total about 100 million lempiras.

Honduran insurance companies are another potential source of investment capital, and could aid the development of new financial instruments by diversifying their investment portfolio. The heavy dependence on government paper and lending is reflected in the figures for 1983 which indicated that 28% of the funds held by seven insurance companies were invested in government bonds, 54% were in direct loans, and 7% were in term deposits.

Increased participation of institutional investors is very important in providing an additional source of capital to private enterprises, but it will not be easy to achieve. It can be expected, for instance, that the banking community will not welcome competition from another, and perhaps more investment oriented, source of capital. It will also be necessary to revise or eliminate the current laws that prohibit unions and pension funds from investing in for-profit ventures. Also it is unlikely, in the absence of increased enforcement and general tightening of the requirements governing financial disclosure, that institutional investors will risk investing in companies based only on financial information provided by the companies.

Bringing about the changes that would increase the amount of domestic capital available for investment in private enterprise can best be accomplished through policy dialogue between the USAID mission and the Government of Honduras.

b. <u>Support initiatives leading to the modernization and improved effectiveness of the regulators and supervisors of banks and companies.</u>

Despite the fact that the US Comptroller of the Currency has had a person in residence for a year helping to improve bank examination procedures, the following conditions were cited by several Honduran businessmen as examples of continuing deficiencies in the integrity of the banking system:

- even when problems are identified by examiners remedial action is not enforced on banks by regulators;

- senior regulators are subject to undue political pressure from those they are charged to examine;

- examination and analytical procedures tend to focus more on examining the strict adherence to laws and regulations rather than providing prudential oversight of institutions.

Banks enjoy a dominant position in the Honduran capital market. It is not unreasonable to expect that investors' confidence in the Honduran market is influenced to a considerable degree by their assessment of the effectiveness with which the banks operate and the overall integrity of the banking industry. If the banks are seen as being subject to political influence, or operating as members of a exclusive club, it will have a very negative effect on the ability of Honduras to stem the flow of flight capital, let alone attract new investment capital. Increasing the effectiveness of the bank examination process, and enforcing the actions required of the banks to improve either their procedures or their financial position would go a long way toward improving the investment climate in Honduras.

The difficulty from the A.I.D. point of view is that it requires a change in the current attitudes of the GOH before additional assistance from the Comptroller of the Currency or from A.I.D. would be welcome, or would have the desired effect. At the present time, the actions available to the USAID mission include only policy dialogue and application of leverage.

We recommend that the USAID, with input from the CoC representative, engage central bank and other GOH officials in policy dialogue directed at the importance of strengthening the bank regulatory function. As leverage, the USAID should prohibit the participation of banks as sub-borrowers or agents that have not been examined and that have not corrected deficiencies noted in the bank examination process. This action by the USAID could accomplish a great deal in increasing competition among the banks in Honduras, and in encouraging the growth of the newer banks that are willing to accept fair regulation and reasonable financial standards.

c. Establish a project to provide training in project evaluation and loan management to bank personnel.

As explained earlier, the scope for effective competition among banks in Honduras is reduced by close cooperation among a few of the larger banks. For the most part, competition for market share is not on the basis of rate or service, but on the basis of "Group Affiliation." That is, banks associated with larger or more powerful financial groups will tend to have a commensurately larger market share as their "natural right." Commercial bank lending is primarily short-term and loans are heavily collateralized. Moreover, the bulk of longer-term loans from banks' own resources and deposits go to preferred clients of the banks. Frequently, these clients are members of the ownership group represented by the banks. To compound the situation, the commercial lending staffs are not skilled in credit evaluation techniques and, therefore, tend to make loans for heavily collateralized or "safe" projects.

While lack of adequate training and experience in project evaluation is a hinderance to the effective operation of most of the banks in Honduras, it is a significant deterrent to the growth and financial success of the smaller banks. More than any other factor, it will severely hamper the development of these banks and their ability to compete aggressively with the established banking group.

We recommend that USAID/Honduras establish a project to provide training in project evaluation and loan management to banking personnel in Honduras. In selecting personnel for the first few training programs, the emphasis should be on staff from the smaller and newer banks. Subsequent programs could be opened to the staff of the more established banks, if necessary. In developing the scope of the training program, the USAID should solicit the input of the banks and review the design of the program with the banks throughout the development process.

d. Continue to support export promotion, especially marketing and technical assistance.

Due to the small size and openness of the Honduran economy, efficient industrial development requires production for external markets in order to achieve economies of scale. However, Honduras has been characterized by an "anti-export" bias, which, coupled with an overvalued exchange rate, has made it more profitable for firms to sell in the domestic market than to export. As a result, Honduras has experienced generally poor export performance since 1980.

In December 1983, the Government of Honduras passed an export promotion law which established a set of fiscal, financial and other incentives aimed at increasing the profitability of non-traditional exports outside Central America. Incentives include tax rebates (CEFEX) equal to 10 to 15% of the f.o.b. value of non-traditional exports, depending on the domestic value added content. The law also established a special rediscount facility in the Central Bank to provide pre-export financing for nontraditional exports. Two producer associations-FIDE and FEPROEXAH--were also established by the law to provide technical assistance to current and potential exports. Nevertheless, cumbersome and complex administrative procedures reportedly reduce the effectiveness of this law.

The USAID mission recently initiated an evaluation of FIDE and FEPROEXAH that might be useful in identifying specific actions that should be taken by these organizations to increase the volume of Honduran exports. Notwithstanding the recommendations that will be forthcoming from these evaluations, we recommend that USAID/Honduras engage the GOH in policy dialogue directed at establishment of a trade financing mechanism that will overcome the detrimental effects of the over-valuation of the Lempira on exports.

One action that would be an appropriate subject of policy dialogue would be converting the trade financing agreement that was established between Honduras and Guatemala on a trial basis into a permanent arrangement. At present, the two countries are experimenting with a reciprocal process of accepting payments for exports into a dollarized account that conveys the right, including a licence, to import an equivalent dollar value of goods. Operation of this program has resulted in the creation of a new financial instrument that can be traded at a premium over the value of the dollarized account, because it also conveys import privileges.

USAID/Honduras should also pursue expansion of the concept currently being tested to include establishment of a unitized trade currency that could serve as a medium of exchange between one or more of the countries in Central America. The advantage of this and the trial system is that it avoids the need for revaluation of currency, but it removes the current barrier to the free flow of goods and capital between countries. It would also eliminate the present confusion and uncertainties arising from the multiple exchange rates that have come into being in Honduras. The importance of a unitized trade currency has been well demonstrated in the experience of the European Common Market.

e. Support the negotiability and securitization of debt through assistance in solving legal and other issues including attacking the notion of par value.

The foreign debt of Honduras, if made fully negotiable, would provide a large supply of securities and create a market. The experience with Stabilization Bonds in Guatemala provides an excellent example of the benefits of converting sovereign debt held by foreign banks to negotiable securities.

Making the foreign private debt of Honduras negotiable would provide both a major supply of financial instruments and a test of the potential demand for such instruments. This could result in a major deepening of the financial markets in a relatively short period of time.

USAID/Honduras can assist in bringing about the securitization of debt in Honduras and could make a major contribution to the development of the economy in doing so. We recommend that the mission contact the banks, particularly the regional banks, holding Honduran debt and solicit their views with regard to packaging and converting their loans for sale in the form of bonds, or other negotiable securities. Discounting of the loans would be required, in all likelihood, but the lenders would be assured of recovering at least a portion of their outstanding loans. Given the current strength of the Honduran economy and prevailing political stability, it is likely that the bonds could attract significant flight capital.

f. Support the conversion of debt to equity by assisting in the design of a debt/equity swap program.

A program of debt/equity conversion could be very useful in financing the privatization efforts undertaken by the GOH. In Chile, a quota system for debt-equity swaps has been set up to deal with inflationary concerns. The Chilean approach would be equally applicable to the Honduran situation. Within the constraints of the country's monetary policy, debt-equity swaps could be used as a method of promoting productive investment in Honduras and as a way to stop the drain of foreign exchange required to service the country's foreign debt.

Debt-equity swaps would: help in the repatriation of flight capital; give an incentive to private foreign investors, in this case any outflow of foreign exchange in the form of dividends would imply a deferral in the outflow of foreign exchange; and assist in the financial restructuring of the domestic borrowers.

We recommend that USAID/Honduras support GOH interest in establishing a debt to equity swap program, and provide the necessary expertise required to design a suitable program. Some of the issues that need to be addressed include the extent of foreign participation in Honduran companies that will be permitted, the types of controls required to prevent speculative activities, and the quotas that will be established to avoid the inflationary effects of increasing the supply of Lempiras.

g. Continue support of the Bolsa effort by encouraging the development of new financial instruments as a necessary precondition to organization of an equity market.

An equity market is a natural outgrowth of an expansion of the private sector and the creation of a variety of financial instruments that are relied on by businessmen to raise capital from private sources. The success of the market, i.e. the willingness of individuals to provide equity in exchange for an ownership position, depends to a considerable degree on the confidence that the investor places in the financial integrity of the enterprise. In the absence of uniformly applied regulations and enforcement of financial disclosure requirements, and virtually no protection of the investor against fraud, it is unrealistic to think that creating an equity market is going to create a major source of new capital. An equity market will evolve as a natural consequence of a combination of events including the establishment of adequate regulatory controls and the growth of private enterprise. Under the present conditions of inadequate safeguards for stockholders, it is possible that small investors, who will probably be held to a 49% ownership position, will see their investment mismanaged away by the majority owners of the company. For these reasons, we recommend that AID/Honduras assist the Bolsa effort by first supporting the introduction and expansion of the volume of private and government domestic and foreign debt securities in the market.

For example, there is no real bond market in Honduras, or for that matter in Central America, with the exception of Costa Rica. In Honduras, government bonds are sold by the Central Bank primarily to commercial banks to cover a portion of their reserve requirements. It would be preferable for the bonds to compete on a free market basis with other securities rather than relying on private deposits to subsidize government spending. By encouraging the securitization of debt and the creation of other financial instruments, such as trade instruments, USAID/ Honduras could have a significant impact on the development of the Bolsa and on expansion of competition within the Honduran financial markets.

AID should also support the Bolsa effort by encouraging changes in macroeconomic policies as suggested in recommendation (i) below. The mission should undertake a more thorough review of specific tax and regulatory policies that discourage the demand for securities and limit the supply of securities, and should seek to change these through policy dialogue. An equities market will then develop as a natural outgrowth of demand and supply conditions. AID/ Honduras should also support the creation of institutions, i.e. financial intermediaries--brokers, dealers, and investment and merchant bankers to encourage companies to raise finance through public placement of securities, as well as a venture capital company that can attract equity participation as recommended below.

h. <u>Establish a venture capital company with management participation in ownership/control.</u>

There are no venture capital companies currently operating in Honduras, although several local investor groups are considering forming a comparable investment company. A well managed ventured capital/investment company could attract considerable equity participation and would be an important alternative to commercial banks as a source of capital. The multinational institutions that fulfilled this important role in Honduran investment in the past have not been active in recent years.

It is a major recommendation of this report that AID establish a regional fund to provide a source for meeting a portion of the capitalization requirements of a multiple number of investment companies in each country in Central America. As explained elsewhere, the rationale behind establishment of a regional fund is that it would be more effective in attracting other multilateral donors, as well as in encouraging investment in regional companies. The majority of funds, however, would be made available to national companies established in each country. The organization of a multiple number of companies would be encouraged to assure adequate competition, and to avoid creation of a monopoly position similar to that enjoyed by the commercial banks in some countries.

The role of the USAID would be to encourage the formation of these investment companies by promoting the concept with local investor groups, and assisting them in applying for an equity investment by the regional fund. There are several groups in Honduras that are potentially eligible for assistance in the organization of an investment company and we recommend that the USAID contact these groups to determine their level of interest and willingness to take an equity position in one of these companies.

i. Support liberalization and rationalization of financial market laws, regulations and tax policies.

In order to provide more stimulus to financial markets development, exchange rates and interest rates should be allowed to float freely. As explained earlier, the multi-exchange rate system currently in effect in Honduras has created severe uncertainties and distortions which inhibit export promotion. In addition, maintenance of an overvalued currency encourages capital flight due to fears of a drastic exchange rate adjustment.

Interviewees in Honduras also pointed out that current interest rate policy has the effect of giving the government unfair advantage in the financial and credit markets. The interest level for government bonds, the dominant instruments in the market, is set by administrative fiat. According to the World Bank data, in late 1982, the Government of Honduras increased the rate paid on 10-year tax free bonds from 7% to 10% in order to attract private sector savers. It also made these bonds redeemable on demand at BCH. As a result, private sector holdings of such bonds increased from L32 million at the end of 1982 to about L198 million in June 1986. Government bonds are also free from income taxes and inheritance taxes. Thus, in the team's opinion, there is a definite tax bias in favor of investing in government paper as opposed to bank paper or commercial investments. A better system would allow the government and private sectors to bid for funds on an equal footing. Furthermore, interest rates are managed by the Central Bank with the apparent objective of placing the government as the privileged borrower. As a result, there is very little competition on either the asset or the liability side of the balance sheet. The Mission, both on its own and in coordination with ROCAP, should promote market determination of exchange and interest rate levels in policy dialogue with the Honduran government.

Recently, a Presidential Commission was appointed to make recommendations for the promotion of a capital market. This commission has generated a general awareness within the business community of the potential to create a strong capital market in Honduras. The first step toward capital market development would be to encourage changes in institutional, legal, financial and tax policies in order to make them more compatible with the development of a money and capital market. For instance, government debt, corporate debt and bank deposits should have comparable tax treatment. The current system discourages the issue of corporate debt instruments because providing a competitive after-tax yield to the buyer makes their before-tax cost prohibitive to the issuer.

The USAID activities required to effect the necessary changes and to achieve greater compatibility of GOH policies with those of other Central American countries are more appropriate as policy dialogue issues than as the subject of project activities. For example, we recommend that USAID/Honduras enter into policy dialogue, utilizing the considerable leverage provided by Economic Support Funding (ESF), that seeks to reduce the barriers to capital market and private enterprise development created by the following conditions:

- fixed and overvalued exchange rates
- interest rates established by GOH rather than market
- inequality of tax treatment for commercial vs. government investments
- bond rates set by GOH instead of by market forces

PANAMA

1. Background

a. The Financial Sector.

The financial system of Panama is highly integrated with the international financial market. The US dollar is the medium of exchange and the absence of capital restrictions on flows allows capital to move freely in and out of the country. These conditions, coupled with an attractive regulatory environment, have allowed Panama to emerge as a major offshore banking center. The peculiar structure of the nation's financial and monetary system has several major economic consequences: a) domestic inflation levels closely follow international levels; b) domestic monetary policy is very constrained since most monetary developments are exogenously determined by the country's balance of payments; and, c) international interest rates largely determine the level of domestic interest rates.[48]

There are 129 private banks operating in Panama. Most of these banks have transactions with both Panamanian residents and nonresidents. Their domestic banking activities are mainly an extension of the international financial system. In addition, Panama has two official banks, the National Bank of Panama and the Savings Bank. Unlike the other countries in Central America, Panama has no central bank, no bank with the ability to emit money, and no bank to hold international reserves. The typical functions of a central bank are divided between the National Banking Commission, which supervises banking activity, and licenses and inspects banks, and the National Bank. The latter serves as the depository for the banking system's reserves and as fiduciary and fiscal agent, in addition to functioning as a commercial bank. According to IMF data, the National Bank receives about 9% of total domestic financial savings. The majority of these deposits emanate from the private sector. The remainder of the Bank's resources consist of foreign deposits and medium-term borrowings. The Bank also functions as a clearinghouse; for example, public sector borrowings from international organizations, or from the Venezuelan Investment Fund, or the Mexican oil facility are channelled through the National Bank. In addition, the Bank is a significant lender to the private sector. In the last few years, it has also operated a money market desk and has become a significant participant in the interbank market.[49]

According to IMF data, the other official bank, the Savings Bank, received about 13.5% of domestic savings in 1985, and provided about 5% of total banking system credit. Close to 90%

---

[48] Republic of Panama, "Economic and Financial Program 1985-1986" (June 1985), p. 4.

[49] Ibid., p. 6.

of the Savings Bank's lending activities are in medium-to-low income housing mortgage loans. It also lends to small industrial and commercial firms with a mortgage guarantee to finance working capital and equipment purchases.

Other parastatal financial institutions include: the Agricultural Development Bank (BDA), the National Mortgage Bank (BHN), the Social Security Institute (SSC), and the National Finance Corporation (COFINA). COFINA, which was established in 1975 to provide long-term development loans to the private sector, has been in a precarious financial position since 1982. At that time, 95% of its B/78 million portfolio was nonperforming, B/30 million had been written off, and accrued interest losses were a further B/.7 million. As a result, the government had to assume responsibility for COFINA's debts. An effort to privatize COFINA through infusion of private financial institution's equity capital, possibly leveraged by concessional funds was considered in 1983.[50] By late 1984, however, the government had decided to abandon this rescue effort and let COFINA liquidate.

The Latin American Export Bank (BLADEX) is also located in Panama. It serves as a regional export bank Its principal purpose is to promote nontraditional Latin American exports by providing short and medium-term credit. BLADEX is concerned with financing actual exports of goods from one country to another, not with financing the manufacture of such exports.[51]

Since 1983, offshore banking activity in Panama has either declined or remained stagnant. According to IMF statistics, both foreign assets and liabilities to nonresidents declined by almost $5 billion between 1983 and 1985. This decline resulted partly because of changes in banking legislation in competing financial centers. In addition, in 1983, the US government allowed banks in this country to set up International Banking Facilities(IBFs), and international banks shifted some deposits from Panamanian branches to their offices in the United States.

In Panama, foreign banks have been a major source of external financing for the local public sector, both for capital project expenditures and current account deficits.[52] However, because international banks operating in Panama are primarily traders and placers, their contribution to the local economy is largely limited to providing employment and additional tax revenues.

---

[50] The World Bank, Panama: Structural Change and Growth Prospects (Washington, D.C., 1985), p. 31.

[51] Arthur Young International, "Republic of Panama," World Business Reports (September 1982), p. 3.

[52] Yoon S. Park and Jack Zwick, International Banking in Theory and Practice (Reading, Massachusetts: Addison Wesley Publishing Company, 1985), p. 153.

In 1986, the banking industry, particularly the fully licensed banking sector, performed very well according to the businessmen interviewed in this study. Contractions, and even departures, among foreign institutions were quickly replaced by domestic interests. A case in point is the Banco del Istmo group which has acquired the substantial operations of the Banco de Colombia in Panama. Not all of the foreign operations experienced contractions: Chase Manhattan and Citicorp are expanding in both commercial and investment banking activities. European, notably Spanish bank activity is on the increase (a Spanish Venezuelan consortium increased its balance sheet totals threefold over the last five years).

According to a report by Arthur D. Little, the principal sources of long-term credit in Panama are the National Bank, which uses IDB funds, and the Agricultural Development Bank. However, the resources of these banks are rather limited and, according to the business community, bureaucratic impediments make it difficult to access these sources of funds. In addition, as already mentioned, COFINA, which was an important source of long-term financing has been in difficulty since 1982. US commercial banks, which had also provided a major source of medium-term credit reportedly are cutting back their operations in Panama. Moreover, the small Panamanian banks that are trying to fill the void are unable to provide the necessary medium and long-term financing.[53]

The securities market in Panama is regulated by the National Securities Commission. In 1984, 81 companies were registered with the Commission. The total value of authorized public placements was almost US$3 billion. The types of securities being offered include: common stocks, preferred stocks, tax credit certificates, bonds, commercial paper, mutual fund options, and subordinate debentures.[54]

Due to the absence of a formal stock exchange, there is little information on Panama's secondary market. However, the Government of Panama is studying the possibility of setting up a stock exchange. Obstacles to establishment of a successful local stock market include:

- economies of scale are limited, which would make it difficult to sustain an efficient market;

- equity is closely held; therefore, only corporate debt and public debt would be available for trading, with the possible addition of short-term money market type instruments;

---

[53] Arthur D. Little, Inc., "A Strategy for ROCAP: Country Findings," Volume II (Cambridge, Massachusetts, December 1985), p. 53.

[54] Arthur Young & Co., "Descriptive Summary: Central American Financial Markets" (November 17, 1986), pp. VI-12, 13.

- the current mechanism for private placement appears to serve adequately those issues which would be considered safe investments by the investing public, and;

- other than banks, the only institutional investors are insurance companies; however, their holdings are, by preference, cash or cash equivalents.[55]

In recent weeks, Panama's political situation has deteriorated considerably. Since early June, the country has experienced political protests and large-scale demonstrations against its military leader, Gen. Manuel Antonio Noriega.[56] It remains to be seen how concerns about Panama's future political stability will affect the country's offshore activities and what impact these fears will have on financial intermediation, domestic investment, and future economic expansion. Panama's position as an offshore center makes maintenance of a "favorable investment climate" a goal of utmost importance.

b. Foreign Debt.

Panama has one of the highest per capita public external debts in the world. In 1983, public foreign debt was US$2.8 billion, up 20% from 1981, and equal to over 60% of total exports of goods and services. The nation's total debt of US$4 billion equaled 40% of the central government's budget, contributing to a 1982 fiscal deficit of US$340 million.[57]

Since Panama has no central bank with the authority to print money and it uses the U.S. dollar as its currency, the government has little control over monetary and fiscal policy. As a result, the public sector deficit can only be financed through dollar denominated borrowing. Historically, the size of that deficit has been determined by the availability of principally foreign financing in a market where long-term capital savings were largely kept and spent by public or quasi-public entities, i.e., the Social Security Fund. Even short-term lending to the nonfinancial public sector by the National Bank is limited by the bank's own dollar credit lines and deposits. In fact, public sector reliance on short-term debt has been minimal, averaging less than 5% of the total. Because it does not print money, the public sector has been forced to borrow increasingly from foreign commercial banks to meet its medium and long-term credit needs.

---

55 Ibid., pp. VI-13, 14.

56 Don Oberdorfer, "US Quietly Reduces Ties to Panama", The Washington Post (July 23, 1987), p. A-1.

57 Thomas John Bossert, "Panama", in Confronting Revolution: Security through Diplomacy in Central America, p. 199.

At the end of 1985, commercial banks were Panama's largest creditors, with US$1.8 billion or 47% of the total external public debt outstanding. According to IMF data, the total amount of debt outstanding was almost US$3.7 billion, or 78.5% of GDP.

c. Capital Flight/Private Sector Investment.

Since Panama has no central bank and the US dollar functions as the legal medium of exchange, foreign exchange controls cannot be imposed and capital mobility is unrestricted.

With regard to private sector investment, Panama has experienced a certain amount of fluctuation depending on the perception of the degree of political stability or uncertainty in the country. Following agreement on the terms of the Canal Treaty in 1977 and the subsequent ratification of the Canal Treaties, there was some restoration of private sector confidence. During that period, the Panamanian government also tried to encourage private investment by introducing new incentives for exports, investment, and employment generation. However, according to a World Bank study, private investment did not recover to the levels of the 1960s and early 1970s. Between 1978 and 1982, private investment in real terms was still less as a percentage of GDP than it was between 1968 and 1973. According to World Bank figures, private investment in constant 1970 prices averaged 19% of GDP between 1968 and 1973, compared to 16% during 1978-1982.[58]

In 1982, as Panama began to feel the impact of the world recession, private investment began to fall again. According to IMF statistics, the private sector's contribution to gross domestic investment fell from 19.3% of GDP at current market prices in 1981 to 18.2% in 1982, 12.7% in 1983 and 10.7% in 1984. Estimates for 1985 indicated an increase to 12.2% of GDP.

Similarly, private sector savings as a percent of GDP have declined progressively from an average of 15.8% in 1981 and 1982 to 12.8% in 1983 and 8.2% in 1984. The estimated level of private sector savings in 1985 was 7% of GDP.

d. Interest Rate Policies.

As indicated earlier, the high integration of Panama's financial system with international financial markets makes domestic interest rates move largely in relation to international interest rates. Thus, domestic rates reflect either the US prime rate or the London Interbank Offered Rate (LIBOR), depending on the cost of funds to the lending institution. At times, Panamanian banks

---

[58] The World Bank, Panama: Structural Change and Growth Prospects, p. 2.

use the Panama Interbank Offering Rate (PIBOR) which they peg at 0.25 to 0.50% above LIBOR.

In some instances, to protect small borrowers from the impact of high international interest rates, the government has provided interest rate subsidy schemes. In recent years, for example, interest rate subsidies have been extended to farmers, and for construction and new housing loans.

e. Foreign Exchange/Trade Policies.

The Panamanian Balboa is the national unit of account and it is fixed at a rate of B1 per US$1. Nevertheless, as already mentioned, the US dollar functions as the legal medium of exchange and, within Panama's particular financial and monetary system, foreign exchange controls cannot be imposed. Furthermore, the government cannot use monetary policy instruments to affect adjustments.

In the area of trade, the Government of Panama has undertaken an extensive review of tariff policies and protectionist practices in recent years, because these are generally regarded as presenting major impediments to export growth. For example, a new Industrial Incentives Law was enacted in March 1986. Under this law, the maximum tariff rates for goods already manufactured in Panama is to be reduced to 60% over a five-year period. At the beginning of 1986, these rates ranged up to 385%.

f. General Economic Conditions.

In 1985, Panama began to recover from a five year period of stagnation. During that period, total investment as a percentage of GNP fell from 23.6% in 1980 to 14.4% in 1985. In 1986, however, all major industries grew, resulting in an overall increase in GNP of about 3% for the year. Agriculture performed exceptionally well, with a 4.8% growth compared to an average of 1.5% and 3.2% for 1970-80 and 1980-1985 respectively. This performance is particularly noteworthy given that agriculture is the fastest growing contributor to nontraditional exports.

Most of the 1985 recovery was brought about by international services (Petroterminales de Panama S.A. (PTP) and the Colon Free Zone), increased power generation, and the remarkable performance of the agricultural sector. Fisheries also showed signs of expansion (the shrimp catch was up 25% early in the year). Panama received a good deal of international assistance which aided the recovery from the 1980-85 slump. The IMF Stand-By agreement and the World Bank Structural Adjustment I (SA I) provided a US$110 million package in 1986; IDB joined in with US$100 million in total commitments for 1986. The USAID Economic Support Fund provided another US$5.7 million net disbursements.

In keeping with the terms of the Stand-By Agreement, the GOP successfully reduced the government deficit to 1.7% of GNP - well under the IMF target of 3.5%, although the reductions came out of the investment budget rather than personnel overhead. In spite of this accomplishment, Panama was declared to be in noncompliance with the financial stabilization program at the end of 1985. This was due to shortfalls in external credit disbursements which led to lower current expenditure and, more importantly, lower investment resulting from the failure to complete the Second Structural Adjustment negotiations (SA II) with the World Bank.

On the income side, additional power generation and the Trans-Isthmus oil pipeline are contributing positively to government coffers. The GOP is also considering moving the low cost housing program to the private financial sector, which would have a considerable impact in lowering government expenditures.

In terms of new policy initiatives, progress was made toward improving export incentives, and there was some reduction in protectionism. The Labor Laws were partially revised to introduce the concept of piecework remuneration; however this only covers firms with up to 30 employees. On the negative side, the privatization program is substantially behind schedule. Also, vested interests continue to slow progress toward a freer market economy despite partial progress achieved under three bills passed in March, 1985 providing incentives to the labor, industrial (reducing protectionist tariffs over a five-year period), and agricultural (reductions in price subsidies, etc.) industries.

2. Recommendations

a. Provide continued support to current financial market initiatives.

In the financial sphere, USAID has undertaken three important initiatives:

(1) Encouraging export development long-term finance, through the leveraging of the new Export Finance Corporation (FIDESA), and a small business rediscount facility offered through the intermediation of private financial institutions.

(2) The Housing Guarantee Program is being redirected through the private mortgage banking network, and it is hoped that existing US legislation may be reinterpreted to allow the placement of the underlying bonds in the Panamanian capital market. The program in Panama will in fact operate by floating bonds in the United States and then passing the funds obtained from these bond issues through the private mortgage banking network in Panama. As of this writing, U.S. legislation has not been reinterpreted to allow the placement of the underlying bonds in the Panamanian capital market.

(3) USAID has also been working with the private sector to determine the type of capital market that should be developed in Panama. Based upon the results of that assessment the mission expects to undertake a capital market development project.

The proposed measures will go a long way toward expanding, perhaps to a regional level, the existing modest financial market. This market has recently introduced relatively sophisticated debt instruments (mortgage and real estate receivables' backed bonds, known in the U.S. market as "pass-through" operations).

The GOP has introduced some incentives to encourage the expansion of the financial market including the exclusion from taxable income of up to 30% of subscriptions to agribusiness related debt issues. A tax credit has also been accorded to the differential between interest charged on low-cost housing mortgages and the average interest charged by the banks on their regular mortgage portfolio. The latter provision ought to be widely imitated in all of the Housing Guarantee Program countries.

Our basic recommendation is that USAID/Panama continue to provide support to these very worthwhile and important contributions to expansion of the financial markets in Panama.

b. <u>Continue support to establish a regional securities market.</u>

The securities traders and investment banking community (including domestic commercial banks that have opened investment banking "windows" or "Capital Market Groups"), are very bullish on the underwriting and security placement potential in Panama. All are actively participating in the working groups encouraged by USAID to submit concrete suggestions for a comprehensive capital markets legislation. While it would only have a minor impact on local investments, there is considerable merit in encouraging the establishment of a market in Panama for the raising and subsequent secondary trading of new investment capital and debt on a regional scale. This approach is preferable to the efforts by individual countries in Central America to create national markets in view of the small number of securities and volume of trading that would be involved.

c. <u>Support the formation of a secondary market for mortgage paper.</u>

Due to recently passed legislation (March, 1985) fixing mortgage interest at subsidized rates for houses up to $50,000, investments in this mortgage paper are only marginally more attractive than a pass book deposit in a savings bank and less attractive than a time deposit. However, paper backed by "old" mortgages or mortgages over $50,000 would make an attractive investment for the public. This would be a first step toward creating a publicly traded capital market.

Legislation appears to be in place which supports the formation and development of a secondary mortgage market. Of special mention are: 1) the tax free nature of investment income managed by the National Mortgage Bank; and 2) the government guarantee of the instrument. The government guarantee would be beneficial in attracting small as well as institutional investors. The law implementing a secondary market has recently been changed and needs clarification.

One major constraint to the development of a secondary market for mortgage paper is that the banks may prefer to be direct holders of mortgages due to improved rate considerations. Since they are the largest generators of mortgages and would probably be the largest institutional buyers of secondary paper, any reluctance on their part would seriously hamper the development of the market. Also, in a tight money environment, banks could view the secondary mortgage market as a disintermediating force and could resist the formation of the market. It appears, however, that the potential benefits of forming such a market far outweigh any objections.

We recommend that A.I.D., through policy dialogue, encourage the GOP to enact the legislation that would establish the secondary market.

IV. REGIONAL ACTION PLAN

This section of the report presents a series of preliminary action plans describing the basic nature and sequence of activities that are required to encourage the expansion of financial markets in Central America. The majority of activities proposed have both a regional and a national component. A major conclusion of the study of the condition of capital markets in Central America was that each country in the region would benefit more from a coordinated approach to technical assistance that recognized the economic interdependence of the countries than from private sector assistance programs developed independently for each country. In the end, of course, it is the individual countries with the assistance of the USAID missions that must carry out the actions that have been identified in the study as key to the expansion of financial markets and economic growth in the region. For that reason, the actions proposed for implementation at the regional level generally involve responsibilities for coordinating and providing support to activities that have been recommended for two or more, but not necessarily all, USAID missions in Central America. The related actions that are proposed for implementation by the missions were described separately for each country, along with country specific actions that are not key to the regional strategy, in the previous chapter and are intended to provide the background to the regional recommendations presented here.

The recommended actions described below are presented in approximate order of priority and increasing time and level of resources required to carry out the activity. The advantages offered by the first few actions listed is that they can effect improvements in the financial markets in the region through very modest expenditures of resources.

Recommendation No. 1: Provide support to securitization and increased negotiability of debt

As noted in the study, the foreign debt situation of the countries in Central America serves as a deterrent to investment in the region. (Tables 6 to 10 in Appendix B provide statistics on the level of external debt and show some of the principal external debt ratios.) While Costa Rica has the most serious foreign debt problem, most of the countries in the region have incurred significant amounts of foreign official and private debt that is a drain on the foreign exchange reserves and general economy of the countries. The situation has been worsened by the fall off in exports experienced by the region, and contributes to the general lack of investor confidence that prevails in most Central American countries.

As shown in Table 9, the total external debt of the six Central American countries considered in this study amounted to $16.1 billion in 1985. Of this amount, about $12.8 billion, almost 80%, was public and publicly guaranteed long-term debt. Although securitization is not necessarily limited to foreign debt--domestic debt could also be securitized--our recommendation focuses on the foreign debt aspect only, since the foreign debt problem is one of the major issues facing Central America today. If part of the current foreign debt were converted into negotiable securities, in a manner very similar to that used in the United States for consumer and auto loans, and second mortgages, it would aid the economies of the countries and contribute to the development of their capital markets. Securitization would benefit the Central American countries by reducing the absolute amount of debt owed to foreign creditors, reversing the flight of capital, and increasing the number of types and volume of instruments in the financial markets. There are two sets of activities that A.I.D. could engage in to help meet these objectives.

The first set of activities would involve engaging government officials in policy dialogue and gaining general support for the concept of securitization. The appeal of debt securities to investors will be much higher if the securities represent a packaging of the debt of several or all of the countries in Central America rather than issues covering the debt of individual countries. Achieving this packaging will require a regional approach and coordination of the participation of the parties that will be involved in the negotiations. It will also require investment banking interest in working with regional and other creditors to package the loans for issuance as securities. This is an activity that the proposed Central American Investment Company might undertake, depending on the timing of the organization of the company. In the interim, however, ROCAP could fulfill an important role in the initial discussions and coordination of this activity.

The recommended actions to achieve the necessary governmental support and develop a securitization program are as follows:

A. Recommended Actions

1 - ROCAP would organize a regional meeting of USAID private sector officers and economists to review both the merits and the approach to be followed in developing the securitization program.

2 - Establish assignments and a completion schedule for USAID personnel meetings with Central Bank and other appropriate officials to discuss and generate support for securitization.

3 - Conduct follow up regional session to determine status of participation of Central American countries and issues requiring resolution before approaching U.S. or other banks holding debt.

The second set of activities involve initiating contact and exploring the interest of merchant banks in packaging and issuing the debt securities.

1 - Assign responsibility for contacting several major and regional investment banks to determine their interest in negotiating and packaging debt issues.

2 - Coordinate and arrange for introduction of merchant banking personnel to government officials.

3 - Provide coordination and other intermediary support required to finalize securitization program.

B. Estimated Level of Effort and Expected Results

The discussions and negotiations required to finalize the securitization program will require an estimated 4-6 person-weeks per each USAID, and 6-8 person-weeks of ROCAP personnel efforts.

The expected results of these efforts would be:

- reduced foreign debt
- return of flight capital
- increased number of types and volume of instruments in the financial markets

The extent to which these results had been achieved could be measured approximately by examination of the national accounts and the general level of securities trading activities.

Recommendation No. 2:
Assist the missions in the development of debt-to-equity swap programs.

As shown in Appendix B, Table 10, virtually all of the countries in Central America are carrying a foreign debt burden that significantly offsets their export earnings and reduces their ability to meet foreign exchange requirements for development activities. Although the level of debt varies among the countries, both in terms of absolute amounts and in terms of the distribution of debt between official and private creditors (see Table 7), the team believes that all of the countries would benefit from the development of a debt for equity conversion program. Therefore, we recommend that ROCAP play a role in coordinating USAID efforts to provide assistance in this area. In the end of course, the swaps must be negotiated and approved by the individual countries, but considerable time and effort can be saved by coordinating the initial A.I.D. activities in promoting debt-to-equity programs.

In Appendix B, Table 11 provides a hypothetical example of the potential benefits of a debt for equity conversion program. The assumptions behind the table are that 10% of the total long-term public and publicly guaranteed foreign debt, outstanding and disbursed in 1985, is swapped for equity and that there is a 90% discount on payments and invested capital. The Central American countries would benefit from such a program in three important ways: the absolute level of foreign debt would be reduced, capital flows to service the debt would decline, and the level of equity in the particular country involved would increase.

A. Recommended Actions

1 - Organize a regional seminar to present a description of how debt to equity programs would work in Central America, and the advantages and disadvantages of these programs. The personnel making presentations at the seminar should include individuals from U.S. banks that have participated in swaps, representatives of companies that have exchanged debt for equity, and individuals with comparable experience from Chile, or Mexico that have been active in the programs in those countries.

2 - Identify one or more merchant or commercial banks that were willing to facilitate the process. This might involve A.I.D. funding some of the costs incurred by these personnel for consultation and travel.

3 - Assist USAID missions in identifying individuals with practical experience in debt/equity swaps that could assist the countries in establishing the necessary controls and review procedures.

B. Estimated Level of Effort and Expected Results

Organizing the debt/equity swap seminar is estimated to require 4-5 person-weeks of ROCAP personnel effort. The time required for preparation and participation by USAID personnel is estimated at 1 person-week per mission for the seminar, and 6-8 person-weeks on an intermittent basis for policy dialogue with central bank and other government personnel. A total of approximately 6 person-weeks of consulting time would be required for the various speakers and experts that would participate in the seminar.

The expected results of the debt/equity program would include:

- reduced foreign debt
- increased divestiture of state-owned enterprises
- increased level of domestic investment
- increased level of foreign investment

Recommendation No. 3: Establish a resident capability in ROCAP to assist in the unification of regulatory and tax environment

The experiences of the European Common Market, the Caribbean Common Market and the Alliance of South East Asian Nations (ASEAN) all demonstrate the economic advantages that can be derived from regional cooperation. While these markets might not function to the ideal envisioned, all of the countries are deriving benefits that have assured their continued participation in these markets. Much of the success of these cooperative agreements can be attributed to the willingness of the participants to discuss and make changes to regulations and policies that create barriers to increased market activity. The economic fortunes of the countries of Central America would be advanced considerably if such a forum could be established for the region. ROCAP has made a start in this direction in supporting the formation of the Association of Private Businesses of Central America and Panama (FEDEPRICAP), but more needs to be done in addressing the barrier to development created by the incompatibilities of the regulatory policies and legislation in the region. The most positive step that ROCAP could take in this direction would be to establish a resident capability to review and work with the individual countries in the revision of their policies to encourage the flow of goods and capital, and expansion of private enterprise. The potential sources for this assistance include INCAE, law schools, or possibly law firms. The key in the selection of a source is that the organization must have considerable experience in Central American laws and tax policies.

A. Recommended Action

1 - Query INCAE, U.S. law schools with a Central American orientation, and local law firms to determine their interests in conducting a comprehensive review of laws affecting commerce in Central America, and in chairing meetings with government officials in the region to discuss the changes required for improved growth.

2 - Based upon the responses received, initiate a competitive procurement action to obtain the required legal services.

3 - In cooperation with the USAID missions, assist in the organization of meetings and conferences with senior government officials to initiate dialogue on current legislative barriers to expansion of regional markets.

4 - Establish a clearinghouse to record and distribute information on the legislation affecting commerce enacted by the countries in the region.

B. Estimated Level of Effort and Expected Results

The efforts required of A.I.D. personnel to carry out these recommended actions are substantial. We estimate that the time required to seek out the potential sources of legal assistance could require 4-6 person-weeks of effort. Preparation of scope of work and other related procurement documentation will require approximately 10-12 person-weeks. Discussions and coordination with the bilateral missions could require another 4-6 person-weeks, some of which would be devoted to establishing the procedures for the clearinghouse.

The expected results of this effort would be significant in terms of their effects on trade and development of private enterprise in the region:

- increased reliance on floating exchange rates
- increased levels of intraregional trade
- increased number of business startups
- increased number of financial instruments

Recommendation No. 4: Establish a Central American Investment Company

Appendix A presents a description of the requirements for and the functions to be performed by the investment company that is recommended to meet the needs for capital in Central America.

A. Recommended Actions

Bringing the investment company into being will require considerable effort at both the regional level and at the individual country level. The major activities include the following:

1 - Initiate discussions with the International Finance Corporation (IFC) to gain their interest and possible commitment to assist in organization and funding of the investment company.

2 - Initiate discussions with investment companies such as Shearson-Lehman, First Boston Corporation, Morgan Stanley, and Merrill Lynch to determine their interest in providing professional management of an investment fund to be established in Central America.

3 - Organize one or more regional sessions to introduce representatives of these investment companies to USAID personnel and to provide a description of how the fund would operate.

4 - Provide technical assistance required by USAIDs to identify potential local investors or to promote the investment company.

5 - Identify the founding private shareholders and obtain their firm commitments for the initial capital.

6 - Initiate discussions with large debt holders and other international donors that might have a potential interest in activities of the company.

7 - Obtain reasonable assurances of participation from these donors.

8 - Prepare the A.I.D. project paper and other documentation necessary to initiate the project review and approval process.

9 - Prepare competitive or negotiated procurement package for selection of professional management team.

10 - Provide assistance to USAID missions, if necessary, in the formation of national investment companies.

B. Estimated Level of Effort and Expected Results

Promotion and organization of the investment company will be a labor intensive and time-consuming task. It will require meeting several times with potentially interested investment houses in the U.S., and numerous discussions with A.I.D./Washington and bilateral mission staff to establish a concrete design for the operation of the company. Discussions with investment houses are estimated to require 6-8 person-weeks. Organization and preparation of the various project documents could easily require 6 person-months of effort. Negotiations and discussions with the bilateral missions are expected to consume another 10-12 person-weeks of effort.

The most easily measured results to be expected from formation of the investment company are those related to business activity, such as:

- increased lending activity
- deepening of financial markets
- increased number of business start-ups
- increased number of jobs
- increases in Gross Domestic Products

Recommendation No. 5:
Assist in the establishment of a trade instrument

Economic growth in Central America is constrained by the relatively small size of the markets of the individual countries in the region and the differences in currency valuation policies that serve to discourage greater intra-regional trade. A trade instrument or mechanism that was accepted by all the countries in the region for payment of trade accounts would have an overwhelmingly beneficial effect on the flow of capital and trade throughout Central America. This would encourage private investment in the region because market opportunities would be greater and the risk associated with exchange rate uncertainties would be reduced.

Resolution of the issues involved in establishing a trade instrument can best be accomplished by promoting and negotiating the policy changes required at the regional level. Considerable work will be required at the individual country level, as well, which will require a considerable coordination effort.

A. Recommended Actions

1 - Promote and organize a regional seminar to be led by one or more consultants from the European Common Market countries with experience in the establishment of the Euro Currency Unit (ECU). The consultants should include trade and finance ministry officials, as well as commercial bankers, and suppliers. The presentation should cover the use of ECU as an instrument of trade finance, as well as its function as a financial instrument.

2 - Provide assistance to the countries in the region in the formation of trade strategies by conducting an analysis of the comparative advantages enjoyed by the countries in the region and export levels required to achieve more equitable trade flows.

3 - Assist the bilateral missions in conducting analyses and making presentations that demonstrate potential trade strategies and the advantages of reliance on a common trade instrument.

B. Estimated Level of Effort and Expected Results

Gaining agreement among the countries of Central America on a common instrument of trade is likely to involve a protracted effort. The most labor intensive aspect of the effort would occur during the organization and presentation of the conference to promote the use of trade instruments comparable to the ECU. While there appears to be some progress in Central America in the use of DICA-type instruments, it is clear that considerably more policy dialogue and deliberation by the governments will be required before there is a common instrument of trade in the region. We estimate that the effort to organize the conference will require 6-8 person-weeks, exclusive of the time of the presenters. Discussions with Central American governments related to the trade instrument could easily entail 1 or more person-years of effort by regional and bilateral mission personnel.

The expected results could easily justify the expenditure of this level of effort, as they would include:

- increased intra-regional trade
- increased number of instruments in the financial system
- reduced foreign exchange requirements

Recommendation No. 6: Organize a regional training program in financial analysis and loan management

In general, the banks in Central America are highly liquid and have money to lend. Moreover, there appears to be a reasonably large number of creditworthy projects in most countries in the region. As was noted repeatedly in the study, however, the traditional lending practices of the banks have tended to deter businessmen from relying on the banks as a source for capital beyond their short-term needs. Some of these practices are the result of the "closed shop" nature of the banking industry in Central America. However, new entrepreneurs trying to form companies also experience difficulty obtaining loans because of the limited analytical skills of the banks' staff. Rather than run the risk of making a wrong decision on the merits of a project, bank staff will either reject the loan or impose collateral or other conditions that create excessive costs for the borrower. Faced with these costs, and a now marginal rate of return, it is not surprising that many potential entrepreneurs decide to invest their time and money in markets outside the region.

Part of the solution toward increasing the participation of the banks in expanding the business base in Central America lies in providing training and increasing the financial analysis skills of the bank staff. This training should include financial and credit analysis, loan management and debt collection. ROCAP should also explore with the Comptroller of the Currency, that office's willingness to organize and conduct a regional training program for bank examiners.

A. <u>Recommended Action</u>

1 - Ascertain, in coordination with the bilateral missions, the willingness of private and state-owned banks to release staff for intensive training in financial analysis and loan management practices. Bank management should also be queried on specific training requirements that they have identified.

2 - Contact the major U.S. banks operating in the region and query them regarding the use of their training facilities in the region, or select an appropriate site available through other sources.

3 - Develop project documentation and budget estimates for conducting the regional training program.

4 - Prepare a scope of work and a competitive procurement package to solicit bids from potential contractors, including U.S. banks, to conduct the training.

B. Estimated Level of Effort and Expected Results

While some time will be devoted to coordination with the USAID missions and soliciting the support of the commercial banks, the major portion of the effort will be taken up with preparation of the project documentation and the procurement package. We estimate that approximately 2 person-weeks of time per mission will be required to canvass the banks. Coordination of this effort and compilation of the results will require about 4 person-weeks of ROCAP personnel time. Preparation of the project documentation and procurement materials is expected to take 12-15 person-weeks of effort.

Here are a number of very positive results that can be expected from the training. They include:

- increased skill levels of banking personnel
- increased number of term loans
- reduced collateral requirements
- increased participation of banks in private enterprise

Recommendation No. 7: Establish a regional MIS to provide improved coordination and dissemination of private enterprise activities

The near collapse of the common market has created a situation in which many companies which were established to serve regional markets are now operating at very low levels of plant utilization. Insufficient coordination of A.I.D. assistance which has led to duplication of some private enterprise activities has also contributed to low plant utilization. Tomato processing plants and cement plants probably provide the most common examples of this situation. Given the fragile nature of the economies in the region, and the very small markets that have resulted from the current trade and currency policies, it is very important that A.I.D. support private enterprise projects that will improve rather than worsen the current imbalances and excess capacities. One way to accomplish this would be to improve the distribution of information related to private enterprise activities among the bilateral missions. This system would alert the missions to projects being considered by other missions or international donors that were duplicative of efforts they might be sponsoring. With this information, it would be possible to restructure the project in a way that made more sense given the other activity, or to divert the assistance to a more productive activity.

The LAC/PS Bureau has suggested this might be an activity of interest to them. The team agrees that the LAC/PS Bureau should take the initiative in implementing this recommendation.

A. Recommended Actions

1 - Solicit input from the missions on their information needs and how well the FPC\CDIE and other systems are meeting USAID needs.

2 - Prepare a final design for the system based upon the comments of the USAIDs and distribute it for review and approval.

3 - Prepare a statement of work and a competitive procurement package to obtain the services of a contractor to program and install the management information system on the computer system currently in use.

B. Estimated Level of Effort and Expected Results

It is estimated that the level of effort required of A.I.D. personnel for review and finalization of the design for the MIS would amount to about 1 person-week for each mission and about 3 person-weeks of effort at the bureau level to coordinate the distribution and review of the system by the other missions. The cost of the work to be done by the systems contractor is more difficult to estimate, but if the missions can get by with hardcopy reports rather than accessing the system directly through a telecommunications net, the cost of developing such a system should be in the range of $150,000 to $200,000 maximum.

Appendix A

CENTRAL AMERICAN INVESTMENT COMPANY

A. Summary of the Requirement

This study, and several before it, have demonstrated that there are critical needs throughout Central America for capital to expand business and to develop the financial markets to service and sustain business development.

These needs are not being met by existing financial institutions which are rigidly structured in profitable local niches. Even if existing policies were revised to provide tax incentives and to reduce the current barriers to capital movement, particularly those effecting the free trade of commercial paper, there would still not be an adequate vehicle to marshall capital, and to deliver the financial and other resources needed to expand and modernize the private sector in Central America.

An approach that holds considerable promise for addressing these urgent needs, and one that would provoke initiation of the badly needed policy changes, is to create a Central American, for-profit, private investment company. This company would be regional in its linkage to outside sources of funding, technology, market access and management, but national in its operations in that the resources of the company would be applied through local investment groups. Its principal business would be to help local investment groups in the development of financial institutions and instruments which would mobilize capital for investment in high priority industries, notably those involved in agri/marine export. It would also assist these groups to evaluate and structure opportunities, acquire financial, technical and management resources and gain market access. The company would be professionally managed by an international investment company.

The initial capital would be provided by a selected group of Central American businessmen brought together by a core group of investment professionals experienced in the business and in operating in Central America. The capital from these sources would be augmented by:

1 - leverage funding from international agencies, of which A.I.D. would be expected to be a leader, to include OPIC, IFC, IDB, and European and Asian agencies.

2 - subscriptions from holders of Central American debt converting their loans into equity in the investment company.

3 - the eventual issuance by the company of its own paper, possibly securitized by Central American debt for which it would also provide a trading mechanism.

4 - flight capital that the company is able to attract back to the region.

It is proposed that ROCAP, together with the A.I.D. missions in the region, take the steps to form a Central American investment company. The next key steps will involve identifying potential professional management groups, designing the financial structure of the company, and obtaining initial commitments of capital.

B. Background to the Requirement

This study of capital markets in Central America confirmed the need, throughout the region, to refurbish and expand the private sector in order to supply the jobs and foreign exchange necessary for development. Yet the assessment of the current situation throughout the region concluded that the existing conditions are tantamount to disinvestment.

Part of the problem was attributed to administrative obstacles to the creation of new enterprises, a situation which has helped to sustain the existing monopolies and oligopolies that characterize competition in the region, and to bureaucratic rigidities that stifle agile competition in the market. The tendencies of the governments in the region to follow tax policies that favor public sector finance are a major component of the structural barriers to attracting investment. Exchange rate policies that have either resulted in overvaluation of currencies, or a profusion of exchange rates, or both, have been a major barrier to trade in the region and consequently to the formation of businesses that need regional markets.

The political situation in Nicaragua, and to a lesser extent in El Salvador, has taken its toll on investor interest and private enterprise development in the region. The worsening of economic conditions in the region as a result of the virtual collapse of the common market, has served to reinforce rather than ameliorate the conditions that brought about the collapse in the first place. And as result, the countries in the region have all assumed defensive and nationalistic postures with regard to their economic policies.

The financial markets in the region were perceived to be rudimentary and underdeveloped in their dependence upon bank lending. Even that source of capital is available only to the favored and on terms which are barely commercially acceptable. Corporate equity is closely held and is not considered a normal investment medium for savings. Tax, banking, and company laws in the region tend to perpetuate the status quo rather than encourage competition which is vitally needed for economic growth. As a result, it is very difficult to mobilize financial resources for investment outside the closely held activities of the dominant economic groups. Given the current economic and social environment in these countries, these groups have little incentive to increase their investments or to encourage competition.

Despite these obstacles, business in the region has shown a remarkable capacity to survive, and given a reasonable opportunity, could capitalize on the comparative advantages of the countries in the region, and have a significant effect in creating additional employment and increasing exports.

Key to the expansion of private enterprise in Central America is access to investment capital. At present, the region is devoid of financial services institutions that are committed to investment and risk taking, and development of the capital market beyond traditional banking services. There is an absence of any major source of investment capital for new ventures, and a lack, in most countries, of medium term funding for new investments and for the expansion of existing enterprises.

The President's Task Force on International Private Enterprise saw this clearly and recommended that A.I.D. not only provide more support to intermediary credit institutions in developing countries, but also establish equity windows in these institutions.

The National Bipartisan Commission on Central America (the Kissinger Commission) encouraged the formation of a privately-owned venture capital company for Central America to address the need for investment capital. Further support for this approach has come from other studies including the Winrock International Report of 1985 to the A.I.D. mission in Honduras which recommended the creation of a trade and investment vehicle, and the Agricultural Task Force Report (1987) to the A.I.D. mission in Guatemala which urged A.I.D. to be the catalyst in the formation of a private regional investment institution.

C. Proposed Activities of the Investment Company

We recommend the formation of an investment company in Central America as part of a strategy for support of financial innovation in the region, and to meet an urgent need for capital that will not be satisfied by existing sources under the current conditions in the region. This private non-bank corporation would serve two very important purposes:

- it would stimulate the creation and growth of companies in Central America that are dedicated to the introduction of new financial services, including venture capital, and;

- it would assist investment groups that invest in the production of exports, particularly marine and agriculture-based.

1. Proposed Services

The proposed investment company would provide equity capital (on a minority participation basis), medium and long-term investment funds, and ancillary services. These services would include access to markets, technology and management to assist them in generating employment and foreign exchange. The company would also assist businessmen in developing new financial instruments and services to aid in the development of a capital market that will support further business expansion.

Among the activities proposed for the company are these:

- equity and venture capital investments.
  The company would participate through the national investment companies in the equity of small and medium scale companies to contribute to their development and growth;

- securities underwriting, dealing and brokerage.
  The company would act as an underwriter, broker and dealer in government securities, corporate debt and equity securities, and money market instruments;

- financial advisory services.
  The company would provide corporate financial services consisting of advice on appropriate capital structure financing, investment analysis, joint ventures and money management. It would also provide comprehensive financial services advice to individuals;

- short and term lending.
  The company would provide short and term lending on its own account. Margin financing would be provided for equity and bond acquisition on a term basis. The company would also provide short-term financing of raw materials and finished goods inventories, as well as medium-term financing for acquisition of machinery and equipment for export oriented enterprises;

- guarantees
  The company would provide partial and full guarantees to other financial institutions for a fee;

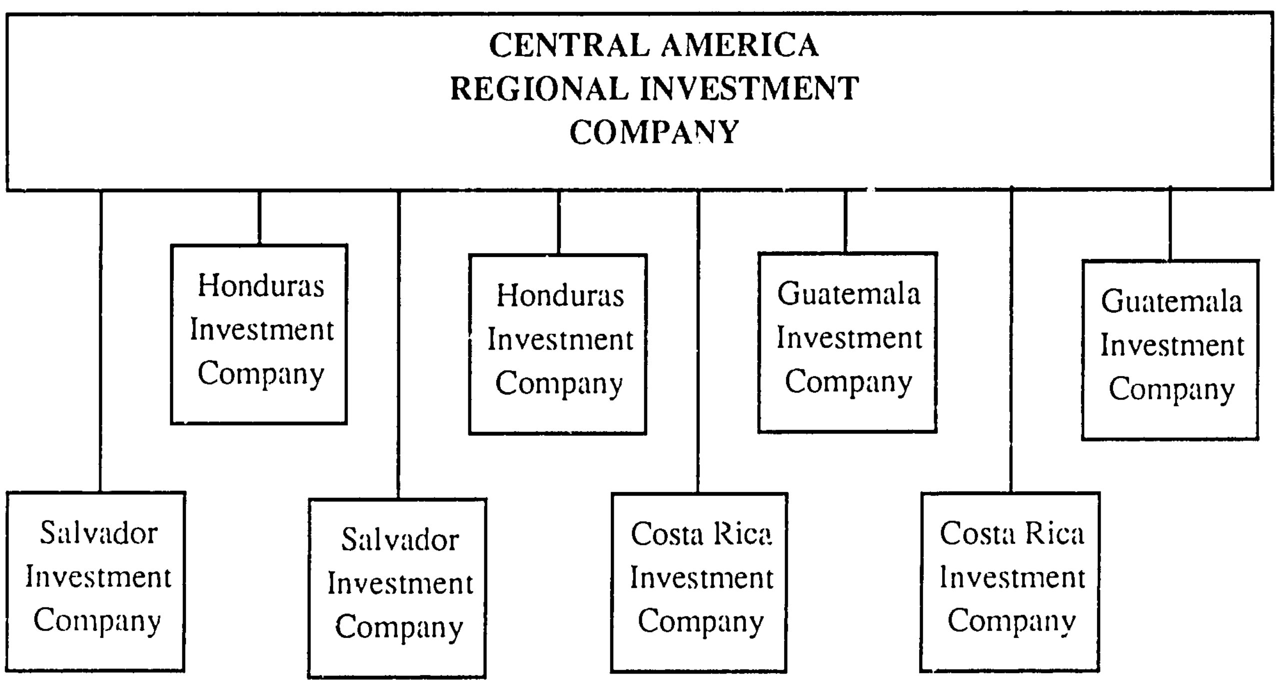
- trade services
  The company would bring exporters together with potential investors/marketers/buyers, and do sourcing in Central America for foreign manufacturers. It would also provide import services for local clients.

- hedging services
  The company would provide advice on foreign exchange, commodities and currency swaps. These services would be provided or directly arranged both in Central America and abroad.

The lending activities of the regional company and the national companies could be protected from excessive foreign exchange risk through the use of Letters of Credit. As loans are approved the investment company (regional or national) would deposit the dollar equivalent of the loan in a bank in the U.S. The bank would be instructed to establish a Letter of Credit for a bank in the country of the borrower. The borrower would draw down the proceeds of the loan through the local bank. This method significantly reduces the foreign exchange risk to the lender, in that the combination of the loan interest and the interest on the U.S. account provides the lender with a hedge against modest levels of devaluation. At the currently prevailing rates of interest, for example, the lender could expect to breakeven even if the local currency fell 10%-15% over the period of the loan.

2. Organization Strategy

While the proposed investment company operations are seen as regional in scope, investment activities would be carried out by a multiple number of investment companies organized in each of the countries in the region. The principal purposes of the regional level organization are to serve as a central focus for funding provided by international donors, and as a source of equity and debt capital for national investment companies. The proposed organizational relationships are depicted below:



The strategy that was selected for organization and operation of the company offers two very important advantages to successful operation of the company:

- the advantages of a regional organization in attracting capital and professional management, and;

- the advantages offered in leaving responsibility for project evaluation and investment decisions to local groups who are more familiar with the opportunities and conditions in their own countries.

More specifically, the advantages of establishing a regional investment company to serve the needs of investment companies in each of the countries in Central America are as follows:

- a regional organization will attract more initial capital because it will create a pool of Central American investors;

- a regional organization will offer greater diversity of risk;

- a regional organization is more likely to attract the funds of international donors than multiple organizations, and;

- the larger size of the investment pool will serve to attract professional investment managers.

Investment activity will be conducted at the country level and will involve the regional organization only as a source of equity or debt capital. The investments are expected to be primarily national in scope, but investments in operations involving two or more countries might occur. The regional organization might be of assistance in these instances, if required. The relationships between the investment company and the national groups would be carried out as follows:

- investments would be made through the country investment groups, whether they invest directly in productive businesses or in those producing financial services. In either case the Company would leverage these groups' financial and other business capital with outside funding, technology and market access;

- proposals would be considered by the Company from any groups meeting its management and financial requirements. The intent is to stimulate competition in the supply of capital and other financial services within the Central American countries. It is anticipated that the Company would become involved with 4-10 groups within a country. This approach contrasts intentionally with past efforts that focused on creating one investment vehicle in each country. In effect, this approach created one more monopoly which subsequently adopted very conservative lending practices to preserve its existence.

D. Investment Company Sponsors

The initial investors will be a group of leading Central American businessmen who have investments and interests in the region. The group will be brought together by a core group of individuals with investment banking experience and practical experience in investing in Central America. As mentioned previously, the potential investment pool for The Company is expected to be large enough to attract professional managers from the larger investment houses. The management fees applied by these firms are highly competitive with the costs of a staff recruited by The Company. Contracting the management function out also offers advantages in the ease of replacement of the management team for inadequate performance.

E. Capital Structure

The initial source of capital would be \$3-\$5 million from regional businessmen, firms and banks. Additional capital totalling \$25 million initially and \$100 million subsequently would be raised from several sources including:

- international donor agencies including A.I.D., OPIC, IFC, IDB, and European and Asian development agencies;

- non-money center banks or other holders of Central American debt that would exchange the debt for shares or other paper of the Company;

- Central American flight capital - the Company would present an opportunity to earn a reasonable return in comparative safety; and,

- multinational companies that have blocked funds in the region and recognize the Company as an opportunity to repatriate these funds.

F. Investment Objectives

The principal objectives of the Company will be to provide equity capital, plus medium and long-term financing, and access to technology, markets and management to investment groups and their projects in the countries in Central America.

The projects to be invested in would possess high growth possibilities and be in basically two areas:

- financial market development (both instruments and institutions);

- products/services which exploit comparative advantage, such as shrimp farming, vegetable processing, etc. The projects need not be regional in scope, and in fact, are likely to be only national in scope in the early years of operation.

The key features of the Company's activities and policies would be:

- provide support to local investment groups (Company investees) in assessment of technology, markets and management;

- represent the Company on the Boards of investment groups;

- encourage formation of a multiple number of investment groups within each country within the management and capital resources of the Company;

- attract funding through conversion of or swapping of Central American foreign debt. The transformation of debt currently held by foreign banks into tradeable equity positions in the company should come to represent a profitable business segment for the Company. Moreover, the Company's active pursuit of this business should position it in Central American privatization programs as a vehicle for divestiture of parastatals through debt to equity swaps.

- issuing the Company's own paper. The paper initially could be securitized by hard currency debt of Central America. A mutual fund could be created by the Company to broaden shareholding in the region and to enhance the Company's own divestiture options.

G. Organization

The company will be organized in a country which provides the necessary flexibility for managing investments in various Central American countries, avoids double or otherwise penalizing taxation, and has a stable, freely convertible currency. Panama is already home to other comparable investment companies, and is a likely candidate assuming that the political situation does not deteriorate any further.

1. Location of Operations

The operating headquarters of the company should be located in Miami to facilitate its joint venture and marketing activities. The other advantage of a Miami location is that it would be regarded as a neutral site by Central American investors, i.e., it avoids the concern that if the Company is in Guatemala, for example, it will favor Guatemalan investee companies.

2. Board Composition

Management of the Company would be provided by a Board of Directors elected by the shareholders. Directors would not be required to be shareholders, but the composition of the Board would be made up of businessmen representing each country in the region, and others with special experience which will enhance the operations of the Company.

The Board of Directors would appoint a non-rotating Chairman of the Board of Directors. The Managing Director would be selected by the professional investment company responsible for managing the fund, subject to the approval of the Board.

3. National Representation

Advisory Boards would be formed in each country comprised of 5 to a maximum of 10 executives from the local business, financial and business-education community. Recommendations for membership on these advisory boards would come from businessmen's organizations and would be confirmed by the Company's Board of Directors. The principal functions of these advisory boards, in addition to providing membership on the Board of Directors, would be to advise the Board on overall business strategies and to assist the Company's management in developing and assessing business opportunities.

H. Management

It is proposed that management of the Company will be provided by a professional international investment company, e.g., Shearson-Lehman, First Boston, Prudential Bache. In the event that a satisfactory arrangement cannot be reached with one of these investment companies, the organizers will assemble a team of experienced professionals that know the region well from the investment banking community.

It is estimated that the administrative cost of running the Company will be about $300,000 to $400,000 per year in the initial years. A general guideline for companies of this type is that administrative costs should not exceed 2.5% of the capital employed. This suggests that it might be necessary to subsidize the administrative operations until the paid in capital position of the Company reached $15 million.

iu

I. Actions Required

The actions recommended for regional implementation in Chapter IV include a recommendation to establish the investment company, and indicate the principal activities that A.I.D. must undertake in carrying out that recommendation. Basically, this will require organizing a small group of potential sponsors of the Company that would be responsible, with A.I.D., for firming up the design and management of the Company, and for making initial contacts with potential Central American investors and international donors to establish their level of participation. The final product of these efforts would be a prospectus that would identify, as a minimum:

- Structure of the Company
- Sponsors
- Capitalization
- Board of Directors
- Investment Committee
- Management and staff
- Investment objectives
- Financial plan
- Proposed share offering
- Projected financial results

Appendix B

TABLE 1

Total GDP Growth Rates
(Percentages)

	Cumulative Average	Annual				
	1970-1980	1981	1982	1983	1984	1985*
BELIZE**	- -	0.7	-4.9	1.5	1.3	- -
COSTA RICA	5.6	-2.3	-7.3	2.9	7.5	1.6
EL SALVADOR	3.2	-8.3	-5.6	0.8	1.5	1.6
GUATEMALA	5.7	0.7	-3.6	-2.5	0.6	-1.1
HONDURAS	4.8	1.2	-1.8	-0.5	2.8	3.0
PANAMA	5.5	4.2	5.5	0.4	-0.4	3.3

*Preliminary estimate

SOURCE: Inter-American Development Bank, *Economic and Social Progress in Latin America*, (Washington, DC: IDB, 1986), p.17

**SOURCE: International Monetary Fund, "Belize - Recent Economic Developments", (Washington, DC: IMF, June 12, 1985), p. iv

TABLE 2

GDP Per Capita Growth Rates
(Percentages)

	Cumulative Average	Annual				
	1970-1980	1981	1982	1983	1984	1985*
BELIZE**	- -	-1.1	-6.7	-0.3	-0.5	- -
COSTA RICA	3.1	-4.8	-9.7	0.2	4.8	-0.9
EL SALVADOR	1.7	-9.0	-6.4	0.0	-1.3	-0.5
GUATEMALA	2.6	-2.1	-6.3	-5.3	-2.1	-3.9
HONDURAS	1.7	-2.1	-4.9	-3.8	-0.6	-0.2
PANAMA	4.2	1.8	3.2	-1.7	-2.5	1.0

*Preliminary estimate

SOURCE: Inter-American Development Bank, *Economic and Social Progress in Latin America*, (Washington, DC: IDB, 1986), p.17

**SOURCE: International Monetary Fund, "Belize - Recent Economic Developments", (Washington, DC: IMF, June 12, 1985), p. iv

TABLE 3

Terms of Trade
(Index 1980=100)

	1981	1982	1983	1984	1985*
BELIZE **	90.8	71.1	70.9	80.6	72.8
COSTA RICA	85.6	76.8	69.8	71.5	69.7
EL SALVADOR	87.4	86.7	75.7	82.4	79.6
GUATEMALA	91.8	79.7	76.0	78.1	75.8
HONDURAS	87.0	82.6	80.6	80.6	78.5
PANAMA	99.8	80.9	82.5	84.1	82.0

*Preliminary estimate

SOURCE: Inter-American Development Bank, *Economic and Social Progress in Latin America*, (Washington, DC: IDB, 1986)

**SOURCE: World Bank, "Belize Economic Report". Report No. 6550-BEL, (Washington, DC: World Bank, 18 December, 1986), p. 5

TABLE 4

Gross Domestic Investment by Dollars
(In millions of 1982 US $)

	1980	1981	1982	1983	1984	1985*
BELIZE **	44	42	44	34	39	33
COSTA RICA	1,208	752	561	746	886	970
EL SALVADOR	522	502	451	412	424	393
GUATEMALA	1,177	1,340	1,097	911	953	793
HONDURAS	781	648	395	419	568	562
PANAMA	1,066	1,133	1,053	833	758	758

*Preliminary estimate

SOURCE: Inter-American Development Bank, *Economic and Social Progress in Latin America*, (Washington, DC: IDB, 1986), p. 395

**SOURCE: World Bank, "Belize Economic Report", Report No. 6550-BEL, (Washington, DC: World Bank, 18 December, 1986), p. 31

TABLE 5

Central American Common Market Exports
1980 - 1984
(Millions of Central American pesos)

	1980	1981	1982	1983	1984
COSTA RICA	270.3	238.0	167.2	198.2	171.8
EL SALVADOR	295.8	206.5	174.2	164.9	157.2
GUATEMALA	403.7	355.5	320.1	308.7	291.4
HONDURAS	83.9	65.9	51.9	61.3	49.4
TOTAL	1053.7	865.9	713.4	733.1	669.8

SOURCE: "Macroeconomic Statistics of Central America", Secretaria Permanente del Tratado General de Integracion Economica Centroamericana, Guatemala City, June 1985, pg. 31; cited in Richard E. Feinberg and Bruce M. Bagley, *Development Postponed: The Political Economy of Central America in the 1980s*, (Boulder:Westview Press, 1986), p.25

TABLE 6

Central America Total External Debt*
1980 - 1985
(US$ Millions)

YEAR	1980	1981	1982	1983	1984	1985
BELIZE	62.9	60.1	69.3	100.3	96.6	117.6
COSTA RICA	2,744.7	3,264.6	3,463.3	3,889.9	3,872.8	4,190.7
EL SALVADOR	914.5	1,130.5	1,404.7	1,679.9	1,708.7	1,735.5
GUATEMALA	1,165.9	1,264.3	1,537.2	1,801.9	2,386.4	2,595.4
HONDURAS	1,469.3	1,682.3	1,801.0	2,086.7	2,326.8	2,712.4
PANAMA	2,986.4	3,378.0	3,932.7	4,389.3	4,412.8	4,709.8
TOTAL	9,343.7	10,779.8	12,208.2	13,948.0	14,804.1	16,061.4

Total External Debt is the sum of public long-term debt, private nonguaranteed long-term debt, estimated short-term debt, and the use of IMF credit.

Source: The World Bank, *World Debt Tables: External Debt of Developing Countries*, 1986-87 Edition (The World Bank: Washington, D.C.)

TABLE 7
Central America
Public and Publicly Guaranteed Long-Term External Debt
(Debt Outstanding and Disbursed - DOD)
By type of creditor
1980 - 1985
(US$ Millions)

YEAR	1980	1981	1982	1983	1984	1985
BELIZE						
DOD	46.9	56.1	62.3	75.5	75.9	94.2
Official	39.8	45.8	47.7	57.9	57.7	78.5
Private	7.1	10.3	14.6	17.6	18.2	15.6
COSTA RICA						
DOD	1,700.9	2,251.9	2,469.3	3,325.3	3,358.1	3,665.2
Official	795.4	938.8	1,105.9	1,436.6	1,459.5	1,745.4
Private	905.6	1,313.1	1,363.5	1,888.7	1,898.7	1,919.8
EL SALVADOR						
DOD	527.1	727.3	957.5	1,346.1	1,387.1	1,460.4
Official	515.6	716.2	866.4	1,127.3	1,193.1	1,310.0
Private	11.6	11.1	91.2	218.8	194.0	150.4
GUATEMALA						
DOD	548.9	806.6	1,144.0	1,388.6	1,990.7	2,148.1
Official	533.8	739.3	997.2	1,095.7	1,194.3	1,355.2
Private	15.1	67.3	146.9	292.9	796.4	792.9
HONDURAS						
DOD	991.2	1,232.9	1,390.5	1,614.3	1,859.9	2,178.4
Official	709.2	858.4	1,002.9	1,190.2	1,437.0	1,716.9
Private	282.0	374.5	387.6	424.1	423.0	461.5
PANAMA						
DOD	2,283.3	2,441.4	2,926.7	3,146.5	3,229.7	3,275.6
Official	581.1	682.2	830.5	1,006.0	1,078.9	1,144.3
Private	1,702.1	1,759.2	2,096.2	2,140.5	2,150.8	2,131.3

TABLE 7 (continued)

Note on definitions:

Long-term external debt: refers to debt that has an original or extended maturity of over one year and that is owed to nonresidents and repayable in foreign currency, goods, or services.

Public debt: refers to an external obligation of a public debtor, including the national government, a political subdivision (or an agency of either), and autonomous public bodies.

Publicly guaranteed debt: refers to an external obligation of a private debtor that is not guaranteed by a public entity.

Debt outstanding and disbursed (DOD): refers to total outstanding debt at year end.

Official creditors: includes loans and credits from the World Bank, regional development banks, and other multilateral and intergovernmental agencies, as well as bilateral loans (loans from governments and their agencies, including central banks, and loans from governments).

Private creditors: includes loans from suppliers and loans from private banks and other private financial institutions, and publicly issued and privately placed bonds or similar instruments.

Source: The World Bank, *World Debt Tables: External Debt of Developing Countries*, 1986-87 Edition (The World Bank: Washington, D.C.)

TABLE 8

Central America Total Public Debt Service*
1980 - 1985
(US$ Millions)

YEAR	1980	1981	1982	1983	1984	1985
BELIZE	1.4	3.2	4.6	5.0	5.1	14.8
COSTA RICA	204.8	196.6	137.6	600.7	350.1	464.1
EL SALVADOR	41.7	47.5	68.0	155.9	194.0	195.9
GUATEMALA	44.8	60.1	102.5	145.8	194.6	254.8
HONDURAS	98.4	117.3	148.9	120.8	129.9	170.5
PANAMA	465.6	494.8	618.0	479.7	536.1	431.6

* Debt service payments are actual repayments of principal (amortization) and payments of interest made in foreign currencies, goods, or services in the year specified.

Source: The World Bank, *World Debt Tables: External Debt of Developing Countries*, 1986-87 Edition (The World Bank: Washington, D.C.)

TABLE 9
Central America Projected Public Debt Service*
(1986 - 1990)
(US$ Millions)

YEAR	1986	1987	1988	1989	1990
BELIZE*	14.9	13.7	12.9	9.8	10.4
COSTA RICA	536.4	957.8	750.9	687.1	618.9
EL SALVADOR	204.7	189.7	186.4	182.7	156.5
GUATEMALA	539.7	332.6	471.1	554.1	219.3
HONDURAS	287.0	284.9	267.6	248.5	224.3
PANAMA	476.9	852.6	779.0	651.7	400.0

* Projected public service payments are estimates of payments due on existing debt outstanding, including undisbursed. They do not include service payments that may become due as a result of new loans contracted in subsequent years. Nor do they allow for effects on service payments of changes in repayment patterns due to prepayment of loans, or to rescheduling or refinancing,including repayment of outstanding arrears, that occurred subsequent to the latest year of reported debt data.

Source: The World Bank, *World Debt Tables: External Debt of Developing Countries*, 1986-87 Edition (The World Bank: Washington, D.C.)

TABLE 10
Central America
Principal External Debt Ratios
1980 - 1985

YEAR	1980	1981	1982	1983	1984	1985
BELIZE						
EDT/XGS (%)	--	--	--	--	76.0	92.2
EDT/GNP (%)	37.2	33.2	43.0	59.7	56.3	67.0
DOD/XGS (%)	---	---	---	---	59.7	73.8
DOD/GNP (%)	27.7	31.0	38.7	44.9	44.2	53.6
TDS/XGS (%)	--	--	--	--	4.0	11.6
TDS/GNP (%)	0.8	1.8	2.8	3.0	3.0	8.5
INT/XGS (%)	--	--	--	--	2.4	4.4
INT/GNP (%)	0.5	1.0	1.4	1.3	1.8	3.2
COSTA RICA						
EDT/XGS (%)	225.1	272.3	303.2	331.6	294.9	330.1
EDT/GNP (%)	59.7	140.2	159.1	138.2	119.4	126.3
DOD/XGS (%)	139.5	187.8	216.2	283.5	255.8	288.7
DOD/GNP (%)	37.0	96.7	113.4	118.2	103.5	110.4
TDS/XGS (%)	16.8	16.4	12.0	51.2	26.7	36.6
TDS/GNP (%)	4.5	8.4	6.3	21.3	10.8	14.0
INT/XGS (%)	10.6	9.6	7.1	42.9	17.3	26.3
INT/GNP (%)	2.8	4.9	3.7	17.9	7.0	10.1
EL SALVADOR						
EDT/XGS (%)	72.0	116.5	161.0	184.9	179.1	--
EDT/GNP (%)	26.0	33.3	41.3	46.8	43.2	46.8
DOD/XGS (%)	41.5	75.0	109.8	148.2	145.4	-
DOD/GNP (%)	15.0	21.4	28.2	37.5	35.1	39.4
TDS/XGS (%)	3.3	4.9	7.8	17.2	20.3	--
TDS/GNP (%)	1.2	1.4	2.0	4.3	4.9	5.3
INT/XGS (%)	1.9	3.1	4.1	6.9	7.5	
INT/GNP (%)	0.7	0.9	1.1	1.8	1.8	1.8

TABLE 10 (continued)

YEAR	1980	1981	1982	1983	1984	1985
GUATEMALA						
EDT/XGS (%)	63.6	83.4	117.3	149.7	189.3	217.1
EDT/GNP (%)	14.9	14.9	17.9	20.2	25.8	23.9
DOD/XGS (%)	29.9	53.2	87.3	115.3	157.9	179.7
DOD/GNP (%)	7.0	9.5	13.3	15.5	21.5	19.8
TDS/XGS (%)	2.4	4.0	7.8	12.1	15.4	21.3
TDS/GNP (%)	0.6	0.7	1.2	1.6	2.1	2.3
INT/XGS (%)	1.6	2.5	4.5	6.2	6.7	8.9
INT/GNP (%)	0.4	0.4	0.7	0.8	0.9	1.0
HONDURAS						
EDT/XGS (%)	151.9	186.3	229.9	256.1	266.9	280.6
EDT/GNP (%)	62.5	67.0	69.3	74.3	77.7	85.1
DOD/XGS (%)	102.5	136.5	177.5	198.1	213.3	225.4
DOD/GNP (%)	42.2	49.1	53.5	57.5	62.1	68.3
TDS/XGS (%)	10.2	13.0	19.0	14.8	14.9	17.6
TDS/GNP (%)	4.2	4.7	5.7	4.3	4.3	5.3
INT/XGS (%)	6.1	8.7	12.4	10.2	9.3	9.9
INT/GNP (%)	2.5	3.1	3.7	3.0	2.7	3.0

TABLE 10 (continued)

YEAR	1980	1981	1982	1983	1984	1985
PANAMA						
EDT/XGS (%)	38.6	34.0	41.8	60.2	67.4	73.8
EDT/GNP (%)	89.6	92.3	98.6	108.4	105.3	107.7
DOD/XGS (%)	29.5	24.6	31.1	43.1	49.3	51.4
DOD/GNP (%)	68.5	66.7	73.4	77.7	77.1	74.9
TDS/XGS (%)	6.0	5.0	6.6	6.6	8.2	6.8
TDS/GNP (%)	14.0	13.5	15.5	11.8	12.8	9.9
INT/XGS (%)	3.3	2.8	3.6	4.0	4.6	4.7
INT/GNP (%)	7.6	7.7	8.4	7.2	7.2	6.9

Symbols used:

EDT: total external debt
XGS: exports of goods and services
DOD: public and publicly guaranteed debt outstanding and disbursed
GNP: gross national product
TDS: total debt service on public and publicly guaranteed debt
INT: interest payments on public and publicly guaranteed debt

Source: The World Bank, *World Debt Tables: External Debt of Developing Countries*, 1986-87 Edition (The World Bank: Washington, D.C.)

TABLE 11

POTENTIAL BENEFITS OF DEBT TO EQUITY SWAPS

(in millions of US dollars)

Before Swap

COUNTRY	BELIZE	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS	PANAMA	TOTAL
GROSS NATIONAL PRODUCT (GNP)	$175.6	$3,319.1	$3,708.3	$10,844.0	$3,189.0	$4,371.4	$25,607.4
EXPORTS OF GOODS & SERVICES (XGS)	$127.6	$1,269.6	$954.3	$1,195.4	$966.5	$6,378.3	$10,891.7
TOTAL EXTERNAL DEBT (EDT)	$117.6	$4,190.7	$1,735.5	$2,595.4	$2,712.4	$4,709.8	$16,061.4
PUBLIC & PUBLICLY GUARANTEED LONG-TERM DEBT (DOD)	$94.2	$3,665.2	$1,460.4	$2,148.1	$2,178.4	$3,275.6	$12,821.9
TOTAL PUBLIC DEBT SERVICE (TDS)	$14.8	$464.1	$195.9	$254.8	$170.5	$431.6	$1,531.7
EDT/XGS	92.2%	330.1%	181.9%	217.1%	280.6%	73.8%	147.5%
EDT/GNP	67.0%	126.3%	46.8%	23.9%	85.1%	107.7%	62.7%
DOD/XGS	73.8%	288.7%	153.0%	179.7%	225.4%	51.4%	117.7%
DOD/GNP	53.6%	110.4%	39.4%	19.8%	68.3%	74.9%	50.1%
TDS/XGS	11.6%	36.6%	20.5%	21.3%	17.6%	6.8%	14.1%
TDS/GNP	8.4%	14.0%	5.3%	2.3%	5.3%	9.9%	6.0%
GAINS FROM SWAP							
Reduction in absolute amount of debt:	$9.4	$366.5	$146.0	$214.8	$217.8	$327.6	$1,282.2
Reduction in capital outflows to service debt:	$1.5	$46.4	$19.6	$25.5	$17.1	$43.2	$153.2
Increase in equity\investment:	$8.5	$329.9	$131.4	$193.3	$196.1	$294.8	$1,154.0
AFTER SWAP							
TOTAL EXTERNAL DEBT (EDT)	$108.2	$3,824.2	$1,589.5	$2,380.6	$2,494.6	$4,382.2	$14,779.2
PUBLIC & PUBLICLY GUARANTEED LONG-TERM DEBT (DOD)	$84.8	$3,298.7	$1,314.4	$1,933.3	$1,960.6	$2,948.0	$11,539.7
TOTAL PUBLIC DEBT SERVICE (TDS)	$13.3	$417.7	$176.3	$229.3	$153.5	$388.4	$1,378.5
EDT/XGS	84.8%	301.2%	166.6%	199.1%	258.1%	68.7%	135.7%
EDT/GNP	61.6%	115.2%	42.9%	22.0%	78.2%	100.2%	57.7%
DOD/XGS	66.4%	259.8%	137.7%	161.7%	202.9%	46.2%	105.9%
DOD/GNP	48.3%	99.4%	35.4%	17.8%	61.5%	67.4%	45.1%
TDS/XGS	10.4%	32.9%	18.5%	19.2%	15.9%	6.1%	12.7%
TDS/GNP	7.6%	12.6%	4.8%	2.1%	4.8%	8.9%	5.4%

Assumptions: Swap 10% of Public and Publicly Guaranteed Long-Term External Debt, Outstanding and Disbursed in 1985, for equity, at a discount of 90% on payments and invested capital.

Note: El Salvador figures for Exports of Goods & Services are for 1984 because 1985 figures were not reported in the World Bank's Debt Tables.

Appendix C

GLOSSARY OF FINANCIAL MARKET TERMS

At par: at a price equal to the face, or nominal, value of a security.

Bond: any interest bearing or discounted government or corporate security that obligates the issuer to pay the bond holder a specified sum of money, usually at specific intervals, and to repay the principal amount of loan at maturity. Bond holders have an IOU from the issuer, but no corporate ownership privileges, as stockholders do.

Capital market: the financial market that provides long-term loans and "risk capital" (in the form of equity) for fixed capital formation that enables businesses to be established or to expand their operations. The capital market is composed of the securities market, which offers equity and negotiable loan funds, and the non-securities market, which provides non-negotiable funds.

Certificate of Deposit (CD): a debt instrument issued by a bank that usually pays interest.

Collateral: asset pledged to a lender until a loan is repaid. If the borrower defaults, the lender has the legal right to seize the collateral and sell it to pay off the loan.

Commercial paper: short-term obligations with maturities ranging from 2 to 270 days, issued by banks, corporations, and other borrowers to investors with temporarily idle cash.

Debt instrument: a written promise to repay a debt; for instance, a bill, note, bond, banker's acceptance, certificate of deposit, or commercial paper.

Equity: from an investment point of view, this is the ownership interest possessed by shareholders in a corporation stock as opposed to bonds.

Equity financing: raising money by issuing shares of common or preferred stock.

Financial market: market for the exchange of capital and credit in the economy. Money markets concentrate on short-term debt instruments; capital markets trade in long-term debt and equity instruments.

Investment bank: firm, acting as underwriter or agent, that serves as intermediary between an issuer of securities and the investing public.

Money market: the financial market that provides loan funds (not equity) to meet short-term working capital needs. All of the financial instruments in this market are in the form of short-term, highly liquid debt.

Present value: value today of a future payment, or stream of payments, discounted at some appropriate compound interest or discount rate.

Primary market: the market for new issues of securities.

Risk: the probability that actual future returns will be below expected returns.

Secondary market: market where previously issued securities are bought and sold.

Term loan: a loan provided for an extended period of time, generally with a maturity greater than one year.

Trade credit: credit on goods purchased by a company from its supplier. The use of trade credit brings different types of companies, including many nonfinancial companies, into the credit system and may, in fact, increase a firm's sophistication in the uses of credit.

Venture capital: the field of investment that concentrates on capitalizing new companies, or funding entrepreneurs who have the ideas and drive to start promising companies and build them into huge successes. The venture capitalist invests his own funds (and funds collected from others) in start-up ventures and, generally, takes a strong management position in the operation of the business.

Yield: the annual rate of return on an investment, as paid in dividends or interest.

Appendix D

124

SELECTED BIBLIOGRAPHY

Alvarez, Oscar, Luis A. del Valle & Hugo Quinto. "Analisis del Sistema Financiero de Guatemala". Guatemala City, Guatemala: Hugo H. Quinto y Asociados. December 9, 1985.

"Analisis de la Actividad Crediticia en Guatemala". Guatemala City, Guatemala: Hugo H. Quinto y Asociados. April, 1986.

Arthur D. Little, Inc. "A Strategy for ROCAP: Country Findings", Volume II. Cambridge, Massachusetts. December 1985.

Arthur Young International. "Republic of Panama". *World Business Reports*. (September, 1982).

Arthur Young & Company. "Descriptive Summary: Central American Financial Markets". Prepared for the Regional Office of Central American Programs, Agency for International Development. November 17, 1986.

Banco Central de Costa Rica. *Leyes Bancarias y Otras Conexas*. San Jose, Costa Rica. 1978.

Banco Central de Costa Rica. *Boletin Estadistico No. 355*. San Jose, Costa Rica. July/ September, 1985.

Banco Central de Costa Rica, Division Economica. *Credito y Cuentas Monetarias: 1982-1985*. San Jose, Costa Rica. September, 1985.

Banco Central de Costa Rica. *Programa Crediticio 1984*. San Jose, Costa Rica. 1984.

Banco Central de Honduras, Departmento de Estudios Economicos. *Boletin Estadistico*, vol. 36, no. 2. Tegucigalpa, Honduras. February, 1986.

Bank for International Settlements. *Recent Innovations in International Banking*. April 1986.

Benitez Bonilla, Alberto. *A Tres Anos de Banca Nacionalizada*. San Salvador: Banco Central de Reserva de El Salvador. 1984.

Bossert, Thomas John. "Panama". In *Confronting Revolution: Security through Diplomacy in Central America*. pp. 183-205. Edited by Morris J. Blachman, William M. Leogrande, and Kenneth Sharpe. New York: Pantheon, 1986.

Buchheit, L.C. "Converting Sovereign Debt into Equity Investment." *International Financial Law Review*. September 1986.

Center for Privatization. "Divestiture of the Banana Control Board Farms". n.d.

Center for Privatization. "Assessment for the Privatization Program of the Government of Panama". n.d.

Central Bank of Belize. *Statistical Digest*. 1983.

Central Bank of Belize. *Annual Report and Accounts*. Belize City, Belize. 1984.

"The Debt Swappers". *Euromoney* (August, 1986): 67-75.

Diaz, Gil. "Mercado de Valores de Panama". n.d.

Downes, John, and Goodman, Jordan Elliot. *Dictionary of Finance and Investment Terms*. New York: Barron's Educational Series, Inc., 1985.

Economic Perspectives, Inc. "Report of the Agricultural Task Force to Guatemala". (Draft). Prepared for USAID/Guatemala. McLean, Virginia, May 1987.

Economist Intelligence Unit. *Quarterly Economic Review of Nicaragua, Costa Rica, Panama*. The Economist Publications (quarterly).

The Enterprise Chamber of Guatemala. "Export Supply of Non-Traditional Products". n.d.

Erbe, Susanne. "The Flight of Capital from Developing Countries". *Intereconomics* 20 (November/December 1985): 268-275.

Feinberg, Richard E., and Bagley, Bruce M. *Development Postponed: The Political Economy of Central America in the 1980s*. Boulder: Westview Press, 1986.

Fox, James W. "Financial Needs for Central American Development". Conference on Alternative Economic Strategies for Central America and the Implications for U.S. Policy. Washington, DC: School of Advanced International Studies. May, 1984.

Free Zone Authority, Ltd./The Services Group. "Free Zones at the Turning Point: A Strategy for Costa Rica". n.d.

Free Zone Authority, Ltd./The Services Group. "Prospects for Free Zone Development in Belize". n.d.

Fundacion Salvadorena para el Desarrollo Economico y Social (FUSADES). *La Necesidad de un Nuevo Modelo Economico para El Salvador.* 1985.

Gayle, Dennis J. *The Small Developing State: Comparing Political Economies in Costa Rica, Singapore and Jamaica.* Brookfield, VT: Gower Publishing Co. 1986.

Gonzalez-Vega, Claudio. "Impacto de la Crisis Economica Sobre la Mobilizacion de Recursos Internos en Centro America". In *El Desarrollo Financiero de America Latina y el Caribe, 1985.* Caracas: Instituto Interamericano de Mercados de Capital. 1985. pp. 219-315.

Hanson, James A., and Neal, Craig R. *Interest Rate Policies in Selected Developing Countries, 1970-1982.* World Bank Staff Working Papers No. 753. Washington, DC: The World Bank, 1985.

IL&T Panama, Business International Corporation. March, 1985.

INDESA. "Mercado Secundario de Hipotecas". n.d.

Instituto Interamericano de Mercados de Capital. *Los Mercados de Capital en America Latina y el Caribe Informe 1984.* Caracas, Venezuela. 1984.

Inter-American Development Bank. "Economic Report - Costa Rica". October 1984.

Inter-American Development Bank. *Economic and Social Progress in Latin America.* Washington, DC: IDB, 1986.

International Monetary Fund. "Belize - Recent Economic Developments". June 12, 1985.

International Monetary Fund. "Belize - Staff Report for the 1986 Article IV Consultation". July 12, 1986.

International Monetary Fund. "Belize - Recent Economic Developments". August 1, 1986.

International Monetary Fund. "Costa Rica - Recent Economic Developments". October 3, 1986.

International Monetary Fund. "Costa Rica - Staff Report for the 1986 Article IV Consultation". September 15, 1986.

International Monetary Fund. "El Salvador - Recent Economic Developments". December 9, 1986.

International Monetary Fund. "El Salvador - Staff Report for the 1986 Article IV Consultation". December 3, 1986.

International Monetary Fund. "Guatemala - Recent Economic Developments". June 16, 1986.

International Monetary Fund. "Honduras - Recent Economic Developments". February 13, 1986.

International Monetary Fund. "Honduras - Recent Economic Developments". February 25, 1987.

International Monetary Fund. *Interest Rate Policies in Developing Countries.* Occasional Paper No. 22. Washington, DC: IMF, October 1983.

International Monetary Fund. "Panama - Recent Economic Developments". June 27, 1985.

International Monetary Fund. "Panama - Recent Economic Developments." September 24, 1986.

International Science and Technology Institute, Inc. in collaboration with Arthur D. Little, Inc. "A Review of Guatemala's Economy 1968-1985". Prepared for USAID/Guatemala. February 1986.

Intrados Group. "Special Issue on Debt/Equity Swaps." *Swaps* (October 1987): 1-12.

Khan, Mohsin S., and Ul Haque, Nadeem. "Capital Flight from Developing Countries". *Finance and Development* 24, (March 1987): 2-5.

Marsden, Keith. *Links Between Taxes and Economic Growth: Some Empirical Evidence.* World Bank Staff Working Papers No. 605. Washington, DC: The World Bank, 1983.

Montealegre, Flora. "Costa Rica at the Crossroads". *Development and Change.* 14 (April 1983): 277-296.

Mora, Gustavo. "Estudio de Factibilidad del Establecimento y Operacion de una Bolsa de Valores en Panama. n.d.

Morgan Guaranty Trust Company. "Note on Debt-Equity Swaps". *World Financial Markets* (September 1986) 11-12.

Newfarmer, Richard S. "The Economics of Strife". *In Confronting Revolution: Security through Diplomacy in Central America*, pp. 206-226. Edited by Morris J. Blachman, William M.Leogrande, and Kenneth Sharpe. New York: Pantheon, 1986.

Nolling, Wilhelm. "Combatting Capital Flight from Developing Countries". *Intereconomics* 21 (May/June 1986): 117-123.

Oberdorfer, Don. "US Quietly Reduces Ties to Panama". *The Washington Post*. 23 July 1987, p. A32.

Price Waterhouse. "Institutional Assessment of Central American Bank for Economic Integration". n.d.

Price Waterhouse. "Analysis of Proposed Loan to CABEI". 1985.

Park, Yoon S., and Zwick, Jack. *International Banking in Theory and Practice*. Reading, Massachusetts: Addison Wesley Publishing Company, 1985.

Quirk, Peter J.; Christensen, Benedicte Vibe; Huh, Jyung-Ho; and Sasaki, Toshihiko. *Floating Exchange Rates in Developing Countries: Experience with Auction and Interbank Markets*. Occasional Paper No. 53. Washington, DC: IMF, May 1987.

Report on the First Central American Economic Conference on Trade, Investment, and Development. Sponsored by the Global Economic Action Institute and the National Congress of Honduras. Tegucigalpa, Honduras. March 12-14, 1987.

Republic of Panama. "Economic and Financial Program 1985-1986". June 1985.

Roberto Brenes y Cia., S.A. "The Potential of Captive Bond Issues as an Alternative to Conventional Bank Financing". n.d.

Shoraka, Jalil. *A Study of the Financial System of Belize*. Report prepared for USAID/Belize and Arthur Young & Co. May, 1986.

United Nations, Economic Commission for Latin America and the Caribbean. *Economic Survey of Latin America and the Caribbean, 1983*, vol.1. Santiago, Chile, 1985.

U.S. Agency for International Development. "PID Private Enterprise Development Project". 520-0341. January 1987.

U.S. Agency for International Development. "Guatemala Capital Investment Intermediation Project". n.d.

U.S. Agency for International Development. "Honduras Compilation of Credit Programs". n.d.

U.S. Agency for International Development. "Honduras - Thoughts about the Creation of an Equity Market". n.d.

U.S. Agency for International Development. "Honduras - USAID Funded Credit Programs". n.d.

Watson, Maxwell; Mathieson, Donald; Kincaid, Russell; and Kalter, Eliot. *International Capital Markets: Development and Prospects*. Occasional Paper No. 43. Washington, D.C.: IMF, February 1986.

Weeks, John. *The Economies of Central America*. New York: Holmes & Meier, 1985.

Winrock International. "Prefeasibility Analysis of the Honduran-American Trade Development Corporation". n.d.

World Bank. "Belize Economic Report". Report No. 6550-BEL, December 18, 1986.

World Bank. *Belize, Economic Report*. Washington, DC: The World Bank, 1984.

World Bank. "Central America Special Report on the Common Market". September 29, 1980.

World Bank. "Costa Rica Issues and Policy Options for Non Traditional Exports". Report No. 6240-CR, May 1987.

World Bank. "El Salvador Country Economic Memorandum". Report No. 5939-ES, April 25, 1986.

World Bank. "Guatemala Economic Situation and Prospects". Report No. 6434-GU, January 16, 1987.

World Bank. "Honduras Economic Memorandum". Report No. 6332-HO, April 17, 1987.

World Bank. "Panama: Structural Change and Growth Prospects". Report No. 5236-PAN, February 28, 1985.

World Bank. "Panama Special Economic Report Metropolitan Unemployment". Report No. 3833-PAN, June 7, 1982.

World Bank. *Panama: Structural Change and Growth Prospects*. Washington, DC: The World Bank, 1985.