COUNTRY PROFILES:
INDUSTRY AND COMMERCE

Belize: Industry and Commerce

A. Industry

The manufacturing sector accounts for about 15% of GDP. It is based on local agricultural output (e.g., two sugar factories, two citrus processors, rice and corn milling); forestry (small sawmills, woodworking shops); livestock (a meat packing plant); three garment manufacturers; and a few small import-substitution industries (e.g., cigarettes, concrete blocks, car batteries, fertilizer packing, toilet paper). Import-substitution industries in Belize don't contribute to the economy substantially because most of them are the so-called "wrap and pack" or "screwdriver" industries that use Belize at the final stage of a long production line. Toilet paper manufacturing in Belize, for example, involves little more than cutting huge rolls made in the U.S. into small rolls. Since the local market is limited, industrial production is basically export oriented, particularly sugar, concentrated citrus and garments. There are products originally destined only for the domestic market but now being exported, for example, beer.

Merchandising is the principal business activity in Belize. Most merchant houses are family-owned and operated, with limited financial capacity and entrepreneurial range, and even the large houses tend to stick to trade rather than to diversify into agriculture or manufacturing. With one exception, a U.S.-owned drawback garment factory, manufacturing consists of small operations that produce for the domestic market and are profitable because of government subsidies and protection from imports. Agriculture provides most foreign exchange earnings -- over 80% in 1981 -- and offers the best prospect for expansion.

Sugar accounts for over 50% of total export earnings, 20% of employment, and 20% of GDP. Sugar production amounted to about 100,000 metric tons in 1981. Citrus is next, bringing in about 10% of export earnings. Citrus production was set back by Hurricane Greta in 1978, but since has risen to about 1.5 million boxes of oranges and grapefruit annually. Lobster, shrimp and scale fish are exported, and there may be commercial fishing prospects beyond the barrier reef in deep water. Despite large timber reserves, Belize is a net importer of wood products.

Belize' workforce totals about 35,000, of which perhaps 7,000 mainly agricultural workers, belong to six unions. The union movement is not considered powerful. Although the unemployment rate is low the job market is thin, and underemployment is considered high.

Agricultural operations are generally inefficient and high-cost, but occasional instances show that they are susceptible to modern technologies and management.

Sugar yields run 12-14 tons per acre, less than half the world average. Almost a quarter of the citrus crop rots each year because of inadequate processing capacity. Various lumber products can be imported better or cheaper. The causes behind these results include difficult topography and the vagaries of a tropical climate; deficient infrastructure; inadequate or unproductive labor; insufficient capital and credit; and perhaps most importantly, the lack of modern managerial and technical expertise. Nevertheless several areas appear to offer considerable potential, given adequate financing and competent management: cattle (for milk and beef), aquaculture, citrus, rice, bananas, and experimental crops such as cacao and kenaf.

The economy of Belize is in a recession. The latest blow was the U.S. sugar quota imposition which has really rocked the sugar industry. The general hope is that through the CBI the negative impact of the U.S. sugar quota will be mitigated; the proposed trade concessions will improve the profitability of citrus production; and new investment supported by ESF funding will pull the private sector out of its present decline.

B. Business and Government

Belize is a peaceful, democratic country where the policemen do not carry guns. The People's United Party has been in power for 30 years, even though most businessmen support the opposition. Today relations between government and business are increasingly collaborative, as the government becomes more aware of business realities, and key businessmen devote more effort to understanding the constraints and demands facing the politicians. Direct government intervention in business consists of the administration of a set of price controls on items of basic necessity, a policy which is being reconsidered and which we expect to see change; and the ownership of several cattle and banana holdings, which government spokesmen say they are trying to sell. Inefficiency and corruption are present in government operations, but neither at a level which would present serious obstacles to the experienced businessman.

C. Finance

Four commercial banks and fifteen insurance companies operate in Belize. The banks provide short-term credit but little long-term funds, even for mortgages. The involvement of the insurance companies in recycling saving into productive investment is extremely limited.

Commercial Banks' Distribution of Loans and Advances
($ US'000)

December 31, 1982

Government Services	$ 7213
Public Utilities	292
Agriculture	12242
Commercial Fishing	265
Forestry	1388
Manufacturing	6619
(Agricultural processing)	(2983)
(Other)	(3633)
Tourism	721
Building & Construction	6292
Real Estate	692
Financial Institutions	159
Distribution	22182
Professional Services	387
Transport	1012
Entertainment	431
Mining & Exploration	926
Personal Loans	5352
Sundries	
Total	66172

D. Foreign Trade and Investment

Belize depends on foreign trade. Most economic activity is trade oriented, and despite an abundance of fertile agricultural land Belize still imports 20% of its food. Principal trading partners are the U.S., U.K., and Mexico. The U.S. is the largest by far, and its share is increasing. The U.K. is second, offering a preferential market for sugar and bananas, while until the collapse of the Peso free port operations with adjacent Mexican states accounted for nearly 30% of Belize' exports. Belize is a member of Caricom, but due to great distances and poor transportation services takes little advantage of those preferential trading arrangements.

Foreign investment is welcome, and represents a large portion of total investment in Belize. It dominates banking, tourism, agricultural processing, and lumber, and is important in light manufacturing and in the production of citrus, rice, and beans.

The government encourage foreign investment through various development concessions: tax exonerations, duty-free capital imports, land leases, repatriation of earnings, etc., as spelled out in a booklet "Investment Incentives and Procedures" issued by the Development Finance Corporation. A few areas -- shallow-water fishing, sugar cane farming-- are closed to foreigners, and official confusion and delays in the process of reviewing applications have in several instances turned away investors.

Belize's foreign investment law allows exemption from income taxes and import duties for as long as 15 years. The country is trying to attract more offshore industries which do both the buying of materials and the selling of their products entirely outside the country. The Williamson Corporation, for example, employs about 500 women workers to assemble Dixie Jeans for sale in the U.S.

UNITED STATES BUSINESS IN BELIZE

Air Florida; air transportation
Aqua Lodge
Barrier Reef; hotel
Barrow Logging; logging and sawmill
Belize Beef; cattle
Belize Cemcol; Caterpillar tractor
Belize Estate & Produce
Belize International; rock quarry
Belize Pharmaceutical
Big Falls Ranch; rice production and
  processing; ADELA equity
Brothers, Wm. C; sawmill
Carr, John; cattle production
Carver Tropical Ranch; cattle
  production
Castle & Cooke
  Belize Brewing; beverage bottling
Caterpillar Americas; Caterpillar
  tractor distribution
Caye Chapel; hotel and resort
Chase Manhattan
  Atlantic Bank; banking
CoHier, John; cattle
  production
Collins Foods
  Kentucky Fried Chicken; restaurant
El Pescador; hotel
Hershey
  Hummingbird Hershey; cocoa
    production

Hide-A-Way Lodge
Hurley, Robert; cattle production
IM Brokers of Florida; lobster
  and fish processing
Keller Caribbean Sports; fishing
  lodge
Kellogg
  Belize Citrus; fruit production
  Belize Feed; feed processing
  Belize Food; food processing
  Caribbean Foods; food processing
  Salada Foods; food processing
Mariah Reef Resort
Minter Naval Stores; pine resin
  extraction and sawmill
Misener Marine Construction;
  port construction
Paradise House; hotel
Placencia Cove; hotel
Prosser Fertilizer and Agrotec;
  fertilizer mixing
Pyramid Island; hotel
Rebxo, diesel engine sales
Renco Battery Factory; manufacturing
obinson Lumber
Seminole Steel Erectors; cattle production
Shore Lobster; shrimp and lobster
  distribution
Snell Environmental Group; shrimp
  production
Stone, Cecil Albert; ranch
St. George's Lodge
Swingle, Dean; ranch
Texaco
  Texaco Belize
Tropical Produce; mango production
Turnefie Island Lodge
Victoria House; hotel
Westmoreland, William; farming
Whitney, Harold; farming
Williamson Industries; garment
  manufacturing
Wyatt, John; farming

E. Main Issues and Constraints in Industry

A serious issue has been price control. The Government controls wholesale and retail margins on most basic imported items and fixes prices on many locally produced goods. In order to obtain approvals for increases, businesses are required to submit audited accounts and it takes a considerable amount of time for the concerned government agencies to process such applications. Even when incrases are allowed, they are often out of date by the time approvals are granted. Price controls also can discriminate against locally produced goods. When there is competition between imports and domestic production the retailer sometimes makes more profits selling the former because it is free from price controls or has an assured margin, whereas the price of the locally produced good is fixed at a lower level.

The processing of applications for development concessions is normally lengthy, requiring the applicant to follow his paper from Ministry to Ministry and officer to officer. Concessions granted under the Development Incentives Ordinance include exemptions on personal and corporate income taxes, import duties on capital goods and, in certain special cases, on raw materials and spare parts for specialized machinery. Exemptions last up to fifteen years, plus a period allowed for establishing the project, depending on the activity.

There is a shortage of managers and skilled personnel in Belize. There are no training facilities for managers and skilled labor in the country. Poor infrastructural facilities, particularly housing, electricity and water, prevent many qualified people from settling in Belize, and discourage locals trained outside from returning. The Government is trying to increase the number of skilled personnel by providing student loans and the upgrading of infrastructural facilities in Belize City and the existing liberal work permit regulations are expected to encourage repatriation and/or importation of skilled manpower.

COSTA RICA

Historic Overview

A. Summary

Until the early 1960's, Costa Rica's economy had been based on the production and export of several primary agricultural products. For the last two decades, Costa Rica's basic economic strategy has been to expand industrial activity in order to absorb a growing urban labor force and reduce dependence on the export of traditional agricultural products, while simultaneously strengthening its agricultural sector. This has meant pursuing an import substitution/infant industry policy in concert with its Central American neighbors and, more recently, attempting to expand exports to other international markets.

Much of this development strategy has revolved around the common measures adopted by the five Central American countries through the Central American Common Market (CACM) mechanism. Protective tariffs, tax incentives, tariff exemptions for materials and equipment and a stable exchange rate are examples of the measures employed to attract private investment in industry. Costa Rica's industrialization strategy, complemented by continued if uneven growth in agricultural exports, was successful in fueling rapid economic expansion during the 1960s and 1970s. Real Gross Domestic Product increased an average of 6.1 percent per year between 1960 and 1978. Annual growth in the industrial sector averaged 9 percent between 1960 and 1968, 7.4 percent between 1968 and 1973, and 8.4 percent between 1973 and 1978, indicating a very positive performance in this sector. This growth was based almost entirely on opportunities in the local and regional markets.

The positive macroeconomic performance ignores several disquieting aspects of this trend, including (1) the continued dependence on the export of a few traditional commodities whose prices have deteriorated in recent years; (2) the establishment of a relatively capital-intensive industry because of incentives to capital, and steadily growing payroll levies; (3) the development of relatively inefficient industries due to the protective policy framework; (4) the near exhaustion of import substitution opportunities; (5) the emphasis on industry at the expense, at least in part, of agriculture; (6) the heavy reliance on borrowed (often foreign) funds for investment capital as a result of Government financial policies; and (7) policies signaling a bias against exports principally through an overvalued exchange rate.

Another distressing characteristic of the economic picture has been the failure of the nationalized banking system to attract internal savings and provide adequate financial intermediation. While an increasing proportion of credit has been channelled to the public sector, private firms have suffered from poor service and inadequate financing such that they have increasingly had to look towards external sources of credit.

These negative trends have now culminated in a situation where a relatively inefficient and highly indebted industrial sector is forced to look for new export opportunities in the face of diminishing local and regional markets as well as sluggish markets in North America and Europe. Industrial and overall economic growth has virtually come to a halt. Not only is industry not in a position to turn to exports without first going through a painful shakedown period, but the necessary policy and support framework is not in place.

The Government realizes that it is faced with a crisis of major proportions. Its strategy for recovery is based on increase support for private sector initiatives and export development, while continuing to meet social welfare objectives.

From the perspective of the private sector, recovery and future growth will be facilitated by the following positive factors: an existing and underutilized industrial base (albeit somewhat inefficient); significant agricultural and agro-industrial potential; a skilled, competitive, productive labor force and strong management resources (largely the result of social policies in education and health); a favorable geographic position that provides easy access to U.S. and Latin American markets; and an increased recognition of the need to export.

The principal constraints confronting the private sector include the acute shortage of foreign exchange, compounded by a confusing and unstable multiple exchange rate system; a severe credit squeeze (local and external), aggravated by a cumbersome and ineffective nationalized banking system; many industries that are noncompetitive in world markets; the limited technical and production management know-how for streamlining industry; the unfamiliarity with marketing know-how for penetrating foreign markets; an inadequate policy and programmatic support framework for exporting; and the cost of maintaining the social programs and the bloated public sector payroll. Furthermore, the country's extremely heavy debt service burden will seriously constrain economic recovery over the medium term.

B. Detailed Description of Costa Rica Industry

The Costa Rican economy has, in the last two decades, undergone a fundamental structural change where industry has become the largest productive sector in the economy, and the relative contribution of agriculture to output has fallen. In 1960, agriculture's share of GDP was 25%. In 1977 this had fallen to 19%. Over the same period manufacturing industry increased its share in production from 14% to 22%. Changing shares in output naturally reflected different underlying growth trends; between 1960 and 1977 industrial growth, at an annual real rate of 9.2% outstripped GDP growth of 6.1% per annum, and considerably outstripped agricultural growth at 4.4% annually. Manufacturing industry absorbed 58,000 new employees between 1963 and 1977, as compared to agriculture, which absorbed 25,000. As a result, industry's share in total employment increased from 11.7% in 1963 to 15.8% in 1977, whilst agriculture's share declined from 50% in 1963 to 33% in 1977. Consistent with these trends, productivity (value-added in real terms per person employed) has been growing in both sectors--at an equal pace of 3.7% per annum since 1963. Relative productivity has not changed since 1963; value-added per person employed in manufacturing is still about two and a half times as high as in agriculture and one and a half times the national average.

Not only has an economy-wide change in production pattern occurred in the last two decades, but the structure of industry has itself changed.

Table 1: INDUSTRIAL STRUCTURE 1960-1977

	Shares in Value Added			Growth Rates	
	1960	1969	1977	1960-69	1969-77
Consumer Goods	79.2	65.2	63.8	6.9	8.1
Intermediate Goods	20.8	31.3	33.1	14.3	9.1
Capital Goods	0.0	3.5	3.1	-	6.9
Total	100.0	100.0	100.0	9.2	8.4

Source: Costa Rica: Trade Incentives and Export Diversification IBRD Report No. 3195 - CR, November 5, 1980.

In 1960 about 80% of value-added in manufacturing industry was in the final consumption goods industries of food, beverages, footwear, clothing, printing and consumer chemicals. The subsector experienced a drop of about 15% in its share of industrial activity in the period 1960 to 1969; thereafter its share declined but little. The most visibly affected industries were food and beverages, which between them accounted for 11 points of this reduced share. Intermediate good production on the other hand experienced strong gains, with textiles, industrial chemicals, plastic and rubber products and metal products registering strong increases in their share of manufacturing activity. Capital goods (mechanical and electrical machinery) of which there was no registered production in 1960, grew to slightly more than 3% of value-added in 1977. Despite this widening of the industrial base, the composition of activity is still heavily slanted towards consumer goods industries. Partly because of the policies of providing high protection for consumer goods industries, Costa Rica has not developed particularly deep or extensive capital or intermediate goods sectors.

1. Import Substitution and Sources of Growth

The policy of import substitution and the tying of industrial incentives to the common schemes of the regional market have exercised a most powerful influence on the development of industry in Costa Rica. One rough measure of the success of import substitution policies is provided by the degree to which domestic production has replaced imports in total supply (Table 2.). When Costa Rica joined the Common Market in 1963, there was little production in many industries. Imports accounted for over 90% of total available domestic supply in such industries as basic metals, mechanical machinery, electrical machinery and transport equipment and over 60% of total domestic supply in textiles, chemicals, and rubber products. By 1977 the percentage of total available domestic supply represented by imports of manufactured goods had fallen from an average of 46% to 40%. In some industries such as food products, beverages, tobaccos, clothing, wood products and furniture (that is, largely consumer goods industries), imports were at

Table 2 RATIO OF IMPORTS TO TOTAL AVAILABLE DOMESTIC SUPPLY 1/ BY INDUSTRIAL BRANCH, 1963, 1971, 1977

CIIU	INDUSTRY	1963	1971	1977
31	Food Products, Beverages, Tobacco 2/	12.2	10.0	8.7
32	Textiles, Clothing, Leather Products	36.2	38.3 3/	29.3
33	Wood and Products, including Furniture	1.3	4.6	2.1
34	Paper and Products, Printing, Publishing	56.7	50.0	43.9
35	Chemical, Petroleum, Coal, Rubber and Plastic Products	67.9	47.5	49.9
36	Other Non-metallic Mineral Products	46.8	30.8	28.7
37	Basic Metals	100.0	84.7	84.4
38	Metal Products, Machinery and Equipment	90.1	69.2	70.9
39	Other Manufactures, including Re-exports	80.8	78.2	64.4
	TOTAL	46.4	42.2	40.3

1/ Expressed as a percentage, Ratio = $M_i/(M_i + Y_i)$, where M_i are subsectoral competing imports and Y_i is gross value of domestic output.

2/ Omits coffee drying and roasting, beef preparation and packing, and sugar refining. These agrindustrial processes, because of their large weight in production, tend to overwhelm the measure of import substitution in food processing, and in total import substitution. See footnote on page 19.

3/ This import ratio increased from 1963 because of a large increase in imports of footwear. For the other categories of the subsector, textiles, clothing, and leather products, the import ratios declined.

Source: MEIC, Comercio Exterior de Costa Rica, and Banco Central, Cifras de Produccion Industrial, 1957-1977.

most 11% of total domestic supply in 1977. There is little scope for further import substitution in these subsectors. Inevitably, further import substitution possibilities exist in the metal mechanical sectors and more generally in intermediate product categories. In view, however, of the very small size of the domestic and regional markets, of the inefficiencies entailed in additional protection, and of certain higher costs to consumers, further import substitution incentives in these sectors should be avoided.

The import substitution process was strongest in the early years of the common market and weakened considerably after the El Salvador/Honduran confict in 1969. Four sources of growth for Costa Rican industry have been distinguished in Table 3: (1) Export expansion to Central America, (2) Export expansion to the rest of the world, (3) Import substitution (seen as the reduction in the ratio of imports to total domestic supply), and (4) The expansion of domestic demand (measured as a residual). In 1971-77 domestic import substitution contributed only 3% to industrial growth in contrast to the period 1963-1971, when 11% of the expansion of industry could be attributed to the process of replacing imports by local production (excluding major food products exported outside the region). 1/ The export expansion to Central America can to a degree

1/ For technical and substantive reasons it is useful to exclude a large part of the food products sector in analyzing the process of import substitution. The technical reason is that the food product sector so dominates manufacturing production that changes in the food subsector easily overwhelm the averages for manufacturing as a whole, thus giving a partial view of the evolution of import substitution in the rest of the manufacturing sector. The substantive reason is that the food product sector is in turn dominated by the export-oriented enterprises (coffee roasting, beef preparation and sugar refining), only a small proportion of whose output is destined for the local market. Thus, the food product averages and that of manufacturing as a whole are heavily influenced by primary-based export-oriented enterprises. Inclusion of these enterprises again confuse the analysis of import-substitution. (In 1977, the food product sector constituted 44% of total manufacturing output; fully one-half of this was the "output" of the coffee roasting, meat processing and sugar refining enterprises. About 70% of the combined output of these products is exported, and more than 95% of these exports are destined outside the region.) Table 3 thus reports calculations in the foods products sector both with and without these export-oriented agricultural processing concerns and the manufacturing totals again present calculations with and without the coffee roasting, beef preparation and sugar refining enterprises.

Table 3: SOURCES OF DEMAND GROWTH (AS % OF TOTAL GROWTH IN OUTPUT) FOR COSTA RICAN INDUSTRIES, 1963-71, AND 1971-77

CIIU	INDUSTRY	EXPORT EXPANSION TO CENTRAL AMERICA 1963-71	EXPORT EXPANSION TO CENTRAL AMERICA 1971-77	EXPORT EXPANSION TO REST OF WORLD 1963-71	EXPORT EXPANSION TO REST OF WORLD 1971-77	IMPORT SUBSTITUTION WITHIN COSTA RICA 1963-71	IMPORT SUBSTITUTION WITHIN COSTA RICA 1971-77	DOMESTIC DEMAND GROWTH 1963-71	DOMESTIC DEMAND GROWTH 1971-77
311-312	Food Products, less Coffee Roasting, Meat Processing and Sugar Refining	8.0	4.3	0.8	13.0	5.9	3.4	85.2	79.3
313	Beverages	0.1	0.0	0.0	0.0	6.1	-5.9	93.8	105.8
314	Tobacco Manufactures	0.0	0.0	0.5	8.8	-2.8	1.2	102.3	90.0
321	Textiles, including Carpet and Lace	15.9	12.9	0.1	0.1	1.1	39.9	82.8	47.0
322	Clothing	4.4	9.0	0.1	0.3	4.4	-3.3	91.0	94.1
323	Leather Products, except Clothing & Footwear	21.0	15.3	-0.5	25.4	25.0	5.9	54.4	51.4
324	Footwear	23.9	6.6	0.0	0.2	-153.0	-5.2	229.0	98.4
331	Wood and Products, including Cork	9.1	6.7	-1.3	2.3	-7.6	3.2	99.9	87.8
332	Wooden Furniture and Accessories	2.3	2.4	0.4	3.4	-9.1	3.6	106.5	90.6
34	Paper, Printing, and Related Products	5.4	3.3	-0.2	0.0	19.6	14.5	75.2	82.1
351-352	Chemicals	13.0	13.2	1.9	1.4	22.7	5.7	62.4	78.6
355	Rubber Products	9.2	11.9	3.3	-2.1	65.1	5.3	21.4	83.8
356	Plastic Products	17.5	17.7	0.0	1.2	-8.9	5.1	91.4	76.0
36	Non-metallic Mineral Products, nei	0.7	2.6	0.0	0.1	34.3	3.9	64.9	93.4
37	Basic Metals	0.0	14.8	0.0	0.2	100.0	2.4	0.0	82.6
381	Metal Products	4.3	14.2	0.2	0.4	78.4	7.4	17.2	77.9
382	Mechanical Machinery	1.5	9.5	0.1	0.2	77.0	-61.4	21.3	151.7
383	Electrical Machinery	0.9	11.4	0.0	5.5	94.3	16.1	4.8	67.0
384	Transport Equipment	0.0	0.1	0.0	0.5	80.8	-13.3	19.2	112.6
39	Other Manufactures	18.1	74.9	11.0	70.5	29.4	31.6	100.3	6.8
	Total	9.3	8.0	0.9	1.6	10.6	3.3	79.2	83.6
	Memo Items:								
	Food Products Sector, including Coffee, Meat, Sugar	4.9	2.5	14.7	12.4	0.5	0.8	80.0	84.2
	Total, including Meat, Coffee, Sugar	9.0	7.3	7.4	19.4	1.7	0.4	81.9	72.9

Source: Bank staff calculations. For methodology, see Annex 1.

BEST AVAILABLE DOCUMENT

be regarded as part of a regional import substitution process. Again excluding those food products which are overwhelmingly exported outside the region, the region provided 9% of the demand impulse for growth between 1963 and 1971 and 8% between 1971 and 1977. In the first phase of high import substitution within Costa Rica, intermediate and capital goods industries were most rapidly establishing domestic bases. The consumer goods industries of food, clothing, footwear and wooden furniture during this first phase, gained significantly from the extension of protection from the national to the regional market, as export expansion to Central America (i.e. regional import substitution) provided a more powerful stimulus to growth than domestic import substitution. In the second period, 1971 to 1977, domestic intermediate and capital good import substitution gave way to export expansion to Central America as the chief source of development; overall, in this latter period regional import substitution as a source of growth dropped in most consumer good categories. In both periods the most powerful stimulus for expansion came from the growth of domestic demand, which in Costa Rica is, to a large extent, the result of buoyancy in traditional and non-traditional exports to third countries outside the CACM.

Even though the impulse for industrial growth coming from regional import substitution has faded, much of the Costa Rican industry continues to be dependent on the regional market. In 1963 for instance 2% of manufacturing output was exported to market countries. In 1977, 13% of manufacturing output was sold to market countries. (Both these figures exclude the dominating influence of processed food exports to third markets from the food sector.) Industries which export a high proportion of their output to Central America included in 1977: basic metals (93%), mechanical machinery (47%), electrical machinery (35%), chemicals (30%), textiles (31%), metal products (24%), plastic products (21%), rubber products (19%), and leather products (18%). These later industries contribute almost 25% of value-added in industry and comprise some 22% of the total value of sales. Only the food and beverages, tobacco, furniture, petroleum, and non-metallic mineral subsectors, in fact, sold less than 5% of their output to the CACM. Thus, a considerable interdependence exists between the regional economy and Costa Rica's manufacturing industry. The industries with high export ratios to the market and which have grown most rapidly behind the protective walls of the market are likely to be particularly sensitive to changes in CACM arrangements.

Export expansion to markets outside Central America has provided a minor stimulus to manufacturing sector growth--in 1963-1971, 0.9% and in 1971-77, 1.6% of industrial growth can be attributed to this source. Overseas markets have been important, however, for particular industries. For the food products sector export expansion to third markets provide 1% of the demand stimulus in 1963-1971 and 13% in the later period 1971-1977. Several industries are now, however, fast increasing their exports outside the region. The wood and furniture products industries are an example; in 1963 these industries together exported 3% of their output to the rest of the world and 2% to Central America. With the formation of the CACM the industries were granted one of the highest protection rates available.
By 1967, exports to the CACM were 7% of output, and extra-regional exports had

dwindled to virtually zero. With the saturation of the regional market, however, the industry has had to look abroad again for markets. In 1977 regional exports had fallen to 4% of total output, and extra-regional exports were back at the position they enjoyed in 1963, i.e., 3% of output. In general, and as can be expected, those industries with a high domestic resource content have been most successful in exporting outside the region.

2. Industrial Concentration

Costa Rica's industrial structure is highly concentrated with a few establishments generating the major share of employment, output, and manufactured exports. In 1975, for instance, those companies which employed 200 or more persons (less than 2% of all manufacturing establishments) employed about a third of the manufacturing labor force and generated about 44% of the sector's value-added. At the other end of the scale enterprises which employed less then 20 persons comprised over 80% of all establishments, employed 20% of the labor forc. and produced only 10% of manufacturing value-added. A recent study has focused more incisively on this problem of concentration. The study reports that those industrial subsectors which generate the largest shares of value-added and employment, are in fact dominated by the activities of one or two firms. In 1975, for instance, 70% of manufacturing value-added was generated in subsectors where two firms at most accounted for more than 50% of the subsector's output; these same subsectors employed 56% of the manufacturing labor force. Thus, a sizeable proportion of manufacturing activity occurs in subsectors where one or two firms dominate production. In 1975, 40 out of 50 of the largest establishments (200 employees or more) in Costa Rica, which together accounted for 41% of value-added in manufacturing, were to be found in these highly concentrated subsectors.

At the same time the evidence is much less clear that large firms exercise the same predominance in the export effort. Large firms do on the one hand contribute by far and away the greater proportion of total manufactured exports; firms which employ 150 or more employees (about 3% of all establishments) for instance produce about 54% of the total manufactured exports of the country. On the other hand, the proportion of output exported is much more evenly spread across firms of different sizes.

Firms which employ ten to 29 persons, for instance, export 26% of their total output--the highest proportion reported among firms of different sizes. If firms are classified by value of output rather than by numbers of employees the same pattern emerges. Firms with value of sales greater than ¢30 million contributed 53% of all manufactured exports, exporting about 22% of their output. Small- to medium-sized firms however, ranging in production levels from ¢10 million to ¢29 million, have, on average, export ratios of 31%.

There is a small but significant difference in the destination of export sales amongst firms of different sizes. Medium-sized firms tend to sell a greater proportion of their export production to the rest of the world; conversely, larger firms export proportionally more to the CACM. Firms of from 30 to 100 employees send, on the average, slightly more than half of their exports to countries outside the common market. Firms which employ more than 100 employees, on the other hand, send little more than a third of their exports to countries outside the CACM. This feature requires explanation, as it might be expected that larger firms are perhaps better placed to exploit economies of scale, and have greater resources to devote to marketing efforts abroad. One possible explanation is that the oligopolistic biases of the domestic and regional markets, with which large firms are so clearly identified, allow them to dominate regional trade and allow them to neglect third-market exports which medium- to small-scale firms cannot afford. In this sense, large firms do not feel compelled, nor does the incentive system encourage production to third markets.

The picture which emerges is thus one of a few large firms dominating manufacturing activity and export activity, operating in highly concentrated market strata, but with a promising participation of medium-sized firms in foreign trade, and especially in the proportion of output destined from these firms to third markets.

3. Import Intensity

Paradoxically, at the same time that industrial strategy has been to replace imports by domestic production, manufacturing activity has become more, rather than less, import intensive. Raw material imports for industry averaged 11% of industrial output in 1960-1962, and this ratio had climbed to 20% in 1975-1977. Several characteristics of industrial development help explain this development. First, the successive replacing of imports by domestic production has largely been at the finished end of consumer goods production. As industry has expanded, and as domestic intermediate and raw materials have either been unavailable or in short supply, the structure of industrial production has veered into import intensity. The process has been aided and abetted by very generous exemptions from the payment of all tariffs for intermediate and raw material imports. In fact, as the exchange rate has been consistently overvalued, the imports of raw materials and intermediate inputs for industry have contained an important subsidy component. A second reason for the high overall import intensity of production is that certain industries which have grown very rapidly are particularly dependent on imports. The chemicals (especially pharmaceuticals, fertilizers, tires) and metal/mechanical industries fall into this category. Table summarizes sector import intensities from a sample of firms which obtain import exonerations.

The phenomenon of increased import intensity in manufacturing has had important consequences for the country's external trade position. In 1960-1962 industrial raw materials were 22% of the country's total imports; in 1974-1977 the ratio had climbed to 37%. In fact the manufacturing sector has consistently run trade deficits; in 1974-1976, for instance, raw material imports for industry exceeded manufactured exports by 25%; excluding the food, beverages and tobacco sector (CIUU 31) the excess of raw materials imports over exports of the manufacturing sector was about 70%. The growing proportion of imports that are inputs to manufacturing activity in the country creates an unwelcome rigidity in balance of payments. External deficits become much more difficult to manage as compressing imports entails depressing, perhaps severely, the level of domestic activity.

Because industry earns much less foreign exchange than it demands (for intermediate and raw material imports), the economy has to rely on agricultural activities to redress the foreign exchange imbalance. Both the cyclical variation in export revenues earned by the latter as well as the fact that foreign exchange demand by industry far exceeds the growth of exchange supply by agriculture set the stage for chronic and ever-deepening balance of payments difficulties. This is why one of the conventional wisdoms about Costa Rica should be changed. It is not simply export price swings any longer, which lead the country into periodic exchange crises. The other edge of the scissors, as it were, is the rapid growth in demand by industry for foreign exchange. The twin effects lead to move pronounced crises than would otherwise be the case. Moreover as the foreign exchange feeds into protected, inefficient industries serving a small market, the country inevitably finds itself on a declining growth path, punctuated by periodic and ever worsening exchange crises. As is well known, developing countries do discover secularly increasing demands for foreign exchange as their economies grow. The elevated levels and peculiarly intractable composition of this demand in Costa Rica is, however, directly attributable to the policies of import substitution followed by the country in the last two decades.

Table 4: IMPORT INTENSITY, EXPORT CONTRIBUTION, AND TRADE DEFICITS OF SELECTED MANUFACTURING ENTERPRISES, 1975-1976 1/

		Imported Inputs as % of Output			Export as % of Output			TRADE DEFICIT AS % OF OUTPUT
		Cent. Amer.	Rest of World	TOTAL	Cent. Amer.	Rest of World	TOTAL	EXPORTS-IMPORTS
31	Food, Beverages and Tobacco	4.1	21.7	25.8	7.9	15.2	23.1	-2.7
32	Textiles, Apparel and Leather	10.8	16.1	26.9	20.2	5.4	25.6	-1.3
33	Wood Products and Furniture	2.1	13.0	15.1	14.2	8.8	23.0	7.9
34	Paper Products and Printing	3.2	31.8	35.0	10.9	1.6	12.5	-22.5
35	Chemicals	6.5	42.8	49.3	29.3	8.3	37.6	-11.7
36	Non-Metallic Mineral Products	2.4	8.0	10.4	2.4	0.0	2.4	-8.0
37	Basic Metals	1.6	79.1	80.7	8.6	0.0	8.6	-72.1
38	Metal Products and Machinery	1.6	46.0	47.6	34.5	7.9	42.4	-5.2
39	Miscellaneous Manufacturing	1.5	36.4	37.9	30.3	0.0	30.3	-7.6
	Total	5.1	31.3	36.4	20.2	8.4	28.6	-7.8

Source: MEIC, World Bank Staff Computations

1/ A sample of 433 firms which, because they receive industrial incentives, have to file with MEIC. Total output of these firms is about 40% of national manufacturing output.

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4. Capacity Utilization

A further consequence of the incentive schemes that have been applied in Costa Rica has been to encourage entrepreneurs to install excess capacity. Over time, low interest rates subsidizing the purchase of capital goods, duty exemptions for the import of machinery and equipment and tax provisions which allow full deductions from the tax base of reinvested profits at the time of capital goods purchase, followed by generous depreciation allowances, have each acted to lower the price of capital below its social opportunity cost. Relative factor prices have been further distorted by high payroll charges (payroll taxes comprise about one-fifth of average gross compensation) which have effectively served to reduce the demand for labor. Excess capacity manifests itself in the low number of shifts worked, in the large number of days when activities shut down (weekends, holidays, etc.), and low intensity of utilization during the work day. A recent study ~~financed~~ by ROCAP estimates escess capacity at 61% in 1981.

C. Credit and the Financial System

The financial sector in Cost Rica has one singular characteristic that sets it apart from most other "free market" countries in Latin America, that is, the "official" (State-owned, Government-controlled) nature of its banking system with its absolute monopoly on demand and savings deposits. While other financial institutions operate in the country, (including seven small private banks and a number of financieras - finance companies) their resources have either originated abroad (through loans and other forms of intermediation) or have been raised locally in the form of equity or the sale of bonds, savings certificates, and similar obligations. The nationalized banking system (SBN) is constituted by the Banco Nacional de Costa Rica, Banco de Costa Rica, Banco Anglo Costerricense, and Banco Credito Agricola de Cartago. While formally there is no functional or geographical specialization, there are informal areas of concentration, as for example agricultural credit with Banco Nacional and industrial credit with Banco de Costa Rica.

The SBN has been characterized as slow, excessively conservative, and incapable of significantly contributing to the economic development of the country because of its implicit lending policies. as well as its inability to mobilize internal savings to any significant degree. Interviews with private sector companies indicate that even applications for small loans take months to process while other banking services are very poor. The average loan size is very small, which when combined with the large number of people involved in processing the paperwork, results in a highly inefficient system. The absence of a profit motive and real competition in the banking sector is largely to blame for this situation.

As early as 1963, the USAID Mission in Costa Rica recognized this problem and assisted in the creation of a private finance institution, COFISA, in order to create an alternative for the private sector and stimulate Costa Rica's industrial development and its participation in the Central American Common Market (CACM). 1/

While COFISA can generally be characterized as a success story, it has not been totally immune to the problems arising from the structure, policies, and practices of the SBN, or from the more dramatic consequences of the Government's financial and monetary policies. As low-priced, long-term AID funds were used up, COFISA increasingly departed from its developmental (pioneering, risk-taking) role in favor of more commercial terms similar to those of the SBN, albeit processed with far greater agility and enormously superior results. Already in 1969, COFISA's short-term loan portfolio equalled its long-term portfolio and the average size of the loans made was only U.S.$24,600. By 1981, when the average size of the loans outstanding had increased to approximately U.S.$60,000 in current dollars, this represented a negligible increase in real terms, and almost the entire portfolio had terms of under three years and interest rates 1 to 3 points higher than LIBOR.

Barred from capturing internal Costa Rican savings by the effective monopoly of the SBN, favored by the Government's monetary policies supportive of an overvalued colon, and having created a network of clients, COFISA undertook to borrow from abroad for relending in Costa Rica. Through 1981 COFISA had multiplied by 25 times the $10 million that AID had provided with its two loans in the early sixties, becoming the country's single largest source of credit to the private sector.

1/ In 1968 a law was passed that allowed the creation of other private financieras, which are not permitted to accept demand deposits. Thus, by the nature of their funding, they are concentrated in very "high price" consumer financing and personal loans, and have had in the aggregate a very small impact on the development of industrial or agricultural production, or on the total volume of credit. Other mechanisms created later, such as the Bolsa de Valores (stock market), have also had little impact to date.

Lack of adequate credit is a major constraint to the continued activity of Costa Rica's private sector. USAID studies and surveys support the private sector claim that Costa Rican business is having serious trouble securing adequate and timely credit to meet its requirements. While these surveys differ as to their estimates of the magnitude of the credit gap, a concensus does exist that the Costa Rican Central Bank's (BCCR) 1982 credit program has not adequately taken into account the combined effect of 1981's 100% plus wholesale price index increase, and the massive devaluation of the country's currency, and as such is inadequate to meet effective credit demand. In the past, when internal financing dried up, the private sector resorted to external borrowing; under present circumstances such external financing is no longer available. Add to this the serious erosion of most Costa Rican firms' equity bases caused by the combined effect of the local currency devaluation and losses from failing markets which together render them unworthy of credit by traditional lending criteria.

During 1980 and 1981, more than 60% of all new domestic credit was destined for the Government and Costa Rican public institutions, at the expense of the private sector. Credit outstanding to the private sector dropped by some 21% in real terms during 1981 as compared with 1980. During the first half of 1981, manufacturing industry received only one-third of the real flow of new credit that had been made available during the same period in 1978.

Critically needed foreign exchange has become increasingly difficult and costly for the private sector to acquire; the lack of foreign exchange is perhaps the single most important constraint that the private sector faces. The Government's own dollar requirements have resulted in the severe rationing of foreign exchange. Stringent measures, which in effect heavily tax Costa Rican exporters, require that dollars earned from exports be converted to local currency at a highly overvalued official/interbank hybrid rate. At the same time dollars required for raw material supplies are often unavailable at the same rate through the SBN, forcing producers to purchase the foreign currency they need at the higher free market rate.

D. Labor Force/Employment

The single most important factor endowment of Costa Rica is its strong human resources base. Costa Rica's private sector is a beneficiary of the country's longstanding commitment to universal education. That policy, although costly, has resulted in a highly literate, relatively well-educated labor force that adapted readily to changing technologies. There have been shortages of certain types of skilled workers from time to time, but these have apparently not been frequent or persistent.

Labor relations have not posed a problem, especially for
the industrial sector where unions have not been strong. Un-
ions are most prominent in the banana industry and public sec-
tor. Government regulations set minimum standards for wages
and benefits. The most common labor-related complaint concerns
the high social payroll charges imposed by Government rather
than wage rates per se, or labor availability, skills, or
behavior.

Management-level talent is considered adequate for the needs of the private sector. This positive situation is attributed to the large numbers of university graduates in general and business administration graduates in particular, the steady supply of 10 to 15 Central American Business Administration Institute (INCAE) graduates per year, and masters-level graduates from foreign universities. The good living conditions in Costa Rica also encourage Costa Ricans and foreign managerial talent to live and work in the country. Skills are said to meet the needs of the business community, with the exception of specialized knowledge of export procedures, markets, and financing.

As part of its overall public education strategy, the Government has given high priority to providing vocational-skills training geared to the country's productive requirements as practical alternatives for youths who do not pursue more academic courses. The Ministry of Education operates an extensive network of <u>colegios agropecuarios</u> (agriculture high schools) and <u>colegios vocacionales</u> (vocational high schools) in which specific technical skills are taught in addition to a basic high school curriculum. It is felt that these schools have been an important source of supply of skilled labor and middle management for the industrial and agricultural sectors during the period.

At the lower end of the scale, the National Vocational Training Institute (INA), sponsored by the Ministry of Labor, trains approximately 220 youths per year in a wide range of skills required by the agricultural, industrial, and construction sectors. INA receives very strong support from the Government, receiving the proceeds of a 1 percent payroll tax on all salaries in the country.

Strong Government support for the development of management skills is manifested by the policy of highly subsidized university education for all who qualify academically. This longstanding tradition has resulted in a great expansion of university enrollment during the past 20 years, albeit at a great cost to the national treasury. Evening classes in business and economics are very popular as a great many employed persons pursue university degrees in those subjects to upgrade their skills and earning potential. Graduate-level business administration courses are not available in the country but INCAE appears to meet the need together with returning graduates of foreign universities. Costa Rica has been a strong supporter and beneficiary of INCAE since its inception.

During the 20-year period (1960-1980) sustained but uneven growth, open unemployment remained quite low, ranging from 4 percent to 6 percent. The current labor force of approximately 725,000 persons is small, even though women have entered it at a rapid rate. Employment grew faster than the labor force during the latter part of the 1970s. Until 1980 the expanding public industrial and commercial sectors were able to absorb labor that left the lower-paying agricultural sector, where underemployment had always been significant.

Today unemployment is accelerating sharply and will continue being one of Costa Rica's most critical problem areas for the decade. Whether or not Costa Ricans are able to bear the extremely lean years ahead will depend, in large part, on what is done to mitigate the hardship for the escalating numbers of unemployed.

Preliminary data from the July 1981 employment survey showed the unemployment rate went up to 8.7%, up from 5.9% in July 1980 and 4.9% in July 1979. In absolute numbers, the unemployed rose from 36,250 in 1979 to 45,560 in 1980 to 69,600 in 1981.[1/] By November 1981, the number of unemployed persons went up to 77,000, in spite of the fact that unemployment historically

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1/Source: July 1979, 1980 and 1981 employment surveys conducted by the GOCR Office of Statistics and Census.

drops in November due to the coffee harvest.[1]

Underemployment, which had remained constant at 7.6% in 1979 and 1980, increased to 9.0% in July 1981. Put in a more down-to-earth context, the number of hours not worked by these underemployed persons in 1981 was the equivalent of 46,000 full-time jobs, seven times the number of new full-time jobs created during the July 1980-1981 period.[2]

Projections made by the Academia de Centroamerica in 1980 show that the labor force will grow from 770,000 in 1980 to 886,000 in 1985. This represents an annual rate of increase of 2.86%, a reflection of both past population growth and a projected increase in the labor force participation rate from 34.8% to 35.7%.

Projecting employment and open unemployment to 1986 can be done on the basis of historical relationships between GDP and employment in past years. Between 1973 and 1978 employment grew at an annual rate of 4.2%, or nearly as rapidly as GDP (4.8%), demonstrating an unusually high elasticity of employment with respect to GDP (0.88).[3] Two factors were in large part responsible for this: (1) a rapid growth in public sector employment alongside employment growth in the productive sectors and (2) a slow growth in industrial productivity, i.e., the introduction of new labor-saving technologies. These trends cannot be assumed to prevail during the 1980's. Public sector employment will have to be constrained by the GOCR's austerity program. Industrial productivity will have to improve on its poor performance of the past in order to be more competitive in new markets.

1/Source: November 1981 employment survey by the Office of Statistics and Census.

2/Source: July 1979, 1980 and 1981 employment surveys conducted by the GOCR Office of Statistics and Census.

3/Defined as the ratio between the rate of growth of employment and the rate of growth of GDP.

Table 5

Labor Force, Employment, and Unemployment Projections, 1980-1986

	Population	Labor Force	Labor Force Participation Rate %	Projected GDP Growth Rate %	Projected Empl. Growth Rate %	Employment	Unemployment	Unemployment Rate %
1980 Actual	2,217,761	770,272	34.73	-	-	724,708	45,564	5.9
1981 Actual	(2,270,610)	(797,001)	(35.14)	-	-	(731,158)	(69,614)	(8.7)
1981 Projected	2,269,000	792,300	34.91	- 0.9	-0.5	721,004	71,216	9.0
1982 "	2,232,220	814,960	35.00	-4.0	-2.4	703,778	111,182	13.6
1983 "	2,377,815	838,270	35.26	0.0	0.5	707,297	130,973	15.6
1984 "	2,433,695	862,245	35.43	2.1	1.3	716,492	145,753	16.9
1985 "	2,490,885	886,905	35.61	2.0	1.2	725,090	161,815	18.2
1986 "	2,549,396	912,270	35.78	2.3	1.4	735,241	177,029	19.4

Sources: Actual 1980 and 1981 population and labor force data from the GOCR's office of Census and Statistics; population and labor growth rate assumptions for 1980-1986 from Academia de Centro América; C. Zuvekas' assumptions regarding the relationship between output and employment, as explained in his report "Costa Rica: A Review of Macroeconomic Conditions, with Projections to 1985."

Up until now the Costa Ricans, a people with rising material aspirations fueled by thirty years of generally improving economic situation, have shown admirable restraint. Though feeling the consequences of the deteriorating conditions, in terms of accelerating unemployment, retrenchment of social services, and rampant inflation, organized labor and other segments of society have made only moderate demands for wage increases. The incidence of strikes and worker support for them has been limited. On the other hand, violent leftist terrorist groups have emerged on the scene. This phenomenon came as a shock to most Costa Ricans. While there was some panic and capital flight as a result, so far terrorism's impact on the precarious economic and social situation has not been comparable to the effect of violence in neighboring countries. Still, Costa Rican traditions of liberal democracy, social dialogue, and lack of political violence are being severely tested.

Export Expansion and Investment Promotion

Faced with a limited domestic market, regional political instability, and growing protectionism and payments problems within the Central American Common Market, it is widely understood that Costa Rica has reached the limits of its industrial import substitution policies. The country must now seek extra-regional export markets for its production if growth is to continue. Many key ingredients necessary to the major economic transformation which this implies are already available in Costa Rica; others are lacking and will have to be put in place.

Costa Rica's general environment and physical infrastructure (water, electricity, roads, etc.), as well as its talented, educated and flexible workforce, are obvious advantages which the country has at its disposal. A generally positive disposition towards foreign investment also favors the development and expansion of exporting efforts by foreigners.

Perhaps the most severe impediment to expanded export production is the dearth of credit described above. The significant amounts of capital required for a reorientation of the economy towards export are no more available for export activities than for any other. The nonbankability of many existing producers compounds the problem. While professional managerial talent is an obvious asset in Costa Rica, specialized knowledge in the areas of export procedures, markets and financing is noticeably lacking.

A number of financial incentives have been enacted over the past decade which give export producers tax credits for nontraditional production or for increases in export production, and which permit duty free importation of intermediate goods ultimately exported. These incentives have had some success in stimulating export activity. Nonetheless, the cumbersome procedures and regulations associated with these measures, and their generally perceived inadequacy, have limited their positive impact. Moreover, the benefits of the incentives appear to be overshadowed by disincentives such as export taxes and the high degree of uncertainty and implicit export tax associated with the current exchange rate regime. These areas must be addressed if any meaningful advances are to be made in expanding Costa Rican exports.

The Costa Rican Export/Investment Promotion Center (CENPRO) was created in 1969 to assist businessmen to market their products overseas, and to assist foreign investors in establishing enterprises in Costa Rica. The concensus of local business on CENPRO is that it has been ineffective both in serving business needs (assisting in the export

marketing of local goods) and in acting as a spokesman for private exporters so as to influence official policy. Moreover, examples of foreign investment directly stimulated by CENPRO are very few, if any.

In Costa Rica there exists a widely held acceptance of the need for, and a receptiveness towards, foreign investment. It is well understood that trade is key to the rehabilitation of the national economy and its future continued growth. Given this favorable disposition, it is unfortunate that relatively few legal and institutional mechanisms exist for the promotion of investment and export activities.

Industry and Commerce

Overview

The 1981 Salvadoran GDP, the value of all goods and services produced in the nation, was approximately $3.4 billion measured in current dollars (See Table II-1). In real terms, 1981 production was almost 20 percent below that of 1978, with predictable implications for private consumption employment, worker/management/ government relations, and political stability.

The causes for this decline lie both within and outside of El Salvador. Within El Salvador, political instability culminating in a military coup in October 1979 led to the ascendancy of a strongly populist, reform-minded government, with little or no base of support among the economic leadership of the nation. This government was successful in stabilizing and reversing a trend toward growing popular unrest, but only at the price of massive reforms of key sectors of the economy, which confirmed and hardened conservative opposition against it and severely taxed the economic structure of the nation. At the same time, sharply falling prices in El Salvador's traditional export commodities, weakness in the Central American Common Market to which El Salvador customarily sells its industrial production, rising petroleum prices, high commercial interest rates for those loans which El Salvador could obtain, and a worldwide recession sharply reduced the financial resources available to the government and the private sector to deal with the nation's problems.

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TABLE 1

GDP

U.S.$ Million

	1978 1/	1979	1980	1981
Consumption	2.553.0	2.800.2	3.057.3	3.257.6
Private	2.165.4	2.357.8	2.552.4	2.745.6
Public	387.6	442.4	504.9	512.0
Fixed Capital Formation	714.4	624.5	467.8	406.2
Private Fixed Capital	501.1	391.7	230.4	209.1
Public Fixed Capital	213.3	232.8	237.4	197.1
Inventory Changes	73.0	-31.0	-68.0	-16.0
Exports of Goods and Services	978.3	1.364.9	1.078.6	933.3
Imports of Goods and Services	-1.217.3	-1.261.2	-1.148.2	-1.195.6
G D P	3.076.9	3.447.4	3.387.5	3.385.5
Agriculture	843.9	1.035.7	899.9	873.8
Commerce	733.2	800.1	805.9	793.6
Manufacturing	481.9	524.4	518.0	492.1
Public Administration	278.9	304.6	353.3	379.9
Personal Services	195.8	209.2	224.3	220.2
Transport, Storage and Communications	116.4	116.7	125.1	118.6
Finance	103.8	114.5	120.8	132.3
Private Construction	73.2	79.3	86.8	90.8
Other Value Added	170.0	195.6	228.2	257.1

1/ Figures do not add because of statistical discrepancy

SOURCE: Central Reserve Bank of El Salvador

COMPONENTS OF REAL GDP

GDP was almost 20 percent lower in 1981 than in 1978, in real terms. Since 1978, overall private consumption in El Salvador has declined by 24 percent (See Table 2). Although population data is scanty because of the nation's unstable social environment, the probable assumption that population has continued to grow during these years would indicate an even sharper decline in per capita consumption. From 1970 to 1977, private fixed capital formation made up 13-22 percent of GDP; in 1981, it had fallen to only 6.2 percent of GDP. In comparison with 1978, exports of goods and services were a real 13 percent lower in 1981 and, most important for an import-dependent economy, imports of goods and services were down by 47 percent. The hardest hit sectors of the economy were construction (down 48 percent since 1978), merchandising (down 37 percent), manufacturing, which depends on imports of raw materials and capital goods (down 32 percent), and agriculture, the mainstay of the economy (down 9 percent).

TABLE 2

PERCENT CHANGE IN COMPONENTS OF REAL GDP

	78/79	79/80	80/81	78/81
Consumption	-4.1	-5.8	-7.6	-20.6
Private	-5.5	-7.3	-8.2	-24.4
Public	5.1	2.9	-4.7	3.0
Fixed Capital Formation	-22.2	-33.0	-25.4	-55.6
Private Fixed Capital	-31.8	-47.7	-22.9	-69.3
Public Fixed Capital	-1.6	-11.0	-27.6	-27.5
Exports of Goods & Servcs.	29.0	-6.1	-25.1	-12.6
Imports of Goods & Servcs.	-11.6	-22.9	-11.3	-47.2
G D P	-1.5	-9.6	-9.5	-19.4
Agriculture	1.5	-5.9	-4.3	-8.7
Commerce	-2.6	-13.9	-14.4	-36.8
Manufacturing	-2.9	-15.5	-17.4	-32.1
Public Administration	3.8	3.5	2.4	10.0
Personal Services	-4.7	-8.4	-14.4	-25.3
Public Construction	-11.3	-5.6	-8.6	-23.5
Private Construction	-17.7	-67.7	-6.0	-75.0
Transport, Storage & Comm.	-6.5	-6.7	-17.4	-27.8
Finance	2.1	-8.1	-3.6	-9.6
Other Value Added	1.6	-5.3	-9.8	-15.9

SOURCE: Central Reserve Bank of El Salvador

BALANCE OF PAYMENTS

The Salvadoran economy is dependent on international trade to provide markets for its industrial and agricultural production and, in return, supply it with imports basic to production and consumption, such as raw materials, capital goods, replacement parts, petroleum, fertilizers, wheat, and medicines. Every major sector depends on imports. As a result, there is a high correlation between the level of real imports (especially production goods), national production levels and employment, although less so. Moreover, although in the past El Salvador has financed most of its own development, it will have to depend more on foreign private investment, in order to absorb the pressures of an already dense and rapidly growing population in the future. Thus, the proposed Caribbean Basin Initiative, in both its trade and investment aspects, meets Salvadoran needs during its immediate economic crisis and, in the longer term, for development.

El Salvador's basic exports are coffee, cotton, sugar and, growing rapidly, shrimp, and also manufactured products sold to the Central American market. In 1979, exports reached a high point of $1.1 billion. In 1982 exports are projected to decline to $775 million, a decline of more than 30 percent in nominal terms. (See Table 3).

Imports reached their high point in 1978 at slightly over $1.0 billion. However, imports fell a low of '972 million in 1980, but in real terms the decline continued through 1981.

TABLE . 3

BALANCE OF PAYMENTS

--in US$ millions--

	1978	1979	1980	1981	Proposed 1982
Exports	801.6	1,129.4	1,072.1	793.1	775.9
Coffee	385.6	675.2	615.2	452.6	398.0
Cotton	98.4	84.6	82.8	52.6	58.1
Sugar	18.9	26.8	13.2	14.0	10.0
Shrimp	10.6	12.3	13.4	18.7	24.5
Other	288.1	330.5	347.5	255.2	285.3
Imports	1,029.0	1,024.5	971.8	980.8	1,043.4
Consumer	266.4	275.9	306.7	297.2	304.0
Petroleum	76.4	114.3	151.3	149.0	161.0
Non-Pet. Production	421.0	418.3	401.8	424.8	469.2
Capital	265.2	216.0	112.0	109.8	109.2
Trade Balance	-227.4	104.9	100.3	-187.7	-267.5
Net Services	-109.7	-121.5	-131.6	-127.6	-129.2
Net Transfers	51.4	51.4	48.9	28.2	40.0
Current Balance	-285.7	34.8	17.6	-287.1	-356.7
Net Bank/Official Capital	128.6	103.3	186.0	253.0	464.9
Net Private Capital	185.8	-246.2	-400.4	- 45.0	- 68.2
Capital Balance	314.4	-142.9	-213.8	208.0	396.7
Balance of Payments	28.7	-108.1	-196.2	- 79.1	40.0
Closing Intl. Reserves	234.4	126.3	- 69.9	-149.0	-139.0
Change in Arrearages	-0-	-0-	41.0	45.6	-30.0
Closing Int. Res. (with arrearages)	234.4	126.3	-110.9	-235.6	-205.6
Level of Arrearages	-0-	-0-	41.0	86.6	56.6

Note: 1982 balance of payments conforms to IMF requirements for reduction of arrearages and buildup of reserves. It assumes passage of the proposed CBI ESF loan of $128 million to El Salvador. Since this may be reduced, tranched, or delayed until late in 1982, the projected 1982 BOP should be viewed as optimistic. Any of the less favorable scenarios would result in reduced imports, production and employment. See text for discussion.

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Salvadoran foreign debt has climbed sharply in recent years, especially non-private foreign debt. At the close of 1979, total national indebtedness stood at $955 million; on March 31, 1982, this debt had increased to more than $1.5 billion, an increase of 63 percent. During the same period, Central Bank and public sector debt more than doubled from $608 million to $1.3 billion. (See Table II-4). Predictably, there has been been an overall decline in the share of private sector foreign debt from 36 percent to 13 percent, and within private sector debt there has been a sharp reduction in short-term debt as lines of credit reach maturity and are not renewed.

The balance sheet of the Salvadoran banking system continues to show a disproportionate share of credit directed to the public sector. Nevertheless, the situation is improving. Credit and investments to the private sector rose from $856 million in March 1981 to $973 million in March 1982, an increase of 14 percent. (See Table 5). For the remainder of 1982 and into 1983, private sector credit demand can be expected to outstrip the financing available, which will act as a brake on economic stabilization and recovery.

Money supply (M1) has shown a 26 percent increase over December 1978 levels. The primary source of this increase derived from an overall increase in cash in circulation.

Money Supply
(Millions of U.S. Dollars)

	12/78	12/79	12/80	12/81	3/82
M1	476	570	624	627	599
Index	100	120	131	132	126

Source: Banco Central de Reserva

TABLE 4

FOREIGN DEBT LEVEL

--in US$ million--

	12/1979	12/1980	12/1981	3/1982
Private Sector	347.7	252.2	215.1	205.2
Short Term	178.6	91.6	67.7	64.8
Med and Long Term	169.1	160.6	147.4	140.4
Central Bank	192.6	486.0	601.2	640.9
Short Term	-0-	185.5	235.3	221.8
Med and Long Term	192.6	300.5	365.9	419.1
Public Sector	414.9	475.1	649.3	708.1
Central Government	260.6	338.2	499.1	552.2
Official Instits.	154.3	136.9	150.2	155.9
Total Debt	955.2	1,213.3	1,465.6	1,554.2
Total Non-Private Debt	607.5	961.1	1,250.5	1,349.0

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TABLE 5

BALANCE SHEET OF SALVADORAN BANKING SYSTEM

IN MILLIONS OF US DOLLARS

	12/78	12/79	12/80	12/81	3/81	3/82
Assets	1,381.9	1,519.0	1,654.1	1,908.3	1,749.1	1,986.6
Foreign Sector	76.8	- 75.3	- 359.8	- 517.8	- 356.8	- 550.8
Net International Res.	234.4	121.4	- 69.9	- 149.0	- 31.4	- 125.4
Other Int. Liabilities	- 157.6	- 196.7	- 289.9	- 368.8	- 325.4	- 425.4
Credit & Investments	1,066.3	1,313.7	1,664.1	1,997.1	1,702.9	2,044.9
To Private Sector	888.2	888.6	870.6	974.4	855.9	972.9
To Official Inst.	159.2	371.3	564.9	518.9	574.6	544.4
To Central Gov.	18.9	53.6	228.6	503.8	272.4	527.6
Other	238.8	280.6	349.8	429.0	403.0	492.5
Liabilities	1,381.9	1,519.0	1,654.1	1,908.3	1,749.1	1,986.6
Money Supply (M_1)	476.1	570.2	623.5	627.4	584.2	598.7
Cash in Circulation	200.2	296.1	287.5	281.3	251.8	262.0
Private Sight Deposits	234.6	231.2	278.7	280.2	271.4	257.9
Offic. Sight Deposits	41.3	42.7	57.3	65.9	61.0	73.8
Other Private Deposits	461.8	449.9	453.9	558.8	503.7	606.2
Savings and Time	460.5	449.3	453.5	556.8	502.3	601.3
Foreign Currency	1.3	0.6	0.4	2.0	1.4	4.9
Central Gov. Deposits	55.3	45.3	61.2	80.1	65.0	80.5
Other Liabilities	267.9	305.6	345.5	461.5	418.1	518.7
Capital and Reserves	117.6	148.0	170.0	160.5	178.1	182.5

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EMPLOYMENT AND THE LABOR FORCE

Employment

A ROCAP study 1/ undertaken in early 1981, estimated unemployment in 1980 to average 225,000-245,000 persons, or 16-17% of a labor force estimated at 1.5 million (Table 6). This figure includes the openly unemployed and the unemployment equivalent of persons involuntarily working less than full time. The sectors most affected have been agriculture and construction (Table 7). Besides the 1981 GDP decrease of 9.5% a major contributor to this level of unemployment was an annual increment in the labor force of 50,000 workers.

Of particular concern is the number of business closings since 1979, as shown in the table below:

BUSINESS CLOSURES

	1979	1980	1981	1982	Reopened	Net Closures
No. Firms	29	108	86	13	45	191
No. Employees	6,981	10,004	5,829	1,782	1,992	22,604

SOURCE: Ministry of Labor, through March 1982.

Employment and unemployment, it should be pointed out, are subject to considerable seasonal variation. Seasonal unemployment is especially high from March through May, following the end of the principal harvest season for the country's major crops. Underemployment is also a problem, both in terms of fewer than desired hours of work and incomes too low to meet basic needs requirements.

Wages

The GOES has established minimum wage levels for various occupations and wage differentials between the Metropolitan San Salvador area and the rest of the country. For non-agricultural workers, the last minimum wage law was enacted on April 29, 1980. The law made effective a minimum wage which increased daily salaries for workers in San Salvador and in

1/ "El Salvador: Economic Assessment and Policy Issues", Clark Joel (AID-ROCAP) and Clarence Zuvekas (LAC/DP).

the rest of the country to 11.00 colones ($4.40) and to 10.00 colones ($4.00), respectively. As an emergency measure, the Law of Economic Stabilization (Decree 544) promulgated on December 22, 1980, effectively froze all salaries until March 31, 1983, with the exception of a one-time 10% salary increase permitted after February 15, 1982. Public workers in fact will not be permitted the 10% increase.

Price Controls

Specific price controls on basic food grains, medicines, medical services, education, and rent remain in effect. No increases are presently expected for these goods and services, nor for petroleum products, which are also regulated. Prices on consumer non durables continue to raise. While the official consumer price index as of October 1981 was 14 percent, some goods--particularly in the import sector, registered price increases in 1981 exceeding 100%.

Union Activity

The current Labor Code permits employers and employees to form industrial unions, company unions, and traded unions. It is the employer' option, however, to hire union or non-union workers. In 1980, registered unions totalled 124 with total membership of slightly over 71,000. While the manufacturing industrial sector accounts for over half the total number of unions (69), the construction sector accounts for the greatest portion of membership (31,140 members, 43.8% of total union members). Total union membership peaked in 1977, with over 76,000 registered members; while in 1978, total membership declined to 55,200. Membership climbed in 1979 to nearly 65,600 and continued to grow in 1980 to over 71,000. Sectors currently showing membership greater than previous years are: agriculture and fishing; commerce (including restaurants and hotels); transport and communication; finance and insurance; and services. Construction, utilities, and manufacturing industries show memberships below their 1977 levels.

In 1979, the number of collective labor disputes (103) almost quadrupled the number registered in 1978 (29), with the vast majority (86) occurring in the manufacturing industry sector. In 1980, as the number of business closings increased from 29 (in 1979) to 137, the number of labor disputes declined abrupltу to 42. The total number of workers affected by the disputes in 1980 was 13,904, resulting in 47,511 man-days of labor lost. The causes of the 42 disputes were: desired salary increased (27); laying off of workers (5); solidarity with other strikers (5); and other causes (5). While statistics for labor disputes in 1981 are not yet available, it is likely to have declined further as a result of an additional 86 business closures and the enactment of the aforementioned Law of Economic Stabilization. The Law not only effectively froze all salaries but also prohibited all organized labor activity with potential economic repercussions.

Labor Force

From 1970-1980, the labor force grew at an annual rate of 2.8 percent. From 1980-2000, the growth rate can be expected to climb to 3.5 percent annually, creating a major employment generation problem. A breakdown of the 50,000 new labor force entrants each year shows that about 4% are executive, professional, and technical. Another 28% possess middle-level skills, while the remaining 68% are unskilled laborers for whom productive employment is not readily available. It is estimated that for every new job created, there are four workers available to fill it. Due to the high growth rate and young age structure of the population, the primary education system absorbs only 75% of the 7 to 15 year-old age group. As a result, about 40% of the total labor force and 56% of the rural labor force are illiterate. Only 15% of agricultural workers have more than a third grade education, compared to 82% of all industrial workers. The low level of educational attainment in rural areas constitutes a barrier to the introduction of modern techniques in agricultural and livestock production. Although the modern sectors have grown (from 1960 to 1979 the percentage of the labor force in industry shifted from 17 percent to 22 percent; in services the shift was from 21 to 27 percent), employment opportunities in these sectors were insufficient to absorb the excess labor force in the agricultural sector.

TABLE 6

CONJECTURAL EMPLOYMENT AND UNEMPLOYMENT DATA, 1971-1981
(thousands of persons)

	(1) Labor Force	(2) Employment	(3) Adjusted Employment	(4) Employment Growth Rate	(5) Unemployment	(6) Unemployment Rate	(7) GDP Growth Rate
1971	1,116	1,028.9	1,029		87	7.8	4.6
1972	1,153	1,076.8	1,077	4.7	76	6.6	5.7
1973	1,191	1,124.6	1,125	4.6	66	5.5	5.1
1974	1,230	1,172.4	1,172	4.2	58	4.7	6.4
1975	1,270	1,220.3	1,220	4.1	50	3.9	5.6
1976	1,313	1,263.2	1,263	3.5	50	3.8	3.9
1977	1,357	1,307.7	1,308	3.6	49	3.6	5.2
1978	1,403	1,234.5	1,352	3.4	51	3.6	4.4
1979	1,451	1,222.2	1,340	-0.9	111	7.6	-1.2
1980	1,500		1,256	-6.3	244	16.3	-8.7
1981	1,550		1,256	0.0	294	19.0	0.0

Sources: (1) IDB, Economic and Social Progress in Latin America, 1977 Report, Chapter 5.

(2) El Salvador, Ministerio de Planificación y Coordinación de Desarrollo Económico y Social, El Salvador: Informe Económico y Social 1979 (San Salvador, August 1980).

(3) 1971-77: Column (2) figures, rounded; 1978-81: Based on the elasticity of employment with respect to GDP from 1971 to 1977.

(4) Column (3).

(5) Column (1) minus Column (3).

(6) Column (4) divided by Column (1).

(7) 1971-79: Same as (2); 1980: Central Bank estimate; 1981: Best-case assumption.

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TABLE 7

OPEN UNEMPLOYMENT RATES BY SECTOR, JANUARY–JUNE 1980

(percentages)

Economic Sector	Economically Active Population	Unemployment Rates					
		January	February	March	April	May	June
ALL SECTORS	1,625,000	7.5	15.8	23.3	22.0	15.4	14.2
Agriculture	711,000	11.8	25.6	48.3	43.3	22.5	18.6
Mining	1,000	-	-	-	-	-	-
Manufacturing	244,000	2.0	6.2	5.6	12.9	8.3	10.5
Utilities	14,000	4.1	9.2	-	7.8	10.7	-
Construction	70,000	14.7	12.6	10.8	13.7	11.0	24.0
Commerce	258,000	1.2	3.1	1.7	3.3	5.3	4.0
Transport	57,000	4.7	7.3	6.4	11.3	9.0	8.8
Banking and Finance	25,000	5.4	4.9	13.2	15.2	6.5	-
Services	234,000	3.0	7.6	7.5	4.7	5.0	5.7
Other	7,000	-	-	-	-	-	-

Source: Proyecto Indicadores de Progreso Social, unpublished preliminary data, February 27, 1981.

Note: See text for the definition of unemployment used in these surveys.

INDUSTRY

DESCRIPTION

After agriculture and commerce, manufacturing makes the largest contribution to El Salvador's Gross Domestic Product. In real terms, the contributions of this sector were 18.9%, 18.7% and 17.5% in 1978, 1979 and 1980 respectively. The importance of manufacturing is further highlighted by the fact that it accounts for approximately 30 percent of the total value of the country's exports and provides employment for nearly 15 percent of the labor force.

The last census of manufacturing in El Salvador in 1978 identified 10,065 establishments, of which 1,319 were plants employing five people or more. In that year, these establishments employed 96,844 people, of which 80,055 worked for those plants employing more than four people.

Payments to workers and employees in 1978 reached US$155.5 million of which 84% were salaries and the remainder other labor costs. Raw material costs were about $920 million, of which some 29% was imported.

The gross production of the manufacturing sector in 1978 was $1,845 million, of which $684.2 million was value added. This production was heavily concentrated in food products (including coffee beneficiating and sugar refining) and textiles which generated 54% of the gross production and 44% of the value added.

Included in the manufacturing sector mentioned above are those agricultural beneficiating plants comprising the preparation of crude coffee and cotton, and the sugar mills. While these plants generate a substantial 37% of total industrial gross production, and 22% of its employment, their capacity as economic generators is relatively less than that of the other manufacturing sub-sectors.[1/]

[1/] These include the following: Food products, beverages and tobacco; textiles and leather; wood and wood products; paper, paper products and printing; chemical products; non-metallic mineral products; basic metals; metal products; and others.

Principal Problems and Constraints

Salvadoran industry has suffered from severe negative pressures from 1978 to the present, resulting from terrorism, labor unrest, political uncertainties, loss of markets, lack of foreign exchange and financial problems. Of 1,128 manufacturing firms with over 4 employees which were operating in 1978, 68 firms had shut-down by 1981 and factory employment declined by over 31%. During the same period new private investment in industrial fixed assets, which was $137.4 million, experienced a 60% drop. Industrial production declined at an accelerating rate of 69% of 1978 levels, in real terms.

a) Financial Problems

After over three years of unfavorable environment, many local industrial firms have suffered losses, decimation of their inventories, physical plant deterioration, and are overburdened with short-term debt.

These conditions have created the following problems:

(1) Technical insolvency. Because of the deterioration of their current ratios these firms cannot qualify for new working capital loans until they work out a revised capital structure.

(2) Deterioration of bank liquidity. Because these firms are legitimately unable to repay their loans, banks are renewing such loans as a temporary measure.

To the extent that this continues, credit for industry will dry up, and bank liquidity will be progressively more impaired.

(3) Lack of Investment Credit. There is no adequate supply of medium and long-term investment credit to finance reconditioning and expansion of existing plants, and in the longer-term to finance new projects. Such financing came traditionally from external sources which are now cut off due to the high political risks of lending to El Salvador, and from the government development bank, INSAFI, which is now bankrupt and in reorganization.

Traditionally, the commercial banking system has limited its industrial credit to short-term working capital loans, and the banks have not developed any substantial capacity in investment credit evaluation.

b) Lack of Foreign Exchange

Because of the deterioration of the country's balance of payments, industry has suffered from an insufficient supply of foreign exchange to finance the import of raw materials and for maintaining the physical plants.

According to estimates prepared in December, 1981, industry will require $341 million to finance imported raw materials, and $239 million for plant reconditioning in the next 12 months in order to reach an industrial recovery equivalent to 80% of 1978 production. This total of $580 million required is $195 million in excess of anticipated foreign exchange availabilities in El Salvador for these purposes during the period in question.

c) Political Risks

The country has suffered from severe problems of guerilla warfare, urban terrorism, negative balance of payments, and loss of internal business confidence, which have seriously restrained the movement of external credit and investment to El Salvador, and impaired the ability of the country to engage in the export of its manufactured goods because of the doubts of the foreign buyers of the ability of Salvadoran manufacturers to perform contracts reliably, due to the aforementioned problems.

These problems have resulted in:

(1) Shutting down of assembly plants in the San Bartolo Free Zone, which depend primarily on the import of semi-processed goods for further processing or completion.

(2) The suspension of major export contracts because of the questionable ability of the manufacturer to obtain sufficient foreign exchange for raw material supplies to assure performance.

(3) The suspension of supplier credit and short-term bank lines to the country.

(4) A net negative foreign investment to the country (capital flight).

d) Lack of Export Know-How

Salvadoran industry has historically produced about 70% of its output for internal consumption, and a large part of its exports of manufactured goods wer sold in the Central American Common Market. The country's industrial exporters do have limited experience in third country markets, such as the United States. However, trade connections, knowledge of the markets requirements in terms of price, quality, packing, etc. could be vastly improved.

Furthermore, over 90% of the manufacturing firms are small to medium-size companies with extremely limited or no export experience whatsoever.

For a more in-depth discussion of the industrial sub-subsector, the reader is referred to Maintaining El Salvador's Private Sector: Industrial Recovery, Checchi and Company, Washington, D.C., December 1981.

COMMERCE

1. Background

Commerce is the second largest contributor to El Salvador's gross domestic product, following the agriculture sector. Percentage contribution for the GDP in 1978 was 23.8%; 23.2 in 1979 and 23.7 in 1980.

According to the latest census for the year 1978, there were 1,349 commercial establishments employing five people or more. These firms employed 29,025 people and paid them a total of $79.5 million in remunerations. Gross sales were $1,360 million and value added was $382.4 million.

The commerce sector has suffered equally with other sectors of the economy from the negative pressures of the past three years: since June 1979 some 167 commercial firms have gone out of business.

2. Constraints

It is important to note that, historically, the principal exporting activities of the private commercial sector were in the sale of the country's agricultural commodities, coffee and sugar. (Cotton was, and, continues to be, exported by a growers cooperative). Exports of manufactured goods were mainly handled by the producing factories, and not by exporting firms. The remaining private commerce of the country has been largely concentrated in importing-distributing firms, and retail merchants.

With the nationalization of the exports of coffee and sugar, the activities of the commercial sector are mainly directed to importing and internal commerce.

BANKING

The Banking sector is comprised of the Central Reserve Bank (BCR), and the following various financial institutions:

10 commercial banks, and 1 finance company
1 mortgage bank
8 savings and loan institutions
1 national home loan bank
1 agricultural development bank
2 savings unions, and
4 foreign commercial banks

INSAFI, the national industrial development bank was recently dissolved due to deep financial problems; it is very doubtful whether its newly created successor institutions, Banco Nacional de Fomento Industrial (BANAFI) and Corporación Salvadoreña de Inversiones (CORSAIN) will ever function.

General Outlook

As can be seen in the table below, the commercial banks have traditionally had the majority of deposits and loans outstanding:

Table 8

GLOBAL DEPOSITS AND CREDIT LEVELS, YEAR-END

($ millions)

Deposits		1979	1980	7/1981
A.	Commercial Banks	$ 695	$ 757	$ 770
B.	Rest of Financial Sector	240	291	N/A
	Total Deposits	$ 935	1,048	N/A
Loans Outstanding				
A.	Commercial Banks	$ 932	$ 788	$ 461
B.	Rest of Financial Sector	$ 706	$ 782	N/A
	Total Credit	$1,638	$1,570	N/A

For the three-year period 1977 through 1979, the nation's commercial banks--including the Banco Hipotecario--kept their loan levels fairly constant at around $950 million with only a slight decline over time. This slow decline in loans outstanding at year-end turned more sharply downward in 1980 when loan levels fell to $788 million, down from $976 million in 1977, for a 23.8 percent drop.

This constant decline in outstanding credit reflects the weakening of El Salvador's economy, i.e., the fact that real GDP has fallen by a real 20% since 1978.

By December 1981, loan levels had not increased significantly; loans outstanding amounted to $950 million. However, considering that the inflation levels for the four-year period exceeds 50 percent, the volume of loans outstanding is significantly lower in real terms.

As can be seen in the following table, refinancing increased sharply from $107 million in 1977 to an unwieldy $150 million in 1980, caused primarily by the banks' seriously weakened cotton and coffee portfolios.

TABLE 9

Bank Loans Outstanding at Year End

($ millions)

	1977	1978	1979	1980	% Change
Agriculture	$262	$234	$225	$202	(29.7)
Industry	128	129.6	118	78.8	(38.4)
Construction	54.4	69.1	57.2	30.7	(77)
Commerce	400	394	400	314	(27)
Refinancing	106	116	94	150	+42
Other Loans	25.6	20.1	37.4	12.7	(101)
Total Loans	$976	962.8	931.6	$788.2	(23.8)

The greatest reduction in credit was felt by the construction and industry sectors, whose financial needs were sacrificed to provide refinancing of unpaid loans. By September 1981, refinancing requirements had reached an extraordinary high $244 million.

External Financing

Over the last few years, El Salvador has seen its external bank financing and trade credit decrease alarmingly. It is estimated that the commercial banks lost approximately $500 million in short-term, trade-related credit facilities from foreign banks since 1979, contributing significantly to the drop in foreign exchange reserves. Official net international reserves were $266 million in 1978, dropping to a minus $197 million by year-end 1981.

Concurrently, trade credit levels have also been reduced substantially. For example, commercial banks are now obliged to deposit dollars, as collateral on an average of 90 days prior to the shipment of goods just to have their clients' letters of credit confirmed. This excessive demand for scarce foreign exchange reduces the economy's ability to import vital raw materials to keep production up.

The severe lack of foreign exchange has been the major constraint to industrial reactivation, greater even than constraints of terrorism and security problems.

The drop in exports and production between 1977 and 1981 caused a dramatic increase in public external debt, from $280 to $649 million. While precise data is not readily available, it is obvious that the term structure of El Salvador's external debt is exceedingly too short, not providing sufficient time to bridge finance the country's economic problems.

But the term structure problem is not limited to the commercial banks' foreign exchange funding. The preponderance of 1981 bank loans was funded by $800 million in deposits of the public in local currency; 35 percent of those deposits were on a demand basis, 28% on time, and only 37% of those deposits were in passbook savings, which provide longer term funds to the banks.

The only other significant longer term funds came from special BCR lines which reached $200 million at year-end 1981. But subtracting the $77 million in bonds and treasury bills outstanding (which the banks must invest in) left slightly more than $100 million in longer term funds outstanding to finance industrial and other long-term projects presented to the banks. While precise data is difficult to obtain, the Checchi study estimates that the average loans term in bank portfolios is about six months. But whatever the true average life, it is obvious that the banking sector does not have the necessary long term funds internally or externally to fund development needs, let alone to jolt the economy out of its stagnant state.

Lending Policies

Before nationalization, control and management of the commercial banks were heavily interlocked with owners of large and medium agricultural, commercial and industrial enterprises. Production and working capital loans were made largely on the basis of personal knowledge and long-standing client relationships. Principal reliance for funds was on the bank's own resources with minor use of BCR rediscount facilities. Few loans were over one year; intermediate capital came largely from external financing and from direct local investment. Under these circumstances the banks did not need or develop any substantial capacity in credit analysis and assistance to clients.

In this sense, it is essential for the Mission to implement an ongoing credit analyst training program to support the human resources needed to prevent the bank reform from deteriorating.

Commercial banks recognize their deficiencies in credit analysis capability; some of them are trying to alleviate it by employing additional staff. Progress is slow, owing to government austerity programs against increasing personnel in nationalized institutions; pay scales are frozen at low levels, and there is limited availability of people possessing the necessary skills.

Bank Nationalization

On March 7, 1980, El Salvador's financial system was nationalized, pursuant to Decree 158. Nationalization involved three basic activities: (1) taking over management and control of the affected institutions; (2) carrying out financial audit to determine net worth of former owners; and (3) issuance and payment of bonds for compensation.

Management and control: This step was achieved by progressive steps culminating in a control of the bank boards by the Central Reserve Bank.

Valuation

As of this date, the Commission has completed the financial audit of each institution, thus evaluating the net worth accounts of the previous owners. As part of the valuation process, doubtful assets (mostly loans) have been turned over to the deposed owners so that they may attempt to recover their cash from shaky borrowers.

Approximately $61 million in compensation was made in the form of five-year bonds bearing nine percent interest (which is taxable). These interest payments to date have been made on time.

Many complaints relating to the bank reform have to do with the fact that the GOES did not consider any intangible "goodwill" in the valuation of the assets of each institution. The critics argue--with some validity--that the organizations nationalized were really worth more than their book value. They point out, for instance, that years of image building, development of branch locations, and managerial experience etc., were assets which did not appear on the balance sheet but did have economic value.

TOURISM SECTOR

1. Resources

At first glance, this sector would appear to be relatively insignificant: its 12 major hotels have only 1,200 rooms, and its private sector direct employment in hotels, food, travel agents and tour operators totalled only 4,782 at its peak in 1979.

Yet its importance in export earnings is revealed in the Table below: tourism was the third largest foreign exchange earner in 1977 and 1978, exceeding sugar and shrimp; and it was the fourth largest foreign exchange earner in 1979. In addition, the multiplier factor of this sector is well-recognized, and will be especially so in a country as high industrialized as El Salvador.

RELATIVE RANKING OF TOURISM TO OTHER EXPORT ACTIVITIES
1976-1979
(Millions of US$)

Year	Coffee	Cotton	Sugar	Shrimp	Tourism	Tourism Rank
1976	375.8	64.0	40.5	11.8	21.0	4th.
1977	596.4	80.9	26.4	10.5	31.8	3rd.
1978P	432.8	100.5	18.9	10.7	36.7	3rd.
1979P	675.1	87.0	26.8	12.6	24.9	4th.

P/ Preliminary figures.

This sector began to develop its international tourism plant in 1975. During the period of 1975 to 1979, much of the total tourism infrastructure constructed in response to increasing flows of tourists. The number of international leisure travelers had increased from 278,761 in 1977 to 293,080 in 1978, resulting in an average hotel occupancy of 65 percent in those years. A new high-standard international airport was constructed near to existing and proposed beach resorts.

2. Constraints

By May 1979, El Salvador's civil tensions had become headlines and the hotel occupancy rate dropped to 39 percent. A traveler's advisory was placed on El

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Salvador by the U.S. State Department in June of that year, and the occupancy rate plummeted to 15 percent. This rate has recovered only slightly since 1979 to 20 percent during 1980 and 1981 and 25 percent in 1982. This low influx of travelers has adversely affected tour operators and other tourism-related businesses.

As it requires at least a 45-50 percent occupany requirement to break-even all hotels except the Hotel Camino Real (where all the foreign journalists stay) are operating in the red. Hotel rates have been slashed by half. The result has been a heavily battered tourism sub-sector.

STRUCTURE AND ORGANIZATION OF KEY PUBLIC SECTOR MINISTRIES

Ministry of Foreign Commerce (MICE)

That past Salvadoran Governments had the political will to foment exports and welcome foreign investment is evident from the promulgation of appropriate legislation. The Export Development Law approved by the Legislative Assembly in September 5, 1974, established not only a mandate but also a legal institutional infrastructure to foment further industrialization. The National Foreign Trade Council comprised of the Ministers of Finance, Economy, Foreign Affairs, and Planning, and the President of the Central Bank was established to formulate and direct policy vis-a-vis foreign trade and investment. The Salvadoran Institute of Foreign Commerce (ISCE) was established as the implementing agency within the Ministry of Economy.

In January of 1980, Decree No. 68 created the Ministry of Foreign Commerce, which essentially absorbed the mandate of ISCE. While ISCE has not been legally dissolved, much of the supportive human resources such as lawyers, administrators, auditors, etc. which the Ministry of Economy provided to ISCE were not shifted to new MICE. It is still not clear whether ISCE will be maintained as an autonomous agency or phased out.

Within MICE's organizational framework there are four Departments reporting directly to the Undersecretary: i) Imports and Exports; ii) Services, Capital, and Technology Transfer; iii) Export Promotion and Development; and iv) Planning. Other entities included under MICE are the National Sugar Marketing Institute (INAZUCAR) and the National Coffee Marketing Instituce (INCAFE), as well as ISCE.

A. Imports and Exports

This department's basic function is to implement the overall policy of the MICE with regard to foreign trade. It issues export and import licenses, issues certificates of origin, gathers data on exports and import, analyzes internal and foreign commerce and is in charge of investigating problems related to importing and exporting goods and services.

The division also administers and controls bilateral trade agreements and interfaces with the Central Bank on international payment mechanisms.

B. Services, Capital, and Technology Transfer

Some of the MICE's more important functions are carried out by this Department, and it is apparent that some reorganization is necessary as is some kind of budgetary support.

For example, the Ministry of Economy was previously in charge of investigating and authorizing foreign firms who desired to establish operations in El Salvador. Now that it is a MICE function, its staff are either hard-pressed to deliver, or simply cannot, for lack of human resources caused by an inadequate budget.

The Department is also responsible for elaborating an export service strategy, monitoring and controlling bilateral and multilateral service agreements, and assuring that agreements with regard to capital and technology transfer are being met.

Another important function of the Department, which was previously carried-out by the Ministry of Economy, has to do with all non-short-term external debt. All such loans or credit facilities must now be first presented to the Services, Capital, and Technology Transfer Department, where the applications are processed, authorized, and passed to the BCR for appropriate registration of the incoming foreign exchange. At maturity, the borrower goes to the BCR with the appropriate form authorized by MICE to request the foreign exchange be sent back to the lender.

Perhaps the most important function which this Department has under its purview is the overall management of the country's industrial free zone, located in the San Salvador suburb of San Bartolo.

C. Export Promotion and Development

The third Department is the Export Promotion and Development Center (CENTRODEC). Its principal functions are to increase and diversify the country's exports and to penetrate new markets. The unit supports the small and medium size firm which has little or no export experience, quality control and/or working capital.

D. Planning

The principal objective of this Department is to develop foreign trade policy based on the overall social and economic development policies of the Government. Its principal functions are to:

1. Design, formulate and propose foreign trade policies.
2. Implement economically feasible export projects.
3. Analyze proposed economic integration schemes.
4. External market research.
5. Identifying new export projects which would require inter-ministerial support to assure their success.

Ministry of Economy

The Ministry of Economy after the loss of some functions to the Ministry of Foreign Commerce is still in a state of transition. Some departments are in the process of reorganization, as is the case with the Transport Office; some are inoperative; and the status of some of the autonomous dependencies, such as the National Industrial Development Bank (BANAFI) is in doubt.

The general objective of the Ministry of Economy is to orient national economic policy and apply it to those sectors of the economy under its responsibility. Its scope covers principally: industry, tourism, energy, mining, transport, internal commerce, and private capital formation.

On paper, the Ministry is organized according to the following functional divisions: Operational Divisions; Regulatory Bodies; Planning, Coordination, and Statistical offices; and Autonomous Entities.

1. Operational Divisions

a. Industry and Tourism: administration of the legal and fiscal incentives relating to industrial and tourism investments. The division's functions include: promotion, project evaluation, granting incentives and control.

b. Energy and Mineral Resources: responsibility for the development and implementation of the country's energy policies, and for the development of the minerals extraction industry.

c. Transport: When fully organized, this office will be responsible for the development and regulation of land, water and air transport, including rate regulation.

d. Internal Commerce: responsibility for the development of internal commerce and consumer price controls.

2. Regulatory Bodies: This division authorizes the organization of new private companies which fall into one of several categories, limited liability company, limited liability company with variable capital, or an anonymous society; and controls their operations as stipulated by law.

3. Planning, Coordination, and Statistical Division

a. Directorate of Planning: planning of all activities at the Ministerial level; preparation of Ministerial budgets; and provisional technical assistance to the Ministry.

b. Directorate of Economic Studies and Evaluations: preparation of general and sectoral economic studies and prepares national account statistics.

c. Directorate of National and Regional Economic Integration: planning programs and evaluating the integration process. This division is virtually inoperative at present.

d. General Directorate of Statistics and Census: responsibility for the census and the collection of other statistical data.

4. Autonomous Entities

The following autonomous operating entities are dependencies of the Ministry of Economy.:

Executive Commission for Autonomous Ports (CEPA), responsibility for seaport and airport development and operations.

Salvadoran Tourism Institute (ISTU), tourism promotion.

National Industrial Development Bank (BANAFI), Provision of medium and long-term industrial credit.

Salvadoran Investment Corporation (CORSAIN), Promotion industrial investment.

Industrial Guarantee Fund for Small Business (FIGAPE), provision of small business credit.

National Productivity Center (CENAP), industrial development assistance.

Electric Power Commission (CEL), electric power development.

PRIVATE SECTOR ORGANIZATIONS

There are numerous trade associations and other organizations representing private sector interests in El Salvador. The majority of these belong to one "umbrella" organization, the Salvadoran Association of Private Enterprise (ANEP). Major organizations, each with its own constituency, which belong to ANEP are: Salvadoran Chamber of Commerce, Salvadoran Association of Industry (ASI), Council of Agricultural Entities (CEA), the Union of Directors of Salvadoran Businesses (UDES), and the National Federation for Small Enterprise (FENAPES). There is also a political organization comprised mainly of the boards of these organizations called the Productive Alliance.

ASI is considered to be the most liberal and progressive among these organizations, and has been supportive of a recent A.I.D.-financed evaluation of the industrial sector. ASI was established in 1958 and has approximately 300 members who are involved in medium- and large-sized industry.

The most outspoken critic of the various reforms undertaken by the Christian Democratic Junta has been the Chamber of Commerce. The Chamber currently has 700 members representing all sizes and types of businesses. Its objective is to defend the principles of free enterprise as fundamentals for progress of the country.

The Council of Agricultural Entities has been described as the most conservative group. Its membership is made up of association representatives involved in coffee cultivation, coffee milling, agricultural input suppliers, livestock and milk producers, and cotton producers.

The Union of Directors of Salvadoran Businesses tends to integrate representatives from all fields of private endeavor. The organization is described as not having much influence.

The National Federation of Small Enterprises is perhaps the least powerful organization. It has only 34 members: 11 small industrialists, nine from the transport sector, nine representing services, and five from agriculture.

Within ASI, the Committee of Exporters of El Salvador (COEXPORT) was founded in 1973 for the purpose of creating more job opportunities through th establishment and expansion of export industries. The association assists industrialists which export or are interested in exporting non-traditional products outside the Central American Common Market. The stated objectives of COEXPORT are:

1. Represent exporters' interests in governmental, private, and international institutions.
2. Obtain and provide information, documentation, and assistance needed to facilitate export activities.
3. Study and recommend measures which would improve the competitiveness of exporting industries.
4. Facilitate the adoption of systems which would improve and control the quality of goods manufactured in El Salvador, particularly export products.
5. Improve export capabilities of businesses through the organization of courses, seminars, round tables, conferences, and the exchange of experiences to benefit industrialists in general and exporters in particular.
6. Obtain consulting services and technical assistance in matters related to export activity, including feasibility of exporting a particular product, identification of markets, distribution channels, packing and shipping, storage, financing, insurance, fiscal and monetary incentives, attraction of foreign capital, and establishment of export industries.
7. Take necessary measures to improve conditions in the transport of merchandise for export, and ensure that exported products arrive in the international markets in optimum and competitive condition.
8. Collaborate with government and private institutions in international trade fairs in which El Salvador is a participant.
9. Undertake all efforts which directly or indirectly contribute to the development and diversification of the country's exporting capacity, to increase the exportation of manufactured goods, and to create a favorable export climate.

COEXPORT has been instrumental in promoting El Salvador's participation in international trade fairs, most recently in Frankfurt, Germany (1980 and 1981), and in the "Feria de las Américas" in Miami (March 1980). Participation in the Frankfurt fair in 1981 resulted in the establishment of artisan marketing contacts in Israel, Holland, and Greece. Also, the Association has cultivated relationships with a number of international organizations, which have provided assistance in export development through seminars and conferences.

The Central American Institute for Research and Industrial Technology (ICAITI) has provided COEXPORT members with information on export opportunities, training, technical assistance, and marketing information on specific products. In 1980, COEXPORT staff members attended several international trade conferences (Canada and Venezuela).

COEXPORT is not only a source of information and international contacts for private sector exporters, but also performs an important function as a source of expertise to public sector entities on export related matters. The association has participated in working groups with the Ministry of Foreign Relations to support efforts in signing of trade agreements with Honduras and reactivation of a treaty with Panama. COEXPORT has also encouraged the signing of a bilateral trade agreement with the Republic of China, which contemplates measures for technology transfer, financing, and investment projects.

In addition, COEXPORT acts as a lobbyist for exporters' interests on the domestic scene. In this regard, COEXPORT spearheaded the request that the Export Development Law be revised and its regulations up-dated, particularly those pertaining to incentives for exporting businesses. The association is presently participating in a Mixed (private sector and public sector) Commission assigned the task of reviewing the Law. COEXPORT is encouraging: 1) a clear definition of the government's support role in the export sector, and 2) the establishment of instruments to provide export incentives such as financial resources, fiscal measures, and tariffs. With the possible phasing out of ISCE, COEXPORT believes it is critically necessary to establish new mechanisms for private sector participation in decision-making regarding the export sector. For example, COEXPORT has requested that the private sector be permitted to take part in the programming of the Country's official participation in international fairs and expositions with ISCE or its replacement as the coordinator.

COEXPORT's fundamental concern at present is the potential involvement of government entities in the marketing of non-traditional exports such as honey and sesame. The association points out that the Export Development Law clearly states that public sector initiatives in this area should only be undertaken when private sector initiatives have not resulted in efficient marketing, and then, only on an experimental, pilot project basis. Moreover, COEXPORT considers the markets for such products to be highly specialized and sensitive to variables of production, quality, and marketing, which require experience and "know-how" not usually available in public sector institutions.

PUBLIC AND PRIVATE SECTOR RELATIONS

It is somewhat difficult to measure the quality of relations between the Public and Private Sectors, as they presently are in transition. The outcome of the March 28th elections does seem to have produced a more harmonious state of affairs between both sectors. During the past two years there had been a complete split between the two sectors which has not completely disappeared. Some private sector antagonism has been directed toward the USG as a result of its support for the reform process.

Under the sponsorship of ANEP, ASI, the Chamber of Commerce, FENAPES, and UDES, there have been two national symposia. At these symposia held in July 1981 and May 1982, each economic sub-sector was invited to expound upon its particular problems. The symposia served to bring the plight of Salvadoran businessman to the attention of politicians and common citizens alike.

The Private Sector now appears to be, if not more confident, certainly more at ease with the direction of the present Government. The heretofore estrangement of both sectors has eased, as it is evident from the Private Sector's interest in cooperating with and joining forces with the present government in solving the economic crisis.

Notwithstanding this new apparent spirit of cooperation, there are some fundamental problems plaguing this new government. Interministerial coordination is seriously lacking, a clear-cut overall policy seems non-existent, and some serious sectoral problems in the banking, foreign commerce, and other vital areas of the economy are evident. There appears to be no definite plan for reversing the economic decline, and the time required to reverse it in light the civil strife looms as an important factor.

In June 1982, the Salvadoran Productive Alliance responded to a request by President Magaña to nominate 18 of its members (3 for each of six key ministries) to work closely with and advise the Government on key aspects of the economy. These committees are viewed by the Mission as key to the establishment of linkages through which mutual cooperation between the GOES and the productive sector can be enhanced, and this effort will be supported as a pa[rt] of the CBI program.

EXPORT AND INVESTMENT DEVELOPMENT

Current Export and Investment Development Policy

With respect to export promotion, the GOES' 1981-1983 Three-Year Plan calls for: a) the consolidation of the Foreign Trade Reform to manage more efficient use of the Country's foreign exchange earnings; and 2) creation of an environment conducive to increasing non-traditional exports in order to recuperate industrial and artisan production to an acceptable level, as well as to improve the economy's base over the medium and long term. As the economy recovers, foreign investment will be welcomed, particularly in the areas of export-oriented industries that use local labor, materials, and other inputs. Joint ventures are preferred.

Export Development Law

On September 5, 1974, the Legislative Assembly approved the Export Promotion Law, which is still in effect. The Law, in effect, established a mandate and legal structure for stimulating industrialization. The legislation implicity recognized the importance of developing extra-regional markets by offering fiscal and other incentives to industries exporting all or part of their products to non-CACM countries. The Law is presently under review for updating of incentives and re-definition of public and private sector roles as a result of changes in agencies involved in monitoring the Law's application.

Free Zone

To aid investors, the country's first Free Industrial Zone has been established in the San Salvador suburb of San Bartolo. The Zone was the first of several planned to be established under the Export Development Law to permit export-oriented industries to operate under advantageous conditions.

Industrial zone firms (which may be 100 percent foreign and export 80 percent or more of their products to non-CACM countries) enjoy duty-free import of equipment, raw materials (including fuels), and other inputs for the project's life in addition to other general incentives. Export-oriented local industrialists under the Export Development Law would also enjoy most of these benefits; but, particularly for the foreign investor, the zone offers certain advantages over domestic production: no administrative processing of imports and exports, no obligation for local investor participation and access to factory facilities and infrastructure.

There are presently four companies employing 800 workers still operating in the San Bartolo Free Zone: AVX (U.S.; electronics; ceramics): Form-O-Youth (U.S.; textiles); TME (Spanish; coats); and Expon (U.S.; pharmaceuticals). By comparison, during 1979, the zone contained some fourteen firms employing 4,200 workers, and plans called for an increase to 20,000 workers by 1982. Motorola alone, wanted to set-up an operation employing 5,000 workers and Beckman Instruments was in the process of expanding its operation to 1,500 workers.

With little additional investment, reactivation of the San Bartolo Free Zone in the short run, and establishment of additional free zones in the medium term could significantly alleviate depressed employment and production levels while generating scarce foreign exchange.

This prospect is particularly true if assembly operations, which prior to 1980 employed thousands of Salvadorans, could be revived or promoted to located in the free zone. Given the location of the international airport, and the new highway connecting the airport to San Salvador, the town of Comalapa may be an ideal location for a second free zone.

General Treaty for Central American Economic Integration

El Salvador is a subscriber to the General Treaty for Central American Economic Integration. Signed in December 1960, this treaty established the Central American Common Market (CACM). Under the CACM the most important incentives regarding investment and trade development are: a) free trade within the CACM area for products of "integration" industries; b) tariff protection; c) import duty exemption on machinery, equipment and raw materials for new or established integration industries; and d) income and other local tax exemptions for variable periods according to industry.

INVESTMENT EFFECTS

Table 10 examines direct foreign investment according to different economic activities and time periods, up to 1970, from 1971 through 1975, and 1976 through 1981. Among the most important areas of investment over all of these periods has been wholesaling which accounted for 20.0 percent of total direct foreign investment. These investments probably were made in storage facilities and transportation equipment primarily to handle imported goods.

The second most important foreign investments were in thread, cloth and textile operations with 15.3 percent. Following textile investments, in order of importance, were lights and electricity, 6.6 percent; financial institutions, 5.6 percent; fertilizer and insecticide production, 5.1 percent; and investment in petroleum refinery operations, 4.8 percent.

Foreign investment peaked in 1979 at $22.5 million, and subsequently has plummeted to $3.6 million in 1981.

TOTAL FOREIGN INVESTMENT

(Millions of U.S. Dollars)

	71	72	73	74	75	76	77	78	79	80	81
Investment	3.6	8.0	3.7	6.1	10.2	10.9	18.5	7.9	22.5	9.2	3.6
Index	100	222	103	169	283	303	514	219	625	256	100

TABLE 10

FOREIGN INVESTMENT TRENDS

(000 U.S. Dollars)

Current Prices

	Accumulated through 1970	%	1971-1975	%	1976-1981	%	Total	%
Agriculture	60.7	.1	470.1	1.5	142.8	.2	673.6	.5
Fishing	56.4	.1	267.9	.8	299	.4	623.3	.4
Mining (non-ferrous)			1,045.8	3.3	272	.4	1,317.8	.9
Quarrying					17.4	.0	17.4	.0
Livestock	99.9	.2			20.0	.0	119.9	.1
Dairy Products	198.2	.4	76.9	.2	(1,028)	(1.4)	(752.9)	(.5)
Fruit and veg. Processing	68.0	.2	56.6	.2			124.6	.1
Oils, fats			200.9	.6			200.9	.1
Milling	1,280.0	2.9	306.0	1.0	(799.7)	(1.1)	786.3	.6
Cacao, chocolate, candy	277.4	.6	3.2	.0	40		320.6	.2
Diverse food processing	60	.1	120	.4	180	0	360.0	.3
Tobacco	3,320	7.5	70	.2	1,562.2	2.1	4,952.2	3.6
Thread, cloth, textiles	3,614	8.2	7,572.6	23.9	10,074.0	13.9	21,260.6	15.3
Ropes					218.8	.3	218.8	.2
Clothing			476.9	1.5	884.9	1.2	1,361.8	1.0
Tanning			195.0	.6	(183.0)	(.3)	12.0	.0
eather products					20.0	.0	20.0	
ioes		-	310.0	1.0	465.0	.6	775.0	
Cardboard Containers	1,094.4	2.5			245.0	.3	1,339.4	1.
Pulp, paper & Cardboard	904.4	2.0	450	1.4	3,327.1	4.6	4,681.5	3.4
Printing	275.2	.6	198.0	.6	79.6	.1	552.8	.4
Chems. exc. fertilizers	55.1	.1			80.0	.1	135.1	.1
Fertilizers, insectic.	6,908.0	15.6	111.8	.4	40.0	.0	7,059.8	5.1
Resins, plastics					230.0	.3	230.0	.2
Paints, varnishes	97.8	.2			931.6	1.2	1,029.4	.7
Pharmaceuticals, medicines	693.6	1.6	90	.3	460.3	.6	1,243.9	.9
Soaps, cosmetics	727.8	1.6	260	.8	211.8	.3	1,199.6	.9
Chemical products	50	.1	145				195.0	.1
Petroleum refinery	3,921	8.8	1,439.6	.5	1,309.7	1.8	6,670.3	4.8
Tires	40	.0	307	1.0			347.0	.2
Rubber products	50	.1			(200.0)	(.3)	(150.0)	(.1)
Plastic products	257	.6	444.5	1.4	318.8	.4	1,020.3	.7
Cement	203.9	.5			(74.7)	(.1)	129.2	.1
Non-metallic, min prod.	329.3	.7	441.3	1.4	1,132.4	1.6	1,903.0	1.4
Steel Products			200.9	.6			200.9	.1
Knives, tools, hdwe.	450.7	1.0	348.4	1.1			799.1	.6
Structural metal	30.0	.0			2,559.0	3.5	2,589.0	1.9
Metal Prod. exc. mach.	741.7	1.7	154.9	.5	(212.0)	(.3)	684.6	.5
Ag. Mach. & Equip.					160.0	.2	160.0	.1
Ind. Mach. & Equip.					79.6	.1	79.6	.1
Office equipment					4,734.1	6.5	4,734.1	3.4
Mach. and equipment	664.8	1.5			32.8	.0	697.6	.5
lectronic equipment	405.1	.9	269.7	.9	1,256.1	1.7	1,930.9	
lome appliances			556.4	1.8	1,280.4	1.7	1,836.8	
Electric Machinery	1,955.1	4.4	803.3	2.5	2,859.4	3.9	5,617.8	

	Accumulated through 1970	%	1971-1975	%	1976-1981	%	Total	%
Vehicles	200	.4			15	.0	215.0	.1
Control instruments			244.0	.8			244.0	.2
Photographic & Optical	134.8	.3			597.5	.8	732.3	.5
Mfg. NEI	49	.1	75.0	.2	134.6	.2	258.6	.2
Lights and electricity	4	.0	533.0	1.7	8,647.9	11.9	9,184.9	6.6
Prod. & Distrib. of gas	609.4	1.4	2,294.1	7.2	1,798.6	2.5	4,702.1	3.4
Construction	51.6	.1	338.7	1.1	132	.2	522.3	.4
Wholesaling	7,956.7	18.0	4,694.1	14.8	15,219.3	20.9	27,870.1	20.0
Retailing	538.2	1.2	1,643.3	5.2			2,181.5	1.6
Restaurants			57	.2			57.0	.0
Hotels	884.3	2.0	(127.9)	(.4)	100	.1	856.4	.6
Transportation	635.4	1.4			80.4	.1	715.8	.5
Warehousing	103.0	.2	13.0	.0	250.0	.3	366.0	.3
Financial inst.	2,612.8	5.9	1,600.0	5.0	3,598.8	4.9	7,811.6	5.6
Other finan. inst.	456.2	1.0	114.3	.4	51.7	.0	622.2	.4
Insurance	160.0	.4	60.0	.2	880.0	1.2	1,100.0	.8
Real Estate	717.9	1.6	934.8	3.0	438.8	.6	2,091.5	1.5
Technical Services	90.5	.2					90.5	.1
Renting Equipment			45.	.1			45.0	0.0
Public instruction					20.0	.0	20.0	.0
Radio and Television	108	.2					108.0	.1
Total	44,201.3	100.0	29,918.1	100.0	64,991.0	100.0	139,110.4	100.0

BEST AVAILABLE DOCUMENT

Of total foreign investment made between 1970 and 1981, the U.S. led all investors with 46.1 percent, followed by Panama, 14.1 percent; Japan, 13.7; and West Germany, 4.9 percent.

Major U.S. investors have included Texas Instruments, 3M, Kimberly Clark, Xerox, Citibank, Chevron, ITT, Bank of America, ESSO, National Cash Register, Coordinated Caribbean Transport, AVX Ceramics, and Cargill. Most of these firms have formed wholly-owned subsidiaries. Subsidiaries not of the wholly-owned variety generally have U.S. participation of 70 to 99.9 percent, however, in some instances U.S. participation has been as low as 26 percent (Crown Zellerbach) to 36.2 percent (Sherwin Williams).

It is anticipated that the prospects for generating foreign investment will be grim in the near future. If and when the country becomes more pacified, foreign investment will resume. The one-time 10 percent investment tax credit will provide additional stimulus to U.S. investors, especially when that investment is made in connection with export-oriented ventures whose products are destined for the U.S.

Given direct U.S. investments in El Salvador during the past ten years the average annual U.S. investment has been $4.65 million. It is noted furthermore that the U.S. investment level has been extremely variable during this period. As a target, 80 percent of the average annual investment, or $3.7 million, is seen as realistic.

U.S. DIRECT INVI

(Millions of U.S. Dollars-Current Prices)

	72	73	74	75	76	77	78	79	80	81
Investment	2.5	1.3	1.3	2.4	2.3	12.4	1.2	14.5	6.7	1.9
Index	100	52	52	96	92	496	48	580	268	76

Ten year average (current prices): $4.65 million

GUATEMALA

I. Commerce & Industry

A. General

After decades of sustained economic growth and prudent fiscal and monetary management, the Guatemalan economy has deteriorated in the past four years. Factors contributing to this deterioration include a decline in exports, a reduction in private investment, and the erosion of the country's public finances. A weakening demand for traditional exports and a contraction in the Central American Common Market (CACM) have reduced export earnings. Political uncertainty throughout most of Central America has led to reduced private investment and tourism revenues. This, in turn, has led to a decline an increase in unemployment and underemployment. Gross domestic income declined further owing to a decline in terms of trade. As a result of large deficits in the current account of the balance of payments and private capital outflows since 1979, the loss of net international reserves has also been substantial.

As may be seen in the following table, industry accounted for 18.8% GDP in 1972, using to 21.3% in 1979. In the same periods commerce accounted for 28.1% and 26.1% respectively. Manufacturing and Public Utilities which had a product value of only $735.6 in 1972 grew to $1,165.3 million in 1979, an increase of 58.4% in constant 1978 dollars.

Table 1

GUATEMALA: GROSS DOMESTIC PRODUCT BY SECTOR
(MILLIONS OF 1978 QUETZALES)

ITEM	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
PRIMARY PRODUCTION	1226.8	1296.9	1372.7	1410.8	1406.8	1537.9	1611.3	1637.0	1672.1	1682.1	1654.3
AGRICULTURE	1223.6	1293.5	1368.4	1406.3	1401.0	1531.2	1600.9	1619.5	1643.7	1662.1	1631.8
MINING	3.2	3.4	4.2	4.5	5.8	6.6	10.4	17.5	28.5	20.0	22.5
SECONDARY PRODUCTION	808.4	886.8	914.1	922.8	1004.9	1209.0	1302.4	1355.2	1419.0	1425.2	1327.5
MANUFACTURING	680.9	739.1	768.6	759.3	845.1	930.9	1004.3	1060.6	1103.8	1071.1	1018.4
CONSTRUCTION	72.9	87.2	81.0	93.6	83.8	183.4	191.9	189.9	201.1	241.4	198.2
PUBLIC UTILITIES	54.6	60.5	64.5	69.9	76.0	94.7	106.1	104.7	114.1	112.7	110.9
SERVICES	2271.3	2437.3	2614.9	2660.9	2791.1	3034.3	3156.8	3364.2	3502.4	3546.3	3443.7
TRANSPORT & STORAGE	251.9	278.9	313.6	321.3	354.2	378.0	410.6	401.4	454.4	458.2	439.7
COMMERCE	1212.8	1302.3	1393.3	1382.8	1512.4	1642.4	1738.0	1659.3	1794.9	1790.1	1681.8
BANKING, INSURANCE & FIN.	99.5	113.8	122.7	130.6	139.6	169.7	185.6	205.4	227.2	229.9	234.1
HOUSING	276.6	282.9	286.6	295.0	240.7	259.2	280.5	269.8	293.5	300.8	308.7
PUBLIC ADMIN. & DEFENSE	207.5	213.2	226.3	251.9	284.4	280.1	299.3	296.8	327.3	366.0	371.8
PERSONAL SERVICES	222.9	246.1	272.4	278.7	259.7	304.7	242.9	531.7	405.1	403.3	407.6
GROSS DOMESTIC PRODUCT	4305.6	4621.0	4901.7	4994.5	5362.8	5781.1	6070.5	6356.4	6593.6	6653.6	6425.5
MEMO											
MANUFACTURING & PUB UTILITIES (INDUSTRY EXCL. CONSTRUCTION)	735.6	799.6	833.2	829.2	921.1	1025.6	1110.5	1165.3	1217.8	1183.8	1129.3

SOURCE: BANK OF GUATEMALA.

BEST AVAILABLE DOCUMENT

B. Industrial Performance . 1972 - 1980

Industry. The industrial output growth rate outstripped th GDP by about 35 percent from 1976 to 1980 when the stimulus from CACM high, despite the small domestic market, lack of knowledge concerning external markets, regional orientation of output, and insufficient ac working capital and medium- and long-term investment financing. Expo non-traditional products have also stimulated industrial production i recent years. In 1982, merchandise exports, net of the five traditio export commodities, increased to nearly half of total merchandise exp

from a small base in the mid-1960s, when they accounted for about one-fourth of the total merchandise exports.1/ However, this is partly a result of reduced coffee and cotton exports due to the existence of export quotas on coffee and a fall in cotton production, which led to a decline in exports of these commodities.

Industry developed initially through import-substitution at the Central American level, encouraged by regional tariff protection and various other fiscal incentives. Consequently, industrial production growth was determined by growth of domestic as well as CACM demand and consisted principally of traditional light consumer goods at a very early stage of development. The industrial sector developed very few backward linkages, which resulted in it having to rely substantially on imports of raw materials. This made the sector more vulnerable to the deteriorating terms of trade.

Industry has been hampered by the recent deterioration in regional trade, as well as a contraction in domestic economic activity. The sectors and the firms which depend on the CACM trade for a significant part of their sales have faced severe financial problems. Increased production costs, reduced regional and domestic demand, and increased working capital requirements led to a financial squeeze in some industrial operations. Cement production, for example, was financially squeezed because of price controls on the output and a decline in internal construction demand.

Industrial incentives reinforced regional import-substitution. Although quantitative import restrictions have not been used until recently, the present incentive framework reinforces the bias toward regional import-substitution at the expense of exports to non-regional markets. With the decline in regional demand, however, new measures are being dis-

1/ The five traditional export commodities are coffee, cotton, sugar, bananas and meat.

cussed in the Economic Cabinet to reduce the effect of this anti-export bias. Revision of the common external tariff is being reviewed in the member countries. The Government asked the Bank to help initiate a study to define an appropriate incentive framework to promote non-traditional exports to non-regional markets. Furthermore, the Government plans gradually to phase out price controls, which exist on a limited number of products, in order to reduce distortions in the structure of production and trade. Overvaluation of the U.S. Dollar, to which the Quetzal is pegged, devaluations in the Mexican Peso, and the Costa Rican Colon have also adversely affected the competitiveness of Guatemalan manufactured products. As a result, the trade weighted real effective exchange rate of the Quetzal has appreciated by about 13 percent during 1981/82. Presently, the industry is facing a severe drop in demand because of contracting CACM trade. According to unpublished preliminary results of a survey conducted by the Chamber of Industry, some subsectors reported very low capacity utilization rates at the end of 1981. In light of the above and the fact that the outstanding debt of other CACM countries to Guatemala reached about 60 percent of Guatemalan exports to this market, or about one-sixth of its total merchandise exports, the need for redirecting exports to non-regional markets through a concentrated effort, by rationalizing the incentive system, providing institutional and marketing assistance as well as foreign exchange needed to import critical inputs, has become increasingly clear.

C. Industrial Performance 1980 - Present

Growth of industrial output declined in 1981/82 because of a fall in both external and internal demand as well as reduced foreign exchange availability to import critical inputs. The decline in domestic demand largely paralleled a reduction in the growth of real income associated with a fall in the terms of trade. Furthermore, the decline in industrial output and the erosion of private sector confidence, brought about by political uncertainty in Central America, have contributed to reduced investment in industrial plants and equipment. Increased production costs, reduced demand, together with high working capital requirements led to a financial squeeze in some industrial operations. Over 180 plants (about 8 percent of the total registered firms in Guatemala) have closed down their operations in recent years, and most firms have not been able to utilize all their installed capacity. According to the preliminary results of an industrial survey carried out in 1981, 57 percent of the firms surveyed utilized only about 50-74 percent of their installed capacity, and only 21 percent of the firms used 25 percent or more of their installed capacity in that year.

Industrial production is concentrated in several major sub-sectors. Food, beverages, tobacco, chemicals, textiles and clothing account for about four-fifths of gross output and nearly three-fourths of value added in the sector. The largest sub-sectors, food, beverages, and tobacco use three-fourths of all domestic inputs purchased by the manufacturing sector. The second largest sub-sector, chemicals, however, is much more dependent on imported inputs. The chemical production is concentrated in medicines, soaps, cosmetics, plastic products, and petroleum refining. The third largest sub-sector, textiles and clothing, include mostly spinning, weaving and clothing manufacture.

Exports of manufactured goods were a major stimulant to industrial development of Guatemala up to 1981. About four-fifths of industrial products have gone to the CACM in the last six years (Table 2). Total industrial exports doubled from US$179 million to about US$368 million between 1977 and 1981. Initially, the CACM had made it possible for some enterprises to benefit from economies of scale. Sales to this market increased in 1980/81 as a result of major production declines brought about by plant closures and reduced production in El Salvador and Nicaragua, as well as expanded Guatemalan trade credits. As economic and political troubles escalated in the neighboring countries, their capacity to repay Guatemala in hard currency decreased drastically after 1980. As a result, outstanding credit extended by Guatemala to the other CACM countries reached about US$220 million at the end of 1981; almost the same debt remained unpaid at end-1982. Increasing obstacles to trade introduced by other members of the CACM to protect their weakest industries against regional competition along with the inability of Guatemala to continue financing this trade led to a further decline of sales to this market. In response to protectionist measures being taken by other members of the CACM, the Guatemalan Government introduced a new regulation which allows for the imposition of special surcharges ranging from 1 percent to 100 percent on imports from Central America, which adopt similar measures for Guatemalan exports. Industrial exports to non-regional markets, however, almost tripled from about US$23 million in 1977 to US$65 million in 1981; up from about 13 percent to 18 percent of total industrial exports. Presently, some firms which are currently selling in CACM are planning to modernize and rehabilitate their installed capacity to sell in non-regional markets. Several product groups, which were previously exported only to the CACM are now also exported to the rest of the world.

Table 2: INDUSTRIAL EXPORTS

	Total Exports (Million $)	Industrial Exports to CACM (Million $)	%	Exports to Non-CACM (Million $)	%
1977	179.2	156.5	87.3	22.7	12.7
1978	217.8	188.1	86.4	29.7	13.6
1979	231.8	202.2	87.2	29.6	12.8
1980	321.7	273.2	84.9	48.5	15.1
1981	367.9	302.9	82.3	65.0	17.7

Source: Central Bank.

62. The system of protection encouraged import-intensive production. Imported inputs for industrial production, equivalent to about 43 percent of the total value of inputs in 1977, have increased more rapidly than production and exports in the last few years. By 1980, the industrial sector generated only about 50 percent of the foreign exchange to pay for its imported inputs through its exports. As a result, the Guatemalan industrial sector is now more dependent on net imports than it was before industrial exports accelerated. In 1982, as foreign exchange, rationed to this sector, drastically fell, industrial production dropped even further, and capacity utilization for some sub-sectors was cut back.

Similar to most other developing countries, industrial activity is highly concentrated in and around the capital city, which accounts for about two-thirds of industrial GDP and three-quarters of large-scale manufacturing. The Industrial Decentralization Law of May 1979 aims at reducing industrial concentration by offering income tax exemptions for industrial investments in the outlying regions. It also gives preference to small-scale industries using domestic inputs intensively, by a 100-percent tax exemption for a 10 year period. This law, however, has not been very effective in the past in inducing the dispersion of industry outside Guatemala City.

II. Business Ambience

A. General

The investment climate of Guatemala is overwhelming influenced by political uncertainty and violence. In addition, the bleak market prospects for the country's major exports, suggest slow or negative growth for the foreseeable future. The deterioration in the country's terms-of-trade and the stagnation, if not retrogression, of the Central American Common Market point to limited domestic purchasing power and excess capacity in installed plant and equipment. ~~Thus,~~ despite a reasonably large domestic market and a rapidly growing population, lack of employment opportunities and lower real per capita incomes mean a modest return on new investment. When political risks are added, the situation appears even more dismal as active entrepreneurs are sometimes subject to terrorist attacks either on themselves and their families, or the productive establishments they set-up. Thus in addition to the market risks associated with an economic recession, the potential investor must deal with political violence as well.

Finally, government policies often introduce rigidities into the economic system which inhibit and prolong the necessary market adjustments. Examples include: minimum wages, foreign exchange controls, price controls, interest rate ceilings, costly subsidies, market regulation and associated "red tape" etc. Even when the policy tool is appropriate to a given situation, there is no guarantee that policies will be "fine-tuned" as economic circumstances change. The policy environment under which the private sector operates can only be improved by open access to government conducive to a productive dialogue on policy issues. There are some indications, that GOG policies will be modified to encourage the private sector. Nevertheless, a definitive evaluation of GOG policies will require additional time because of the newness of the present government. Currently, the most important factors affecting investment in Guatemala include:

a) Exchange controls - Controls were reintroduced on April 23, 1980 and have been progressively tightened as the official reserve situation has worsened and probably will have to be tightened further. Ostensibly, these controls are designed to limit capital flight. Under current legislation, the rate of remittance of profits, dividends and amortizations of foreign capital invested in Guatemala is limited to 15 percent per annum for five years in every ten year period and 5 percent for remaining years. At this writing, there is a severe shortage of foreign exchange currency causing normal imports to be curtailed or postponed.

b) Tax liabilities - corporations and individuals both foreign and domestic are subject to the same moderately progressive income tax schedule. Capital gains are treated as ordinary income and are taxed at the highest applicable rate. No credit or offset against Guatemalan taxes is provided on income taxes paid abroad. Dividends and profits remitted abroad are subject to an 11 percent profit remittance tax.

c) Labor Code - There are a series of labor benefits and payroll taxes which increase the effective cost of labor by about 50 percent over the nominal wage rate. These traditional benefits and employer contributions include mandatory annual vacations; Christmas bonus; indemnization; social security; recreation and manpower training taxes.

d) Industrial Decentralization Law (Decree 24-79) - The law provides tax and other incentives for establishing new industries outside the Department of Guatemala. The objective is to create employment opportunities in the rural areas. Incentives include lower income taxes, government financing at subsidized rates of interest and preferential utilization of industrial facilities built by the government. To date, few firms have taken advantage of these incentives because of a lack of adequate infrastructure in the rural areas. This inadequacy raises the costs of production above any tax or other savings offered under the program.

e) "Draw Back" Export Incentive Law (Decree 30-79) - The purpose of this law is to encourage the establishment of export enterprises that use national labor. All participating firms must be approved by GUATEXPRO. Incentives include duty free imports of raw materials used in production of exported goods and exemption from the stamp tax on all transactions except the final commercial invoice. Other tax incentives include total income tax exemption for ten years and exemption of import duties on capital equipment and lubricants. New legislation will soon be proposed to increase incentives under the program.

f) Free Zone for Industry and Trade (Decree 22-73 and 15-79) - This law establishes a free zone in the Atlantic port of Santo Tomas de Castilla. Enterprises located in the zone are exempt from import duties, quotas, export taxes and other levies. However, all products imported from the zone into Guatemala are subject to normal taxes and duties.

g) National Petroleum Law (Decree 62-74) - This law establishes the "minimum bases" for petroleum exploration and development in Guatemala. Accordingly, there is a minimum state participation of 55 percent of all hydrocarbons produced. The GOG reserves the right to receive its participation in cash or in kind. If paid in cash, the price will be the international price as determined by the government. Petroleum companies are required to "prefer" Guatemalan technicians and build first-class roads, schools and hospitals in the areas where they operate.

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B. Import Substitution and Export Promotion Policies

Present industrial policies have been determined by the regional import-substitution strategy following Guatemala's participation in CACM. This meant having to accept a common external tariff and fiscal incentives for investment. As such, the existing incentive system has not been conducive to encouraging industrialists to search for and sell in non-regional markets. Guatemala's participation in the CACM provided manufacturing firms with a larger protected market and helped expand industrial production and employment. At the beginning, Guatemala benefitted from the integration movement because it had the most dynamic manufacturing firms in the region. However, the net effect of the CACM trade on foreign exchange earnings, in hard currencies, have been negative. Since exports to the CACM only generate hard currency revenues when there is a trade surplus, such surpluses have been exceeded by foreign exchange outlays on imported inputs which go into production of those exported goods.

Table 3

GUATEMALA: STRUCTURE OF INDUSTRIAL EXPORTS AND IMPORTS, 1977-1981
(percentages)

	1977	1978	1979	1980	1981
1. Manufactured/Total Exports	15.4	20.2	19.2	21.8	27.8
a) Central America	13.5	17.4	16.7	18.5	22.9
b) Rest of World	1.9	2.8	2.5	3.3	4.9
2. Semi-Manufactured/Total Exports	5.1	6.8	8.9	13.0	11.7
a) Central America	4.3	5.2	6.3	7.5	5.3
b) Rest of World	0.8	1.6	2.6	5.5	6
3. 1 + 2	20.5	27.0	28.1	34.8	39
a) Central America	17.8	22.6	23.0	26.0	28.2
b) Rest of World	2.7	4.4	5.1	8.8	11.3
4. 1 + 2/Total Value of Manufactured Output	11.2	12.0	12.6	16.3	-
5. Imported Capital Goods/Total Imports	31.0	32.3	29.1	23.6	23.9
a) For Industry	14.4	16.4	15.1	12.1	13.2
b) For Transport and Communications	7.3	7.2	5.9	4.6	3.8
c) Other	9.3	8.7	8.1	6.9	6.9
6. a) Fuels Total Imports	11.7	12.2	15.6	21.2	22.1
b) Other Intermediate Goods/Total Imports	32.3	30.6	30.5	32.8	32.4

Source: Bank of Guatemala and Bank Staff Estimates.

The system of protection encouraged mostly consumer goods. The initial common external tariff on imports was high for consumer goods and low or non-existent for intermediate and capital goods. Because of generous exonerations, tariffs actually paid for imports represented only a part of the ad-valorem equivalents of the relevant tariffs. As a result of this structure, the present tariff system gives more protection to domestic production of light consumer goods than to intermediate and capital goods. However, since specific components of the common external tariff systems comprised of a significant share of tariffs for all categories of goods initially, the ad-valorem equivalents of these tariffs declined considerably over the years as a result of the erosion of specific components of the tariffs by continuous inflation. Furthermore, as exemptions grew through the years, effective protection among industrial [illegible] became more uneven.

In view of the slow growth prospects of the regional market, Guatemala introduced several incentive mechanisms to promote non-traditional exports to non-regional markets. A national export promotion center (GUATEXPRO) was established in 1971 for this purpose. GUATEXPRO is responsible for collecting information on non-traditional exports, sending trade missions to other countries, representing Guatemala at international trade fairs, providing information to exporters about external markets, analyzing export potential of selected industrial and agricultural products, as well as assisting foreign investors in establishing export-oriented industries. The private sector is also in the process of establishing its own export promotion agency, called GUATRADE. However, the main feature of the present export incentive system remains the draw-back system, which allows exporters to be reimbursed for import duties on inputs used in the production of their exports to non-CACM countries. The Government has recently redefined and expanded the access to this mechanism nationwide, which was previously limited to firms operating outside Guatemala City. Under the new framework, GUATEXPRO will officially approve applications for utilization of this mechanism based on the level of employment to be created, and the perceived marketability of the products in the non-regional markets.

In response to a moderate level of industrial exports to non-regional markets, the Government is considering some proposals in order to strengthen industrial exports. These include:

(i) an export credit fund for non-traditional exports, with an initial amount of US$100 million, to be partly financed from a 1 percent import surcharge;

(ii) an export tax rebate or credit for non-traditional exports (Certificado de Abono Tributario, CAT) equivalent to ten percent of the FOB export value (as proposed by the Ministry of Economy) which exporters could discount in financial markets;

(iii) the establishment of a special public agency for export insurance; and

(iv) the revision of the import tariffs.

In this connection, it is likely that the Ministry of Finance will not adopt the tax rebate mechanism as an export promotion instrument in view of limited fiscal resources of the country. A CACM proposal for a revised common external tariff is also being carefully reviewed in all member countries. The proposed tariff aims to (i) convert all specific duty rates to equivalent <u>ad-valorem</u> rates; (ii) consolidate various existing rates into one rate; (iii) reduce the number of tariff schedules significantly; (iv) change the nomenclature from that of the CACM to that of the Customs

Corporation Council (Brussels). Although these elements of the proposed tariff system are positive, the future success of this proposal in its implementation will be influenced trade regimes of the member countries. including exchange rate policy and payments and exchange restrictions. The effect of the proposed tariff on effective protection for industrial branches will have to be determined.

Despite the relatively high cost production permitted by protectionism, Guatemalan products were able to fabricate some new products which could compete in Non-CACM markets. These

... Non-traditional exports[17]/ to non-regional markets are projected to grow at roughly 14 percent a year in real terms during the second half of the 1980s, equal to the rate of the late 1970s, which started, albeit, from a low base. Table 4 shows the diverse groups of non-traditional products which have contributed to export growth in the recent past—a major share of them depending on agricultural inputs. The diversity of both non-traditional export groups and geographic diversity of new foreign markets should facilitate continued rapid expansion in exports despite slower world economic growth. Since a likely expansion of Guatemalan exports would not constitute a significant proportion of projected world trade, any trend toward growing protection in industrial and developing countries would not likely be a major deterrent to success of the export diversification strategy.

Table 4: EXPORTS OF SELECTED NON-TRADITIONAL PRODUCTS
(millions of US$)

	1977	1980	Real Growth Rates 1/ 1977/80
Fresh and Dried Fruit	25.4	59.1	108
Medicine and Pharmaceuticals	29.3	49.8	52
Manufactured Food Products	28.3	48.9	54
Vegetables	7.2	33.7	318
Comestics	16.6	31.4	69
Insecticides	10.2	27.3	139
Manufactured Textile Products	18.6	24.4	17
Rubber Products	10.0	23.1	106
Electrical Equipment	10.6	19.9	68
Manufactured Wood Products	4.5	6.7	33
Fertilizers	1.1	5.1	314
Total	161.8	329.4	82

1/ Deflated by export price index.

Source: GUATEXPRO.

17/ Non-traditional exports = merchandise exports minus exports to CACM minus exports of coffee, cotton, sugar, bananas, meat, petroleum ..

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C. Industrial Finance

The most severe factor affecting investment over the last two years has been the withdrawal of foreign bank credit and supplier credits to Guatemala. This situation reflects a growing preoccupation over the political stability of the region and prospects for long-term repayment. Currently, Guatemala is suffering a balance-of-payment crisis which threatens to interrupt normal business operations because of a lack of "hard currency" credit. As of May 31st 1982, the Central Bank estimated $170.5 million of excess liquidity in the banking system. The lack of demand for local currency credit is related to the lack of foreign currency convertibility. That is, a substantial element of local credit demand is derived from the demand for imports.

The banking system has provided additional short term credit to the industrial sector to cover substantial uncollected accounts of CACM buyers. (See Table 5 below)

Table 5

GUATEMALA: NEW LOANS OF THE BANKING SYSTEM
BY ECONOMIC ACTIVITY 1/
(MILLIONS OF QUETZALES)

ITEM	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
AGRICULTURE	36.4	42.0	51.2	92.4	90.5	85.5	84.6	92.6	88.4	150.5	161.5
LIVESTOCK	12.8	15.2	17.5	18.0	17.7	18.9	15.9	19.8	31.0	28.2	27.9
FORESTRY AND FISHERIES	0.5	0.2	0.2	0.5	0.4	0.5	0.4	2.7	1.6	2.4	2.5
MINING	0.1	0.1	-	0.2	0.2	0.6	1.7	3.4	0.9	4.8	4.0
INDUSTRY	52.3	52.1	64.1	122.6	122.9	129.3	145.0	149.5	195.0	247.9	242.2
CONSTRUCTION	17.7	17.8	19.6	27.3	14.4	62.9	64.8	66.2	67.4	69.9	69.2
COMMERCE	37.8	37.2	40.0	58.1	58.2	60.2	95.7	127.3	129.6	138.5	166.0
TRANSPORT	2.4	1.1	1.4	1.2	4.5	3.3	5.3	3.8	7.5	4.9	3.7
SERVICES	4.5	4.6	5.2	9.5	15.1	21.1	27.0	29.2	41.0	32.3	31.2
CONSUMPTION	5.1	6.7	7.8	8.5	15.2	15.0	20.4	26.4	25.5	39.2	38.3
TRANSFERS	13.6	15.1	11.8	11.6	31.7	26.0	37.4	51.2	55.6	47.1	59.3
OTHER	-	-	-	-	9.6	10.1	8.8	7.4	20.0	11.5	4.9
T O T A L	183.2	192.1	218.8	349.9	380.4	433.4	507.0	579.5	663.5	777.2	810.7

1/ INCLUDES DISCOUNTED PAPERS.
2/ ESTIMATED.
SOURCE: BANK OF GUATEMALA.

Given its inadequacy of Guatemala's foreign reserves the system is unable to maintain this form of support to its industrial community.

Development finance corporations (financieras) are the only financial institutions that make long-term loans to industry. Therefore, long-term financing to medium- and small-scale industries and to agro-industries through financial intermediaries could strengthen the export diversification effort and create urban and rural employment. There are currently five financieras operating in Guatemala. / The combined assets of these financieras almost doubled to over ten percent of the total assets of the consolidated financial system between 1977 and 1982. Their share in total industrial lending also rose at a high rate, from nearly 13 percent in 1977 to over 40 percent in 1982. Half of their investment loans were extended for three years, and another 40 percent for five years or more, with more than one-half of these loans going to industry. During 1977-82, financieras' industrial credit portfolio increased by about 54 percent a year, with their assets growing by 57 percent annually. Private financieras achieved average return on assets (before taxes) of about three percent during this period. However, the average return dropped in the last four years; it fell to 2.4 percent in 1981. The decline resulted from a reduced financial spread (onlending rates have not kept up with the increased cost of borrowing), increased competition (i.e., the two new private financieras were established in 1981) and low credit demand of the last two years.

The increasing involvement of the these financieras is detailed in Table 6. The largest private financiera, FIASA, increased its loans by about 22 percent a year between 1977 and 1982; almost doubling from 1979 to 1980. In contrast to the state-owned CORFINA, which relied on fiscal transfers and concessionary foreign loans, FIASA tapped bond sales, which increased from about Q 1.6 million in 1972 to about Q 42 million in 1982. While bond sales had been made to the public in previous years, the 1981 bond issue was financed by the Bank of Guatemala, which, since it increased interest rates, purchased bonds at par to avoid a capital loss to bondholders. CORFINA'a loan portfolio grew by nearly 12 times from 1977 to 1982, with the share of foreign sources rising from about one-tenth to over two-thirds of total liabilities. As a consequence, its debt-equity ratio jumped from less than 1 in 1977 to almost 39 in 1982. At the same time, profits turned into losses. Its rate of return on total assets fell from 2 percent in 1972 to 0.5 percent in 1981 and -1.1 percent in 1982.

Table 6 OUTSTANDING LOANS TO THE INDUSTRIAL SECTOR
(Millions of Quetzales)

	1977		1980		1981		1982 1/	
Institution	Q	%	Q	%	Q	%	Q	%
Commercial Banks	157.1	87.3	264.6	83.0	277.9	68.5	292.3	59.4
Financieras	22.8	12.7	53.9	17.0	127.9	31.5	200.1	40.6
Total	179.9	100.0	318.5	100.0	405.8	100.0	492.4	100.0

1/ As of June, 1982

Source: Superintendence of Banks

Financieras are not restricted by interest rate ceilings both on lending and borrowing operations, which makes it easier for them to lend to medium-scale industry. Since financieras are not allowed to accept deposits from the public, they finance their operations through their capital resources, the sale of bonds, use of the Central Bank rediscount facility, and from external funds.8/ The liability structure of the private financieras changed considerably from 1975 to 1982. While foreign resources declined from about US$10 to about US$8 million, domestic resources increased from about US$6 million to about US$121 million during

8/ In the past, these funds came from CABEI and USAID.

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Industrial credit levels and policies are clearly related to the overall credit this period. Domestic bonds accounted for 77 percent of total liabilities by the end of 1982. In the past, bonds constituted a major part of their sources of funds. These three to eight year bonds (some of them with repurchase commitment) are attractive to the commercial banks because they give them the opportunity to invest their excess liquidity. The interest on these bonds is tax-free and yields a higher return than government bonds. The financieras' bonds yield 11 percent compared to only 5 to 8 percent on government bonds. Many financieras' loans are at variable interest rates. The financiers' current lending rates vary between 16 percent and 18 percent, while CORFINA's fluctuates between 2 percent and 11 percent.

D. Labor Markets and Employment

The high rate of population growth projected during the rest of the century will put severe pressure on Guatemala's development prospects. By the turn of the century, population will be around 12 to 13 million, about 60 percent higher than in 1982. This will increase the demand for education and health services, potable water, food, and housing. The labor market will be strained to offer an increasing number of jobs for a rapidly expanding work force. Although some land still remains that can be utilized for agriculture, further exploitation of land is expected to provide neither enough jobs nor food for a significant share of the population in over-populated areas such as the Altiplano.

Because of a fall in economic growth, employment in 1982 declined to less than 2.1 million compared to a work force of under 2.4 million. The open unemployment rate increased from only 2 to 3 percent in the early 1970s to 7.8 percent in 1981, and to an estimated 12.7 percent in 1982 (Table 16). Cheap interest rates and tariff exemptions on capital goods imports have discouraged more labor-intensive types of production. Because of the latter, the competitiveness of domestic supplier industries vis-a-vis import substitutes was reduced. The difficult growth prospects of the economy give further urgency to the creation of more employment per unit of output. The distortions in factor pricing, which retard this result, can no longer be justified.

POPULATION, LABOR FORCE AND EMPLOYMENT, 1973, 1980-82

	1973	1980	1981	1982	Annual Growth Rate 1973-82
Total population, thousands	5,870.5	7,262.0	7,479.9	7,704.3	3.0
Working age population, thousands 1/	3,815.8	4,720.3	4,861.9	5,007.8	3.0
Economically-active population, thousands	1,767.2	2,233.3	2,308.9	2,387.4	3.4
Employment, thousands 2/	1,706.6	2,117.5	2,128.1	2,083.4	2.2
Labor force participation rate, %	46.3	47.3	47.5	47.7	0.3
Unemployment, thousands	60.6	115.8	180.8	304.0	19.6
Unemployment rate, %	3.4	5.2	7.8	12.7	15.8

1/ Working age group includes 10-64 age group in Guatemala.

2/ Elasticity with respect to growth rate of GDP of 0.6 is assumed.

Source: Statistics Office, Bank staff estimates

The Guatemalan Labor Market

Low GDP per capita, low capital endowment per worker, a high illiteracy rate, and poor health conditions in Guatemala have led to a labor market in which average productivity and wages are low; characteristics typical of a country with an excess supply of labor. The large number of small farms do not provide sufficient employment. Many families earn wages below the poverty threshold, and the labor force continues to grow rapidly. Labor is, therefore, abundant for low productivity urban jobs at the prevailing low wages. The expected increase in the participation rate of females, particularly in urban areas, could strain the labor market further and increase unemployment rates even more in the future.

Labor does not represent a very high cost for Guatemalan employers. Although minimum wages, both in the urban and in the rural sector, were almost doubled in 1980, real wages remained below those of the mid-1970s. Furthermore, surplus labor and weak unions have tended to make the labor market relatively flexible. The major policy to ameliorate the existing employment problem and to increase the present low level of earnings should be economic expansion propelled by the more labor-intensive sectors (e.g., housing, marketing of artisan products, medium-scale industry, etc.)

The Urban Labor Market. High population growth in the urban areas, migration from the rural areas, and the increasing female participation rate led to a yearly increase of the urban labor force of 4.3 percent during the last decade. The urban work force was two-fifths of the total in 1980, and the urban participation rate was 47 percent, 7 percent higher than the rural average. Females represented around one-third of the urban work force, much higher than the national and rural averages of about 12 and 5 percent, respectively. The Department of Guatemala and its metropolitan area are the main pole of migrant attraction, since they offer the opportunity for higher wages, better access to utilities and public services, and an improved social life compared to the limited opportunities in rural areas and other urban communities.

The Rural Labor Market. About two-thirds of the work force now live in rural areas. During the last ten years, the economically-active rural population grew at half the rate of its urban counterpart. The main export crops (coffee, cotton and sugarcane), have provided a major share of rural employment. However, the need for labor for these crops is seasonal, with the greatest demand at harvest time, and employees hired at harvest time have limited work opportunities during the rest of the year. About half of the small farmers in the Altiplano region are employed only during two to four months each year on coastal farms. Having no other income, these and many other small farmers must farm for survival. The increasing rural population has access to a limited amount of land suitable for farming. From 1964 to 1979, the growth of population was more than twice the increase in farmland. Even if all suitable land were to be evenly distributed among the rural heads of households, the average farm size in 1995 would still be no more than 4 ha, and a farm of that size would be insufficient to support a family of five and produce a food surplus sufficient to feed 3.5 urban dwellers (Table 17). The situation is more serious

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because of the uneven distribution of farm land and the present use of land which is not suitable for sustained farming operations. In the last 15 years, the number of farms of less than 0.7 has almost doubled. The area occupied by these subeconomic units increased by only 69 percent. Hence, 167,000 families occupy only 1.3 percent of all farmland, providing them with an average of one-third has each. A less well-known trend is the increasing preponderance of farms within this size range increased by 42 percent, accounting for about four-fifths of the increase in the total farmed area during the period.

The Unemployment Problem

Low unemployment rates in Guatemala disguise the high level of underemployment. The open unemployment rate slowly rose from about 1.5 percent in the 1950s and 3.5 percent in the 1970s, before it accelerated to 12.7 percent in 1982. However, more than 30 percent of the work force is estimated to be underemployed, a significant part of which is in the rural areas.

The rural sector has little potential to create further employment possibilities without a major export diversification effort, even though it has more than three-fifths of the population. The share of the labor force in the rural sector of about two-thirds of the total did not change from the 1950s. Although a modern export agriculture subsector with higher productivity levels has developed, the traditional subsector, characterized by small production units and subsistence levels of living, still predominates.

Unemployment indicates working less than eight hours per week or earning less than the subsistence income.

The agriculture sector could contribute more to employment generation in the medium-term. Exploitation of the northern slopes of the highlands by rubber production and the Peten area by livestock and forestry, would provide about 30,000-40,000 new jobs. However, the greatest employment creation in the medium- and long-term must come from urban activities; and the leading sector must be the industrial and the agro-industrial sector, using mainly domestic agricultural inputs. This should also stimulate economic activities in the rural areas. However, it is in the cities, where the supply of labor and open unemployment are increasing and will be most severe. Industries based on agricultural raw materials and oriented to supplying non-regional markets could provide a major push to reactivate the whole economy, and create demand for labor and agricultural inputs from the rural sector. Marketing of artisan products abroad would also help increast the incomes of the Indian segment of the population.

Although the potential from significant employment creation in the construction sector is limited in he short-term, the Government could at least partially stimulate this sector by institutionally strengthening the National Housing Bank (BANVI), as well as allowing the commercial banking system to provide mortgages, possibly through a fund to be created in the Central Bank. Employment expansion in the service sector, which accounted for almost half of the new jobs created between 1973 and 1981, would largely depend on the restoration of social and political stability agricultural sectors. However, a large share of the jobs in he service drop in foreign tourism because of the occasional violence, has made tourist-linked service job expansion less probable in the short-term. However, tourism may contribut to employment generation in the medium- and long-term if the political situation improves.

E Private Sector Organization

The private sector in Guatemala has traditionally organized itself along sectoral lines. The major business chambers include the Chambers of Commerce, Industry, Agriculture, Finance, Construction and Tourism. These chambers provide services to their members and have acted as pressure groups in dealing with the GOG. The organized private sector typically lacks a unified voice and has little capacity or interest in addressing the socio-economic problems facing the nation. The various professional associations also display similar institutional weaknesses and have a limited overall perspective.

However, under the pressure of events the private sector has organized the Chamber of Enterprise (CAEM) which represents all elements of the sector and in actively pursuing policy dialogue with the GOG.

The Guatemalan Chamber of Enterprise (CAEM) acting through its various operational divisions will also actively engage in investment promotion activities. This promotion will entail visits to the United States by local private sector "ambassadors" who will discuss investment opportunities with U.S. businessmen in their home offices. Some of these executives will be invited to Guatemala to see first-hand perspective investment projects. Once the U.S. investor decides to invest in Guatemala, CAEM will provide follow-up investment services to facilitate the transition to the local business environment.

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As the first project of the CAEM Economic Development Division, a trading company task force has been formed to develop an export promotion project geared to trade incentives provided under the Caribbean Basin Initiative. The trading company along with a supporting Export/Import credit facility will provide an institutional vehicle to bridge the gap between the domestic producer and the foreign consumer. The trading company will offer a package of services designed to facilitate trade and encourage investment. The proposed Guatemalan Trading Company will provide pre-and post export financing; market intelligence; guidance on product design and development; logistical support and prepare export/import documentation.

The cooperative movement which has been supported by AID is one of the few private sector organization representing the rural population. Unfortunately, a lack of adequate management ability has hindered the operation of cooperative (non-profit) enterprises. This deficiency has limited the role of cooperatives in terms of their contribution to the national economy.

HONDURAS: Industry and Commerce

A. Summary Description

1. Gross Domestic Product

The most recent year for which data on the Gross Domestic Product (GDP) are available for public and private sectors is 1980. In that year, the private sector accounted for 82% of GDP, as shown in Table 1, below:

Table 1: Gross Domestic Product

Gross Domestic Product At factor cost	($ Millions at Current Prices) Public Sector	Private Sector	Total	% Private
GPD	387	1,829	2,216	82
Primary Production:	10	670	680	99
Agriculture and related sect.	10	622	632	98
Mining	-0-	48	48	100
Secondary Production:	52	482	534	90
Manufacturing	3	348	351	99
Construction	-0-	134	134	100
Utilities	49	-0-	49	-0-
Services:	325	677	1,002	68
Transport and Communications	52	118	170	69
Commerce	1[illegible]	264	283	93
Finance	29	76	105	72
Housing	-0-	148	148	100
Public Administration	98	-0-	98	-0-
Other Services	127	71	198	36

Source: Central Bank

As can be seen from the above table, the economy in 1980 was in large measure a private sector economy. Even though over the last two years some large private businesses have become more state owned due to their failure to pay off loans to state owned financial institutions, the picture in 1982 was probably not significantly different than it was in 1980 in terms of overall GDP composition and private/public sector participation.

2. Gross Domestic Investment

Following the strong private sector GDP participation, gross domestic investment is also strongly private, as shown in Table 2. In 1981, the private sector accounted for 70% of gross domestic investment, and 90% of

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Table 2: Gross Domestic Investment

	($ Million at Current Prices)			
	1978	1979	1980	1981
GDP at market prices	1,896	2,244	2,726	2,909
Gross Domestic Investment (GDI)	512	632	727	659
Fixed capital formation (FCF)	489	587	686	667
Total Private Sector	293	371	428	450
Total Pub. Sector	196	216	258	217
Inventory changes	23	45	41	- 8
Private Sector Fixed Investment as a percent of:				
GDP	15	16	16	15
GDI	57	59	59	68
FCF	60	63	62	67

Source: Central Bank of Honduras

Table 3: Labor Force Characteristics

	GDP ($ Millions)	Labor Force	GDP per Worker ($)	% of Lab. Force
Total	2,228	1,012,471	2,200	100
Primary Production:	732	598,067	1,223	59
Agriculture and related sect.	692	594,928	1,164	59
Mining	40	3,139	12,743	-0-
Secondary Production:	519	166,956	3,109	16
Manufacturing	373	128,786	2,896	13
Construction	110	34,323	3,205	3
Utilities	36	3,847	9,358	-0-
Services:	977	247,448	3,948	24
Transport and Communications	193	29,665	6,506	3
Commerce	291	84,541	3,442	8
Finance	94	9,315	10,091	1
Other*	399	123,927	3,270	12
Private/Total	82	96		

*Includes public sector employment of approximately 50,000, excluding military
Source: Ministry of Labor; Economic Planning Council

foreign exchange earnings. Domestic private investment is concentrated heavily in agriculture, manufacturing, and commerce. Public Sector investment is heavily concentrated in basic infrastructure which serves as a complement to private sector investment. Although there has been increasing public sector investment in productive enterprises in recent years, the amount of such investment is small in comparison to total investment. The GOH, through mixed capital corporations, is the major shareholder in two of the largest investments made in the last five years- the Olancho Forest Corporation (CORFINO) and the INCEHSA Cement Plant. It also has played an important role in private investment mainly through the National Investment Corporation (CONADI), by issuing direct loans and guarantees, and taking equity positions in mixed capital ventures.

3. Labor Force

The private sector accounts for 95% of employment (excluding members of the armed forces), as indicated in Table 3 above. The labor force participation rate is about 27 percent. This figure has not risen appreciably over the last few years.

4. Size of Firms

The most recent data available on size of firms are published figures from the 1975 industrial census, which are summarized below. The firm sizes were ordered by gross production for purposes of compiling these data.

Size of Firm	No. of Firms	Cum. %	Production ($ Millions)	Fixed Assets	Number of Employees	Average Salary ($)
Very Large	5	-0-	135	94	3,103	2,652
Large	95	0.2	252	129	14,673	1,594
Medium	749	2.0	107	80	18,987	1,029
Subtotal	849	2.2	494	303	36,763	1,392
Small	36,973	97.8	NA	NA	NA	NA
Total	37,822	100.0				

In terms of number of employees, firm sizes in 1975 were as follows:

Number of Employees	Number of Firms
100 and over	81
50 to 99	94
20 to 49	196
5 to 19	478
1 to 4	36,973

As indicated above, productive units are extremely small in both absolute and relative (i.e. compared to U.S. standards) terms.

5. Private Sector Organizations

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The Honduran private sector has not organized itself effectively to promote the cause of private enterprise development. At present, there are a number of weak trade associations, which are grouped into an association called the Honduran Private Enterprise Council (COHEP). COHEP is a small, unaggressive group which operates on a budget of about $30,000 per year, which covers an executive secretary, office help and miscellaneous expenses. It shows no signs of becoming the strong institution that would be needed to responsibly represent the private sector with the government and other private sector organizations.

The major trade associations are the Chambers of Commerce, the Cattlemen's Association, and the National Industrialists Organization. There are Rotary Clubs, Lions Clubs, and Junior Chambers of Commerce in a number of cities. There is a Honduran - American Chamber of Commerce and a National Exporters Association, both of which are new organizations that cut across trade association lines, and both of which have recently joined COHEP. A new private sector organization, the Pro-Honduras Association (APROH), received its legal recognition in January, 1983. Also crossing trade association lines, its goals are political as well as developmental. There are also a number of strong labor unions, and two large confederations of unions.

Given the large number of organizations, it is not unusual for important private sector personalities to play a role in a number of organizations - both as members and leaders of the private organizations described above, and as representatives to mixed public - private sector institutions. The latter include the recently reactivated Superior Planning Council, the Central Bank Board of Directors, and the Directorates of semi-autonomous and autonomous government institutions.

B. Current Situation

After good progress in the late 1970's, the Honduran economy's real growth rate dropped from an average of 7% during the late 1970's to less than 0.5% in 1981. Preliminary estimates for 1982 indicate that real GDP growth is expected to decline by 1%, prospects for improvement in 1983 are worse. With a 3.5% yearly increase in population, GDP growth per capita is negative and declining sharply. Honduras remains the poorest country in Central America. Compared to the national per capita GDP of $565, ninety percent of the 2.4 million rural inhabitants have a per capita income of only $100.

Ultimately, the prospects for improving living standards depends on increased trade, and investment in productive activities. There have been numerous studies of investment possibilities in Honduras. It is difficult and perhaps misleading to deal with Honduras' comparative advantage on an industry or sector level, as the feasibility for any specific product or investment may not follow general trends. In general feasibility studies indicate, and informed Hondurans and outsiders familiar with Honduras confirm, that the country can be a competitive producer in agriculture, agro-industry, raw lumber, wood products including furniture manufacture, and light assembly industries. Tourism and mining hold promise.

Honduras has several advantages which favor increased trade and investment:

1. Infrastructure is adequate for most types of productive activities and commercialization. There is a good paved primary road network which connects major cities and port facilities. Puerto Cortes is the best,

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most efficient port in the Caribbean from Veracruz, Mexico, to Colon, Panama. Electric energy is usually reliable, except for a few specific locations, and will be abundant starting in 1985. Water is a problem in many locations, but can usually be obtained through well drilling.

2. Accessibility to major markets is excellent, with regular shipping services, including regularly scheduled air freight, dry liner, and roll-on, roll-off cargo service to and from Miami. The flight time is so short that frozen products arrive still well refrigerated without special arrangements. However, port charges at Puerto Cortes are very high and transportation, perhaps reflecting the low volume of major export products, tends to be expensive on a per unit, per mile basis.

3. Labor Considerations. The labor pool is large and easily trained, and labor costs are comparable to or lower than other countries with which Honduras might compete for investment. Skills availability may be a problem for certain types of industries and technical skills, but the mixed public-private sector skills training institute is willing to provide training in short supply areas. Labor unions are strong and the labor code is stringent. However, the labor unions are mature by the standards of developing countries and bread and butter issues predominate. We believe that the labor code is applied fairly and consistently by developing country standards. A summary of the Embassy's Labor Report is attached as Annex A.

4. Prices and Taxes. Prices are not controlled except in the case of three or four basic foods and petroleum products. Income taxes approach U.S. rates but the progression to the top rate of 44% is more gradual than in the U.S. Import taxes are generally high by comparison to developed country standards. There is a 1% export tax on all products except traditional agricultural products, on which higher taxes have been imposed. Royalties are charged on mining industries. Outside these taxes, the tax bite is low.

5. Financial Services. Honduras has ample financial services. The banking sector consists of 15 private banks, including branches of three foreign banks, and three specialized public development banks. In addition, there are a few small finance companies and several large and well established insurance and financial services operations. The quality and sophistication of these institutions is better than in most developing countries.

6. Commercial Organization. The country's commerce is almost wholly in the hands of the private sector, and operates in a competitive environment with minimal government regulation and interference.

7. Government Policies. Successive governments have been supportive of private investment in Honduras. Foreign and domestic investors are afforded equal treatment under the Honduran constitution. U.S. firms have been engaged in profitable endeavors in Honduras for over a century. The present regime has strongly encouraged private sector development. It recently initiated negotiation of a Bilateral Investment Treaty with the U.S., and has requested that Honduras be declared eligible for western hemisphere treatment of conventions. Whatever restrictions on investments and trade

exist generally result from the regulatory climate more than from the legal structure. The difficult regulatory climate usually takes the form of lack of coordination and conflicting goals by GOH agencies.

The Embassy's 1982 Investment Climate Statement, which is attached as Annex E, contains an ample description of government policies and attitudes toward private sector development and foreign investment. The generally positive environment has occasionally been dampened by abrupt policy changes which dampened private investor enthusiasm (e.g. nationalization of timber in 1974; limitations of the size of private agricultural land holdings in 1975). However, such occurences have been rare and government policies have been remarkably stable over the years. Honduras is conservative, pro-business, and pro-foreign investment. The military and business elite represented by both the National and Liberal parties is unlikely to change this orientation.

C. Constraints to Increased Production, Investment and Output

1. Long Term Constraints to Development

a. Limited Markets

Honduras' limited domestic market and high dependence on a few major exports (coffee, bananas, beef, and lumber) pose a serious constraint to its long term development. With a population of 3.8 million, most of whom are not really part of the country's economic mainstream, and a Central American market of some 20 million people, there are limited internal opportunities for efficient production of many basic products and consumer preference items. Furthermore, export markets for traditional crops are affected by world overproduction and strong competition. For example, coffee exports are limited by export quotas, and the market for bananas is controlled by a few major firms. Lumber is produced all over the world and high transportation costs from Honduras limit the markets within which Honduran producers can be competitive. Prices for the country's principal agricultural exports make Honduras' economic growth susceptible to the vagaries of international commodity markets. Honduran manufacturers have increased their penetration of the Central American market somewhat over the last twenty years but the country is the least involved of the five in the Central American Common Market as measured by share of imports or exports. Although Honduras withdrew from the common market in 1970, it has negotiated bilateral commercial agreements with the CACM countries which parallel CACM trading preferences. Over the last few years, this market has contracted severely due to declining demand, problems in clearing payments, and increasing barriers to free trade among the Central American countries. The U.S., Caribbean, Asian, and European markets for non-traditional products have not been exploited effectively to date.

Development Strategy and Government Policies

The Honduran economy has historically been conservatively managed and has traditionally followed a private enterprise model. When Honduras entered the CACM in 1960, an import substitution, protectionist development strategy naturally followed. Much of its industrial sector has developed under special incentives adopted by the CACM. The easy import substitution opportunities were exploited long ago and regional demand for basic products is being met. However, having grown up under the protectionist mantle, the country's industrial products are not very competitive outside the region.

The GOH eliminated most of its traditional investment incentives in 1981 as part of an overall effort to reduce its budget deficit. The incentives had proven very costly to the state and were hard to administer fairly. A commission of GOH and private sector representatives has recently prepared a new draft export incentives law which is intended to provide new incentives, simplify their administration, minimize their ultimate cost to the state, and reduce the bias in favor of capital intensivity. The Ministry of Economy and the Honduran Exporters Association have requested technical assistance from A.I.D. to help them analyze the draft law. The Mission has requested proposals from U.S. firms to provide this assistance, which will be financed from PDES funds. This assistance is expected to contribute to adoption of new export incentives legislation during 1983.

In addition to incentives, the country's already adequate infrastructure must be better-utilized for productive activities. Improvement of the country's free trade zone system is needed to attract foreign investment for export operations, and the feasibility of establishing free enterprise zones (oriented toward domestic production) needs to be further studied and implemented if feasible. In addition to the usual benefits from such zones - duty free imports (for free trade zones), and a simplification of bureaucratic procedures - their improvement could help domestic and foreign investors alike to overcome a major constraint to increasing investment at present - the shortage of foreign exchange. This problem and its manifestations - import permits, long waits for foreign exchange at official rates, and delays in production and shipping - are creating serious difficulties for most private sector firms at present.

A free trade zone now operates in Puerto Cortes under the auspices of the National Port Authority. It adjoins the country's major Caribbean Coast port and the six firms that now operate there are highly satisfied with the facilities and the management. There are nine additional unoccupied factories on the site, and ample room for construction of additional facilities. The zone has not been promoted adequately and has not attracted the kind and magnitude of investment expected. The Port Authority is now requesting offers from U.S. firms for promotion services.

The law which established the free trade zone in Puerto Cortes also authorized establishment of similar zones in five other towns: La Ceiba, Tela, Amapala, Coa, and Choloma. The Port Authority is preparing plans for development of free zones in these sites. As well, the Ministry of Economy has indicated interest in exploring further the possibility of urban enterprise zones in inland areas of high unemployment, such as Tegucigalpa, San Pedro Sula and Choluteca.

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In the early 1970's Honduras underwent a populist experiment involving, among other things, the creation of a number of parastatal enterprises. Much of the investment that took place during this period was government sponsored or enjoyed government guarantees. Large amounts of external debt were contracted to finance these ventures--also a break with tradition. Confronted with the political and economic realities of the 1980's, these policies turned sour.

Thus far, the parastatal institutions remain intact. CONADI (the National Investment Develpment Corporation) has ceased financing new projects, but retains ownership in a number of ventures. Indeed its ownership shares of some installations have increased as loans have been capitalized in lieu of repayment. COHDEFOR (the National Forestry Corporation) continues to dominate the primary forest industry with pricing policies inimical to conservation. COHBANA (the National Banana Corporation) retains an active role in banana marketing.

C. GOH Service Operations

There are a number of services now provided by the GOH which could be provided much more efficiently by the private sector.

(i) Grain Storage Facilities

Most of the country's grain storage capacity is in the hands of the Honduran Grains Marketing Institute (IHMA). The facilities are not well managed and lose money for the Government.

(ii) Olancho Forest Reserve

This major forest reserve is now being developed by the Olancho Forest Corporation (CORFINO) - a 96% state owned corporation. Partial financing for infrastructure and a sawmill has been obtained from IDB. To fully develop the reserve, an additional state investment of several hundred million dollars will be needed over the next 15 years. Given the past experience of state owned and run productive activities, it is doubtful that CORFINO will reach financial self-sufficiency. The greater prospect is for a large and continuing drain on the treasury. The recent Presidential Agricultural Mission raised serious doubts about the feasibility of the major planned investment - a pulp and paper mill.

d. [redacted] GOH Support Services for Private Sector Development of the Industrial, Agricultural, and Forestry Sectors

The major GOH financial and technical assistance to the country's industrial, agricultural, and forestry sector comes from three large autonomous organizations: The National Investment Corporation (CONADI), the National Agricultural Development Bank (BANADESA), and the Honduran Forestry Development Corporation (COHDEFOR). Each of these organizations has been significantly less successful than projected by the proponents of its creation. Yet, each of them has a potentially vital role to play in the country's development.

(i) CONADI

CONADI should be the major source for mobilization of equity capital for new and expanded industrial ventures. However, during the last seven years it made a number of poor investments, took over a number of failing enterprises in which it had an interest, and ended up unable to pay some $200 million in debts to its creditors. At present, it is making no new loans, but concentrating on collecting on its delinquent portfolio. Its debts are being renegotiated. The GOH is considering several plans for getting CONADI reorganized and ready to function again.

BANADESA should be a major lender to small and medium farmers who cannot get credit and technical assistance from commercial banks. However, in its 32 years of existence (30 as BANAFOM, 2 as BANADESA) it has provided minimal attention to small farmer needs and has invested a major portion of its resources in industrial operations such as sugar mills and a milk processing plant. It has decapitalized several times, and was recapitalized most recently in June, 1982. BANADESA has requested AID financing consistently over the last few years. AID has sent BANADESA a list of objectives that must be reached before any consideration would be given to providing additional financing. These objectives include shedding its productive activities, implementing a regionalization program, and collecting an appreciable amount of its delinquent debt. BANADESA appears to be making some progress, and may meet the objectives within the next year or so.

(iii) COHDEFOR

COHDEFOR should be primarily a regulatory agency, with the special functions of reforestation and fire protection, to ensure sustained productivity of Honduras pine forests. However, since its creation in 1973, it has been primarily involved in marketing lumber exports and operating sawmills. In addition to discouraging private investment in the forestry sector, it has done a poor job in its production and marketing activities. The revenues provided to the state have fallen way short of expectations. The recent Presidential Agricultural Mission recommended a significant restructuring of the forestry sector, including the recommendation that COHDEFOR get out of the marketing business.

The limits of the import substitution and mixed public/private development strategy, the strong dependence on external capital flows, and very limited efforts to mobilize domestic capital for investment and production purposes became apparent some years ago. Recent problems of political and economic stability in the region and world economic conditions have caused them to become even more obvious. Although the private sector model is espoused by policymakers and businessmen, habits regarding the state's role in enterprise are hard to change. A serious attempt to develop appropriate policies through which to foster economic growth in the changed situation of the 1980's has not yet been made. The lack of appropriate policies, of a consistent regulatory climate, and effective GOH administration of economic development incentives is a major long term constraint to increased trade, investment, and economic development.

Socio-cultural and Human Resource Constraints

With regards to the three major elements of entrepreneurship - energy, initiative, and imagination - Honduran performance is mixed. Relatively few Honduran companies have exported successfully on a sustained basis. Knowledge of the U.S. market and marketing know-how are virtually non-existent and few Honduran companies have successfully penetrated the U.S. market. Products tend to be the same year after year with inadequate attention to product design and consumer tastes. The private sector has traditionally shunned joint ventures with outside investors. Despite a large number of organizations, it has not organized effectively to promote the cause of free enterprise, promote the country's economic development, or provide services to the business community.

Neither the private sector nor the Government has made a serious, sustained effort to attract outside investors to the country, make them feel welcome and ease their problems in obtaining government permits and classifications. Quite the reverse, obtaining normal permits, etc. has often taken much too long and has discouraged many potential investors. Whether this will change in view of the serious situation in which the country now finds itself cannot be predicted with certainty. The silent resentment against foreigners and covert resistance to them as neighbors and competitors may speak louder than the overt positive, pro-free enterprise attitude now emanating from the government and the private sector. Interestingly, however, resident U.S. investors in Honduras feel strongly that good investment opportunities here abound. The problem is mainly getting through the front door.

Honduran entrepreneurs are often high on enthusiasm, but short on talent and follow through. They do not appear to have the same drive as their U.S. or even other Central American counterparts. One well-informed observer has described Honduras' entrepreneurs as exhibiting a grocery store mentality in a supermarket world. Their experience as entrepreneurs is largely empirical. The major industrialists, for example, are former merchants who moved into industrial operations during the last generation.

Honduran entrepreneurs and top executives often define the lack of middle and upper middle level management talent as a serious constraint. However, the entrepreneurs themselves do not make the best use of the management talent available in the country. In general, they delegate little authority, and rarely make such delegations explicit. Even with good training, often acquired at great expense in specialized schools and universities in and outside of Honduras, managers do not gain sufficient on the job experience in decision making due to uncertainty regarding the degree of authority delegated and their hesitance to take on responsibility. The resulting dissatisfaction encourages rapid movement of managers from one job to another. This strengthens the highly centralized decision making process evident in most firms, where almost all decisions taken directly by the boss. In sum, it appears to us that the attitude and capability of entrepreneurs, top executives, and mid-level managers may also be an important long term constraint to private sector development. A notable exception to all of the above is the San Pedro Sula business community, which includes a good number of energetic, talented, and dynamic entrepreneurs.

2. Short Term Constraints

From 1977 to 1979, internal stability and favorable external conditions combined to help Honduras experience one of its few periods of robust economic growth. The strong performance of the economy was largely fueled by a dramatic rise in coffee prices, the recovery of banana production after a major hurricane in 1974, the increasing participation of government in economic activity, and an active private sector.

Since mid 1980, however, a rapid deterioration of the economy has taken place. The precipitous decline in coffee prices from their 1977 peak combined with soft export markets for its other tropical agricultural products, worsening terms of trade for its principal products, the turmoil in Central America, and the worldwide liquidity squeeze have contributed to a strong downward trend in investment, production and real per capita income. Honduras presently finds itself in a moderate to severe recession and prospects for a revival in growth in the near future are not favorable.

Despite its recent disappointing growth rate and recent import transaction controls imposed by the Central Bank, Honduras remains a relatively open economy. Throughout the last decade, exports have accounted for an average of 29% of GDP, while imports have increased their share from an average of 32% during the first half of the decade to an average of 39% during the second half. Yet, despite the country's comparative advantage in producing its principal export crops, a large increase in exports is needed to finance the external resources, such as fuels, capital equipment, and the technology required to diversify the economy's production base.

Present economic conditions - the uncertain climate for private investment, worsening balance of payments, large government fiscal deficit, and, sizable reduction in loans to the private sector in real terms through the banking system - are serious constraints to reversing the present stagnation of the economy in the short run.

The Caribbean Basin Initiative (CBI) is expected to provide significant incentives favoring the growth of exports from basin countries and thereby facilitate increased trade with the U.S. Honduras is ill-prepared to take advantage of the benefits for exporters of Basin countries that will result from the CBI. Some of the key constraints to increasing exports are a lack of knowledge on the part of potential exporters about the world market requirements and conditions, difficulties in product design and production, and inadequate export promotion and services.

HONDURAS - LABOR REPORT: 1982

SUMMARY

Positive political developments buoyed the fortunes of labor during the past year. For the first time in 18 years, Honduras returned to a fully constitutional, civilian and democratic rule. The installation of Dr. Roberto Suazo Córdova as President of the Republic on January 27, 1982 capped a two year political process which was guaranteed by the military and staunchly supported by labor and other democratic sectors. The Suazo government's deep commitment to administrative reform, its democratic outlook and dedication to a corruption free government, served to strengthen the labor sector notwithstanding minor slippage in total employment caused by a continued downturn in the country's economic performance during 1981 and 1982.

The ranks of organized labor decreased slightly during the year. General decline in business performance, characterized by some plant closings and layoffs, was largely to blame. A significant shift in the composition of labor federations occurred with democratic ORIT-affiliated federations suffering significant losses to both the General Workers Central (CGT - Christian Democrats) and the United Federation of Honduran Workers (FUTH - Marxist dominated).

The Honduran economy continues to be sluggish with real economic growth at less than 0.3 per cent for 1981. Estimates for 1982 demonstrate that real GDP growth will decline some 1.4 per cent with only a modest increase expected in 1983. With a 3.5 per cent yearly increase in population, GDP growth per capita is negative and declining sharply.

Unemployment and inflation increased in 1981 and 1982 and continues to plague labor. Official unemployment and underemployment statistical figures suffer from poor or non-existent data procurement practices, and generally belie true economic conditions. In 1982 the GOH did not act on raising the minimum wage but did implement a controversial constitutional amendment providing a "7th day's pay for 6 day's work" and a "13th month's pay for 12 month's work". This measure provides an effective increase in salary of 25 per cent for workers who were not already contractually entitled to this benefit. Wage negotiations in the private sector resulted in similar increases.

The democratic confederation, the CTH, maintains good relationship with President Suazo and his economic cabinet. During the past year, the Minister of Labor has forged closer ties with the CGT and FUTH. The private sector and labor experienced almost harmonious relations in view of the "off" year for collective bargaining agreements. Few major strikes occurred during the year. Strikes which occurred were generally politically motivated, albeit including ostensible economic demands.

The Honduran labor movement continues to function within a framework of basic freedoms -- speech, press and assembly -- which are generally respected. Trade unions span the ideological spectrum and no overt government suppression has been detected. A pro-Soviet trade union federation formed in 1981 continues to thrive.

Honduran labor increased its international exposure. A significant number of labor leaders attended numerous training courses and conferences throughout the world. Leading Honduran labor figure and former FESITRANH president Céleo González was named to the executive board of the American Institute for Free Labor Development (AIFLD). Increased activity on the part of CLAT and the West German Friedrich Ebert Foundation -- which opened an office in Honduras -- was also evident.

1982 INVESTMENT CLIMATE STATEMENT

HONDURAS

A. GOVERNMENT ATTITUDE TOWARD FOREIGN PRIVATE INVESTMENT

Honduras has long maintained an open door policy to foreign investment. U.S. firms have been engaged in profitable endeavors in Honduras for over a century. Successive governments have repeatedly enunciated the desire for increased foreign participation in the development process. Foreign firms are widely viewed as a source of new capital, export earnings, technology and jobs. President Roberto Suazo Cordova, inaugurated in January 1982, has indicated on a number of occasions that his government encourages investment, both domestic and foreign. His Administration has worked constructively with U.S. firms to save jobs and maximize the use of scarce financial resources.

Under the Honduran constitution, foreign firms enjoy national treatment in terms of rights and obligations. Also, the 1928 U.S./Honduras Treaty of Friendship, Commerce and Consular Rights provides for Most Favored Nation Treatment for investors of either party. Foreign companies operating in Honduras are subject to provisions of the Honduran Commercial Code and to the same tax laws as domestic enterprises. The industrial, agricultural, tourism, and mining sectors benefit from several legally established investment incentives which are available to foreign and domestic investors on an equal basis.

Whatever restrictions on investment and trade exist generally result more from the informal regulatory climate rather than the legal structure. This is a situation that both domestic and foreign firms have to contend with. As the Honduran economy has grown in size and complexity, the government's role has also increased. At times growing pains have occurred, showing up in the form of lack of coordination and conflicting goals by relevant agencies. However, such problems usually are overcome by Honduran pragmatism and informality, which enable liberal case by case application of those laws that might otherwise restrict foreign investment.

Geographically, culturally, economically, and politically, Honduras is principally oriented toward the Atlantic. It has a long tradition of friendship with the United States, emphasized by President Suazo's cordial reception by President Reagan in Washington in July 1982 and a reciprocal visit by President Reagan to Honduras in December 1982. American presence in Honduras is generally regarded as a positive factor, both in the public and private sectors.

The book value of U.S. direct foreign investment in Honduras is estimated at $230 million. Four "Fortune 500" companies -- United Brands, Castle and Cooke, AMAX Corporation, and Texaco -- have significant installations in Honduras, ranking among the top five firms in the country. In total, there are 125 American firms, subsidiaries, and affiliates in Honduras, not counting representatives, dealers, or licensees.

Given Honduras' democratic government, its space, its sophisticated private sector, its willing, dependable and eminently trainable work force, its excellent climatic conditions suitable for raising and processing a wide variety of agricultural crops, and its geographical proximity to the United States, Honduras should be one of the key beneficiaries of the Caribbean Basin Initiative.

B. ECONOMIC OVERVIEW

The second largest country in Central America in terms of land area, Honduras is mountainous and sparsely populated. It reports the lowest per capita Gross Domestic Product (GDP) [$565 World Bank - 1981] in the region, and second lowest in the Western Hemisphere. Honduras has made vigorous efforts over the last three decades to develop, creating much of the basic physical infrastructure and diversifying its economy away from banana monoculture. Paved highway mileage has increased sixteen fold over the last 20 years providing access to a number of previously remote areas.

A 270 megawatt hydroelectric project now under way will supply abundant electricity to the country when completed in 1986. Under the current rate structure, the cost of electricity to industrial users ranges from $.0496 to $.0516 per KWH, depending on the quantity used. For commercial users, the corresponding range is $.1214 to $.0701 per KWH.

Modern port facilities are located at Puerto Cortes on the Caribbean side -- where container loading is available -- and San Lorenzo on the Pacific side; construction has resumed on a new Caribbean port at Puerto Castilla. International telephone and telex service is now readily available.

The Honduran economy is essentially agricultural. It is characterized by a substantial foreign trade sector, which accounts for more than 40 percent of GDP. The private sector dominates the economy, although there was a large amount of government and government-guaranteed investment in the 1970s. A small industrial sector -- 15 percent of GDP -- has developed rapidly in the past two decades producing goods mainly for the domestic market and for export to neighboring countries. Grains for domestic consumption are produced largely by small holders and occupy the majority of the cultivated land area. Forestry lands are under government control, and only the GOH Forestry Corporation, COHDEFOR, may export lumber. Coffee, grown in the mountains, and bananas, from the coast and large river valleys, account for half of Honduras' export earnings. Other exports are lumber, meat, cotton, mineral concentrates, sugar, soaps and detergents, cigars, tobacco, fruit juices and preserves, textiles and apparel, and wood products. Continuing efforts are being made to promote nontraditional industries for both export and domestic markets.

The United States is Honduras' principal trading partner, taking more than 55 percent of its exports and providing 43 percent of its imports. The United States is also the country's main source of commercial bank credit and its largest bilateral aid donor. Leading imports are petroleum, chemicals, capital and transportation equipment, and consumer goods. Despite continuing balance of payments deficits, in which petroleum costs figure heavily, Honduras has thus far succeeded in maintaining the value of the Lempira at its historic rate of two-to-one in relation to the U.S. dollar. Traditionally, there have been virtually no impediments to obtaining foreign exchange. However, exchange controls requiring licensing and a prior deposit for imports have been imposed as a temporary measure; the GOH is committed to ending them as soon as possible. Public sector external debt totals $ 1.5 billion; four-fifths of this figure is on highly concessionary terms to international finacial institutions; the balance is to commercial banks. Less than 10 percent of total private sector debt is currently being rescheduled. Private sector foreign debt is currently estimated at $300 million.

Honduran economic policies are generally straightforward. Price controls were eliminated in early 1982 on all but half a dozen basic items: powdered milk, eggs, bread, medicines, fuels and transit fares. Price supports exist on domestically produced basic grains, sugar, and cement. Most interest rate movements reflect international financial market trends, although there is a ceiling on lending rates. The tax structure consists principally of levies on foreign trade transactions supplemented by a 5 percent sales tax and an income tax with 44 percent as the highest marginal rate of taxation. The tariff regime is intended primarily as a revenue instrument.

Although now much more greatly diversified than even 25 years ago, the Honduran economy remains very susceptible to the vagaries of world commodity markets. After four years of unprecedented real growth averaging over 7.5 percent per year in the late 1970s, Honduras entered a period of sharp economic decline in 1980 as a result of soft world markets for primary products, a severe shortage of credit, high interest rates, and high petroleum costs. The depressed state of the world sugar market, compounded by the imposition of sugar quotas by the U.S. in 1982, and a decrease in its International Coffee Organization quota, at a time when production of these commodities reached an historic high, have dealt particularly severe blows to the Honduran economy.

Real growth in Gross Domestic Product (GDP) was less than 0.3 percent in 1981 and will likely be negative for 1982. Only modest improvement for real GDP growth is foreseen for 1983. The inflation rate was slightly above 9 percent in 1981 and 1982. The return to fully constitutional rule with the inauguration of President Suazo in January 1982 has had a positive effect on business confidence. However, in view of the scarcity of loan money and high interest rates, it has so far been difficult to convert this positive climate into tangible accomplishments.

C. POLICIES TOWARD INVESTMENT

The Honduran constitution provides for national treatment of foreign investment. Also, there are a number of legally established investment incentives which are available to foreign investors (see Section D). Foreign participation in some areas -- broadcasting, distributorships, lumber, and fishing -- is restricted by the requirement that majority ownership be held by Honduran nationals. With a few exceptions, the 1975 Agrarian Reform Law limits the amount of land an individual or corporation may own. The amount varies from 100 hectares (247 acres) to 2,000 hectares (4,942 acres), depending on location and other physical factors, such as irrigation. Also, non-Hondurans may not own property within 40 kilometers of national boundaries -- including maritime boundaries -- except in urban areas. In general, however, there are no sectoral or geographical preferences or restrictions other than those dictated by such practical considerations as proximity to port facilities, climate, etc.

Formation of a partnership or corporation is a procedural matter with no special restrictions applied to foreigners. However, small business, i.e., equity capital of less than $25,000, is reserved to Hondurans. Residency permits are readily obtained.

Licenses and permits are necessary for a wide variety of activities. GOH administrative as well as legal procedures are reputedly not immune to influence. These can be employed to restrict access and are often a frustrating, time consuming process for the inexperienced foreigner. Occupational licensing by professional bodies is, in practice, limited to nationals. COHDEFOR, the national forestry authority, licenses woodworking firms under procedures which sometimes appear to be applied unevenly.

Foreign companies operating in Honduras are subject to the provisions of the country's commercial code-the same as domestic enterprises; likewise, they are subject to the same tax laws once the period of their eligibility for special investment incentives has expired. At present, there are no formal, coordinated investment screening mechanisms.

Joint ventures enjoy the full protection of Honduran law; however, in most cases 51 percent of the capital must be Honduran. In practice this is not a problem.

In theory, there are no restrictions on the remittance of royalties and dividends abroad, although dividends paid to nonresident foreign investors are subject to a 15 percent tax rate versus 10 percent for nationals and resident foreigners. The 5 percent differential is to compensate for nonresident foreigners not paying income tax on dividend earnings. However, the country suffered a severe drop in export earnings in 1982 which, by the end of the year, produced a substantial backlog of unmet requests for foreign exchange. The government responded with broad controls on imports and access to foreign exchange. One practical result of the temporary foreign exchange controls has been substantial delays in access to foreign exchange for the remittance of royalties and dividends as these are accorded relatively low priority under the present control system. However, the Central Bank has acted pragmatically to assure that the flow has not been cut off entirely.

Patents and trademarks are protected, but must be registered with the Ministry of Economy. Foreign patents may be confirmed in Honduras for the same period as in the country of issuance. Honduras is a party to the General Inter-American Convention for Trademark and Commercial Protection (Washington 1929), the Convention on Literary and Artistic Copyrights (Buenos Aires 1910), and the Convention for the Protection of Inventions, Patents, Designs, and Industrial Models (Buenos Aires 1910).

Exports are subject to a 1 percent export tax, except for meat, sugar, bananas, coffee, and minerals, which are taxed at a higher rate. Imports are presently taxed by category and subject to temporary surtaxes totaling up to 30 percent. The government has introduced legislation to move to an ad valorem import tax in 1983, coupled with adoption of the Brussels Tariff Nomenclature and inclusion of the surtaxes in the new tariff.

With the exception of the specific investment incentive provisions discussed in Section D, import and export taxes apply equally to foreign and domestic investors.

The import of raw materials and other goods and services is regulated by the Central Bank. Under the present temporary system of exchange controls, implemented in May 1982, imports are divided into five categories from highest to lowest priority. Category I comprises essential consumption items, medicines, and educational materials; Category II, fuels and lubricants; Category III, raw materials and other agricultural and industrial inputs; Category IV, machinery, equipment, and spare parts: and Category V, other goods and services.

Application for, and approval of, the import permit constitutes only half of the process since in most cases application must also be made for foreign exchange to pay for the imports. Delays of four months and more for approval of an import permit and the request for foreign exchange were common in 1982. This situation is expected to gradually improve in

1983 as Honduras' supply of foreign exchange increases and as the Central Bank gains experience with its system of controls. The Government of Honduras is committed to returning to a system of open trade as soon as economic conditions permit.

Some imports produced in Central American Common Market (CACM) countries enjoy preferential tariff treatment through a series of bilateral commercial treaties containing product lists for free entry as annexes. There are no other discriminatory policies affecting imports from non-CACM countries.

D. INVESTMENT INCENTIVES

The industrial sector benefits from several legally established investment incentives. In general, these incentives favor new or expanding enterprises which significantly expand the country's industrial base, satisfy basic needs, and either generate or conserve foreign exchange through import substitution and/or increased exports. Small and medium size industries and craftsmen are exempted from import duties and related fees for selected categories of imports for varying periods of time. Large export oriented investors ($500,000 and above and employing 75 or more Honduran workers) are eligible for income tax liability reductions of up to 50 percent. Honduras is a signatory to the Central American Agreement on Fiscal Incentives for Industrial Development.

Incentives for the tourist industry include a one-time, 100 percent exemption from import duties, consular fees, etc. on imports of construction materials, furnishings, equipment, etc., depending on location. (This law favors enterprises located outside of the population centers of Tegucigalpa and San Pedro Sula.) Tourist industry enterprises are also exempt from income taxes for up to ten years, depending on location and the ratio of net profit to invested capital.

Under the Agricultural Development Law, agricultural enterprises are exempt from import duties and related charges on imports of equipment, seeds, fertilizers, fuels, and other selected items.

Revisions to the Mining Code made in 1982 offer new mining ventures lower tax and royalty rates for the first five years of their existence. Total tax liability for new and established mines was limited to 55 percent under the revised law.

"Drawback" enterprises are exempt from import taxes on raw materials and semifinished products incorporated into final products which are exported outside of Central America. However, except for a few firms in the Puerto Cortes Free Zone, this program is not widely used.

In 1976, the Government of Honduras established a free zone in the port city of Puerto Cortes (about 60 kilometers from San Pedro Sula). Enterprises operating in the free zone may import merchandise free of tariffs, customs, and related fees; manufacture, process, or handle any item not prohibited by law; and freely export finished goods, except that not more than 5 percent of production may be imported into Honduras upon payment of normal duties. Profits earned by enterprises within the zone are exempt from taxes. The zone offers a wide range of administrative, logistical, and other services to businesses operating in the zone.

The above investment incentives are prescribed by law and are available equally to domestic and foreign investors, except as noted below.

E. PERFORMANCE REQUIREMENTS

The Central American Agreement on Fiscal Incentives for Industrial Development favors those industries which utilize a significant portion of raw materials of Central American origin. Incentives provided by implementing legislation in Honduras therefore vary according to the proportion of such materials used in the manufacturing, assembly, finishing, or packaging process: the greater the fraction of Central American produced raw materials, the more liberal the incentives.

Incentives provided under the Honduran program for small and medium size industries and for craftsmen vary according to proportion of locally produced raw materials utilized in the manufacturing, assembly, finishing, or packaging process. Again, the greater the fraction of locally produced raw materials, the more liberal the incentives.

To qualify for large-investor incentives provided by the Government of Honduras, an enterprise must have a capitalization of U.S. $500,000 or greater, employ at least 75 Hondurans, and export at least 25 percent of its production. If the enterprise is involved in the packaging or manufacture of consumer goods, at least 35 percent of the value of materials used in production must be of Honduran origin.

Incentives provided to the tourist industry are more liberal for enterprises located outside of Tegucigalpa and San Pedro Sula. However, the income tax reduction-incentives do not apply in any year in which net profit exceeds 20 percent of invested capital, regardless of location.

The Agricultural Development Law of 1970, as amended, favors enterprises which: promote agricultural production, especially of those items that contribute to improving the national diet; stimulate the diversification of agriculture through the introduction of new crops and animal species; boost rural income and employment; improve marketing channels; and provide increased training and other social benefits to persons in the agricultural sector.

G. ANTICIPATED CHANGE IN INVESTMENT POLICIES

No major shifts in investment policies are anticipated. The Suazo Administration can be expected to continue its support for private investment. The Suazo Government has moved to restore Honduras' financial credibility by working out a stand-by arrangement with the International Monetary Fund, by rescheduling a small portion of the public sector external debt (staying current on the rest), and by reaching a settlement with the foreign creditors of the Banco Financiera Hondurena (a commercial bank which failed in 1980). A gradually improving economic situation in Honduras and the world in general will facilitate and encourage the flow of foreign capital to Honduras. Passage of the trade and investment portions of the Caribbean Basin Initiative legislation by the U.S. Congress should serve as a further inducement for U.S. and other foreign investment in Honduras.

H. BILATERAL INVESTMENT AGREEMENTS

The 1928 U.S./Honduras Treaty of Friendship Commerce and Consular Rights provides for Most Favored Nation treatment for investors of either party. The United States and Honduras also signed an Agreement for the Guarantee of Private Investments in 1955, and an Agreement on Investment Guarantees in 1966. Honduras is party to the Central American Agreement on Fiscal Incentives. Provisions for bilateral investment are included in the commercial treaties Honduras has with Costa Rica, El Salvador, Guatemala, Mexico, Nicaragua, and Panama. Honduras plans to conclude commercial agreements, which will likely include provisions on investment, with Argentina, Chile, Colombia, and Venezuela in 1983.

The Government of Honduras has expressed interest in entering agreements with Belize and the Dominican Republic. Negotiations on a Bilateral Investment Treaty with the United States have recently begun.

I. OPIC PROGRAMS

The Overseas Private Investment Corporation (OPIC) has long been active in Honduras. OPIC currently holds active insurance contracts of $38,662,063 for coverage against expropriation, $34,047,940 against war, and $32,022,396 against currency inconvertibility. OPIC has also financed the expansion of five U.S. businesses or joint ventures in Honduras since 1980. There is substantial potential for OPIC to expand its operations in Honduras, and OPIC has indicated a strong willingness

J. LABOR

The total labor force in Honduras exceeds one million, of which some 200,000 are organized. The Honduran Labor Code is considered progressive and is generally favorable to the workers. Honduras has long had a vigorous democratic trade union movement -- the best organized in Central America. Business, government, and labor alike point this out with pride as a pitch for attracting new investment. Cooperation between unions and employers is uniquely high, and this is reflected in a relatively low number of labor disputes and prevailing conditions of labor peace.

There is a variable minimum wage schedule ranging from a high of $3.65 per day for banana plantation, mining, refinery, port, and railroad workers, to $3.30 per day for industrial workers in the largest city, to $2.00 per day for rural agricultural workers. However, in practice, the prevailing wage paid in the industrial sector and by all foreign companies is much higher -- over $10.00 per day. Textile and tobacco workers often work on a piecework basis. The Honduran constitution provides for payment of 7 days' wages for 5 and 1/2 days' work for workers paid on a weekly or biweekly basis and 13 months' for 12 months' work for monthly salaried workers. Officially, unemployment is estimated at 10.8 percent but is widely believed to be much higher. Underemployment is estimated to be around 60 percent.

There is a general shortage of skilled workers. Most workers are either illiterate or have not more than a few years of formal schooling. A relatively small segment of the population (less than 20 percent) have more than a primary education. Approximately 2 percent of the labor force are college graduates. Within the educational system there is a strong tendency to prepare individuals for the commerce and service sectors (e.g., lawyers, secretaries, accountants). Very few individuals are prepared in the industrial trades at either the high school or university level.

Skills training programs are available through the National Skills Training Institute (INFOP). However, employers report only mixed satisfaction with the quality and relevance of the courses. Newly founded companies frequently find that employees trained in in-plant training programs -- which represent an additional investment cost -- are more effective than graduates from INFOP. (Arrangements can be made with INFOP for in-plant training courses.) U.S. investors who have trained their own workers report excellent results in skills acquisition and retention and in productivity. They also note that long term employee loyalty is an additional benefit from in-house training.

Mid-level management skills are also in extremely short supply. There is a dearth of training available in the management trades. High technology industries that have need for highly skilled workers either send these workers out of the country for training or bring in outside technicians to provide training in plant.

K. FOREIGN INVESTMENT STATISTICS

Embassy's best estimates of foreign investment in Honduras, drawn from official and other sources, are as follow:

Country	Estimated Investment*
United States	230.0
Japan	18.0
El Salvador	11.3
United Kingdom	6.7
West Germany	5.3
Venezuela	3.2
Guatemala	3.1
Costa Rica	2.0

*In millions of U.S. dollars.

Embassy estimates of the book value at the end of 1982 of U.S. investment in Honduras, by product category, are shown below:

Product Category	Estimated Investment*
Bananas and related	120
Mining	53
Oil refining	15
Forestry and wood product	5
Meatpacking	4
Tobacco	4
Beverages	4
Fishing	4
Fats, oils, and related	3.5
Other	18.5
TOTAL	230.0

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Fats, oils, and related	3.5
Other	18.5
TOTAL	230.0

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L. CAPITAL OUTFLOW POLICY

Capital outflow has been a significant problem for Honduras since 1979, following the rapid escalation of political violence in neighboring Nicaragua and El Salvador. A certain amount of capital flight had always existed but was usually offset by larger capital inflows. This was especially the case in the late 1970s when international commercial banks, flush with loanable funds, substantially increased their lending here. Net capital outflows since 1978 are estimated at $500 million. This figure includes a reduction in suppliers credits, declining levels of commercial bank credit; the conversion to domestic source borrowing from foreign source borrowing by multinational corporations having operations here, and capital flight. In December 1980, the government implemented its first measures to stem capital outflow by requiring a Central Bank permit for all foreign exchange payments exceeding $5,000. This was followed by measures to require documentation of return of export earnings in September 1981, import licensing in May 1982, and a prior deposit requirement on foreign exchange for imports in October 1982. Although present controls (discussed in Section C above) do not address the outflow of investment capital per se, they effectively limit capital outflow by assigning higher priority to other uses of the increasingly scarce commodity.

Honduras is itself a developing country (the second poorest in the Hemisphere) and is not in a position to provide incentives for investment by its citizens in other developing countries. However, elements of the Honduran private sector do have investments abroad, notably in other countries of Central America and in the United States. The amount of such investments is not large.

UNITED STATES BUSINESS IN HONDURAS*

Abbott Laboratories
- Abbott Laboratorios; *pharmaceutical manufacturing*

ACF Industries
- Polymer; *plastic and resin manufacturing*

Agencia Guilbert; *importer and agency representative*

Agencia Rhinehart; *U.S. and foreign firm representative*

Agrodinámica Holding Company
- Industria Ganadera de Honduras
- Oriente Industrial
- Ranchos de Choluteca
- Repastadora de Oriente

Air Florida; *air transportation*

Airlift International; *air cargo carrier*

Alberti International
- Caribbean Products; *shrimp processing*
- Empacadora Alus; *beef processing and slaughterhouse*
- Empacadora Cortes; *food processing*
- Rancho Lorenzo, *meat processing*

Alberto Culver
- Alberto Culver Centroamericana; *cosmetic and hair preparation manufacturing and distribution*

Alimentos Marinos Hondureños; *shrimp and lobster packing plant*

Allied Corporation
- Texgas Gases Nacionales; *water heaters*

Amapala Marine; *yacht building*

AMAX
- Rosario Resources; *silver, lead and zinc mining*

Amed International
- Amedicor; *medical supplies*

American Biltrate Rubber Company
- Compañía Hulera Sula; *rubber product manufacturing*

American Express; *credit card services*

American Home Products
- Fort Dodge Laboratories; *veterinary medicine*

American International Group
- American International Underwriters; *insurance*
- Hanover Insurance; *insurance*

Anthony's Key; *resort*

Araca Petroleum; *oil exploration*

Arthur Young & Company; *accounting*

Baby Togs
- Novelty Honduras; *children's clothes manufacturing*

BankAmerica
- Almacenes de Deposito; *banking*
- Bank of America; *five branches*
- Credomatic de Honduras; *Master Charge credit card services*

Bayman Club; *resort*

Beatrice Foods
- Chitos de Honduras; *food processing*

Bell Western
- Compañía Minera Bell Western de Honduras

Bemis
- Compañía de Sacos Centroamericana; *burlap and cotton sack manufacturing*
- Fábrica Textile Semis Handal; *cotton thread and fabric manufacturing*
- Bemis Bijao de Honduras; *paper bag manufacturing and wholesale*

Boise Cascade; *lumber products*

Bufete Gutierrez Falla

Calmaquip, Ingenieros de Honduras; *commission agents for hotel and hospital equipment*

Camiones y Equipos de Sula

Cargill
- Alimentos Concentrados (ALCON); *animal feed processing*
- Centrocom; *poultry production*
- Fanalco; *animal feed manufacturing*

Caribbean Corporation; *boat building*

Caribbean Lumber Company
- Industria Madera del Norte; *wood products*
- Industria Maderera del Occidente; *lumber mill*

Casa Comercial Mathews; *construction machinery*

Casa Comercial Munson; *Mack truck distribution*

*An indented item is a subsidiary, affiliate, or branch of the corporation immediately above it.

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Castle & Cooke
- Aceros Industriales
- Banco del Comercio
- Cervecería Hondureña; *beer and soft drinks; four branches*
- Cervecería Tegucigalpa
- Compañía Agrícola Industrial Ceibeña; *vegetable oil processing; LAAD equity*
- Compañía Bananera Antillana
- Dole Pineapple of Honduras
- Enlatadora del Campo
- Envases Industriales de Honduras; *metal container manufacturing*
- Fábrica de Manteca y Jabón Atlántida; *oil, margarine and soap*
- Frutera Hondureña
- Industria Aceitera Hondureña; *cotton seed oil processing*
- Manufacturera de Carton; *paper box manufacturing*
- Nacional Inmobiliaria
- Plásticos; *plastic material manufacturing*
- Semillas Mejoradas
- Servicios Agrícolas
- Servicios de Investigaciones Areas
- Standard Fruit; *fruit production*
- Standard Fruit and Steamship

Cat Ketch; *boat manufacturing*

Central American Cigar Company; *cigar manufacturing*

Cerritos de Honduras; *mining*

Chamco
- Chamco Construction; *road construction*

Champion International
- Danli Industrial; *paper products*
- Maya Lumber; *lumber mill*

Charles P. Evans; *sawmill*

Chase Manhattan
- Banco Atlántida; *banking; 38 branches*
- Inversiones Atlántida

Citicorp
- Banco de Honduras; *banking; five branches*

Clark Equipment
- Atlas Eléctrica; *refrigeration equipment and supplies*

Colgate Palmolive
- Colgate Palmolive Centroamérica; *toothpaste and soap manufacturing*
- Colgate Palmolive West Indies; *dentifrice and soap distribution*

Construction Aggregates; *construction*

CPC International
- Alimentos de Istmo; *corn starch and vegetable oil processing*

Crescent Construction; *construction*

Crescent Corset; *textile manufacturing*

Crown Cork & Seal
- Crown Cork Centroamericana; *cork manufacturing*

Dibrell Brothers
- Exportadora de Tabaco de Honduras; *tobacco production*

Diners Club
- Diners Club de Honduras; *credit card services*

Distribuidora Industrial; *electrical component distribution*

Eaton
- Cutler-Hammer; *electrical control panel and box manufacturing*

El Paso
- El Paso Mining & Exploitation; *mining*

Electronicos Diversificados Hondureños; *electronic parts manufacturing*

Exxon
- Esso Standard Oil
- Essochem de Centroamérica; *chemical product marketing*

Fábrica Industrial de Alimentos de Honduras; *condiment processing*

Fábrica de Resortes "El Tecolote"; *auto and truck spring manufacturing*

First Boston
- Compañía de Credito; *banking*

Foremost-McKesson
- Famosa; *ice cream and condensed milk production*

H.B. Fuller
- Adhesivos Industriales
- Aerosoles de Centroamérica
- Comercial Kioskos de Pintura
- Comercial Punto de Viniles
- Kativo Comercial
- Kativo de Honduras; *paint and varnish manufacturing and wholesale*
- Kioskos de Pinturas
- Pinturas Surekote
- Punto de Viniles

General Mills
- Agua Finca de Camarones

General Telephone & Electronics (GTE)
- GTE Sylvania; *electric houseware manufacturing*

Granja Mareana; *hog farm*

Gulf+Western Oil
- Petroleos de Atlántida; *petroleum exploration*

Hacienda Corbano

Halliburton
Brown & Root; *contracting*

Harold McKay; *lumber and timber consultant*

Harrison & Associates; *gold and silver mining*

Hemphill Schools; *school*

Hershey Foods
Hummingbird-Hershey; *cocoa*

Holiday Inn

Hon-Bra; *bra manufacturing*

Honduras Oil & Water Drilling Industry (HOWDI); *oil and water drilling and mineral exploration*

Hotel Honduras Maya

Hybur; *shrimp and lobster packing for export*

IBM World Trade Corporation
IBM de Honduras; *business equipment distribution*

Imesa; *liquor import and export*

Impex; *merchandise import and export*

Imported Brands; *liquor import and export*

Industrial Electric Service; *electrical appliance sales and service*

INRECORP Group
Compañía de Café Creole
Marisens del Caribe (MARCASA); *[illegible]*

International Executive Service; *business consultants*

International Wood Products; *wood components; LAAD equity*

The Interpublic Group of Companies
McCann-Erickson Centroamericana; *advertising agency*

Kem Manufacturing
Kem Centroamericana; *chemical product manufacturing and sales*

Le[illegible]e y Derivados (LEYDE); *food processing; LAAD equity*

Líneas Aéreas Nacionales; *LAAD equity*

Lloyd
Lloyd Petroleum; *oil exploration*

Louisiana Land & Exploration
LLE Petroleum; *mining*

The Lovable Company
Lovable de Honduras; *women's clothes manufacturing*

Maderera Subirana; *sawmill*

Manufacturas Electrónicas (MANEHSA); *electrical repairs*

Manufacturera Cortez; *men's underwear manufacturing*

McDonald's; *fast food*

Mejores Alimentos de Honduras; *food processing; LAAD equity*

Mendieta, Fortín, Lagos y Asociados

Meridian Engineering; *construction*

Merriam & Merriam

MILISI; *shoe import and export*

Milson Magee Lumber; *logging and sawmill operations*

Mineral International
Mayan Minerals; *mining*

Mobil
Mobil Exploration Honduras; *petroleum exploration*
Mobil Oil; *petroleum*

Mohawk Industries
Compañía Cabos Caribe; *broomsticks*

National Car Rental Systems; *auto renting*

Nello L. Teer; *contracting*

Norton Simon
Max Factor & Company; *cosmetic distribution*

Occidental Petroleum
Occidental de Honduras; *oil exploration*

Olivia Tobacco Company de Honduras

Palmeto Bay Resort

Pan American Life Insurance
Compañía de Seguros Panamerican; *insurance*

Pan Americ[illegible] World Airways; *air transp[illegible]ation*

Parker-Hannifin; *auto part manufacturing*

Parker Tobacco

Paul Laeton; *flavoring and fragrance exporting*

Peat, Marwick, Mitchell & Company; *accounting and auditing*

Pesquería del Caribe; *fish processing*

Phelps Dodge
Electroconductores de Honduras (ECOHSA); *electrical conductor manufacturing*

Pietro; *caimen and crocodile farm*

Plantas del C[illegible]ibe; *plant production and export*

Plantas Lindas

Plata; *industrial equipment representative*

POLCO; *flavoring and fragrance exporting*

Port Royal; *marine services and yacht building*

Port Royal Farms; *retirement and vacation community*

Price Waterhouse & Company; *accounting and auditing*

Procesadora de Mariscos y Peces de Honduras (PROMAHO); *fish*

Productos Consolidados; *plaster, paint, and chalk manufacturing and distribution*

Productos Industriales de Madera; *lumber mill*

Reef House; *resort*

Remington Business Systems
Máquinas de Escribir Remington; *typewriters*

REPCO; *wood production*

Rey Café; *coffee production*

R.J. Reynolds (Del Monte)
Banana Development Corporation of Costa Rica (BANDECO); *farm management*
Conservas del Campo; *food processing*

RI-DO; *importing and exporting*

Roatan Developments
Roatan Lodge; *tourist resort*

Robinson Lumber & Export; *lumber*

Rodin Warehouse & Ramirez Cold Storage
Empacadora del Norte; *food processing*

Sale City; *clothes manufacturing*

Sanco, S.; *industrial goods import and export*

SCM
Glidden de Honduras

Sea Farms; *technical assistance in shrimp cultivation*

Seahawk Oil International; *oil exploration*

Sears Roebuck & Company
Sears Roebuck; *department store*

Seatrain Lines; *shipping*

Selmont Oil
Petroleos de Honduras; *petroleum exploration*

Shell Oil; *oil exploration and distribution*

Shrimp Culture; *shrimp farm*

Siemens; *electrical equipment*

The Signal Companies
Signal Exploration; *oil exploration*
Signal Oil & Gas; *oil exploration*

Singer Manufacturing Company of New Jersey
Singer Commercial Sula; *electrical appliance distribution*

Spyglass Hill; *resort*

Standard Oil of California
Compañia Petrolera Chevron; *oil products*

The Stanley Works
Stanley Centroamericana; *machete manufacturing*

Star Commercial Refrigeration; *refrigeration equipment distribution*

Sterling Drug
Sterling Products International; *pharmaceutical product manufacturing*

Stokely-Van Camp; *pineapple production*

Sunrise Fashions
Jozmin; *clothing*

Tabor International

Terminales de Cortes; *custom brokerage and freight transport*

TESTCO; *swimming pool and purificatio[n] system distribution*

Texaco
Estación del Servicio Texaco
Refinería Texaco de Honduras; *petroleum refining*
Texaco Caribbean; *service station*

Textiles Red Point de Honduras

Textiles Rio Lindo; *cotton cloth manufacturing; ADELA equity*

Theonett & Company
Theonett Centroamericana; *soft dri[nk] concentrate manufacturing*

Timex
Relojes Timex; *watch distribution*

Transamerica
Budget Rent-A-Car; *auto renting*

Transcarga; *freight transport*

Transway International
Coordinated Caribbean Transport (CCT); *ocean transport*
Tropical Gas (TROPIGAS); *gas an[d] equipment distribution*

Union Oil
- Union Oil Company de Hondur? oil drilling and exploration

United Brands
- Caribbean Enterprises
- Compañía Agrícola de Rio Tinto: *food production*
- Empresa Hondureña de Vapores
- Fábrica de Aceites de Palma
- Fábrica de Cajas de Carton
- Frigorífica Hondureña
- Numar de Honduras: *vegetable oil processing*
- Polymer: *rubber and plastics*
- Productos Acuáticos Terrestres (PATSA)
- Servicio de Investigación Agrícola Tropical (SIATSA)
- Tela Railroad: *fruit production, cattle production and slaughter*
- TRT Telecommunications
- Unimar: *palm oil*

United Marketing

United States Tobacco
- Tabacos de Honduras: *tobacco products and smokers accessories*

United Technologies
- Compañía Otis Elevator: *elevator sales*

Villa Utila: *restaurant*

Viveros Industriales

Warnaco
- Warner's de Honduras: *clothes manufacturing*

Webster International

Welsh Energia y Petroleos

William Itaimes: *sawmill*

Woodscraft

Worth de Honduras: *baseball manufacturing*

Xerox
- Xerox de Honduras: *business machine distribution and services*

YU-HWA: *clothes manufacturing*

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NICARAGUA: Industry and Commerce

I. Industry

A. Range of Activities

Over the last 25 years, Nicaragua's industrial sector, including processed agricultural goods (beef, shrimp, sugar, etc.) and construction and mining has become increasingly important to the economy. In 1980 it produced about 30% of GDP, employed 16% of the labor force and generated 43% of Nicaragua's exports. Manufacturing growth was facilitated by two distinct developments, both export related. One was the strong expansion of exports of processed agricultural products, of which sugar, cotton and beef were the most important. The second was the creation of the Central American Common Market (CACM) which offered opportunities for substituting imports within the region, particularly in the production of intermediate goods such as chemicals, pharmaceutical and metal products. Exports of manufactured products increased from US$11.5 million in 1960 to US$274.1 million in 1978 or over 19% per year. Annual export growth rates in excess of 25% were achieved in eight of the 18 years in this period. Since the rate of inflation was modest over the period, the reported growth rate in exports is nearly in real terms. The structure of manufactured exports, defined broadly to include processed agricultural goods, also became more diversified. In 1960 processed food represented 70% of the total, with wood products providing most of the remaining 30%. By 1978 processed food was still the largest export subsector (60%), but wood products accounted for only 5%. Others such as chemicals (16%), textiles (6%) and metal products (4%) also contributed to exports. Within the processed food subsector, sugar and meat constituted nearly 60% of total exports. Other important items were frozen shrimp, milk products, and cotton seed oil. The most important chemical exports were insecticides, caustic soda and polyvinylchloride; exports of textiles involved mostly cotton cloth; most wood products exports were in the form of sawn wood and their manufacturing value added content was low.

B. Tariff Protection

The formation of the CACM was probably the most important factor shaping Nicaragua's industrial development in the sixties. The Common External Tariff (CET) schedule specifies low import tariffs on capital goods and raw materials and high tariffs (ranging from 49%-148%) on final consumer goods. A "temporary" 30% surcharge on import duties was also established for 5 years in 1973 and again in 1978. Another major policy instrument was the Central American Agreement on Fiscal Incentives for Industrial Development (CAAFIID), which expanded on existing Incentives of Nicaragua's 1958 Industrial Development Law (IDL). CAAFIID classified firms in three incentive categories according to type of product and raw materials used. This incentive structure, together with the tariff barriers mentioned above, strongly favored the development of regional import-substituting intermediate goods industries and gave relatively little support to the development of exports (other than agroindustries) outside the CACM.

Some specific incentives for expansion of manufactured exports outside the CACM were created in the late 1970's but they were concentrated in enclave industries (firms exporting their total production and generally importing a large proportion of raw materials or semi-processed goods). Decree 332 of 1972 granted import tariff and tax exemptions to firms exporting their total production outside the Central American area, and a more recent step in the same direction was the decree of March 1976 regulating the establishment of free zones. The first of these was developed near Managua's international airport. In 1977, a special Central Bank credit line was established, to finance non-traditional manufactured exports. The credit line operated through the commercial banks, financieras, and the Instituto de Fomento Industrial (INFONAC), providing short-term credit (up to 180 days) to finance 80% of the value of non-traditional exports. Export promotion activities, particularly market research and technical assistance in exports, were begun by the Nicaraguan Center for Export Promotion (EXPORTEMOS), which was created in 1974.

C. Mining

Mining exports have been important for many years, and largely involved gold, silver, copper and zinc. The growth of manufacturing exports has been more recent. Mining exports reached their peak in the 1940's and 1950's, when world prices for copper and zinc were favorable. Subsequently, base metal prices declined. However, in recent years the price of gold has risen sharply, and gold became Nicaragua's leading metal export. Annual exports of gold alone reached 65,000 ounces during the four years prior to the revolution. Largely as a result of (i) the creation of a protected regional market and (ii) increasing world demand for Nicaraguan agroindustrial products, exports of manufactured products increased from US$11.5 million in 1960 to US$274.1 million in 1978. Starting from a low base, annual export growth rates in excess of 25% were achieved in 8 of the 18 years covered by this period. The structure of manufactured exports also became more diversifie during the same period, although intra-CACM trade provided decreasing scope for expansion into new products as the easiest import-substitution possibilities at the regional level were used up. In 1960 processed food represented 70% of the total, with wood products providing the remaining 30%. By 1978 processed food was still the largest export subsector (60%), but wood products accounted for only 5%. Other subsectors such as chemicals (16%), textiles (6%) and metal products (4%) were also important exporters. Within the processed food subsector, sugar and meat constituted nearly 60% of total exports and other important items were frozen shrimp, milk products, and cotton seed oil. The most important chemical exports were insecticides, caustic soda and PVC; exports of textiles involved mostly cotton cloth; most wood products exports were in the form of sawn wood and their manufacturing value added content was low. Export diversification occurred largely within the protected CACM and Nicaragua's manufactured exports to countries outside the CACM, which were 49% of total manufactured exports, showed a different composition than regional exports. In 1978, processed foods accounted for 91% of manufactured exports outside the CACM. The only other significant items were textiles, chemicals and wood products with 3% each of the total.

D. Labor

By 1978 Nicaragua still had only a relatively small and unskilled industrial labor force of 79,000, and employment in mining was about 3,000. Manufacturing accounted for 10.6% of the economically active population, down from 11.6% in 1972. A major short-term drop occurred as a result of the 1972 earthquake, when the economically active population in manufacturing fell from 67,717 to 58,726 persons. Employment quickly began to recover, but largely as a result of the overall slowdown in manufacturing growth, it only reached the 1972 level by the end of 1976. With an annual average population growth of about 3.5% during the last 10 years and a growing urban sector, Nicaragua faces the double challenge of providing enough jobs for its rapidly growing population and of fostering the types of skills required by these jobs. Compared with other CACM countries (except Honduras) the labor force in Nicaragua is probably less skilled, as a result of a low adult literacy rate and lack of vocational training facilities. Nevertheless, average daily labor costs (i.e. wages and other benefits) were slightly higher (1976 data) than those of other Central American countries, except for Costa Rica.

II. THE WAR AND ITS EFFECTS

A. Decline in Output and Employment

In spite of political disturbances in 1978, industrial output and value-added actually managed a very small increase (less than 1%) in that year over the previous peak recorded in 1977. With the outbreak of full-scale conflict in June 1979, industrial production virtually ceased for almost two months and there was a strong contraction in domestic demand. Nevertheless, industrial output and value added (down for the year by 26% and 27%, respectively) did not show the sharper decline anticipated. The reason for the better than expected performance of the industrial sector was the performance of industrial exports. They actually increased 11% in 1978, and although they declined in 1979, they only declined by about one-half the rate that output declined. An analysis of changes in export volume for individual products, shows that in 1978, over one-half of major items exported had volume increases and that the rest suffered only relatively small reductions. Although in 1979 all goods except beef products had volume declines, processed farm products, which were mostly destined for the US and other non-CACM markets, declined very little overall, while most of the largest volume declines occurred in manufactured goods destined for the regional market. It seems clear that as the domestic situation deteriorated over 1977-79 industrialists increasingly began to seek to increase exports, especially outside the CACM, not only because the domestic economy had become unable to absorb its share of industrial output, but also because the proceeds of export sales could be held abroad as a hedge against economic collapse.

B. Physical Damage and Looting

Shortly after the cessation of fighting, several independent assessments were undertaken of the physical losses experienced by the industrial sector. Damage was most severe in the industrial area along the north highway in Managua where a number of plants were completely destroyed and many others suffered major damage. This zone contains the heaviest concentration of industry in Nicaragua. While the urban centers of Esteli, Matagalpa and Masaya all suffered heavy damage, the industrial plants in those and other areas experienced relatively less damage then those in Managua.

The current replacement cost of the damaged industrial facilities (buildings, machinery and equipment) was estimated at about US$50 million. A considerable proportion of this represented office buildings, storage, warehouse and related facilities. The loss in productive facilities was therefore estimated at 5% to 10% of the book value of fixed assets for the entire sector. Many plants, which suffered no damage to production installations, experienced widespread stock losses, as a result of the looting of inventories of raw materials and finished products, and the value of inventory losses was estimated at US$60 million. A study by the Central Bank of 160 enterprises representing about 60% of the total gross value of manufacturing output indicated that they experienced losses equivalent to some 28% of the value of their inventories as compared to damages equivalent to 9% of fixed assets. While 16% of the firms had damages in excess of 25% of the value of fixed assets, 44% experienced losses in excess of 25% of the value of their inventories.

A major constraint on firms seeking financing for rehabilitation of output was their weak financial situation as well as the lack of funds in the banking system. Financial and other records were destroyed, either as a result of physical destruction from the war or as a deliberate act by the former owners. Many factories which were able to undertake some production did not restore their inventories of finished products due to political uncertainty and because demand had stagnated due to loss of income. Industry also experienced serious losses of managerial and technical personnel. During the period of intense fighting, a relatively large share of trained profes-

C. Post-War Reconstruction of Industry

1. Priorities

One of the major objectives of the Government's 1980-81 Recovery Program was to restore the productive capacity of the economy. First priority was given to rehabilitating the agricultural sector in time for the Spring 1980 planting, by greatly expanding the area under cultivation. A second, but still urgent priority was to recover lost industrial output. In its immediate reconstruction efforts, the new Government established three main priorities for the agricultural and industrial sectors: (a) restore production, particularly of foodstuffs; (b) generate employment; and (c) promote exports. Given the gradual restoration of transportation and communications, improved administration and the availability of international financial assistance, it was hoped that industrial output in 1980 would regain about 87% of the 1978 peak level. On the production side, this would require some progress to be made in rehabilitating damaged facilities and restoring lost inventories of spare parts and production inputs and in overcoming the problems caused by the losses of key managerial and technical personnel in many of the former Somoza-controlled enterprises. On the demand side, it was considered likely that, in the face of the large personal income losses sustained over 1978 and 1979, consumer purchases of other than absolute necessities would be kept at a minimum. Exports, which were expected to play a major role in maintaining industrial activity and in generating urgently needed foreign exchange were expected to account for about one-third of the gross value of industrial output.

2. Policies

Based upon Decree No. 3 of July 19, 1979, which authorized the Procurador General de Justicia to proceed immediately to intervene in, requisition and confiscate "todos los bienes de la familia Somoza, militares y funcionarios que hubiesen abandonado el pais en Diciembre de 1977", the state acquired a large portion of the productive facilities of the nation. The state now owns the mining sector outright, and in industry, effectively controls (though majority ownership in major enterprises) the construction, wood processing, and metal-mechanics industries, and has important holdings in textiles, chemicals and agroindustry (particularly meat packing, cotton ginning, sugar refining and milling of basic grains). These sectors together represent about four-fifths of industrial value added, and, since the state now accounts for 31% of the gross value of industrial production, its role will be a major factor in the future development of Nicaraguan industry. It should be noted that these enterprises could hardly have been considered as purely private prior to the revolution.

Four state corporations have been established to control state industrial enterprises and three state corporations to control mining and fossil fuels. The largest industrial entity is the Corporacion Industrial del Pueblo (COIP) which is under the Ministry of Industry and has an equity share in enterprises in textiles, food processing, construction, chemicals, metal-mechanics, wood products and printing. A separate entity, Agroindustrias de Reforma Agraria (AGROINRA), was responsible for most state agroindustrial activity. This function is now being carried out by a new Directorate General of Production in the Ministry of Agricultural Development (MIDA). Managers of individual enterprises are now directly responsible to one of MIDA's 18 regional offices. In addition, the Corporacion Forestal del Pueblo (CORFOP), which is part of the Instituto Nicaraguense de Recursos Naturales y del Ambiente (IRENA) is responsible for the industrialization of wood products, and the Instituto Nicaraguense de Pesca (INPESCA) controls fish catching and processing. The Instituto de Minas e Hidrocarburos (INMINEH), controls mining of metals through Corporacion Nicaraguense de Desarrollo Minero (CONDEMINA), non-metallic minerals through Corporation de Minerales no Metalicos (COMNOMET) and petroleum refining through Empresa Nicaraguense del Petroleo (PETRONIC).

The marketing of certain agricultural products which represent an important part of agroindustrial processing is now the responsibility of the state. The purchase of producers' output, its sale to processors, and the marketing of processors' output is the responsibility of the Empresa Nicaraguense del Algodon (ENAL) for cotton, the Empresa Nicaraguense de la Carne (ENCAR) for meat, Empresa Nicaraguense del Azucar (ENAZUCAR) for sugar, Empresa Nicaraguense del CAFE (ENCAFE) for coffee, and the Empresa Nicaraguense de Alimentos Basicos (ENABAS) for basic grains. In addition, the Empresa Nicaraguense de Importaciones (ENIMPORT) is responsible for the imports required by the industrial sector and the Empresa Nicaraguense de Promociones de Exportacion (ENIPREX) for industrial exports. A decentralized agency, the Instituto Nicaraguense de Administracion Publica (INAP), has been established under MIPLAN with responsibility for systematizing the administration of public enterprises and for training public officials.

As of June 30, 1980 the state held a majority interest in 91 industrial enterprises, of which 70 were managed by COIP. COIP's total shareholdings involved a total of 99 enterprises, including the 70 majority owned firms, a minority interest in 22 and intervention 2/ in 7 enterprises. In some cases where COIP has a minority interest, it is the largest share-holder, and therefore assumes a leading role in the firm's activities. COIP is headed by a director, who also has the title of Vice Minister of Industry. COIP is organized into five departments: management of enterprises, planning finance, administration and industrial relations. Each of the enterprises in which COIP has shares have been grouped into subsectors (food processing, chemicals, textiles, construction materials, metal-mechanics, plastics, wood processing and paper and printing). Each of these subsectors has been established as an organizational unit (i.e. "complejo industrial") under the

Department of Management of Enterprises, and has a coordinator, who is responsible for integrating and directing the activities of the COIP enterprises in that particular subsector. In the cases in which COIP has a majority shareholding (and in some cases in which it is an exceptionally large minority shareholder), COIP appoints an administrator to manage the enterprise. One of COIP's main problems has been finding administrators with sufficient experience at the enterprise level. COIP's subsectoral coordinators appear on the whole to be quite capable and knowledgeable about their areas of responsibility.

Performanc

The table below shows industrial activities in the context of GDP prior, during and after the civil war. Performance was good up to 1977, but then deteriorated substantially. In 1980 a substantial recovery was recorded but it was below Government targets.

NICARAGUA: Industrial and Mining Output

(in millions of Cordobas-1958 prices)

	1970	1975	1977	1978	1979	1980
GDP (market prices)	4664.3	6112.7	6428.2	5982.5	4470.3	4915.8
(% change per year)	-	5.6%	2.6%	-6.0%	-25.3%	10.8%
Agriculture	1073.1	1427.9	1499.1	1593.6	1351.6	1213.6
(% change per year)	-	5.9%	2.5%	6.3%	-15.2%	-10.2%
Industry (total)	1261.6	1756.6	2023.1	1864.1	1266.1	1486.9
(% change per year)	-	6.8%	7.3%	-7.9%	-32.1%	17.4%
Manufacturing	1071.0	1426.6	1635.1	1638.8	1190.7	1348.9
Construction	158.3	304.2	340.5	188.9	51.0	101.6
Mining	32.3	25.8	47.5	36.4	24.4	36.4

The Banking System

Prior to the war, Nicaragua had a mixture of public and private commercial banks and specialized financial institutions regulated by the Central Bank (BCN) and monitored by a Superintendent of Banks. Government institutions, accounting for 53% of the financial system's total assets in 1976, included the National Bank of Nicaragua (BNN), the country's largest commercial bank; the National Development Institute (INFONAC); the Banco de

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la Vivienda, a public housing bank; and two institutions specializing in small-scale loans. Private institutions included seven commercial banks, six finance companies and six financial warehouses, which together accounted for 43% of total assets. Despite the diversity of institutions, two competing private groups controlled approximately three-fourths of the total assets of the private financial institutions.

The largest and most important financial institutions were multi-purpose intermediaries; however, a certain degree of specialization by sector was reflected in their loan portfolios. BNN concentrated on agriculture and livestock loans, private banks on commercial and industrial loans, and INFONAC and the finance companies on industry. INFONAC has been the major lender of medium and long-term funds for industry and agriculture; however, since 1972 the banking system has been able to draw on the FED, administered by the Central Bank, for such lending.

After a long period of monetary stability, the financial sector had come to share many of the characteristics of more developed financial systems, and the banking system had expanded to include 227 branches and agencies located throughout the country. While some of the public financial intermediaries were poorly run, Nicaragua's private banks enjoyed the public confidence and were generally considered to be sound and well-managed institutions

The situation of the country's financial intermediaries began to deteriorate after 1977 and worsened substantially during the subsequent two years. Commercial bank deposits fell between March 1977 and mid-1979 by 23% while total loans outstanding increased by one-third. Interest and principal arrears accumulated to about 30% of total loan portfolios. The resulting drain of resources was financed through increased borrowings from foreign sources and the Central Bank. Foreign currency borrowings during the period rose by 150% while borrowings from the Central Bank increased by 230%. The devaluation of the Cordoba by 43% in April 1979 increased the liabilities of the banking system, as most of its foreign loans had been lent in local currency.

The Government nationalized private domestic financial institutions, named new managers to replace those who had left the country and provided some liquidity support through BCN to keep these institutions in operation to prevent a total collapse of the system. The banking Superintendent ordered detailed internal audits of all institutions, including an assessment of the quality of all outstanding loans. This effort was complicated by the expansion of the public sector, since many new state-owned firms owed large sums to state-owned banks which, in turn, owed large sums to foreign creditors. In late 1979, BCN undertook stodues of how the banking system could be restructured and recapitalized and began to introduce a number of changes

On June 17, 1980, a complete reorganization of the structure of the banking system was announced. The total number of financial institutions was reduced through a series of mergers to 5: Banco Nacional de Desarrollo (BND); Banco de America (BAMER); Banco de Nicaragua (BANIC); Banco Popular (BP); and Banco Inmobiliario (BIN). The Government's objective in creating the new structure was (a) to minimize the cost of maintaining separate institutions servicing the same clientele, (b) pursue a policy of decentralization which would do away with the clustering of branches in major urban areas, (c) enabl better coordination at the national level of institutions with clearly separate objectives and, (d) increase public confidence in the banking system by limiting it to a few well-established institutions fully backed by the Government. The entire system was placed under the direction of the newly created Corporacion Financiera (CORFIN), which acts as a holding company for the five banks, providing overall direction in the implementation of the Government's monetary policy and ensuring overall consistency of banking practices throughout the system.

III. CURRENT SITUATION AND TRENDS

From the low base of 1979, industrial production increased by only 2.8% in 1980, a much lower growth rate than agriculture (14.3%) or construction (34.8%). The low growth of industrial production was the result of wartime damage, financial difficulties, loss of critical management staff due to immigration, and the continued deterioration in the economies of Nicaragua's Central American trading partners. More recent reliable information on industrial production is not available at present. Recent cable traffic from Nicaragua indicate that industrial output of products not destined to the CACM is growing, but figures were not given.

PANAMA

I. PERFORMANCE AND STRUCTURE OF INDUSTRY AND COMMERCE

Since the end of World War II, the economy of Panama has undergone a process of structural alteration which has produced a significant shift in the relative importance of the sectors of the economy. While the economy was traditionally based on agriculture, primarily for subsistence serving the needs of a small population, and the industrial manufacturing sector was virtually non-existent, in the last two decades the tertiary sector (services, commerce, transportation and public administration) has greatly increased its share of GDP. In this period the expansion of the agricultural and industrial sectors was limited by the dimensions of the domestic market. However, the establishment of a strong international banking center and of an international free trade zone in Colon; the growth of trade utilizing the Canal and the massive investments made by the Government in the country's infrastructure (hospitals, schools, roads, elecricity and sewage) have transformed Panama into an economy characterized by the prevalence of a tertiary sector with strong international links. The rapid growth of the tertiary sector has not been matched by a parallel expansion of the agricultural and industrial sectors. Efforts to modernize agricultrual production have mainly been directed towards export crops, while yields of crops for domestic consumption have remained relatively stable. Despite a severe recession in the 1970's, which has prompted the beginning of a process of modernization, industry is still basically limited by the dimensions of the domestic market and based on substitution of imports rather than on export growth.

The following Table 1 sets forth the relative percentage contributions of the primary, secondary and tertiary sectors of the economy in 1950, 1960, 1970 and 1980.

TABLE 1

SECTORS' CONTRIBUTIONS TO GDP

(Percentages)

	1950	1960	1970	1980
Primary Sector (1)	29	23	28	14
Secondary Sector (2)	13	21	23	19
Tertiary Sector (3)	58	56	59	67
	100	100	100	100

NOTES:

(1) Agriculture, fishing and mining

(2) Industry and construction

(3) Services, commerce, transportation, public administration

Source: Comptroller General, Directorate of Statistics and Census

When examined from the perspective of current sector contribution to GDP and employment, the agriculture, services, commerce, and manufacturing sectors account for over 50% of GDP and 70% of employment, with the agriculture and service sectors each employing about 30% of the labor force. The details are shown in the accompanying table.

TABLE 2

SECTOR CONTRIBUTION TO GDP AND EMPLOYMENT, BY ORDER OF MAGNITUDE

	Sector	% of 1980 GDP		Sector	% of 1979 Employment 1/
1.	Commerce	14.0	1.	Agriculture	29.4
2.	Services	13.7	2.	Services	27.4
3.	Agriculture	13.7	3.	Commerce	13.5
4.	Manufacturing	13.7	4.	Manufacturing	10.1
5.	Transport	11.6	5.	Construction	5.9
6.	Finance	7.8	6.	Transport	5.4
7.	Construction	5.2	7.	Finance	3.7
	Total	79.7			95.4

Latest available data. Relative positions would not have changed substantially over one year.

Of more interest than the static situation depicted in Table 2 and complementing the changes discussed in Table 1 by primary, secondary, and tertiary categories is the dynamic picture shown in Table 3 of the dramatic shift in the sectors stimulating growth over the thirty year span between 1950 and 1980.

TABLE 3

LEADING SECTOR CONTRIBUTION TO GDP GROWTH BY ORDER OF MAGNITUDE [1/]

Sector	% of GDP Growth 1950-60	Sector	% of GDP Growth Employment [1/]
1. Manufacturing	19.8	1. Transport	20.7
2. Services	15.5	2. Finance	14.2
3. Commerce	14.7	3. Services	14.2
4. Agriculture	13.5	4. Commerce	12.4
5. Construction	7.9	5. Manufacturing	7.2
6. Transport	5.9	6. Agriculture	6.8
7. Finance	3.7	7. Construction	2.4
Total	81.0	Total	77.9

See footnote Table :

Of the total change occuring in GDP over the 1970-80 period, manufacturing accounted for only 7.2% and agriculture for only 6.8% of GDP, a significant drop from 19.8 and 13.5 percentages of the 1950-60 period. The relatively rapid growth of the transport sector during the 1970-79 period is due principally to the large increase in its storage subsector which reflects the growth in the Free Zone activities. In like manner, the financial sector's rapid rise reflects growth in

the banking sector which has

received stimulus by the GOP since the early 1970s.

In summary, over the past decade the importance of the manufacturing sector as an engine of growth has waned as easy import substitution opportunities have disappeared and as more emphasis has been given to the other sectors, especially finance and transport.

Table 4 also reveals the employment generating effects of each sector over the 1970-79 period, illustrating the service sectors importance in the Panamaina economy over the last ten years.

TABLE 4

SECTOR CONTRIBUTION TO EMPLOYMENT GROWTH DURING 1970-1979 PERIOD [1]

	Sector	% of Empoyment Growth 1970-1979
1.	Services	52.0
2.	Transport	13.2
3.	Manufacturing	11.7
4.	Finance	11.3
5.	Commerce	10.1
6.	Construction	7.8
7.	Electricity	2.8
8.	Mining	0.2
9.	Agriculture	3.6
10.	Canal Area	5.3
	Total	100.0

A. Recent Peformance and Near-Term Prospects

After three years of relatively high growth, economic activity slowed in 1981. In large measure the slow down was due to the effects of world-wide recession, particularly in the hard-hit economies of neighboring Latin American countries, and the resultant decrease in demand for Panamanian exports of goods and services. In addition, the construction boom that Panama has experienced since 1978 finally slowed as a consequence of sustained high interest rates and reduced demand for luxury apartment housing and commercial office space. Current trends indicate slightly lower real growth in 1982, probably less than two percent. High unemployment and low agricultural productivity continue to be serious problems. Panama's success as an international banking center nevertheless continues to grow, with 130 banking entities currently licensed in Panama. The sectors of the economy which advanced in relative importance in 1981 were commerce, banking and other finance, various services, and transportation and communications. The "productive sectors" of agriculture, manufacturing, and construction declined in relative importance.

1. Investment

Total real investment started to fall in 1973 at the beginning of a recession which lasted until 1978. In 1975-76, public sector investment was expanded to compensate for declining private investment. Then in 1978 and 1979, public investment dropped as the private sector recovered. By 1980, total gross investment in real terms had just barely reached the same level as in 1972. By 1981, private investment began to drop again as a new recession took hold. High interest rates and reduced profits are important factors currently inhibiting new investment.

New domestic investment was 23.3% of GDP in 1980, the last year for which data are available. The share of total investment accounted for by the private sector declined in 1980 from 65.2% to 57.2%.

Much of the private investment was in financial and other services, commerce, and real estate speculation. In 1980, 57.2% of new investment was in housing and other construction, 12% was in transportation and communications equipment, and only 30.5% was in machinery.

Although credit grew in 1981, the largest rate of expansion was in credit to the public sector, followed by commerce (trade). The lowest rate of growth was in construction loans. Agricultural loans showed good growth, better than in 1980, but loans to industry increased at a slower rate than the previous year. Credit outstanding to agriculture constituted only 6.5% of the total in 1981, and loans to industry comprised only 9.0% of the total.

In the years 1975-78, net foreign investment usually was negative, but in 1979 it turned positive, in the amount of some $49.7 million, according to GOP figures. The bulk of the foreign investment is in the fields of industry, commerce, and agriculture. A much higher proportion of foreign investment is in industry than is locally generated investment. U.S. cumulative investment in Panama was about $1.8 billion in 1980, according to Department of Commerce data ($2.2 billion if investment in offshore firms registered in Panama is counted). This puts Panama in third place, behind only Brazil and Mexico, in U.S. investment in Latin America, remembering that a large proportion is in financial institutions.

In addition to the BIT with the U.S., Panama has initiated a BIT with Great Britain, and is actively working with the Federal Republic of Germany and Japan on similar agreements.

Export Sector

As of 1979, a survey of manufacturing establishments in Panama with five or more workers listed 628 such establishments. Total employment in those establishments was 29,547 and the payroll was $110.9 million. Sales value was estimated at $1.2 billion and local value added was $379.8 million. In 1981, manufacturing accounted for 12.9% of the GDP and employed about 10% of the work force. Industry in Panama is mainly oriented toward the domestic market and is concentrated in Panama City, Colon, and the province of Chiriqui. At least half of the output is accounted for by products related to agriculture. By value, the largest industries are in food processing and beverages, followed by metal fabrication, non-metallic minerals such as cement and other construction materials, clothing and shoes, paper and paper products, petroleum products, various chemicals such as soap, detergent and alcohol, printing, and wood furniture.

Between 1960 and 1970, the average annual growth rate of industrial output was 9.0% in real terms. The growth rate fell off in the 1970's, experiencing a steep decline in the recession period of 1974-76, then a resumption of growth in 1977. Industry grew 5.5% in real terms in 1979, 4.0% in 1980, but fell 2.3% in 1981. The drop in 1981 was partly due to the effect of the temporary suspension of oil refinery production that year because of a glut in the world fuel oil market. The rest of the manufacturing sector registered a real growth of 2.8%, versus

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growth of 6.0% (not including the refinery) in 1980. The drop-off in the rate of growth of manufacturing activity in the last year or so is due primarily to reduced demand for several important export products and to reduced demand for construction materials.

he most rapid growth in recent years has taken place in food processing and beverages (both alcoholic and carbonated) and in clothing. Paper and paper products production has also expanded. Nevertheless, by 1979, output had only regained the level already achieved in 1970. Among the more serious problems industry faces are a small domestic market, strong international competition, and small production units. Outside of agricultural and fishing products such as bananas, sugar, shrimp, coffee and meat, Panama has very few other significant exports. The largest manufactured export is clothing, which has shown sustained expansion in the last several years, growing from a value of $8.6 million in 1978 to $14.0 million in 1981, and moving into fifth place in 1981 among Panama's exports. Other important processed or manufactured exports include petroleum products (mostly fuel oil residual to the refining process), condensed milk, fish meal, fish oil, banana puree, rum, paper products such as cartons, leather products, canned seafood, mayonnaise, mustard, and tomato products.

Other than beef and repairs to vessels and aircraft, there are few identified production services (non-GSP, non-duty free, non-textile) that could benefit from a one-way free trade zone as proposed under the CBI. No locally manufactured export of this type to the United States exceeded $50,000 in 1980.

3. <u>Potential for Expansion of Non-Traditional Exports</u>

Probably the most important opportunity for Panama is the establishment of more light assembly industries, such as those under a "Maquila" program. Panama's Maquila Program has been in existence for several years, but has produced only modest success. The program provides for a wide range of tax and other incentives in order to stimulate labor intensive industries. It allows businesses which establish production operations to be exempt from certain import duties and taxes, provided that the products are sold out of Panama. To date about a half dozen firms have been established under the program, the largest of which is a factory making women's undergarments. Panama has many advantages in comparison with other countries in the region, such as absence of exchange and repatriation risk and relative political stability. One interesting possibility is the development of a Far East-Panama-United States investment and trade triangle, with the establishment of assembly industries in Panama by Far Eastern firms for export to the United States. This could be an important supplement to investment attracted from Europe and the United States and could be expected to grow in the future as several countries in the Far East develop higher technology products and encounter increased labor costs.

Panama could also seek to take advantage of opportunities presented when products from various countries lose GSP eligibility due to exceeding competitive need limitations.

Further expansion of agro-industry and food processing for export has good potential. Besides agricultural products, seafood processing could be expanded significantly and efforts are underway to attract more investment in this area. Frozen and processed meat, fruit and vegetable products not now exported, and spices and condiments have good potential.

Another comparative advantage for Panama is its geographic location and huge volume of ship traffic through the canal. Expansion of ship and aircraft repair facilities serving international customers, such as the drydock and repair yard now being expanded under the management of a French firm, and other marine services offer special possibilities.

The major factors tending to restrict further development of export industries probably are labor laws and attitudes, governmental pricing and subsidy policies, governmental bureaucracy, and possibly, disadvantageous freight rates. The labor practices are most frequently cited by visiting businessmen as reason for not locating manufacturing activities in Panama. Labor costs may be slightly higher than countries in the Caribbean Basin, but probably not much out of line with most of the others. Panama's minimum wage for unskilled labor is 75 cents an hour in metropolitan areas and 65 cents in the interior. A major disincentive is a perceived lack of consistency and fairness in application of GOP labor laws and regulations and difficulty in using the appeal process. This situation has improved recently, however, with new leadership in the Ministry of Labor and increased governmental efforts to improve its relations with the private sector. Price control policies are becoming more flexible , and in any event, these controls do not apply to exported products. The establishment of a one-stop investment promotion center (National Investment Council) should help in overcoming any bureaucratic obstacles presented to foreign investors. This agency is also extending assistance to enterprises already established in Panama. This could result in a sharp reduction in complaints about difficulties in dealing with the bureaucracy. Apparently conference freight rates are somewhat high for shipments to and from Panama and the United States, especially in comparison with some competitor nations. Conversations with local shipping agents indicate that the rates are highly negotiable and that an exporter should be able to obtain an attractive rate on request if he plans to ship in quantity.

Longer Term Prospects

In view of the limited domestic market the development of export industries, such as light assembly, manufacturing and agro-industry is receiving much attention. GOP policies are developing in directions appropriate to achieving this objective. New incentives for investments in both industry and agriculture have high priority, such as concessional finance to small and medium businessmen and farmers, and establishment of industrial zones. A major effort to attract more foreign investment is underway. In agricultural policy, there is a movement away from the priority accorded in past year to collectives toward provision of credits, re-establishment of agricultural extension services, and promotion of improved technology.

An agricultural incentives law now under consideration aims to promote investment in this sector through tax incentives and other measures. There is also consideration of revising the system of import quotas in favor of a rationalized tariff system.

In general, a shift of emphasis to the private sector is evident. This has been confirmed in recent policy statements by Government officials and by the recent round of Cabinet changes. Some changes in the price control system are being attempted although there are no plans to abolish price controls altogether. Milk price increases recently announced evidently are part of this new flexibility.

Panama is in a good position to take advantage of the opportunities offered by the CBI through its geographic location, good port facilities and other infrastructure, its monetary system and absence of exchange or convertibility risk with respect to the U.S. dollar, its banking center, the Colon Free Zone, its pool of educated manpower, and its attractive political and social climate.

Financial management should continue to be conservative over the next few years. Continued high interest rates and a drop in anticipated tax revenues due to the economic downturn probably will force even greater budgetary austerity. The GOP has engaged a consortium of financial advisors and is heeding their advice, along with that of the IMF.

Finance

The financial sector is well developed in Panama. As in many developing countries, there may be a shortage of venture capital and long-term credits, as well as credits available to the small business sector. On balance, however, financing is not a constraint to the expansion of exports.

Financial Services Sector

The International Financial Center was legally established by Cabinet Decree No. 238 of July 2, 1970. This decree reformed the banking system and created the National Banking Commission to regulate the system.

The financial sector in Panama has been the most dynamic and rapidly growing sector in the economy. During 1981 it grew 22.1% and constituted about 9.2% of the total Gross Domestic Product (GDP). The number of banks licensed to do business in Panama increased to 130 and the total assets of all the banks rose to over $46.3 billion by the end of 1981.

Panama does not have a stock market and bonds are used in a relatively limited manner. Financial intermediation is done within the offshore banking system, directly on a bank to bank basis.

Of the 130 banks in Panama, 65 have general licenses which permits them to do business both inside and outside of the country. About 30 of these participate actively in the local market while the rest do it in a limited fashion.

From 1974 to 1981, local loans had been decreasingly financed from external deposits in the banking system. By the first quarter of 1981, a new local deposits were sufficient to cover local loans. By December 31, 1981, Panama has resources valued at $46.3 billion of which $3.146 billion are placed in local loans while $3.201 billion are local deposits. This trend reflects the continued economic and political stability which has occurred after the signing of the Panama Canal Treaties, and investor preference for high yielding time deposits over riskier investments.

As the largest volume of domestic loans are made for trade and commerce, the commercial banking sector is accustomed and structured to handling short term working capital loans. Government financial institutions are the principal source of medium and long term funding, in particular to small and medium enterprises.

b. <u>Agricultural Credit</u>

In the agricultural sector. one problem has been difficulty in obtaining medium and long term funds. The short term commercial credit extended to the agricultural sector comes from a limited number of private banks (Bank of America, Chase Manhattan Bank, Banco Fiduciario and Banco de Colombia), which lend on a commercial scale, primarily for production, processing and marketing of such products as sugar, rice, coffee and beef. Medium and long term credit is supplied almost exclusively by the official agricultural development bank, Banco de Desarrollo Agropecuario (BDA) and the Banco Nacional de Panama (BNP). In the period 1976-80, total bank credit to the agricultural sector increased at an average annual rate of 4.9% (nominal rate). In addition, commercial bank credit to the agricultural sector grew at an average annual rate of 1.3% from 1976-80, which represents a negative rate of growth in real terms.

c. Industrial Credit

short-term trade credits, and are normally reluctant to provide longer term financing for fixed assets, although some of the banks do provide medium term (3 to 5 years) credits for their largest and most reliable customers. Most of the loans granted by the banking system for industrial purposes have consisted of short term credit for working capital, or to finance purchase of raw material and other inputs required by companies for production. Industrial term lending is basically undertaken by two GOP-owned institutions, the Banca Industrial window in the BNP and the Corporacion Financiera Nacional (COFINA).

The IDB has collaborated with the GOP since 1964 through 5 loans granted to the BNP to help develop Panama's private industrial sector. In the period 1977-79, the BNP approved 123 industrial loans for a total of $9.6 million and in the first half of 1980, BNP's industrial lending increased sharply to $8.2 million for 24 projects.

COFINA has recently received a $20.0 million loan from IDB and with these resources it will primarily finance fixed assets, leaving working capital finance to the commercial banks. COFINA will concentrate on the financing of manufacturing industries.

COFINA was created as an autonomous Government owned financial development company in December 1975, to promote and finance productive industrial enterprises in accordance with the Government's national development plan and to encourage increased commercial bank financing of industry through cofinancing. Almost all of its projects have been in the private sector and its gross approval of loans and equity investment totalled 35.9 million in 1981.

IDB has estimated that over the 1981-83 period, total industrial investment in Panama, excluding large projects may be about $165 million, of which $20.0 million will be covered by the BNP, $60.0 million by retained earnings and equity contribution, leaving uncovered demand for funds of $85 million, to be provided by the commercial banks and COFINA.

Trade Finance

Most of the credits approved locally are directed to commerce and a large portion of these goes to firms established in the Colon Free Zone. As can be observed in the following chart, 38% of the internal credit balance is utilized by the commerce sector.

Balance of Internal Credit Outstanding by Activity
December 31, 1981
(In millions of dollars)

Public Institutions	$ 572
Financial Enterprises	77
Agriculture	89
Livestock	104
Fishing	11
Commerce	1,196
Industry	283
Housing	512
Other Construction	147
Personal Consumption	150
TOTAL	$3,141

Source: Comision Bancaria Nacional

Trade Flows

1. Exports

Historically the U.S. has been the recipient of nearly 50% of Panama's exports. The figure rises to 65% if the exports to the Canal Area are included. The neighboring five Central American countries, with Costa Rica and Nicaragua the most important, receive 13%, while the rest of the Caribbean Basin including Mexico account for just 5%. The South American countries led by Venezuela Colombia and Ecuador receive an even lower 3%. Outside of the Americas, except for a few exports to Saudi Arabia, Japan and Siria (less than 1% of exports), the remaining 13% of Panamanian exports are shipped to Europe. Africa and Oceania account for less than .01%

As with most developing countries, Panama depends upon a small number of basically primary products for export. Twelve products provide 84% of all export revenues. Within the group of twelve, the four products bananas, shrimp, sugar and petroleum products provide 72% of the export revenue. Coffee, clothes fish meal, canned milk, lobster, fish oil and rum supply the additional 12%. These four products account for 63% of the export revenues received from all other countries.

The first four products mentioned above provide Panama with 87% of the export revenues received from the U.S. For all other countries the figure is 63%

2. Imports

On the import side, the U.S. again dominates, providing Panama with about 33% of its imports. Asia follows at 28% with Saudi Arabia oil accounting for most of the expenditure.

Presumably this will be changing as the San Jose oil agreement with Mexico and Venezuela goes into full effect. As in the Saudi Arabian case, Panama's oil imports from Venezuela place South America in third place with 14% of the imports. The five Central American countries supply just 5% of Panama's imports while the remaining countries of the Caribbean Basin provide 11%. All of Europe supplies just 8%, and Africa and Oceanic together supply less than 1%.

II. BUSINESS AMBIENCE

A. Political Factors

Since 1968 the Panamanian Government has been characterized by an amalgam of populist ideological forces. During its early phase the Torrijos Government supported and organized poor farmers, competed with established private agricultural producers and though unintended it discouraged production through imposition of price controls. In urban policies, there was complex legislation emphasizing Government regulation. Some business men were exiled.

In recent years, however, fiscal policies have been more pragmatic; production, rather than distribution, has begun to be emphasized and the private sector's role has become increasingly recognized. The facts of economic life have turned the nation's attention to domestic finance, national economic growth and investment--there is an acceleration of interest in the stimulation of business and investment. For example, the U.S. and Panama are presently negotiating a bilateral investment treaty, the first of its kind in the region. Private sector leaders have expressed their pleasure at this turn of events.

The Government of Panama remains generally committed to the continuation of the "revolutionary process" which emphasizes redistribution of national wealth and resources. It seeks to enlist the energies and resources of the private sector in extending that process.

While some Government leaders do not share fully the private sector's pragmatic views, most Panamanian leaders are aware of the need to have a strong private sector supporting their efforts to redistribute the nation's wealth. They appear to recognize the need for an expanding tax base from which to finance various Government programs. There have been significant indications that restraints, either real or imagined, are being removed from the private sector. There are also indications that top GOP officials understand that the revolutionary process cannot be expected to continue without the support and assistance of a vital private sector to complement and finance the work of the public sector.

The Cabinet changes of April, 1982 indicate that the GOP is continuing to turn toward a more balanced approach in its relationship with the private sector, and offer the prospect that the GOP will favor private enterprise even more in the coming years. In addition, the National Guard continues to exercise a strong voice within the nation's political process, and its new Commander, Gen. Paredes, has advocated a strong private sector in the nation's economy.

The CBI has apparently quickened the Governments' interest in accommodating the private sector and has led to a more focused dialogue between them. The Office of the Vice President has assumed the responsibility for directing the efforts of the Government in respect to the CBI and it will clearly continue to receive serious attention at all levels of Government.

Investment Climate and Incentives

The climate for foreign investment in Panama is positive. Government attitudes and incentives encourage foreign investment, especially in sectors which will provide significant employment opportunities for Panamanian workers. Use of the U.S. dollar and the absence of mechanisms for controlling financial transactions guarantee unrestricted foreign exchange flows. This is one of Panama's most important assets in attracting foreign investment. In addition, Panama makes virtually no legal or practical distinction between foreign and domestic private investment. There are no restrictions on foreign ownership of industry, only retailing and certain professions are limited to Panamanian nationals. A number of tax and other incentives are available for foreign investors in such areas as the Colon Free Zone, Financial, Tourist and Industrial Sectors.

In the Colon Free Zone, businesses are entitled to very favorable tax treatment on their external operations, including a maximum graduated income tax of 8-1/2%. In addition, they receive liberal tax credits, based on employment levels, and a 95% income tax rebate during five years for new firms meeting certain investment requirements. Firms are exempted from other types of taxation, except real estate taxes.

In the financial sector, banks are exempted from income tax on international operations. Special provisions safeguard privacy of banking records. In 1976, following its success in promoting the banking industry, Panama established special laws designed to promote growth of a reinsurance center. The law exempts profits from reinsurance on foreign risks from income taxes and local insurance taxes.

In the tourist sector, legislation enacted in 1972 provides broad incentives for investment in tourist facilities, including exemption from import duties on materials and furnishings and exemption from income, property and other taxes. Despite these incentives, the tourist industry in Panama remains relatively undeveloped compared to other Caribbean nations which offer similar advantages of climate and proximity to the United States.

In the Industrial Sector, Panama has promoted manufacturing production through special incentives for many years. The most important incentives offered include: exemption during a contract period from import duties on equipment and raw materials; exemption from income taxes on reinvested profits exceeding 20% of net taxable income; and special provisions for loss carry-over and depreciation. Panamanian law also provides special tax incentives for manufactured and other exports, including total tax exemption based on a system of tax credit certificates.

In addition to the above incentives, in 1979 Panama established a special incentive program for promotion of "light assembly industries". The program is designed for companies which will export their entire production of finished products It is anticipated that such companies will import most of the required components for their assembly operations. The program is administered by the Ministry of Planning and Economic Policy and provides substantial assistance to prospective investors, including completing legal and technical requirements and recruiting labor force.

The United States and Panama have signed Bilateral Investment Treaty (BIT) that will formalize rights and guarantees of investors in each of the two countries. The agreement, as currently structured, will cover key areas of interest to existing and potential investors such as national treatment; compensation in case of expropriation; indemnification for war damage; transfer of capital, profits, and funds; and settlement of disputes between parties and between indivivuals and firms and parties. The agreement, when ratified by legislative will not only reinforce the position of existing U.S. investors in the already favorable Panamanian climate for foreign investment, but also serve as an additional motivation for new investment. At the same time

The Government's current policy is not to expand any further than necessary into areas that are traditionally thought of as belonging to the private sector, although it continues to enter into partnerships with private foreign investors for the development of large projects, such as the Trans-Panama Oil Pipeline and the proposed Cerro Colorado Copper Mine.

The GOP has indicated that it would like to sell or otherwise dispose of some of its less profitable enterprises, such as the Contadora Island Hotel, an oil palm plantation project, and the National Machinery Corp. It already has closed its Pacific Banana operation. Others such as the large La Victoria Sugar Corporation are important employers and cannot be phased out in the short term, although current policy is to examine various alternatives and, if possible, to move in that direction.

C. Government's Role in the Economy

Water, power, and telecommunication services are state-owned, along with some financial services (the Banco Nacional, a savings and mortgage bank, and agricultural and industrial development banks). Also state-owned are the railroad, port facilities, the national airline, a bus transport company (although most public transportation remains private), some tourist facilities, the National Casinos and Race Track, and the Colon Free Zone.

The Government owns two industrial operations, the La Victoria Sugar Corporation and the Bayano State Cement Enterprise, and operates Citricos de Chiriqui, a large juice concentrating plant and citrus growing operation. In the agricultural field, the Government distribute grains (except wheat) and some vegetables through the Agricultural Marketing Institute. It also owns a flour mill, a meat processing plant, banana planations and has been involved in the formation of collective farms and cooperatives.

Labor

Of a total workforce of about 550,000 more than 20% are employed by Government. Agriculture and industry, the sectors on which the CBI is expected to have most impact employ only 29% and 10%.

respectively. The industrial labor force numbering only about 53,000 counts only about 34,000 of its members as permanent employees. The trained industrial labor pool is thus small and will undoubtedly constitute a bottleneck in industrial expansion. Such expansion is expected to be the main absorber of the unemployed who now are estimated by USAID to number close to 100,000.

While such a national rate of unemployment is in itself cause for concern, large pockets of higher unemployment dot the urban areas. In Colon, for example, unemployment may be as high as 25%-35% of the workforce. In 1979-80, an AID survey in four low-income neighborhoods in Panama City and Colon found unemployment rates among low-income families of almost 40%. Unemployment, at 24% for this survey sample as a whole, rose to 39% for individuals from families with per capita incomes of $500 or less. For women and young people unemployment rates were 45% and 65%.

Although policies and programs to reverse growing unemployment are now beginning to take shape, the workforce is growing, nowhere more so than in the metropolitan area surrounding the canal. As a result of a declining birth rate, from over 3% in the late sixties to an estimated 2.2% in 1980, the labor pool is growing faster than the non-working population (under 15 and over 64). Therefore, whereas the labor pool was 53% of the population in 1970, by the year 2000 it will be in the 63-67% range. The economically active population (which is about 60% of the labor pool) is forecast to double in the 25 year period, from 537,000 in 1975 to 1.1 million in 2000.

The metropolitan area will soon comprise half the nation's population -- and no abatement in urban migration is expected. According to the latest, probably understated, official data, some 58% of the total national economically active population is located in the Metropolitan Area.

Three factors presently work to keep unemployment high; the first is the impact in Panama of the 1975-77 recession, caused in part by worldwide dislocation due to sharp increases in OPEC's oil exports, but also by a drop in domestic investment resulting from unfavorable reaction to a series of Government policies (e.g., price controls, labor code, exiling of business leaders) and leftist rhetoric. Not until 1979 did the economy reattain 1974 employment levels, while the EAP steadily increased. The second factor, already mentioned, is population growth and growth of the labor pool. The third factor, is the relative capital-intensivity of the economy and the policies which govern it, which translates into fewer jobs per dollar invested.

Using alternative assumptions about the GNP growth rate, it appears that if unemployment is to be held at reasonable levels, the economy must average an annual GNP growth rate in excess of 8%. At a growth rate of 6%-8% GNP the nation could absorb sufficient labor only by increasing its labor-intensity. Failure to achieve growth rates under conditions noted above could bring about unemployment rates ranging from 10%-29.5% over the 20 year period from 1980 to 2000. The 3.6% GNP growth rate experienced in 1981 and the lower rate predicted for 1982 fall far short of meeting the employment requirement.

Information concerning the supply of skilled labor is not readily available, however, it is generally assumed that skilled workers are in short supply.

Labor productivity is another area in which reliable statistics are not available. The Panamanian work force is, however, considered to be as productive as the work force in other Central American countries. As shown by the recent record production levels of the Panama Canal Commission, the Panamanian worker is responsive to incentives. Informal comparisons of a Panamanian plant with a nearly identical plant in Costa Rica show slightly higher per worker output in Panama.

Although only 15% of the workers are unionized, unions are politically influential. Unions have concentrated their organizing efforts in the transport and service sectors of the economy, but with strong support also in the banana plantations. Some important sectors, such as banking and the Colon Free Zone, are not well organized.

Minimum wage rates are established by the Government, and differ on the basis of type of industry and geographic location. While this gives the Government a strong role in the wage setting procedure, collective bargaining plays its own important role in certain industries. The present minimum wage in the Panama City/Colon area is $0.75 per hour. In the rural area it is $0.65 per hour. In July the minimum may be increased to $0.95 per hour. Most industries tend to pay slightly higher hourly wages than the minimum for unskilled workers.

Fringe benefits, many of which are legal requirements of the Labor Code, add approximately 40 to 45% to the average wage costs.

Little information is available on work conditions and the industrialization climate, especially on a sector by sector basis. Compliance with the standards or protection offered to the workers by the Labor Code is generally considered better by foreign-owned industries than by locally owned companies, perhaps because of stricter regulation by the GOP of these standards in foreign-owned enterprises.

E. GOP Policies and Institutions

Since 1976 the GOP has given intermittent attention to measures designed to stimulate investment in the private sector, primarily through fiscal incentives to attract light industry. Among the incentives are complete exemptions from: import duties, mandatory contributions, taxes on machinery, equipment and spare parts used in the assembly process; import duty exemption on all raw materials or semi-finished components used in the assembly process; total income tax exemptions, including any capital gains or income generated by exports. One of the principal aims of the fiscal incentive package is to make the Republic a processing as well as a distribution center. To further stimulate the location of light assembly in Panama, the Government grants "in bond" licenses for assembly plants anywhere in the Republic so that these can be located near available labor pools outside urban areas.

The light assembly program (Maquila Program), which started in the first quarter of 1979, had seven companies with signed contracts by the end of June 1980, for a total investment of $24.4 million and the creation of 1,612 jobs. Negotiations with twelve foreign firms are currently taking place."

As an encouragement to export industry, GOP regulations provide for granting negotiable tax credit certificates valued at up to 20% of the value added in the production process. The regulations have recently been amended so that these certificates are now fully negotiable nine months after their date of issue. Legal and administrative measures have been approved to promote the export of meat, sugar and other products.

The response by the private sector to the incentives of the 1976-80 period has been less than might have been expected due to the antagonism that developed between the private and the Government sectors in the early 1970s over the latter's incursion into private sector activities (e.g., nationalization of the utility companies, and financing of state cement and sugar industries) and the promulgation of a very pro-labor Labor Code. Eliminating the suspicions and doubts, which inevitably arose as a result of these incursions, has been a slow and difficult process for the GOP. Since 1981, however, there have been unmistakable signs that the Government and the private sector are moving toward a workable relationship: the Labor Code has been favorably amended and both sectors have begun a series of dialogues that augur well for rapprochement.

Not in recent memory has a Panamanian Government taken such an active role in presenting and explaining its new budget, and future investment and development plans to the nation as it did with the 1982 budget. Newspapers carried a series of articles explaining the plans, costs and benefits. And, underscoring the importance the GOP places in gaining acceptance and cooperation among the many elements of society, high Government officials, with the Vice-President taking the lead, took the message directly to leading financial, industrial, business and labor groups, many of whom have been openly skeptical of Government intentions in the past.

While it is unlikely that the GOP will ever consider totally eliminating price controls and interest rate subsidies, there is an apparent commitment to improve these policies. The GOP is keenly aware of the problems that price controls can create and have created in Panama. Yet, it also recognizes that a small economy like Panama tends to contain monopolies and oligopolies which require some regulation.

Several plans for establishing a new pricing policy are circulating within the GOP.

The GOP has recently intensified its interest in export industrial development. It is reviewing the capabilities and limitations of the existing institutions and programs which bear upon the export sector, and is seeking to establish new institutions and coordinating mechanisms to improve public sector performance. In pursuing these interests it is continuing to consult with private sector representatives and with international organizations. Recent Government initiatives include the following:

Agricultural Policy Development: Several initiatives are being undertaken or being designed. Principal among them is the upgrading of MIDA's planning division capability to analyze the impact of pricing and other policies.

Issuance of MIDA's Basic Lines of Action, in which concern for the entire food system and the institutions that service it is manifested. This is an important change from past programs which tended to focus on food production problems in isolation.

Issuance of a Draft Agricultural Incentive Law which recognizes the need to make the sector responsive to market forces and private investment.

Creation of a Small Scale Enterprise Extension Service. The BNP is initiating technical extension services for small-medium businesses to strengthen their technical, financial and sales and management procedures.

Employment and Industrial Policy Review and Development: Through a BID-financed industrial sector study, industrial policies will be examined to assess changes needed to attract more investment. Price and interest rate policy analyses will be key elements of the study; through the Policy Analysis and Research Systems (PARS) unit, a series of economic policies studies relating to investment and employment will be defined in order to provide recommended solutions to the Executive and Legislative Branch of existing constraints.

As a result of a GOP funded feasibility study, a National Investment Council (NIC) has been established and is now operational. This provides a "one stop" service to private investors. Governed by a board consisting of Government and private sector representatives; it has research and policy formulation functions and offers a continual formal channel for governmental/private sector interchange. An budget, a~~dequately~~, has been approved for the agency, and excellent staff recruited. It has already induced several U.S. and foreign firms to establish operations in Panama.

An Export promotion function is carried out in the Ministry of Commerce and Industry (MICI), in a department which also has a foreign investor search function. Although the division has overseas representatives in Zurich, Tokyo, Miami, Los Angeles and Washington, these are generally non-professional. The Agency is basically passive, in that it responds to inquiries generated by a UN funded network and the International Trade Center in Switzerland. It publishes the substance of these inquiries in a weekly paper which is distributed to the industrial community. Companies which invest under the provision of laws administered by this department may receive export bond payments.

The Maquila Program a previously independent industry promotion operation has been absorbed by the ICP. It provides special incentives, such as exemption from certain aspects of the Labor Code, a "one stop" investor assistance, service assistance in acquiring access to finance and in compliance with export formalities. Firms investing in Panama under the provisions of the "Maquila Law" are not eligible for participation in the export bond program. This ineligibility has limited the attractiveness of the Maquila Program to investors, but the organization has provided excellent and rapid service to foreign firms who have used its facilities and is well regarded by those firms.

The recently established Policy Analysis and Research Unit (PARS) within the Ministry of and Commerce Industry is also being considered for integration into the NIC. The analysis and research undertaking planned by the PARS have since the CBI been increasingly focused on those areas of inquiry which may bear upon Panamanian ability to export competitively.

COFINA plans to establish a discount window for export loans made by commercial banks. A local consultant is preparing a project paper which will provide the basis for a loan request to IDB for funding of the window.

C. Private Sector Organizations and Activities

Panama's Private Sector Organizations (PSO's) are grouped in a relatively sophisticated network which effectively represents the full spectrum of business interests. Prior to 1968, these organizations worked closely with GOP institutions towards the improvement of business conditions related to their specific activities. Membership was limited mainly to the larger better capitalized companies that could afford to belong. High Government officials were on the whole drawn from these groups and the upper stata of professionals, thereby providing a natural and continuous link between the two sectors.

With the establishment of the Revolutionary Government and the subsequent proscription of political parties, cooperation faded. GOP institutions were reorganized to reflect the aim of the Revolution to effect socio-economic development through direct Government participation in all sectors. To open the way for this new system, legislation was enacted from 1969-1974, which substantively restricted market forces and business practices. Oppressive price controls were put on everything from beef to lumber. Rents on residential and commercial properties were frozen and existing contracts had to be modified to agree with new laws and regulations. A complex and productivity-limiting Labor Code was enacted into law. This tended to exacerbate labor unrest and, in some cases, contributed to collapse of previously profitable companies.

These legal and fiscal uncertainties forced the business sector to look to the PSO's for leadership and help, in moderating the Government's position. The 1973-74 construction slump and record high interest rates intensified tensions. PSO membership increased rapidly and attendance was high.

The Camara de Comercio, Sindicato de Industriales (SIP) Asociacion Panameña de Ejecutivos de Empresa (APEDE) and Camara Panameña de la Construccion (CAPAC) became meeting places where businessmen could exchange information and devise unified responses to the evolving policies of Government.

The PSO's united under the Consejo Nacional de la Empresa Privada (CONEP) which became the frontline bargaining representative for business on major issues, while the individual PSO's represented the more specific interests of their memberships.

As friction declined and businessmen learned to work within the new framework attendance at meetings dropped but membership continued to grow as new investments began slowly to be made. At the same time prominent businessmen and professionals went into Government service and worked to improve the business environment.

Today, the PSO's are surprisingly active and positive organizations led by a new generation of managers and proprietors tempered by a decade of interaction with their Government and by the problem of worldwide inflation.

Following the legalization of the political parties in 1979, and a series of Government actions intended to accomodate the private sector, the Government has taken steps to intensify the dialogue with the private sector, through their representative organizations.

The Vice Presidency has invited PSOs to review the Government's Investment Plans for 1982-86; the Ministers of Agriculture and Commerce and Industry held a day-long conference, attended by the President, to explain to the private sector 1982 plans of the public sector agriculture agencies. The President of the Republic has met with the Inter-American Council of Commerce and Production (CICYP) to discuss economic development and collaboration; high Government officials (Ministers, Ambassadors and heads of autonomous institutions) have participated in the Annual Conference for Business Executives, explaining their programs and projects. Moreover, a program is under development to stimulate and coordinate private investment through the National Investment Council, which includes PSO representation. In fact, the Private Sector Organizations now have such an active role in GOP policy making, that it is important to know and understand their particular areas of interest. A short background on each PSO follows:

A. Consejo Nacional de la Empresa Privada (CONEP)
(The National Council of Private Enterprise)

The Consejo Nacional de la Empresa Privada was organized in 1964 as the political arm of the Private Sector. Its major objective is to promote and strengthen the free enterprise system in Panama. CONEP is organized as an institution of institutions, representing the major business and professional organizations in the country.

Currently CONEP is active in formulating broad policy positions in representation of the private sector and consulting on both a formal and informal basis with the GOP.

B. Sindicato de Industriales de Panama (SIP)
(Industrialists Union of Panama)

The SIP was founded on August 10, 1945. Its objective is to promote social and economic development throught the advancement of industrial activity in general. SIP started out with 22 manufacturing firms and now has 278 members. It has representation in joint Private/Public Sector Commissions which shape economic policy. Work is underway on improvement of such diverse legal systems as the Labor Code, Social Security Laws, Tariff Code, etc.

SIP has been very active in promoting an open dialogue between the public and private sector and has hosted a series of meetings at the highest level in the GOP.

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At present SIP is promoting the creation of a productivity center, and USAID/Panama, at their request, is providing technical assistance, through the American Productivity Center, to help conceptualize such a project.

Camara de Comercio, Industri... y Agricultura de Panama
(Panama City Chamber of Commerce)

The Camara de Comercio is the oldest business organization in Panama (founded in 1915), and is the principal representative of the merchandising and service companies in the Panama City area.

At the present time the Camara has representatives in several joint (Public/Private Sector) commissions dealing with such areas as tariffs, customs duties and procedures, bilateral trade agreements and price policy. These representatives are supported by salaried Camara employees and volunteer work committees.

The American Chamber of Commerce of Panama has several ideas and already has contributed valuable assistance in lobbying through its Washington contacts for passage of the CBI legislation without major dilution. The AmCham has offered its assistance to the GOP in intensifying and making more effective promotion efforts in the United States. It plans to proceed with preparation of promotion materials that will be more effective with corporate decision-makers than those used to date and to use the resources of its membership to disseminate this information.

D. Asociacion Panameña de Ejecutivos de Empresas (APEDE) (Panama Business Executives Association)

The APEDE was founed in 1958, by a group of Panamanian businessmen meeting at the Centro de Desarrollo y Productividad Industrial (CDPI). The Centro was a Government institution conceived to introduce technological and management practices to existing Panamanian industries. During the 60's APEDE developed the Centro de Estudios Superiores de Administracion (CESA) which began offering courses in business administration and finance. CESA today is the principal non-profit institution offering management training in Panama.

E. Camara Panameña de la Construcciòn (CAPAC)

(Panama Construction Chamber)

The Camara Panameña de la Construccion (CAPAC) was organized in 1961 as a private organization which grouped builders, suppliers and professionals in the construction industry for the purpose of promoting, developing and protecting the sector's activity. Its membership is large and active.

As the representative organization for one of the most important sectors in the Panama economy, the CAPAC has been very active in the formulation of Government fiscal and legal policy related to new residential construction.

Since Panama does not have craft unions to oversee and administer the training and licensing of skilled workers, the CAPAC, together with the construction workers union, has established basic skill categories in each specialty. CAPAC carries out training programs and seminars for laborers aimed at improvement of manual and supervisory capability.

F. Asociacion Nacional de Ganaderos (ANAGAN)

(National Cattlemen's Association)

The ANAGAN was founded in 1958, and presently incorporated about 3,000 members in the country. The association was established for the purpose of voicing the interest of the cattle sector and participates actively in a series of GOP commissions.

G. Asociacion Bancaria de Panama (ABP)

(The Panama Banking Association)

Eighty percent (80%) of the banks established in Panama are members of the ABP. This organization's basic objective is to promote the interests of its affiliates in the Panamanian Banking System. The ABP represents its members in a series of GOP commissions where it has an opportunity to voice its opinions on matters pertaining to the development of the International Banking Center.

H. Asociacion Panameña de Exportadores (APEX)

(Panamanian Exporters Association).

The APEX is an organization which was established in 1976 primarily by members of SIP to represent exporters. The association recently became active and, with the announcement of the CBI, steps have been taken to explore the possibilities of forming a Trading Company.

I. Consejo Interamericano de Comercio y Producción (CICYP)

(Interamerican Council on Commerce and Productivity)

The CICYP is an Interamerican Federation established in 1941. Its local membership in Panama include about 40 key business people who have been former presidents of other business organizations. CICYP plays a low key role, promoting activities which encourage and increase private sector participation in economic policy analysis and programs in general. This organization continues to sponsor, with USAID/Panama support, seminars for private sector leaders in July 1982. The participants review the role of the private sector in the economic and social development of Panama and devise action plans to strengthen that role.

J. Fundacion Panameña para el Desarrollo (FUDAPE)

(The Panamanian Foundation for Development)

The FUDAPE is a private volunteer organization which was created in August 1981 and is aimed at helping micro-enterprises through credits and technical assistance. FUDAPE is just in the process of organization and is working very closely with the Pan American Development Foundation (PADF) in its initial stages. Drawing upon PADF experience elsewhere this organization can be used to channel assistance to cottage industries and small contractors in an effective manner.

K. Small Scale Enterprise Organizations (SSEO)

Union Nacional de Pequeñas Industrias (UNPI)

(National Union of Small Industries)

Sindicato Nacional de Pequeñas Empresas (SINAPE

(National Union of Small Enterprises)

UNPI and SINAPE are essentially voluntary organizations. They have Boards composed of members elected to office and have no paid staff members. Both UNPI and SINAPE, have the following common objectives:

- Established a fund for financing SSE's

Create a technical assistance service for members

Create a legal department to serve members

Promote changes in various laws which adversely affect SSE

Since they both have relatively small memberships, and are competing for recognition as the principal representative of small industry, they have been largely unsuccessful in getting the institutional support needed to move into a productive stage.

L. Compañeros de las Americas

(Panama-Delaware)

The Compañeros have recently initiated joint programs with their counterpart in the State of Delaware embodying a wide range of areas of cooperation.

The Panama-Delaware group will exchange commercial information on a regular basis principally to stimulate investor interest in locating in Panama and in identifying markets for Panamanian exporters in Delaware.

- Under an arrangement between the University of Delaware and the University of Panama, a scholarship program has been formulated under which Panamanian students will study business administration in Delaware.
- The Compañeros have met with officials of the Port of Wilmington in order to develop communications with Panamanian businesses with potential to use the port for import or export.

Infrastructure

The GOP and the Private Sector regards improvement port facilities and construction of industrial parks as major infrastuctural requirements for facilitation industrialization. Port improvements project are being discussed with international lending institutions, and various port studies are planned.

Plans are being advanced to utilize buildings in the reverted areas of the Zone to serve as industrial sites; and construction of small industrial parks in the interior are in various stages of planning.